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ROUNDTABLE

MANAGING THE BUYOUT PROCESS

As private equity continues its frantic pace in many parts of the world, buyouts have changed significantly in only a few years. Fund managers have adapted their methods of finding new targets and formed consortiums to execute larger deals. They are taking advantage of plentiful debt markets, streamlining due diligence processes and ensuring that management is adequately incentivised to carry the deal through to exit. Private equity firms have also recognised the need to act quickly to build value as soon as the deal closes. With no indication that the competition for assets will subside, managing the buyout process has become critically important to success.

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THE PANELLISTS

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With buyout volumes in Q1 2007 representing the highest first quarter on record, it is clear that competition for good assets will continue to grow. In this environment, what new strategies have emerged to enhance success rates in today's deals?

Peterson: Everybody believes it is harder to find good targets. In private equity, that is one reason we are seeing more club deals moving upscale to capture large targets, which previously were confined to the realms of corporate-to-corporate stock swaps. Now, private equity is clearly playing in that area. As time goes on, we will also witness more cases of private equity clubbing together with corporates. They will set up 'mini funds' in which the corporate and the private equity contribute on a 50/50 basis and chase targets that have strategic aspects for the corporate partner – vertical or horizontal opportunities up and down the supply chain, for example. Many of these arrangements will be treated like a joint venture, the corporate partner will not have to consolidate it on their books. While some deals will involve target businesses that can be improved, this structure allows corporates to dip their toe in the water and see if a particular business works. If it does, the corporate will probably have the right of first refusal to buy the entity. If they decide they do not want to absorb it, they will sell it with the hope of achieving a good exit multiple. So we can expect a real evolution in the types of structures being used in this market. Ultimately, success takes more than just having access to capital and smart people – it's about having an industry focus.

Dunmore: We've seen a lot of club, or consortium, deals (or potential deals) lately. I am not sure a consortium approach increases the chance of a deal being successful but club deals are certainly expanding the range of buyouts that may be done. But the diffusion of control in club deals may reduce the ultimate success rate. The move to having lenders also take an equity piece may address this as lenders who are also shareholders seem less likely to expect a share of control (and in some cases there are reasons why they should avoid any suggestion of control). There also seems to be an increased emphasis on relationships with existing managers, often as the first step in the process with efforts to lock in management support early. And in terms of success rates in closing deals, the liquidity in the market allows purchasers to offer higher multiples and valuations in order to secure shareholder support.

Zakas: Whereas the PE firm's traditional target was a middle-market company with stable cash flows, low debt and the need for only a little management attention, today those opportunities are nearly exhausted or unaffordable. One strategy is to expand investment criteria with the intent of acquiring targets that are atypical for buyout groups, with the hope that the less competitive environment will result in a better purchase price or at least securing the deal. Examples include larger public companies, targets in other countries and companies in non-traditional industries, such as real estate and technology companies. Another strategy is to seek targets in industries in which the acquirer has specialised industry knowledge. In this case the PE firm may be better positioned than other bidders to identify value or realise greater value post-closing, and thus be able to justify paying a higher price.

Athanason: Buyers are still in strong competition. To win auctions, many offer no financing contingencies and seller friendly purchase agreements in terms of reps and warranties and indemnification provisions. Post transaction success really depends upon the match between the buyer and the acquisition. If the buyer brings management talent, industry expertise, and synergistic opportunity with its other portfolio companies, success is most likely. If the acquired company has strong management, their ability to become a platform for add-on deals increases deal success potential as well.

Cho: From an Australian-NZ perspective, we have seen increasingly flexible, innovative and aggressive debt structures, the use of clubs for the bigger deals and bidders making their bid as 'clean' as possible, and minimising bid conditions. This in turn has meant financing conditions such as certain funds clauses have been tightened from the financiers' perspective. In Australia, the PBL/CVC/PBL Media deal and the Seven/KKR deals used joint venture structures that enabled the existing owner to cash out part of its ownership while co-investing with private equity to gain the benefits of any future upside. Due diligence processes have become more streamlined and efficient.

Tanenbaum: It may not be a question of new strategies so much as a question of better and more meticulous execution of existing strategies. At the historically high price levels at which assets are trading, falling in love with an acquisition opportunity can be very costly. This means that successful pre-acquisition evaluation and diligence may prove to be the single, most important determinant of success. We have been told by clients that some of their best business decisions involve passing up transactions. The perception that liquidity for all but the largest companies in the US equities market has been reduced appears to be causing buyout firms to plan for longer holding periods. This translates into the need to focus much more closely on adding value on the operating side from the moment an acquisition is consummated.

