ESSEC Global BBA

Private Equity & Venture Capital (Xavier Caron)

Group Case Study 13: A & B, two 'build-up' investments

Situation and questions

- We are in year n. A middle-market growth equity fund ('The Growth Equity Fund') has done two minority investments alongside entrepreneurs who were carrying 'build-up' strategies.
- The first investment (A) was done in year n-6 and exited in year n-2. It has been highly successful. The other investment (B), done in year n-5, is not yet exited.
- The key elements of the two transactions are described below.
- Can you please:

    Make a summary of key similarities and differences between the two transactions?

    Calculate the ownership of the holding companies, at exit for A, and in year n+5 for B?

    Calculate the return (multiple on capital invested) of the transaction A for The Growth Equity Fund?

    Explain what have been the main value creation drivers of transaction A?

    Explain what went wrong with investment B: strategy, management, execution, financing?

    Give your opinion on the kind of exit routes that could be followed by The Growth Equity Fund for transaction B?

Transaction A (1): History and strategy

- As all build-up investments transaction A consists in the acquisition of a 'platform' company followed by 'add-on acquisitions'.
- The platform company is a family company founded in the 1960s:
  - Distribution of ventilation equipment to installers;
  - Strong regional position;
  - Successful track record of acquisition;
  - Financial performance above sector average (10% EBITDA margin vs sector average of 4%).

- Strategy presented by the entrepreneur at entry:
  - Construction of a national leader by the platform company trough acquisition of other family owned regional players;
  - Success should be favoured by:
    - The fragmentation of the sector in many local companies: Companies below 10 people represented 60% of the market;
    - A resilient market (need for constant renewal of ventilation systems driven by regulation).

Transaction A (2): Platform company's financial position and performance at entry of The Growth Equity Fund in year n-6

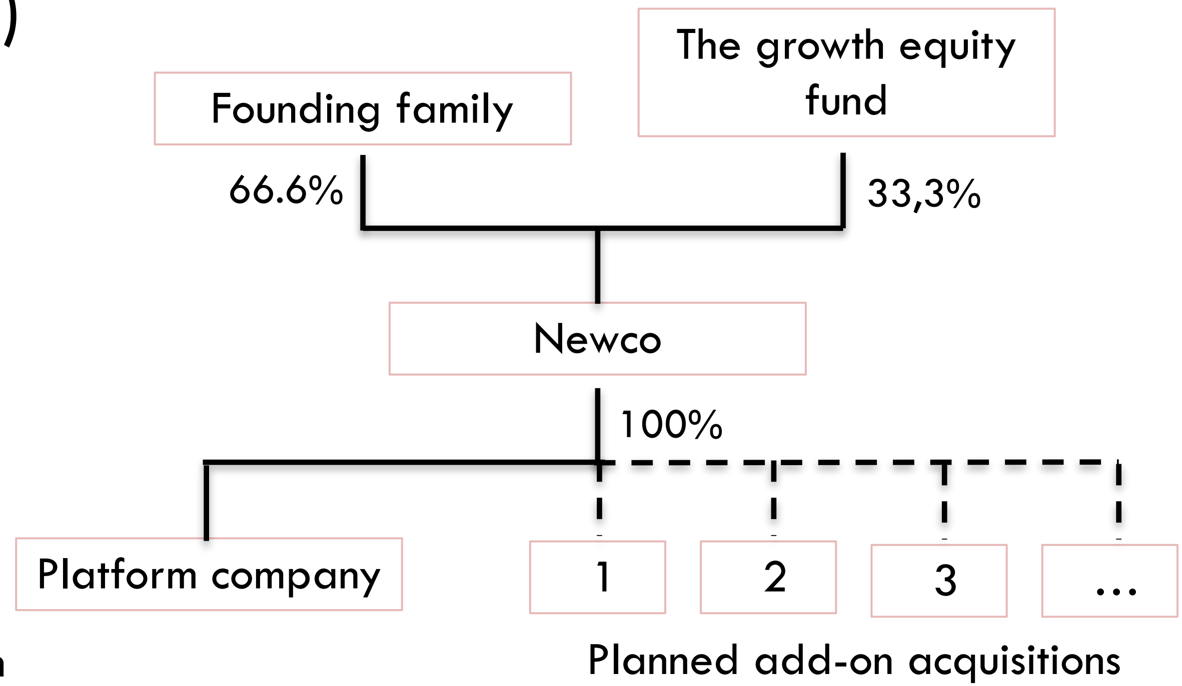
€ million	**Year n-6 (entry)**	
Revenues	**23,0**	**100**
EBITDA	2,5	10,9%
EBIT	**2,3**	**10,0%**
Interest paid	0,01	
Income tax	0,6	
Net profit	1,7	7,3%

Platform company A at year's end n-6 (entry)			
Assets	**€ million**	**Liabilities**	**€ million**
Net fixed assets	9	Shareholder's equity	11
Other assets (working capital)	6	Financial debt	4
Cash	3	Other liabilities (working capital)	3
Total	**18**	**Total**	**18**

Transaction A (3): Structure of the transaction (entry of The Growth Equity Fund)

Creation of a Newco (holding company):

- Equity contribution in shares by the founding family for 33.3% (1/3) of the shares of the platform for of €4 million (i.e. €12 million equity value)
- Equity contribution in cash



by the Growth Equity Fund of €2 million (based on_a €4 million pre-money valuation of the Newco, equal to the contribution in shares by the founding family).
- The Newco raises a senior debt of €6 million, bullet.
- Use of funds: acquisition of 67.7% (2/3) of the shares of the platform company from the founding family (ate a price based on an equity value of €12 million).

