Saïd Business School Cases

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Petco Animal Supplies B – October 2010

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This Note was prepared by Tim Jenkinson and Ludovic Phalippou as the basis for class discussion.

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Introduction

2010 marked the fourth anniversary of Petco's second LBO in 2006. When the two private equity firms had first acquired Petco in April 2000, they were able to produce quick and high returns, exiting within 2 years at an internal rate of return (IRR) in the range of 100%. However, since they re-acquired the firm, business had been much tougher.

When TPG and Leonard Green bought back Petco in October 2006, they had taken full advantage of banks' generous deals, taking out a $700m "cov-lite" term loan (see Exhibit 1).[1] These loans required only minimal amortization payments and had disappeared after Lehman Brothers' bankruptcy. In addition to bank debt, the deal included $500 million of eight-year mezzanine financing from GS Mezzanine Partners 2006 Onshore Fund with GS charging 10.5% annual interest. The mezzanine financing is non-amortizing and thus paid through interest only. They also negotiated a $200 million revolving credit facility to provide a cushion for volatility in cash flow. The equity cheque they had written was about $765 million. In the heady days of late 2006, the 7-year term loan seemed like an eternity. But deadline was approaching now. If they couldn't exit the company by 2013, they would have to re-finance the debt since Petco didn't have enough cash to pay off the debt. The conversations with banks were going to be very different compared with 2006 when it was a borrowers' market. During the financial crisis, Petco (like most private equity-held companies) survived despite high leverage. This was possibly due to light covenants and the large credit facilities mentioned above. But it meant that the banks took the hit, tempering their appetite to provide leveraged finance.

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Exhibit 1: Deal structure for the LBO for Petco in 2006

	Amount (Million)	EBITDA multiple	Debt and Equity %	Term (Years)	Interest
Revolving facility I ($ 180m)	0	0	0%	6	L+150
Revolving facility II ($ 20m)	0	0	0%	6	L+250
Term Loan B	700	3.34	35.60%	7	L+250
Subordinated Notes	500	2.39	25.40%	8	L+925
Total Debt	1200	5.73	61.10%		
Equity by LG	350	1.67	17.80%		
Equity by TPG	415	1.98	21.10%		
Total Equity	765	3.65	38.90%		

Source: LCD

[1] Covenant-lite term loan: The debt issued by banks with fewer restrictions on collaterals, payment terms, income level.

Fund Cycle and Fund Raising: TPG and Leonard Green

TPG IV raised $5.3 billion in 2003 and was now halfway through its divestment period. TPG V raised a staggering $15 billion in 2006 and very shortly after, TPG VI was raised and collected another $18 billion.[2] This made TPG the largest PE firm in the world at that point ahead of Goldman Sachs, Carlyle and KKR, respectively second, third and fourth.[3] But like many private equity firms, TPG invested little once the crisis hit. As of September 2009, TPG VI had invested only 11.3% of the capital committed (Exhibit 2). TPG IV performed fine, though not spectacularly, with an IRR of 1[illegible].3% and a return of $1.35 per $1 invested. Unfortunately, however, TPG V was much larger (~3x as big as TPG IV) and was underwater with an IRR of -16.7% (Exhibit 2).

TPG V's poor performance was partially due to its April 2008 investment in Washington Mutual Inc. (WaMu), a top 6 US savings-and-loan company. The distressed WaMu received a $7 billion equity injection from a group of investors led by TPG. TPG invested $1.35 billion in equity across three of its funds: TPG Partners V, TPG Partners VI, and TPG Financial Partners LP.[4] TPG V had invested $475 million equity in the WaMu deal.[5] Six months later, WaMu filed for bankruptcy, and TPG lost its entire investment. This is the biggest loss in the history of private equity and is particularly notable for the speed at which it happened.[6,7]

Leonard Green was in another situation, both in where they stood in their fund-raising cycle and their performance. Their fund V raised $5.3 billion in 2006, and they now had to raise their fund VI. Reaching at least the same size as the previous fund was a normal objective. Their fund V had an IRR of 18% and a multiple of 1.23, which was probably quite good for a vintage year fully hit by the crisis. Their 2003 fund (Green Equity Investors VI) had roughly the same returns as TPG Partners IV (See Exhibit 3).

