STATE *of the* MARKET 2020

EVERCORE | Private Funds Group

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From Buy-Outs to Solution Capital: The Power of Partnership

by Christian Rochat, Clayton, Dubilier & Rice

Christian Rochat is a Partner at Clayton, Dubilier & Rice (CD&R), based in London, and has 24 years' experience investing in private equity. Prior to joining CD&R, Mr Rochat was a Managing Director at Morgan Stanley Capital Partners and a Director at Schroder Ventures (now Permira). Previously, he also worked in the London and New York offices of Morgan Stanley's Mergers and Acquisitions department. He holds a BA and PhD in Law from the Université de Lausanne, as well as an MBA from the Stanford Graduate School of Business.

More than ten years after the global financial crisis, the rise of private equity continues to appear unstoppable. This is particularly true in the case of buy-outs, where ever-rising fund sizes are matched by an increasing number of managers — both traditional GPs and new direct investors such as family offices or large pension and sovereign funds. The impact of growing competition and 'dry powder' has been well documented, with acquisition multiples rising, transaction processes getting shorter, and debt markets being tapped with greater proficiency.

Private equity managers have not stood still as they have scaled. They have seized the opportunity to build specialist skills and to tailor dedicated vehicles around new strategies: specialist sector or regional funds; longer-term, lower-return 'core funds'; and so on. While this proliferation is not entirely new, it creates a challenge for investors trying to assess risk–return prospects on a consistent basis and through a single framework, leaving aside the risk of portfolio fragmentation driven by increasing manager diversity. Where different investment mandates coexist under a single roof, they can also generate organisational and motivational complexity at the GP level.

In an industry that owes its success, in large part, to the entrepreneurial freedom of its agents, it is inevitable that there be as many strategic responses to the sector's evolution as there are managers. The most compelling strategic directions remain rooted in the simple precepts that have supported the buy-out industry since its beginnings: flexibility, alignment, and trust.

TRADITIONAL BUY-OUTS: AGENCY ISSUES AND THE INFORMATION ADVANTAGE

In the large cap segment, long gone are the days of the management buy-out (MBO), where management teams secured the acquisition of their business to then select the most willing private equity backer. The allure of this approach is easy to see: management teams enjoyed an unassailable information advantage, and their backer was able to harness this advantage while effecting a positive alignment between capital and management investors. Rather quickly, however, the 'auctioning' of management teams and the financial package races that ensued turned many adept executives from long investors into option holders. Their sponsors were forced to rely increasingly on their own underwriting and less tangible bonds of trust with management. At the same time, sellers were able to rely on competition among multiple bidders to neutralise management's information advantage; the institutional buy-out seemed to eclipse the MBO.

It is somewhat ironic that the rapid growth and maturation of private equity have brought back features of the old MBO in the context of ever more numerous secondary LBOs. Over the last few years, transactions between private equity sponsors have grown to account for roughly one-third of private equity exits. In these transactions, incumbent management often play a pivotal role in the selection of their new backer, with management packages serving as one of the key qualifying — or even deciding — factors. Yet the fierce competition over assets seen repeatedly in the market means that information advantages are harder to come by. Prospective investors now face some straightforward questions: are management more of a seller or a buyer? And if they are a buyer, is it on terms that will support an enduring partnership through good times and bad?

A proper answer to these questions requires more than being 'management's best friend' — it calls for an independent assessment of risks and opportunities that aligns with that made by a mature, sophisticated management team. At CD&R, we believe that such assessment needs to rely not only on the work and insights of a seasoned investment team, but also on the experience of proven operators who can see (and have seen) the world through the same lens as management. As such, our investment process generally involves a combination of CD&R's financial and operating professionals working together to build and underwrite our investment case, before helping management deliver this case through to exit.

