"Why LBO firms can outbid strategic buyers"

Importance and presence of factors affecting their competitiveness

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Abstract

The aim of this master's thesis is to identify and discuss the importance and presence of factors affecting an LBO firm's relative competitiveness and hence ability to outbid strategic buyers. By making use of previous research, the current debate and a survey conducted on the Swedish M&A market, 14 factors have been identified and analysed with regard to their presence and importance in connection to an LBO investment. Value creating factors linked to the holding period have gained most support with management incentives, active ownership and leverage as factors pointed out as most important by the authors.

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1. Introduction

1.1 Background

In recent years, LBO firms have become increasingly more competitive with strategic buyers in the M&A market. Historically, this has not always been the case. Strategic buyers have traditionally had the advantage over LBO firms, particularly in auctions, because the strategic were able to subtract synergies generated from the acquisition that would not be enjoyed by the LBO firm. As a consequence of becoming more competitive, the volume of deals made by LBO firms has dramatically increased both in terms of number and value.

In a recent survey, 61% of the 100 largest companies on the London Stock Exchange said that they expected further increased competition from LBO firms in the future. Roger Kimmel, vice chairman of Rothschild, points out that it as recently as five years ago was rare for LBO firms to outbid strategic buyers. This situation however seems to have changed. According to John A. Katzenberg, managing director at Citigroup, strategic buyers have been losing ground to LBO firms in recent years and are more often outbid.

This has also been identified on the Swedish market. Anders Nyrén, CEO of Industrivärden, claims that the strategic buyers are pressured by not having the ability to justify the prices paid by LBO firms. Harald Mix, co-founder of Altor, has also identified a trend where the strategic buyers have lost some their strength when competing for potential acquisition targets. In recent years, the acquisitions of Munksjö, Dynapac and Myresjöhus are three examples where strategic buyers with a good strategic fit have been outbid by LBO firms (Affärsvärlden, 2005). The famous industrialist Rune Andersson claims that LBO firms are able to pay roughly 30-40 per cent higher than strategic buyers (Dagens industri, 2005)

1.2 Purpose

The question is hence how the LBO firms, despite the lack of possible synergies, are able to compete with the strategic buyers. The purpose of this master's thesis is therefore to identify and discuss the importance and presence of factors affecting an LBO firm's competitiveness and hence ability to outbid strategic buyers.

1.3 Scope

When analysing the relative competitiveness of the LBO firm, there are two sides of the coin. One can analyse factors affecting both the LBO firm and the strategic buyer or choose to take the perspective of one. We consider the strategic buyers alleged ability to count for synergies as have being present over time. In this thesis we will therefore consider the strategic buyer's investment approach as given and take the perspective of the LBO firm. We further believe that this approach will reduce complexity and thus facilitate a better understanding of the phenomena.

1.4 Relevance

Articles relating to LBO firms have been daily occurring in recent time. The increased media attention has been triggered by the increased activity of these firms. A significant share of these articles has therefore been related to acquisitions made by the LBO firms. Voices in the debate have however given several and often contradictory answers to the causes behind this increased activity and competitiveness of the LBO firms. We therefore identified a need to clarify or at least get a better understanding of the causes as we believe the LBO market nowadays constitutes an important part of the Swedish capital market.

1.5 Disposition

Chapter 1:
The first chapter aims to facilitate an understanding of our thesis. First, we give background information to the chosen subject followed by an introduction of our problem formulation ant the purpose and scope of our thesis.

Chapter 2:
In this chapter we start by explaining the scientific method used when conducting this study, the data collection and criticism of the sources used. We also discuss the strengths and weaknesses of the study and practically describe how the work was performed.

Chapter 3:
We will in this chapter give a description of the Swedish M&A market in order to give the reader an insight into the nature of the industry studied. It will start with a description of the relevant actors on the M&A market and the role of private equity. We will then discuss different kinds of buyouts and the emergence of leveraged buyouts.

Chapter 4:
We will in this chapter explain the LBO firm's investment approach in order for the reader to get a deeper insight of the different mechanisms of an LBO. We begin by going through the LBO investment in detail. We thereafter introduce our framework which will be used throughout the thesis. We find it important to understand the different aspects of an LBO in order to facilitate a better analysis.

Chapter 5:
In this chapter we will first explain the relevant theory that we will use for our analysis. We will then introduce the factors found, categorized according to the general framework presented in chapter 4. The factors in this chapter are presented strictly theoretically and are hence not analysed according to importance.

Chapter 6:
We will in this chapter perform an analysis on the factors presented in chapter 5. We will look at what research and the current debate have found to be most important regarding each factor. This will give the reader a better understanding of each factors importance as well as a thorough analysis of what previous research has found

Chapter 7:
In this chapter we will present our findings from the empirical study made on the Swedish M&A market. The data is first presented for the total population followed by data from LBO firms, strategic buyers and advisors respectively.

Chapter 8:
Based on the findings from research, current debate and our survey we will in this chapter discuss and analyse the relative importance and presence of the identified factors.

Chapter 9:
This chapter will list the most important findings of our thesis. We will thereafter apply these findings to our framework

Chapter 10:
In this chapter we discuss the takeaways of this thesis and discuss and suggest areas for future research.

2. Method

In this chapter we will start by explaining the scientific method used when conducting this study, the data collection and our criticism of the sources used. We will also discuss the strengths and weaknesses of the study and practically describe how the work was performed.

2.1 Research method

There is always a risk that personal experiences and individual references have an impact on the results of scientific work. Our ambition has however always been to present the results and outcome of our empirical study in an objective manner. Method can be understood as the various ways in which data can be collected and/or analysed. Below we will explain what methodology we have chosen when conducting this master thesis.

We have chosen to do a quantitative deductive study. This means that you start out with a theory to which a body of data is matched. In order to determine which factors that possibly can explain why LBO firms can outbid strategic buyers we have started out by going through relevant literature on the subject. This has helped us to determine the factors that previous research and literature has found to be most important. We have then taken these findings and conducted a survey on the Swedish M&A market in order to get an indication about what factors the different players on the Swedish market consider to be most important.

Two main paradigms, deductive and inductive methods, can be distinguished when conducting social science studies. The deductive method starts from theory and the inductive method starts out from the empirical framework. Our work has been characterized by a creative process where theory and the empirical framework has been put in relation to each other with the purpose of enlarging the understanding of the factors influencing the LBO firm's ability to outbid strategic buyers. Generally speaking, the method used in this study is deductive to its nature. The staring point was going though theory on the chosen subject and later testing the theory on the market in order to get an indication of what factors the market consider to be most important.

2.2 Data collection

We have chosen to use both primary and secondary data when conducting our study. The difference between the two types of data is that the researcher registers the primary data himself/herself. Secondary data is collected through other situations (Lundahl & Skärvad, 1999).

2.2.1 Collection of primary data

The collection of primary data has been made through an electronic questionnaire. We have further had e-mail contact with individuals at LBOfirms with the purpose of gaining more insight in relevant aspects of our study. The main source of primary data has however been the questionnaire, which will be given a thorough description in the following section.

2.2.2 Selection of questionnaire participants

We have chosen to conduct one part of our master's thesis through a questionnaire which we have focused on the factors possibly explaining why LBO firms are able to outbid strategic buyers. The reason behind our choice to conduct a questionnaire study is mainly based on our belief that it is a good way to get an indication of what factors the market participants believe are most important. We of course had the choice of conducting a more qualitative approach through personal interviews. Due to the large amount of interviews available in articles and limited time available among LBO professionals we found it more interesting and rewarding to conduct a survey.

The questionnaire was sent out by e-mail to 154 individuals on the Swedish M&A market. In order to facilitate this study and targeting the relevant players we had to define the M&A market relevant for this study as consisting of LBO firms (SVCA members active within buyouts), strategic buyers (industrial companies on the SSE A-list) and advisors (investment banks, consultants and accountants). The strategic buyers were chosen as a group as they constituted the counterpart in the bidding auction. The reason for choosing the industrial companies on the SSE A-list were based on our belief that these were big enough to be considered as a potential acquirer. When analysing the LBO process we found the investment banks, consultants and accountants to be the players that were in contact with the LBO process. We further selected the most dominant players from these three sub-groups.

We have aimed at getting a balanced weight of the three categories of participants, i.e. to get a balanced response rate from the different categories of participants. We therefore sent out approximately the same amount of questionnaires to the three categories. A further problem was to identify the persons with relevant information. We always tried to contact the most senior people at the participating companies. When this was not possible we asked the respondent to forward the mail and the questionnaire to relevant individuals within the same organisation.

2.2.3 Questionnaire design

We have identified three main problems linked to the questionnaire survey. First, we had the problem of identifying suitable persons in possession of relevant information. The second problem was to get in contact with these persons and the third and last to get them to cooperate. We found that the most critical part of our data selection was to get a satisfactory response rate. We were aware that the people at the selected companies generally had limited time available to answer our survey. The solution to this problem was to make the questionnaire as easy and user-friendly as possible. This was done by formulating the identified factors in a way that people easily could relate to. However, we do not feel that the quality of our study was compromised since we were able to include all relevant factors in the questionnaire. To further increase the response rate, we obliged ourselves to send the completed study to the individuals who participated.

The participants were sent an e-mail explaining the purpose of our study. Attached to the e-mail was the questionnaire that the participants could download and answer electronically. By using this form of questionnaire our aim was to limit the time required to receive, complete and return it. We further enhanced the user friendliness of the questionnaire by requesting the participants to only select five factors out of fourteen that they felt was most important when explaining why LBO firms can outbid strategic buyers. The question was formulated more as a statement which we actually did not have any statistical proof of. The usage of such a straight forward approach has its pros and cons. There was a risk that respondents opinion would deviate from the statement and hence create an unwillingness to participate. We however believed that this would limit any misinterpretations and also increase the response rate. This statement is further frequently mentioned in the current debate why we hoped it would trigger an interest for the questionnaire among the participants and hence increase the response rate.

The participants were further asked to rank the selected five factors from 1 to 5 (1=most important etc). If they wanted to provide any extra information and own opinions a designated field was provided for this purpose. Our choice to use an *internal ranking*[1] from 1 to 5 instead of an *independent ranking*[2] variant was also made on the assumption that it would limit the time required to understand and complete the questionnaire and therefore increase the response rate. When the questionnaire was completed the respondents simply saved it and e-mailed it back to us. Improperly finished questionnaires were not regarded in our study.

2.2.4 Interpreting the data

Among the 154 questionnaires that were sent out, we received 50 correctly completed (additionally, 3 questionnaires were incorrectly completed and hence not accounted for). This constitutes a response rate of 32.5%. As stated in the previous section we received the electronic questionnaire by email. The data from the completed questionnaire was manually plugged into our own excel model group wise. By relating the number of answers for a single factor at each rank to the total number of answers for this rank we could see the share of answers relating to a certain factor. At first sight, from a statistical perspective this approach seems rather unsophisticated. However, given the design of our study with the internal ranking system, this approach enabled us to rank the internal importance of each factor without having to weigh the factors based on the rankings. The problem with using a weighted value is that we were unable to identify whether the respondent consider the factor to be close or far off the nearest ranked factor. This for example makes it difficult to draw any conclusions based on the weighted average approach. Our chosen approach instead resulted in a value between 0 and 1 for each factor on the highest rank. The next step was thereafter to add the number of answers received on the second rank and the number received on the first rank and then divides this sum with the total amount of answers for the two categories (twice as many as before). The result was a value between 0 and 1. This procedure was then done for the remaining factors. The result gave a trend of the importance of different factors among the respondents. To further analyse the different aspects of the received results we grouped the factors according to our framework. By weighting the data we were able observe important trends among the respondents.

2.3 Collection of secondary data

The secondary information has been used to improve our knowledge on the research subject, facilitate the research and analysis and serve as a tool when constructing our questionnaire. The data that has been used in our work is literature, articles, and other written information covering private equity in general and LBOs in particular. In the search for relevant literature we have used different channels. Internet has been an important aid when finding relevant information and we have used several databases provided by the SSE Library when screening for relevant information. We also studied prior SSE master thesis with a focus on

[1] All factors must have a different number. The rank of a single factor is therefore dependent on the ranking of the other factors.

