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Art of the exit

Between January and June, promoters and promotees completed leveraged buyouts worth $256 billion, the second highest total for the first half of any calendar year. You'd be excused for assuming that anybody and her sister-in-law could close a private-equity deal, but exiting is another story.

The art of the exit is the topic at hand, and there's hardly a timelier one, given the $2.5 trillion that's said to be burning a hole in the p.e. promoters' pockets or the survey finding that 95% of investors expect to maintain or increase their private-equity exposure in coming years (both facts courtesy of Preqin Ltd.). The big problem is that the private market has grown richer than even today's public market. Exiting is pointless when it means taking a loss.

Everybody knows the p.e. elevator pitch. A deal-doer, spotting an inviting public target, arranges to buy it whole with lots of borrowed money. More than an equity-enhancer, the debt is a taskmaster, forcing post-deal management to cut costs and boost revenues. Before long, the now shipshape private company is ready to rejoin the public market.

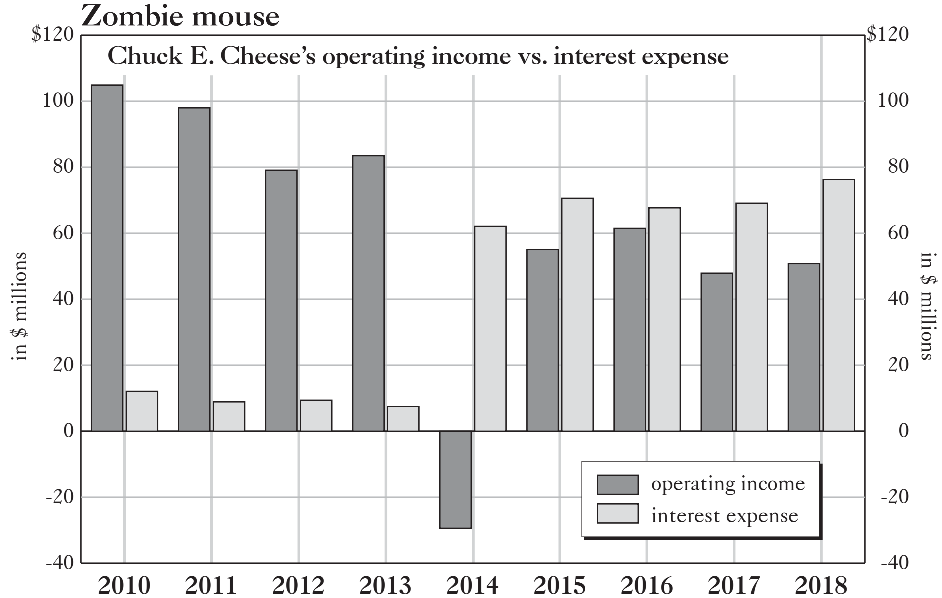
But is the public market ready to have it? Veggie-burger makers get the green light. Tech companies, ditto. We'll have to see about Univision, Inc., which is reported to be preparing a sale. But pizza-parlors-cum-video-game-arcades? We now turn to Chuck E. Cheese, a 2014-vintage LBO slated to re-list this month. It's straining—jumping through hoops, or PIPES—to get a deal done.

In the lexicon of the ultra-low interest-rate world, Chuck E. Cheese is a zombie. It's long failed to cover interest expense from operating income. And because the corporate mascot is a mouse, Chuck E. is technically a zombie mouse. Yet even this living/dead Mus musculus has found easy access to leverage.

Banks are not the go-to source for restaurant borrowing this cycle, advises John Hamburger, president of the Franchise Times Corp. Larger franchisees are rather refinancing with nonbanks, which have fewer scruples against extreme leverage. The borrowers have two basic options, Hamburger tells colleague Evan Lorenz: "One is these term-B loans [i.e., loans extended by non-bank lenders]. KKR has been big in this, so a lot of large franchisees have gone this way. They can get more leverage, maybe six to seven times Ebitda with very low amortization, perhaps 1% a year. It's been allowing some sponsors to pull dividend money out. The second thing is 'unitranche' lenders, where they will do a combination of senior debt and mezzanine debt [in a single loan]."