Moreover, a successful partnership requires both sides to contribute their fair share towards the success of the joint enterprise. In today's world of almost limitless capital, private equity sponsors are expected to bring more than funds. They provide access to their often extensive networks; many come equipped with internal operating resources and a business improvement playbook; and they can deploy in-house M&A and financing capabilities to portfolio companies. In our experience, strong, confident CEOs really welcome a sparring partner who can accompany them on an unpredictable, multi-year journey — support them, but also challenge them when needed. Fulfilling this role calls for attributes not often associated in the public imagination with 'barbarians at the gate':

- Respect and integrity — these are the compass of productive long-term relationships.
- Patience and perseverance — trust is not built overnight, and is cemented in adversity.
- Loyalty and teamwork — there is no place on private equity boards for prima donnas and 'Monday morning quarterbacks'.
- Candour and courage — mutual trust allows, and calls for, hard truths and decisions.
- Creativity and passion — conceived as transition capital, private equity would not be able to justify its place without dedication to change and innovation.

It is no coincidence that the above attributes mirror the values we believe are enshrined in the CD&R partnership. They are explicit cultural and behavioural traits which have informed our strategy and execution since the firm's inception more than 40 years ago. We believe that such consistency has allowed firms such as ours not only to succeed in the evolving world of traditional buy-outs, but also to break the mould and extend our partnership model to owners and sellers of businesses.

SOLUTION CAPITAL: FLEXIBLE, COLLABORATIVE INVESTING

In the last decade, Bain estimates that private equity has accounted for between 9% and 11% of M&A transaction volume by number of deals.[1] In the overwhelming majority of cases, sponsors have been the sole buyer, alone or in partnership with other financial investors. Private equity has thus been providing significant liquidity to the M&A markets, giving owners greater comfort and flexibility to divest businesses when they wish to do so.

In a less visible but notable way, private equity has more recently developed an active role in tailoring collaborative transactions that respond to the special needs of business owners and do not fit within the straight sale–purchase model. This development has been particularly significant at CD&R, where more than 60% of capital invested over the last decade has been in so-called solution capital or partnership transactions, covering a range of needs and situations where, for example:

- Corporate owners decide to focus their resources and attention away from a line of business, but recognise that a full sale might be difficult or suboptimal because of depressed earnings or the organisation not being ready for a conventional M&A;
- Corporate owners recognise that fast-growing divisions could achieve their goals more rapidly as independent companies, but wish to retain a meaningful exposure to these divisions;
- Entrepreneurial management teams seek to access not only capital, but also operating and management skills to accelerate their growth and transformation;
- Family-controlled businesses are looking for a partner to help manage issues ranging from leadership transitions to growth and operational challenges; and
- Corporate and family-owned businesses seek a partner who can facilitate a strategic transaction.

In each of these situations, a collaborative effort between business owner and private equity sponsor is required to address the partners' needs in terms of upfront cash proceeds, valuation and capitalisation of the target, governance, joint vision for the business, and ultimate exit. The resulting highly customised transactions feature a variety of terms: investments in convertible preferred shares, or in ordinary shares; majority or minority stakes; LBO-style or corporate debt structure; varying dividend commitments, governance rights, put and call provisions, standstill clauses, etc. We believe the key requirements for the private equity sponsor are (i) a trust-based relationship with the seller, (ii) the ability to work creatively, flexibly, and patiently towards crafting the transaction, and (iii) the opportunity to contribute to value creation in the target.

A WIN-WIN SOLUTION

We believe the track record of partnership transactions is now sufficiently mature to confirm the value for both parties. For the seller, we believe these transactions deliver several benefits, including (i) a more certain, less disruptive process than a traditional auction, (ii) significant upfront cash proceeds combined with the retention of significant equity upside plus the benefit of private equity-led value creation, and (iii) the ability to accommodate leverage, dividend, governance, and other ongoing constraints it may face. For the private equity investor, we believe partnership deals help to achieve (i) a collaborative, more transparent due diligence process which reduces the information asymmetry between buyer and seller, and (ii) an alignment of interests favouring the settlement of a fair price and, post-closing, the fast and joined-up start of the value creation work.

The values of partnership investing have demonstrated the potential for renewal and lasting worth — and this bodes well for the future of private equity firms dedicated to such values.

1. *Bain & Company, Global Private Equity Report 2019, 2019.*