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[2] In 2008, TPG also raised a distressed financial services fund with roughly $6bn in commitments, and raised roughly $4bn for its Asian fund. See http://www.pe[illegible]media.com/Article.aspx?article=27378&hashID=413DFE46271B4836A58A1C2D32794B001892[illegible]D

[3] http://www.peimedia.com/productimages/Media/000/200/447/TPG_sample_final.pdf

[4] http://blogs.wsj.com/deals/2009/01/12/with-alltel-deal-closing-tpg-puts-much-needed-win-in-the-books/

[5] http://online.wsj.com/article/SB122247093070880789-search.html?KEYWORDS=tpg+and+Washington+Mutual&COLLECTION=wsjie/6month

[6] Other investors in the WaMu $7 billion infusion include PE firm Blum Capital Partners, hedge fund [illegible]anton Capital, and TPG limited partners who were invited to co-invest.

[7] TPG's loss in WaMu echoed the collapse of LBO firm Forstmann Little & Co. Forstmann Little & Co was one of the largest and most prominent global PE firms of the 1980s and 1990s and it is the only sizeable PE firm to have disappeared. Unlike for large hedge funds, it is extremely rare for large PE firms to be driven out of market. Forstmann Little somewhat departed from the standard private equity model in 1999-2000 by making large equity injections into two telephone companies: McLeod USA Inc. ($1 billion) and NEXTLINK Communications Inc. ($1.25 billion). Similar to TPG's investment in WaMu, Forstmann Little lost its entire investment (over $2 billion) less than a year later. After that Forstmann Little never raised a new fund and faced law suits from angry investors.

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And in 2006, they too almost tripled the size of their previous fund, raising $5.3 billion. Unlike TPG, however, they did not raise another large fund right after fund V. With such a wide gap between them, these two firms were seen as shopping on different sides of the LBO market, yet they had Petco in common.

Exhibit 2: LBO funds of Leonard Green & Partners and Texas Pacific Group.

Fund name	Vintage Year	Size ($mm)	Invested ($million)	Called %	Multiple	IRR
Green Equity Investors I	1990	216	216	100	5.34	n/a
Green Equity Investors II	1994	311	300	96.6	2.[illegible]1	13.9%
Green Equity Investors III	1998	1,244	1,129	90.8	2.[illegible]5	n/a
Green Equity Investors IV	2003	1,852	1,759	95	1.23	10.5%
Green Equity Investors V	2006	5,300	1,605	30.3	1.23	18%
TPG Partners I	1994	721	7[illegible]0	102.6	3.53	36.3%
TPG Partners II	1997	2,500	2,535	101.4	1.74	9.9%
TPG Partners III	2000	3,414	2,922	85.6	2.43	24.7%
TPG Partners IV	2003	5,3[illegible]0	4,370	91.9	1.35	11.3%
TPG Partners V	2006	15,000	12,585	83.9	0.71	-16.7%
TPG Partners VI	2008	17,300	2,011	11.3	0.57	n/m

Source: Preqin. (Data as of 9/2009)

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Petco's Performance

Petco was established in 1965 and is the second-largest pet supply specialty retailer in the United States. The company is headquartered in San Diego, CA and boasts about 1,100 stores across the country with locations in all 50 states, making it the only pet store to serve the entire nation. Its stores carry up to 10,000 different pet-related items at any time. Petco had been in PE hands early on. PE firm Thomas H. Lee had brought them to their 1994 IPO and sold their stakes over the following years. After a good start, Petco's success diminished in the late 1990s. During the first half of 1998, Petco suffered more than $8 million in net losses while their stock plunged from $30 to $5 a share during 1997-98 in a booming stock market. The company rebounded in the following years and with the announcement of the takeover by TPG and LG the stock price ended up right above $20.

Comparing the health of Petco to that of main competitor PetSmart, Petco was clearly ahead in 2000. As shown in Exhibit 3, Petco had half the revenues of PetSmart but two thirds of its EBITDA. In 2006, when the second LBO occurred, i.e. when TPG and LG bought it for the second time, Petco had half the revenues and half the EBITDA of PetSmart. Because PetSmart remained listed, we can observe their financials over the last three years (2008-2010). For Petco we know only the revenues. The figures are shown in Exhibit 3.

