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NANYANG TECHNOLOGICAL UNIVERSITY | SINGAPORE

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Public Lectures

The Economics of Buyout

5 December 2024, Thursday 6.30 pm - 9 pm Hybrid Event

MODERATOR

MR. KEOY SOO EARN
Global Consulting
Deloitte Private Leader
Deloitte

SPEAKER

PROF. MICHAEL S. WEISBACH
Ralph W. Kurtz Chair in Finance
Ohio State University

NANYANG TECHNOLOGICAL UNIVERSITY | SINGAPORE

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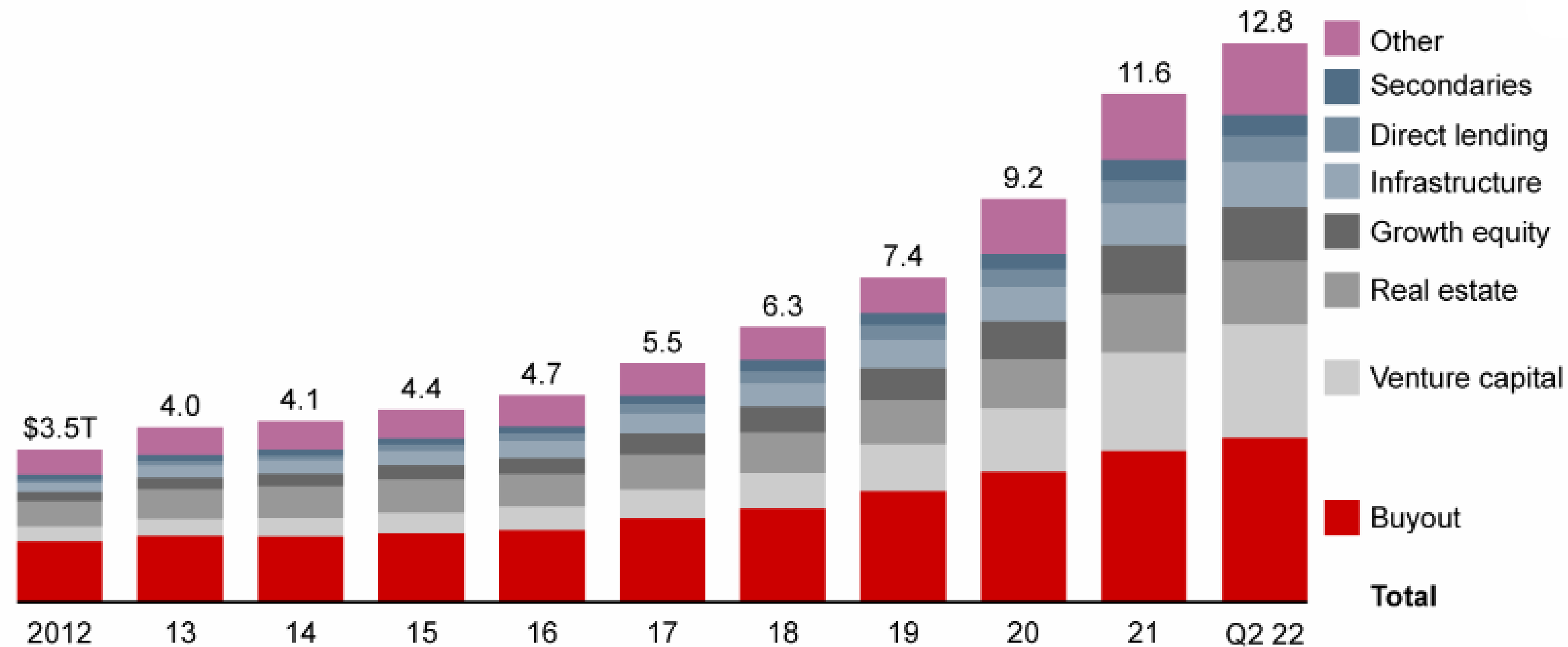
The Economics of Buyouts

