

Articles

Out of the Shadows: Private Equity Goes Public

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2007 may be remembered as the year that private equity businesses emerged from the relative obscurity of the financial pages to become the subject of sustained interest in the mainstream media. IGD's Chief Economist James Walton explains why Private Equity is making the headlines, and what it means for the food and grocery industry.

The private equity business is conceptually very simple – investors seek to acquire partial or total control of an established business, boost business performance as quickly as possible and then sell their stake at a profit. The term venture capital is occasionally used as a synonym for private equity, but is more often used to refer specifically to firms that provide funding to support entirely new ventures.

Leaders in the field including Damon Buffini (Permira), Robert Easton (Carlyle Group) and Simon Walker (British Venture Capital Association) found themselves appearing – often somewhat uncomfortably – in both TV studios and Parliamentary committee rooms. The BBC's *Dragon's Den* TV programme has even managed to turn the operation of private equity into a form of popular entertainment, making media stars of both hard-headed investors and ambitious business owners.



Sourced: www.thisismoney.co.uk

In order to avoid confusion, this article uses the term private equity (*a.k.a.* PE) in the broad sense, to refer to any businesses other than banks which specialise in providing funding to others in return for a share of the target business, with the aim of realising a profit on exit.

Private equity is, in some respects, a calculated gamble. Whereas bankers enjoy certain legal rights over borrowers (*eg*: the right to be repaid at the specified rate, the right to seize assets in the event of default), private equity investors are dependent on the success of the business concerned if they are to make a return. They may, therefore, be somewhat more "hands-on" in terms of their approach than traditional lenders, setting rigorous performance targets for any business which they are involved with.

Private equity investors have been actively involved in the grocery industry for many years, operating across the entire supply chain. They were actively involved in six major transactions in the UK grocery and foodservice sector in 2007, which together had a total enterprise value of c.£2.6bn. In spite of a slowdown in the second half of 2007, the year compared favourably with 2006, which saw only three major transactions with a combined enterprise value of c.£300m. (Source: McQueen, January 2008)

UK grocery & foodservice transaction analysis						
Year	Date	Target	Sector	Bidder	Vendor	EV
2006	Jan-06	Bargain Booze Ltd	Grocery	ECI Partners LLP	BWG Foods Ltd	£64m
	Feb-06	Kwik Save (171 Stores)	Grocery	Back To The Future Ltd	Somerfield Ltd	£200m
	Sep-06	DBC Foodservice Ltd	Foodservice	Baugur	Danish Crown	£30m
					Total	£294m
2007	May-07	Booker Group Ltd	Foodservice	Blueheath Holdings Plc	Baugur	£253m
	Jun-07	Thresher Group Ltd	Grocery	Pension Insurance Corp	Terra Firma Capital Partners	£250m
	Jun-07	Thresher Group Ltd (75% stake)	Grocery	Vision Capital	Pension Insurance Corp	£250m
	Jun-07	CI Traders Plc	Grocery	Duke Street Capital	Listed company	£401m
	Jun-07	Brakes Group	Foodservice	Bain Capital	Clayton, Dubilier & Rice	£1,400m
	Sep-07	Costcutter Supermarkets (51% stake)	Grocery	Bibby Line Group Ltd	Kaupthing	£86m
					Total	£2,640m
					Overall total	£2,934m

Note:
1. The Thresher Group Ltd sale to Vision Capital also included Bighthouse, a retailer of domestic appliances and furniture products

Sources: Mergermarket, Factiva, McQueen

When compared with other business activities, grocery has a number of characteristics which might make it particularly attractive to private equity investors: it is a well-established industry with proven business models, consistent consumer demand and stable, cash-generative businesses.

This latter point is a key concern, since many private equity deals are funded through debt, with investors borrowing heavily. The need to fund significant regular repayments throughout their involvement with the target business means that consistent cash generation is essential. More importantly, grocery businesses often have significant physical assets (eg: stores, distribution centres) which make possible a number of financial manoeuvres, most notably sale-and-leaseback, which works as follows:

Having taken on debt and acquired some or all of a target business, a private equity investor may decide to sell-off some assets to a management company and then lease them back. The cash lump sum generated by the sale is then used to pay off much of the loan, thus effectively reducing the overall cost of the acquisition.

In the grocery industry, Somerfield provides a useful example of such activity. The business was acquired in 2005 by a consortium including Robert Tchenguiz, Apax Partners and Barclays Capital; the buyers subsequently sold off the Kwik Save subsidiary business to the BTTF group and then instructed Citigroup to dispose the freeholds of 230 Somerfield stores.



Assets divested through sale-and-leaseback scheme also vanish from the business's balance sheet, reducing the value of capital owned by the company and thus creating an instant improvement in Return On Invested Capital (ROIC).