Fortunately, because Moody's rated Petco's Term Loan, we have further information on Petco's financial performance after it was taken private. In fact, using minimal assumptions, we can replace all of the question marks in Exhibit 3. All you need to know is that Moody's Research Report revealed that Petco's Debt-to-EBITDA ratio was 6.7 in 2008, and [illegible].1 in 2009.[8]

It is also worth pointing out that when the crisis hit Moody's changed its outlook on Petco from stable to negative and downgraded its term loan rating from Ba3 to B1 (May 2008). But in mid 2009, Moody's revised its outlook back to stable while reaffirming Petco's term loan ratings.[9] The stable outlook reflected expectations that Petco's operating metrics were stable, and that the company could generate enough cash to finance its operating and capital needs. Finally, once you have replaced the question marks in Exhibit 3, you can compare the numbers to those projected at the time of the LBO (Exhibit 4). You may also want to look at Petco's equity value to see what TPG and LG could earn if they were to exit the deal now (2010).

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[8] http://www.moodys.com/research/Moodys-changes-PETCOs-outlook-to-stable-from-negative--PR_234083

[9] http://www.moodys.com/research/Moodys-affirms-all-ratings-for-PETCO-outlook-revised-to-stable--PR_181838

Exhibit 3: Financial Comparison of Petco & PetSmart

	2000 pre-1st LBO	2006 pre-2nd LBO	2008	2009
Revenue				
Petco	990	1,996	2,550	2,700
PetSmart	2,110	4,234	5,065	[illegible]
EBITDA				
Petco	88	209	?	?
PetSmart	127	489	595	606
Equity				
Petco	264	1,639	?	?
PetSmart	475	3,483	2,942	2,391
Total Debt				
Petco	248	493	?	?
PetSmart	521	518	1,214	1,289
Total Assets				
Petco	512	2,132	?	?
PetSmart	996	[illegible]	4,156	3,680

Source: Wharton Research Data Services, US Securities and Exchange Commission

Exhibit 4: Petco Projected Financials as of 2005

In USD millions	Estimated			Forecast		
	2006	2007	2008	2009	2010	2011
Net Sales	2,209.3	2,410.5	2,626.4	2,850.3	3,073.7	3,302.3
% Growth	10.7%	9.1%	9.0%	8.5%	7.8%	7.4%
EBITDA	226.9	255.7	297.9	334.5	369.6	406.4
% Margin	10.3%	10.6%	11.3%	11.7%	12.0%	12.3%

Source: U.S. Securities and Exchange Commission.

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Exit Options

Now think about what you would do if you were TPG/LG at that point in time. Below we discuss the potential exit options (partial or full).

IPO (Initial Public Offering)

An IPO occurs when a private company offers its shares to the general public. The company is then publicly traded. It usually takes some time until the IPO can be completed. It also takes a lot of management time and fees are quite high (often 7% in the US; much lower in Europe). In addition, investors would typically leave money on the table when bringing a company public. The typical underpricing is 10% but it can often be much higher. IPOs used to be considered the road to glory in the 1990s, and the 2002 Petco IPO certainly brought high returns for TPG and LG. But increasingly, PE firms try to avoid IPOs.

There are a number of key decisions to take when considering an IPO: First is the location of listing (where to list). A stock can be traded on different stock-exchanges and issues such as visibility and liquidity are central here. Second, and related, is the choice of the level of regulation. For example London main market and NYSE are more regulated than London's Alternative Investment Market (AIM). Several commentators argue that the US stock-markets are losing to their foreign competitors due to their heavier regulatory environment (e.g. Sarbanes-Oxley). Third is timing. IPOs are very cyclical. There are some prolonged periods of time with very few IPOs ("cold markets"). Fourth is the amount to sell. Not all shares can be sold on the issue date, and there is a lock up period (from six months to over a year).[10] Finally, another element to consider is that the key driver of demand in an IPO is usually growth. Investors want a growth story. That story was certainly there in the 2002 IPO of Petco but does it exist at this time? Petco did invest heavily in an innovative product segment in 2009 by launching *Unleashed* (a specialty store for only premium, natural, organic and raw pet foods), but this may not be enough sustain a successful IPO.

