TRENDS IN PRIVATE EQUITY EXITS

The first half of 2010 saw long-awaited changes in the prospects for value-realizing exits by private equity funds. Secondary buyout activity, initial public offerings and leveraged dividend recapitalizations, propelled by improving credit and equity markets, provide insights into what we may see in the near term.

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In the past year, private equity sponsors have been faced with a dynamic "exit" landscape. Sponsors looking to achieve successful exits have had to identify private equity buyers who have access to debt capital or significant equity capital that must be invested due to limited remaining investment horizons. They have also had to react quickly when initial public offering (IPO) windows open, be prudent when those windows close or are crowded out and seize opportunities when portfolio company leverage becomes available to finance stockholder distributions.

A sponsor's ability to effectively use the available exit opportunities in 2010 will significantly impact its investors' returns and, in turn, its prospects for raising a future fund. This is particularly true in the current environment of reduced limited partner demand and private equity fundraising declines. In the first half of 2010, US private equity funds raised $45.1 billion, down 26% from the $61.2 billion raised during the same period last year (*Dow Jones LBO Wire, July 7, 2010*) and significantly lower than the $288 billion peak of 2007 (*Thomson Reuters, Buyouts, April 2010*).

>> For more information on private equity sponsor exit strategies, search Buyouts: Overview on our website.

Sponsors evaluating exit opportunities should consider the recent changes to certain exit methods that have emerged in 2010, including the:

- Return of secondary buyouts (sales to other private equity funds).
- Ability to conduct IPOs.
- Availability of financing for dividend recapitalizations.

SECONDARY BUYOUTS

Before the credit crisis, sales of portfolio companies by one private equity fund to another (secondary buyouts) were a popular strategy for funds seeking a liquidity event. Because lenders were willing to lend into buyouts at increasingly higher leverage multiples and on increasingly favorable terms, private equity buyers were willing and able to pay higher purchase price multiples for sponsor-backed businesses.

As a result of the credit freeze, secondary buyouts, along with other types of leveraged acquisitions, suffered a steep decline in 2008 and 2009. But secondary buyouts have increased significantly in 2010. In the first half of 2010, they totaled $13 billion, compared with less than $0.5 billion in the same period in 2009 (*Dealogic (as of April 6, 2010)*). This recent resurgence in secondary buyouts in the face of an M&A market still recovering from the recession is notable for the confluence of factors contributing to this rebound.

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ACCESS TO LEVERAGE

The greater availability of credit is prominent among the factors contributing to the increase in secondary buyouts. Private equity funds, particularly dependent on debt financing for their buyouts, suffered disproportionately during the credit freeze compared to strategic buyers, many of which continued to finance deals with cash on hand, existing debt facilities and, although perhaps at depressed market levels, incremental equity financing.

Beginning in late 2009 and into 2010, however, acquisition financing has opened up to some extent, permitting the return of leveraged deals. Notably, in June 2010, Madison Dearborn Partners completed the acquisition of BWAY Corporation in a secondary buyout from Kelso & Company with over 70% debt financing (for more information, search Madison Dearborn under Public Merger Agreements in PLC What's Market on our website).

DRY POWDER

The increase in secondary buyouts is also partly attributable to time constraints confronting both private equity buyers and sellers. Private equity buyers, on the sidelines for a substantial portion of the last two years, are in many cases racing against the clock to invest committed capital before the expiration of their fund investment periods (typically up to five years), at which time they will lose the ability to call uninvested capital (known as "dry powder") for new investments. In addition, because sponsors' management fees are generally tied to capital actually invested during the investment period, the desire to avoid management fee reductions puts additional pressure on the need to put dry powder to work.

Similarly, in many cases private equity sellers, hoping to weather depressed portfolio company valuations during the credit crisis, retained investments longer than initially anticipated and are now under pressure to exit investments and return capital to investors. In particular, sponsors looking to raise funds in the future need to demonstrate to their limited partners their ability to continue to deliver sustainable above-market returns.

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INITIAL PUBLIC OFFERINGS

Private equity-backed IPOs surged in the last three quarters of 2009, peaking in the final quarter of the year (*Renaissance Capital's Global IPO Market Review and 2010 Outlook, January 2010*). In 2010, the IPO trend has continued, with the first quarter of the year posting almost the same number of private equity-backed IPOs as the last quarter of 2009 (*Renaissance Capital's Global IPO Review: 1st Quarter 2010, April 1, 2010*). In fact, private equity funds were behind three of the five largest IPOs in the first quarter of 2010: Sensata Technologies, Symetra Financial Corporation and Generac Holdings.

