The Art of the LBO

November 2004

Agenda

I. An Overview of Leveraged Buyouts
II. The Building Blocks
III. Putting It All Together
IV. How It Happens in Reality

I. An Overview of Leveraged Buyouts

What Are LBOs?

What Is an LBO?

A **L**everaged **B**uy**O**ut is the acquisition of an entire Company or division

- Buyer (the "Sponsor") raises debt and equity to acquire Target
  - Borrows majority of purchase price
  - Contributes proportionately small equity investment
- Buyer grows Company, improves performance
  - Relies on Company's free cash flow and asset sales to repay debt
  - Potentially makes add-on acquisitions
  - Later sells or IPOs all or a portion of the Company to exit investment

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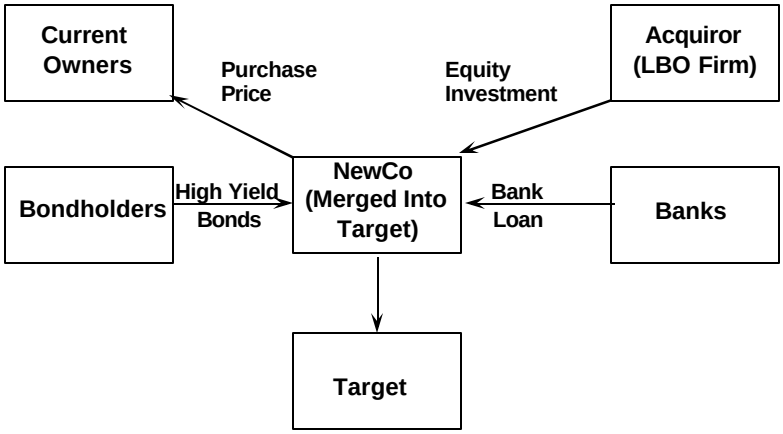
What Is An LBO?
Typical Leveraged Buyout Structure



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More Common Than You Think…

Some prominent LBOs:

Company	Sponsor	Size
	Silver Lake	$2.0bn
	TPG, Bain & GS	$1.6bn
CINEMARK	Madison Dearborn Partners	$1.5bn
	KKR	$1.5bn
	THLee	$1.1bn
	Bain	$1.0bn
	Blackstone	$700mm

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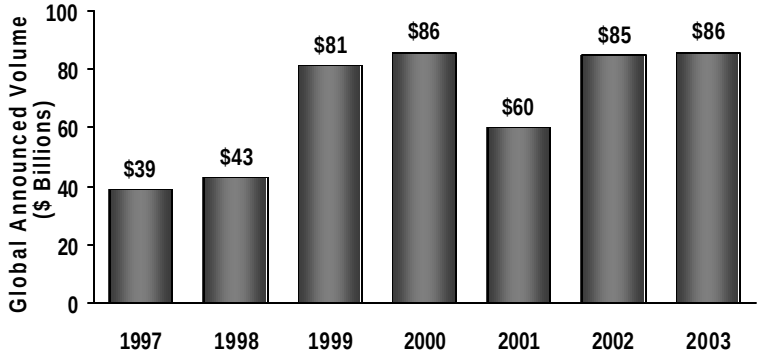
Value of LBO Activity: 1997-2003



Source: GS F&P, Securities Data Co., Buyouts, Thompson Financial Securities Data

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LBO Analysis – An Important Banker Tool

- M&A valuation
  - Complements other valuation techniques
- Acquisition financing
  - LBO
  - Corporate acquisition
  - "Staple-on" financing
- Dividend recapitalization
- Straight debt financings
- Complex merger plan analysis
  - Cash flow impact vs. EPS

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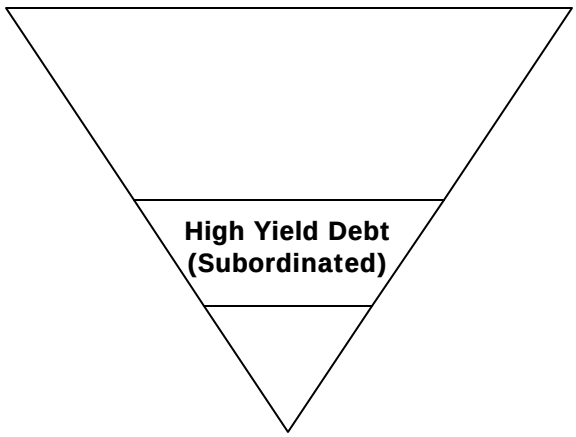
II. The Building Blocks

How Are LBOs Financed?