Consortium deals are increasingly common as deal sizes escalate. What are your thoughts on the challenges that may arise from these arrangements?

Athanason: The biggest challenge for club deals is control. Which PE firm leads the deal? How do multiple firms affect good governance? We've seen two prevalent structures. Usually, one buyout firm takes the 'lead' position and maintains the majority of control. We have seen fewer issues with this type. More recently, there have been more deals where two or more buyout firms are 'equals'. More often than not, a 'multi-headed monster' results, where interests diverge and affect the investment's management to the point where it has trouble operating effectively. Ideally, having like minds on governance of the company, strategic direction, and ultimately exits is worth striving for before a club structure is set.

Tanenbaum: The first issue is a permutation of the dog sled adage that the lead dog has the good view. There will always be decision-making challenges when decisions need to be made jointly by collaborators who are also, in other contexts, competitors. It can ▸▸

be done well, but usually involves some stress. The most critical issue is that club members often find, over time, that their thoughts on timing of liquidity events often diverge. This is usually the result of differences in their portfolios that emerge over time. The apportionment and sharing of management and advisory fees paid to them by the acquired entity can also be a bone of contention over time as their respective contributions become clear.

Zakas: The multiplicity of parties results in a greater potential for conflicts. From an operational perspective, members of the consortium may differ as to how to generate returns, whether through financial engineering, operational changes, new management or other strategies. Even greater issues are presented by critical events, such as material changes in the company's business, the financial distress of the business or the timing or method of exiting. Structures must provide clear rules for resolving disagreements, and various types of decisions may require the unanimity, a supermajority or even a simple majority of the club members. Because of such complexity and recent inquiries by US regulators as to whether club deals are anti-competitive, increasingly PE firms are seeking equity not from other PE firms but in the form of direct investments in the target by their limited partners, who may be easier to deal with. In some cases, PE firms may require their limited partners to pay fees for investing in the transaction.

Dunmore: The main challenges are shared control, board representation and veto rights. Shared control often results in an extended decision making process, sometimes with shareholders having conflicting agendas or ideas about value creation (particularly if the club includes both financial and strategic investors). This can be a particular problem if the shareholders agreement provides operational level decision making to shareholders and not at an operational level. Given the size of transactions generally seen in club deals, the only full exit option may be an IPO and this may create issues around when small stakes may be sold without triggering tag or drag rights. And as we're seeing in the US, there is also the spectre of competition/anti-trust issues.

Cho: We do not see this as any different to any other consortium arrangement. Private equity consortia have generally worked together well and key issues on ownership or control can usually be anticipated and documented in the consortium agreement. The rest comes down to relationships, both at the individual and firm level.

Peterson: In club deals, every member of the consortium must contribute something that is valuable to the deal. They must have a role in the deal, whether it's the financing aspect, the legal considerations or the execution. You don't see club deals in which two parties perform the same role because that results in unnecessary duplication and the potential for disagreements. Another interesting factor in these deals is that none of the mega deals have run into significant problems. Presently, there is a chummy club atmosphere where partners are working together and equally incentivised. But no one is certain what will happen if trouble arises, which some have suggested could be in the next 18-24 months. It is difficult to fix problems by committee in a crisis phase, and there will be a real test of alignment and leadership. However, even if there are problems with consortiums, the appetite for deals means they will still occur – just with more attention paid in the pre-deal phase to better structuring of documentation, duties and responsibilities in the event the deal goes wrong.

In a market with lots of cash and fewer places to invest it, relationships with management may provide the needed competitive advantage to identify opportunities with extraordinary potential returns.

NIGEL DUNMORE

How are private equity buyers approaching the issue of management retention and incentivisation? Are there variations between large and smaller deals?

Tanenbaum: It looks like partnering with management is more important than ever in light of the following trends. Sellers are sophisticated, and bargains are rare these days. So, the likelihood of a quick flip has been diminished, and the need to anticipate an elongated holding period is obvious. That means that adding value from an operating perspective from day one is critical. The likeliest means of accomplishing this objective is to partner with a strong, existing management team. That this will require serious financial incentives is akin to a law of physics. It is true that in larger deals, it is more likely these days that new senior managers may be introduced into a situation, and existing managers may be presented with alternatives that might include remaining in the same or different positions, or accepting transition or termination packages.

