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Public-to-Private Transactions are Here to Stay

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Private equity-backed public-to-private (PTP) transactions have been on the increase in recent years. The total value of PTP transactions rose from £3 billion in 1998 to £8.9 billion in 2000, almost a 70 per cent increase. While the year 2000 total included the largest single PTP transaction yet recorded (£3.5 billion for property group MEPC), the trend is nevertheless set to continue. By value, PTP transactions in 2000 constituted some 50 per cent of total transaction value in the United Kingdom for transactions with a value of £10 million or more. Not only is this trend here to stay, but with in excess of 1,500 listed companies with a market capitalisation of less than £250 million, there are also plenty of potential targets.

Institutional shareholders have made it very clear over the last 2–3 years that, when it comes to the smaller end of the market, they are more than pleased to consider the changes of ownership represented by companies moving out of the public market place and into private ownership. It has become increasingly less efficient and less attractive to invest in smaller capitalised companies.

While the PTP market could not be described as mature, there have been an increasing number of transactions undertaken since the first of

the recent wave of these transactions in 1997, when Electra Fleming bid for William Cook plc as part of its 'white knight' defence strategy against an unwelcome bid. Certain private equity houses, banks and advisers now have strong track records in handling PTP deals, this familiarity further facilitating the current strong flow of these transactions.

Candidates for PTP

As the recent KPMG survey into investment in smaller quoted companies (SQC) has confirmed this year, 90 per cent of this group fall well below the ideal minimum market capitalisation desired by institutional investors. Fund managers increasingly find themselves under pressure to invest ever-larger sums of money in bigger, more liquid stocks. Despite the SQCs' strong performance in the market, their stocks are too illiquid – often due to shares being held by family members or one major shareholder – and do not bring the returns required to warrant fund managers researching and reporting on them. With investment prospects fairly remote and retaining a listing both relatively expensive and restrictive, more and more SQCs are contemplating de-listing. As an aside, this also accounts in part for the dramatic decline in initial public offerings (IPOs) seen in 2001, with reported activity at its the lowest level for over a decade. As an exit route for private equity investors, if the stock is not in the technology, media and telecommunications sectors the prospect of an IPO is clearly worse than it was, for example, 2–3 years ago.

For companies that are experiencing short-term trading problems but have a sound business plan, this inability to raise funds from their investor base also makes it increasingly attractive to seek private equity investment through a PTP transaction, particularly if bank lending is also close to loan facility limits. There are also a few niche companies to be found that are reverting to private ownership – whose business and/or largely entrepreneurial management style does not fit well within the public market or which perceive the market as either disinterested or consistently undervaluing their business – and which perhaps should not have gone to the market in the first place.

Key factors in a PTP transaction

A disparate shareholder base will create difficulties. One rule of thumb is that the top six shareholders should cover a good proportion of all

equity votes – ideally at least 50 per cent. This means that you have relatively fewer parties to approach at the relevant stage in the process and have the opportunity to build up a strong percentage of irrevocable undertakings to accept the proposed offer.

The reasons for choosing a PTP route can be varied – a shortage of capital, management succession gaps, family shareholders seeking an exit, or perhaps the need for acquisitions are among those most commonly cited. Over and above the premiums that shareholders are likely to achieve on the market value of their holdings, presenting a coherent case for a PTP can be half the battle in allaying any possible suspicions about the proposed deal and in gaining support from shareholders, staff, analysts and the media.

In the past, bidding for public companies entailed an acceptance of limited due diligence. This contrasted with private equity investors' needs for very full due diligence prior to investing. The process is now well understood by those with experience of PTP transactions, including the manner in which proper due diligence may be completed prior to the making of an offer.

There is a belief in some quarters that the proposition of a PTP transaction is enough to motivate investor interest. This is clearly not the case – you still need to look at the business plan; make sure that you have a strong management team in its own right; and have a view on the eventual exit. These will need to be in place before a private equity house will seriously entertain a deal.

Given that a number of PTP propositions come about because a company is experiencing trading difficulties, you need to be clear that it is because the market is against you, and not that the incumbent management is the root of the problem. Private equity investors would be looking for returns on their capital and would require to be persuaded that the adverse trading can be corrected in the short to medium term.

Management buy-ins are virtually a non-starter in this sector of the market since outside management will not be deemed to have sufficient knowledge of the business to execute the PTP successfully. However, nowadays the incumbent management team is often supplemented by external managers who are perhaps well known within the industry, have the relevant contact base (or have been backed before) and therefore have a track record with the private equity investors. This creation of the team – a buy-in management buy-out or 'BIMBO' – has certainly become more common. Further,

the private equity investors will usually wish to appoint one or more independent non-executive directors to the board of the company.

The price of PTP

You also need to look at the type of premium that will need to be paid in order to take a company private. The premium currently attributed to the quoted price of the equity ranges on average between some 38 and 44 per cent, although clearly worked out on a case-by-case basis depending on prevailing circumstances. The price of the shares, including any premium, together with any debt to be refinanced plus the costs of executing the PTP, will add up to the total sum to be funded.

The way in which a prospect is reviewed by a private equity institution is fundamentally exactly the same whether it is private or public; the only difference with a PTP transaction is in the process that has to be undertaken in order to complete the deal involving many technical issues, all of which must be addressed. These include obtaining access to information, due care in holding discussions with potential backers and the taking of security by the banks backing the PTP. In all cases, the takeover panel will be consulted at an early stage.

A number of additional parties will be involved in a PTP transaction who would not usually be involved in a non-PTP situation. They include communications and PR firms, share registrars and company brokers. Their activities, together with the requirements to produce certain public offer and related documentation, have an impact on the overall costs of PTP transactions. The overall level of costs involved in taking a company private can therefore accumulate and any transaction below £20 million should be reviewed in this respect (ie the proportion of costs in relation to the overall deal becomes increasingly high below this level).

Beyond 2001

With a potentially inexorable shift in funding from institutional investors to private equity houses, the prospects for companies seeking to go private by this route are constantly improving. Private equity investors are different types of owners and will want to be close to the businesses in which they invest. Those with proven track

records will bring with them the experience to create better businesses for the market and for managers and employees.

One cannot ignore the current downturn in economic activity, although perhaps this time round it will not be as deep as has been the case in the past. In contrast to the recession of the early 1980s, the United Kingdom is at virtually full employment and interest rates appear to be sustainably low. Vendor price expectations will certainly need to realign but the reality is that starker economic conditions also create new opportunities. Such opportunities will be taken up by private equity investors, particularly given the significant levels of funds raised over recent years. Within these opportunities there will be PTP transactions which will remain a feature of the private equity landscape for the foreseeable future.