The Building Blocks

Types of Acquisition Financing



~ 45%

~ 25%

~ 30%

100%

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How Are LBOs Financed?
Hypothetical Example

($ in millions)	12/31/2003	% of Capitalization	Cum. Multiple of LTM EBITDA
Revolving Credit Facility - 6 Years	$ 0.0		
Tranche A Senior Term Loan - 6 Years	150.0		
Tranche B Senior Term Loan - 8 Years	200.0		
Total Senior Secured Debt	**350.0**	**43.8%**	**2.9x**
Senior Subordinated Notes due 2014	200.0		
Total Debt	**550.0**	**68.8%**	**4.6x**
Management Rollover Equity	50.0		
Sponsor Cash Equity	200.0		
Total Equity	**250.0**	**31.3%**	**—**
Total Capitalization	**$800.0**	**100.0%**	**6.7x**

LTM EBITDA = $120.0 million.

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Comparing the Building Blocks
How the Pieces Differ

- **Ranking in Capital Structure**
- **Cost**
- **Structure of Coupon or Dividend**
- **Maturity and Amortization**
- **Callability and Prepayment**
- **Fees to Underwriters**
- **Ratings**
- **Covenants and Legal Restrictions**
- **Marketing and the Capital-Raising Process**
- **Investor Base**

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Private Equity
Terminology

- Most junior money in the capital structure
- Typically no dividends
- Voting control at all times
- Co-investing with other sponsors
- Raised in the "alternative investment market"
  - Portion from Sponsor – "put your money where your mouth is"
  - Pension funds, endowments, investment portfolios, investment banks, commercial banks, "fund of funds"
  - Represents 5% to 10% of investors' portfolios
- Net IRRs to LPs are generally 15-25%

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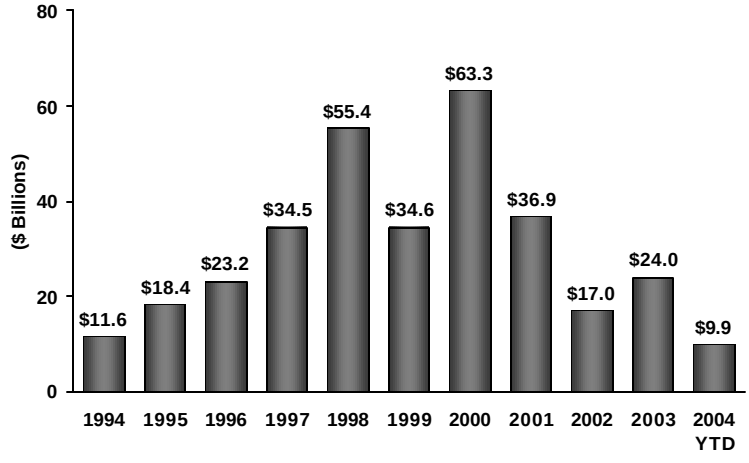
Size of the Private Equity Market
US Fund Raising Activity



Source: Buyouts Magazine

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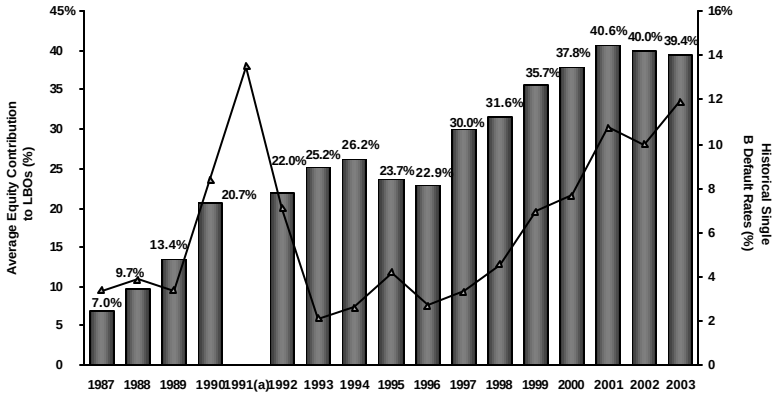
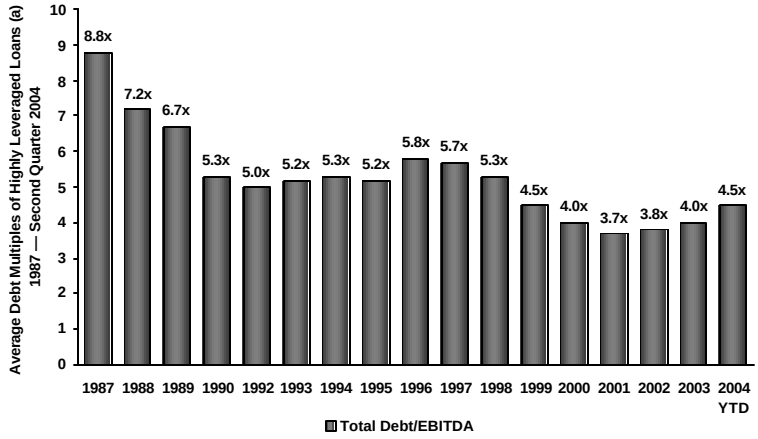
Average LBO Equity Contribution