Earlier during the year, Petco stated in a government filing that $4.35 million in stock options were exercised by 53 officers/directors of the company, including its senior management team. Some observers believed the filing signaled a first step toward Petco's private equity owners taking the company public again. However, Petco officially denied the rumours, claiming it as "routine action".

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[10] Can be rationalized by concerns over asymmetric information – need reassurance that original investors haven't massaged the figures then exited

Trade Sale

The most common exit strategy for PE firms (see Exhibit 5), a trade sale refers to the sale of company shares to industry investors. The trade buyer is usually motivated by synergies and economies of scale. It is therefore usually operating in the same industry, and willing to pay a premium. However, competition and regulatory concerns are important impediment to such deals and make the PE firm run the risk of being unable to sell the company while having paid all the transaction costs.

PetSmart is the only real direct competitor of Petco. The rest of the industry consists of small and independently owned operations with about 58.7% of industry players being non-employers (stores without paid employees). Even among businesses that have employees, the majority employs fewer than four workers. More than half (65.0%) of the Pet Stores industry's revenue comes from PetSmart and Petco.

In 2006, PetSmart actually wanted to buy Petco and restructure Petco's top management. TPG and LG offered $29 a share while PetSmart offered $33. Nonetheless, Petco's board approved the TPG/LG offer. The fact that the cheaper offer had been selected led to a class action suit that had just been settled in 2010 with Petco paying a $16 million fine. PetSmart seems rich enough to buy Petco since its last financials reveal that it is sitting on $300 million of cash (non-tabulated). Yet perhaps, anti-trust legislation may have prevented such a transaction.

Secondary Buyout

A secondary buyout occurs when one PE firm sells its equity stake to another. It is now the second most common exit channel for PE firms (see Exhibit 5). The usual route would be to organize an auction to execute such a sale. PE firms will not care too much about poor past growth. Maybe a specialized buy-and-build shop might be interested because of the fragmentation and the consolidation that has already started in that industry. But many PE firms have a lot of dried powder (unspent cash they need to spend before the end of their investment period), and so the offer may appeal to a broader set of PE firms.

It is often difficult to see what a private equity firm can do that the previous one did not manage to do. Most importantly, this exit channel is not really an exit for some investors. If a Limited Partner is investing in both the buying fund and the selling fund, then it is not exiting the deal. It stays in its portfolio, but it has to bear the transaction costs. Such transaction costs are easily above 5% of the equity stake (about 2% of transaction value).

But will a trade sale, or secondary PE sale, raise more money than a flotation (i.e. IPO)? It should depend in part on what happens to control. When buying an entire company, the acquirer may be willing to pay a control premium. However, IPOs are sold to a broader public and if it was successful in creating interest and/or competition

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between investors then more money may be raised. Another element that may be considered is sentiment. As mentioned above, IPOs are very cyclical, with period during which certain type of stocks are “hot”, i.e. potentially over-valued.

In practice, it is difficult to know which route realises higher returns and the answers may be time-dependent due to cycles. Typically private equity owners prepare some basic information for a number of investment banks, ask them to pitch for business and advise on valuation and which is the best exit route. Interestingly, sometimes, the PE firm initiates an IPO, gets early signals from the underwriter (the consortium of investment banks) about the capital that can be raised and if a trade buyer and financial buyer steps in and offer more, the IPO is cancelled and the company is sold to those buyers.

Partial Exit

If the business is not ready for complete exit, there are some partial exit options. The usual route is a dividend recapitalization. Usually, dividend recaps are leveraged (called leveraged dividend recapitalization), which means that the company assumes additional debt to partly or fully use to pay for a dividend. A non-leveraged dividend recapitalization is financed by using cash that the company already has on hand. Petco seems lean on cash but could try to take advantage of its recent upgrade by Moody’s to conduct a leveraged dividend recap.[11]

Pre-crisis, there had been a wave of dividend recaps. For example, in 2006, according to Fitch data, there had been 40 dividend payouts totalling about $10 billion and these dividends enabled buyouts companies to recover 72 percent of their investment within 20 months.[12] But post-crisis they became more difficult because of the difficulty to borrow.