Michael S. Weisbach

Private Capital is Incredibly Important



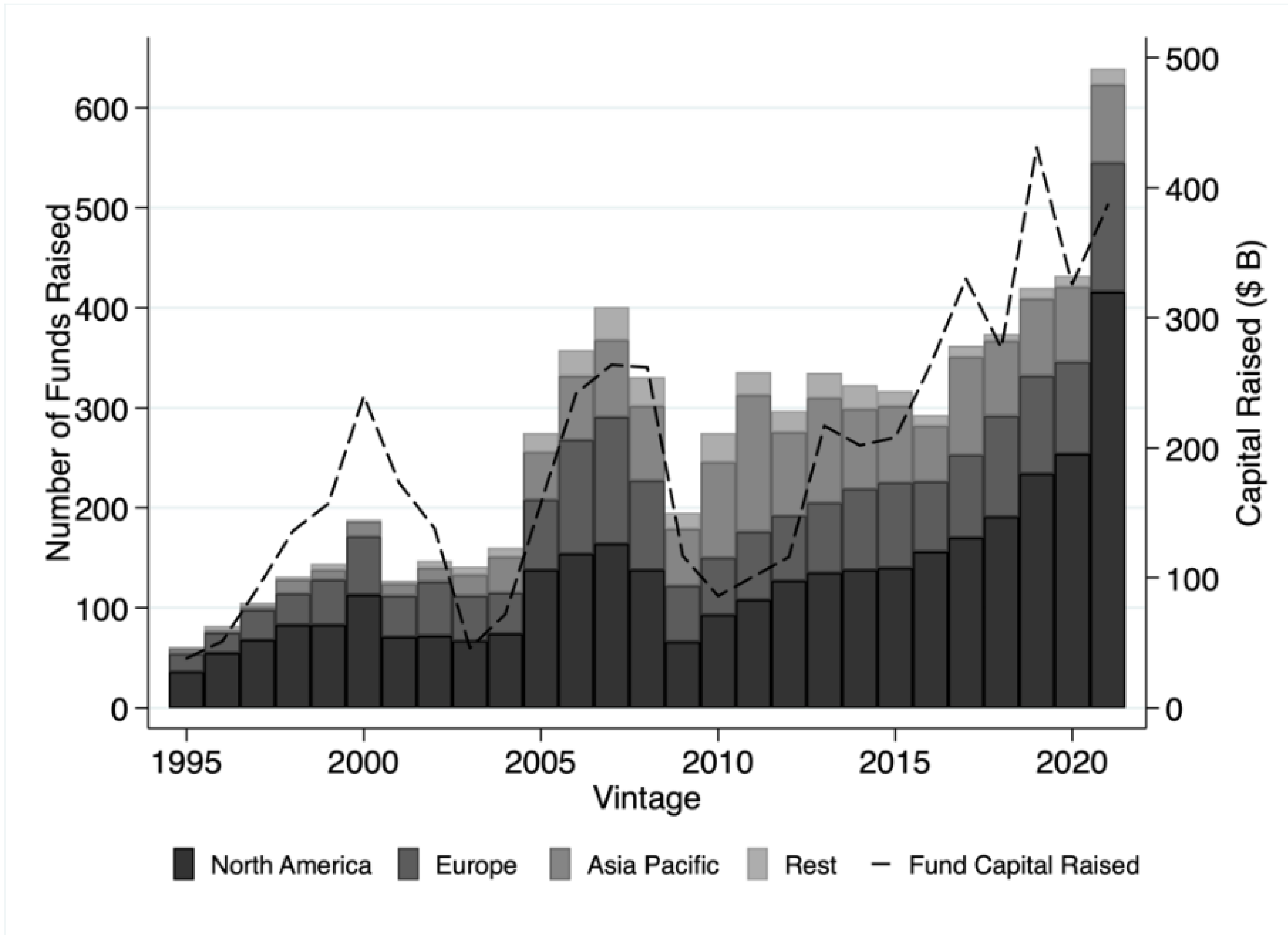
Source: Bain & Company "Private Equity Outlook in 2023: Anatomy of a Slowdown"