(a) No data for 1991
Source: Portfolio Management Data and Standard & Poor's

...But Equity Alone Is Not Enough
Using Leverage to Turbo-Charge Returns



(a) Criteria: Pre-1996: L+250 and higher; 1996 to date: L+225 and higher; Media and Telecom loans excluded; there were too few details in 1991 to form a meaningful sample.
Source: Portfolio Management Data.

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Leveraged Bank Debt
Terminology

Ranking	Senior secured, most senior debt in the capital structure
Interest Rate	Floating, typically LIBOR + 250 bps and higher, quarterly payments
Maturity	Varies with credit profile, typically 5-8 years, but before more junior debt
Callability	Typically prepayable at par
Fees to Underwriters	1.75% to 2.25%
Ratings	Usually BB+ to B+ (rating agencies now rate bank loans)
Covenants	Maintenance covenants, set out in "Credit Agreement"
Marketing	Sold via syndication process and confidential offering memorandum ("bank book")
Process	Diligence, commitment, launch, syndicate, fund

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Leveraged Bank Debt
Terminology

- Revolving Credit Facilities vs. Term Loans
  - Revolvers allow multiple drawings (like a credit card)
  - Term Loans are funded at closing
- Pro Rata Facilities
  - Consist of Revolvers and "A" Term Loans ("Term Loan A")
  - Sold to traditional commercial banks
  - Same LIBOR spread, 5-6 year maturities, even amortization
- Institutional Tranches
  - Consist of "B", "C" or "D" Term Loans
  - Sold to over 100 institutions and funds
  - Progressively higher spreads, 6-8 year maturities, minimal front-end amortization

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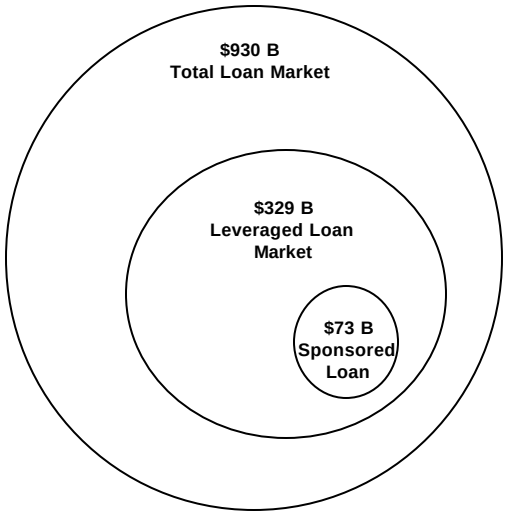
Leveraged Bank Debt
Only a Subset of the Broader Loan Market



