

Six key misconceptions regarding buyouts

1	Buyout companies lay off more people than other firms.	→
2	Buyout financed companies are overleveraged.	→
3	Buyout houses are short-term investors.	→
4	Buyout houses leave nothing of a company once they have sold it.	→
5	Buyout houses de-list listed companies to the detriment of existing shareholders.	→
6	Club deals aim to reduce the price paid to sellers.	→



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Do buyout houses lay off more people than other firms?

Buyout houses created 420,000 jobs between 2000 and 2004

Thanks to the strategic improvements made to businesses targeted for investment, European buyout firms created 420,000 new jobs between 2000 and 2004¹. Instead of destroying employment, buyouts contribute to job creation.

Buyout-financed companies play a key role in the European job market

Buyout-financed companies employ 3.5 million people in Europe¹. These figures cover many concrete examples, such as the German cable company “Kabel Deutschland”, which increased its number of employees from 2,240 to 2,610 between 2002 and 2006. This also applies to “Seat Pagine Gialle”, which raised employment levels from 5,340 to 6,660 persons between 2004 and 2006.

Working for a private equity-financed company provides more job security in comparison to other companies

Buyout-financed companies expanded staffing levels by 2.4% per year between 2000 and 2004¹. At the same time, employment in the European economy only grew at a rate of 0.7%. Consequently, people working in a buyout-finance company have on average greater job security than those working for other types of companies.

This is also the case for companies acquired by a buyout house for the second time, since research has shown that their employment level grew substantially more than for the economy as a whole¹.

¹ CEFS/EVCA (2005): “Employment contribution of Private equity and Venture Capital in Europe”.

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Overleveraging a company jeopardises its value...

What does it mean when a company is overleveraged?

An overleveraged company does not produce sufficient cash flow to pay the interest on its debt and reimburse this debt. Consequently, the company undergoes cost saving and restructuring programmes. If the situation is not remedied, bankruptcy is a potential outcome.

When a company is overleveraged, all stakeholders are affected:

- Creditors are not sure that they will recover their funds;
- Employees fear for their wages and their jobs;
- Shareholders see the value of their investment decrease substantially.

This means that when a buyout house invests and becomes a shareholder in a company, it does not over-leverage this company since this would have a negative impact on the value of its investment. Moreover, creditors generally refuse to provide financing for a company that appears to be overleveraged.

...so buyout houses carefully assess the debt level of their investee companies...

When a buyout house invests in a company, the capital structure of the company can be modified to contain a higher percentage of debt and a lower percentage of equity. This type of decision is justified by two main reasons:

- The initial capital structure resulted from the sub-optimal use of financial resources while creditors, e.g. banks, are willing to lend more to the company because they believe in its economic strength;
- Buyout houses are active shareholders which initiate strategies aimed at increased margins and higher cash flows for their companies.

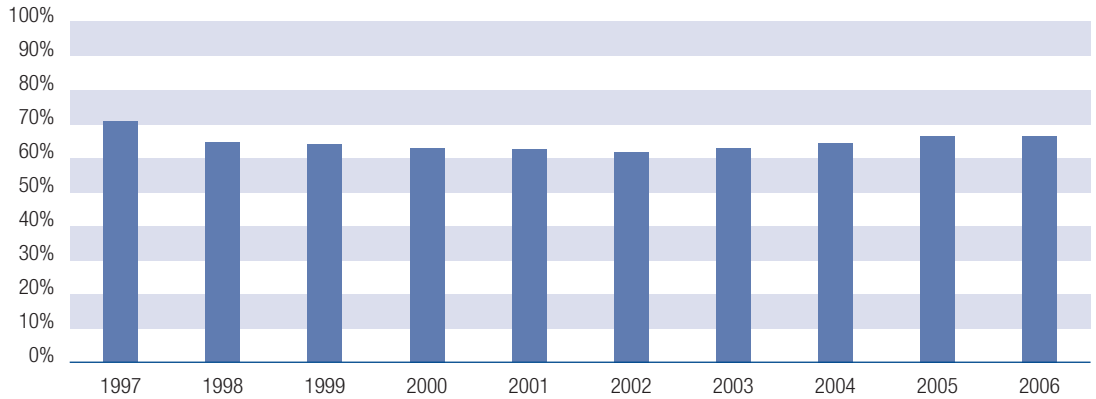
This last point has been confirmed by several studies conducted in large as well as small markets. A recent study carried out in Belgium involving 53 companies demonstrated that two years after a buyout, their cash flow on average represented 7% of sales compared to 4% before the buyout (this increase was achieved while the average number of employee grew by more than 13% during the same period²). →

2 Solvay Business School, Brussels (2006) "Private Equity in Belgium – Value Creators or Locusts?" by Valentin Toubeau

Are buyout-financed companies overleveraged?