Dunmore: With the growing recognition and acceptance of buyouts in the market, it seems easier for buyers to partner with new managers – for example, to get shareholder approval for management buy-ins rather than management buyouts – than it was in the past. But this is still relatively rare and it is still as important for buyers, financial buyers in particular, to align, both financially and strategically, with existing management. Plus, in a market with lots of cash and fewer places to invest it, relationships with management may provide the needed competitive advantage to identify opportunities with extraordinary potential returns.

Athanason: Attracting and compensating the right management team is key to the success of an investment. Besides the higher risk with larger deals, I don't see a difference. The best performing PE managers will be those that can attract and keep the best ▸▸

portfolio company management. While more time should be spent with retaining management in specialised industries where management has a strong grip on fundamentals for the business or their place in the industry/company is critical, there is a lot of great talent in the market so, in general, bringing talent in will be an increasing trend.

Peterson: Incentivisation is one of the most important areas in terms of making sure management is focused on what the private equity fund is trying to achieve. It is not just about driving growth and efficiency; there are many qualitative aspects of deals regarding market expansion and so on. While a select number of private equity firms have the luxury of both financial and operational partners who can help portfolio companies, the majority do not have operational partners. Most are betting on the existing management team, so they need to make sure they work with the right people and put appropriate incentives in place.

And this priority is not different for larger and smaller deals. A lot of time is spent on the incentive structure – from options plans to educating management on the business strategy – prior to the deal and up to signing and close. The other point to note is that incentive plans today have a broader number of participants. Historically, there may have been a handful of individuals participating directly in the upside. Today, the entities are larger and require more people to have their oars in the water at the same time.

Zakas: In the current environment, success often results less from financial engineering than from operational improvements, and a strong management team is key to achieving success. Many larger PE firms have begun bringing a broad array of operational and management expertise in-house. The availability of such expertise may make some PE firms less dependent on the target's management. On the other hand, a smaller firm that is resource-constrained may be more dependent on the target's management, and may have to provide more significant financial incentives to retain management. Although management retention may be less of a priority in large deals, paradoxically the larger PE firms often are able to pay more and thus are able to retain management or recruit talent from smaller companies.

Cho: Management incentivisation is no less important in larger deals. It is an essential part of the due diligence process for financial sponsors to get to know existing management and critically assess their credentials and track record. If there is quality existing management, then the right level of management incentivisation will produce the necessary alignment of interests and hopefully requisite upside on exit.

How would you describe the financing market for leveraged transactions today?

Dunmore: Today there is much less need for the 'hard sell' to investors. Excess supply has put borrowers in a position to request and receive new favourable terms. Most notable is the emergence of what are commonly referred to as covenant lite loans (loans with few or no financial covenants). We are also seeing financing terms now that allow the borrowers to replace any lender in a syndicate. Lenders are also making concessions among themselves in order to participate in a syndicate; for example, a lender may agree to lose its vote if its voting right is not exercised within a prescribed time.

Peterson: We are in a highly dynamic lending environment. Five years ago there was an extremely tough liquidity market. Today, banks are very aggressive in providing credit to the private equity industry due to the competing alternatives to finance deals. It has reached a point where covenants are much more relaxed, there are less stringent requirements, and automatic options to defer interest have been included. The aim is to build in flexibility to accommodate a bump in the road. Both corporate and private equity borrowers are making sure they negotiate the loosest type of credit possible.

The other trend we are seeing in private equity is the desire to have their debt in friendly hands in case there is a problem down the road. They want debt holders to be willing to work with them rather than a group that tries to find an opportunity to takeover the business in some way. Another feature of the market is that when bondholders need to consent to a takeover because their debt will stay in place, they are moving from the passive stance of previous years to a more activist mindset. If they don't like the buyout, or are dissatisfied with the premium on offer, they have been pushing to improve their position. Sophisticated investor groups – hedge funds and others – are engaged in arbitrage-type plays in some of these deals and consequently demand a better price or better terms.