Source: Loan Pricing Gold Sheets, Buyouts Magazine, Standard & Poor's - 2003

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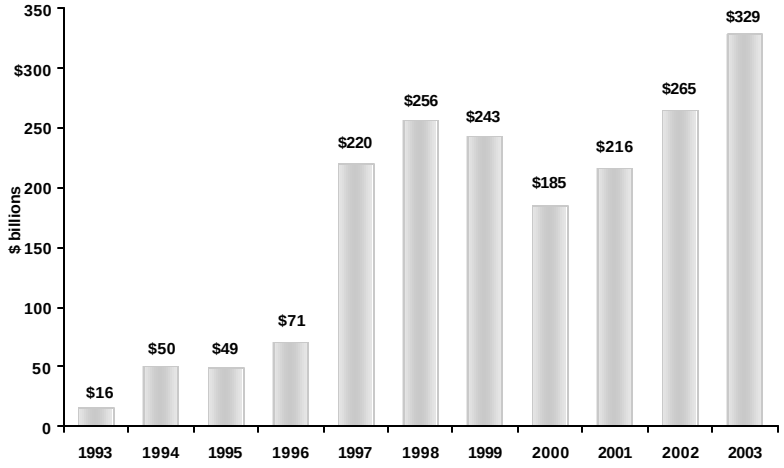
Leveraged Bank Debt
Historical Growth in the Market



Source: Portfolio Management Data 1993-2000; Loan Pricing Corporation 2001-2003

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High Yield Debt
Terminology

Ranking	Usually subordinated and/or unsecured
Interest Rate	Fixed, expressed as a coupon, varies with credit quality, semiannual payments
Maturity	"Bullet" maturity in 10 years
Callability	"10NC5" and 35% "Equity Clawback" now standard
Fees to Underwriters	2.5% to 3.0%
Ratings	Usually B+ to CCC+
Covenants	Incurrence covenants, governed by the "Indenture"
Marketing	Sold via SEC Prospectus / 144A Offering Circular
Process	Diligence, documentation, roadshow, price, fund

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Mezzanine Financing
Terminology

- Structure
  - Rank / Return / Equity / "All-In"
- Investors
  - "Mezz" buyers in the market
  - Banks / Other financial institutions
- Issuer's Perspective
  - Leverage equity more; push risk / return profile
  - Fill hole in cap structure
  - Disclosure / Size

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LBO Market Activity

- LBO activity continues to be very strong
- Extremely receptive financing markets
  - Large amount of bank loan refinancings and new CLOs
  - Substantial cash positions of high yield mutual funds
- Large corporations divesting assets to reduce debt
- Return of the jumbo LBO

$7.05 B

$4.75 B

$4.3 B

- Financial sponsors creating consortiums to cover large equity investments and diversify risk
- Although the LBO market is back, sponsors remain disciplined

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III. Putting It All Together

The Analysis

The Five Simple Steps of LBO Analysis

- Step #1: Evaluate the Story
  - Is this a good debt story?
  - What are the risks?
  - What is the "real" EBITDA?
- Step #2: Construct Sources & Uses
- Step #3: Run the IRRs
- Step #4: Does the LBO work?

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Step #1 – Understand the Story
Dig a Little Deeper

- Is this a good debt story?
  - Stability of revenues: Cyclicality? Contracts? Customers? Organic growth?
  - Margins: Commodity risk? Supplier reliance? Pricing?
  - Capex: Maintenance vs. discretionary?
  - Working capital: Seasonality? Overall management?
  - Management team: Track record? Acquisitions?
- What are potential risks and mitigants?
- Projections
  - Are they realistic?
  - How do they compare to historical?

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Step #1 – Understand the Story
EBITDA Revisited

- What is the right time period to use?
- Don't take EBITDA at face value – look for adjustments
- Common add-backs
  - "Restructuring" charges
  - Non-cash compensation
  - Asset impairments
  - Sponsor fees
  - Money-losing businesses
- Are adjustments really non-recurring?
  - Look at historical financials
  - Use common sense

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Step #2 – Construct Sources and Uses

Sources		Uses	
Revolving Credit Facility	$ 0.0	Purchase Target Equity	$ 250.0
Term Loan A	150.0	Refinance Existing Debt	525.0
Term Loan B	200.0	Transaction Costs	25.0
Total Senior Debt	350.0		
Senior Subordinated Notes	200.0		
Total Debt	550.0		
Management Rollover Equity	50.0		
Sponsor Cash Equity	200.0		
Total Sources	**$800.0**	**Total Uses**	**$800.0**

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Step #2 – Construct Sources and Uses
The Typical "Sources" of Funds

- Bank debt ("Senior" debt)
  - Start with 2.5x senior leverage
  - Price term loan @ LIBOR + 3.00%
  - Use 100% excess cash flow sweep
- Total debt
  - Start with 4.5x total leverage
  - Difference between total and bank is high yield debt
  - Minimum high yield size of $150mm
  - Price high yield @ 10.00%
- Equity contribution
  - Minimum 30% contribution
  - New sponsor cash equity vs. management rollover