Dividend recaps are basically an arbitrage between debt and equity markets by PE firms. Some of the most spectacular (internal rates of) returns in private equity have been achieved through dividend recaps because of the dividends coming early on in the life of the investment and often for an amount similar to what the investors had put in the deal. For example, the largest dividend recap in Europe has been that of Amadeus Global Travel Distributions by BC Partners and Cinven Group in 2007 for $1.6 billion (to pay a record dividend of the same amount), less than two years after buying the company.[13] Another famous one is that of Edgar Bronfman Jr. and PE buyout firms THL Partners, Bain Capital, and Providence Equity Partners. They purchased Warner

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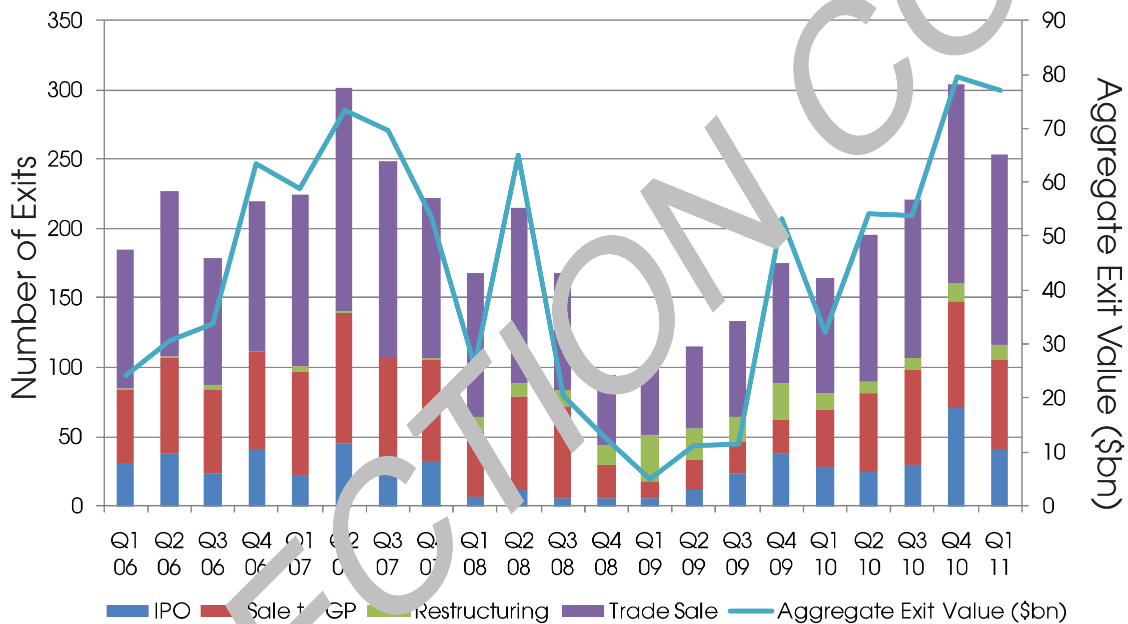
[11] Note that the PE firm also often charges a fee to the portfolio company to organize a partial exit such as a dividend recap or an IPO.
[12] http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a.viLGhVPark
[13] http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a.viLGhVPark

Music Group in 2004 and a year later they received about $1.4 billion of dividend from a dividend recap.[14] In both cases the dividend was higher than the original investment.

Some dividend recaps are quite infamous, however. For example, in 1993, Bain Capital invested $8 million in GS Industries. Less than a year later it collected a dividend of $36 million via a dividend recap. While the dividend recap is not the only culprit it contributed to increase the debt of the company which filed for bankruptcy in 2001; 4500 people lost their job (from the peak year).[15]

Exhibit 5: Exit routes by PE firms



Source: Preqin: Q1 2011 PE Deals and Exits, globally

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[14] http://dealbook.nytimes.com/2011/05/06/how-well-did-warner-musics-investors-do/
[15] http://www.politifact.com/truth-o-meter/statements/2012/may/16/barack-obama/obama-ad-claims-romney-bain-left-misery-wake-gst-s/