THE
DEALMAKER

THIS MONTH:

With all this private equity money sloshing around, there's a good chance your MBO could end up as a secondary buy-out, says Christian Doherty. It's an exit, Jim, but not as we know it...

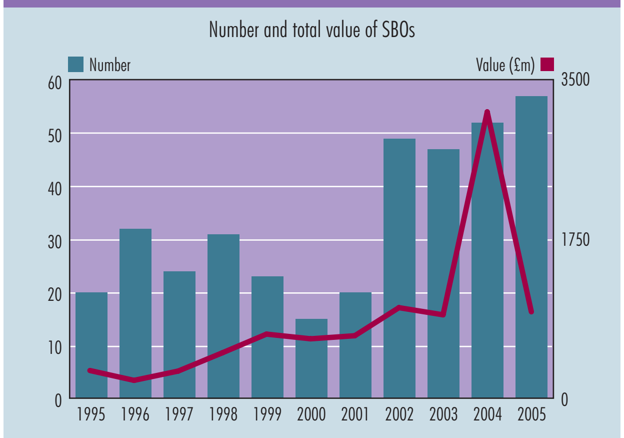
THE MONEY-GO-ROUND

SECONDARY BUY-OUTS – too much private equity money chasing too few opportunities? Or proof that PE firms are now a fixture on the investment landscape?

Either way, you need to work out how to play these deals if you're thinking about joining – or you're already part of – an MBO team. Why? Well, 2005 was another great year for secondary buy-outs. "The market was pretty buoyant overall, and SBOs were a major driver of that," says Mark Wignall, chief executive at Matrix Private Equity Partners. "The research shows that both the number and value of SBOs have increased. Partly that's because private equity firms have had a successful few years and are looking for opportunities. There's also a pretty liquid debt market out there. And you've got what is an ideal climate for buy-outs – there's economic equilibrium."

Grant Berry, LDC: expect the competition between trade buyers and private equity players to keep the market buoyant in 2006.

SECOND HELPINGS ALL ROUND



Impressive numbers: while buy-outs in general have risen steadily in the past 15 years, SBO deals have seen a step-change since 2003 as private equity funds have swelled in size and MBOs have soughts exits. But is this any more than just a money-go-round? Source: CMBOR

Good news too, then, if you're looking to do an MBO. But if you're already there? Well, many of the same reasons you did the buy-out in the first place will make a second private equity owner preferable to the other potential exits. Quoted company regulation is getting even more onerous. Corporate life hasn't got any less stifling. You retain a nice slice of equity. And you'll be doing a deal with professional investors, not doing an endless run of road-shows.

Wignall reckons there are several industries that private firms are gravitating towards. "IT is perennially popular," he says. "It's a sector that encourages innovation and growth. Food production is also an exciting one. And we're seeing several deals in wellbeing, lifestyle and fitness businesses. People in the UK – and especially men – are spending a lot more on this stuff, so there's good potential."

These are all sectors that have also seen their fair share of MBOs in the past five years. And that's critical. We're into the window for exits on buy-out deals done at the last market peak, in 2003, so we have willing sellers as well as buyers, and that benign economic and debt position. In other words, a perfect storm.

Strong cash-flow, growth potential, good management and consolidation opportunities will help your case. "The key driver in all this stuff is change," says Wignall. "When that happens there's competition and consolidation, and that creates opportunities for PE."

Will 2006 continue the SBO's good run? Grant Berry at LDC reckons the signs are good. "We've got a diverse business landscape that, with good economic and trading conditions, will continue to provide a healthy supply of investment opportunities," he says. "We expect the larger end of the mid-market in particular to grow during 2006 as competition for assets amongst private equity firms and trade buyers continues."

That said, the final question you might want to answer before doing an SBO is: what are the returns expectations of the PE investors? If prices are up thanks to that competition for assets, you might find your SBO backers are going to make things for management teams that bit tougher – when you've already worked the business hard during your first MBO. So take care.

WHERE NEXT...

www.cmbor.org For all your stats needs
http://snipurl.com/PE_conf Autumn conference on buyouts
http://snipurl.com/barcap
http://www.ldc.co.uk www.matrixgroup.co.uk/
http://snipurl.com/Bpoint Four leading players

NEW BACKERS, NEW CASH

SBOs aren't just driven by an MBO backer looking for an exit. Some FDs seek out investors for a change of strategy.

FD: Andrew Carr
Company: Merlin Entertainments
Sector: Leisure
Buy-out date: May 2005
Outgoing PE: Hermes Private Equity
Incoming PE: The Blackstone Group
Deal value: £102.5m

"WE DECIDED TO go ahead with a secondary buy-out because we wanted to grow the business through acquisitions and it had become clear that our then-backers wouldn't be able to help us with that. There were quite a few interesting deals on the horizon and we didn't want to be left behind by our competitors.

"It was entirely our initiative to go ahead and find new backers, there was no pressure from our existing investment group. We just went out and did it. We were slightly constrained by having a tight window of opportunity to get the deal done, since we had our eyes on a couple of time-sensitive acquisitions.

