Debt in Private Equity Deals: A Role Play

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This case presents the financial and operational situation of a company subject to a Management Buy-In. Students can be divided between lenders (Banks, or Private Debt firms) and borrowers (Private Equity firms) and discuss the appropriate capital structure for the target company. In doing so, students are expected to become fluent in the language of leveraged finance, and to learn by doing the logic behind the choice of debt quantum, structure, price (yield) and covenants.

Keywords: Capital structure, Debt covenants, Debt capacity, Debt pricing, Term loans, Senior and Junior debt, Mezzanine, Management Buy-In, Negotiation dynamics, Credit committees

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TH14 Advisors LLC, a London-based Private Equity firm focusing on mid-market deals, is currently seeking investment opportunities for its most recent buyout fund, which was closed four years ago. Among others, TH14 has identified CFCStore, a retail business for high-end sport accessories, which it would like to acquire. Two weeks ago, TH14 has succeeded in getting to the final bidding round in a competitive auction against a small number of other, very similar, Private Equity firms.

CFCStore is owned by a Russia-based parent conglomerate which seeks to divest its various corporate holdings as the owner (Mr. Roman A.) wants to retire. CFCStore is a classic LBO target. In its history, CFCStore has never had any debt on its balance sheet, and has never had any cash issues (partly due to the deep pockets of its Russian parent).

CFCStore was founded by Gus M. in 1905. Although always quite successful, its growth became exponential in June 2004, when it hired a Portuguese CEO. The CEO that year became one of highest paid CEOs in the country with a £4m *p.a.* package, which increased to £5m the very next year. Its sales numbers are generally impressive. The stores are not particularly appealing but achieve nonetheless the highest sales per square meter figures in the country. The margins are poor though as CFCStore employs many star sellers who are expensive and do not necessarily work well together. This configuration also results in high staff turnover.

The senior management, however, has been quite stable and is well-regarded due to the impressive sales numbers. Yet, the Stanford-educated CEO has been described by a Dutch-based competitor as "one of the

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most hated managers in Europe." A senior manager reports that: "he's arrogant. Some people say a bit arrogant. They're massively understating it. He gets under people's skin. They don't like that." His verbal war of words with a number of competitors has left his popularity level at an all-time low, but despite that reputation there's no denying that the 51 year-old is one of the most successful modern-day managers.

CFCStore sells sports apparel (*e.g.,* specialized shoes, football jerseys, tennis rackets, golf equipment, fancy road bikes), and target rich consumers. The stores are smaller than those of Decathlon and the items are generally of higher quality (but obviously, much more expensive). It is no coincidence that the first stores, where most sales still occur, are located in a posh neighborhood of West London. As mentioned above, an attraction of the stores are the sales people who tend to be famous sports people, who are paid a fortune. These people are usually foreigners. In fact, CFCStore has been criticized at times in the past for having not a single British employee.

Over the last 10 years, CFCStore has grown same-store revenues at 7% *p.a.*, primarily through price increases. Perhaps, they had a sheer bit of luck as well. CFCStore makes about £300m *p.a.* in revenue, and £50m *p.a.* in EBITDA. Today, CFCStore operates 31 stores across the UK, 20 of which are leaseholds (with an average lease of 10 years) with total annual rent of £24m this year. The remaining 11 stores are owned as freeholds, representing 20% of the retail square footage and valued at £50m on the balance sheet. Revenue growth did

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not collapse during the 2008-2011 crisis, or during the Covid-19 crisis as sales moved to the internet and people picked up their orders in the stores. However, in recent times, it has come under increasing pressure from existing competitors and new entrants in the high street and out-of-town retail sites such as Decathlon and cash-rich ADCity. Low price internet competition from players such as Amazon.com or Sportsdirect.com has also been significant, especially during the Covid-19 crisis.

