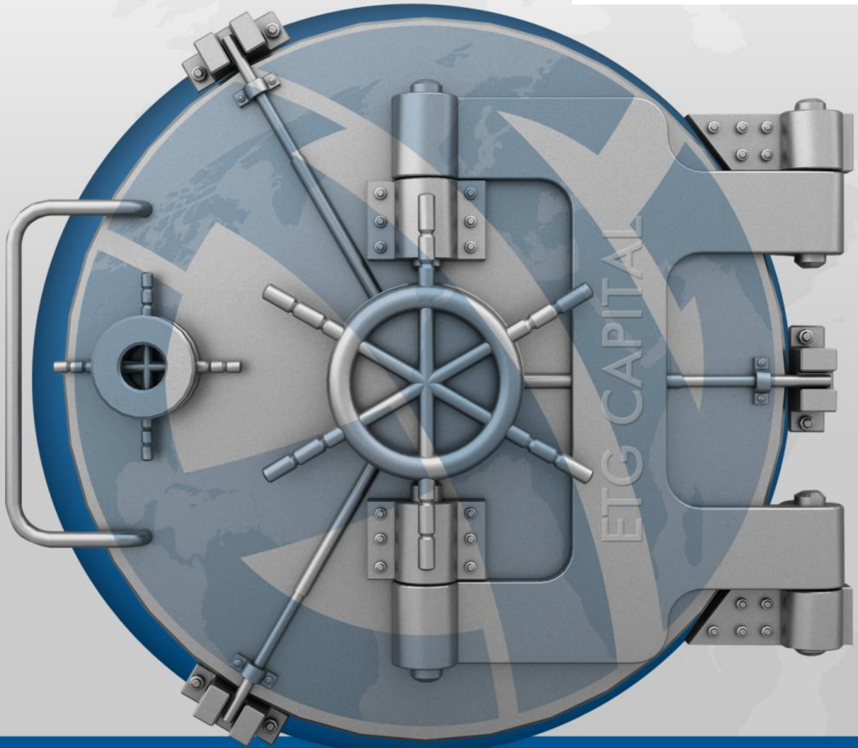
LEVERAGED BUY-OUTS (LBOs)
BOOM TO BUST

June 10, 2010 presentation to EQUIFAX



David D. Tawil
(212) 300-6791
david.tawil@etg-capital.com

The Bottom-Line

1) **Buy Low and Exit High**

2) **Use someone else's money** to:

    (i) multiply the return *or*

    (ii) to cushion the loss

Private Equity

What is Private Equity?

- An alternative investment strategy that involves investing in privately held companies.

- The key feature is the private nature of the securities purchased. Investments in private equity are **illiquid**.

- Investors invest for the long-haul; investment horizons may be as long as **5 to 10 years**.

Partnership Structure

- Limited partnership consist of limited partners (LP) and general partners (GP).

    - LPs are the investors, *i.e.*, the main providers of capital. These are typically wealthy individuals, endowments, pension funds, and other institutional investors.

    - GP is responsible for the day to day management of the partnership's investments.

Compensation

- GPs are compensated through a fixed **management fee**, as a percentage of committed capital, and profit sharing of investment gains known as carried interest, or simply, **carry**.

- While the fee and carry vary across partnerships, the 2-and-20 is a standard that many funds gravitate towards.

- 2-and-20 means that the annual management fee is 2% of the committed capital, and when final investment gains are realized, 20% of the profits go to the GP as their profit share.

Retail Private Equity Players

Anna's Linens (Rosewood Capital)

Barneys (Istithmar)

Burlington Coat Factory (Bain Capital)

Dollar General (KKR)

HD Supply (Bain Capital)

Hudson's Bay Company (NRDC Equity Partners)

Linens 'n Things (Apollo Management)

Lord & Taylor (NRDC Equity Partners)

Party City/Amscan (Weston Presidio)

Restoration Hardware (Catterton Partners)

Ross-Simons (Freeman Spogli)

Sears/Kmart (ESL Holdings)

ShopKo (Sun Capital Partners)

Leveraged Buy-Outs
The Basics and Advantages

- LBOs are a way to take a public company private.
- LBOs are financed with **large amounts of borrowing** (*leverage*), hence the name.
- LBOs <u>*use the **assets** or **cash flows** of the company to secure debt financing*</u> (bonds or bank loans) to purchase the outstanding equity of the company.
- After the buyout, control of the company is concentrated in the hands of the LBO firm and management, and <u>*there is no public stock outstanding*</u>.
- Acquiror looks to realize its investment in **3 to 5 years**
- Target returns are approximately 25%