Zakas: Five years ago, buyout funds were forced to search for financing. Often the absence of mezzanine financing required financial buyers to 'fill holes' in the capital structure creatively, by using, for example, seller subordinated debt and equity. Today, buyers encounter a wide variety of potential debt sources, including hedge funds, investment banks and even other PE firms, all eager to provide financing. The terms of available debt financing are quite competitive, and it's a 'buyer's market'. Often

It has reached a point where covenants are much more relaxed, there are less stringent requirements, and automatic options to defer interest have been included. The aim is to build in flexibility to accommodate a bump in the road.

GREG PETERSON

the competition drives pricing to a common point, with stapled financing being an extreme example.

Cho: There is still a tremendous amount of liquidity in the Australasian debt markets. The arrival of the global financial sponsors has meant the financing landscape became more competitive and capital structures have become more flexible and innovative. We are witnessing an increasing convergence globally in financing terms and documentation. Examples include doing away with a traditional amortising tranche, covenant-lite packages, equity cures, better intercreditor terms for subordinated/mezzanine debt and more limited market flex clauses. Strong sponsors have been able to control the debt term sheet process, bidding multiple banks against each other to get the best terms.

Tanenbaum: There is some basis to suspect that the ascendancy of the mega buyout firms over the last five years has led banks and other financial intermediaries to perceive the need to be particularly forthcoming and accommodating whenever mega buyout firms present them with an opportunity. This enhanced receptivity may be more the continuation of a trend than a change, and cannot be explained by this factor alone. The significant liquidity in the debt markets over the last several years has conditioned lenders to be somewhat aggressive in seeking opportunity. The relatively decent interest rates and business environments have made it possible for most leveraged enterprises to operate without major mishaps. Against this backdrop, lenders are now looking at a US economy that is at best flat and, in some sectors, trending down. This will cause lenders to be much more focused on protecting themselves against credit and restructuring uncertainties that may present themselves in the post honeymoon (18-24 months from closing) period.

Athanason: Lenders may be taking more risk because they feel that their loans at least cover the enterprise value in a distressed sale. More lenders are willing to get into LBO loans today for nice current yield, a chance at a plausible growth story with downside protection to own the equity to repay debt in a distressed situation. Banks are also being pressured to be more aggressive to maintain market share with hedge funds and unregulated finance companies.

Why are lenders so eager to participate in the buyout boom?

Zakas: In today's capital markets, lenders faced with a challenge in putting funds to work, look to provide leveraged products for the fees and yield they provide. Historically, private equity firms have invested successfully, producing returns that have outpaced those of US public capital markets. Moreover, the default rates of portfolio companies have been low. Although some analysts speculate that the end of the current cycle is near, thus far there has not been a rash of distressed portfolio companies. Given the profitability of leveraged finance products, it is understandable why lenders seek to continue lending to the buyout market in the current economy.

Dunmore: Current appetite is based on a combination of lenders having a large amount of cash to deploy and the absence, to date, of significant defaults. Though speculation as to when both of these factors will change is rampant.

The leveraged finance area has proven to be so lucrative for lenders over the last few years that it has all but eradicated the memory of past hiccups.

JAMES R. TANENBAUM

Athanason: Because their cost of capital is cheap, the relationships with the PE community are becoming more important to banks. Also pushing banks is an increase in competition with alternative sources of financing (hedge funds, GS and ML middle market financing groups, etc.) and this segment is higher margin business for banks so will remain competitive.

Tanenbaum: The leveraged finance area has proven to be so lucrative for lenders over the last few years that it has all but eradicated the memory of past hiccups. Also, more precisely crafted and sophisticated new financing products have created an additional measure of comfort on the part of lenders. Finally, there are not too many other places where they can get comparable risk-weighted returns. It looks like greed should be able to continue to outrun fear for the remainder of the year.

Cho: In Australia, the general low and stable interest rate environment, combined with high liquidity in the market has meant margins on corporate loans are at historically low levels. Not surprisingly, leveraged finance margins continue to attract lenders. There is also the opportunity in the leveraged finance market for lenders to earn other fee income from providing underwriting for takeout financings (such as high yield/listed notes).

Peterson: First, lenders simply don't want to miss the opportunity to participate in deals. Second, most of them are not only participating in the debt structure, they are also investing side by side with the co-investor syndicating the equity. They have interests in other aspects of the capital structure to generate their expected returns. Putting debt on the table opens the door to generating other types of fees, whether it's investment banking fees or equity participation. It's a big play. Lenders have changed their outlook from securing basic returns and ensuring collateral control is in ▸▸

place if something goes wrong, to actively seeking ways to increase those returns. They are approaching private equity (and corporate) borrowers with a broader suite of products.

