Taking a Fresh Look at Club Deals

An analysis of the evolution of multi-sponsored buyouts

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Key takeaways

- **Club deals are becoming less frequent.** Thus far in 2018, they represent 20.1% of all non-add-on leveraged buyouts (LBOs) in the US and 16.9% in Europe compared to the 39.8% and 29.7%—respectively—seen in 2001-2004.

- **Despite several highly publicized failures, club deals are approximately 50% less likely to go out of business or bankrupt than sole-sponsor buyouts.** Portfolio companies go out of business or file for bankruptcy in 7.2% of club deals compared to 14.5% of sole-sponsor buyouts.

- **$1 billion+ club deals have outperformed sole-sponsor buyouts over the past eight years.** These buyouts tend to see a larger increase in enterprise value, are more likely to undergo recapitalizations (recaps) and utilize significantly more add-ons.

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Overview

Club deals have received recurrent negative attention from the media and limited partners (LPs).[1] In 2006, the US Department of Justice began investigating the industry's practice of forming consortiums to limit the number of potential buyers for a deal, thereby mitigating the competitive bidding process and driving down prices; in the end, The Carlyle Group, Blackstone and TPG Capital paid over $300 million jointly in fines without admitting guilt.[2] In addition, LPs are apprehensive about overconcentration risk because an LP may have ownership of one company across multiple funds. There have also been several high-profile bankruptcies, including Energy Future Holdings (formerly TXU)—which is perhaps the PE industry's most infamous failure—and Toys "R" Us, causing massive financial and job loss. Moreover, critics suggest club deals have too many decision makers—which can be especially troublesome when things go poorly—with no party assuming complete control. Finally, incentives can differ if general partners (GPs) are on different exit timelines due to the specific vintage and investment timeline of their fund. Despite these concerns, we believe club deals are worth another look from a performance perspective. To that end, a 2016 review by Ward Blokker found that not only is performance better for club deals, but the portfolio companies experience higher levels of growth and profitability.[3]

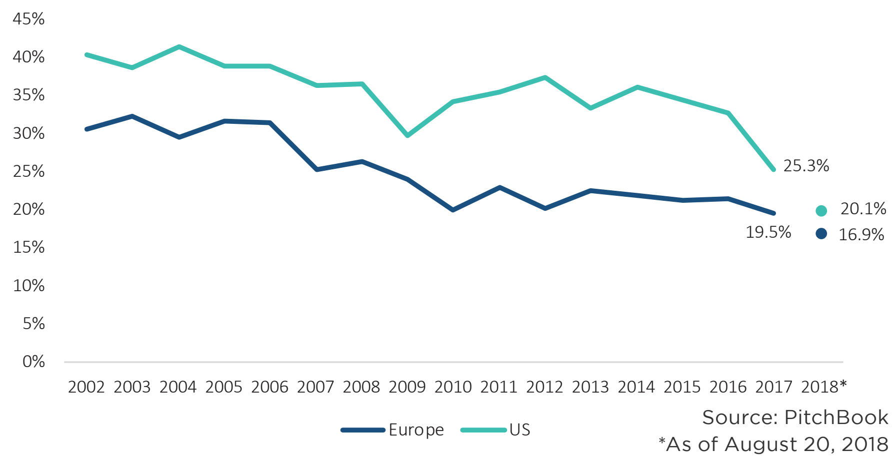
State of the market

In the early 2000s, club deals were done simply to pool capital and buy out larger companies than any single PE firm could target on its own. This simplistic model has matured over time, just as the PE industry has. The club deals of today—which have consistently decreased in prevalence—are focused on multiple GPs bringing expertise to the deal and having a more targeted approach, though pooling of capital is still an underlying reason. Between 2001 and 2004, club deals accounted for 39.8% of non-add-on buyouts in the US and 29.7% in Europe. By 2018, those figures dropped to 20.1% in the US and 16.9% in Europe.

1: Club deals will be defined as a buyout with more than one sponsor. This can include non-PE firms such as corporations, sovereign wealth funds and family offices.
2: "Private equity funds find strength in numbers?," Financial Times, Javier Espinoza, November 27, 2017
3: "A study on the economic impact of private equity club deals in leveraged buyouts," Ward A. Blokker, July 2016

It is unsurprising that GPs have increasingly opted to do buyouts sans other investors; buyout fund sizes have swollen to the point that many GPs now have the financial firepower to do a sole-sponsor LBO of a size that probably would have required a consortium in the past. Moreover, many LPs are seeking to boost co-investments to get more direct access to deals and lower fees, which can provide additional capital in place of a co-GP. David Rubenstein nicely sums up how LPs are looking to invest: "They want to go into a fund, but co-invest additional capital—no fee, no carry—and since so many large investors have that interest, they are now going to GPs like us and saying 'If you have a big deal, don't call up one of your brethren in the private equity world. Call us up.'"[4] However, a study published on the performance of co-invested capital found that these sidecar vehicles had underperformed—on average—the GP's main fund.[5]