"We gave the investment bank that was advising us a list of boxes that the new backers would need to tick – and that helped the process run more quickly. Credibility was a major factor in terms of what we were looking for from a new PE backer. We wanted to be taken seriously when we were bidding for other businesses. So we needed real clout behind us.

"IF MANAGEMENT TAKES TOO MUCH MONEY OUT OF THE BUSINESS, THEY CAN LOSE THE HUNGER – THE INCOMING VC KNOWS THAT"

"The private equity firm we eventually went with is US-based. That was an advantage as it meant we could look to crack the North American market more easily – and look at a far wider range of possible deals.

"The one thing I didn't like about the selection process was that you got so little time to meet and get to know people. It's tough to do yourself justice in just 45 minutes. I think you need at least two hours to fully explain the business and the future plans.

"But we did learn a lot from that process. The key element any FD needs to keep in mind is: don't over-sell the business! Remember, it isn't a deal where you sell an idea and ride off into the sunset – you have to make your valuation and business plan work in the future. So be cautious.

"The first year of trading is the most crucial of the whole deal, so structure your plan to allow wriggle room so you can hit your targets. If you get the business projections for the first year wrong you'll be playing catch up from then on.

"And you've got to be honest. Be up-front. You're dealing with smart guys and you won't be able to pull the wool over their eyes for too long. If you make mistakes, which everybody does, then be the first to admit it. That'll do you much more good in the long term than covering things up. Being up-front will improve their confidence in you as a management team. And the thing about chemistry and confidence is that you won't test it until something goes wrong. If you're trading well, then you'll never need to get into it.

"As far as negotiating the deal for the management team is concerned, there's a balance to be struck, and there can be conflict. The problem is that if management takes too much out of the business then they can lose the hunger – the incoming VC will know that and will want to avoid it. And you'll find that there are two types of management teams. There are the ones who are simply in it for the money. And then there are the ones who have a genuine passion for the business, for whom the cash won't be so important. It helps to understand where everyone's coming from before you start negotiating the SBO package.

"If you're used to running a business which is PE-backed and you're comfortable that the arrangement allows you enough independence, the chances are that the SBO shouldn't really make too much difference to your day-to-day life. But if you're faced with the choice of a better price for greater PE involvement, then you'll need to make a decision. Is the monetary reward worth the loss of freedom?

"My final piece of advice would be to detail somebody to keep a tight rein on the fees. If you're not careful you can have too many people involved and it can cost you a fortune. We're in ten territories, so there was a lawyer in every one and it really mounted up. At the end of the process you get hit with a lot of bills. So keep it monitored at all times."

Andrew Carr, finance director

THE CFO'S STORY

HIT Entertainment FD Jim Weight has been involved in several buy-outs and is something of a PE watcher. What's his take on SBOs?

"The first buy-out I did was part of the take-private and break-up of Westminster Healthcare. I think in that year, 2002, it was one of about two. Last year there were about 60. So there's been a huge increase in both numbers and value.

"Looking ahead, it's pretty clear that the secondary buy-out is going to be the **most popular form of exit** for VCs. IPOs are on the slide somewhat. Why is that? Well, partly because there's a lot of excess private equity money out there floating around that needs to be spent. Plus, there are a lot of debt providers out there looking to pump debt into businesses. As a private business, you can put more debt into the structure, and the bonus is that the interest payments are tax deductible. It can be so expensive to be a plc for a host of other reasons. Even for a small company, you can be looking at hundreds of thousands of pounds. And there's a growing feeling that many businesses are simply more efficient when run as private companies.

"So **the IPO route can be bureaucratic and costly**. The other likely exit for an MBO, **a trade sale, will almost certainly leave you out of a job**. The SBO route would then appear the best way.

"For a start, you know what to expect from private equity backers, since you'll have been working with them for a while anyway. You'll be used to having one main shareholder who will want some involvement in how the business is run. And the best thing about opting for a secondary buy-out is that **you have some control over who buys the business**.

"The PE house will rely on you to offer the best valuation of the business. During those discussions, you also get the chance to find out a number of things: **can you work with them** – is the chemistry good? And is it the deal best for you and the business?

"A good rule of thumb is to find out **the headcount of the PE house** and the number of investments they have. Divide the first by the second – if there are two bodies per investment, expect a lot of interference. If it's half a body, chances are you'll be left to your own devices."

"YOU WANT THE INTEREST OF YOUR BACKERS, BUT NOT THEIR INTERFERENCE"

FD: Ben McGinn
Company: Robinia
Sector: Care homes
Buy-out date: January 2006
Outgoing PE: Bridgepoint
Incoming PE: Barclays-LDC
Deal value: £80m

"WE'RE A PROVIDER of residential care to people with severe learning difficulties. We've got about 80 homes and over 500 beds. The nature of the business means we've got a stable income stream, since most of our clients are local authorities. That means our sector as a whole is very attractive to institutional investors and private equity backers. In fact they've been buying up anything that moves in the sector recently.

"The company was owned by the founder and an MBO helped her to partly realise her investment in July 2003. Since then we've grown the business both organically and through acquisitions. Then in 2005 the founder decided she wanted to retire. The only way for her to do that was to fully realise her investment, so an SBO looked a good option.

