ACQUISITION FINANCE, DR M NAWAS

MASTERCLASS FUSIES & OVERNAMES, DR M NAWAS, 29 June 2021

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1. THE CURRENT CAPITAL MARKETS

LEADERSHIP,
ENTREPRENEURSHIP,
STEWARDSHIP

THE THEORY ON EXPECTED RETURNS

Follows the standard Capital Asset Pricing Model (CAPM):

$$R_i = R_f + \beta_i(R_m - R_f) + \alpha_i$$

- Risk-adjusted basis
- Starting point is the “risk free rate” R_f
- More risk = higher return

But, in practice the relationship between risk and return, more and more, is non-normal

INTEREST RATES ON THE DECLINE

EXPECTED INVESTMENT RETURNS, APRIL 2021

Risk Profile		R_f^*	Defensive → Very offensive				
Asset allocation	equities	0%	20%	35%	55%	75%	90%
	fixed income	0%	70%	55%	35%	15%	0%
	money	100%	10%	10%	10%	10%	10%
Expected Return**		-0.5%	1.4%	2.3%	3.4%	4.4%	4.8%
Standard deviation		0%	7.4%	9.1%	12.0%	15.2%	17.4%

*EONIA
**Geometric average return based on a 10-year horizon

Source:
ABN AMRO
MeesPierson

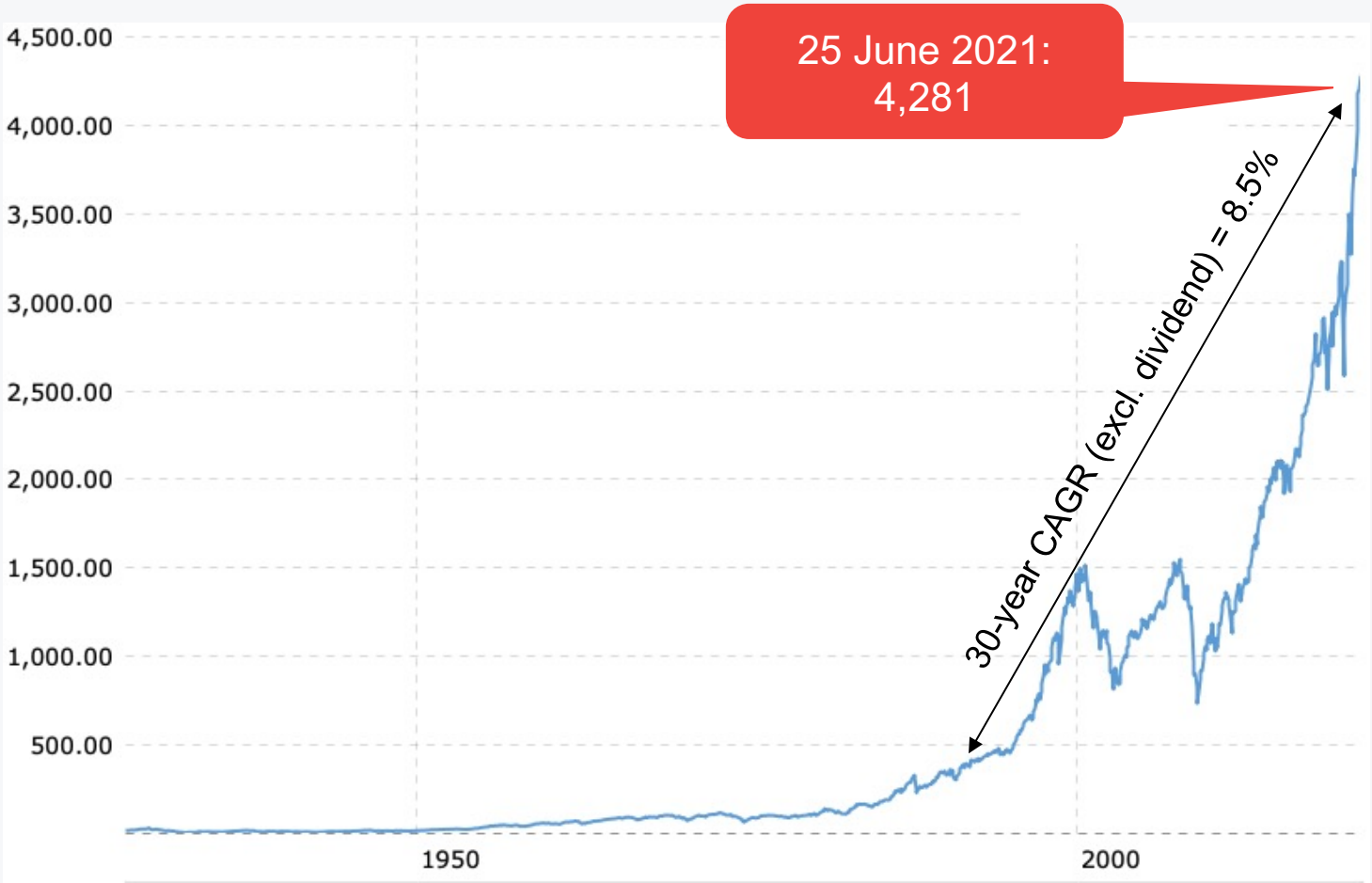
SOME CALCULATIONS

Risk Profile	R_f	Defensive → Very offensive				
Expected Return	-0.5%	1.4%	2.3%	3.4%	4.4%	4.8%
Risk Premium*	n/a	1.9%	2.8%	3.9%	4.9%	5.3%
Standard deviation	0%	7.4%	9.1%	12.0%	15.2%	17.4%
Sharpe Ratio**	n/a	25%	31%	33%	32%	28%
2 x standard deviation	0%	14.8%	18.2%	24.0%	30.4%	34.8%