[2] All factors can have the same number. The rank of a single factor is therefore not dependent on the ranking of the other factors.

leveraged buyouts to get a picture of how a thesis could be carried out and what sources they had found to make the study relevant. Further information was obtained from homepages of organisations such as SVCA, EVCA and other relevant sources. We have also closely followed the current debate regarding private equity by reading articles in the major Swedish business magazines such as Dagens Industri and Affärvärlden.

2.4 Critical assessment of the study

We have found some specific strengths and weaknesses in our study that we feel are important to point out. We believe the main strength is that this thesis provides a clear overview of the LBO process and its different aspects. This is particularly obvious through the creation of our own framework. We have further covered a wide range of sources including previous research, current debate and primary data which we believe has given a balanced picture of the phenomena. There are however a number of shortcomings that we feel is important to point out. Firstly, we did not analyse the possibility that the strategic buyers behaviour have changed over time, causing the LBO firms to gain in strength. Furthermore, there is always a risk that our own opinions reflect the outcome of the thesis. Finally, there is also a risk that we may have left out important factors early in the process which in turn excluded them from our survey. Finally, one possible limitation of the survey findings is the potential difficultness of identifying the difference between the primary and secondary lever factors, i.e. the difference between factor 6, 7 and 9, 10.

3. The M&A market

We will in this chapter give a description of the Swedish M&A market in order to give the reader an insight into the nature of the industry studied. It will start with a description of the relevant actors on the M&A market and the role of private equity. We will then discuss different kinds of buyouts and the emergence of leveraged buyouts (LBOs).

3.1 Acquisition candidates

3.1.1 LBO firms

The definition of an LBO firm used in this paper is a private equity firm acquiring companies through a so called leverage buyout. These firms are generally investors without other businesses in the same industry and have hence limited opportunities to realise any synergies. An LBO firm is therefore mainly interested in the cash flow and returns generated by the acquired company during the *holding period*[3].

3.1.2 Strategic buyers

The strategic buyer is mainly interested in a company's fit into their own long term business plans. Their interest in acquiring a company may include vertical expansion (toward the customer or supplier), horizontal expansion (into new geographic markets or products), eliminating competition or enhancing some of its own weaknesses (technology, marketing, distribution, research & development etc) as a way to realize possible synergies.

3.2 Private equity's function

Private equity is investing equity capital in unquoted companies. According to Kraft (2001), private equity companies have a number of important functions on the capital market. First, the firms function as *investment* companies where they place the money of investors in

[3] The limited amount of years when they own the company. Usually 5-7 years

private companies. Secondly, they have an *evaluation* and *valuation function*, where they screen, evaluate and select potential companies with high growth opportunities according to their estimated value. Finally, they supply young, innovative companies with money in order to foster their growth and development, and hence have a *financing function*.

3.2.1 Investment stages

Private equity investments can be made during different stages of a company's life and are normally divided into two categories; *venture capital* and *buyout*. Venture capital is investments in recently started firms that need capital to grow while buyout investment is a later stage investment in relatively mature firms. Private equity firms focusing on such transactions are referred to as *LBO firms*.

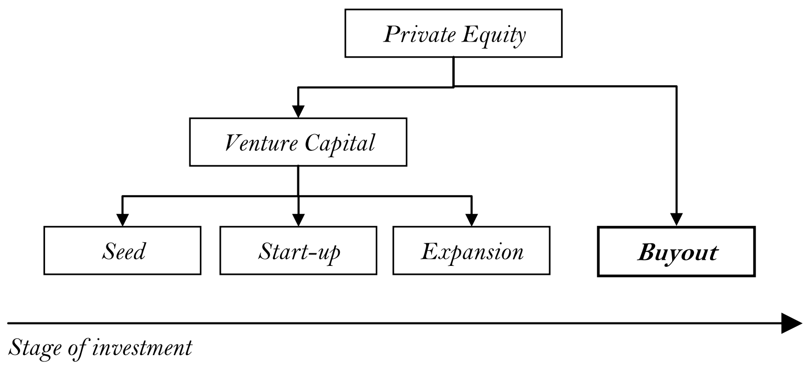


Figure 3.1 Buyout is a later stage private equity investment

3.3 Buyouts

3.3.1 Leveraged buyouts (LBO)

A buyout is often referred to public-to-private or going private transactions where the target company is delisted from a stock exchange. The major part of all such transactions is financed by taking on a large amount of debt. This has given them the name *leveraged buyouts* (LBOs). LBOs also comprise private companies that are bought out by investors financing the deal with a large amount of debt. There are different types of LBOs including the following:

- *Management buyout (MBO)*
  The current management, backed by an LBO firm, buy out the company. A major share of all LBOs up to date has been through these types of transactions.

- *Management buyin (MBI)*
  An external management team buys out a company backed by LBO investors. At first sight, the MBI and the MBO seem very similar. As the level of private information differ substantially this is, however, two different types of transactions. Additionally, MBIs are more often hostile as the outside investor identifies that the current management do not realize the full potential of the company (Robbie & Wright (1995).

- *Institutional buyout (IBO)*
  The new owners are solely institutional investors or LBO firms. If they decide to hold on to the current management, this will usually be rewarded with equity stakes

in the bought out company through different types of *equity ratchets*[4] (Wright et al., 1991). The difference between the MBO and the IBO is therefore whether the current management gets their equity stake through being a part of the bidding group (MBO) or through a compensation package (IBO).

- *Buy-In-Management-Buy-out (BIMBO)*
  Salvatore & Olsen (2003) mention this combination of the MBO and MBI, where the current management, together with external managers, buy out the company backed by LBO investors. Other variants include *Management Employee Buyouts*, where management and employees both provide equity.

3.3.2 The emergence of leverage buyouts

Internationally

LBO firms that buy out companies have its origin in the USA. The PE-market has existed there since the 1950's and has during the last 30 years been an investment alternative for institutional investors. It is hence in the USA that the largest and most developed market for private equity exists. PE-markets tends to be mostly developed in countries whose financial system to a large degree are market based, like the US and the UK, and less developed in countries whose financial system to a large extent are bank based, like Germany (Riksbanken).

Sweden

Private Equity companies have been present in Sweden for more than 25 years. The first LBO transaction in Sweden was carried out by Procuritas in 1986. Since then, the number of LBO firms as well as number of buyouts and capital allocated to the sector has increased rapidly. In the beginning of the 1990's the LBO industry was fuelled by regulatory changes allowing pension funds, banks and insurance companies to allocate a larger part of their portfolio into equity. This in combination with the economic crisis in Sweden at that time, when a lot of companies focused on their core businesses and sold out a lot of divisions at a discount, created a suitable environment for growth in the private equity segment. Due to good performance of individual funds and a shift in the market, it is however primarily in later years that they have become more significant and attracted greater media attention.

Profitability within the Swedish LBO market is considered to have been good over the past ten years. However, one should bear in mind that collated and reliable statistics are difficult to obtain. The return ratios that have been presented, however, show that the 1990s was an extremely favourable period. In 2005 the private equity companies in Sweden managed a total capital of about 235 BSEK whereof the LBO firms amounted for about 2/3 of this amount. These 235 BSEK is about 0,4 percent of the GDP which means that Sweden, as a percentage of GDP, is the second largest private equity market in Europe, only beaten by Great Britain.

Total managed capital amounts for about 10 percent of the value of the Stockholm Stock Exchange. Around 50 percent of the committed funds is managed by three private equity investment companies, EQT (SEK 51 billion), Industri Kapital (SEK 35 billion) and Nordic Capital (SEK 22 billion). (www.svca.se)

[4] Equity ratchets provides for the managers' shareholdings to increase in value at the expense of the shares held by the financing institutions, if the company meets performance targets over a period of a few years. The value increase may occur because restrictions are lifted, because new rights are acquired or because the equity holding itself increases.

Almost 75 percent of the capital managed by Swedish private equity investment companies is targeted at investments in later phases of the company life cycle, that is, the buyout segment. Roughly 90 per cent of buyout investments, or almost 70 per cent of the total private equity, is managed by the ten largest private equity investment companies in this segment. During 2005 the Swedish private equity companies invested roughly 40,4 billion SEK in 637 different projects. Even if the number of investments has decreased slightly, the amount of money invested has increased from 16,8 billion SEK in 2004 to 40,4 billion. Only during the last quarter of 2005, 171 investments were made amounting to 4,3 billion SEK. This rapid increase in investment capital points to the fact that private equity is becoming more established and an increasingly important factor in the Swedish financial markets and industry. Of the 40,1 billion SEK that was invested, the largest part went to buyouts with 35,1 billion SEK or roughly 87 percent. If one looks at the number of deals, the buyout segment only amounted for about 10 percent. (SVCA quarter 4 report).

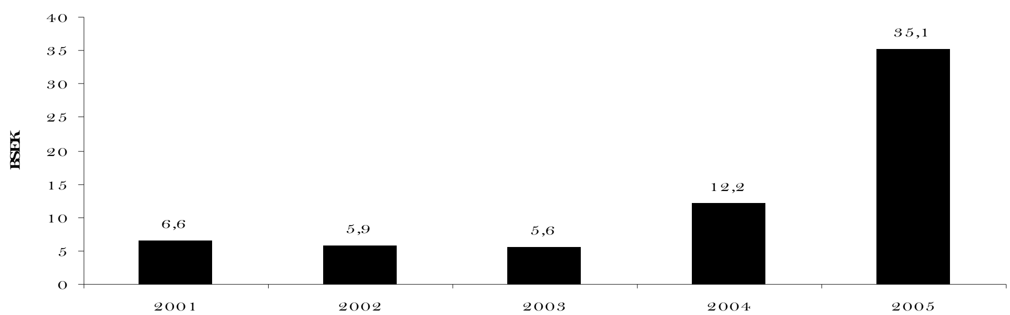


Figure 3.2 Capital invested in leveraged buyout on the Swedish market

During 2005 there were also a record number of exits, 168 companies with a total value of 60 billion SEK. This is twice as much as the year before and the highest number so far. On average the exits generate a return of 3,3 times the capital invested in the funds, money that to a large degree is repaid to the investors (pension funds in particular). The number of negative exists (bankruptcy etc.) has shown a decrease ever since the first quarter of 2003, while the positive exits has remained at a steady and high level during the last year.

4. The LBO investment

We will in this chapter explain the LBO firm's investment approach in order for the reader to get a deeper insight of the different mechanisms of an LBO. We begin by going through the LBO investment in detail. We thereafter introduce our framework which will be used throughout the thesis. We find it important to understand the different aspects of an LBO in order to facilitate a better analysis.

Section 4.1-4.3 will describe the LBO investment in detail. Section 4.4 will thereafter describe the structure and characteristics of the limited partnership. We believe it is important to understand both parts in order to get a deeper insight of the different mechanisms of an LBO as well as to facilitate a deeper analysis later in our thesis. Finally, we will in section 4.5 introduce our framework.

4.1 Transaction phase (A)

We have divided transaction phase A into three main steps; *target identification*, *target evaluation and target acquisition.* We have further identified the *target valuation* to be conducted on an ongoing basis. This section has therefore been placed at the very end of this section (4.1.3)

4.1.1 Target identification

Sourcing
The ability to generate a solid deal flow, ideally with access to a large number of proprietary transactions, is frequently mentioned as a clear indicator of the quality of an LBO firm (Gottschalg & Zollo, 2002). The LBO firm generally has four different sources to get access to potential acquisition candidates;

- *Public deals* - Deals known to the entire industry. Usually have a large number of potential acquisition candidates
- *Proposed deals* - Deals proposed to the LBO firm by a third-party intermediary, usually an investment bank
- *Network deals* - Deals accessed through the LBO firms network, either through personal contacts or organisational relationships.
- *Proactive deals* - Deals initiated in a proactive fashion by an LBO firm, e.g. by approaching potential companies within a specific sub-sector.

Screening
According to Gagliano & Olsen (2003), there are a number of characteristics of a potential target company that make them suitable for an LBO. First, the company should have a capital structure that allows them to take on a large amount of debt, which often is characterised by a *strong and wealthy balance sheet* with a relative low level of debt. In order to be able to service the new debt, a firm should have *stable and predictable cash flows.* Such firms generally have a *strong market position* with *low risk of new entrants.* Strong cash flows can also come from a *low future capital requirements* and the possibility to sell off assets that do not fit into the company's business model. Furthermore, the firm should be *able to take on cost cut programs* in order to increase the profitability. As the investment period is limited, it should be possible to identify a number of *attractive exit opportunities.*

The main purpose in the screening process is to determine the characteristics by collecting the following two types of data; *quantifiable information* and *qualitative information.*

- *Quantifiable information* - Include financial information such as cash flow and earnings characteristics, company size, ownership structure.
- *Qualitative information* - Analysis of the target's business model, management track record and potential and value creation potential. The targets competitive edge is further another crucial factor.

