FUNDING THE MEGA-DEAL

DAVID LATTER OF APAX PARTNERS EXPLAINS HOW THE SPECTACULAR GROWTH IN PRIVATE EQUITY MARKETS IN RECENT YEARS HAS GIVEN RISE TO A NEW BREED OF TRANSACTONS.

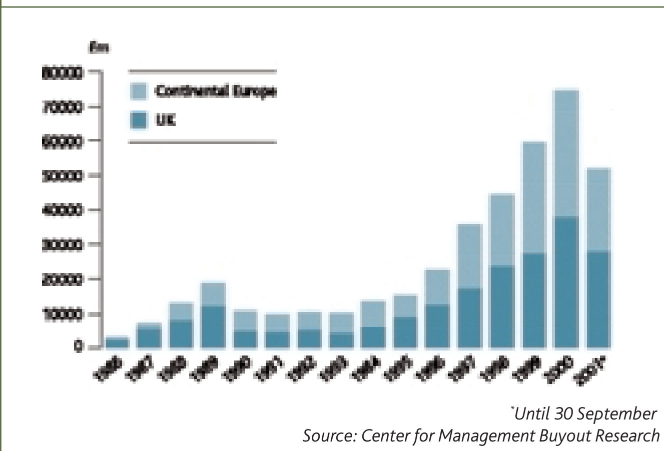
The growth in private equity markets in recent years has been nothing short of spectacular. Last year saw a record £23.4bn of transactions completed in the UK, and a figure close to this amount is expected for 2001. This compares with £5.8bn in 1995 and represents a compound annual growth of 33% over the past five years (see *Figure 1*). The increasing scale of buyout transactions, and the significant returns that have been achieved on the best buyout funds, has fuelled the raising of ever-larger funds over this period. The first jumbo (more than €1bn) European fund was raised in 1998. Just three years later there are more than 20 such funds (see *Figure 2*), and an estimated €60bn-plus of private equity money available for investment. Assuming a typical capital structure of 40% equity and 60% debt, this translates into €150bn of deal capacity in the market.

FOLLOWING THE ECONOMIC CYCLE. However, in contrast to the pace of fund-raising, the pace of investment into buyouts has started to show a decline for the first time in nearly 10 years. A total of £4.5bn of transactions were completed in the third quarter of this year, down 37% from £7.1bn the previous quarter and down 50% from the third quarter of 2000. It is not clear whether this downward trend will continue and, anecdotally, there are large numbers of transactions in the pipeline. However, it is interesting to note that in the past buyout activity has generally followed the economic cycle, as evidenced by the dramatic fall-off in volumes between 1989 and 1990 (see *Figure 1*).

One view is that, as corporate activity slows and lending banks tighten their belts, buyout activity will inevitably follow the trends in the wider mergers and acquisitions (M&A) market. UK M&A volumes fell by more than 80% in the first half of 2001, compared with the first half of 2000 – albeit that much of this fall was accounted for by the inflated value of paper transaction valuations in 2000. If anything like this pattern is replicated in the buyout markets, this would imply a significant amount of over-capacity in the market.

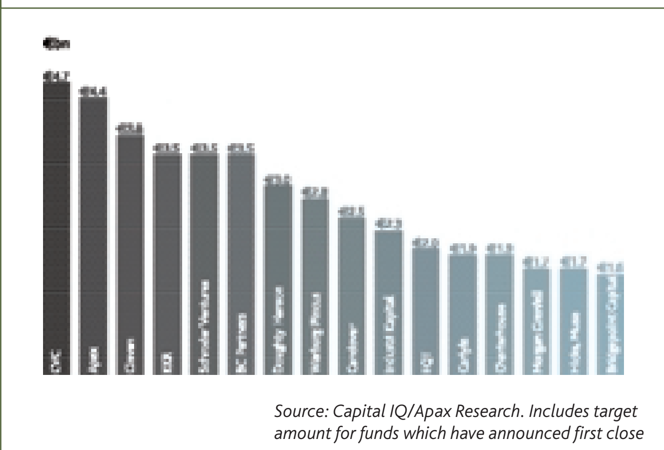
There are, however, a number of reasons not only to disbelieve this view, but to think that the current environment may actually create more attractive opportunities for private equity houses than ever before. Many of these opportunities are likely to come from

FIGURE 1
UK AND CONTINENTAL EUROPE BUYOUT VOLUMES.