*Risk Premium = Expected Return - R_f

**Sharpe Ratio = Risk Premium / Standard deviation

S&P500 SINCE 1928: GROWTH AND VOLATILITY

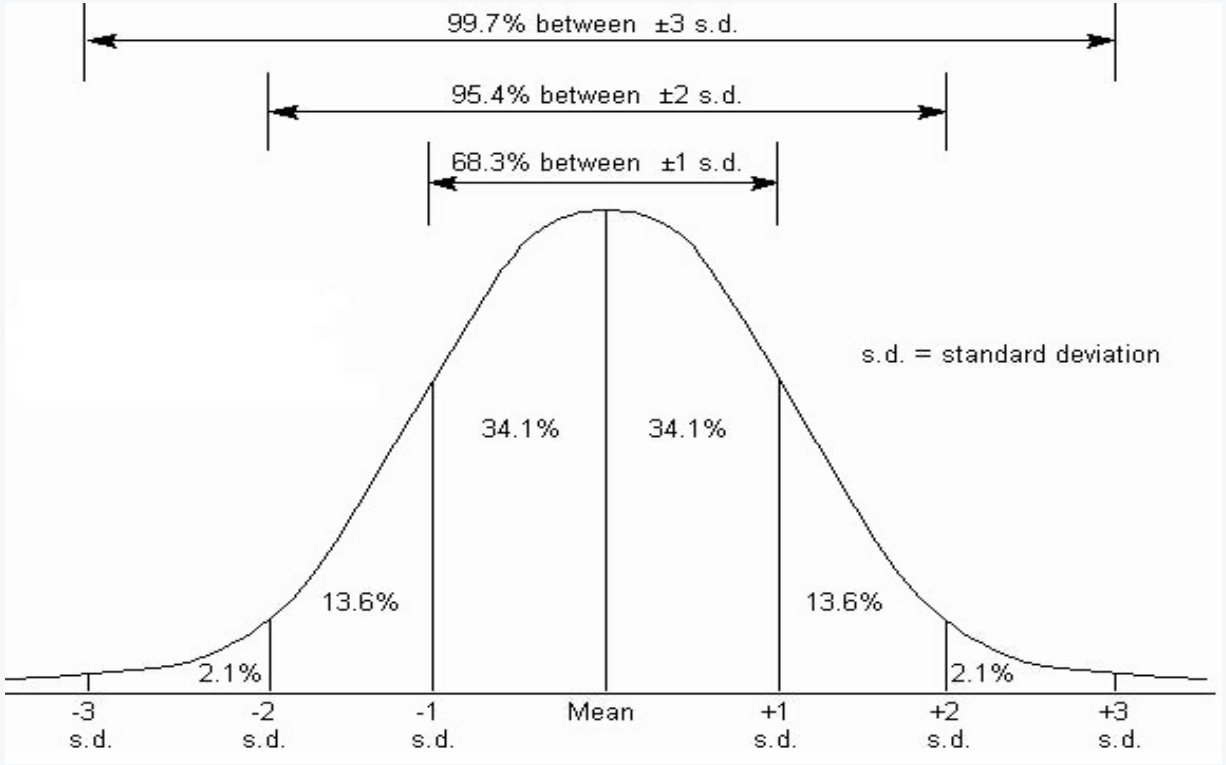


Source:
http://www.macrotrends.net/2324/sp-500-historical-chart-data

S&P500, INFLATION ADJUSTED

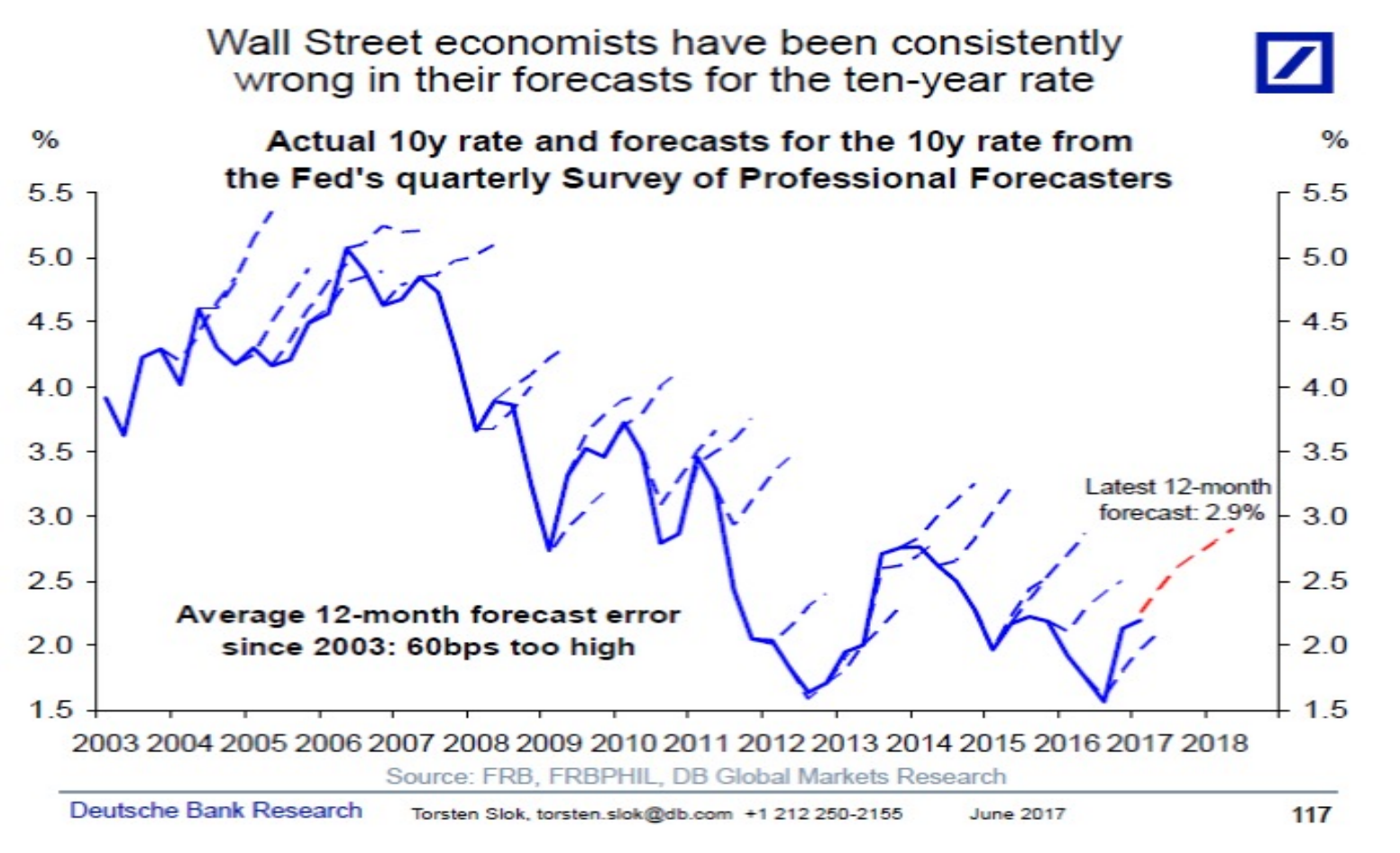
S&P500, INFLATION ADJUSTED AND LOGARITHMIC