"The first thing was to establish a correct value for the business. We got Rothschild bank to help us with that. They also helped with the business plan. Then we had to get the information memorandum written. That has to include all the information in order to run the auction process. It took about three weeks.

"Parallel to that, we were also doing the vendor due diligence, with PwC's help. The main reason you concentrate on that is to avoid the buyer doing it. That means *you* keep control of the process and you can run it in the way you want. It's a defensive move and one that worked for us. You do have to remember, the due diligence process is multi-layered – there's tax people, insurance, property, commercial and so on.

"One of the most difficult things is the need to stay neutral. The management team is always on the wrong side of the deal when the sale process is on – you're trying to get the best price for the seller, but also the best value for the buyer, so it's a difficult balance to strike. Remember, as the management team, you have to live with the price the buyer pays. You're also looking to minimise the amount of debt you put into the business. And, of course, you're trying to do all that while also running the company.

"The point is to find the right backer. But the idea that you can pick your purchasers is a bit of a misconception. I suppose technically you can refuse to go with someone if you really don't get on. But that rarely happens. It's tough to say no when you're also the seller. Another vital aspect for management is how much the new backer expects you to reinvest in the business and how much you can realise. The rollover of your investment is an important factor: how much clean/free equity are they offering?

"The process can be quite sporadic, with lots of meetings happening a lot of the time. And just when you think you're on top of it all, something else lands >

on your desk. The most stressful part for me was being stuck in a hotel room in London trying to do detailed financial analysis while most the necessary documents were at head office. Nightmare.

"What do you want from your backers? You want their interest but not their interference. You don't want them coming in and re-writing the business plan, or throwing out what you'd agreed before the deal. Other than that, it's mainly about the value they place on the business and the terms of the deal going forward. Do you get any upside for exceeding expectations, for instance? Do you rank alongside the PE as institutional investors? And who will be chairman? That's massively important.

"You want them to be available to you at the other end of the phone if you need advice, and to have their involvement on the board, too. But we didn't want them telling us how to run the business. You want them there as a sounding board – someone who will offer you an honest critique of what you're doing. And you want them to be there to say, 'Go for it.'

"My best advice? Get the right advisers. Don't just go for someone who'll do it cheapest. Good ones are worth the money. And you want them to be available to you – make sure you'll be an important client to them, otherwise you won't get such good value."

Ben McGinn, finance director

"BE COMPLETELY UP-FRONT ABOUT WHAT YOU WANT FROM A NEW BACKER"

FD: Steve Herring
Company: Pets at Home
Sector: Pet care
Buy-out date: August 2004
Outgoing PE: 3i
Incoming PE: Bridgepoint
Deal value: £230m

"THE COMPANY WAS PRIVATE and had seen huge growth throughout the nineties, with 3i as the backer. There was a big acquisition in 1999 and the following three years were largely spent integrating that. Then the guy who had set up the company decided he wanted an exit. So in March of 2004 we engaged Rothschild to help us out. It was decided that a secondary buy-out would be the best way forward.

"The main reason for an SBO? The absence of a serious trade buyer. Our position in the UK meant that there wasn't anyone who could make a bid for us. We did sound out a few larger retailers, but nothing came of it. And frankly, the business was far better suited to a private equity deal. We had 160 stores at the time, and we wanted to get that up to around 300. We believed that going public would be a drag on that expansion. So we went ahead with the buy-out.

"Once we'd settled on an SBO, we did a brief beauty parade of advisers and then began the auction process. It was clear to us that there are a number of different styles of private equity firm. Some are a lot more hands-on than others. We told the advisers what type of PE backer we were looking for – one that would be committed to the business, but would let us run it day to day without too much interference.

"The auction involved presentations to eight private equity houses. (In retrospect, that was too many – six would have been ideal.) Then they all came back with bids. Bridgepoint was deemed to be the best one and we went with them. It was also one of the firms that appealed to us in terms of their style. They told us they would be there for the monthly board meetings, but beyond that, it was our business to run.

"Choosing which backer to go with is a difficult decision. If someone you don't like comes in with the best price by far, you're in a quandary, as is the person selling the business. So we tried to make sure that the discussions were not entirely about price. It's also about the relationship you strike up with the PE guys. To make sure we got off on the right foot, we said 'give us your best price based on these principles'. That laid out the terms on which we were prepared to deal.

"So my big advice would be to be very up-front about what you're after from a new backer, both in terms of the relationship and the deal for management. We used our advisers to benchmark various similar deals and to look around at what the market would bear. Thankfully the outgoing owner was happy to allow enough to be left on the table to keep the management incentivised.

"The key to it all is clarity. As FD you have to be straight down the line about... everything. But don't let the difficult decisions rest entirely on your shoulders. There's a danger that you'll end up alone in the office with all of the stress. Involving other members of the team in the process helped me a lot.

"The toughest part of the process was preparing all the documentation, especially for the banks. That was really hard and took a lot of time.

"My final piece of advice would be to do as much of the vendor due diligence as you can before the process proper kicks off. That will shift a lot of the burden off you once the deal starts, and you won't have people coming back to you with all kinds of questions."

Steve Herring, finance director