Importantly, the IPO market withstood global market turbulence during the second quarter of 2010, with eight sponsor-backed IPOs obtaining almost $1.7 billion of sale proceeds (*Reuters Media, July 28, 2010*). Two of the largest IPOs of the year were filed in the second quarter — the $4.6 billion IPO of HCA Inc. (backed by KKR and Bain Capital) and the $1.75 billion IPO of Nielsen Holdings (backed by KKR, Blackstone, The Carlyle Group and Thomas H. Lee Partners). These deals followed closely on the heels of the $720 million IPO in November 2009 of Dollar General, also backed by KKR.

The recent wave of portfolio company IPOs as a means of ultimate sponsor liquidity is driven by multiple factors, including:

- The slow (but not necessarily steady) stock market ascent over the past 18 months.
- Looming debt maturities and the pressure on the large number of portfolio companies acquired with significant leverage during the mid-decade buyout boom to refinance or pay down debt.
- Improvement (or at least stabilization) of operating and cash flow results at portfolio companies.

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DEALS

Summaries of the following recent public offerings mentioned in this article are available on the PLCWhat's Market database on practicallaw.com.

>> Under Initial Public Offerings, search:

Dollar General Corporation

Generac Holdings Inc.

Symetra Financial Corporation

CHALLENGES TO ACHIEVING LIQUIDITY

A portfolio company IPO is often just the first step of a staged process to provide returns to a sponsor and its investors. Sponsors often do not achieve full or even partial liquidity at the time of the IPO. This has particularly been the case in 2010, with IPO investors and underwriters sensitive to the use of proceeds in the IPO given the high leverage of sponsor-backed portfolio companies, limited alternative debt refinancing options and continued macroeconomic uncertainty.

Some private equity funds have been able to partially exit from their portfolio company investments through IPOs in 2010, but often only after the portfolio company has used significant proceeds from the sale to pay down indebtedness. For example, in March 2010, Bain Capital sold down over 20% of its ownership in the Sensata Technologies IPO for net proceeds of almost $170 million. Although 83% of the shares initially offered was issued by the company and only the remaining 17% was sold by Bain Capital, 100% of the overallotment option (known as a "green shoe") was offered by Bain Capital. As a result, about half of Bain Capital's net proceeds were earned following the IPO pursuant to the exercise of the green shoe. Up to $350 million of the approximately $440 million of net IPO proceeds received by Sensata Technologies was used to pay down indebtedness owed to bondholders.

Many private equity funds, however, have not been so lucky and have been completely blocked from selling in 2010 IPOs. For example, in February 2010, CCMP Capital Advisors was unable to sell any of its position in the almost $250 million Generac Holdings IPO. Many private equity-backed IPOs, like the Generac Holdings offering, have also seen reductions in offering size as volatility has returned to the stock market in 2010 amid the European financial crisis and mixed results from leading macroeconomic indicators.

In addition, few private equity-backed IPOs in 2010 have priced above the underwriter's target range (with some even pricing below the target range) as investors have reacted to poor post-market performance in many sponsor-backed IPOs relative to the overall 2010 IPO market. For example, neither Graham Packaging Company Inc. (Blackstone) nor Douglas Dynamics, Inc. (Aurora Capital Group and Ares Corporate Opportunities) were able to sustain an IPO price within their initial range of $14 to $16 per share. Graham Packaging priced at $10 in February and Douglas Dynamics at $11.25 in May. Further, 13 sponsor-backed IPOs that priced in the first six months of 2010 have slumped 2% in the first month of trading, after averaging gains every year since 2001 (*Bloomberg and Renaissance Capital LLC May 2010*).

In light of this relatively unpredictable sponsor-backed IPO market, even completing an IPO like the Generac Holdings IPO should be considered a success, as it enabled CCMP to preserve its equity and position itself for a future exit through the public markets. By contrast, some recent IPOs by private equity-backed portfolio companies have had to be scrapped entirely. For example, Avenue Capital Management and other investment funds saw Magnachip Semiconductor's $125 million IPO dumped three months after its initial filing.

When private equity funds are not allowed to sell any of their shares in a portfolio company IPO (such as in the Generac Holdings IPO) or are able to take considerable dollars off the table but not achieve full liquidity (such as in the Dollar General and Sensata Technologies IPOs) sponsors must rely on strong public markets to complete their exit strategy through future registered secondary offerings and unregistered resales under Rule 144 of the Securities Act.