The screening process is usually followed by an *indicative bid* on the target by the LBO firm. The purpose with this bid, which is not binding, is to demonstrate for the seller that the LBO firm is interested enough to get a closer look at the target.

4.1.2 Target evaluation

Depending on the characteristics of the market, or if the company is private or public, it can be more or less difficult to obtain information of a potential target. An LBO firm generally use a two step approach for gathering information; *internal analysis* and *due diligence.*

- *Internal analysis*
  This type of evaluation is an in-house research that is conducted by the LBO firm itself. In order to create a better understanding about the company, the industry, management, financial information etc., information is gathered through telephone calls, article searches, databases, contacts etc. The internal in-depth analysis is usually followed by another bid.

- *Preliminary due diligence*
  With the help of an external advisor, the LBO firm collects and analyses information about the target company. The length of the due diligence phase varies wildly, since it depends upon the complexity of the fund, its geographic remit, the size of the manager's organisation and the availability and quality of the information supplied by the manager. The most common types are *strategic-*, *financial-*, *legal- and operational due diligence.*

4.1.3 Target acquisition

Getting closer to the actual acquisition, there are a number if steps that have to be completed in order for the LBO firm to acquire the target. Some important steps that have to be completed are: *management presentation*, *letter of intent*, *confirmatory due diligence*, *confirmation of valuation indication*, *negotiation of financing terms*, *and negotiation of the final contract.*

Once the contract is *signed*, the target's shares are transferred to the new owner, usually a new company, a so called *Newco*. This is a special purpose vehicle - i.e. a company formed specifically for the purpose of making the acquisition. For further description of the creation and purpose of the Newco, see section 4.4

4.1.4 Valuing the potential target

The purpose of the valuation is primarily to form the decision making material in a bidding process, this by establishing the highest price that can be offered without causing an economic loss for the acquirer. Another purpose with the valuation is also to provide an in depth knowledge about the mechanisms that affects the value of the target company. By performing a valuation of the company, the knowledge about which factors that are value driving in the industry and the specific company will increase. This is important because it can seldom be said that there is a unique value of an asset. The value of a specific asset or company is governed by the assumptions that are made about the future. LBO firms generally have a different valuation approach compared to the strategic buyer. While the strategic buyers generally use the traditional *discounted cash flow model* as their main valuation technique, LBO firms use a different variant, the so called *LBO model.*

The LBO model
This valuation model used by LBO firms is a variant of the traditional DCF, and is based on the same underlying assumptions. The difference, and reason why it is used for LBOs, is that the model takes the perspective of a LBO firm who has to obtain a required return to the

investors. LBO investments have a horizon of approximately five to seven years, and the return from the major part from the returns comes from the future exit. The model calculates the returns to the different investors based on different projections about company performance during the holding period and at what price (multiple) the company can be sold for at time of exit. As earlier mentioned, LBO investment is financed by taking on a large amount of debt, leveraging the returns to investors. As a result, the price the LBO firms are willing to pay for the company is not only dependent on the future operational performance, but also on the company's ability to take on debt. The feature of the model enables the LBO firm to incorporate different capital structures and what types of leverage (senior, mezzanine debt etc.) can be supported by the company under current capital markets conditions. (Dealmaker, 2005)

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 LBO firms 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. (Dealmaker, 2005)

4.2 Holding period

According to Kraft (2001), the purpose of the private equity firm during the holding period is to actively control, coach and monitor the company. The goal is to realize the full corporate value. There are a number of ways in which LBO firms can create value for its owners during the holding period. Generally speaking one can label these value generating aspects of the deals as factors such as; *market appreciation*, *sector appreciation*, *financial engineering* and *operational/strategy improvements*. Historically, many LBO firms solely relied on their ability to generate return from their superior skills within financial engineering. With an increased competition within the industry, this trend has changed with more LBO firms increasing their focus on operational improvements in order to drive real performance and achieve a competitive edge.

4.2.1 Financial engineering

Generally, a part from the equity component, LBO´s are financed through different multiple tranches[5] of debt. The tranches usually have different features in terms of maturity and repayment schedules. One important feature of the financing is it should enable the LBO firm to change the capital structure over time as market conditions change. The number of tranches used differs among the deals with regular *bank debt* and *mezzanine loans* as the most common types used.

The LBO firms put a lot of effort to find the optimal capital structure for the target company. Investors in buyout funds generally demand a high return on the investment and leverage is seen as an easy way to obtain higher returns. The suitable transaction structure varies from case to case and between different types of industries. Factors like expansion potential, return, estimates are just a few of the factors that have to be considered when deciding the optimal structure. Gagliano & Olsen (2003) found the following structure to be applicable for most LBO transactions:

[5] A piece, portion or slice of deal or structured financing. This portion is one of several related securities that are offered at the same time but have different risks, rewards and/or maturities. "Tranche" is the French word for "slice".

Type	Portion	Cost of capital	Investor
Senior debt	50-60%	7-10%	Banks
			Insurance companies
			Credit companies
Mezzanine debt	20-30%	10-20%	Mezzanine funds
			Insurance companies
Equity	20-30%	25-35%	Management
			GP and LP
			Advisors

Figure 4.1. Common capital structure in an LBO

4.2.2 Operating and strategic improvements

The ability to manage the portfolio company during the holding period has become increasingly important element when generating value from the investment. Many LBO firms have come to realize the importance of operating skills in bringing value to their investments. For those firms there are many ways in which they can enhance their operating capabilities. They can retain the services of prominent industry figures, cooperate with consulting firms, or hire operating specialists to work within the investment process
.

There are numerous ways of improving the portfolio company's strategy and operations. A study made by McKinsey & Co has however identified areas that are crucial when improving the portfolio company's operations (in terms of EBITDA growth). The study underscores the importance of value creating initiatives implemented at the portfolio company level and includes operating actions in the following five areas:

- *Management* - Business underperformance can often be traced to management shortcomings. It is therefore crucial that the new owners asses and address the capabilities of the existing management and organizational structure.

- *Business strategy* - Some portfolio companies pursue incomplete or flawed strategies. Actions to be taken should hence focus on creating strategies designed to maximize the portfolio company's core sustainable competitive advantage. When doing this, focus should also be on improving the company's financial profitability. Common strategy changes taken by LBO firms include "buy & build" or corporate refocusing.

- *Business knowledge / offering* - To create value at the early stages of the investment it is required that the owners meet with a broad spectrum of customers, competitors, and suppliers. This will facilitate an assessment of the portfolio company's offering, its service levels as well as new business opportunities. This provides valuable information that in many cases leads to improvements in the price/value/service proposition to the customers.

- *Productivity/Efficiency* - There are a number of ways in which new ownership can bring value by analyzing the portfolio company's work processes. This includes reducing unnecessary expense, exploring sourcing alternatives to improve quality and lower costs, and incorporating lean manufacturing practices in order to improve quality.

- *Profitable revenue growth* - It is often the case that sustainable revenue growth leads to a superior valuation upon exit. It is hence in the new owners' best interest to bring value to their investments by driving revenue growth. This can be done by supporting innovation and development of new products, building brand awareness through marketing initiatives, broadening the channels of distribution and strengthening the sales force of the company.

4.3 Transaction Phase B

4.3.1 Exit alternatives

The two most popular ways to realize the buyout investment is through a *trade sale* or an *initial public offering (IPO)*. A trade sale is when the company is sold an industrial buyer or another LBO firm while the IPO is when the company's shares are listed on the stock exchange. The IPO generally demands substantial planning as well as a relatively high work load. Another negative factor is that the buyout association is assumed to keep a portion of the shares, which in turn increases the risk and also crowd out new investments. A third way to extract cash from the investment is to carry out a *recapitalization*. A common practice in the industry is however to run mutual processes and evaluate the potential exit opportunities parallel.

A common way to calculate the return is to use the *internal rate of return (IRR)*[6]. The IRR is a good measure for these types of investments as it takes the time value of money as well as several investments into account (Forsberg & Karam, 1999). The simplicity with one single measure is another attractive feature that has made it popular.

4.4 The limited partnership

The LBO funds are mainly organized as limited partnerships where a new company is created, the Newco[7], with two types of investors; the Limited Partner (LP) and the General Partner (GP)[8]. Like the name reveals, the LP have limited liability[9] to the fund and generally invests the bulk part (97-99%) of the funds capital. In return they get return if the fund performs well in the form of profit sharing and preferred returns. The GP invests a minor part of the capital (1-3%), has unlimited liability to the fund and operates the investments during all phases. In return they get a management fee and profit sharing.

The advantages for having this kind of structure are mainly two. First, the structure enables the GP to invest a small part of the funds capital and have limited liability while the LP can invest a larger part and obtain limited liability. Secondly, it creates tax transparency so that the investors know in advance when and how much they will be forced to pay in tax.

6 $IRR_{Gross} = \left[\frac{Value_{Exit}}{Value_{Entry}}\right]^{1/time} - 1$

7 The Typical label for any newly organized company, particularly in the context of a leveraged buyout

8 The GP is what we in this paper refer to as the LBO firm

9 They cannot lose more than the invested amount.

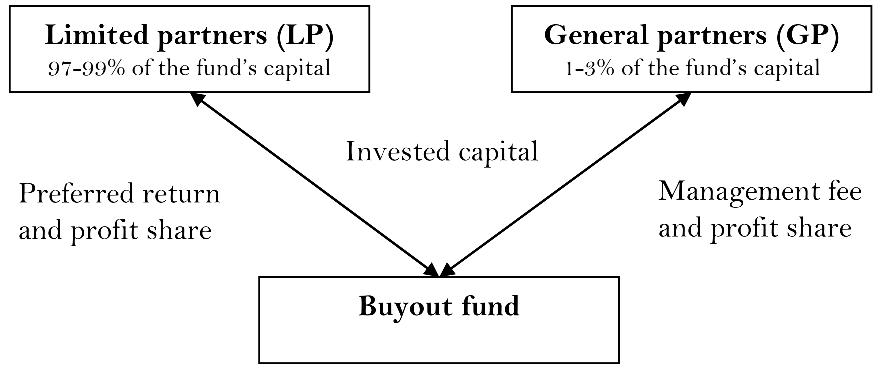


Figure 4.2. The limited partnership structure *Source: Riksbanken*

The profit sharing system for this kind of investment is relatively standardized. The LP generally gets a preferred return if the fund performs over a certain level. Additionally, they get 80% of the profits for the funds when the investments have been realized. The GP on the other hand, receive a management fee of around 1.5 to 2% of the managed capital that should cover salaries and other operating expenses. When the investments are realized, they get the remaining 20% of the funds profits.

4.5 Introduction of our framework

Our conclusion when conducting research for this thesis is that there are no generally accepted frameworks on how to perform an LBO. We however believe that most LBO firms could identify themselves with some general ideas, why we have created a framework. The purpose of creating this framework is to reduce complexity and enhance the understanding of the different aspects of the LBO investment. The framework is constructed on a two dimensional basis. The *first dimension* illustrates the progress of an LBO investment over time. The *second dimension* describes the *actions* and the *purpose* of these actions within each phase.

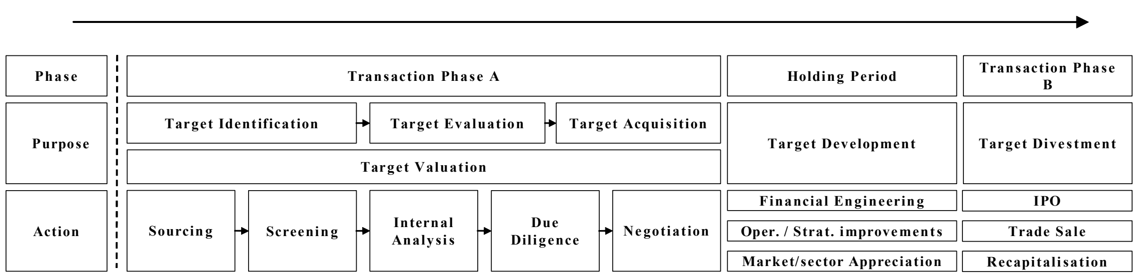


Figure 4.3 Our LBO investment framework

As can be viewed the framework above, we have divided the LBO investment into two main phases; transaction phase (A+B) and the holding period. The reason for using this approach is that we believe that the characteristics of the two phases differ substantially. Our decision to merge the two transaction phases (A+B) is based on our belief that most transaction linked factors have an impact both during the acquisition as well as the exit.

