NEWS ANALYSIS

Club buyout deals are becoming increasingly common, as private equity houses band together to purchase larger companies. But these deals do not always go smoothly and there are some concerns about what happens when houses fail to agree on strategy or exit timing and about the impact on LPs' investment diversification.

In the club

The joining forces of several private equity houses to buy an asset is not in itself a new development and goes back to the early days of the industry. But what does seem to be changing is that club deals are becoming increasingly common at the top end and also that because of the growth in private equity funds much larger sums are generally involved than in the past.

Another shift is that often in the past the rationale for a club deal was to bring in a house with specific industry expertise, while today the main reason is frequently to increase the funds' firepower so that ever-larger acquisitions can be made.

In many ways the development of club deals is a positive one for the industry because it is enabling buyout houses to acquire companies they would not be able to do on an individual basis. "It's a sign of an expanding market as it allows funds to go after larger assets," says Piers Dennison, investor relations director at Candover.

Banding together at the top end can also enable houses to get a good price on assets because it reduces competition. This is because there is inevitably less competition the more expensive the asset and if the larger houses are already in a club they are not competing against each other.

But there can be problems, seen most recently at UK pub company Spirit Group, where a complex financing structure is thought to be causing difficulties in dividing up the interests of its private equity owners Blackstone, CVC, Merrill Lynch and Texas Pacific.

Alison Hampton, a consultant at law firm Lovells, says when planning any club deal it is essential for the potential partners to agree issues up front, such as who is in control, how strategic changes will be handled and how and when exits will be implemented. "These things should be agreed even before they put in a bid," she says.

"From an LP perspective the main problem is portfolio diversification"

Mounir Guen, CEO of private equity advisers MVision, says: "There's nothing wrong with club deals per se. The issue is when things go wrong, who sorts it out?" He adds that often there are riders and leaders in the club and that the leader is not necessarily the largest fund. What is important is establishing early on who the leader or leaders are, he says.

Andre Jaeggi, managing director at LP investor Adveq Management, agrees: "There have been situations in buyouts where nobody is really in charge. In venture capital the club model makes it clearer who is doing what than in buyouts." He acknowledges that the increasing size of buyouts makes club deals necessary in many cases but is concerned at what he sees as the lack of clarity when it comes to each house's role and responsibility.

Candover's Dennison says it is crucial to discuss in advance key questions about exit strategy and timing. "You must be careful when you team up with someone that they have a similar outlook and philosophy and are at a similar stage in their fund cycle. There's no point going into business with a house that tends to hold its investments for 10 years if your approach is three years."

Expert advice

Jaeggi says in the 1990s club deals in private equity tended to be about bringing in specific expertise for a restructuring, such as Silver Lake or Francisco Partners being brought in on a tech deal because of their industry know-how. Another LP executive, who asked not to be named, suggested many of the current club deals lack the commercial rationale of involving different houses according to their expertise: "When you see Goldman Sachs, Texas Pacific and Blackstone together you wonder what's the point because it's not like one of those houses has expertise that the other don't."

Colin Curvey, an associate director at Duke Street Capital, which has two club deals in its portfolio, says one of the big differences today is the sums involved. "When you look back at club deals in the past the sums were much smaller. The original Focus deal, for example, required four partners to raise just a few million pounds."

He says that the more funds involved in a deal, the more complicated it gets. "If you have two funds then they can generally agree about most things and act as one, but when you have four it gets trickier. In larger clubs with more than two investors I would imagine a de facto leader emerges and the others will only veto decisions when they feel quite strongly."

Lovells' Alison Hampton agrees that the fewer the houses involved, the easier it is to establish roles and responsibilities. This is particularly so when the houses involved have a similar approach and philosophy. She says: "Another important issue is the personal relationships because when you unpeel some of these consortia you find the individuals often know each other from way back. If good personal relationships are there that can help a lot if there are problems later on."

A concern in some quarters is the perception that club deals lead to escalating fees, given the number of parties involved. Others argue that because transaction fees are generally based on the enterprise value of the target company then fee levels should not be higher in a club deal than if an individual house was acquiring the company.

Candover's Dennison says: "I think the fees claim is a bit of a red herring because total fees will be no higher than if it was an individual house acquiring the company. What may be different is whether the GPs concerned rebate the transaction fees to LPs but that's a question for the partnership agreement and is nothing to do with whether it's a club deal or not."

A bigger issue, at least for some LPs, is the concern that club deals are contributing to "asset inflation" and that they are making it harder for LPs to diversify risk.

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Andre Jaeggi is worried about the frequency with which one club of private equity houses is selling an asset to another club, in the secondary market. The issue is that many LPs will be invested in several of the big funds and so may find themselves indirectly paying a higher price for a portfolio company they already "own".

Jaeggi says: "I can see the benefit where a regional private equity house is selling to a pan-European fund and the company is moving up the chain, but where one club group is selling to another group with a similar skill set then there's the danger of asset inflation. You wonder whether the sale is simply based on one group of private equity houses needing to exit and the other needing to invest."

Mvision's Mounir Guen agrees, noting investors are having to grapple with a different dynamic over the underlying exposure they have, since the upsurge of club deals in the secondary market: "Two GPs selling a portfolio company to another group of GPs on more expensive terms makes LPs wonder if it's not just about a rotation of ownership but at a higher price and without the company leaving the private equity system."

In addition to this concern is the question of risk diversification, says Erik Kaas of Partners Group: "From an LP perspective the main problem is portfolio diversification because if I'm invested in three buyout funds and they're in a club deal I've got a lot of exposure to one company."

He adds that generally club deals must be looked at on a case-by-case basis as to whether they make commercial sense. "How the houses work together is very important because there are lot of conflicts over who is running the show and over how and when to exit an investment," he says.

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Despite the potential pitfalls in club deals it looks like the trend is set to continue because without them private equity houses will not be able to target such large companies. "Most buyout funds would rather be the sole owner but where you don't have the fire-power on your own or want to bring in a house with a specialist angle it makes sense to do a club deal," says Duke Street's Curvey.

He adds that club deals have enabled private equity houses to target ever-larger assets. "If you read the papers it sounds like private equity is taking ownership of everything but in reality there are huge swathes of the stock market that are out of reach because of the size of those companies. Club deals bring some of those companies within the reach of private equity."