Private Capital is Incredibly Important

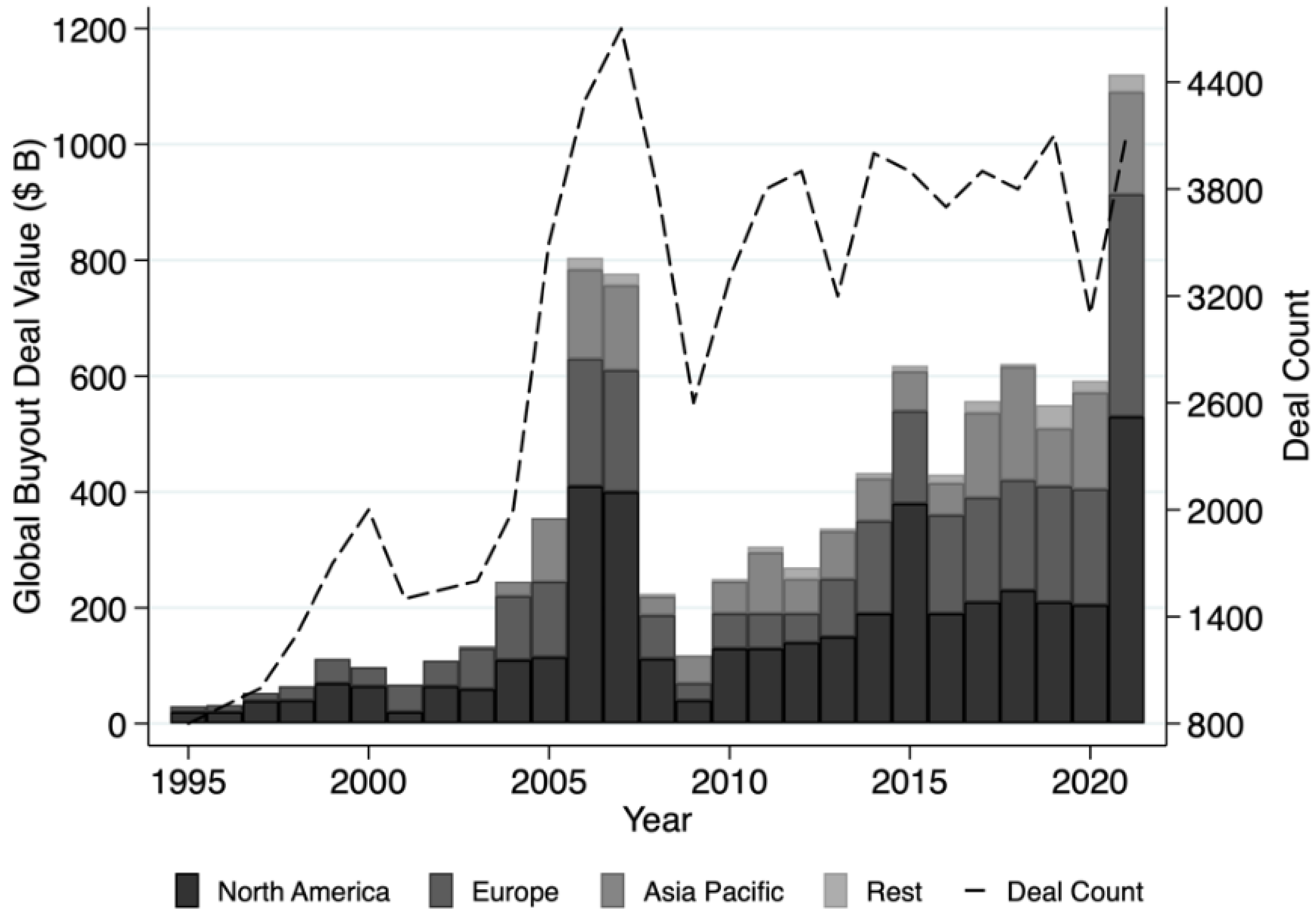
- In the US, private capital market raise about $1 trillion each year
- About half is in buyouts
- Why?
- What is it about buyout market that makes them such a powerful financing vehicle?
- What does the future hold for buyout market?