MEAN, STANDARD DEVIATION, CONFIDENCE INTERVALS

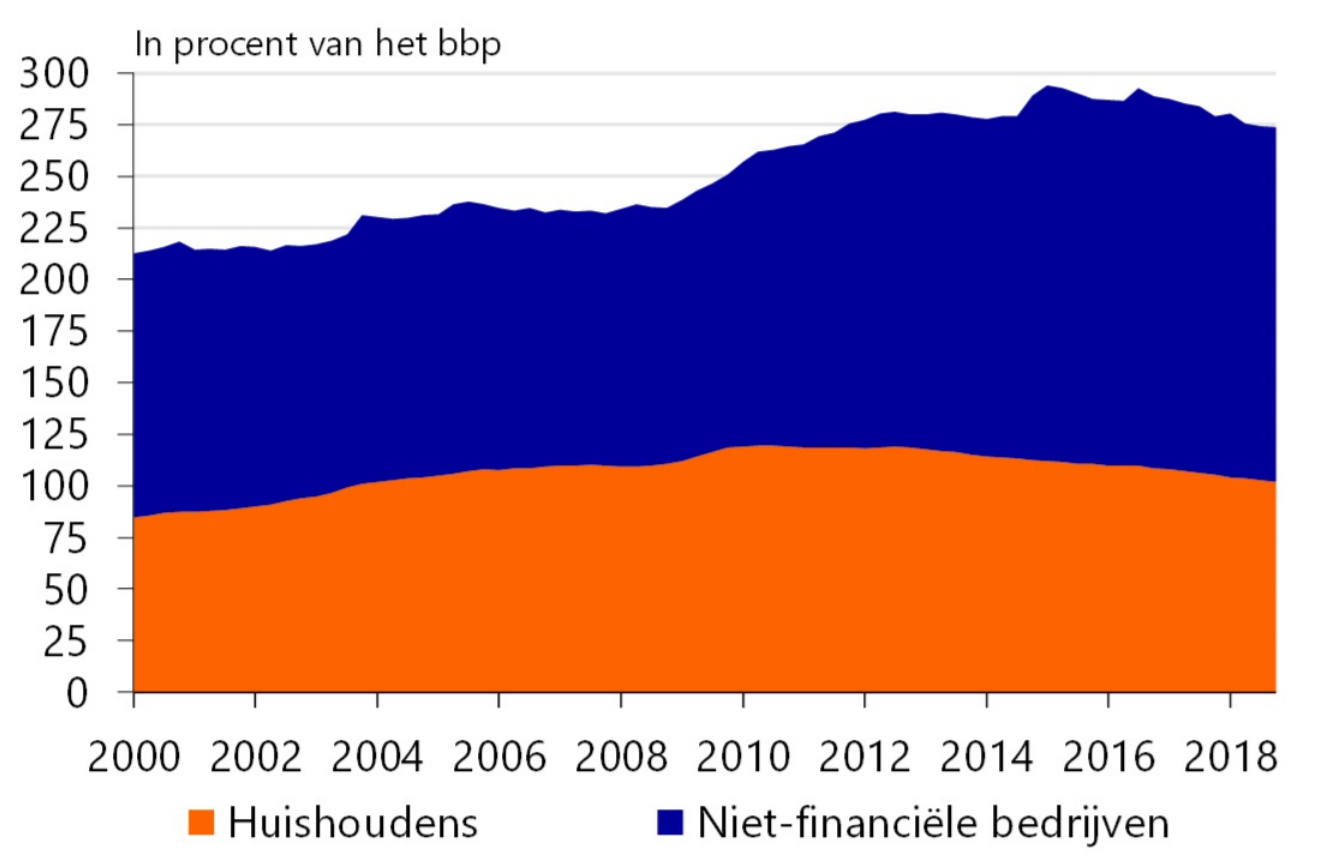


NORMAL DISTRIBUTION

WHEN WILL IT TURN?