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Step #2 – Construct Sources and Uses
The Typical "Uses" of Funds

- Retire existing debt
  - Existing covenants will typically prohibit post-LBO debt levels
  - Don't forget tender/call premiums
- Pay transaction fees & expenses
  - Bank debt fees: 1.75% to 2.25%
  - High yield fees: 2.50% to 3.00%
  - Don't forget legal expenses
- Purchase target equity
  - Make this the "plug" to balance Sources & Uses for now

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Step #3 – Run the IRRs

- Calculate returns depending on future "exit strategy" in Years 3–5
- Typical exit analysis contemplates outright sale of company
  - Make base case exit EBITDA multiple = entry multiple
- Deduct net debt in exit year to compute future equity value
- Allocate equity to owners based on ownership
  - Financial sponsor vs. management
  - Exercise of warrants if appropriate

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Step #4 – Does the LBO Work?
Ask yourself the following questions:

- Do the senior and total debt multiples "make sense" in the context of the overall purchase price multiple?
- Are the coverage ratios adequate?
  - EBITDA / Interest Expense > 2.00x
  - (EBITDA - Capex) / Interest Expense > 1.50x
- How is the bank debt amortizing?
  - Is the bank debt completely repaid by year 7?
- What are the results after running more realistic and downside cases?
- What are the expected credit ratings?

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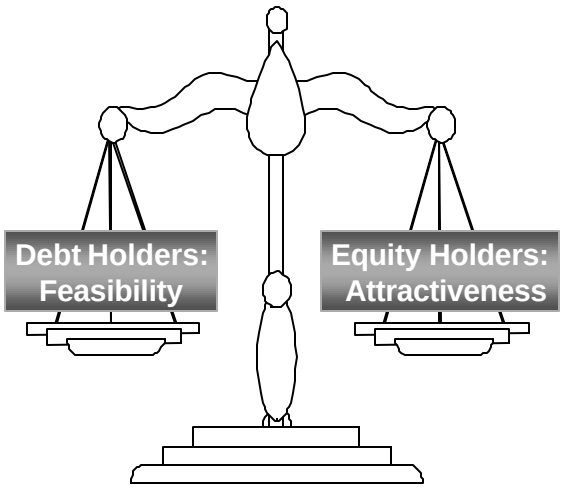
Step #4 – Does the LBO Work?

Iterate Until The LBO Works For All Constituencies



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Step #4 – Does the LBO Work?

How Does the Implied Valuation Compare?

- Triangulate with Other Enterprise Valuation Techniques
  - Deal Comps
  - Common Stock Comps
  - Other Recent LBOs
- Can a financial sponsor beat a strategic?
  - Synergy opportunities
  - Merger plan analysis

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IV. How It Happens In Reality

The Tension between Buyer and Seller

The Scenario

- An attractive business is up for auction
- Your client is a large private equity player
- Tomorrow is the final bid deadline
- You believe your client is competing vs. a large corporation and other financial sponsors
- The corporate can pay tomorrow in cash
- The seller wants to know you're good for the money
- Your client wants guidance from you on:
  - Maximum leverage
  - Certainty of funds
  - Financing conditions

What Does the Seller Want?

- Seller generally wants to maximize selling price
- But not all bids are created equal — seller also wants certainty
  - How long between signing and closing?
  - Sponsor generally needs to raise the debt in this period
  - Compare with corporate buyer with available stock/cash
- Mere promise by buyer to raise the debt is insufficient
- Seller wants legal commitment
- Although Sponsor has committed financing, the letters typically have "outs" that weaken the commitment

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What Can the Buyer Do?

- Buyer must make seller comfortable that the financing risk is minimal by providing committed financing
- Committed financing is usually comprised of a bank commitment and a bridge commitment
  - The bank commitment typically represents the senior secured portion of the capital structure (i.e., "Bank Debt")
  - The bridge commitment typically represents the subordinated portion of the capital structure (i.e., "High Yield")
- Sponsor typically has access from its own funds but check absolute dollar size of equity needed

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The Commitment Letters

- The bank and bridge commitments are comprised of four letters
  - Commitment letter that covers both facilities
  - Fee letter for the bank facility
  - Separate fee letter for the bridge facility
  - Engagement letter for the take-out of the bridge facility

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