*Until 30 September
Source: Center for Management Buyout Research

FIGURE 2
CURRENT EUROPEAN PRIVATE EQUITY FUNDS.



Source: Capital IQ/Apax Research. Includes target amount for funds which have announced first close

☐ **CASE STUDY: YELL GROUP LIMITED.** In May 2001, Apax Partners Funds, together with Hicks, Muse, Tate & Furst, acquired Yell from BT, for £2.14bn. Yell is a leading provider of classified advertising directories and associated products and services, principally to small- and medium-sized companies and consumers in the UK and the US. The company operates through print, telephone and internet-based media and includes the Yellow Pages, the UK classified advertising directory business, and the US-based Yellow Book, a sector-leading yellow pages publisher in the US. In the year ended 31 March 2001, group turnover was £774.3m and Ebitda was £234.2m. The total acquisition price therefore represented 9.1x Ebitda.

☐ **THE EQUITY STORY.** Yell has a number of characteristics as a business which make it an attractive asset for the equity funders:

- the classified advertising directories market is a large, growing market worth about $24bn worldwide;
- Yell owns the leading classified advertising directory business in the UK;
- directory advertising is considerably more resilient than other forms of advertising during a recession;
- there is a high degree of revenue visibility within the directories business and therefore a high degree of Ebitda predictability within the business; and
- the growth potential of the business is enhanced by Yellow Book, the market-leader in the rapidly growing independent directories sector in the US.

One of the main challenges to managing this business will be the new regulatory environment. The UK Office of Fair Trading (OFT) has determined that the consumer oriented Yellow Pages directories business does not have effective competition in the UK. As a result, Yell is required to reduce advertising prices by RPI -6% a year from January 2002. Some of the impact of this reduction will be offset by increasing volume and trading customers up to higher value advertisements.

☐ **THE FINANCING PACKAGE.** Despite the potential negative implications of the OFT pricing regime, the predictable nature of Yell's cashflows made it highly attractive to the banking markets. A total debt multiple of 6.2x Ebitda was achieved through a £1,450m debt package underwritten by Merrill Lynch, CIBC and Deutsche Bank. The package consisted of £950m of senior debt facilities and £500m in a bridge to a high yield bond. Equity of £550m, a working capital facility of £100m (of which £40m was drawn at completion) and a vendor loan of £100m from BT completed the capital structure.

There was a high level of demand for the senior syndication, which completed in July. The senior piece comprised a £600m A tranche priced at 2.375%, a £175m B tranche priced at 3%, and a £175m C tranche at 3.5%. The high yield comprised tranches of £250m and $200m priced at 10.75%. A third tranche was issued at a discount of 52.133% on a face value of $288.25m. Interest is not paid but accrues at 13.5% for the first five years and then becomes payable in cash at 13.5% on the face value of the bond. This non-cash-pay element in the high yield financing was integral in the setting of cash-pay interest to Ebitda covenant ratios in the senior facility.

Demand for each tranche was strong, and the bonds have since traded up to 102-4 as at 22 November 2001, although trading is limited as many investors hold on to their positions. Benchmark rates have, of course, fallen since the issue but, even so, at these prices Yell's implied credit spread has narrowed.

☐ **CHALLENGES FOR TREASURY.** David Scriven, Treasurer of Yell Group, had a number of comments about the particular challenges of buyouts for the treasury function, both in terms of the transaction itself and managing the business going forward. A key determinant of treasury strategy at Yell is the covenant structure. Buyout covenants are typically set to give 20% headroom on the company business plan. This compares with an estimated 50% headroom that might have been available to Yell as a demerged BBB entity. Hedging out interest and currency rates exposure enables the full 20% headroom to be available for operational variance. Yell opted to hedge the full amount of the senior interest with a 27-month swap taken out soon after completion. They were dealt at approximately the same interest rates as had been assumed in the banking covenant model.