Club deals are slowly declining as a proportion of large buyouts
Club deals (#) as a proportion of non-add-on LBOs by region



Source: PitchBook
*As of August 20, 2018

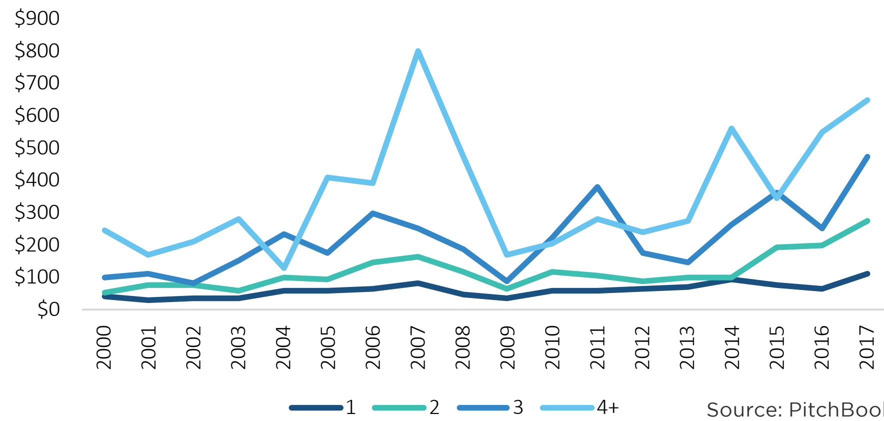
For GPs contemplating a buyout with a consortium, they often must consider the numerous drawbacks as perceived by LPs. However, club deals offer some compelling benefits, including allowing GPs the ability to bid on larger companies than they could before. Club deals also permit buyers with differing expertise to partner on deals, driving additional operational capabilities. Furthermore, debt financing is typically less expensive when lenders see multiple GPs involved. With several prominent club deals recently announced—including the $18 billion Bain-led group's buyout of the Toshiba memory unit and the $20 billion Blackstone-led buyout of Thomson Reuters' Financial & Risk business—it is evident that club deals still hold a place in today's PE dealmaking environment.

4: Thomson Reuters conference, David Rubenstein, April 4, 2013
5: "Investing Outside the Box: Evidence from Alternative Vehicles in Private Capital," Josh Lerner, Jason Mao, Antoinette Schoar & Nan R. Zhang, August 15, 2018

The more, the merrier

As buyout fund sizes have ballooned, so too have club deal sizes. In fact, club deal sizes since 2000 have risen more rapidly than sole-sponsor buyouts—growing at a compound annual growth rate (CAGR) of 8.9% compared to 6.6% for sole-sponsor buyouts. PE firms want to write substantial equity checks to spend down dry powder, meaning the more investors involved in a deal, the larger one may expect the deal to be. On average, there is a clear step-up in size for each additional sponsor.

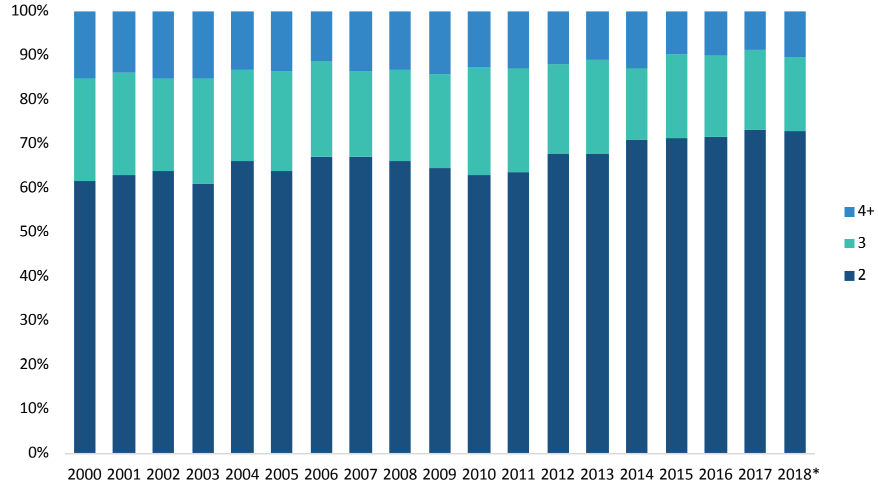
Buyouts with additional sponsors complete larger deals
Global median deal size ($M) by investor count