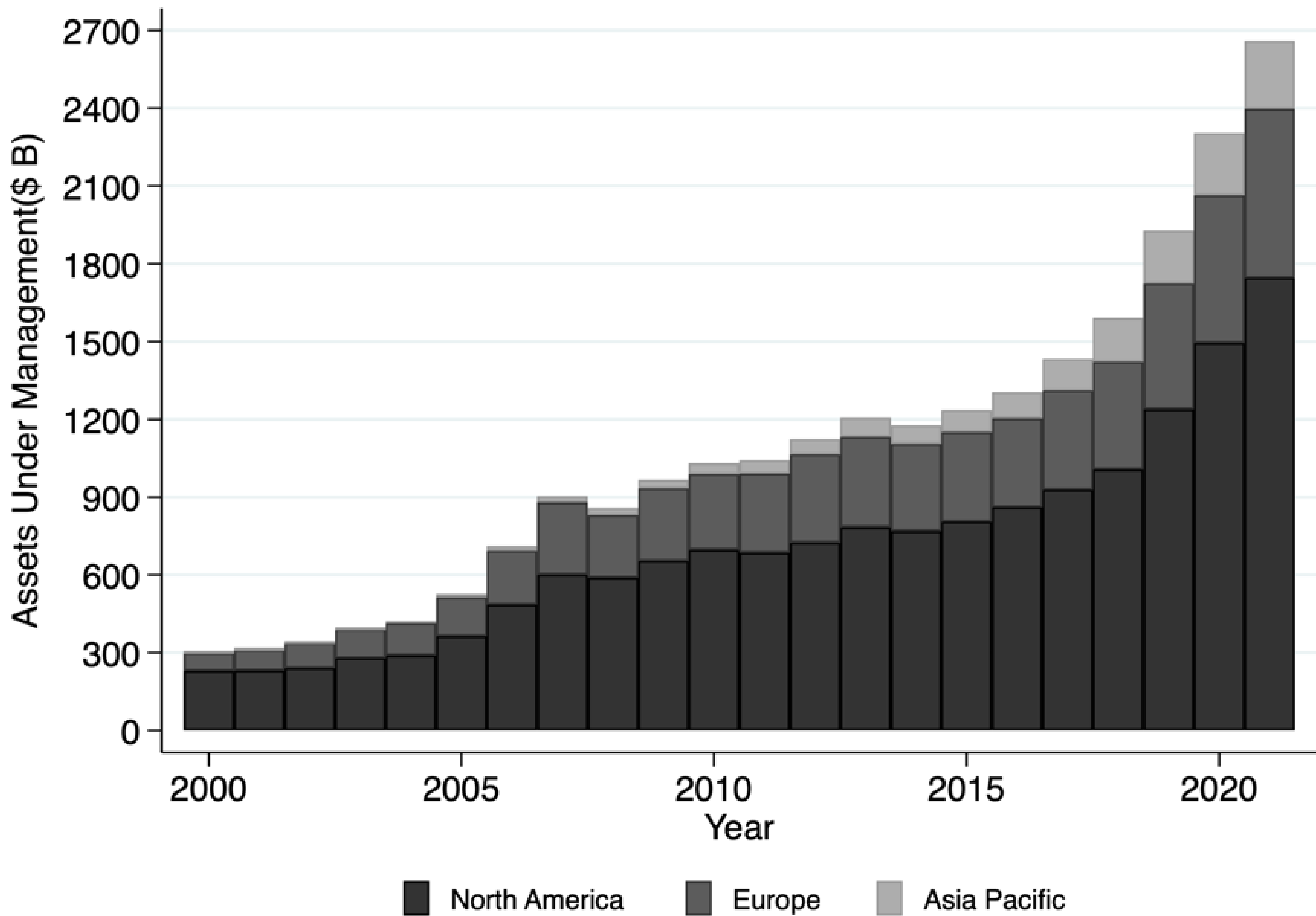
This Talk

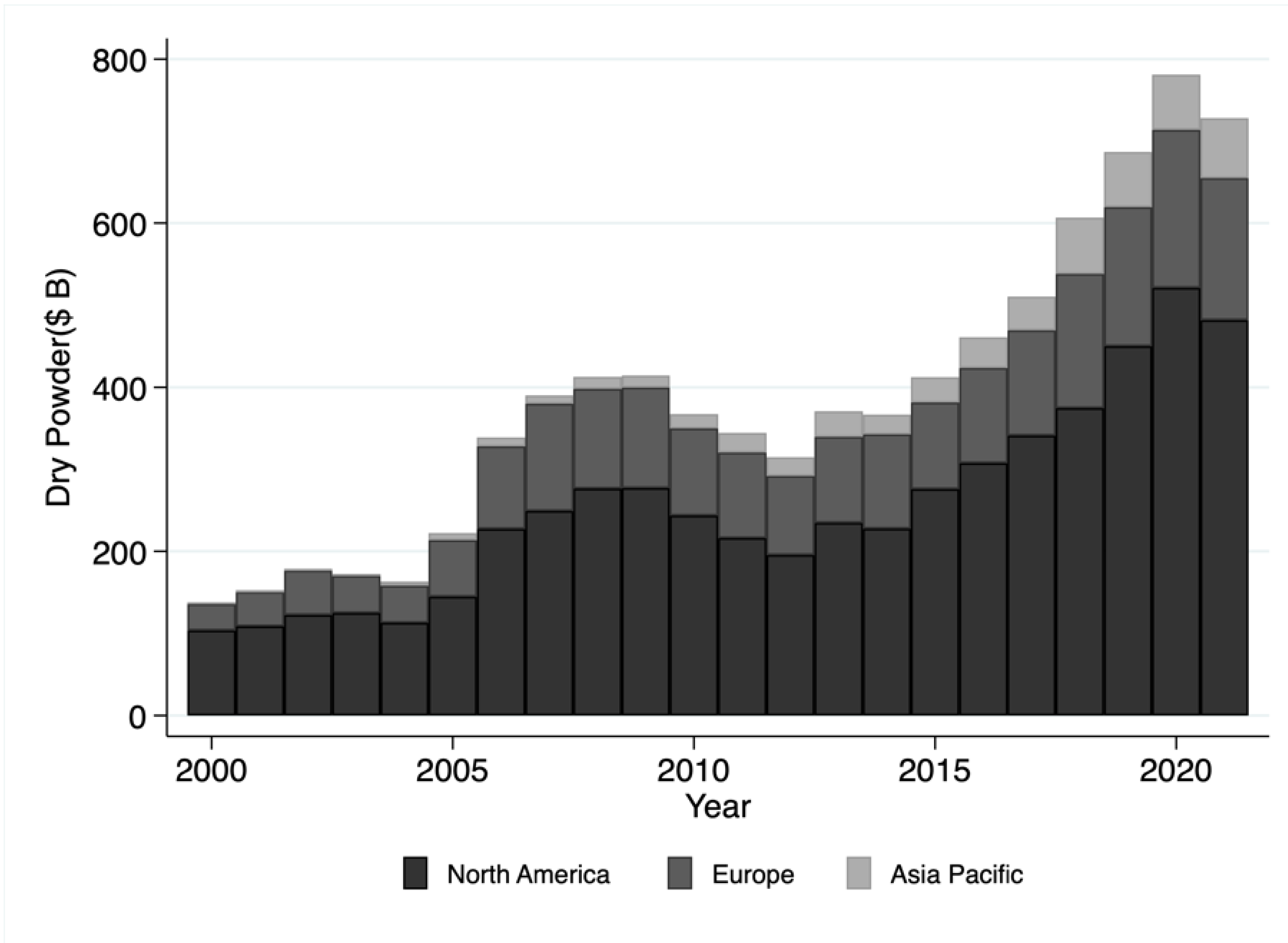
- Present some facts about the buyout market
- Explain the economics of the buyout market
- Discuss why buyouts have become such an important phenomenon
- Present some common strategies used by buyout firms
- Speculate on the future of private vs. public capital market.