When structuring the debt side of their deals, what considerations are financial sponsors making in today's market?

Cho: As debt is such a major component of the funding structure, it is critical for financial sponsors to get the optimal debt structure and the best terms and conditions. Capital structures have become more flexible and innovative as sponsors and banks try to maximise leverage to support higher bid prices. The different debt tranches have also attracted a deeper and more varied investor base as a consequence, helped by the high levels of liquidity in the market. Examples include holdco/opco PIK notes, unlisted PIK toggle mezzanine notes, listed subordinated notes or in the senior debt piece, doing away with an amortising Tranche A. New investors into these debt tranches include institutional investors, hedge funds and specialist mezzanine funds.

Peterson: Financial institutions are basically giving borrowers much more flexibility. Clearly, in that environment, borrowers will ask for as much as they can. If liquidity was not so high, and investors were not competing fiercely to participate in deals, private equity firms would certainly be spending much more time on the financial structuring aspects. Deals that five years ago would have required a complex capital structure comprising bank debt, revolvers and high yield are today being financed primarily with senior debt. Any sort of slowdown or tightening of credit will prompt a return to the type of financing vehicles and engineering required to strike debt agreements half a decade ago.

Dunmore: Debt structure and terms are very important both in regards to the rate of return an acquirer can achieve and the operational constraints on the business while working towards that return. By operational constraints I mean both financial covenants and availability and flexibility of capital to match the business strategy. But keep in mind that obtaining the best terms and conditions does not necessarily mean obtaining the lowest cost or largest amount of debt. Debt providers can provide invaluable expertise in the acquisition process as well as being a resource in the operation and sale of the business, if a good partnership is established at the outset. And the ability of a firm to go back to, and work with, the same lenders repeatedly expedites the process which may provide a critical advantage.

Given the importance of debt in a leveraged capital structure, it is more necessary than ever to match the terms of the particular debt instruments to realistic expectations as to how the company will perform over the investment time horizon.

DENNIS L. ZAKAS

Zakas: Debt is plentiful, purchase prices are high and accordingly, many acquisitions are highly leveraged. Given the importance of debt in a leveraged capital structure, it is more necessary than ever to match the terms of the particular debt instruments to realistic expectations as to how the company will perform over the investment time horizon, typically 5-7 years for a PE firm. The particular lenders are as important as the terms of the debt. An array of options has allowed many acquirers to be choosy not only about the debt terms and conditions, but also about their lenders. For example, although a hedge fund may provide better terms than a traditional lender, a hedge fund may be less flexible when confronted with defaults, and may have less capacity for making further loans in the event of financial distress. Some PE firms are even using their negotiating power to exclude hedge funds from their lending syndicates.

Athanason: Today, more than ever, acquirers are using a wide array of debt tools to improve and differentiate their bids. This is because there are a wide array of tools available but more so due to the fact that leverage has gotten so high that a relatively small downturn can trip up covenants in less thoughtful structures. This can often mean the difference between bankruptcy and an organised refinancing. This is important now because some banks and certainly hedge funds are being more aggressive about enforcing debt terms and taking control.

Tanenbaum: It depends on the transaction. For some it is critical, and for others, merely important. The key point here is that, in the last several years, there has been enormous interest in creating, and enormous interest in purchasing, preferred securities and debt instruments that are novel, address particular needs, and provide financing flexibility that was unknown even five years ago. The extraordinary growth of the structured securities market is illustrative of this trend. In the next few years, we will come to view the intersection of acquisition financing and structured products as the norm. Especially in Europe, many buyouts have been financed, in part, through the issuance of hybrid securities.

Can you provide some insight into the evolution of the due diligence practices applied to private equity transactions?

Peterson: In this era of expanded multiples and competition for deals, buyout firms are undertaking far more commercial and market diligence. They need to understand how management perceives the financial operations of the business but more often they also want an independent sanity check. A lot of them are moving beyond 'rolodex diligence' where they call a select number of people who used to work in the industry. They now want to get deeper into the deal, much further than an anecdotal summary

from a chief executive on how the deal might work. At the same time, sellers are spending more time on reverse or sell-side diligence. Savvy sellers, both corporate and private equity, are spending the time to conduct due diligence on themselves prior to an exit so that value stays on their side of the table when negotiating the deal. Historically, it has been common to see value leakage when a company does not prepare itself appropriately and, in the height of the deal, potential buyers uncover areas that lead to the seller making comprises to complete the deal.

