FIN580
Entrepreneurial Finance

Case 2 Brazos Partner and the Tri-Northern Exit

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Today’s Agenda

- What is Brazo’s investment strategy?
  - Who is Brazos?
  - Brazo’s investment strategy
- Tri-Northern deal
  - Did the Tri-Northern deal fit with Brazos’?
  - Did Brazos get a good deal?
  - What value did Brazos add?
- Sell or Hold?

1.1. Who is Brazos Private Equity Partners?

- Middle market leveraged buyout (LBO) firm
- Randall Fojtasek (CEO), Sutherland (MD)
- 14-year history
- $1.4 billion of capital under management
- Three funds in history
  - 1st fund in 2000: $250 million
  - 2nd fund in 2005: $400 million
  - 3rd fund in 2008: $715 million

1.1. Who is Brazos Private Equity Partners?

1.2. What is Brazo's investment strategy?

- Deep connections in a geographic niche
  - Located in and has sourced most of its deals from Texas and the South
  - Relationship-driven

- Understanding of unique concerns facing family-owned businesses: Generational Transfer Transaction (GTT)
  - Tax-efficient way to provide liquidity to owners of family owned businesses without requiring them to relinquish majority-ownership control
  - How does it align various interests?

1.2. What is Brazo's investment strategy?

- How does it align various interests?
  - The elders usually are risk-averse due to the concentrated wealth
  - The youngers want to pursue strategies for growth with higher risks.

- GTT provides liquidity to the family through selling 49.9% of the business to Brazos, allowing the owners to retain control.

2. Tri-Northern deal

- Tri-Ed Distribution
  - Founded in 1982, a branch-based distributor serving the western market with electronic security and low voltage product.
  - Roth (CEO) and Comunale (COO)
  - Based in New York, and spinout from a much larger manufacturer (Tyco) in 2005

2. Tri-Northern deal

Exhibit 5a 2009 Tri-Ed Distribution Income Statement

$ in thousands	**2007**	**2008**	**2009E**	**2010P**
Net Sales	$201,338	$225,366	$223,661	$245,186
% growth		*11.9%*	*-0.8%*	*9.6%*
Gross Profit	43,542	45,667	47,728	54,137
Operating Expenses	38,545	39,650	37,571	42,604
EBITDA	4,997	6,017	10,157	11,533
As a % of Sales				
Gross Profit	*21.6%*	*20.3%*	*21.3%*	*22.1%*
EBITDA	*2.5%*	*2.7%*	*4.5%*	*4.7%*
Operating Expenses	*19.1%*	*17.6%*	*16.8%*	*17.4%*

Source: Internal company documents.

2. Tri-Northern deal

- Northern Video Opportunity
  - Founded in 1986, a retailer of industrial video equipment
  - Leading telesales distributor of video surveillance equipment
  - "America's CCTV Expert"
  - Based in California, a family held business that was owned by two brothers

- 2009 Summer, the two companies talked for a potential merger

2. Tri-Northern deal

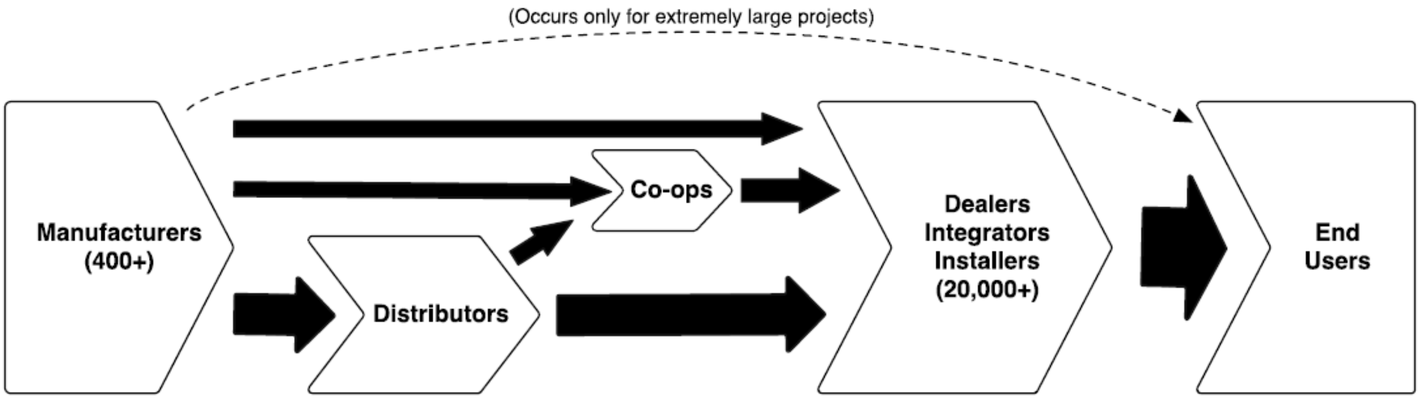
Exhibit 5b 2009 Northern Video Systems Income Statement

$ in thousands	**2007**	**2008**	**2009E**	**2010P**
Net Sales	$141,073	$156,611	$142,996	$150,275
% growth		*11.0%*	*-8.7%*	*5.1%*
Gross Profit	20,679	23,630	20,650	21,685
Operating Expenses	17,156	17,400	12,524	13,160
EBITDA	3,523	6,230	8,127	8,525
As a % of Sales				
Gross Profit	*14.7%*	*15.1%*	*14.4%*	*14.4%*
EBITDA	*2.5%*	*4.0%*	*5.7%*	*5.7%*
Operating Expenses	*12.2%*	*11.1%*	*8.8%*	*8.8%*

Source: Internal company documents.