Source: PitchBook
*As of August 20, 2018

The frequency of buyouts with three or more sponsors is declining, mirroring the relative drop we see for club deals in general. In 2000, 38.5% of club deals involved three or more sponsors; by 2018, that figure has fallen to 27.1%. The expansion of buyout fund sizes means it takes fewer financial sponsors to bid for companies than in the past. For example, JAB Holding and BDT Capital Partners' $7.2 billion buyout of Panera Bread in 2017 would have likely required additional sponsors a decade ago. Blackstone and Carlyle are looking to launch a joint bid for Arconic—the current bid would give Arconic an enterprise value of $18.3 billion—which would be the fifth largest two-sponsor buyout in history. Furthermore, the largest club deal of 2018 was able to go through with only three sponsors, a far cry from the 16 investors in the $17.6 billion Freescale Semiconductor buyout in 2006.

Club deals are using fewer sponsors
Global club deals (#) by number of investors

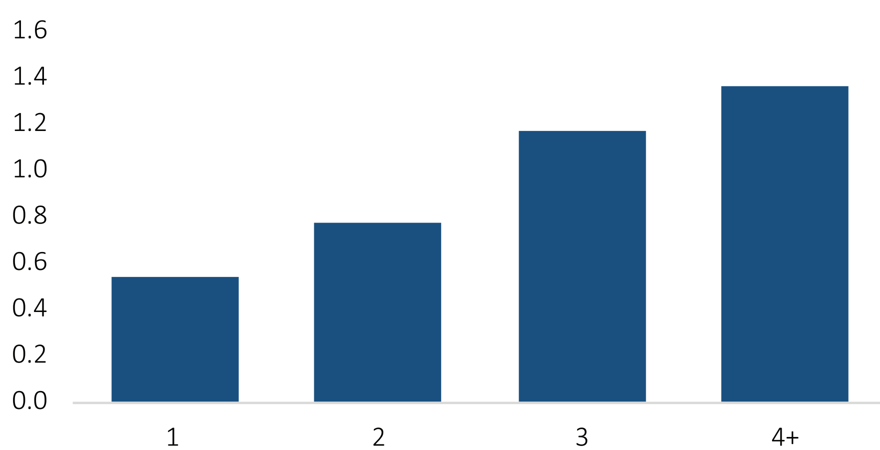


Source: PitchBook
*As of August 20, 2018

Add-on activity

Add-ons—a subject on which we have recently published several pieces—continue to proliferate within the PE industry. Across the board, platform companies are undergoing more add-ons than ever before as financial sponsors use the buy-and-build strategy to augment top-line expansion in this low-growth environment. With additional financial sponsors comes the ability to undergo and incorporate additional add-ons, because additional investors allow for more rigorous investment monitoring and plan implementation. The data confirms this showing that club deals have exhibited a penchant for add-ons, completing 0.95 per platform buyout from 2000 to 2012, compared with 0.54 for sole-sponsor buyouts.

Buyouts with additional sponsors complete more add-ons
Global average add-ons (#) by investor count (2000-2012)

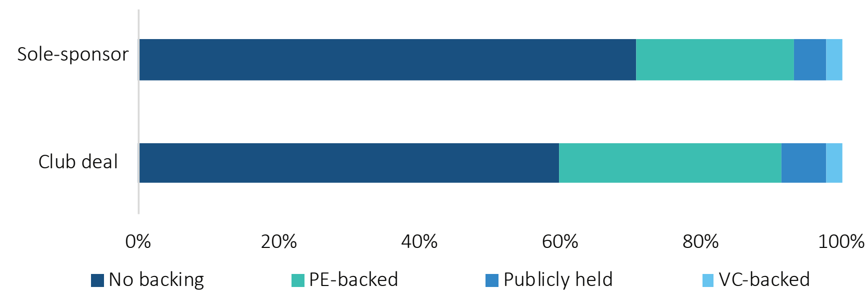


Source: PitchBook
*As of August 20, 2018

Coming and going

Many of the high-profile club deals have been take-privates, including those of Freescale Semiconductor, Kinder Morgan and TXU. Despite the attention generated around a select few transactions, publicly held companies have made up just 6.4% of club deals between 2008 and 2017, though this number is well above the 4.6% for sole-sponsored buyouts. Club deals also source buyouts from PE-backed companies more often than sole-sponsored buyouts, with PE-backed companies representing 31.7% of club deals and 22.4% of sole-sponsor buyouts. Interestingly, the difference in deal sourcing for club deals and sole-sponsor buyouts in these areas is nearly proportionate, with club deals 39.1% more probable to undertake a take-private and 41.5% more likely to target a PE-backed company.