TH14 identified CFCStore when it was scanning the UK retail market for new investment opportunities and believes it can improve CFCStore's performance with this strategy:

- Replace CFCStore's existing management with a new management: the Management Buy-In (MBI) team. This team consists of the former Chairman, Chief Executive and Finance Director of AFCStore (CFCStore's main competitor) which has been run by the trio since 1996. AFCStore had consistently higher margins and appeals to a broader public. Its headquarters is in Highbury (North London), a diverse neighborhood. AFCStore executives have been successful over a much longer period of time, but has had some difficulties in recent years. Overall, however, they are praised for their outstanding consistency and modesty. On the recent sale of AFCStore, the MBI team generated £50m for themselves and now looking for their next opportunity. The incumbent CFCStore team will be fired on day one. This approach will instantly improve the public image of CFCStore. Stores will get a makeover; their dull blue paint would be replaced by white and red stripes.
- Retain key existing middle management with sweet equity in CFCStore for those persons identified as top performers. TH14 has already identified that Peter C., Head of New Store Development, has a great track record in identifying new sites and negotiating below-market lease rates. William G., Head of Branding, has also shown consistent flair in keeping CFCStore's brand interesting and his TV advertising campaigns have won industry awards.
- Sell the existing 11 freeholds in a "sale and lease-back" transaction. TH14 estimates that they could sell all freehold stores in the first year for total consideration of £85m, which they intend to use to pay a dividend out of the company back to the fund. Incremental rent on these sold stores is anticipated to be in the region of £6m *p.a.*
- Improve the margins and cash conversion rate of the business by using the MBI team's knowledge of best practices at AFCStores. In particular, they believe that they can improve EBITDA margins by cutting costs (*e.g.,* firing expensive fancy sales people), and cash conversion through better working capital management.
- Open stores in Asia and Middle East. TH14 sees opportunities to grow further out of their heartland into new areas such as the Middle East and China, in particular.
- Launch a proper CFCStore retail website, which requires an investment in systems, an advertising campaign and significant programming work. This more technical work-force is in short supply at CFCStore, but the MBI team is well-connected to a number of French engineering schools who provide this type of workers at low cost-to-quality ratios.
- Invest in expanding into Continental Europe. The MBI team has worked in foreign markets before and TH14's research shows that the French, Dutch, Belgian, German and Spanish markets are under-penetrated with high-end sport stores. Some countries are to be avoided though; *e.g.,* TH14 has a poor image in Ireland due to some previous investments that turned out to be profitable in the short run (but less so in the long run) and infuriated the local population. Overall, the MBI team believes

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it will be easy to replicate their previous success abroad, whether this growth is achieved organically or by add-on acquisitions.

Table 1 shows CFCStore's basic financials. The fiscal year end is December 31.

- Historic years have been audited by a major accounting firm.
- Y0 is the current management's estimate but they appear on track to meet that forecast.
- Forecasts have been prepared by TH14 and the MBI team. They have not been discussed with CFCStore's current management and have been prepared completely in isolation. They follow the assumption that the MBI team has full control of the business from Y1.

TH14 has waited to get all the information and to finalize its MBI plan before approaching different lenders. The lenders have all received the same selected financial information over the last few days. Given the highly competitive nature of the auction, no lenders have been given a chance to meet the MBI team as yet nor to ask questions. The last communication from TH14 to the lenders was last night by voicemails to their various relationship contacts:

Hi. We'd love to work with you on CFCStore and we're looking forward to chatting through your terms. We think this deal will be a great one. We cannot wait to oust the current CEO. The MBI team is fantastic and will really give a kick to the existing operations. The internet site will be a quick win and the expansion is easily do-able. Just to let you know the way we're thinking:

- ✓ *Confidentially, we are going to bid £500 million (10x FY0 EBITDA) in the final round. We think much of this price can be financed by debt.*
- ✓ *The MBI team is great and you'll love meeting them. In order for them to implement the plan, they'll need to be unconstrained in how they, and we, operate the business.*
- ✓ *The deal is exciting: we will have lots of opportunities to invest the company cash-flows over the coming years, many of which we only have early ideas as yet.*
- ✓ *We've done most of the due diligence in-house, and the MBI team's plan and views should get you and your credit committee over the line on understanding the commercial case.*
- ✓ *I'm sure you agree the sale and lease-back strategy is a great way to realize value in the short term - it's a key way for us to realize quick returns for the fund.*
- ✓ *On exit we reckon we can either float the thing or merge it with a large European retailer*

Hope to hear from you soon. It would be great to work with you, but remember we're in a competitive process here. In particular, I want you to be innovative - if you have problems or concerns, see if you can structure around them. In this way, I'm sure we can find a deal that works for both of us. As always, we are talking to a number of lenders to achieve the best package for us.