2. Tri-Northern deal

- Electronic Security Industry



	Manufacturers	Distributors	Co-ops	Dealers/Integrators
Leading Players	Honeywell, Tyco, United Technologies Corp (UTC)	ADI, Tri-Northern, Anixter, Alarmax	PSA, SNA	ADT, Broadview, Protection One (all mainly residential alarm players)
Market Size	~$9B in sales	~$5B in sales (~$4B bought from manufacturers, plus ~20% gross profit)	~$550–600MM total buying power	~$14B revenue from product pass-through (not incl. labor), ~$44B total revenue
Market Structure	Top 3 players hold 30% market share, but more than 400 vendors have competitive products	Top 4 players hold 40% share, highly fragmented below this (100s of players)	Supports ~$2.2B in integrator sales across ~250 members	Extreme fragmentation: ~20,000 companies with more than 50% under $1MM in revenue

Source: Adapted by casewriter from unpublished company documents.

2.1. Did Tri-Northern deal fit with Brazos?

- Investment size ($127 m)
- Location
  - Portfolio companies from Fund I are exclusively located in Texas.
  - With Fund II, Brazos began to expand into the South-East
  - Tri-Northern was a Fund III deal
    - Neither company was located within Brazos' geographic niche
- Brazos' proprietary GTT transaction was not used for either acquisition

2.1. Did Tri-Northern deal fit with Brazos?

- How does the Tri-Northern deal fit with Brazos' strategy?
  - When is it appropriate to deviate from your strategy?
  - How will it look to LPs?
    - Brazos needs to have a good story for why this deal really is on strategy or it needs to be a very good deal

2.1. Did Tri-Northern deal fit with Brazos?

- Brazos has had prior experience with similar companies.

- Tri-Northern deal was just a very attractive LBO opportunity, and Brazos was in the right place at the right time.
  - Both businesses' had strong cash flows, and the security industry seemed ripe for future growth and consolidation.
  - Potential synergies and opportunities from combining two companies' customer bases

2.1. Did Tri-Northern deal fit with Brazos?

- Where are all the other potential investors in this deal? “Why am I so lucky?”

2.2. Did Brazos get a good deal?

- A combined valuation of $127.1 million
- 6.5x times the combined EBITDA of $19.6 million
  - Exhibit 5, 8, 9, 10
  - They expect to grow at a CAGR of at least 14%.

- Financing
  - 66% debt
    - Asset-based-loan: 54.6 million
    - Subordinated mezzanine loan: $33.4
  - 34% equity
    - Brazos Fund III: $31.7 million (70% of ownership)
    - Management equity: $10.4 million
    - Mezzanine lender: $3.3 million

2.2. Did Brazos get a good deal?

- Exhibit 8 (distribution of projections) and 9 (returns) suggest limited risk.
- On the upside,
  - IRR between 41.7% and 67.8% on a three-year hold period
  - IRR between 34.1% and 51.9% on a five-year hold period
- On the downside
  - 7% over three years and 11% over five years

- The transaction will likely clear the 30% IRR threshold that private equity investors typically look for, with VC type returns if the company does well

2.2. Did Brazos get a good deal?

Exhibit 9 February 2010 Projected Returns

	3-Year Hold (Approx. Mar-13 Exit) 6.5x Exit		5-Year Hold (Approx. Mar-15 Exit) 6.5x Exit	
	IRR	MoIC[a]	IRR	MoIC[a]
Management Case	67.8%	4.7x	51.9%	8.1x
Brazos Investment Case	41.7%	2.8x	34.1%	4.3x
Downside Case	7.0%	1.2x	11.4%	1.7x

Source: Internal company documents.

Note: Returns assume exit EBITDA multiple equals entry multiple, and that net debt declines to $57,250 for three-year hold period and $32,500 for five-year hold period.

[a]MoIC = Multiple of Invested Capital.

2.3. What value did Brazos add?

- What would have happened if Brazos had not been involved.
  - They found each other and identified numerous synergies that could result from a potential merger prior to Brazos' involvement.

2.3. What value did Brazos add?

- Brazos investments
  - "De-risking" the deal: both management teams were able to take some money off the table
  - Complex integration steps and add-on acquisitions with a significant discount
    - Significant reduction in working capital requirements from 12.5% in 2010 to 8.7% in 2011(Exhibit 11)
    - Increasing the cash flow that could be used to reduce the net debt levels
    - Add-on acquisition: purchase additional EBITDA via acquisitions at valuations 1.3X, 3.1X, and 5.4X

3. Sell or Hold

- Buyout offer
  - $220 million enterprise valuation for the combined distributor
  - Accepting one of these offers would generate a 3X MoIC on the 2010 $31 million equity investment, or a 72% IRR
  - $220 million valuation would represent multiple expansion from 6.5X at the time of purchase to 8.0X in 2012, based on the $27.3 million March 2012 TTM EBITDA (Exhibit 13)

3. Sell or Hold

- Who would sell or hold Tri-Northern?