Queso Holdings, Inc., the parent company of Chuck E. Cheese, is the one that's poised for a public sale, but it won't be a conventional offering. The zombie mouse is rather opting to merge with Leo Holdings Corp. (LHC on the Big Board), a quoted blind pool, or "special-purpose acquisition corporation." A SPAC conducts no business operations of its own but exists

Zombie mouse



source: company reports

to merge with some future partner. It provides that arranged spouse with a public presence, perhaps some cash and a ticker symbol.

Chuck E. Cheese Brands, Inc., created by the Queso-Leo merger, is expected to trade under the ticker CEC on the New York Stock Exchange.

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It irked Nolan Bushnell, co-founder of Atari, Inc., to discover that he made lower returns by manufacturing video games than a saloon owner could by providing those same amusements to the boys at the bar. Chuck E. Cheese's Pizza Time Theatre, the first family restaurant that combined food, animated entertainment and an indoor arcade, proved a lucrative alternative to the adult beer-and-game model. The first location opened on May 17, 1977 in San Jose, Calif. Bushnell had chosen a coyote as the corporate icon (the restaurant was going to be called "Coyote Pizza"), but the costume vendor sent a rat suit to the grand opening instead. There was no time to lose, so cute little Chuck E. Cheese began life as Rattus.

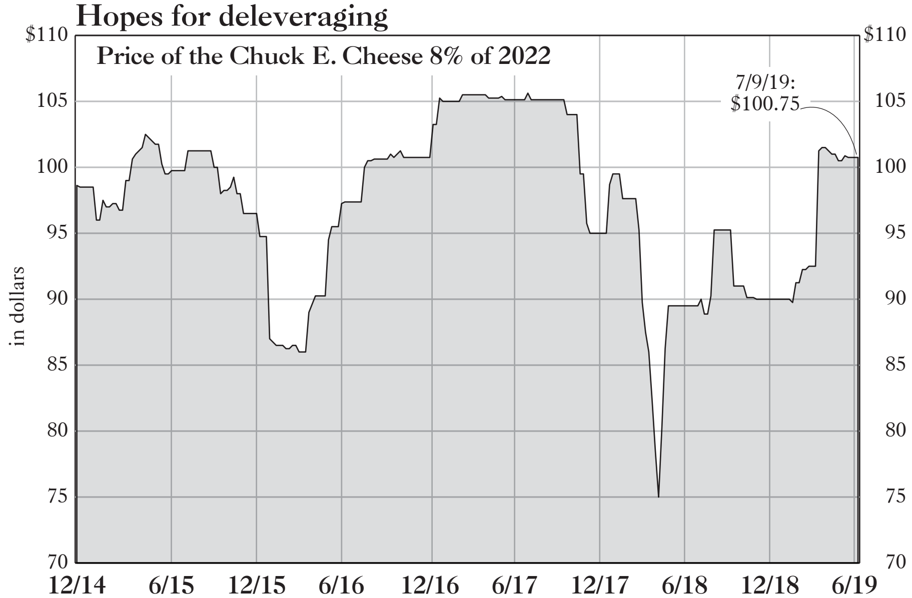
Apollo Global Management, LLC bought CEC for $1.4 billion, representing a lofty 8.1 times trailing earnings before interest, taxes, depreciation and amortization, on Feb. 14, 2014. Like Bushnell 37 years earlier, Apollo worked fast, structuring the acquisition as a tender offer rather than a merger (obviating the need to mail shareholders a proxy statement) and setting the go-shop period at 14 days instead of the customary 30 to 60 days.

Apollo needn't have rushed—to judge the half-decade of operating results, it would have been better served to slow-walk its bid or even to walk it backwards. Dwindling Ebitda generation is mainly responsible for a rise in the ratio of net debt to Ebitda to 6.6 times in 2018 from 5.7 times in 2014.

"Moody's and Standard & Poor's stamp Chuck E. Cheese Caa2/triple-C, not surprising given the record," Lorenz relates. "What might surprise you is that last year's interest cost averaged just 6.4%; comparably rated junk-bond issuers pay almost 12%."

CEC operates 609 Chuck E. Cheese restaurants (516 company-owned, 93 franchised) and 141 Peter Piper-branded ones (38 owned, 103 fran-

Hopes for deleveraging



source: The Bloomberg

chised). Children are the clientele, younger ones for CEC, older ones for Peter Piper. Company-owned restaurants deliver all but 2% of revenue (with Chuck E. Cheese outlets contributing the vast bulk of that income), making CEC the kind of asset-heavy restaurant operator that investors love to spurn.