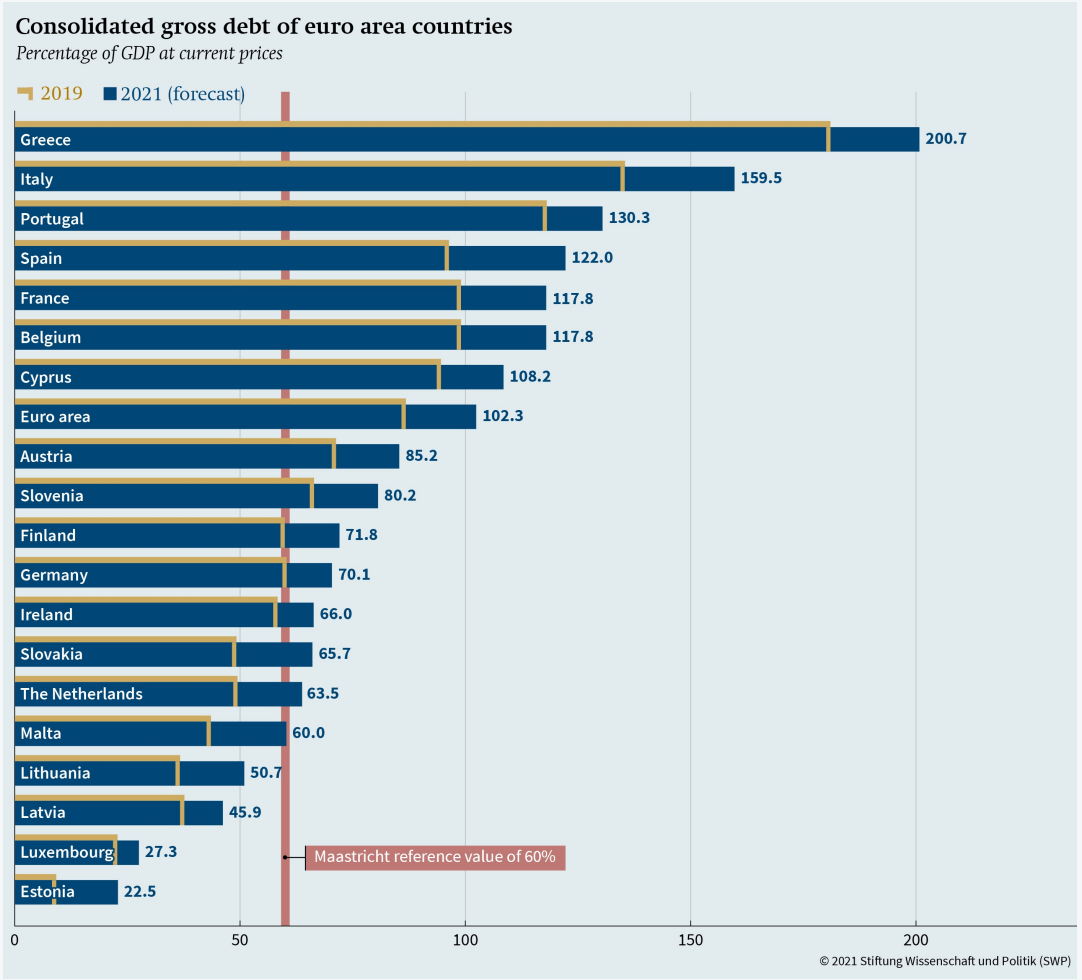


PRIVATE DEBT UP…



Source: RaboResearch 2019

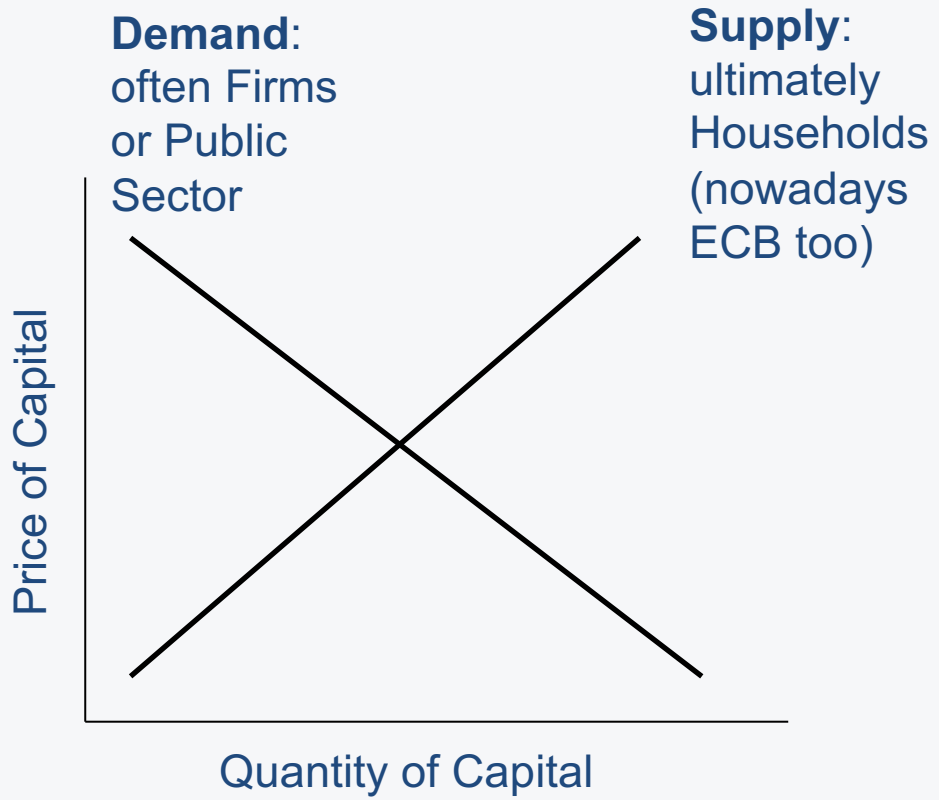
…AND PUBLIC DEBT UP



R_f LIKELY TO REMAIN LOW

More savings, due to higher life expectancy and higher income inequality

Less investments, due to lower population growth, government austerity and lower prices of capital goods