Tanenbaum: In recent years, the diligence process has changed for buyouts and for most other activities. The US has generally led the way in this regard. This is the result of the Sarbanes-Oxley reforms, that themselves are an outgrowth of a series of well publicised financial frauds. Acquirers of US public companies understand that they will, either directly or indirectly, bear responsibility and liability for certain disclosure issues. Investors are more focused than ever on a target company's existing internal controls and procedures. Likewise, they are focused on ensuring that, post transaction, all of the necessary controls and procedures will be in place in order to permit the company to comply with its Sarbanes-related certifications. Investors and lenders have little tolerance for issues that surface after a closing but that should have been foreseen much earlier.

Athanason: Behind the scenes of every successful buyout is tailored, robust due diligence which helps managers to pay the right price and structure the deal advantageously. As club deals become more prevalent and deal costs are spread, we also see a greater willingness to probe deeper into the prospect; deeper analysis of projections, post acquisition plans and synergy achievement planning and analyses. These added due diligence steps also provide more comfort as multiples increase in a competitive bid market.

Cho: Due diligence processes have become more sophisticated, streamlined and efficient, necessitated in part by a favourable sellers' market where vendors have been able to dictate terms such as minimal warranties and truncated due diligence processes. In competitive vendor-run auction processes, vendor due diligence reports are becoming increasingly common and assist in minimising the time required for bidder due diligence.

Zakas: In recent years, competition for deals has caused the pace of due diligence to accelerate and in many cases the depth of due diligence to diminish. The auction rules typically impose a very short time period for conducting and completing due diligence. Virtual data rooms and other technologies have streamlined due diligence and made it more efficient from the seller's perspective, but have deprived the buyer of opportunities for additional on-site visits, which facilitate a better understanding of the target's business and culture.

Dunmore: There have been a lot of interesting changes in recent years, some fundamental and others procedural. As the regulatory environment has become more complex and strict, due diligence in this area has become more important and considered. And as funds go public, there is increased pressure on those funds to enhance their transactional diligence to reduce the risk exposure they and their shareholders have. At the same time, the popularity of secondary buyouts in recent years has often made due diligence reports available from previous transactions and has allowed the secondary purchaser to rely on continuing warranties and indemnities from the previous buyout therefore less diligence is conducted for such buyouts. It's increasingly the practice for firms to place the costs of due diligence on the target company but at the same time the trend towards vendor diligence reports and virtual data rooms is reducing the cost of the diligence exercise.

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YUEN-YEE CHO

How can legal issues in the pre-close phase affect the overall long-term success of a deal, and what areas are buyers targeting?

Dunmore: Assuming that success in this case means maximising IRR then it is critical for legal counsel to consider how to remove any impediments to doing so. If the value proposition requires using existing management, then, as discussed earlier, how management will be incentivised and retained becomes indispensable. This in turn impacts the purchaser's risk exposure as a purchaser wooing management may be less likely to take a strong position on the representations, warranties and indemnities sought from those people that really know the target (particularly where it is a secondary sale). If the value proposition is focused on increasing free cash flows then the resulting capital structure and debt, intercreditor and equity terms are more crucial – though again, managing risk exposure through the representations, warranties and indemnities in the purchase agreement is also indispensable.

Cho: Looking ahead, it is important to make sure there is sufficient flexibility in the deal structure to accommodate the financial sponsor's strategies for the business and ultimate exit. This can be done by incorporating flexibility or headroom in the debt financing terms to enable funding of growth strategies such as roll-ups.

Zakas: Although the key issues in structuring M&A deals have not changed, the relative bargaining power of the parties (and thus the way the issues are resolved) has changed. In the current frothy market, the balance of negotiating power has tipped strongly in favour of the sellers, and thus deal terms, such as indemnification and the scope and survival periods of representations and warranties, all favour sellers. With a healthy acquisition this imbalance may not be meaningful, but in today's environment the terms of the transaction may not give a financial buyer sufficient redress in a problem situation.

Athanason: The legal agreement formalises the deal agreed to by the parties. The indispensable factor is doing the right deal – not a legal priority. The right deal is usually identified through robust diligence and bringing management and industry synergies to the table. Perhaps lawyers would serve buyers best by structuring for an efficient exit – especially when the buyer is a PE firm.

