

Verbatim

Evaluating a Buyout

It's the board's job to judge whether an LBO will benefit shareholders, says private equity leader Justin Wender

When management proposes a leveraged buyout, boards must analyze the deal carefully and dispassionately, says Justin B. Wender, president of New York-based private equity firm Castle Harlan. Here are his views:

If management wants to take a company private through a leveraged buyout, how should the board approach the idea?

As a director, your first obligation is to your shareholders. You need to ensure that you're performing your fiduciary duty. That means forming an independent committee to evaluate all the options for the business. You need to ensure that there is a fair process that allows others who might have an interest to take a look at the business and have an equal shot, creating a competitive tension. Any deal also needs to be looked at in concert with the investment bank, to make sure that what is being offered is not only the highest price but is also a fair price to shareholders based on all the market comparables. Where do the other companies trade? What are our prospects relative to theirs? What are the risks to shareholders? The process is partly numerical, but a lot of it is also subject to analysis.

Why do you need a committee? Why wouldn't the whole board be involved?

If several members of management are buying the business and they are

on the board, clearly they are conflicted. The independent committee is set up as a way to remove conflicts from the process as best as one can.

Are there right and wrong ways of getting a fairness opinion?

The fairness opinion is not typically given by the bank representing the buyer of the business. It's typically a third party who has no interest or someone who is representing the company in the process. That isn't to say that if one of their giant clients in some other areas of their business is involved in the transaction, there can't be some element of conflict.

Isn't there suspicion that some managers compensate themselves too richly when they take a company private?

Typically, the compensation packages for folks who are going through some sort of transaction are already embedded in their contracts. It's not that new compensation would be created as part of going private. The big wealth gain is that it's typical in an option package or restricted stock package to have vesting occur on the change of control.

So management has an inherent conflict in these deals?

It depends on what their stock position is. Let's say management has a pretty sizable stock ownership. Selling at a high price makes them money and makes shareholders money. Instead, if management has terrific current income packages but not as much equity, there might be a conflict the other way—management is incented never to sell the business.

Why do some companies go private to fix themselves instead of restructuring while they are publicly traded?

There is increasing scrutiny and regulation, and that has had an impact. CEOs are spending much more of their time on compliance issues and dealing with shareholders and analysts and the outside world. They have less time for their business than they might like.

Private equity firms were prepared to offer \$50



billion to take the French company Vivendi private. Is any publicly traded company immune?

When it comes to public companies and public stock prices, it's a market. If a share price trades below the value that private equity firms perceive exists, they become a takeover target either for strategic buyers or for LBOs. If you look at the top 10 mergers and acquisitions of last year, most of them were strategic deals.

In the case of Harrah's Entertainment, a group of investors led by the Texas Pacific Group and Apollo Management bought the company for \$17 billion and doubled its debt load to more than \$20 billion. Why did they do that, and was it wise?

Obviously, leveraging a business is taking on some degree of additional risk. However, if a business can support the debt load, and the debt can be

than historically might have been possible, they've teamed up together to go after larger businesses. That means you have multiple owners as opposed to one private equity firm. At the peak of the deals of the 1980s, the one involving RJR Nabisco, you had one LBO firm doing a transaction worth more than \$10 billion. Now you've got the equity being shared. It's partly a function of more equity going into LBOs today than we saw in the 1980s.

So today's transactions are bigger than before?

There are more equity dollars and the companies are bigger. The average size of a Standard & Poor's 500 company is probably five or six times bigger than it was in 1987. In the '80s, you might have put up 10 percent equity. Today, you might put up 35 percent equity.

But if one of these LBOs soured, wouldn't these

Directorships

Wender is a director of several Castle Harlan portfolio companies, including:

- Ames True Temper
- Morton's Restaurant Group
- McCormick & Schmick's
- Caribbean Restaurants
- Polypipe Global Holdings

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put on in ways that minimize the risk by, for example, having less amortization of that debt in the short term, there is an opportunity to make a larger return on the equity. Not being involved in this deal, I can't attest to whether it's safe or not. But certainly there are billions of equity dollars going in, coming from people who believe it's a very smart bet.

Will some of these deals come unstuck when there's a change in the economic cycle?

It's true in all companies that an economic cycle can have an impact. It's going to very much depend on the structure of the debt that was taken on and the ability of these private equity players to improve the underlying businesses that they're buying. This is a phenomenon of the past three or four years, when we've had a generally improving economy. We haven't been through a down cycle. It's relatively untested.

What exactly is a club deal?

It is a transaction typically shared among several private equity firms. It could be as many as six or seven. To approach companies on a larger scale

traditional rivals start fighting among themselves, with bad consequences for the company?

The good news is that all these owners have shared interests. They would come together and agree on a plan to get the business back to where it needs to be. They all have very significant upside profits riding on the answers. At least they have a shared incentive structure.

Is it fair for management to take a company private and reap big gains from which public stockholders are excluded?

The complication with that analysis is that doing a buyout creates a different risk profile. If you take a business and double its debt, you're taking different kinds of risks than when public shareholders were involved. The other point to add is that most of these buyouts probably will end up being taken public. Private equity firms own businesses typically for three to five years, and they look to get liquidity. As you get businesses on a scale of Harrah's, it's possible they will be sold to strategic buyers. But it's more likely that they will be public again. ■