STRUCTURAL FEATURES CAUSING NON-NORMALITY

- Low interest rates move the market towards more risk-taking
- Increased herding behaviour, due to algorithmic trading
- Events “somewhere” have consequences “elsewhere”, due to globalization
- Hedge funds, with big leverage, can move the market
- Speculation leads to volatility leads to speculation and so forth..

IMPACTS ON THE FINANCING OF ACQUISITIONS

1. Acquisition prices may be inflated, so your timing may be wrong
2. Macro-economic recessions may come back and endure with a big effect on your business plan
3. Inflation risk: how will it impact your acquisition returns?
4. Volatility can outweigh fundamentals, so financial prognoses for acquisitions need to be stress-tested

2. ACQUISITION FINANCE

LEADERSHIP,
ENTREPRENEURSHIP,
STEWARDSHIP

LEVERAGED FINANCE

- The usual way of financing Leveraged Buy Outs (LBOs)
- Standard acquisition finance method for financial sponsors, also sometimes used for corporates
- A form of structured finance, but there are other forms too (e.g. CMBS at Great Wolf)

WHAT IS STRUCTURED FINANCE?

The application of financial structuring techniques to change a risk profile:

- To shift risks from one counterparty to another
- To “reverse engineer” investor or lender appetite
- To cater to varying risk/reward trade offs via tranching

VARIOUS GOOD REASONS TO ACQUIRE

- Diversify into a start up
- Scale up

- Merge for growth, market power or for cost saving

- Break up
- Spin off

- Re-engineer
- Re-finance

- Cash extraction
- Managed wind down

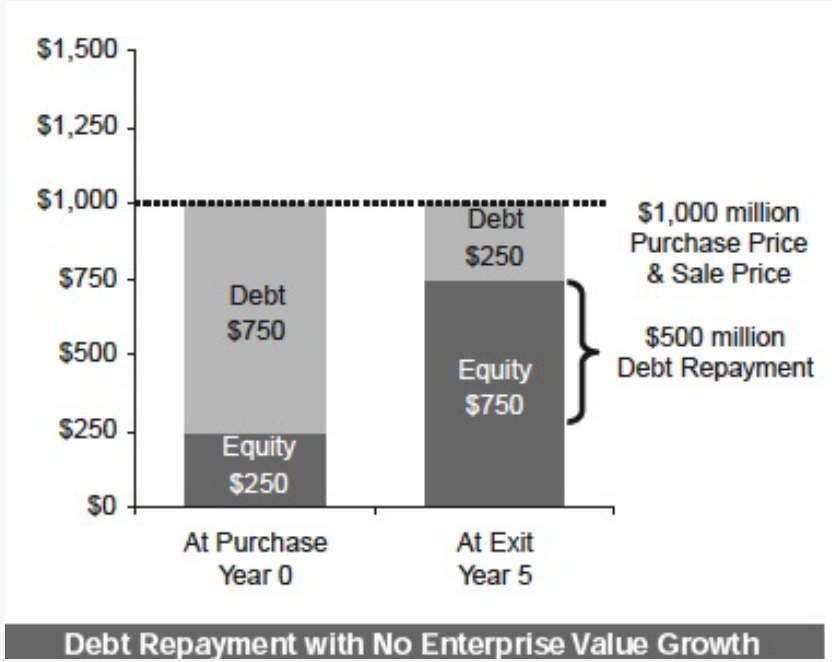
ACQUIRERS' MONETIZATION STRATEGIES

- Permanent integration, i.e. no "exit" so only for strategic buyers

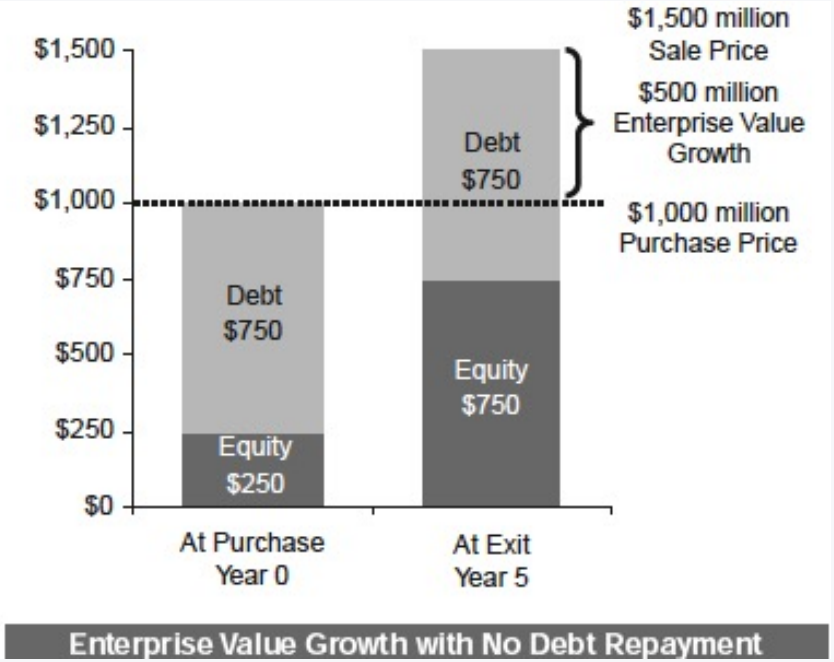
- De jure exits:
  - Strategic sale
  - SBO = Secondary Buyout
  - IPO = Initial Public Offering