RESALES AND FOLLOW-ON OFFERINGS

Typically, at the time of a leveraged buyout, the sponsor negotiates with the portfolio company for contractual registration rights. Registration rights

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in this context include demand registration rights and piggy-back registration rights. Demand rights enable the fund to cause the portfolio company to "go public" and sell the fund's shares by means of a registered IPO and to cause the portfolio company to complete subsequent registered follow-on public offerings to sell any holdings of the fund remaining after the IPO. "Piggy-back" rights permit the fund to include shares in a registration being effected by the portfolio company for its own account or for the benefit of other selling stockholders.

When exercising its registration rights (particularly in an IPO), the fund must contend with contractual limitations (such as agreements with lenders) and market conditions (including underwriter requirements and public investor resistance), which may limit its ability to exit at the time of the offering. Further, whether or not the private equity fund sells shares in the IPO, the underwriters typically require, and public investors have come to expect, that the private equity fund will be prevented (or "locked up") from selling any additional holdings in the public company for 180 days after the IPO.

Absent a resale of its restricted securities in a follow-on registered offering, a sponsor often looks to resell restricted securities to the public in an unregistered resale under Rule 144. If a private equity fund holds at least 10% of a public company's outstanding equity and/or maintains representation on the public company's board of directors, it is generally considered an "affiliate" of the public company for purposes of Rule 144. Affiliates are subject to significant holding period, volume and manner of sale limitations in public resales under Rule 144 as compared to non-affiliates. A private equity fund affiliate typically can only sell through broker trades or with a market maker, and the amount of securities it can sell in any three-month period is limited to the greater of 1% of the company's outstanding equity securities or the average weekly trading volume in those securities over a specified four-week period.

>> For more information on Rule 144 resales, search Resales Under Rule 144 on our website.

As a result of the 180-day IPO lock-up and the Rule 144 limitations discussed above, a private equity fund will often use its registration rights to cause the public company to file a "shelf" registration statement 180 days following the IPO. The underwriters rarely waive the 180-day lock up requirement and will only consider doing so if the company's stock has consistently traded well above the IPO price. A shelf registration enables the private equity fund to sell down its position in the company over a period of time, whenever the fund determines market conditions to be favorable. For example, under their registration rights agreement with Dollar General, KKR and other investors forced Dollar General to file a follow-on shelf registration statement in 2010 to provide KKR and the other investors the ability to sell their holdings in future public offerings. Following an early release from the 180-day lock up, the first shelf takedown (of many) was completed by the investors in April 2010 for approximately $700 million.

Given the limited ability (and in many cases inability) in 2010 of private equity funds to sell their holdings in portfolio company IPOs or Rule 144 resales, private equity funds will likely continue to look to these kinds of follow-on public offerings for their ultimate exit. The success of these exits is dependent on whether the public markets remain sufficiently robust throughout the remainder of 2010 to support secondary offerings in meaningful amounts and at favorable valuations.

>> For more information on offerings that can be done after an initial public offering, search Follow-on and Secondary Registered Offerings: Overview on our website.

LEVERAGED DIVIDEND RECAPITALIZATIONS

For the first time since the credit crisis, the first six months of 2010 saw a significant increase in leveraged dividend recapitalizations (see *Box, What is a Leveraged Dividend Recapitalization?*). In the first quarter alone, lenders provided $6.4 billion in leverage for dividend recapitalizations in the US, four times the total amount provided in all of 2008 and 2009

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WHAT IS...?

WHAT IS A LEVERAGED DIVIDEND RECAPITALIZATION?

A leveraged dividend recapitalization is a financing technique under which a sponsor causes its portfolio company to issue new debt to pay stockholders, including the private equity fund, a special dividend. This often allows the private equity fund to quickly recoup much (if not all) of its initial equity investment without selling its ownership interest in the company, allowing the fund to take cash off the table when available and potentially help improve the return on the investment for the fund and its investors.

Leveraged dividend recapitalizations are generally legal under applicable state laws if the company is still solvent and can meet certain capital or surplus minimums after paying the dividend. However, a failure to satisfy these requirements and similar requirements in federal bankruptcy law can result in the transaction being set aside as a fraudulent conveyance (requiring the stockholders to refund all or a portion of the dividend) and, in some cases, in personal liability for directors of the company approving the dividend. During the mid-decade buyout boom, with debt financing easily available on favorable terms, many sponsors took advantage of leveraged dividend recapitalizations to achieve successful interim exits. The use of leveraged dividend recapitalizations fell out of favor at the outset of the credit crisis and the resulting loss of easy credit.

combined (*Standard & Poor's Q1 '10 Leveraged Buyout Review*). While the return of the leveraged dividend is somewhat reminiscent of the upswing during the credit boom of 2005–2007, a close examination suggests that leveraged dividends today are frequently, but not always, initiated to rebalance portfolio company capital structures saddled with excess equity rather than to leverage the portfolio companies to generate increased returns.