5. Explaining factors in the literature

In this chapter we will first explain the relevant theory that we will use for our analysis. We will then introduce the factors found, categorized according to the general framework presented in chapter 4.

The factors in this chapter are presented strictly theoretically and are hence not analysed according to importance.

The LBO firm's relative competitiveness and ability to outbid the strategic buyer should depend on how they value the target company compared to the strategic buyer. We hence search for factors that generate value to the target company for the LBO firm (compared to the strategic buyers).

When studying the literature, we have identified several relevant factors that could affect the LBO firm's competitiveness and their ability to outbid the strategic buyer in a positive way. There are of course numerous of potentially explaining factors mentioned in the literature and current debate. By increasing the scope of each factor we have been able to reduce the amount which in turn reduce complexity and create a better overview of the phenomena. We believe that this approach is crucial when later conducting our survey as well for the following analysis.

5.1 Sources of value generation

Berg & Gottschalg (2004) explain potential sources of value generation in an LBO. The researchers take the perspective of an equity investor and identify different sources that could increase the equity value in an LBO. According to their view, source of equity value could be described according to the following equation:

*Equity Value = Valuation Multiple * Revenues * Margin – Net debt*

Difference in equity valuation should hence be related to variations in at least one of these equation components. When analysing the source of these components Berg & Gottschalg identify two main sources of value generation to the equity value of a company; *value creation and value capturing.*

- *Value creation* - Fundamental improvements in the performance of the company that effect revenues and/or margins. Such improvements could include operating performance, reduced cost of capital etc.

- *Value capturing* - Increase in the equity value that occurs without any changes in the underlying performance of the company. This could for example include increases in multiples for comparable companies.

The sources of value creation can are further categorised by Berg & Gottschalg by using Porter's (1985) findings that value creation can be obtained on a *primary* and *secondary lever.* Secondary value creation can for example be obtained through reduced agency costs or incentive alignments between owner and management. Primary value creation has a direct impact on the numbers which could for example operating improvements.

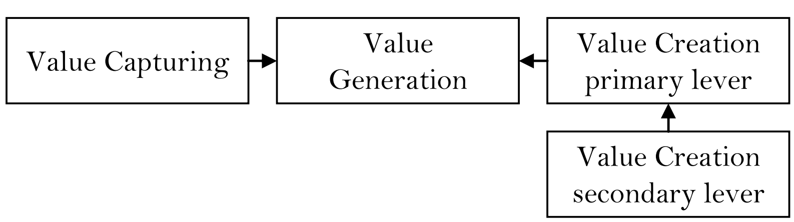


Figure 5.1 Value creation in LBOs *Berg & Gottschalg (2004)*

5.2 Transaction linked factors

Baker et al. (1998) identifies three ways for the LBO firm to capture value within the within the process of conducting the deal; finding the right acquisition target, limit the competition from other buyers and management of the negotiation and acquisition process.

5.2.1 Target identification

Anders (1992) concludes that LBO firms often perform regular extensive research which in turn helps them to carefully select suitable acquisition targets. Additionally Kaufman et al. (1996) shows that their extensive networks within the industry give them access to these attractive deals. According to Gottschalg & Zollo (2002), successful buyouts take place in industries with high EBITDA margins, i.e. strong cash flows. They further argue that the ability to generate solid deal flow, ideally with access to a large number of proprietary transactions, is a clear indicator of the quality of an LBO firm.

Magowan (1989) further argues that sophisticated buyout investor have the capability to identify and take advantage of the "conglomerate discount effect", which states that multi unit companies are traded on a discount compared to the sum of the stand alone value of each unit.

Samdami et al. (2001) identified that some LBO firms target companies in certain markets coloured by fragmentation. The goal with such transactions is to use leverage and cash for suitable add-on acquisitions to consolidate the market (Seth et al., 1993) and thus create economies of scale and a dominant market position.

Factor 1: Superior ability to identify a suitable target company

5.2.2 Evaluating the target company

LBO firms often possess a huge network consisting of management teams and companies in different industries. Fox et al. (1992) argues that the network could create superior expertise compared to other potential buyers that could be used in an advantageous way.

Factor 2: Superior network and expertise when evaluating the target company

5.2.3 Acquiring the target company

Butler (2001) means that LBO firms are often considered being tough negotiators and performing a high quality acquisition process. They are often considered to move fast and put pressure on the seller which in turn often limits the competition from other parties.

The acquisition capability constitutes a valuable resource to the LBO firm that the strategic buyers, for which acquisitions are exceptional and infrequent events, cannot develop. LBO firms are in a position to extract systematic rents from their acquisition capability, because it is difficult for the seller to quantify the magnitude of operational improvements and the impact of new business initiatives that the management will entertain under the new incentive system in an LBO context (Barney, 1988).

Factor 3: Superior deal making expertise

LBO firms tend to have good relationships with key institutions in order to negotiate favourable terms that otherwise would have been impossible for the target to obtain. This is a result of the fact that buyout investors are returning clients within the debt market and are considered to be excellent customers that pay their duties (Frankfurter et al., 1992).

Factor 4: Superior ability to negotiate favourable borrowing terms

5.2.4 Valuing the target company

As mentioned, multiple valuations are commonly used when determining the value for companies. Through the LBO firms experience and strong presence on the capital market they may have a superior ability to predict the future evolvement the valuation multiple, both from peer and a market perspective. One could therefore argue that the LBO firm could take advantage of this and thus incorporate a different *sector appreciation* and/or a *market appreciation* in the valuation. The LBO firm could also have other superior abilities within the valuation process such as defining and choosing the correct peer firms, using correct discount rates or better estimations of cash flow and earnings.

Factor 5: Superior ability to conduct a correct valuation of the target

5.3 Holding period linked factors

5.3.1 Strategic and operating improvements

As the organizational and ownership structure often changes after a buyout, it is possible to take such actions that can improve the operational efficiency (Kaplan, 1989b). After an acquisition, a number of actions are taken in order to change and improve the organisation (Wright et al., 2001). A common action for LBO firms is to carry out a number of so called cost cutting programs (Baker, 1992). Studies have shown that these programs have lowered the cost of production. Additionally, many companies experience an increased productivity as a result of the buyout.

It has often been argued that LBO firms reduce the spending to the expense of R&D. The findings in the literature are divided but some researchers (Hall, 1990; Smith 1990b) have found evidence of such a reduction. Finally, LBO firms tend to reduce the overhead costs by creating a less bureaucratic organization (Butler, 2001)

As another way to limit the costs, many LBO firms try to reduce the capital spending and have a tighter management of the working capital (Baker et al., 1989; Samdami et al., 2001).

LBO firms therefore generally reduce the capital tied in accounts receivable and inventory compared to the pre-buyout period (Eastwood et al. 1989) and have significant lower levels of working capital that non-LBO firms in the same industry (Holthausen et al., 1996). There is also a tighter control of the capital expenditure on investments which often lead to increased efficiency in the companies' production and improved cash flows (Seth et al., 1993; Kohlberg, 1989)

Buyouts are further considered to be a way to make the market more efficient by removing, or at least threaten to remove, inefficient management team (Jensen et al., 1983) and is a common practice in the industry (Anders, 1992). By getting rid of the underperforming management teams the operational effectiveness can increase which increases the cash flow and thus the value of the company.

Factor 6: Value generation through operating improvements

A common practise pursued by LBO firms is corporate refocusing (Seth et al., 1993) where non-core businesses are divested and there is an increased focus on the company's core business (Wiersema et al., 1995). The company's resources are therefore more focused to maintain and strengthen the competitive advantage (Easterwood et al., 1989)

Factor 7: Value generation through an improved strategy

5.3.2 Financial engineering

Some researchers (Lowenstein, 1985; Bull, 1989) hold the belief that there is a value generation in a buyout caused by increased leverage. By taking on more debt the tax-deductible interest payments increase, which in turn have a positive impact on the company's cash flows (Singh, 1990). Due to the risk of lowering the company's credit rating, industrial buyers sometime lack the opportunity to finance acquisitions through large amounts of leverage.

Increased leverage also creates a higher amount of interest payments that has to be paid, which in turn could force the management to limit unnecessary spending of cash flow within the firm. The increased interest burden also increases the risk of default, which in turn forces the management to work even harder and act even more in the interest of the owners to make the company survive. Furthermore, it increases the governance as the budget gets more limited (Baker et al., 1989). Hence, this indirect effect of leverage points to the fact that there could be a possible reduction of agency costs. Research has found that the agency problem is important when analyzing buyouts (Opler et al., 1993).

Anders (1992) concludes that buyout associations possess a unique expertise of the capital markets and use this on their portfolio companies. Kaufman et al. (1993) share this view and identify how LBO firms assist the management in handling issues related to the process of obtaining an optimal capital structure.

Factor 8: Value generation through increased leverage

A common practice in a buyout is to force or let the management buy or get an equity stake in the firm (Baker et al., 1994). This increases the interest alignment between owners and managers as the cost of running the company in an inefficient way increases for the managers (Smith, 1990). Another result of the increased ownership is that the management share the upside of the firm to greater extent (Jensen et al., 1976) which in turn encourage them to take better decisions that will create value for the company (Palepu, 1990). This is called the "LBO fever" as managers are willing to take any action in order to make the company successful (Houlden, 1990). Management incentive systems are especially important as they serve a double function: they motivate the management of the portfolio company while at the same time increasing the probability to retain the leadership of the acquired firm (Gottschalg & Zollo, 2002).

Ofek (1994) argues that a management team could use private information in an advantageous way. According to Hite et al (1989) they could even manoeuvre or lower forecasted earnings in order to achieve a lower acquisition price than an informed buyer would be willing to pay (Kaplan, 1989b).

Factor 9: Interest alignment through increased management ownership

A concentrated ownership structure in the company leads to a more active role for the representatives on the board (DeAngelo et al., 1984). They get access to important material and have the possibility to follow the managements work closer (Palepu, 1990). As a result, a buyout creates a structure that allows a better monitoring and controlling of the company's operations and its management (Singh, 1990). Bull (1989) finds that LBO firms are less involved in the daily operations than strategic buyers but that their representatives have a closer relationship to the portfolio company's management and its operations.

LBO firms are considered to be professional investors that have specialised in buying companies. The large number of transactions that these firms carry out implies that they would have a relative higher knowledge how to monitor post-LBO firms to other investors in the market (DeAngelo et al., 1984). When it comes to advising, representatives from the LBO firm often possess a network of contacts as well as own experience that are favourable for the development of the firm. This can help the company both in its daily operations as well when deciding strategies and goals (Baker et al., 1989). This also holds for the recruitment of managers, finding potential acquisition targets or to find business partners.

In some cases, divisions of larger corporations lack the entrepreneurial spirit that is required to develop the business in a favourable way. It can be a lack of headquarter resources or an organizational structure that affects the spirit in a negative way. In the case of a buyout, the structure of the organization as well as the attention from the LBO firm can help to remove such negative behaviour (Lowenstein, 1985).

Finally, researchers have found that LBO firms generally have tighter budget targets (Anders, 1992; Baker et al., 1994). This forces the management to work harder to meet the expectations (Baker et al., 1989). Financial targets are generally very optimistic and the LBO firms expect the profitability to increase substantially during the holding period (Butler, 2001).

Factor 10: Concentrated, and hence active ownership, generates value

5.4 Overvaluation

When summarising the covered spectra of the identified factors we came to the conclusion that there was another level of explaining factors. So far, we have focused on the LBO process as such. However, it has often been claimed that the LBO firms are overvaluing their investments. A logical reasoning is therefore that there could be external factors affecting the LBO firm's valuation process. We however found little support for this in previous research why we decided to look for potential explaining factors in the current debate.