Currency exposure in the business is limited because the Yell Group operates as two distinct domestic businesses, in the UK and in the US. Covenants, however, are set in sterling, so there is some currency translation exposure to the extent that the sterling and dollar components of ratio numerators and denominators differ. The US business is expected to contribute a greatly increased proportion of group Ebitda in the future, and currency hedging is therefore focused around adverse movements of the dollar.

Scriven also commented on the complexity of completing a buyout transaction of this scale. Timescales are typically compressed and detailed reviews of documentation mechanics are often left until late in the day. In order of importance, the documents with the most direct impact on the treasury function are the senior banking facility, the inter-creditor agreement and the bond indentures. Complex accounting and administrative arrangements have to be set in place to support the provisions and undertakings agreed in often wide ranging multi-party negotiations. Treasury input into these documents at an early stage helps to ensure that treasury specific issues do not fall between the cracks and that the final agreements, while commercial and creditworthy, are also workable.

Complexity aside, Scriven had found in general that the concentrated shareholder base in a buyout made it far easier to get a clear view on policy from shareholders. Private equity shareholders are real rather than apparent, unlike the Belgian dentist or the man on the Clapham omnibus. Finally, the complexity of putting together a high yield offering memorandum should not be underestimated, and it is a credit to the company that it managed to get the issue away just over a month following completion.

'THE NEED FOR COMPANIES TO PARTNER WITH PRIVATE EQUITY HOUSES IS LIKELY TO BE GREATER THAN EVER'

companies looking to realign their strategic initiatives and/or raise capital. There are numerous examples of companies that borrowed heavily during the recent bull run to fund acquisition strategies that proved to be over-ambitious.

Faced with a deteriorating earnings outlook, these companies may struggle to service the debt they have taken on. Marconi, KPN and NTL are some of the most public examples of a problem that is concentrated in the telecoms sector, but is likely to stretch beyond that. Asset disposals from such companies provide an immediate opportunity for private equity funds. Private equity funds are better positioned than strategic acquirers to meet aggressive corporate timetables, and increasingly have the scale and experience to become credible purchasers for large corporate assets. A classic example of this is the recent £2.1bn purchase of BT's Yellow Pages businesses (Yell) by Apax Partners Funds and Hicks Muse Tate & Furst (see *Case Study*).

THE NEW CORPORATE LANDSCAPE. Aside from purchasing non-core assets, private equity firms will likely play a wider role in the restructuring of the corporate landscape, as partners to some major corporates. A recent example of this was Schroder Ventures' August 2000 deal to acquire electronics distributor Veba Electronics in partnership with distribution companies Arrow and Avnet. Schroders set up a consortium with the two trade partners and executed a simultaneous purchase and carve-up of the business, with Schroders retaining the Memec business unit for its own funds.

In general, the need for companies to partner with private equity houses is likely to be greater than ever, with public market valuations depressed and the new issuance market effectively closed for a large proportion of companies. Similarly, the public-to-private route can be expected to be increasingly attractive to a range of corporates finding their growth plans constrained by an unforgiving stock market.

The combination of these factors is likely to ensure a healthy deal flow for private equity funds over the years to come. Against this changed corporate background, however, the characteristics that go to make a successful buyout are largely unchanged. Most important of these remains the predictability of cashflows, enabling financial leverage to be applied to the business. This criteria being satisfied, the equity provider will look closely at the market position of the company, historical performance and future projections, and of course, the quality of the management team. Finally, it is desirable for there to be a 'blue sky' scenario for the company that could turn a good equity return into a potentially spectacular one.

David Latter is an Associate of Apax Partners Ltd.
david.latter@apax.co.uk
www.apax.com