OVER-EQUITIZED CAPITAL STRUCTURES

The limited availability of debt financing during the credit crisis forced many private equity buyers to fund acquisitions with a greater percentage of equity than they are generally accustomed to, particularly compared to the levels of leverage they had become accustomed to during the buyout boom. Over the course of 2008–2009, deals were increasingly funded at lower leverage multiples, and those periods saw significant increases in the average equity contribution by private equity sponsors to US buyouts (*Standard & Poor's Q1 '10 Leveraged Buyout Review*). To be sure, average equity contribution by private equity sponsors increased from under 33% in 2007 to over 50% in 2009 (*Standard & Poor's Leveraged Commentary & Data Group*). And where deal-to-fund size ratios permitted, a number of deals were funded entirely with equity, with a view towards subsequent leveraged recapitalization when credit markets opened up.

More recently, however, increased appetite for risk (perhaps the result of a perception of improved overall economic conditions or investors reaching for better returns than can be provided by historically low US treasury yields) has contributed to increased willingness on the part of lenders to fund into dividend recapitalizations. For example, in July, Nordenia International AG completed a EUR280 million bond offering that, together with cash on hand, was used to refinance existing debt and to fund a EUR195 million dividend. The Nordenia dividend returned to its sponsor, Oaktree Capital, cash in excess of the amount Oaktree had invested in the company since acquiring a majority stake in 2006 (*Dow Jones LBOWire, July 6, 2010*). In another example, in February, Intergraph Corp. paid its sponsors, Hellman & Friedman, TPG Capital and JMI Equity, a $350 million dividend, funded with a $300 million term loan and cash on hand (*Standard & Poor's Leveraged Commentary & Data Group*).

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MECHANISM TO ADD LEVERAGE

Though scarce during the credit freeze, leveraged dividends are not new. However, the structure and resulting leverage ratios of recent transactions illustrate a new twist. The Nordenia transaction, while certainly not an aberration, more closely resembles the leveraged dividends before the credit crisis than current iterations. Even the Intergraph dividend, which Moody's called an "aggressive dividend payout" prompting a ratings downgrade, was funded largely with a secured term loan and otherwise with cash on hand.

Wary credit parties have adopted, and ratings agencies have perhaps come to expect, a more conservative structure for the recent leveraged dividend recapitalizations than was conventional during the days of easier credit. Recent transactions have involved debt financing more senior in the capital structure and have resulted in lower leverage ratios. In particular, a majority of these dividend payouts have followed the Intergraph model, being funded through secured term loans rather than the Nordenia model, being funded with subordinated, unsecured notes.

In recent leveraged dividends, private equity funds have often offered lenders a senior position in the portfolio company capital structure because both the pre- and post-dividend leverage ratios are generally lower than was typical only two years ago (often attributable to improved portfolio company operating performance following the end of the most recent recession rather than any significant reduction in leverage over that time period). While before the crisis private equity portfolio company leverage averaged as high as 6.2 times, currently the average is in the ballpark of 4.5 times (*Standard & Poor's Leveraged Commentary & Data Group*). For example, even after giving effect to its $1.75 billion leveraged dividend in February 2010, HCA's leverage was 4.41 times EBITDA, well below its 2006 year-end leverage of 6.29 times (for more information, search HCA under SEC Forms 10-K and 10-Q: Fortune 500 in PLC What's Market on our website), and Intergraph's leverage, after giving effect to its dividend payout, was about 5.2 times.

The ability to provide senior positions in the capital structure and lower overall leverage ratios both suggest that, in many cases, sponsors have been using the leveraged dividend recapitalization not as an exit strategy but rather as a mechanism for obtaining normal leverage levels in deals that were initially funded with substantial equity in excess of traditional levels.

LOOKING AHEAD

It remains to be seen whether the conditions creating recent exit opportunities will be short-lived or whether the developments seen so far in 2010 provide insights into the private equity exit markets for the remainder of 2010 and into 2011. The global economy and the US financial system remain fragile and unforeseen economic, regulatory and market-based developments will likely continue to impact the availability, timing and effectiveness of exit opportunities.

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