There is a trend with increased amount of capital invested by pension funds and other institutions. This together with low borrowing rates drives up the amount of capital available for investment. Critics are therefore claiming that the LBO firms possess too much capital with exaggerated valuations as a result (SvD Näringsliv, 06-03-22). There is a risk of irrational behaviour for the buyout investor. This should become increasingly important in competitive bidding situations where the sunk cost for analysis, negotiations and due diligence in case of losing the deal may cause such behaviour. Lowenstein (1985) found that the premium paid to pre-equity holders increased substantially in MBO transactions with three or more competing parties than with one single. This could imply that LBO firms would pay in excess of the assets real value

Factor 11: Excess capital (equity + debt) available exaggerates valuations

Furthermore, it has become more common that LBO firms buy and sell companies to each other. This could point to a potential problem that there are not enough interesting target companies for the LBO firms to invest in. According to the critics, this phenomenon has resulted in an "upward spiral" where buyouts funds are trading target companies to each other at ever higher prices and valuations (SvD Näringsliv, 06-04-03). In 2005, 60 percent of the companies involved in private equity deals were sold from one PE-firm to another on the so called second hand market (SVCA Q4 2005). By driving up the prices on a "closed market", the companies are out of reach for suitable industrial owners or for the regular stock market (SvD Näringsliv 06-04-03).

Factor 12: Overvaluation caused by LBO firms selling to each other

A risk with the increased valuations is that the portfolio companies may become more vulnerable to the general conditions of the economy (Business Week 06-02-27). With the increased competition for suitable target companies and high valuations there is a risk that deals are priced to perfection. For these investments to turn out profitable, they will need a strong economy and a management team that are able to execute perfectly.

Factor 13: Overvaluation caused by too optimistic assumptions

Furthermore, the valuation of the companies that was bought a couple of years ago has benefited from the decline in interest rates which has led to higher multiples which in turn has driven up the valuations. The return on these objects could therefore be extraordinary and not the long term potential for private equity returns. The large inflow of new capital and the increased competition for suitable target companies has created higher valuations and could also mean that PE-firms have to work even harder with the portfolio companies to create value. To simply change the capital structure by selling of assets or taking on new loans, which has worked before, will probably not be sufficient.

Factor 14: Overvaluation caused by historically favourable macro conditions

5.5 Applying factors and sources of value generation to our framework

We have identified 14 factors that we believe can affect the LBO firm's competitiveness and ability to outbid the strategic buyer. To create a better understanding of the value generation process of an LBO we have added Berg & Gottschalg's sources of value generation to the framework. As the sources of value generation are connected to the characteristics of each factor, we have also added the 14 identified factors to our framework. Through taking these two steps we have both created a better understanding of the sources of value generation as well as where in the LBO investment the value is generated.

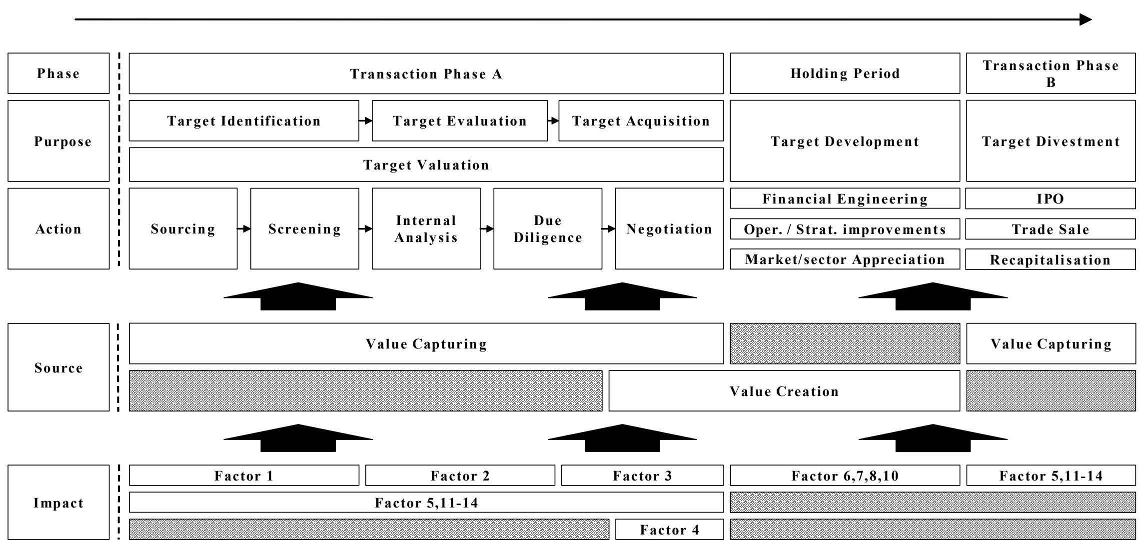


Figure 5.2 Applying factor impact and sources of value generation to our framework

The mapping of the first ten factors relating directly to the LBO process was a relatively straight forward process. We however found it more difficult to map the four remaining factors relating to a potential overvaluation. Our conclusion is that these factors are external with an indirect effect on the valuation process of the company. We therefore consider the impact of these factors to cause some sort of irrational behaviour in the process of valuing the target company which could result in an overvaluation.

6. Factor importance

We will in this chapter perform an analysis on the factors presented in chapter 5. We will look at what research and the current debate have found to be most important regarding each factor. This will give the reader a better understanding of each factors importance as well as a thorough analysis of what previous research has found.

6.1 Transaction phase

6.1.1 Target identification

Kreuter et al. (2004) found support for the importance of extensive research by LBO firms when identifying suitable targets. According to their study, buyouts that originated from other sources than publicly known deals generated superior returns. However, this does not conclude that it should affect their ability to outbid strategic buyers. Instead, it rather points to the importance of their deal sourcing capability to generate value to the investment. The study further found that deals originating from advisors had superior returns to deals sourced from the LBO firms' network. One could therefore argue that the importance of their network have less impact in the early transaction phase of an LBO.

6.1.2 Target evaluation

According to survey made by McKinsey & Co, proprietary knowledge during due diligence is easier to come by and more quickly understood. Firms become highly refined in terms of identifying the company characteristics that make up their investment "sweet spot," making identification of potential good deals an efficient and relatively rapid process. One could argue that these findings implies that the fact that LBO firms are returning customers on the M&A market have resulted in superior deal making capabilities compared to strategic buyers.

6.1.3 Target acquisition

According to research conducted by Bank of America, LBO firms have been found to move quickly and a have superior deal-executing capabilities compared to their strategic counterparts. When analysing a number of acquisitions they found the LBO firms, due to these capabilities, could outbid the strategic buyers.

There is however no evidence that the management should favour the LBO firm in the process of an MBO. Premiums paid in LBO are comparable with those in inter-firm mergers that are characterized by arm's-length negotiations between the buyer and seller. The evolvement of structured bidding auctions and the extensive information requirement have limited these opportunities (Lee, 1992). Research has also found that it is unlikely that the management would be capable of monopolizing the bidding in favour of their interests.

6.1.4 Target valuation

Anders Nyrén, CEO of Industrivärden, argues that there are substantial differences in the valuations used by LBO firms and strategic buyers. He claims that these differences originate from incorrect discount rates used by strategic buyers. Arne Carlsson, CEO of Ratos, also supports this view. He claims that a general opinion on the market is that the strategic buyers often tend to be more risk averse. Nyrén further believes that the differences is a result of a very conservative capital market that demand a risk premium not reflecting the current low interest rate environment. Many financial advisors also find it remarkable that the strategic buyers often implement a fixed required rate of return on all their investment, often not sensible to changing conditions in the market (Business Week 06-02-27).

More technically, it has been argued that the LBO firm's ability to outbid the strategic buyer is based on the expected exit value. The model assumes a future divestment where the seller, because of the amortisation of loans, has an equity stake that represents a larger part of the total enterprise value. As they view the investment on a stand-alone basis, they are also able to use a more flexible valuation approach and financing approach. This flexibility originates from the fact that they only have to consider one factor, the IRR, which is solely determined from this particular investment. Moreover, the LBO firms have more of a long-term view on their investments and hence do not demand annual (or quarterly) returns. The strategic buyer, on the other hand, has to consider a number of different key ratios on the company as a whole and investors that demands short term returns (Kristoffersson & Mårtensson, 2005).

6.2 Holding period

6.2.1 Operational improvements

Swedish industrialist Rune Andersson claims that the reason for the success of the LBO firms is that they have a different framework to operate within compared to the strategic buyers. This is exemplified in the recent debate regarding the buyout of Gambro, where EQT and Investor claim that the buyout allows them to take actions that otherwise would have been impossible. Börje Ekholm, CEO of Investor, claims that this is a result of a longer investment horizon by management and owners (Affärsvärlden, 2006-04-03). Juuka Ruuska, CEO of OMX, have identified that the portfolio companies return to the stock exchange in better shape than when they left. Their views are supported by statistics from Nutek, which state that portfolio companies of LBO firms performed better than their industry peers. During 1999 to 2004, the number of employees as well as turnover grew three times as much as in the companies listed on the OMX A.-list.

According to Jesper Almström, head of due diligence at Ernst & Young, the reason why the LBO firms can add substantial value to the companies during the holding period is that they have a clear strategy for their investments. He further argues that these portfolio companies get an owner with capital available for restructurings, investments and add-on acquisitions. The industrial buyers, on the other hand, rather limit their capital spending due to a short sighted approach on the capital market (www.ey.se).

A study made by Gottschalg & Zollo (2002) however failed to provide support for a knowledge transfer from the LBO firm to its portfolio company on the operational level. The primary source of value creation was instead the reduction of agency cost, which enabled a more efficient use of existing resources of the portfolio company. According to their findings, this efficiency enhancement was achieved through highly powered incentive systems for the management and the specific monitoring and controlling role of the LBO firm.

In a study made by Kreuter et al. (2004), management incentive manipulation was considered to be the strongest determinant of the performance of an LBO. According to Rune Andersson, the effect of equity ownership by management is further increased through substantial differences regarding personal taxes. The taxation rules in Sweden, he claims, clearly favour LBO firms. This is mainly due to the fact that officials in LBO firms can to a large extent receive capital-taxed compensation whereas officials in publicly traded companies have high marginal taxes on their income. This, he claims, could point to management in target companies favouring LBO firms. The importance of the current management is further supported by recent research, which identifies a negative performance impact in connection to the replacements of the management. (Gottschalg, 2002)

6.2.2 Financial engineering

Historically, many LBO firms solely focused on financial engineering to generate value to their portfolio companies. Some researchers argue that is not the case today (Wright et al., 2001), where the LBO firms have to show growth in the company in to be able to make a successful exit (Butler, 2001). This implies that the importance of financial engineering as a source of value generation has diminished over time. This view is supported by a study made by Gottschalg (2002), which cannot show any clear evidence between leverage and LBO performance. This study point to the fact that major value generation cannot be derived from the level of leverage. As the buyout industry is facing increasing competition companies have been forced to create value through improvements of their operations in order to reach suitable returns. When competing with a strategic buyer, leverage should however still be an important factor. Rune Andersson claims that strategic buyers cannot use leverage to the same extent as LBO firms. This, he states, can be traced to fact that industrial buyers are "not allowed" to finance their acquisitions with the same degree of debt as LBO firms. Investors on the stock market as well as the banks would probably not approve of debt to equity ratios above 0.5.

Besides the level of leverage, Rune Andersson argues that the fact that LBO firms have shorter investment horizons enables them to structure and time their deals better. It is hence relatively easier for LBO firms to survey business cycles and interest rates and hence maximize their financial leverage. The low interest rates also play an important role and give the LBO firm cheap financing. Roger Kimmel, vice chairman of Rothschild states that the low interest rates create a lot of activity on the M&A market.

6.3 Overvaluation

Critics are claiming that the development with LBO firms acquiring companies from each other is not healthy. By driving up the prices on a "closed market", the companies are out of reach for suitable industrial owners or for the regular stock market. In 2005, 60 percent of the companies involved in private equity deals were sold from one PE-firm to another on the so called second hand market (SvD Näringsliv 06-04-03). A number of such deals have been made in recent years, not least in Sweden and the other Nordic countries. One example is the roof rack manufacturer Thule who was sold by EQT to Candover, a fellow LBO firm, for 4.2 billion SEK in October 2004. This, and other deals alike, points to the possible problem that there are not enough interesting target companies for the LBO firms to invest in. This view is supported by a study made by Gottschalg & Zollo (2002) that show that the intra-industry trade of companies among LBO firms has resulted in lower returns.

