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Dealmaker

Providing business owners and managers
with M&A market insight

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In this issue

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The return of the Leveraged Buyout: LBO is back in vogue

With transaction volume of nearly $94 billion, 2004 was a blockbuster year for leveraged buyouts (LBOs). It is estimated that Private Equity Group (PEG) backed transactions now represent approximately 10 percent of the market, up from only 5 percent historically. To put this into perspective, the dollar volume of LBOs doubled each year in both 2003 and 2004. This higher activity has been driven by a number of factors, not the least of which is the widespread availability of debt capital for sponsor backed buyouts.

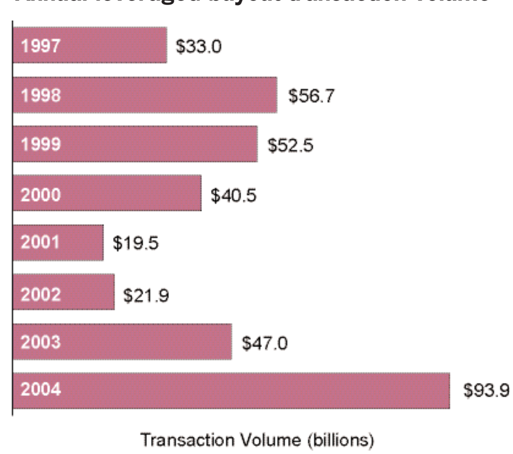
Today, many private equity funds are flush with cash to invest. Some estimate committed funds exceed $100 billion. In the last decade, private equity groups have raised hundreds of billions to fund future acquisitions, much of which has not yet been spent. With many funds maturing, these groups must now invest these funds in acquisitions or return them to their limited partners.

Additionally, after a two to three year lull, private equity funds are raising new commitments like never before, with $35 billion being raised in the first quarter of 2005 alone, compared to less than $50 billion for the entire year in 2004.

Also driving higher activity is the current aggressive lending practices of finance companies, banks and a relatively new entrant to the LBO capital scene – hedge funds. In today's capital markets, there is more debt available for buyouts, as well as plenty of competition among lenders. Average total debt to EBITDA for LBOs in today's market is approximately 4.0x, which hasn't varied meaningfully. However, the amount of senior debt relative to subordinated debt used to fund buyouts has increased considerably, thanks to a relatively new financing vehicle known as "second lien" loans. Senior debt to EBITDA in LBOs averaged 3.0x in 2004, up from just 2.3x over the past few years.

Average LBO valuations are also higher than they have been in years. In 2004, the average enterprise value to EBITDA multiple was 6.8x on transactions under $250 million. Compare this to only 5.8x in 2002. With this change, the valuation gap between financial buyer and strategic buyer valuations has closed. ■

Annual leveraged buyout transaction volume



How to value a company, Part III

By Rebecca Tarby, Grant Thornton Corporate Finance senior associate

In the final installment of our three-part series entitled, "How to value a company," we will examine the discounted cash flow modeling approach, the method most commonly used by investment banks and stock analysts, which when populated with appropriate assumptions, is often considered the most effective and accurate way to value a company.

Traditional discounted cash flow

The traditional discounted cash flow model (DCF) provides a theoretical basis for valuation that takes into account a company's future growth prospects. In the simplest terms, a DCF analysis looks at the expected future cash flows to be generated by the business and discounts these cash flows back to a net present value.

A DCF model relies on a projection for a limited number of years, most commonly a five-year period, based on cash flow visibility and/or specific characteristics of the subject company. Projections are based on company management's best estimate of future performance, including (but not limited to) projected revenue growth, gross and operating margins, working capital requirements and anticipated capital expenditures needed to achieve projected levels of growth. Using these assumptions, free cash flow can then be calculated for each year of the projection period. For the purposes of the DCF, free cash flow is generally defined as operating profit plus non-cash changes such as depreciation and amortization, less capital expenditure requirements, changes in working capital and cash taxes.