Number of Funds Raised
0
100
200
300
400
500
600
Capital Raised ($ B)
0
100
200
300
400
500
1995
2000
2005
2010
2015
2020
Vintage
North America
Europe
Asia Pacific
Rest
Fund Capital Raised


Global Buyout Deal Value ($ B)
1200
1000
800
600
400
200
0
4400
3800
3200
2600
2000
1400
800
Deal Count
1995
2000
2005
2010
2015
2020
Year
North America
Europe
Asia Pacific
Rest
Deal Count


Assets Under Management($ B)
2700
2400
2100
1800
1500
1200
900
600
300
0
2000
2005
2010
2015
2020
Year
North America
Europe
Asia Pacific


800
600
400
200
0
Dry Powder($ B)
2000
2005
2010
2015
2020
Year
North America
Europe
Asia Pacific

The Nuts and Bolts of Buyouts

- Buyouts are Usually Done Through "Funds"
- Long-Term Commitment (usually at 10 years) for Investors (LPs)
- Sometimes possible (but expensive) to exit position
- Delegate all decision rights to Fund Manager (GPs)
- Fees are high:
  - Management Fee (normally 2 %)
  - Carried Interest (normally 20%)

To induce investors to provide capital, returns must be high enough to offset:

- Illiquidity
  - Capital is tied up for 10 years, sometimes longer
- Risk
  - Buyouts typically use at least 50% debt to total capital. Leads to a "beta" of about 1.7.
- Fees
  - Gross returns must be high enough so that after subtracting "two and twenty", investors are still satisfied.
- GP is operating with "one hand tied behind his back"!

Given these costs, why do investors provide capital?

- Returns historically been good.
- Average TVPI (1995-2021) is about 1.6 for US buyout funds, 1.5 for European funds, and 1.4 for Asian funds
- Average PME (1995-2001) is 1.17 for US funds, 1.26 for European funds, and 1.07 for Asian funds.

How do GPs do it?

- How do GPs earn returns sufficient to attract capital despite the hurdles they face??
- What is it about buyouts that attract so much capital?
- Answer: Corporate Finance!!
- They can make valuable investments that simply cannot be made through traditional financing vehicles.

Finance 101

- Management proposes project.
- Calculates NPV.
- If NPV is positive, then they go ahead with project.
- Typically, would finance with debt if project is relatively safe and has collateralizable assets.
- Would finance with equity if the project is riskier
- Works well if project is something that current management and firm can adopt without external supervision.

“Conditional” Projects

- Many potential projects are what might be called “conditional” projects.
- These are projects that are positive NPV only if certain conditions are met.
- For example, an acquisition might be positive NPV only if there is a management change, a divestiture, or a change in operating strategy.
- If existing management will not enact the changes, then the project is not positive NPV.

What is a "Conditional" Project?

- Supposed a company is worth $30 per share with current management/policies"
- Could be worth $50 per share if there is a:
  - Management Change
  - Divestiture of a Manager's favorite division
  - Increase in debt that forces manager to cut back on unnecessary expenditures.
- Acquiring such a company would be positive NPV if one of these conditions are met.
  - Likely to be met with a buyout but not with current management.

Buyouts and Conditional Projects

- Buyouts usually give control to highly motivated, knowledgeable GPs.
- Can take projects that are positive NPV conditional on managerial actions.
- These are projects that can be financed through buyouts but not through traditional finance.

What can GPs do that small shareholders, banks, or bondholders can't do?

- Can manage firms actively.
  - Change management teams
  - Change operating strategies.
- Can be flexible in their investments (acquire different securities)
- Have strong incentives to increase value of portfolio companies
- There are a number of strategies GPs use to increase value

Strategy 1: Reduce free cash flow

- Buyouts increase leverage significantly
  - interest payments reduce free cash flow
  - focus management on generating profits and reduce wasteful expenditure .
- The ‘classic’ strategy, as articulated by Jensen (1986)
  - Still adopted in most buyouts.
  - But such ‘financial engineering’ can be done by any GPs, it is only now a competitive advantage relative to corporate acquirers.