- De facto exits:
  - Asset stripping
  - Managed wind down
  - Dividend Recapitalization

ENTERPRISE VALUE GROWTH, CASH RETURN, IRR



Debt Repayment with No Enterprise Value Growth



Enterprise Value Growth with No Debt Repayment

Cash return = 750/250 = **3.0x**
IRR = (cash return)$^{1/t}$ – 1 = $(3.0)^{1/5}$ – 1 = **24.6%**

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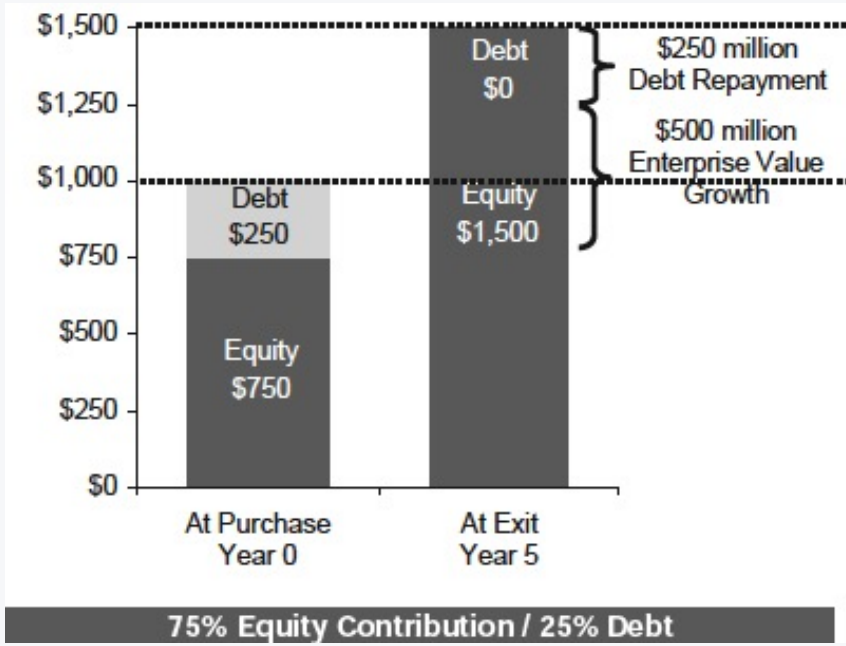
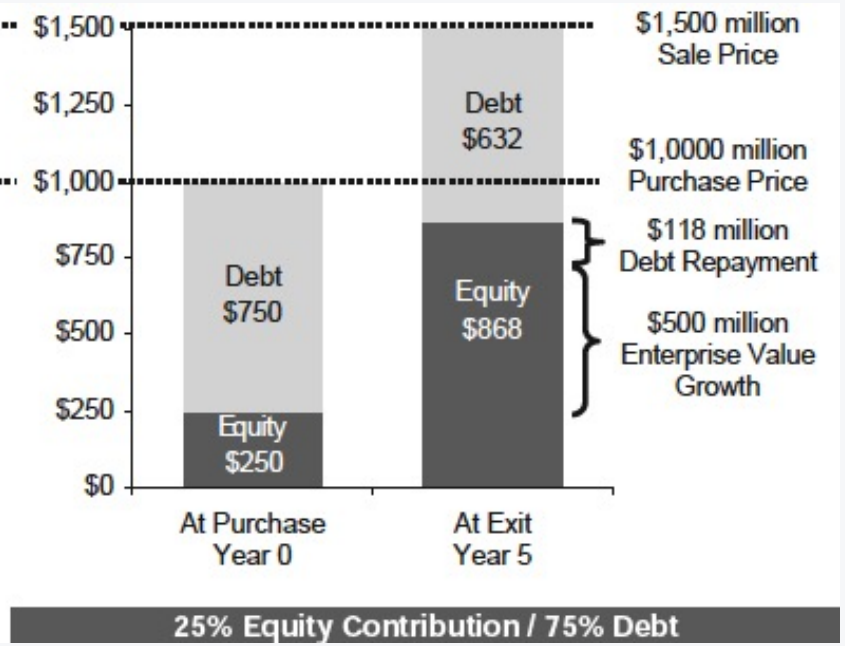
Note: these examples abstract from the difference in cost of debt between the two scenarios

THE RETURN INCENTIVE TO LEVERAGE





Cash return = 1500/750 = **2.0x**
IRR = (cash return)$^{1/t}$ – 1 = $(2.0)^{1/5}$ – 1 = **14.9%**

Cash return = 868/250 = **3.5x**
IRR = (cash return)$^{1/t}$ – 1 = $(3.5)^{1/5}$ – 1 = **28.3%**

Note: these examples abstract from the difference in cost of debt between the two scenarios