Your task. Your team either works for TH14 or for a lender.

TH14: You are the CFCStore deal team. You are keen to do the deal: you haven't made any investment in your area of expertise (retail) in the last 2 years. You genuinely believe in the CFCStore investment case and you believe that the investment is a good deal for TH14. You are also cognizant of the fact that TH14, like many PE firms, earns a deal fee every time an investment is made and the bonus pot is currently too low for the latest top-end Peugeot car.

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There is also the business under your ownership to think about. You do not want a lender to put too many constraints on what you can do with the business and its cash. You are also aware that a retail business is cyclical, and you need room in your covenants to manage for a downturn. Clearly, you also want your interest costs as low as possible, both for the business and for the impact on your own returns. Any mandatory cash amortization of debt principal puts the business's cash flows under pressure. Finally, you know that it is unattractive to deal with a syndicate; they make any future negotiations more cumbersome and they may sell your debt on to other parties who could make life difficult for you. Dealing with one lender is easier.

There is also a fine line to walk. You will negotiate with a lending teams and you will want to push them hard to achieve the above. But if you push them too far and they agree, they risk being rejected by their credit committee and you will not have a financing package to complete the transaction. It is impossible to test the credit committee in advance and it is only a one-shot chance. You will negotiate with two lenders to get the most competitive offer that you think is deliverable. You will bid your stated price for CFCStore, £500m, but a good debt package will allow you to pay more than others if the vendor tries to tweak you higher.

Lender. You also have no particular competitive advantage on this deal compared to your rivals, either in your understanding of CFCStore or the types of finance that you can provide. You are in a tough position. You are behind on your fee targets for this year, but with 3% fees on this deal you could blow the roof off: enough to get you out of the woods. You very much want to win the deal. Still, you know that credit committee will be tough. You will agree something in advance with TH14 and then present this to the committee. Your presentation to the committee is not a negotiation and it is a one-shot chance – the committee either approves or doesn't approve. You know that the committee will only approve something that has an adequate control of risk, and where the debt has the right amount of safeguards attached to it. They will look at how quickly the debt gets paid back, the returns on that debt, and the constraints and freedoms you have given to the management team of CFCStore. Examples of deals that your credit committee has approved in the past are shown below.

How to tackle it? To start with, try to structure your basic thoughts:

- What are my views on what TH14 are investing in and their plans for the business?
- How realistic are their financial projections? What could go wrong?
- What do I think are the top-ten key attractions and risks in this deal?
- How could a debt holder mitigate or control these risks?

And then more specifically, from your party's point of view:

- What should debt pricing look like compared to the average deal?
- What should structure look like compared to the average deal?
- What should the covenant tests look like?
- What should be in the legal documents to cover:

a) Information & monitoring rights
b) Restrictive covenants

- What is most likely to be most important to the other party, and the credit committee? What items are "must haves", and what items would you be prepared to trade?

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Table 1: Selected actual and projected financial Information

GBP Millions	Y-3	Y-2	Y-1	Y-0	Y1	Y2	Y3	Y4
UK Business	251	270	288	206	225	218	201	120
% Growth	*8%*	*8%*	*7%*	*n.m.*	*n.m.*	*n.m.*	*n.m.*	*n.m.*
International					10	20	30	45
% Growth						*100%*	*50%*	*50%*
Internet Site				100	120	180	270	405
% Growth						*50%*	*50%*	*50%*
Total Revenue	251	270	288	306	355	418	501	570
% Growth	*8%*	*8%*	*7%*	*6%*	*16%*	*18%*	*20%*	*14%*
Gross Profit	81	83	88	96	124	164	221	263
% Margin	*32%*	*31%*	*31%*	*31%*	*35%*	*39%*	*44%*	*46%*
Rent (pre-sale-lease back)	21	23	24	25	29	35	42	49
Other Overheads	16	17	18	21	25	31	45	48
Total EBITDA	44	43	46	51	70	98	138	166
% Margin	*17%*	*16%*	*16%*	*17%*	*20%*	*23%*	*28%*	*29%*
Free Cash Flow*	19	17	18	20	36	61	97	121
% Conversion	*43%*	*38%*	*38%*	*40%*	*52%*	*62%*	*70%*	*73%*

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