Transaction A (4): Execution of the strategy between years n-6 to n-2

- Acquisition of 6 add-on companies in 4 years:
  - Partially paid in cash and partially paid in shares of the Newco.
  - The typical add-on is a regional leader, with good management and profitability but with margin for improvement.
- Creation of a national brand.
- Synergies:
  - Human resources;
  - Encouragement of 'Best practices' within the group, based on the model of the platform company which is regarded as the better-managed company in the sector;
  - Launch of a nationwide subsidiary dedicated to the maintenance market.

Transaction A (5): Financing of the add-on acquisitions

- Cumulated transaction structure of the add-on acquisitions:
  - Cumulated revenues and EBIT of the add-on companies of: €60 and 3.6 million;
  - Acquisition at an average EV/EBIT ratio of 5x;
    - Acquisition Enterprise value of the add-on companies of €18 million;
  - Net debt of the add-on companies of €2.9 million;
    - Equity value of the add-on companies of €15.1 million.
- Financing:
  - €9.1 million capital increase of the Newco, based on a pre-money valuation of €6 million (equity value of €6 million unchanged):
    - Contribution in shares of the add-on companies by the vendors: €4.55 million;
    - Contribution in cash by the platform's founding family: €2.275 million;
    - Contribution in cash by The Growth Equity Fund: €2.275 million.
  - New senior debt raised by the Newco of €6 million.

Transaction A (6): Consolidated financial position (Newco + platform + add-ons) and performance at exit in year n-2

€ million	Year n-2 (exit)	
Revenues	**76**	**100**
EBITDA	9	11,8%
EBIT	7,5	9,9%
Interest paid	0,5	
Income tax	2	
Net profit	5	6,6%

Consolidated A (Newco + platform + add-ons) at year's end n-2 (exit)

Assets	€ million	Liabilities	€ million
Net fixed assets	27,1	Shareholder's equity	22,1
Other assets (working capital)	17	Financial debt	17
		Including acquisition debt	5
Cash	5	Other liabilities (working capital)	10
Total	**49,1**	**Total**	**49,1**

Transaction A (7): Exit process of The Growth Equity Fund in year n-2

- In year n-2 the founding family, the CEO (member of the family) and The Growth Equity Fund agreed to launch an M&A process driven by an investment bank:
  - Contacts with almost all the Growth Equity and Lbo funds in the country and other ventilation products distributors in Europe;
  - Eight letters of interest (LOI) of trade buyers and eight from PE funds;
  - PE funds were by far the best bidders;
  - Management plaid a key role in the process in convincing the potential acquirers that the group had still a significant growth potential, both in revenues and EBIT.
- After a second phase with five PE funds, exclusivity was given to one, and the transaction finalized at an EV based on a 9.3x EBIT multiple.

Transaction B (1): History and strategy

- As all build-up investments transaction B consists in the acquisition of a 'platform' company followed by 'add-on acquisitions'.
- The platform company is a family company founded in 1980.
  - Historical activity of manufacturing of chemical products for btob markets sold via distributors.
  - Three production facilities in 2005.
- Strategy presented by the entrepreneur at entry in 2005:
  - Construction of the company's own distribution network (sales force) that should be well aware of the specific needs of each segments of the market;
  - Development trough the relationship with key corporate accounts with recurring demand;
  - Widening markets trough trading products.

Transaction B (2): Platform company's financial position and performance at entry of The Growth Equity Fund in year n-5