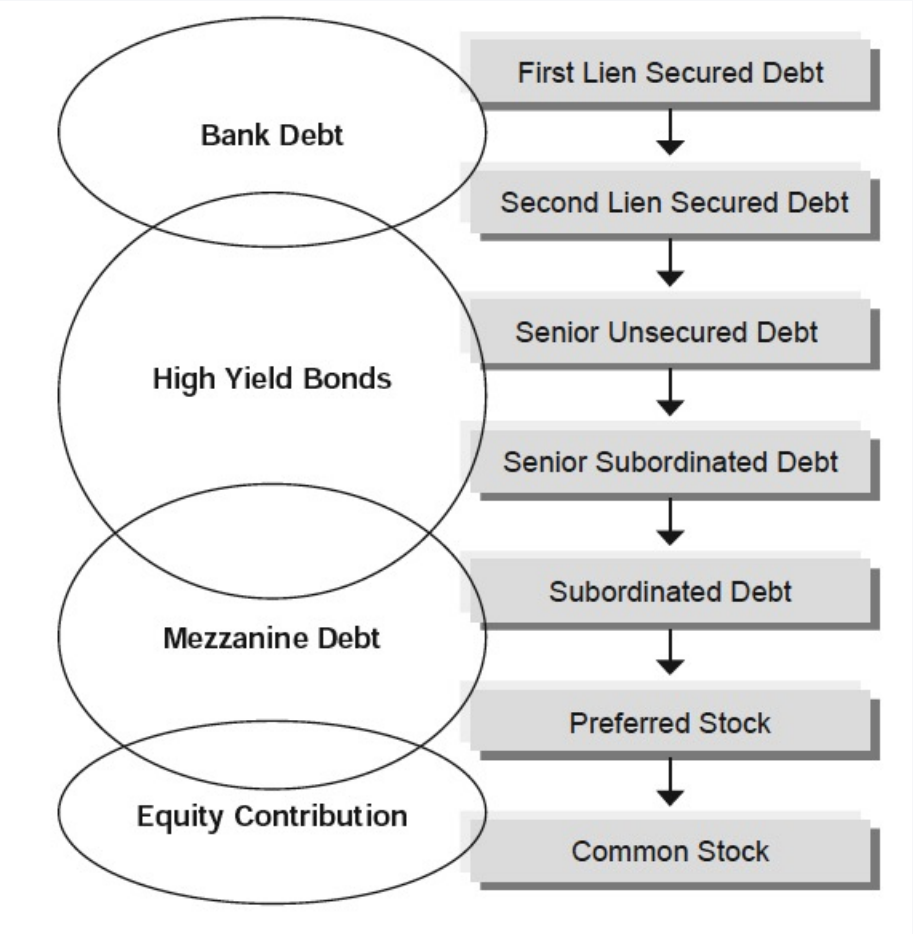
ACQUIRERS' RISK MANAGEMENT STRATEGIES

- Minimize initial and ongoing equity: the risk incentive to leverage
- Invest via funds rather than direct
- Spread portfolio across multiple funds
- Non-recourse financing of targets, or, better still, parts of targets

CHARACTERISTICS OF A STRONG LBO TARGET

- Strong cash flow generation
- Leading and defensible market positions
- Growth and bolt-on acquisition opportunities
- Efficiency enhancement opportunities
- Low capex requirements
- Strong asset base
- Proven management team

TRANCHING OF SOURCES OF FUNDS



TYPICAL FORMS OF BANK DEBT IN NL

- Depending on size: bilateral, clubbed, or syndicated
- **RCF** = Revolving Credit Facility: 5y committed, floating rate, 1st lien, flexible drawing, for working capital purposes
- **TLA** = Term Loan ”A”: amortizing loan, same tenor and pari passu with RCF
- **TLB** = Term Loan “B”: large 5-7y committed, fixed rate, bullet or balloon loans, 1st lien, for capex, placed with buy-to-hold investors