The typical Chuck E. Cheese restaurant measures 12,700 square feet and generates 43% of revenues from food and 57% from entertainment. It delivers $1.6 million a year in sales; the average Peter Piper Pizza brings in $1.8 million—and, for context, the average domestic McDonald's, with a mere 4,000 square feet, yields $2.7 million.

Deleveraging is at the heart of the CEC going-public plan. By merging with Leo Holdings, the company gains not only a public ticker but also the approximately $200 million that Leo raised from its own shareholders. Concurrent with the merger, CEC will likewise receive $114 million from the unnamed investors in a so-called PIPE, or "private investment in public equity." Earmarked for debt reduction, the cumulative $314 million will lower leverage to approximately 4.1 times Ebitda.

First up for redemption on the CEC balance sheet are the senior unsecured 8s of 2022, of which $255 million are outstanding. The merger news lifted those claims to 101.75 from 92.5 and from 75 as recently as May 2018—around $20 million a year that Chuckie won't be paying the creditors. Lyndon Lea, chairman and CEO of Leo Holdings (i.e., the SPAC), said on the April 8 call divulging the merger that that's "enough to fund about 35 remodels, so those savings will be reinvested back into the business to create growth. De-leveraging the balance sheet will unlock significant free cash flow, which will accelerate investments and further drive growth."

Given plans to remodel 60 stores in 2019 and another 90 in 2020 at a cost of approximately $550,000 per store, the $20 million won't go very far. In the past five years of Apollo management, CEC has laid out $418.9 million on capex, or $176.4 million less than its cumulative depreciation and amortization expense.

"All of this comes as CEC is trying to boost its value proposition," Lorenz observes. "Last year the chain unveiled an all-you-can-play option on its game floor, allowing parents to buy for their kids blocks of play time rather than individual game tokens." (On July 2, a token user tweeted: "Chuck E Cheese tokens are cool and all but I'd rather earn Bitcoin." The official CEC account replied: "To each his own fake currency.")

And there's this inducement for risk-averse investors: "It's been around for 42 years, and we can see through the last three cycles. CEC has grown through those cycles," said Lea on the same April call. "This is a very defensive play with very attractive cash characteristics."

"Looking ahead," added Chuck E. Cheese CEO Thomas Leverton, "future initiatives could include extending the CEC brand through game apps, at-home food, merchandise, film and media and pursuing M&A initiatives on an opportunistic basis. In short, there are so many ways that we can leverage our brand, while also serving as a platform for consolidation."

But the cluttered, distracted present may have something to say about that beckoning future. Leverton himself has conceded the new competitive threat presented by the "bounce houses and trampoline parks" popping up in once-vacant storefronts whose grateful owners charge rent not materially higher than free. Fortnite and Facebook tantalize child consumers as do the likes of the newly competitive Domino's: Why go out for pizza when the pizza will come to you and when your kids have games on their phones?

CEC's comparable-store sales—flat or negative in six out of the past nine years—already bear the competitve scars, falling by 7.6% between 2010 and 2018, even as the consumer price index rose by 16.3%. Anemic 0.4% growth in second-quarter results strengthens a skeptic's conjecture that a 7.7% leap in first-quarter growth was owing more to easy comps and calendar anomalies than to business improvement.

Nor does a projected mini-burst in overdue capex guarantee a return to growth. This year, CEC is targeting outlays of $103 million, slightly above the $100.7 million in depreciation and amortization expense in 2018. In 2011 and 2012, the prior two years when CEC spent more on capex than depreciation and amortization, same-store sales contracted by 2% and 2.9%, respectively.

"Not that you would know CEC has struggled from the presentation that management released with the merger announcement," Lorenz observes. "The company highlights the 7.7% first-quarter comp on multiple slides and lets prospective investors know that the company targets an 8.2% compound annual growth in Ebitda between 2018 and 2020, despite the fact that adjusted Ebitda has declined since Apollo bought Chuck E. Cheese and Peter Piper in 2014. And—wouldn't you know—CEC compares favorably to peers based on projected 2018–2020 revenue and earnings growth?