Buyout houses carefully assess the level of debt they can use when bidding for a company. The graph below shows the ratio of debt used by buyout houses when acquiring companies. This ratio has not substantially changed in recent years. In 2006, the ratio was 66%, similar to the level of 2005. The 2006 figure is lower than the level shown in 1997 (66% compared to 70%).

Average European debt contributions as percentage of total transaction value 1997- Q3 2006



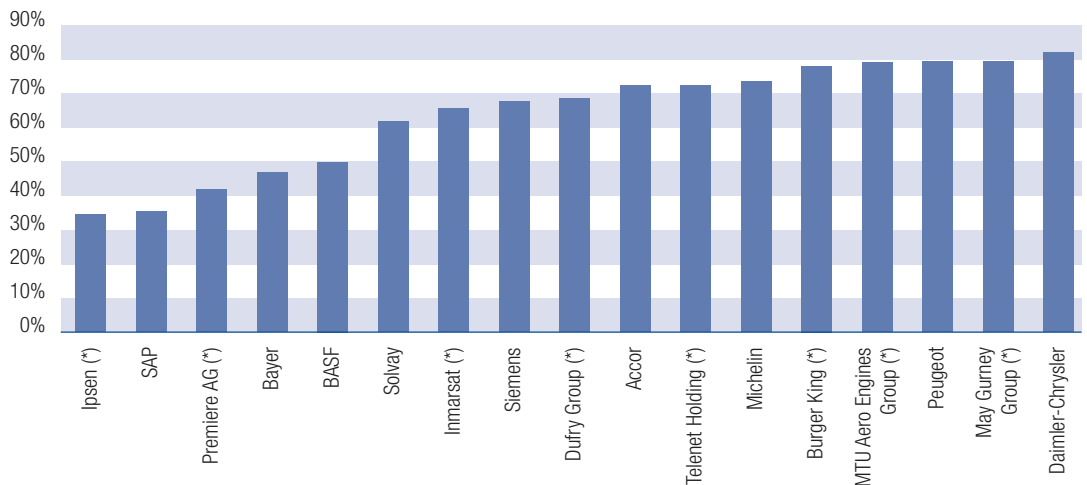
Source: S&P LCD at www.pmdzone.com

The data refers to the leveraged loan market and covers loans that are syndicated to borrowers in Europe. It only takes account of LBO transactions, including all sponsored activity such as refinancing and recapitalisations.

...investee companies that do not appear overleveraged when compared to other firms

When looking at companies floated on stock markets by buyout houses in 2005 or 2006, we see that their debt ratios expressed as a percentage of their total assets do not significantly differ from those of listed blue chip companies (see graph below).

Comparison of debt ratios of listed blue chip companies with companies recently floated by their buyout houses (as percentage of total assets)



Note: (*) denotes a company that has been recently floated by its buyout house either in 2005 or in 2006.

Source: EVCA – Latest company annual report (2005 or 2006)





A long-term investment horizon...

Buyout houses generally have an investment horizon of maximum ten years. This time horizon stems from contractual agreements binding buyout houses to their investors (such as pension funds, insurance companies and banks).

A long time span like this does not fit the definition of short-term investing, which implies a holding period of less than one year.

More concretely, buyout houses also distinguish themselves from short-term investors by the way they manage their investments.

Short-term investors take advantage of market trends but do not influence the way the underlying companies operate. Buyout houses have an opposite strategy, which first aims to improve the health of underlying companies in order to fully benefit from favourable market developments.

...combined with a future vision for investee companies...