A further indication of this development is despite that the stock market has boomed for three consecutive years the number of IPO's is less then the number of delistings in that period. During the last three years the number of companies listed on the Stockholm Stock Exchange has decreased with 49 companies, despite the overall positive development of the SAX index. (NUTEK) There have however been recent events that could point to a revival of the IPO as an attractive exit. Arne Karlsson, CEO of Ratos, means that the good performance of the stock exchange, together with the relative good performance of recent IPO's, make the stock exchange more attractive when the LBO firms are looking for potential exits. This could however also be a sign that the boom on the stock market is reaching its peak, and that the LBO firms know this and wants to maximize their returns before the stock market goes down again. According to Dealogic, which tracks the industry, LBO backed IPOs have performed worse than other offerings. Analysts ascribe some of that discrepancy to concern by investors that private equity firms will later cash out of their position, depressing the stock price. Over time, though, that gap often narrows and some LBO offerings have outperformed other offerings according to Dealogic.

Another indicator of possible overvaluations is the amount of capital available on the LBO market. Many fund managers are starting to worry that funds are overpaying the deals and taking on to much debt. One indicator in favour of this statement is that several buyouts have been valued at multiples way above industry average in the recent period. With an increased competition for deals, LBO firms have increased the amount of debt used when financing the acquisitions. An illustrative example of this is a statement made by Robert Kravis, vice chairman of Rotschild: "Unfortunately, there is a flip side to having access to plentiful capital. It means that too many people without experience in building businesses have too much money."(www.tuck.dartmouth.edu, 2006)

At the same time as investors are bidding for targets, banks are competing for the financing of the deals. Between 2000 and 2002, the average buyout was financed with four times EBITDA. By the end of 2005, this figure had risen to 5.6. Credit rating firms therefore believe that the banks are less conservative when lending money today compared to some years ago. Many advisory firms who have experienced that many deals in the recent period have been priced to perfection share this view. In order to survive, they will therefore need a strong economy and a management that executes perfectly. The low interest rate have further driven up the debt levels and increased the risks of the investments. Martin Fridson, CEO of high-yield bond-market strategist Fridson Vision, believes that many firms will be unable to service their debt if the interest rates don't remain on today's low level. "If they don't, this buyout boom could go bust, leaving a pile of junk-rated companies, defaulted debt, and lost equity in its wake". This view is further supported James E. Hamilton, president of the Blackstone Group, who is pessimistic about the economy, interest rates and the credit markets. "I feel people are paying prices that are too full". He further believes that some mistakes will be made. "We have become more conservative about the types of companies we buy, the prices we pay, the exit multiple assumptions and so on and so forth."

The criticism that there is too much money on the market and the borrowing terms are too good, which in turn drives up the prices on target companies, has little support within the LBO industry. According to Gustav Bard of 3i, high prices do not affect the calculation at a horizon over a few years, and failed deals are very seldom (Veckans Affärer 06-04-03). Further he claims that the financial structure is significantly more robust than the case of the real estate bubble for example. The industry could however run in to trouble and returns could go down, but this is not the same saying that it is a bubble he claims. One possible scenario of a failed deal could be that the banks does not allow as generous credits as before, and hence less favourable conditions for PE-companies when it comes to bidding for a target company. His view is shared among many colleagues within the industry that also disagree with the premise that there is a bubble ready to pop. They note that private equity is still only a small part of the M&A market, and they say that if they've done their homework, they will have made the right bet.

7. Empirical study on the Swedish M&A market

In this chapter we will present our findings from the empirical study made on the Swedish M&A market. The data is first presented for the total population followed by data from LBO firms, strategic buyers and advisors respectively.

To further analyse the importance and occurrence of the identified factors we conducted a survey on the Swedish M&A market. The aim of this survey is to get a more comprehensive view of what the market believes is most important. A questionnaire was therefore sent to *LBO firms*, *strategic buyers* and *advisors*, three groups that we consider to be active participants on the Swedish M&A market with a deeper insight of the phenomena that we investigate in this thesis.

Based on the data received from the three groups, the analysis of data will be made on the phase, purpose and source level of our framework. Due to limited amount of factors used in the questionnaire, we are unable to analyse any data on the action level of our framework.

7.1 Trends in collected data

7.1.1 Total data sample

On phase level, the collected data implies that the general opinion among the respondents is that most value generation takes place during the holding period. The analysis on the purpose level shows supports these findings and further states that financial engineering is considered to be most important, followed by operating improvements. Target acquisition is considered to be the most important part during the transaction phase, but on the whole it seems to be little support for transaction linked value generation. On the individual factor level we get support for this trend and can identify that increased leverage (8) is considered to be the most important factor among the respondents. Other important holding period factors are management ownership (9), operational improvements (6), strategy improvements (7) and concentrated ownership (10). A part from holding period related factors, overvaluation through excess capital (14) and deal making expertise (3) are considered to be two important factors. On the source level, we can observe that the respondents' first choices consider LBO firms to create as well as capture value on an equal basis. Taking choice 2-5 into count, it however seems like the respondents consider the LBO investment to create rather than capture value. Interesting to observe is that our findings imply that a general opinion among the respondents is that LBO firms are paying too much for acquisition targets due to excess capital (14). Other overvaluation factors get little attention.

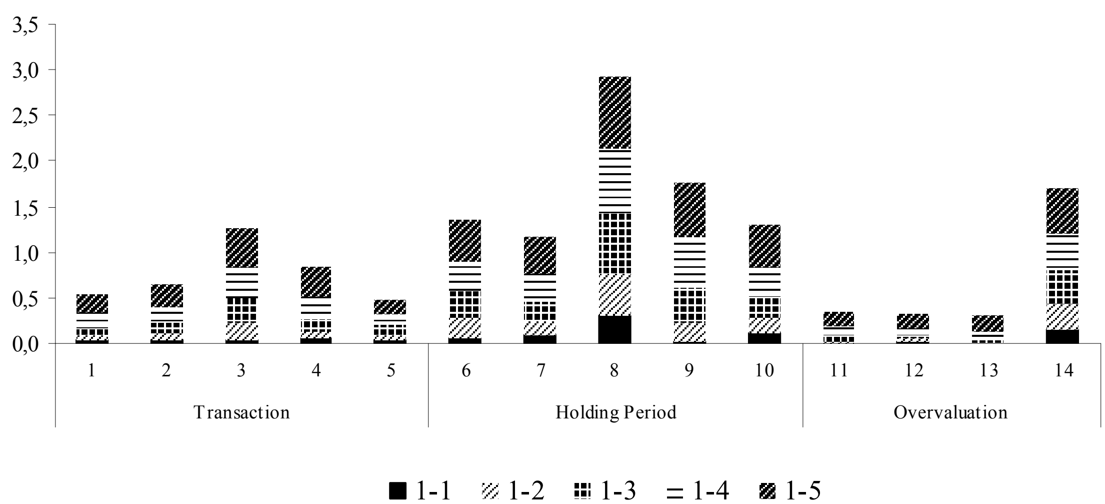


Figure 7.1 Factor importance – total

7.1.2 LBO firms

The data collected from LBO firms shows a clear trend that the respondents consider most value generation to occur during the holding period. This trend is further supported through an analysis on the purpose level. This level shows that the respondents from the industry consider most value generation to take place through operating improvements followed by financial engineering. An understandable view as leverage is not a competitive factor to other LBO firms. A second thought, this should not affect their answers in the study as the aim of this survey is to investigate their relative competitiveness to strategic buyers and not to other LBO firms. Outside the holding period, target acquisition is considered to be most important. On the factor level one can observe that the most important factors (6-10) except for one (3) can be linked to the holding period with the concentrated ownership receiving most attention (10). In the transaction period, the deal making expertise (3) is considered to be the most important value generation factor. The data further implies that there are little belief that overvaluation is commonly occurring in the industry. On the source level, the data supports that LBO firm creates rather than captures value during the LBO.

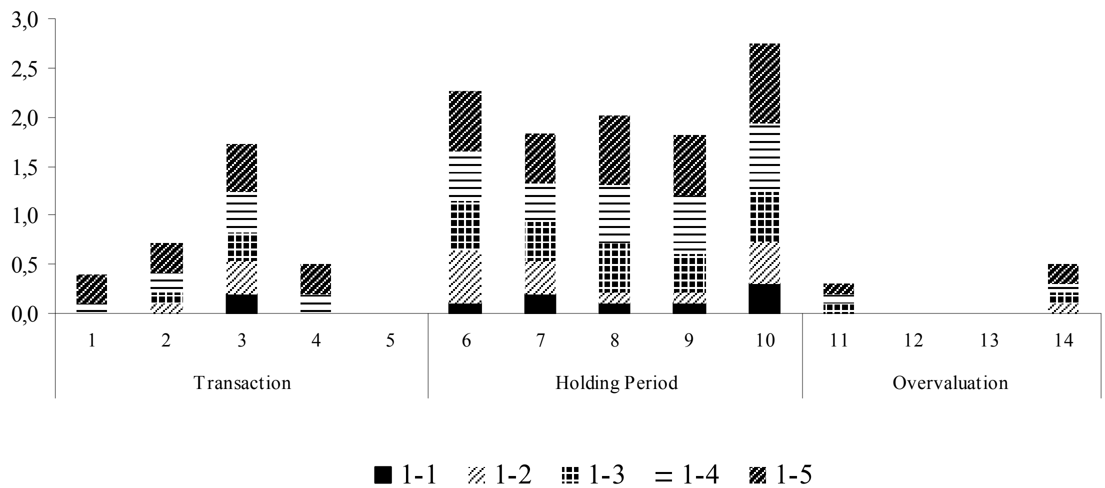


Figure 7.1 Factor importance – LBO firms

7.1.3 Strategic buyers

On phase level, perhaps a little bit surprisingly, data shows that value generation is connected to the holding period rather than the transaction period. On the purpose level, this is however explained by the fact that financial engineering is considered to be very dominant. Operating improvements and target identification get some support but are small in comparison to financial leverage. If the LBO industry agreed upon the importance of factors relating the holding period, on factor level, no such general belief can be traced by the data collected from strategic buyers. The strategic buyers on the other hand, seem to have more of a widespread belief of where the LBO firms generate value. The data implies that the strategic buyers consider increased leverage (8) to be the most important factor. A part from the LBO firms the data supports access to excess capital results in overvaluations (14). There is however no significant differences compared to the other three groups regarding the overvaluation in connection o LBOs. On the source level, there is no clear indication whether the respondents believe in a value creation or a value capturing process of an LBO.

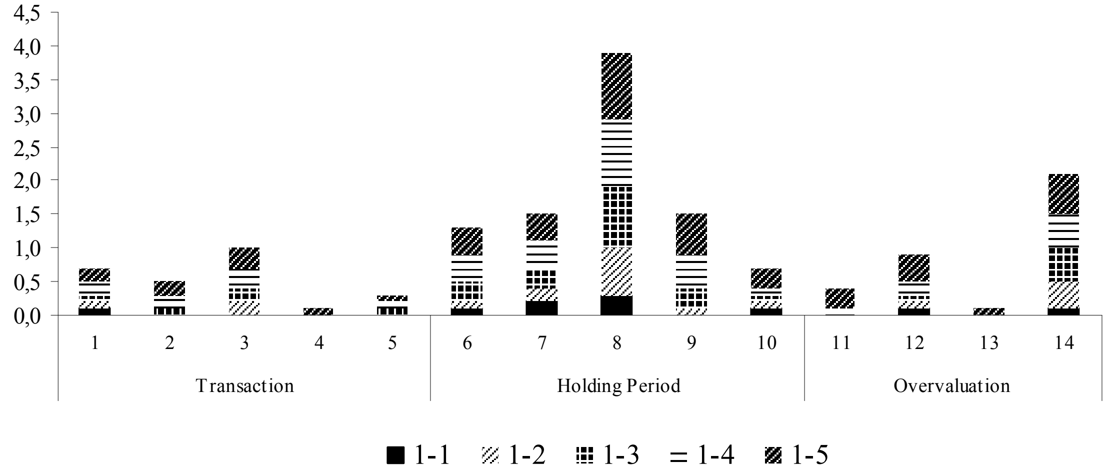


Figure 7.1 Factor importance – Strategic buyers

7.1.4. Advisors

On phase level, as in the other groups, data shows that respondents in this group believe that the major part of the value generation takes place during the holding period. On purpose level, we find a similar pattern to the strategic buyers with financial engineering as very dominant. Compared to the industrial buyers, the advisors however believe that the target acquisition is more important. On factor level we also find a similar pattern with the strategic buyers with increased leverage (8) and overvaluation through excess capital (14) as the two most important factors. The advisors however assign greater attention to the increased ownership by management (9) and the transaction linked (excluding overvaluation) factors as a group. Not surprisingly, they also consider the valuation be of greater importance than do the LBO firms and the strategic buyers. On source level we find no clear indication whether the advisors consider the LBO to have value creating or value capturing characteristics.