Advantages of LBOs

- Ability to operate outside the public eye or out from under larger parent
- Alignment of management and owner interests
- Liquidity for founders/management without ceding operational or day-to-day influence
- Tax advantages associated with debt financing

Leveraged Buy-Outs
Ideal Characteristics of the Target

Ideal Financial Characteristics

- Strong, predictable **cash flows** to service the financing costs related to the acquisition
- Limited **working capital** and future capital requirements
- Readily **separable assets** or businesses that could be made available for sale, if necessary

Ideal Business Characteristics

- Strong **management team**
- **Competitive advantage** through well-known brand names, strong market share or as a low-cost producer
- Real **growth** potential
- Not subject to prolonged **cyclical swings in profitability** (a problem with commodities, maybe; long cycles help mitigate the risk)
- Products that are not subject to rapid **technological change**
- Viable **exit strategy**

Leveraged Buy-Outs
Strategies

1) Finding cheap assets – buying low and selling high (value arbitrage or multiple expansion)

2) Unlocking value through restructuring:

- Financial restructuring of balance sheet – improved combination of debt and equity
- Operational restructuring – improving operations to increase cash flows

3) Value Creation

- Management incentives and agency cost effects
  - Increased ownership stake may provide increased incentives for improved performance
    - Better aligns manager /shareholder interests
    - Debt puts pressure on managers to improve firm performance to avoid bankruptcy
- Managers, investor groups have better information on value of firm than shareholders
- Other efficiency considerations
  - More efficient decision process as private firm

Leveraged Buy-Outs
Capital Structure

- Although there is no set capital structure for an LBO, it must be designed to meet the requirements of the specific situation within the constraints of the financial markets.

- Consideration is given to the company's existing and forecasted **cash flow**, its **capital expenditure** requirements, its **working capital needs** and the **investment strategy**.

- The most important objective of any capital structure is to provide a financial foundation that gives the company the ability to implement its business strategy and permits flexibility in reacting to adverse circumstances

Secured debt (a.k.a. bank debt, which includes bridge loans, revolving lines of credit, term loans)

The target company offers collateral for every dollar of the loan.

- It is generally the most senior debt in any firm's capital structure.

Unsecured debt ("junk bonds", high-yield debt", "subordinated debentures", "sub debt")

- If an acquiror needs to borrow an amount that exceeds the value of their tangible assets, it raises unsecured debt. The lender makes the loan even though the target has no collateral to pledge.
- The lender demands a higher interest rate for the added risk.

Discount debentures ("zeros")

They accrete for a few years, before requiring the borrower to pay interest. In other words, if the target company borrows $100 MM of zeros at 10%, it doesn't pay any interest the first year, but it owes $110 MM at the end of the year.

Leveraged Buy-Outs
Exit Strategies

1) **Sale of Company**

Liquidity: High

Considerations

Existence of strategic buyers

Financial buyer valuations are lower

Limited buyer universe for large companies

2) **Recapitalization**

Liquidity: Moderate

Considerations

Constraints of existing debt

Continued ownership

3) **Public Offering**

Liquidity: Moderate

Considerations

Dependent on equity market (Valuation, Degree of liquidity)

Low receptivity to cashouts

Not available for all types of businesses

Leveraged Buy-Outs
A Simple Example- Buy a House

- Buy a house / company for $100
- Minimal down payment ($20)
- Significant leverage /debt ($80)
- Cash flow (your wages / company earnings) must meet debt payments

- Over three years, mortgage / debt payments reduce principal to $75
- Over three years, value of the house / company rises to $125

- Sell company for $125
- Subtract $75 of debt
- $50 profit on $20 investment in three years

Leveraged Buy-Outs
Risks

- Rising interest rates
- Higher asset valuation - overpayment
- Political backlash
- More regulation of industry
- Economic slowdown
- Failure of exit strategy

Now, imagine a convergence of all of these risks…….

About ETG Capital

After 6 years at Credit Suisse, building from startup to $450MM total exposure, spinout in 3Q 2009

- Capital constraints
- Business/Independence constraints
- Looming regulatory constraints

Diversified investor base

Capitalization 50% or greater (most banks 9-12%)

Put options <u>only</u>; no other investments

About ETG Capital

Flexibility:

- Small balances (greater than $250K)
- Middle-market and private companies
- Fluctuating balances
- Odd tenors

Independent opinion.

No formality of Client ID.

David D. Tawil

(212) 300-6791

david.tawil@etg-capital.com

ETG CAPITAL

VENDOR PROTECTION WHEN IT COUNTS

152 WEST 57TH STREET NEW YORK, NY 10019 212.300.6700 WWW.ETG-CAPITAL.COM