Buyout houses increase the value of their investments through a combination of three elements:

1. Better use of financial resources, notably through an appropriate use of debt
2. Improved company operations
3. Redesign and refocus of the corporate strategy

By acting on these three elements, buyout houses enhance the growth potential of companies until their value is fully recognised by other investors, who then want to become shareholders in the company themselves.

Better use of financial resources is implemented relatively quickly and the results show rapidly.

Improving the operational quality of a company takes longer and therefore more time is needed before the related benefits start to surface.

Redesigning a company's corporate strategy is a long-term endeavour, the outcome of which often takes years to materialise.

...translates into buyout houses qualifying as long-term investors

In light of this, it is not surprising that more than 50% of buyout houses usually plan to remain shareholders in their companies for more than 4 years³. Such long holding periods apply to both SMEs and large companies. A recent study conducted in 2006 revealed that buyout houses remained shareholders in their biggest companies for an average period of 3.5 years⁴.



³ CMBOR/EVCA (2001): "Survey of the Economic and Social Impact of Management Buyouts and Buyins in Europe". [For more info, click here.](#)

⁴ ERNST & YOUNG (2006), "How do European Private Equity Investors Create Value?". [For more info, click here.](#)



The success of buyout houses depends on their ability to build strong companies...

Asset stripping and overleveraging are often presented as the usual recipe used by buyout houses to create value through investee companies. If this were really the case, only empty shells would be left after the buyout company's exit. This overlooks the fact that value creation needs to be recognised by the next shareholder, who will then decide whether to acquire the shares held by the buyout house.

Buyout houses have been successful for many years in producing superior returns for their investors because they have managed to sell on their investments to corporations (or other type of buyers) that recognised the value created by buyout houses in their investee companies.

Buyout houses increase the value of their investments thanks to a combination of three elements:

1. Better use of financial resources, notably through an appropriate use of debt
2. Improved company operations
3. Redesign and refocus of the corporate strategy

On top of the fact that rating agencies tell us that default rates for buyout financed companies are currently at historically low levels, their economic strength is also demonstrated by their performance after buyout houses have decided to sell them.

...that continue to grow after buyout houses have sold them

A recent study showed that the share price of companies that were originally supported by buyout houses outperformed other floated companies by 11 percentage points three years after their IPO on a stock market⁵. Another study also revealed that larger buyout companies floated on a stock market tend to perform even better than smaller buyout companies⁶.

It is therefore not surprising that 85% of companies that had a buyout house as shareholder state that without the intervention of this active investor, the company would have developed more slowly⁷.

5 Ritter R. J. (2006): "Some factoids about the 2005 IPO Market".

[For more info, click here.](#)

6 Lerner J. and Cao J. (2006): "The performance of reverse leveraged buyouts".

[For more info, click here.](#)

7 CMBOR/EVCA (2001): "Survey of the Economic and Social Impact of Management Buyouts and Buyins in Europe".

[For more info, click here.](#)



Why do buyout houses de-list companies? Is this not to the detriment of existing shareholders?

A company is delisted because it is undervalued

A key reason for the delisting of a company is its undervaluation by the stock market⁸. This has two effects on the business:

- Shareholders do not get the reward for their investment and are likely to accept an offer from outside investors (private equity or other). In return, shareholders receive liquidity and a premium on the share price, which is why they support delisting.
- Secondly, the management of the undervalued company is limited in trying to develop the company. It is difficult to raise equity by issuing more shares given that interest from new investors is low and that current shareholdings would be diluted. Additionally, the company cannot increase its debt levels, as financial support from banks is unlikely.

Consequently, the development and growth possibilities of such a company are limited, which is why delisting and going private becomes a preferred solution.

Each year, private equity identifies between 30 and 60 undervalued companies

In 2006, 44 companies were de-listed by buyout houses in Europe, with €41bn paid to their existing shareholders. Since 2000, buyout houses have identified between 30 and 60 undervalued companies per year⁹.