- Why do you want to sell?

3. Sell or Hold

- Why do you want to sell?
  - Valuations being offered are very attractive
  - Three ways to profit from a private equity transaction
    - Use debt to purchase a company that has the ability to generate greater cash flow than the firm's cost of capital
    - Implement operational improvements that increase the cash flow of a company
    - Sell a company for higher multiple of cash flow than they purchased it for
  - $220 million: they would be profiting from all three of these techniques.

3. Sell or Hold

	2-Year Hold	
	3/31/2012	
	8.0x Exit	
	Proposed Sale	
	IRR	**MoIC**
Exit in March 2012	72.20%	3.0x
Enterprise value	$ 220,000	
Less net debt	$ 82,110	
Equity value	$ 137,890	
Brazos stake (69.9%)	$ 96,348	
MoIC	3.0	
EBITDA multiple	8.0	
IRR	72.2%	
Investment	3/16/2010	- $ 31,740
Exit	3/31/2012	$ 96,348

3. Sell or Hold

- Freeing partners to focus on other investment
- Market conditions may change after all
- After completing the core integration steps and realizing some of the major synergies, it is unclear how much scope for additional value creation remains for Brazos to implement
  - “We have already done most of the items on our list”

3. Sell or Hold

- But is this the optimal moment to sell?

3. Sell or Hold

- Why do you want to hold?
  - ► The opportunity costs of continuing to hold the company
  - ► Calculate incremental returns for holding the company for an additional three years
  - ► Brazos could continue to earn a 27% annual return on their investment beyond what they have already achieved if they held onto Tri-Northern for an additional three years. (Exhibit 14)
  - ► $220 million valuation already prices in these future gains.

3. Sell or Hold

- Why do you want to hold?
  - What the LPs going to do with their capital once it's returned.
  - It is unlikely that the LPs in Brazos Fund III have immediate access to another opportunity that is as likely to earn 27% annually at a similar level of risk as continuing to hold Tri-Northern.

3. Sell or Hold

- Why do you want to hold?
  - Acquisitions are one area where there is clearly room for continued value creation.
    - Fragmentation in the industry (Exhibit 4) suggests a large pipeline of additional add-on opportunities to help grow the company
    - the targeted locations list (Exhibit 12a) show that there are geographic opportunities in Tri-Northern's current service map.

3. Sell or Hold

- Why do you want to hold?
  - ▸ The final two offers Brazos is considering are from financial buyers
    - – Given they are sophisticated negotiators, it is a reasonable question to ask whether there Brazos is leaving money on the table at the offered valuations.

3. Sell or Hold

- Why do you want to hold?
  - ▸ But, maximizing returns for LPs is not the only set of motivations likely to influence the Brazos investment committee.
    - – Brazos has an interest in maintaining the reputation that the businesses they put up for sale still have unrealized value in them and avoiding any implication that there are adverse-selection issues at play with the businesses it puts out to market.
    - – Non-financial factors: the management team may have a desire to keep running the company independently

3. Sell or Hold

- The state of the debt markets
  - 2012 were quite frothy again
  - Middle-market lenders were financing deals at total debt to EBTDA ratios of 4.53x, approaching the peak of 5.6x reached in 2007 prior to the financial crisis in 2008.
  - Lenders seemed to be favoring large private equity firms.
  - The bidders for Tri-Northern included many large private equity firms, with access to very inexpensive debt.

3. Sell or Hold

- The state of the debt markets
  - ► Axelson et al. (2013) report that credit market conditions affect the prices paid and are the main driver of the quantity of debt used in buyouts.
  - ► Martos-Vila, Rhodes-Kropf and Harford (2012)
    - – Overvalued debt markets cause financial buyers to increase activity and outbid strategic buyers
  - ► This explains the willingness to accept the offer by Brazos, as who knew when the frothy debt market would end and foreclose their ability to sell at a high multiple.

3. Sell or Hold

- Fund raising cycle of Brazos
  - Fund III was raised prior to the financial crisis in Oct 2008
  - Four years later now and they have yet to have any exits.
  - Brazos partners are likely motivated by the practical need to have some results to show to future LPs when it comes time to raise Fund IV.
    - an exited deal that generated an IRR in excess of 70% for LPs would make a nice pitch slide!

4. What Happened?

- On April 5th 2012, a large mid-market buyout firm purchased Tri-Northern from Brazos Fund III.

- The new firm managed over $5 billion in assets and the secondary acquirer also had a much larger staff in comparison to Brazos.

4. What Happened?

- Tri-Northern expanded its acquisition efforts, enabled no doubt in part by these staffing resources, as even small acquisitions are very labor intensive.

- The company had rebranded as “Tri-Ed” (dropping “Northern”) and had expanded from 47 locations at the time of the sale from Brazos to 60 branches nationwide.

4. What Happened?