Tanenbaum: A great company and a first rate management team are likely to succeed whether or not lawyers have considered, and advised clients concerning, the key factors. Likewise, considering the indispensable factors may not do much to provide investment success in the context of a poor company and unable management. In structuring an acquisition agreement and ancillary documents, particular attention, nevertheless, should be devoted to representations, warranties, covenants and those provisions that delineate who will have the authority to make decisions regarding the direction and strategy of the business, and who will have the authority to organise and structure liquidity events. In order for the legal documentation to be useful, it must provide a structure in which the various constituencies can review and, hopefully, reach consensus concerning, these matters.

Now that old 'asset-stripping' and 'financial engineering' methods are largely outdated, what methods have evolved to replace them?

Larger PE firms now develop 100-day plans when an acquisition closes, which include detailed tactics to create the value conceived by the origination team.

MICHAEL G. ATHANASON

Athanason: Larger PE firms now develop 100-day plans when an acquisition closes, which include detailed tactics to create the value conceived by the origination team. A buyer may immediately sell non-strategic assets, such as sub-products, real estate, etc. In the case of real estate, besides sales, we have seen companies initiate sale/leaseback transactions to unlock the value of hidden real estate. Companies may also re-structure the management team. In addition, we are seeing many companies implement unlevered ESOP plans in lieu of 401-k plans. This is one way to increase cash flow, realise tax benefits and align all employees with shareholder value creation.

Tanenbaum: Lots of sponsors talk a great deal about synergies being a critical component of value creation. The problem is that the existence of synergies is ascertainable, in reality, only after the acquisition has been consummated. In the cold light of post-closing, a fair bit of this discussion sounds more hypothetical than real. Over the last year, we have seen several successful sponsors becoming even more sharply focused on using their acquisitions as platforms for consolidating other enterprises, enhancing enterprise operational capability through a variety of approaches, and facilitating the availability of financing on terms superior to those that would have been available to the enterprise prior to the buyout. All of these initiatives can have a role in value creation.

Dunmore: Buyout firms have been expanding their in-house skill sets in order to provide value not only through financial engineering but also through operational and strategic engineering. There have been a number of high profile operational executives recruited to equally high profile firms and this trend is likely to continue.

Cho: Strategic roll-ups or bolt-ons are a key feature. The ability of buyout firms to bring management and industry expertise from their other investments/connections can add significant value to the acquired business.

Zakas: Often, in the current environment, the best way to create value is to focus on the fundamentals of the business, a process that should begin during due diligence and should continue during the company's life cycle. Management of a privately-held company can focus on longer-term objectives rather than on the next quarter's results. To create value buyers should resist the temptation to over-leverage the business, strip out cash and/or starve the business from the investment capital necessary for growth. On the other hand, financial engineering remains possible in some cases. Common techniques include leveraging the balance sheet (often in anticipation of a public offering), stripping out assets and flipping the company in a relatively short time or engaging in sale-leasebacks of real estate assets.

Peterson: A number of buyout houses have adopted a shared services approach in which they buy a company and scour it from top to bottom to identify where every dollar is spent, from major vendors to insurance programs, telephone bills and IT. They then integrate the company into the portfolio and 'link' it to existing companies to procure discounts and make it more efficient. This ▸▸

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technique will continue to grow in popularity as a means of adding post deal value. Another trend is for private equity firms to take a laser-like focus on a target's area of strength. Often a private equity buyer will look at the component pieces of the business and either split them up or sell them off to concentrate on the underlying drivers of the business. This tends to happen more under private equity ownership than corporate ownership.

A third area is private equity's ability to tap into contacts and ideas regarding expansion of the business. Buyout firms have a tremendous number of contacts – including industry stars and advisers – with whom a portfolio company can be put in touch to accelerate value creation. For example, a company may need to open in China, Taiwan or Korea, and the private equity firm has partnered in the past with individuals who can help to execute the plan. This saves a lot of time and the execution is normally much better. On its own, the portfolio company may never have been able to gain access to such individuals.

How do you see the private equity industry shaping up over the next 2-3 years?

Zakas: Over the next few years, there may be enough liquidity in the market to sustain a high level of activity, but at some point the cycle will come to an end, perhaps precipitated by a tightening in debt markets. The decline of clubs in favour of side-by-side investments by limited partners should continue. US public companies increasingly will leverage themselves to fend off takeover attempts by PE firms. Limited partners will demand increasing rights, transparency and oversight. US legislators concerned with the recent successes of private equity at the perceived expense of public markets will continue efforts to increase the legislation of PE firms.