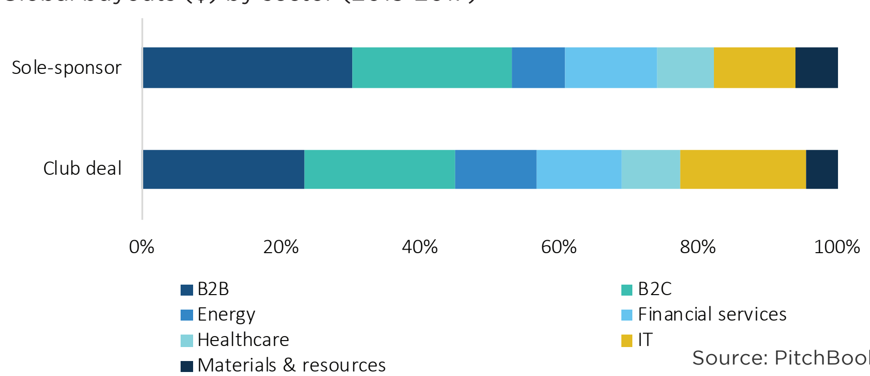
Club deals show a proclivity toward institutionally-backed companies
Target company backing status (2008-2017)



Source: PitchBook
*As of August 20, 2018

Club deals have also shown a propensity to invest in technology firms, a trend that has become significantly more pronounced over the past five years. In fact, 18.1% of capital invested by club deals was in the technology sector compared with 11.7% for sole-sponsor deals. Larger club deals, such as the $18 billion Toshiba Memory buyout, show the expanding interest in the sector by PE firms and non-financial sponsors, such as Apple and Dell, which also invested in the buyout.

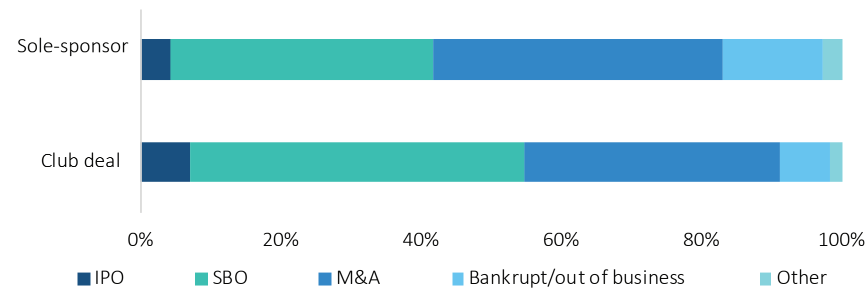
Club deals favor technology buyouts at the expense of B2B
Global buyouts ($) by sector (2013-2017)



Source: PitchBook
*As of August 20, 2018

Notorious failures, such as TXU and Toys "R" Us, have sullied opinions on club deals. While these cases garnered inordinate media attention, sole-sponsored buyouts are actually twice as likely to go out of business or bankrupt than club deal buyouts, with this outcome occurring in 7.2% of all club deals and 14.5% of all sole-sponsored buyouts. Another point worth considering is how much more frequently club deals exit via an IPO. Many club deals are enormous, often limiting the potential buyers to another consortium, a strategic buyer or an IPO. To that end, 4.2% of sole-sponsored buyouts exit through an IPO, compared with 7.1% of all club deals.

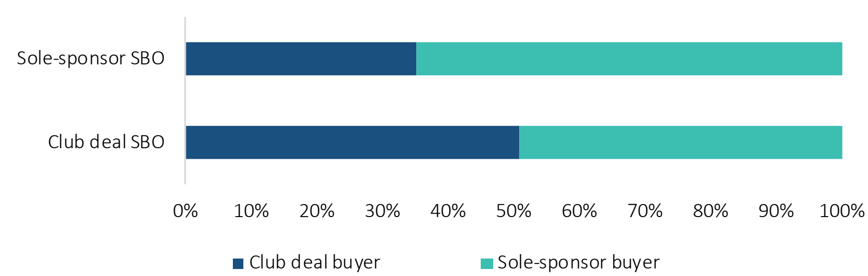
Club deals are less likely to go bankrupt than sole-sponsor buyouts
Global exits (#) by type (2008-2017)



Source: PitchBook
*As of August 20, 2018

Secondary buyouts (SBOs) are more prevalent among club deals than sole-sponsor buyouts, which is interesting given that most club deals are done because one financial sponsor cannot write a large enough equity check. 47.7% of club deals exit via SBO versus 37.5% for sole-sponsor buyouts. Diving one level deeper, we see how much more frequently club deals are sold to another consortium. 50.8% of club deal exits via SBOs are sold to another consortium versus 35.2% of sole-sponsor buyout exits via SBOs.