Strategy 2: Refocus operations

- Identify and sell non-core assets
  - allowing increased focus on the core business
- Many companies become complex portfolios of different businesses
  - They have few synergies
  - They only reduce idiosyncratic risk for mgmt & investors
  - Investors can diversify at much lower cost
- Buyout funds can reassess the importance of each asset
  - free from any legacy decisions or arguments
  - sell or close down non-core assets

Strategy 3: Enhancing executive management

- Replacement of Chair, CEO or other senior executives
- Common for the buyout fund to bring in one of its roster of 'operating partners' to chair the board.
- The suitability of the C-suite will be a key focus of due diligence
- Successors are normally proven industry experts
  - especially those familiar with the demands of working with buyout fund owners.

Strategy 4: Operational efficiencies

- Common strategies involves
  - Improving IT systems to enhance management information,
  - Increasing out-sourcing,
  - Renegotiating supplier contracts,
  - Closing less efficient plants
  - Worker layoffs

- Such 'operational engineering' trumps 'financial engineering'.

- Reductions in employment are often focused on less productive establishments, with more productive parts of the business growing.

Strategy 5: Scale economies

- Roll-ups of fragmented sectors and accelerated expansion
- Also often involves add-on acquisitions in fragmented sectors
  - can often be achieved at low valuation multiples relative to the market leaders
- Can also be achieved by taking a domestic business to other international markets, and by accelerating expansion within existing markets.

Strategy 6: Corporate orphans

- Divesting business units from large conglomerates that are marginalized from the core business
- Many conglomerates have businesses with loose economic logic tying them together
- The corporate orphans (the more peripheral business units)
  - Suffer from a lack of attention from the board
  - May be starved of funds to invest in the business
  - Acquiring such business units from their parent company and giving them full attention has been an important strategy for buyout funds.

Strategy 7: Privatization

- Taking state-owned enterprises into the private sector

- State-owned enterprises frequently lack
  - Autonomy
  - strong management
  - access to finance

- Buyout funds can be an alternative to public listing of such businesses
  - Especially where the management needs to be improved
  - Where assets that have not traditionally been owned privately.

Strategy 8: Transition in ownership

- Enabling transition from individual- or family-owned companies

- Businesses that grow and flourish without ever becoming public companies
  - Can often have concentrated ownership
  - Can face challenges in successions
  - Can benefit from more professional management.

- Win-win solution
  - Buyout funds can bring in management expertise and create value
  - Founders can exit and cash out

Strategy 9: Distressed investments

- Buying companies that are facing financial distress

- A specialist strategy, as it requires a different set of skills on
  - acquiring and re-negotiating particular tranches of debt
  - restructuring existing fixed commitments, such as property leases or supplier
  - dealing with legacy pension liabilities

- Funds focusing on such strategies referred to as distressed debt funds, but they often become the dominant equity owner in the same way as a buyout fund.

Strategies and Conditional Projects

- Traditional Finance works well for projects that existing management can propose and operate
- The 9 strategies I detailed (and many others) could be called “conditional”, in that they are only value-increasing if certain conditions are met.
- Such investments can be accomplished by buyouts but not traditional finance.

What does the future hold, for buyouts and private capital more generally?

- Private Capital markets can finance conditional projects that cannot be financed by traditional finance.
  - But is much more expensive.

- Future importance of private capital will depend on the value of conditional investments vs unconditional investments!

My Prediction: Private Capital Markets will continue to grow rapidly!

- As world becomes more complicated, more and more investments will be "conditional".
- New technology will advance at an increasing rate, which will lead to new venture backed companies.
- New kinds of funds appear all the time (all of which are based on conditional investing).
  - Secondary Funds
  - Continuation Funds
  - GP-Stakes Funds

Tim Jenkinson's Mantra

- "Private capital markets are at least as important and far more interesting than public capital markets in the Twenty-First Century Economy."

Thank You!