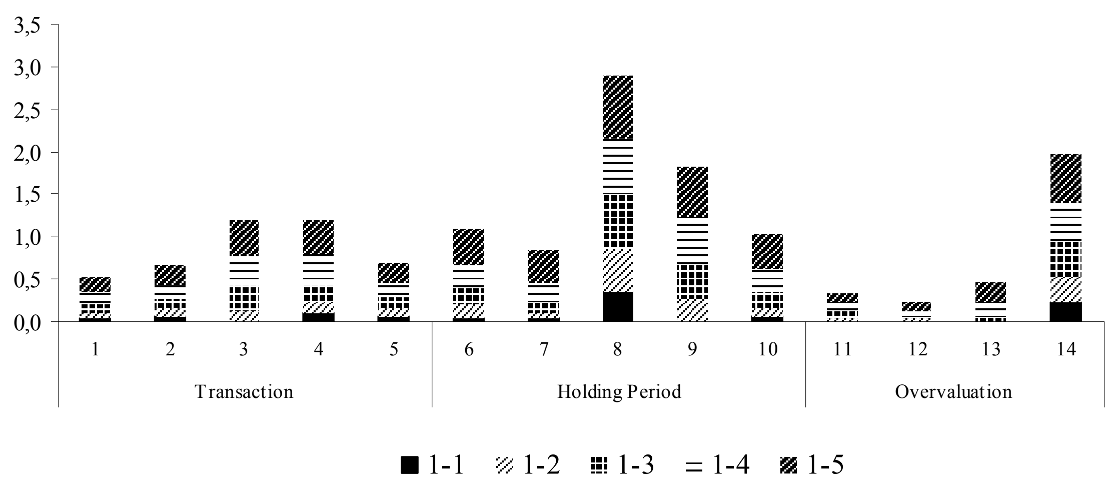


Figure 7.1 Factor importance – Advisors

7. Discussion and analysis

We have not found any clear evidence that the LBO firm should have superior abilities in the process of identifying and evaluating target companies. We base this argumentation on our findings within previous research, current debate as well as our own survey. It rather seems like that the LBO firms have a good ability to identify targets in certain industries or segments in order to limit the competition from other buyers, including the strategic. Some people argue that the LBO firm can conduct a superior due diligence process. We have however not found enough evidence to support that this argument holds or that this factor should be of such importance that it will really affect the relative competitiveness of the LBO firm to greater extent.

The LBO firms capabilities during the target acquisition period however seems to be of greater importance, both according to previous research and our own survey. LBO firms have been found to move quickly and a have superior deal-executing capabilities compared to the strategic buyers. It has also been argued that they have developed a superior acquisition capability. According to our own survey, both LBO firms and advisors consider it to be of moderate importance while the strategic buyer finds it less important. A reason for this could be that the strategic buyers do not have the possibility to compare their own process with the LBO firms'. They should further not be as experienced as acquisitions must be considered to be exceptional and infrequent events for most strategic buyers.

Another factor with connection to the acquisition period is the negotiation of favourable borrowing terms. Both previous research as well as the current debate highlighted the potential importance of the LBO firm's ability, as an excellent returning customer on the debt markets, to negotiate favourable borrowing terms. We have however not found any evidence that this should be the case. Our survey could indicate that the market consider this factor to be of limited importance.

Surprisingly, even if the technical valuation approaches is one aspect that differs substantially between LBO firms and strategic buyers, we have not found any indications that this would affect the relative competitiveness. According to research and our survey, we would argue that the important differences between the two instead lie in what data that is plugged in to the valuation models. We have identified different views of what discount rates to use as frequently reoccurring. Critics are claiming that the strategic buyers are using discount rates that do not reflect the true cost of capital for the investment. This is however just a common opinion and has not been empirically proven. Furthermore, our own study did not yield any additional indication why we found it hard to determine the importance or even the existence of such a phenomena. Some people are further arguing that any such differences will disappear over time.

We have identified that a common view is that the buyout allows the LBO firm to undertake value generating actions. This seems to be a result that the private environment allows them to make value generating changes without interference from the capital markets. A good indicator that this could be the case is that portfolio companies historically have performed better than their industry peers. We find support for this through our survey where the respondents, with emphasis on the LBO firms in particular, believe that the LBO firms generates value to the portfolio company by making operating and strategic changes.

A recent McKinsey & Company study of private equity firms in Europe and North America called "Excellence in Private Equity" concluded that operating improvement measured in terms of EBITDA growth was the main source of value creation in nearly two–thirds of all of the most successful deals. It also concluded that owning and building value through an active ownership model is a time- and resource-intensive process. The McKinsey study underscores the importance of value creating initiatives implemented at the portfolio company level.

Research has however failed to provide support for a knowledge transfer from the LBO firm to its portfolio company on the operational level. Instead, the value generation process take place on another level. As mentioned, the framework created by Berg & Gottschalg (2004) includes two different levers of value creation. According to research findings, the primary source of value creation was achieved through highly powered incentive systems for the management and the specific monitoring and controlling role of the LBO firm. These findings are further supported by the findings from our survey which shows the relative importance of the secondary lever value creating factors such as the importance of management ownership and the active ownership by the LBO firm. Due to the limitation of our survey, we however find it inappropriate to draw any conclusions whether the first or secondary lever should be of greatest importance. However, research has found the secondary lever to be of greater importance than the primary lever and a very important factor when determine the sources of value generation in an LBO investment as a whole.

Research has found that the importance of financial engineering as a source of value generation has diminished over time and that there are no clear evidence between leverage and LBO performance. The general view is however that leverage still is an important advantage for the LBO firm when bidding for a target with historically low interest rates enabling the LBO firm to get cheap financing. Even if the LBO firm may have a required rate of return they can achieve superior returns on investment through the usage of leverage, and thus enable them to outbid the strategic buyer. According to our survey, all groups except for the LBO firms considered leverage by far to be the most important factor affecting the LBO firm's ability to outbid the strategic buyer.

As could be viewed in the chapter 6, the question whether LBO firms are overvaluing their acquisitions has captured a great amount of attention, both in previous research and the current debate. One reason for this is of course that it at this point is impossible to determine whether the LBO investments are overvalued or not. Several sources have been argued to cause overvaluation. First, there is a debate whether the low interest rates, generous lending restrictions and large investments from pension funds have supplied the LBO firms with too much capital. Critics claim that this should be the case and further argues that this in combination with the increased competition for target companies have caused the LBO firms to overvalue their acquisitions. This view is supported in our survey where the respondents believe that the excess capital available is one of the strongest factors affecting the LBO firm's ability to outbid the strategic buyer. This could therefore indicate support for the critics' opinion that the large amount of capital causes overvaluation.

The generous lending has, according to critics, made the LBO investments way to risky and sensitive for future economic movements. First, there is the risk that the LBO firms will get problems to service their debt payments in case of rising interest rates. Secondly, the debt has enabled huge LBO investments during the last years, investments that have to be realised in the coming years. Critics are claiming that the LBIO firms are facing a risk that they will be unable to flip their investments at profitable prices. The trend that LBO firms increasingly more buy companies from each other have created a debate whether this is a sign that this already is the case and that the intra-industry trade of portfolio companies is a way to postpone this. Research lack evidence whether this trend has caused overvaluations but indicates that returns are lower from such transactions.

Among the LBO firms, there is little or not support to the view that they should overvalue their investments. They however believe that the LBO industry as all other industries could run in to trouble. This is, as they claim, not an indication that there should be a bubble coming up. They point to the fact that very few deals have failed, and that their ability to create substantial industrial value in the portfolio companies have created a more robust financial structure. We get support for this view in our survey where the respondents from the LBO firms where any of the factors explaining their ability to outbid the strategic buyer by overvaluation get any significant support.

The purpose of our thesis has been to identify what factors that affect the relative competitiveness and ability to outbid the strategic buyer. Until now, this has been made from the perspective of the LBO firm. We have considered the strategic buyer in theory to be superior to the LBO firm because of its ability to count for potential synergies when bidding for a target. A reoccurring view when comparing the two players has been the questioning of the existence of such synergies. The most obvious evidence that support this view is the negative impact on the acquirers share price in connection to an announced deal. Strategic acquisitions are generally considered to result in substantial costs for organizational change and integration (Sitkin & Jemison, 1996). Such costs are considered necessary to take in order for a following realisation of synergies to take place. Suboptimal integration decisions, cultural incompatibilities and inaccurate implementation strategies are common problems that can increase these costs to such extent that they outweigh the synergistic value (Schweiger, & Weber, 1992). From what we found, an LBO firm can avoid most such costs.

8. Conclusion

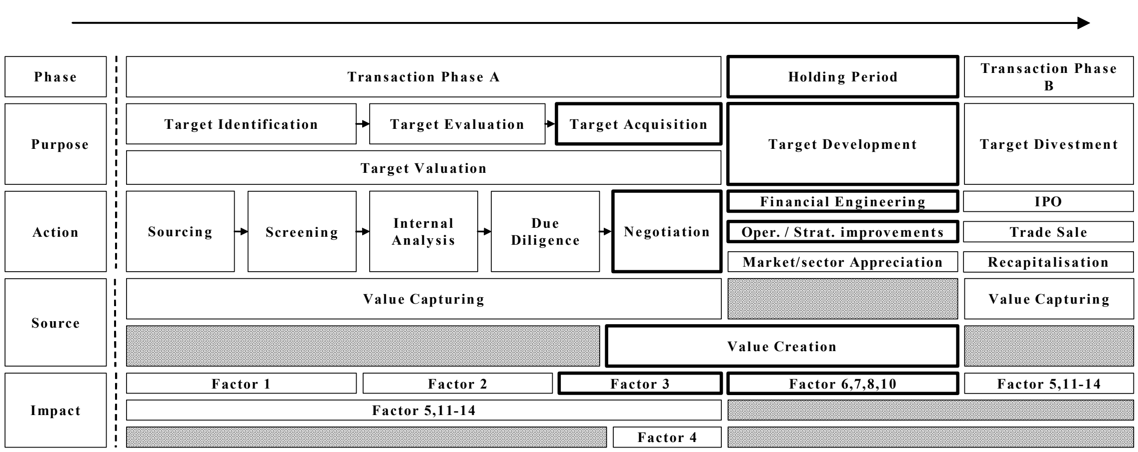
Based on the findings from research, current debate and our survey we will in this chapter discuss and analyse the relative importance and presence of the identified factors.

To summarise our findings one could argue that the following factors are the most important determinants affecting the LBO firm's relative competitiveness and ability to outbid the strategic buyer. When analysing the different phases of an LBO we have found the holding period to be of greater importance. Looking at this period from a greater perspective, we have found indications that the purpose of the LBO firm is to facilitate an improvement of the portfolio company rather than conducting these improvements themselves. From this perspective, secondary lever value creating factors such as the creation of *management incentive programs* and *active control and management of the portfolio company* have been identified as important factors.

We have further identified the LBO firm's ability to use *leverage* to a greater extent as an important factor. The general view seems to be that this factor is of great or even greatest importance. Previous research has however failed to find clear support for this view. What can be determined is however that LBO firms would probably not have the same competitive strength compared to the strategic buyer without the having the possibility to use leverage to such extent. Moreover, the LBO firm's *deal making capabilities* is identified as relatively important to other factors. Due to repeated acquisition LBO firms have gained superior knowledge how to acquire companies.

The question whether the LBO firms are overvaluing their investments is something that we find impossible to answer in this thesis. Generally speaking, the LBO firms do not comply with the notion that their investments are overvalued and that a bubble is being created. We have however identified the *excess amount of capital* available as the most probable explanatory factor if that should be the case.

By applying the conclusion of our thesis to the framework, we have summarised the findings in the table below:



Important areas affecting the LBO firm's relative competitiveness and ability to outbid the strategic buyer.