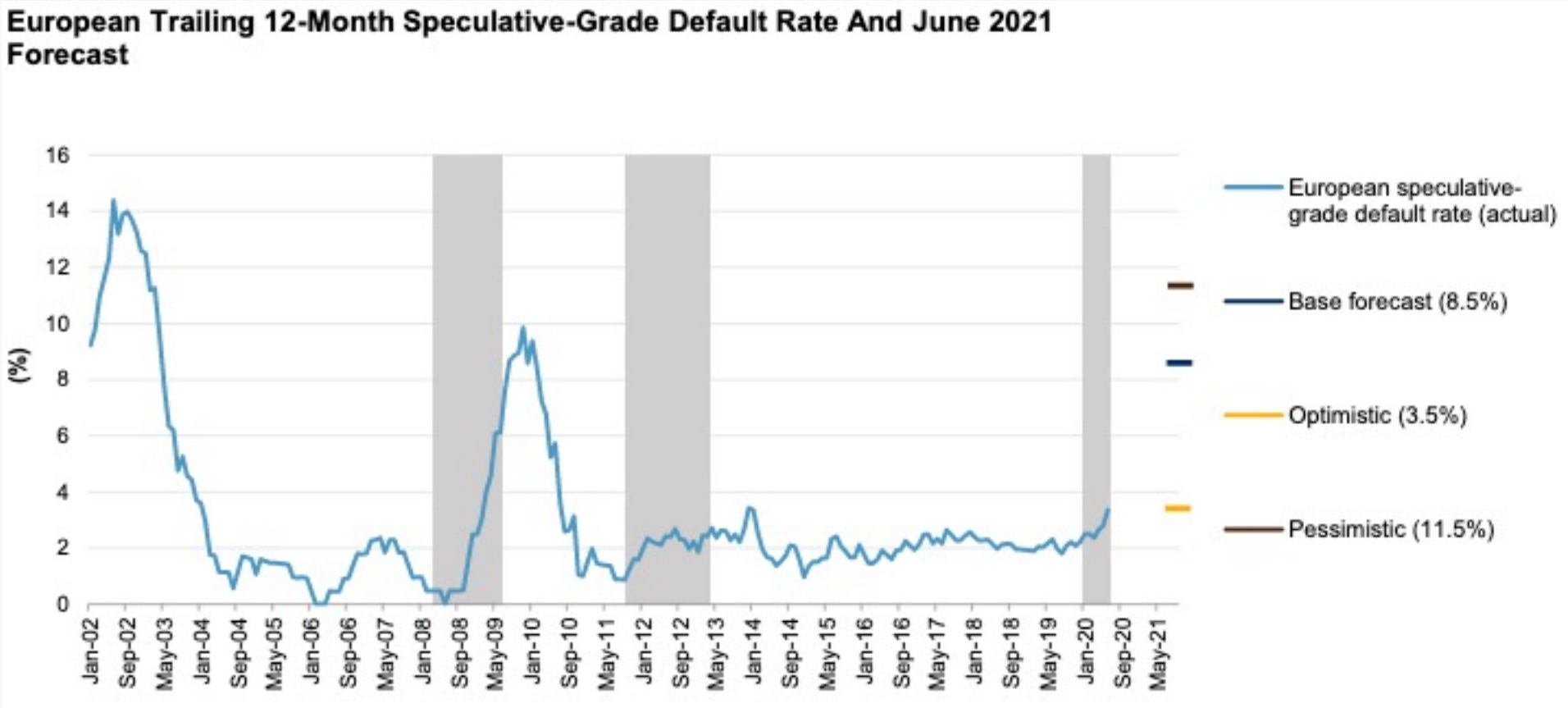
EQUITY AND QUASI-EQUITY

- **Mezzanine**: highly negotiated, 7-10 year quasi-equity, with specified limited voting rights, high margin either cash or PIK (Payment In Kind), sometimes with stock-options attached, placed with dedicated buy-to-hold investors

- **Sponsor equity**: common or preferred with full voting rights for the PE firm or acquirer

- **Management equity**: skin-in-the-game of the management team either by cash contribution or as performance-linked stock options

EUROPEAN HIGH YIELD DEFAULT RATES



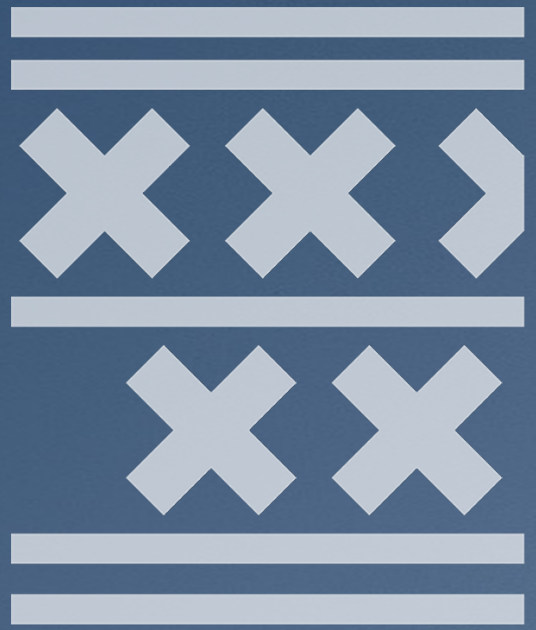
Source: Standard & Poor's 2020

STRUCTURED FINANCE PROS AND CONS

+ Ability to tailor supply of financial instruments to demand
+ Ability to increase overall leverage
+ Creates access to funding for companies who lack the access

- Complex
- Expensive to structure
- Less liquid

2. THE CENTERBRIDGE / GREAT WOLF RESORTS CASE



LEADERSHIP,
ENTREPRENEURSHIP,
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CENTERBRIDGE CASE – SUMMARY

- Great Wolf is a chain of water park resorts in the US. Originally family-owned, it went public in 2004 with a market cap of $600 million
- From 2004 to 2009, it grew from 4 to 11 locations
- From 2002 to 2011, it was consistently loss-making, despite considerable growth in EBITDA and EBITDA margin (Exhibit 3)
- In 2012 its market cap was $128 million. Apollo bought the 100% of the equity, after a bidding war, for $262 million. It assumed debt of c.$530 million, giving Great Wolf an Enterprise Value of $800
- In 2015 Centerbridge was considering paying an Enterprise Value of $1.35 billion

CENTERBRIDGE CASE – FINANCING PROPOSALS

- Centerbridge had two financing proposals:

  1. Traditional LBO financing arranged by Nomura, Macquarie and RBC:
     $575 million in corporate bank debt, and
     $250 million in high yield bonds

  2. CMBS financing arranged by JP Morgan Chase and Citibank:
     $500 million in senior CMBS notes, and
     $370 million in CMBS mezzanine

- The financings varied too in costs and covenants

CENTERBRIDGE CASE QUESTIONS (NL)

1. Welke verdienmogelijkheden zag Apollo in 2012 bij de acquisitie van Great Wolf Resorts?
2. Waarom zou Apollo in 2015 Great Wolf aan Centerbridge verkopen, in plaats van er nog iets langer aan vast te houden?
3. Wat zijn de voors en tegens van Secondary Buy Outs (SBO's)?
4. Welke verdienmogelijkheden zag Centerbridge in 2015 bij haar acquisitie van Great Wolf Resorts?
5. Welk financieringspakket zou Centerbridge moeten kiezen en waarom?
6. Hebben de overnames door Apollo en vervolgens door Centerbridge op de lange termijn waarde gecreëerd voor de business van Great Wolf Resorts?

CENTERBRIDGE CASE QUESTIONS (ENG)

1. In 2012, what opportunities did Apollo identify for the business?
2. Why would Apollo sell rather than continue to hold Great Wolf in 2015?
3. What are the pros and cons of SBOs?
4. What did Centerbridge see in 2015?
5. Which of the two financing packages should Centerbridge choose?
6. From a long-term perspective, where the buyouts buy Apollo and Centerbridge valuable for Great Wolf?