Once free cash flows are determined for each year, these amounts are brought to a present value using a discount rate – typically based on the company's expected weighted average cost of capital (WACC). The WACC, which is defined by the relative cost of the company's debt and equity (see sidebar for formula) is also viewed as the "required rate of return" for the company and its investors to compensate them for the inherent risks of ownership and realization risk for projected cash flows.

Because it becomes more difficult to determine a realistic estimate of cash flows the further out a projection goes, at the end of the DCF's projection period, there are several ways to deal with this ambiguity. Two of the more common methods include:

- **The exit multiple methodology:** Many DCF models incorporate the assumption that at the end of the projection period, the subject company is sold for a "market" valuation. In practice, market valuation is often estimated based on a multiple of EBITDA. The DCF then calculates the present value of the sale proceeds using the same discount rate as used above. Although this methodology takes away the guesswork of predicting future cash flows, the determination of terminal value can have significant impact on the overall valuation, and therefore, market valuation assumptions must be chosen wisely.
- **The perpetuity value methodology:** Another method commonly used in DCF models is the perpetuity approach, in which rather than being sold, the subject company is assumed to operate "in perpetuity" or to infinity using an estimated long-term rate of growth (which is often pegged to predicted long-term inflation growth). This method is typically considered more conservative than the terminal value approach, as it can not be skewed by "end-of-projection" valuation assumptions, however, changes in the long-term growth rate assumption can still have a significant impact on overall results.

The leveraged buyout model

The leveraged buyout model (LBO) is a variation on the traditional DCF, and is based on the same underlying projections. The LBO model, however, goes further, looking at valuation from the perspective of a financial buyer who must deliver a return to its investors. Financial buyers, such as private equity, venture capital and mezzanine capital providers, often have required rates of return for each investment based on

> (continued on Page 3)

Discounted Cash Flow (DCF) standard calculation:

$DCF = CF1/(1+r)^1 + CF2/(1+r)^2 + \dots.\ CFn/(1+r)^n$

Key:

CF = free cash flow for designated period

r = discount rate (WACC)

Weighted Average Cost of Capital:

WACC = E/V*Re + D/V*Rd * (1-Tc)

Key:

Re = cost of equity

Rd = cost of debt

E = the market value of the firm's equity

D = the market value of the firm's debt

V = E + D

E/V = percentage of financing that is equity

D/V = percentage of financing that is debt

Tc = corporate tax rate

How to value a company, Part III (continued)

the expectations of their investors. These returns are generated primarily through the sale of the company down the road – usually “exiting” five to seven years from the date of the initial investment – at which time the firm's investors reap their returns from the proceeds of the sale.

In general, the greater the debt (and less equity) a financial buyer can structure into a transaction, the higher its ultimate returns. As such, the amount a financial buyer is willing to pay for a company is not only dependent on the company's projected performance, but also constrained by the capital structure that the buyer can impose. The LBO model incorporates assumptions for how much, and what types of leverage (senior, subordinated and/or mezzanine debt, etc.) can be supported by the company under current capital markets conditions. Taking these parameters into account, as well as an assumed “exit” value, the LBO determines the maximum valuation possible to achieve the required rate of return for each investor, generally ranging from 16 percent to 35 percent depending on the type of investor.

Because financial buyers generally require a higher rate of return than the discount rate (WACC) used in the traditional DCF, an LBO analysis will typically yield a lower valuation than the DCF. Taken together, DCF and LBO analyses can give an excellent picture of the range of valuations achievable from different buyer groups.

As always, it is important to note that no one valuation method should be relied upon in a vacuum. Rather, each should be taken in context with other valuation techniques such as the previously discussed comparable companies analysis (Fall 2004) and precedent M&A transaction (Winter 2005) approaches. If you have missed the first two articles in the “How to value a company” series, please visit www.GrantThornton.com/Dealmaker. ■

In both the traditional DCF and LBO models, it is important to note that results are only as good as the assumptions used - unrealistic or unfounded growth, operating and capital structure assumptions will yield unreliable valuations and often set unrealistic expectations.