"In another slide, headed 'Attractive free cash flow dynamics,'" Lorenz goes on, "CEC touts its strong free cash flow, which amounted to $130 million in 2018. But a footnote defines free cash flow as adjusted Ebitda less maintenance capex. By management's reckoning, less than one-half of capital expenditures were for maintenance. Between 2014 and 2018, the company generated a cumulative $57.2 million in free cash flow under the more traditional definition of cash flows from operations minus *total* capex. That was less than the $64.6 million that CEC generated in 2013 alone, the year before Apollo purchased the company.

"And after a half-decade under Apollo, there are precious few costs left to wring out of CEC," Lorenz continues. "On the May 9, 2018 earnings call, management announced its latest cost-cutting program, which targeted $3 million in savings, of which $2 million were expected to be realized by year end. This is a rounding error next to the $896.1 million in revenue generated last year."

What would CEC's capital structure look like once the deal closes? At $10.23 per Leo Holdings share, there would be 71.5 million CEC shares outstanding, indicating a $731 million market cap. Shares would be apportioned as follows: Leo stockholders, 20 million; PIPE investors, 12.2 million; Leo's management, 3.3 million; Apollo, 36 million. After the intake of $291 million in cash, net debt would drop to $761.1 million, valuing the prospective merger at 8.1 times adjusted Ebitda, the same multiple at which Apollo took CEC private in 2014.

(The above debt calculation does not include the present value of operating leases, and Chuck E. Cheese signs long-term—10 to 20 year—contracts on its properties. Owing to the adoption of ASC 842 in the first quarter, CEC just started recognizing a liability for discounted future lease payments: $577.5 million as of March 31.)

Certainly, SPACs are not the low-cost vehicle for coming public. For instance, Leo thought it necessary to issue 10 million warrants along with those 20 million shares, the warrants exercisable at $11.50 per share. There are more such inducements—"earnouts" as well as warrants—embedded in the deal. Suffice it to say that the prospective CEC shareholder should be careful what he wishes for. A higher stock price means more dilution.

And high private valuations spell trouble at the exits of the bull-market superhighway.

"Since 2014," Lorenz points out, "the average LBO purchase price has been in excess of 10 times Ebitda, higher than the 9.9-times peak reached in 2007, according to Bain & Co. In order to wring a return out of high-priced portfolio companies, private equity needs some combination of rapid earnings growth (hard in mature, oversaturated sectors like restaurants) or even higher exit multiples.

"Despite this mathematical hurdle, private equity continues to go shopping for restaurants," Lorenz continues. "Take Bojangles', Inc., the Cajun chicken chain. After debuting on the public markets in 2015 at $19, the share price sunk to a low of $11.55 at year-end 2017. Enter, in January 2019, Dimensional Capital Management, L.P., which purchased the company, lock, stock and barrel, for $16.10 a share, a price that valued the chain at 14.1 times Ebitda.

"Roark Capital Group has rolled up Arby's, Buffalo Wild Wings and Rusty Taco into one company, Inspire Brands, Inc. In December 2018, Roark added Sonic Corp. to the fold, buying the burger joint for 15.6 times Ebitda and at an all-time-high share price.

"It isn't just a restaurant problem," Lorenz proceeds. "In October, KKR & Co., Inc. paid $9.5 billion, or 15.7 times Ebitda, to buy Envision Healthcare Corp. But more public scrutiny on runaway healthcare expenditures has not been helpful to the emergency-room operator, and the Envision senior unsecured 8¾s of 2026, which came to market at par 10 months ago, have sold off to $72.50, indicating that the public value of Envision is less than what KKR paid for it only last fall."

President Trump's new plans to ensure that America pays less for drugs than other developed nations do may receive rare bipartisan support. But it can hardly delight the world of private equity. According to Bain's 2019 Global Private Equity Report, healthcare companies were the best-performing LBO sector between 2009 and 2015.

How has Apollo fared with its zombie mouse? The $1.4 billion price tag in 2014 included $350 million in equity. Apollo contributed no funds with which to buy Peter Piper (a sales leaseback of Chuck E. Cheese restaurants funded that transaction). In 2015, the promoter paid itself a $70 million dividend, lowering its invested equity to $280 million. Based on a $10.23 Leo share price, Apollo's stake would be worth $368.3 million, delivering an annualized return to the private-equity overseer of 5.2%. Over the same period, the S&P 500 compounded 9.4% per annum.

It's far from the 12% per annum that 65% of p.e. investors expect each year according to Preqin, but far from a complete disaster. Still, where are the customers' yachts?

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