Other key financial advantages occur in the field of tax. In the UK at least, businesses pay corporation tax on the profit remaining after interest payments. Obviously, a company which has just been acquired through a leveraged buyout has a much higher level of borrowing than it had before and therefore has higher interest payments to make. The tax liability of the company may therefore be much reduced.

Private equity businesses – and the wealthy individuals associated with them – enjoy a number of other tax benefits and this has made them the subject of considerable debate and controversy over the last year in both the US and the UK. Interestingly, some prominent individuals in the private equity field (such as Sir Ronald Cohen co-founder of Apax Partners, Peter Taylor of Duke Street Capital) have indicated cautious support for reforms which might increase their personal tax liabilities. Others, however, have questioned the wisdom of this, noting that capital has few national ties and is capable of migrating rapidly between markets in search of the most favourable tax regime. In view of this, any move to increase the UK government's tax take may simply drive private equity businesses overseas.

Whilst private equity activities have generated considerable adverse comment (such as from the TUC), it is possible to identify a number of positive outcome from their activities. In particular, the threat of intervention by private investors can exert a degree of financial discipline within a marketplace in that any business which fails to provide competitive returns for their current owners may be sold.

Looking ahead to 2008, it is anticipated that levels of private equity activity are likely to be somewhat reduced, mainly as a result of disruption in the commercial credit market; with credit now expensive and hard to come by, private equity operations are likely to be curtailed. A marked slowdown in the UK's commercial property market may also undermine the financial case for deals involving sale-and-leaseback.

Investors can be expected to become much more selective when considering possible transactions, although the relative stability of the grocery industry may mean that it remains attractive when other industries lose their allure.

There are, however, other possible investors that are much less reliant on credit. Sovereign wealth funds, especially those connected with energy-exporting nations, have seen their coffers flooded with cash over recent years, thanks to soaring world energy prices. Delta Two, the company which sought to acquire a stake in Sainsbury's in 2007, is one example of such fund. Delta Two is one of several investment vehicles controlled by the Qatar Investment Authority – effectively the Emir of Qatar's personal savings account.

The central banks of some Asian nations have likewise seen their capital holdings grow rapidly over recent years as consequence of rising trade surpluses, foreign-investment inflows, and exchange rate policies.

In 2006, Asia's central banks held US\$3.1tn in foreign-reserve assets, 64% percent of the global total and nearly three times the amount held in 2000 (source: McKinsey Global Institute, December 2007). These investment funds are owned by nations rather than by private businesses but may be expected to behave in a very similar fashion to other investors by seeking diverse portfolios, featuring stable and well-known companies with good long-term growth potential.

With vast investment funds still in search of profitable and defensible opportunities, grocery companies around the world – whatever their speciality – may expect to remain the subject of intense interest throughout 2008 and for some time to come.

Investor strategy varies widely, but almost any grocery business might be of interest to a private equity or sovereign wealth fund. The major difference between the two is that private equity investors will tend to seek out businesses which are currently not performing as well as they might and where performance might be corrected relatively quickly – “fixer-uppers”, in other words.

In the grocery industry, manufacturers may be particularly vulnerable, since in recent years manufacturer shares overall have not kept pace with the rest of the UK stock market, thus becoming relatively cheaper to acquire. Where a manufacturing business is taken over by a private equity buyer, a root-and-branch review of operational practices is likely to follow, with any perceived inefficiencies being purged. Any subsidiaries which might potentially stand alone may be sold off in order to recoup debts incurred in the takeover, with a subsequent buyer doubtless repeating the review process.

Where the private equity buyer also owns other complementary businesses, they may instead be combined to form a new group. Premier Foods is an example of such a conglomerate, assembled by private equity group Hicks, Muse, Tate & Furst before being floated in the stock market in 2004.



Sovereign wealth funds, on the other hand, might seek out better-performing, stable companies, with a view to holding on to them in the longer term and major retailers may prove to be attractive prospects. In the retail sector, any takeover is likely to impact upon relationships with suppliers as the new business owner seeks quick and simple means for boosting cash margin.

This focus may result in the renegotiation of pricing and payment terms, or the rationalisation of ranges and supplier contacts. If the business is subsequently sold on to another buyer, then suppliers may face a second, even tougher round of renegotiations as the new buyer likewise seeks to maximise the value of the investment.

Where stores are sold off in the aftermath of corporate activity, other retailers may be able to take advantage of the opportunity to acquire new stores in large numbers, expanding their own portfolios quickly and easily. The sale of former *Kwik Save* stores by Irish entrepreneur Brendan Murtagh in July 2007 provides an example of such a bonanza, with the Co-op, Sainsbury's and Tesco all benefiting.

From the above, it will be clear that the structure of company ownership in the grocery sector will continue to change rapidly in 2008 and beyond, presenting both challenges and opportunities for market participants.

IGD thanks McQueen Ltd for its assistance in sourcing the figures used in this article

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