An example of this is what is commonly referred to as the “hockey stick” projection, in which overly aggressive revenue growth is shown without a strong rationale or historical basis.

As with all methods of valuation, the DCF modeling approach has advantages and disadvantages

Advantages:
- Because the DCF is based on company-specific information, rather than general industry metrics or comparisons to unrelated companies, results can be more targeted and specific.
- Models can be adjusted to look at a wide variety of growth scenarios and can incorporate expected synergies or additional cost savings available to a buyer.

Disadvantages:
- Results are only as good as the assumptions going into the model - unrealistic assumptions can skew results and small changes to inputs can often have much larger effects on the outcome.
- There is no certainty that projected future results can be achieved.
- Because buyers do not often give full-credit in a valuation for expected synergies or additional cost savings, a DCF that incorporates these items may yield an over-inflated view of what the market is willing to pay.

Interview on the topic of cross-border M&A: Why international buyers cannot be ignored

How important are foreign companies to the U.S. merger & acquisition market?
Extremely important: In 2004, one in every eight U.S. companies sold was acquired by a foreign company.

Have foreign companies always been this active in the U.S. M&A market?
Since 2000, we have seen international buyers become very aggressive acquirers of U.S. businesses. This is in stark contrast to the 1990s, when foreign companies were not really a factor in U.S. M&A.

What factors explain increased cross-border activity? Is it related to the devaluation of the U.S. dollar?
Counter to logic, cross-border M&A activity is not really influenced by fluctuations in exchange rates. The single greatest factor driving cross border activity has been globalization of world economies. In fact, global competitive pressures, particularly for U.S. manufacturing, is forcing many U.S. companies to either acquire overseas manufacturing capabilities or exit the market, perhaps selling to a foreign company.

Additionally, the United States continues to be viewed as a relatively safe place for investment, with cross-border M&A becoming a widely-used vehicle for direct investment in the United States by foreign companies.

What countries have been most active in U.S. target cross-border M&A?
Outside of the United States itself, the country producing the most buyers of U.S. companies is Canada. Other active countries are the United Kingdom, Germany, France and Japan. Collectively, these five countries represent more than 60 percent of cross-border M&A.

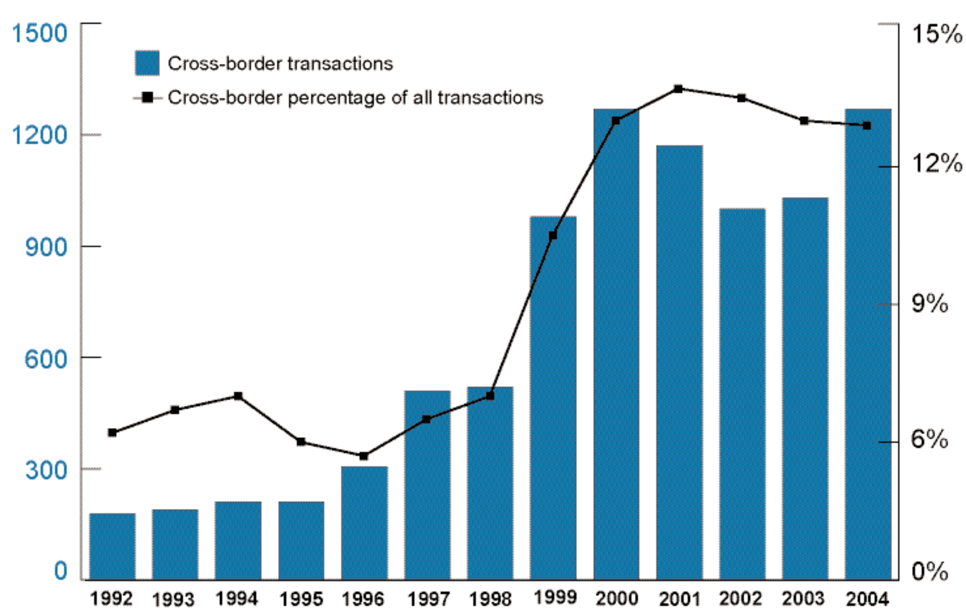
What have been some examples of U.S. cross-border M&A activity?
- Unilever (UK) acquired Coty, Inc. in May 2005 for $900 million. (consumer)
- Yell Group plc (UK) announced its intention to acquire TransWestern Publishing Co. for $1.6 billion. (publishing)
- Toronto Dominion (Canada) acquired BankNorth Group Inc. in March 2005 for $2.0 billion. (banking)
- BAE Systems (UK) acquired United Defense Industries in March 2005 for $4.5 billion. (defense)