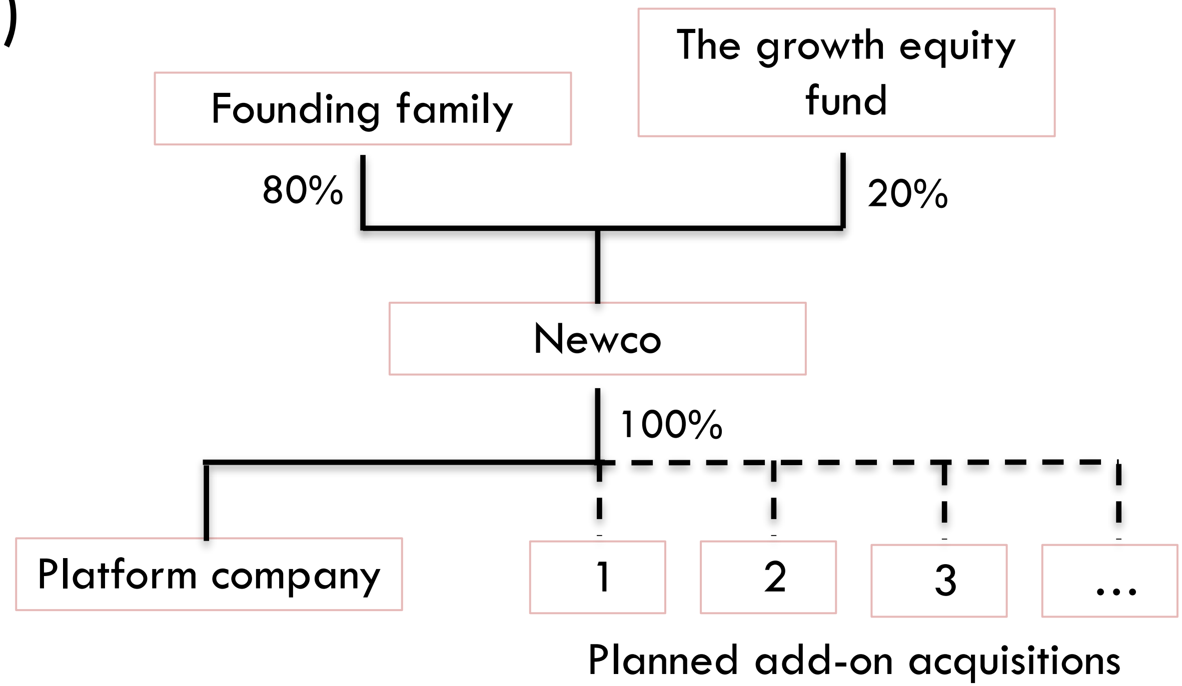
€ million	Year n-5	
Revenues	**28,0**	**100**
EBITDA	1,8	6,4%
EBIT	**1,5**	**5,4%**
Interest paid	0,25	
Income tax	0,25	
Net profit	1,0	3,6%

Platform company B at year's end n-5 (entry)			
Assets	**€ million**	**Liabilities**	**€ million**
Net fixed assets	10	Shareholder's equity	7
Other assets (working capital)	14	Financial debt	8
Cash	3	Other liabilities (working capital)	12
Total	**27**	**Total**	**27**

Transaction B (3): Structure of the transaction (entry of The Growth Equity Fund)

Creation of a holding company.

- Equity contribution in shares by the founding family for 100% of the shares of the platform with a valuation of €8 million.
- Equity contribution of The Growth Equity Fund of €2 million (based on a pre-money valuation of the Newco of €8 million).



- Use of funds: new equity financing of the platform company (capital increase).
- No senior debt.

Transaction B (4): Execution of the strategy

- Two add-on acquisitions per year in average.
  - Partially paid in cash and partially paid in shares of the holding company.
  - Domestic and international.
- Building-up of a 500 people sales force.
- Widening markets:
  - New btob industrial segments;
  - Pharmaceutical;
  - ‘Tertiary’ market: hygiene products.
- Since the beginning the consolidated performance of the new group B gas suffered from:
  - Local competition in the countries where the group has entered through acquisitions (price pressure);
  - Need to constantly restructure the sales force;
  - Low revenue synergies as the products offered by the group tend to be less complementary than expected.

Transaction B (5): Financing of the add-on acquisitions

- Cumulated transaction structure of the add-on acquisitions:
  - Cumulated revenues and EBIT of the add-on companies of: €260 and 16 million;
  - Acquisition at an average EV/EBIT ratio of 5.0x;
    - Acquisition Enterprise value of the add-on companies of €80 million;
  - Net debt of the add-on companies of €48 million;
    - Equity value of the add-on companies of €32 million.
- Financing:
  - Capital increase of the Newco of €10 million, based on a pre-money valuation of €12 million:
    - Contribution in shares of the add-on companies by the vendors: €8 million;
    - Contribution in cash by the platform's founding family: €2 million.
  - New senior acquisition debt in the Newco of €22 million.

Transaction B (6): Consolidated financial position (Newco + platform + add-ons) and performance in year n

- Indications given by the market are that the EBIT multiple that could be used to value the B group in a trade sale could be around 7x.

€ million	Year n	
Revenues	**277**	**100**
EBITDA	10	3,6%
EBIT current	5	1,8%
Restructuring expenses	4	
EBIT after restructuring expenses	1	
Interest paid	1	
Income tax	0	
Net profit	0	n.s.

Consolidated B (Newco + platform + add-ons) at year's end n (current)

Assets	€ million	Liabilities	€ million
Net fixed assets	42	Shareholder's equity	42
Other assets (working capital)	55	Financial debt	32
		Including acquisition debt	0
Cash	5	Other liabilities (working capital)	28
Total	**102**	**Total**	**102**