Cho: While the stockmarket and company fundamentals remain strong, interest rates and inflationary pressures continue to be contained and there is high liquidity in the market, the industry should continue to grow in the next 2-3 years. A major failure in a high profile leveraged deal may of course prompt some reassessment of this. The industry should be able to withstand the closer scrutiny by the regulators and the public given that its business model involves wealth-creation and bringing value-add strategies to existing businesses. Part of the challenge is educating the public and regulators as to the benefits the industry brings to existing businesses and the consequential wealth-creation impact and increased competitiveness for the broader economy.

Tanenbaum: In the US, private equity and buyout firms will be executing IPOs. The leadership of these firms have been successful because they know when to buy and know when to sell. That they are now selling to the public would suggest to the sceptical that we are approaching a market top. History would, with a few exceptions, tend to support this view. In the next several years, I would expect the buyout firms that have exhibited price and sector discipline to continue to do well, but the statistics for buyouts across the board may peak and begin to decline.

Dunmore: In the next 2-3 years I predict we will see the continued increase of equity participation by lenders; the re-engagement of banks in proprietary buyout transactions; a continued scrutiny on and dialogue about regulation, disclosure, competition and tax issues; increased difficulty in maintaining returns and some significant defaults causing the pendulum to swing back in the other direction, reducing the availability of debt.

Peterson: At the moment, trade buyers are wondering: How do we partner, compete or even collaborate with private equity? In the past, synergy value was on their side and they knew they could outbid private equity. But private equity is more savvy about how much debt they are willing to put on a deal, and how they will recap it to take their money off the table. This encourages them to structure a little bit more into a deal than a corporate might. Because of debt ratings, corporates are reluctant to load a target up to the same extent as a private equity fund. So the balance has shifted in favour of private equity.

With respect to scrutiny from regulators on club deals, transparency, etc., when any industry generates these types of returns, regulators will assume there is something wrong. Many people argue the private equity industry competition and market forces are enough to regulate an industry; but that has never prevented a determined politician from passing a law. To diminish the scrutiny and negative press, private equity funds will have to spend time explaining themselves and emphasising the value and jobs they create than they have in the past.

From a liquidity standpoint, it looks like a robust market for the next 12 months at least. There are still some tightening issues, particularly in the US: the auto market is going through a period of transformation, along with the housing and sub prime markets. Historically, this has bled into other industries, but for now it remains surprisingly isolated. To be sure, liquidity and debt availability will not last forever. Still, private equity funds are evaluating their remarkable returns, the upper quartile of which have been over 30 percent on a gross basis. Knowing that conditions might change, they are taking actions you expect from prudent investors making sure they don't load too much debt in their deals in case there is a downturn. They are also spending more time pushing for flexibility in their debt covenants. This response will be necessary if they encounter any softening in the global macroeconomic environment.

Athanason: There continues to be large amounts of capital invested in private equity – primarily because of the need of large pension funds and other large investors to diversify and increase their returns. Private equity, even with its growth over the past years, still only makes up about 20 percent of the M&A market. Over the next 2-3 years private equity will continue to be a strong force in the M&A market. Its perception should continue to improve and it will continue to be a benefit to the economy as a whole and the millions of people employed by private equity-owned companies. In addition, the mega funds will continue to grow and become an ever increasing force in the M&A market. With these larger pools of funds, more and more companies will fall into these PE firm's ability to mount credible bids. Over time we will increasingly see strategic acquirers using tactics and debt markets similar to PE firms. Indeed, strategic buyers may be forced to be more aggressive to compete for good deals as they experience critical losses to PE firms. ■

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James R. Tanenbaum has concentrated his practice on corporate finance and the structuring of complex domestic and international capital markets transactions. He represents issuers, including some of the nation's largest financial institutions, underwriters, agents, and other financial intermediaries, in public and private offerings of securities as well as issuers, investment banks, and purchasers in hybrid, mortgage-related, and derivative securities transactions. Mr. Tanenbaum works closely with leading investment banks to formulate new methodologies for securities offerings and to structure innovative financial products. He has also represented many technology-based companies, including biotech and medical device companies and a range of emerging Internet software and technology companies.

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