Public to Private Management Buyouts/Buyins, 2000-2006

Year	Number	Number (% of all deals)	Value (€ m)	Value (% of all deals)
2000	62	5.5	21,216	28.5
2001	48	4.1	15,633	23.9
2002	35	2.9	10,991	16.3
2003	54	4.2	9,271	14.1
2004	30	2.3	13,294	16.5
2005	42	3.0	31,525	24.6
2006	44	3.1	40,891	25.5

Source: CMBOR/Barclays Private Equity/Deloitte



⁸ Weir C.M., Laing D. and Wright M. (2005): "Incentive effects, monitoring mechanisms and the market for corporate control at going private transactions in the UK". Study on UK public and privates shows that 63% of the analysed deals relate to market undervaluation.

[For more info, click here.](#)

⁹ CMBOR/Barclays Private Equity/Deloitte (2006): "European Management Buyouts".

[For more info, click here.](#)

Shareholders of de-listed companies receive a higher price than they would have obtained for their listed shares

To delist a company, a large majority of shareholders are required to accept the sale of their shares at the offer price. For the UK, 75% of a company's shares are required to re-register the target as a private company and 90% to squeeze out minority shareholders¹⁰. Shareholders can subsequently ask an independent investment bank to analyze the offer, as was done in the case of Qantas, to evaluate the Macquarie and Texas Pacific Group offer.

It should not come as a surprise that studies on UK and US public to private transactions show that shareholders receive on average 45% more for their investment than what the market would have given them before the buyout deal was announced¹¹.

10 SJ Berwin (2007): "Public-to-private: An overview".

[For more info, click here.](#)

11 Wright M., Renneborg L., Simons T. and Scholes L. (2006): "Leveraged buyouts in the U.K. and continental Europe: Retrospect and Prospect", European Corporate Governance Institute (ECGI).

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Due to risk diversification, buyout houses join forces...

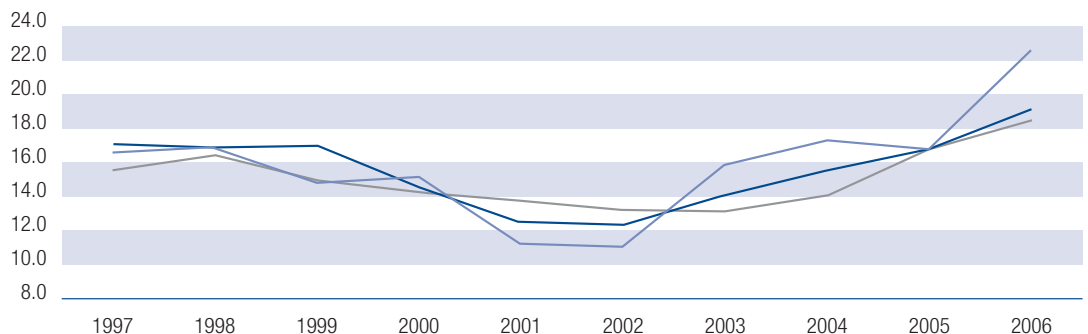
For contractual reasons, buyout funds can only invest 10%-20% of their fund in one single company. This is to limit risk and to ensure the diversification of the fund. To have access to new investment opportunities in the form of bigger deals, buyout houses have joined forces, but while keeping the risk for their investors stable.

Moreover, club deals allow buyout houses to share costs and resources when analysing and preparing an investment. This is very similar to the syndication of deals by venture capital investors.

...in a market characterised by increasing prices...

The positive economic climate in Europe and the high levels of M&A activity have increased valuations for companies by over 50% since 2002¹². As a result, buyout houses need to pay more for a business today than what they would have paid a few years ago.

All M&A - Enterprise Value / EBITDA



Source: Dealogic

...which is the consequence of larger auctions benefiting the sellers

Nearly all large deals are sold through an auctioning process, in which an investment bank is hired to find potential buyers on behalf of the seller. These buyers are not only buyout houses, but they can also be other financial investors or trade buyers. An example is Alitalia, which received offers from 11 bidders, of which three were buyout houses. Similarly, Landesbank Berlin has drawn interest from 19 parties, of which seven are buyout houses.

Such auctions contribute to the rise in prices paid for buyout deals, which amounted to 28% between 2004 and 2006 for deals of over €250m¹³.

¹² Source: Dealogic.

¹³ CMBOR/Barclays Private Equity/Deloitte (2006): "European Management Buy-outs".

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