Those examples all appear to be mega-deals. Are foreign companies also active in acquiring middle-market U.S. companies?
Very much so. Seventy-five percent of U.S. cross-border deals disclosing valuations had a price tag of under $100 million. Contrast this with all U.S. transactions, where 60 percent of all U.S. transactions disclosing prices in 2004 involved deal sizes of under $100 million.

Aren't cross border deals more difficult to get done?
They can be, especially without resources on the ground overseas. At Grant Thornton Corporate Finance, even on smaller deals, we can employ multi-national deal teams involving corporate finance colleagues in London, Paris, Hamburg, Hong Kong and Tokyo.

What ramifications will this have on U.S. companies?
For U.S. companies considering a sale, the key to maximizing price is to create a robust competitive auction amongst multiple bidders. With foreign companies playing such a key role in the U.S. M&A market, overseas bidders must be included to obtain the higher price. This is particularly true in manufacturing, where global competition often plays a larger role. ■

Cross border transactions vs. cross border percentage of all transactions



Grant Thornton Corporate Finance news

New hires

Grant Thornton Corporate Finance is pleased to announce that Benjamin Gerwin has joined the Boston-based corporate finance team as an associate. Most recently, Ben worked in the merger & acquisitions group of J.P. Morgan in New York City, where he completed a variety of M&A engagements in the specialty chemical, information technology staffing and professional sports franchise industry segments.

Grant Thornton Corporate Finance in the news

Christopher Kampe, director at Grant Thornton Corporate Finance, was featured recently in the May 30 issue of *Factset Flashwire Weekly*, an M&A publication published by Factset Mergerstat. In the article titled, "Private equity goes on a retail shopping spree," Kampe discusses the general interest of private equity investment in retail deals in the current M&A market.

Recent speaking engagements

On June 7, Kampe also gave a presentation to the Minneapolis chapter of Financial Executives International on the topic of mergers & acquisitions. The presentation covered current trends in the merger & acquisition market, including recent changes in the availability of capital and its impact on valuation multiples, and the resurgence of the leveraged buyout.

On June 16, Grant Thornton Corporate Finance was the gold sponsor for the Association for Corporate Growth's (ACG) Boston Chapter's 11th Annual Spring Conference. Held at the Sheraton Boston Hotel, the event drew participants from more than 30 states, bringing together over 1000 individuals, including more than 400 private equity investors. Thomas Lee, founder of Thomas H. Lee Partners, a legend in the world of leveraged buyouts, addressed the group as the event's key note speaker.

Grant Thornton Corporate Finance: Who we are

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Content for *Dealmaker* is produced by Stephen McGee and Christopher Kampe, directors with Grant Thornton Corporate Finance. For more information on any of the topics covered in this newsletter, please send an e-mail to Stephen.McGee@gt.com or Christopher.Kampe@gt.com.

In 2004, Grant Thornton International was credited with 121 M&A transactions worldwide, placing the firm 16th in the annual M&A league tables produced by BVD Zephyr. This is the fourth year in succession that Grant Thornton International has placed in the Top 20, ranking 19th in 2003 and 18th in both 2001 and 2002. Grant Thornton International has approximately 1,000 corporate finance professionals around the world.

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