Club deal SBOs are more often sold to another consortium
Global SBO exits (#) by seller type (2008-2017)



Source: PitchBook
*As of August 20, 2018

Show me the money

As important as the previous topics are, performance is what matters. To approximate change in enterprise value (EV)—which we use as a proxy for performance—we assessed portfolio companies' change in deal size during PE ownership. Additionally, we use the IPO post-valuation as our exit value. To get a more nuanced performance picture, we broke out the results into two buckets of deal sizes: deals less than $1 billion and $1 billion+ deals. The rationale for this is that club deals tend to skew larger, and we aimed to keep the results consistent and to not compare smaller average sole-sponsor deals to larger club deals. The results for buyouts less than $1 billion show a common theme; with the exception of the 2011-2014 group, performance between the two buyout types is approximately even. True, club deals did marginally outperform in three of four periods, though perhaps the more important trend is performance steadily declining over time for both groups.

Club deals match sole-sponsor buyouts as performance trends lower
Global median % change in EV (less than $1B) by exit year

Source: PitchBook
*As of August 20, 2018

On the other side are the $1 billion+ buyouts. The data here shows an interesting story with opposing trends for club deals and sole-sponsor buyouts. Our data shows that $1 billion+ club deals have handedly outperformed sole-sponsor buyouts over the past eight years. However, sole-sponsored buyouts outperformed club deals for buyouts with an exit year of 2010 or prior. In addition, performance for club deals improved in each successive time period, while it sank for sole-sponsor buyouts.

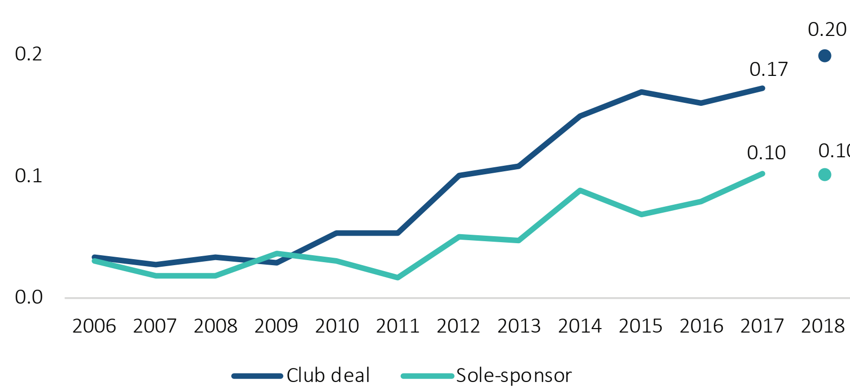
Getty Images is a fitting example of the recent outperformance of club deals; in 2008, Hellman & Friedman and Farallon Capital Management acquired Getty via a $2.1 billion LBO. In 2012, Carlyle bought Getty Images via a $3.3 billion sole-sponsor buyout, netting the sellers a hefty gain in addition to the multiple dividend recaps Getty Images underwent along the way. Just last month, Carlyle announced it was selling the majority of Getty Images back to the Getty family for $2.6 billion ($250 million in equity sale and $2.35 billion in debt rolled over)—lowering the company's enterprise value to approximately $3 billion. The performance difference cannot be fully attributed to club deal versus sole-sponsor—timing, debt load, industry shifts and more contributed. However, additional sponsors may have assisted in the superior performance.

Club deals go from underperforming to outperforming sole-sponsored buyouts
Global median % change in EV ($1B+) by exit year

Source: PitchBook
*As of August 20, 2018

GPs can extract value from portfolio companies beyond simply increasing the enterprise value. Recaps, and subsequent distributions, have become a popular method for boosting performance. To that end, we find club deals now undergo twice as many recaps as sole-sponsor buyouts, meaning club deals experience additional performance that is not fully captured by change in deal size. Recently, club deals exhibit superior performance compared to similarly sized sole-sponsor buyouts and are more likely to squeeze out additional performance via a recap.

Club deals undergo significantly more recaps
Global average recapitalizations (#) by exit year



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Implications for LPs and GPs

We believe it is time for LPs and GPs to go beyond the stigma and utilize data to reassess their thoughts on club deals. These multi-sponsor buyouts offer some advantages over sole-sponsor buyouts, notably a lower chance of bankruptcy or going out of business. Performance has favored larger club deals in recent years, though the benefits of smaller club deals are not so clear. In general, dealmakers should take a nuanced approach to this long-maligned strategy and increasingly infrequent type of deal.