9. Final comments and further research

In this chapter we discuss the takeaways of this thesis and discuss and suggest areas for future research.

When commencing our thesis, our belief, coloured by the climate of the current debate, was that the LBO firms had a clear advantage over the strategic buyer. Over the course of writing our thesis, we have however found that neither the strategic buyer nor the LBO firm seems to have a clear advantage. What is true, however, is that the market no longer assumes that strategic buyers will pay more than a fund due to synergies alone. LBO firms are steadily increasing their presence on the M&A market and the pressure for increased returns are forcing them become extremely competitive in winning deals. This has resulted in a highly competitive market where LBO firms are competing aggressively against strategic buyers. This competition has turned out not only to be based on price, but also on structure and deal terms. One takeaway from writing this thesis is that both LBO firms as well strategic buyers will be better off if they are able to avoid competitive auctions. In order to maximise their returns they should instead look for target companies where such auctions are not present.

We have identified that the there is a limited amount of research describing the value generating process during the transaction phases. Even if LBO transactions generally are coloured by a limited amount of publicly available data, it would be interesting to perform an in-depth analysis of this period. We have further identified that there is a lack of statistics describing to what extent the LBO firms actually outbid the strategic buyer (or vice versa), something that would be of general interest and interesting to study.

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11. Appendix

The appendix includes the following:

1. *The design of the questionnaire used*
2. *The data analysis from the questionnaire*
3. *Our framework*

The design of the questionnaire used

Guide:

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1. Select **5 of the 14** factors you consider best explains why buyout firms can outbid industrial buyers.
2. Rank the factors from **1 to 5 by importance**. Use the drop down menu to select the correct number. (1= most important… etc.)
3. If you have identified factor(s) not mentioned in this paper or have any other thoughts, we would highly appreciate if you could share this with us. Please use the designated field for this.
4. Save the form and return it to 19370@student.hhs.se

As our timeframe for this project is limited, we would highly appreciate if you could return the completed form no later than **May 5th**.

All information will be handled and presented anonymously!

Please see appendix for further explanation of the factors

Questionnaire

The financial buyer's ability to outbid the industrial buyers is based on…

Factor 1. Superior ability to identify a suitable target company **none**

Factor 2. Superior network and expertise when evaluating the target **none**

Factor 3. Superior ability to conduct a correct valuation of the target **none**

Factor 4. Overvaluation caused by financial buyers selling to each other **none**

Factor 5. Overvaluation caused by too optimistic assumptions **none**

Factor 6. Overvaluation caused by historically favourable macro conditions **none**

Factor 7. Excess capital (equity + debt) available exaggerates valuations **none**

Factor 8. Superior deal making expertise **none**

Factor 9. Value generation through operating improvements **none**

Factor 10. Value generation through improved strategy **none**

Factor 11. Superior ability to negotiate favourable borrowing terms **none**

Factor 12. Value generation through increased leverage **none**

Factor 13. Interest alignment through increased management ownership **none**

Factor 14. Concentrated, and hence active ownership, generates value **none**

Please select only 5 factors!

Comments (*Missing factors etc.***):**

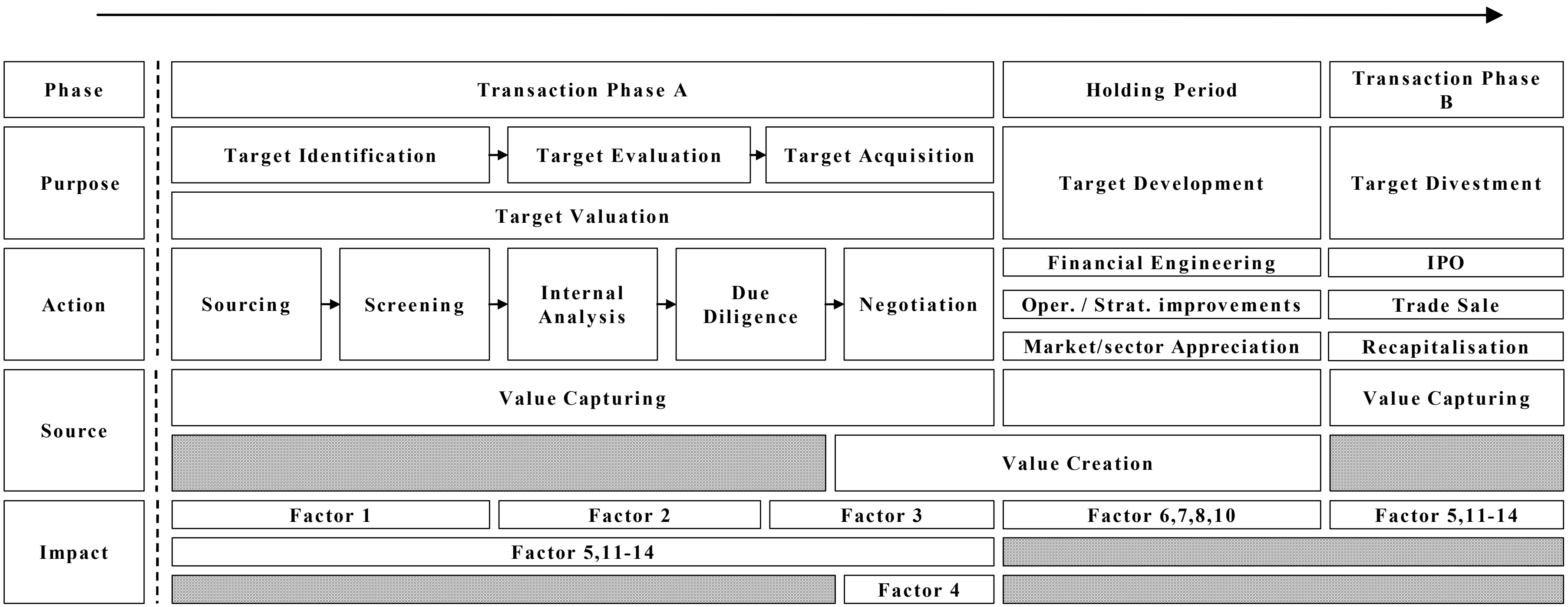
Enter comments here...

	Total					Financial buyers					Industrial buyers					Advisors				
Individual factor importance	**1-1**	**1-2**	**1-3**	**1-4**	**1-5**	**1-1**	**1-2**	**1-3**	**1-4**	**1-5**	**1-1**	**1-2**	**1-3**	**1-4**	**1-5**	**1-1**	**1-2**	**1-3**	**1-4**	**1-5**
Superior ability to identify a suitable target company	4%	6%	8%	16%	20%	0%	0%	0%	10%	30%	10%	10%	10%	20%	20%	3%	7%	10%	17%	17%
Superior network and expertise when evaluating the target	4%	8%	10%	18%	24%	0%	11%	10%	20%	30%	0%	0%	10%	20%	20%	7%	10%	10%	17%	23%
Superior deal making expertise	4%	18%	28%	34%	42%	20%	33%	30%	40%	50%	0%	20%	20%	30%	30%	0%	13%	30%	33%	43%
Superior ability to negotiate favourable borrowing terms	6%	8%	12%	26%	32%	0%	0%	0%	20%	30%	0%	0%	0%	0%	10%	10%	13%	20%	37%	40%
Superior ability to conduct a correct valuation of the target	4%	6%	10%	12%	16%	0%	0%	0%	0%	0%	0%	0%	10%	10%	10%	7%	10%	13%	17%	23%
Value generation through operating improvements	6%	22%	28%	34%	46%	10%	56%	50%	50%	60%	10%	10%	30%	40%	40%	3%	17%	20%	27%	43%
Value generation through improved strategy	10%	14%	22%	30%	40%	20%	33%	40%	40%	50%	20%	20%	30%	40%	40%	3%	7%	13%	23%	37%
Value generation through increased leverage	30%	47%	66%	72%	78%	10%	11%	50%	60%	70%	30%	70%	90%	100%	100%	37%	50%	63%	67%	73%
Interest alignment through increased management ownership	2%	20%	38%	56%	60%	10%	11%	40%	60%	60%	0%	10%	30%	50%	60%	0%	27%	40%	57%	60%
Concentrated, and hence active ownership, generates value	12%	16%	24%	32%	46%	30%	44%	50%	70%	80%	10%	10%	10%	10%	30%	7%	10%	20%	27%	40%
Excess capital (equity + debt) available exaggerates valuations	0%	2%	8%	10%	14%	0%	0%	10%	10%	10%	0%	0%	0%	10%	30%	0%	3%	10%	10%	10%
Overvaluation caused by financial buyers selling to each other	2%	4%	4%	8%	14%	0%	0%	0%	0%	0%	10%	10%	10%	20%	40%	0%	3%	3%	7%	10%
Overvaluation caused by too optimistic assumptions	0%	0%	4%	10%	16%	0%	0%	0%	0%	0%	0%	0%	0%	0%	10%	0%	0%	7%	17%	23%
Overvaluation caused by historically favourable macro conditions	16%	29%	36%	40%	50%	0%	11%	10%	10%	20%	10%	40%	50%	50%	60%	23%	30%	40%	47%	57%

Phase importance	**1-1**	**1-2**	**1-3**	**1-4**	**1-5**	**1-1**	**1-2**	**1-3**	**1-4**	**1-5**	**1-1**	**1-2**	**1-3**	**1-4**	**1-5**	**1-1**	**1-2**	**1-3**	**1-4**	**1-5**
Transaction	27%	27%	27%	30%	32%	12%	17%	13%	18%	23%	19%	27%	24%	27%	32%	36%	31%	34%	36%	35%
Holding	73%	73%	73%	70%	68%	88%	83%	87%	82%	77%	81%	73%	76%	73%	68%	64%	69%	66%	64%	65%
Sum																				

Purpose importance	**1-1**	**1-2**	**1-3**	**1-4**	**1-5**	**1-1**	**1-2**	**1-3**	**1-4**	**1-5**	**1-1**	**1-2**	**1-3**	**1-4**	**1-5**	**1-1**	**1-2**	**1-3**	**1-4**	**1-5**
Target identification	7%	6%	6%	8%	9%	0%	0%	0%	6%	13%	19%	9%	6%	10%	9%	5%	6%	7%	9%	7%
Target evaluation	7%	8%	7%	9%	10%	0%	14%	8%	11%	13%	0%	0%	6%	10%	9%	11%	10%	7%	9%	10%
Target acquisition	9%	13%	14%	16%	16%	27%	22%	12%	17%	17%	0%	9%	6%	7%	9%	8%	13%	17%	19%	19%
Target valuation	8%	8%	9%	8%	10%	0%	3%	3%	2%	3%	7%	9%	9%	9%	13%	10%	9%	10%	10%	11%
Financial engineering	55%	46%	46%	38%	34%	27%	14%	40%	34%	29%	56%	62%	57%	48%	43%	60%	48%	43%	36%	33%
Operating improvements	14%	18%	19%	20%	21%	47%	47%	36%	31%	26%	19%	11%	16%	17%	18%	5%	14%	16%	18%	20%
Sum	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%

Source importance	**1-1**	**1-2**	**1-3**	**1-4**	**1-5**	**1-1**	**1-2**	**1-3**	**1-4**	**1-5**	**1-1**	**1-2**	**1-3**	**1-4**	**1-5**	**1-1**	**1-2**	**1-3**	**1-4**	**1-5**
Value creating	50%	55%	56%	59%	60%	81%	80%	75%	74%	71%	55%	38%	47%	49%	50%	35%	51%	52%	57%	59%
Value capturing	50%	45%	44%	41%	40%	19%	20%	25%	26%	29%	45%	63%	53%	51%	50%	65%	49%	48%	43%	41%
Sum	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%


Phase
Transaction Phase A
Holding Period
Transaction Phase B
Purpose
Target Identification
Target Evaluation
Target Acquisition
Target Development
Target Divestment
Target Valuation
Action
Sourcing
Screening
Internal Analysis
Due Diligence
Negotiation
Financial Engineering
IPO
Oper. / Strat. improvements
Trade Sale
Market/sector Appreciation
Recapitalisation
Source
Value Capturing
Value Capturing
Value Creation
Impact
Factor 1
Factor 2
Factor 3
Factor 6,7,8,10
Factor 5,11-14
Factor 5,11-14
Factor 4