Value Creation in European Private Equity Investments: Theoretical Framework and Case Study of PE Primary and Secondary Investment in Poundland - UK-based company.

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Abstract

It has been widely debated whether Leveraged Buy-outs (LBO) can create value. Whilst this thesis tackles this question, it also goes one step further and explains how LBOs generate returns, namely through utilizing such features as a high level of debt, active corporate governance preventing an empire building phenomenon and alignment of managements' and shareholders' interests by forcing the latter to take significant equity stakes at the firm. PE firms put also extensive efforts to implement operational efficiencies at their portfolio companies, including increased asset utilization, improved total productivity and cost reductions. On the other hand, they significantly increase a top line through an expansion, both organic and M&A driven. This paper looks at those drivers both in academic sense and on an example of Poundland: UK-based company that has undergone two LBOs. The case study part shows a shift in value creation, from pure financial engineering tactics to increasing importance of operational improvements.

Table of content

1. **Nature and brief history of PE industry** 5

2. **What is value creation and how it could be achieved?** 7

3. **Short survey on studies investigating whether LBOs create values** 10

4. **Analysis of levers of value creation** 11

4.1. Acquisition selection criteria, deep due diligence 11

4.2. Pricing negotiation and leveraging experience of prior negotiation 12

4.3. Financial engineering, and impact of access to funds 14

4.4. Impact of management and managerial package on the value creation 17

4.5. Operational improvements such as EBITDA margins' improvements 19

Operational improvements, such as total factor productivity 20

Employees' discretion and motivation 21

Effective monitoring and improved corporate governance 22

Capex and R&D 23

Divestments 24

Cutting costs 24

4.6. Sales price negotiations and finding the right buyer 25

5. **Case study structure – Poundland** 27

5.1. Background of the company 27

5.2. Sector 29

5.3. Timeline of the company 29

5.4. Was the value created? IRR calculation 30

5.5. Main drivers of value creation 31

5.6. Financial Analysis of the company 33

5.7. Value creation under WP 34

Entry multiple 34

Leverage 37

Operational improvements 37

Management changes and incentives' packages – analysis of alignment between shareholders and management 44

EBITDA multiple expansion at the exit 46

5.8. IPO – unexpectedly favourable exit 47
IPO tactics 48
Sale story 48
Board preparation 49
Offer price – valuation 50
First day and month trading 52
Over-allotment right 53
5.9. Post-IPO 54
Poundland's plans to acquire 99p stores 54
WP's sale of further 14% of Poundland 57
CMA's decision on anti-trust 57
5.10. Comparison to Advent International LBO of Poundland and value creation 58
IRR calculation 58
Attribution to different drivers 59
Group Structure 61
Financial Analysis 61
Leverage 62
Operational improvements 63
Management changes and packages 64
6. **Conclusions** 65
Limitations and propositions for future research 66

This paper will investigate how private equity firms create value for their investors. In Section 1, I will explain a nature and provide brief history of PE industry. Subsequently, Section 2 will be devoted to a definition and mechanisms of value creation. Section 3 contains a short survey on studies investigating whether PE investments create values. In Section 4, I will investigate methods of value creation utilising a wide framework of levers on a basis of available literature. Finally, Section 5 is devoted to one case study, analysing how two different PE firms unlock a company value. Section 6 concludes this Master Thesis.

1. Nature and brief history of PE industry

Private equity is a medium of long-term equity investment that is not publicly traded on an exchange. The industry is composed of two types of actors: 1) investors, such as banks, family offices, pension funds, university endowments and high net worth individuals, that contribute capital, and 2) private equity firms that find appropriate companies to buy, make investments and manage them. Private equity firms invest the entrusted investors' capital into companies, most of the time using a certain additional debt raised from banks or other debt market participants such as private debt funds. Thanks to financial leverage through significant use of debt, PE firms are able to deliver enhanced returns to equity investors. Managers of PE funds are often referred as the General Partners (GPs), while investors are known as the Limited Partners (LPs): the latter term emphasising the limited liability of LPs who can lose at most the sum of their committed capital contributions and nothing above that limit.

A leveraged buyout (LBO) is an acquisition of a company, either privately held or public, that operated as an independent business or a subsidiary of a larger company, using a significant amount of debt to pay for the purchase price of the company. However, it should be noted that some PE players also invest with minimal debt usage or taking minority positions and still are able to deliver high returns. Often, the assets of the entity being acquired are used as a collateral for the loans. It can be considered ironic that a company's prior success, in the form of accumulation of tangible assets on its balance sheet, can be used against it as a collateral by a PE fund that acquires it. Consequently, some consider LBOs as an especially ruthless, predatory tactic. The purpose of LBOs' structure is to allow companies to make large acquisitions without having to commit a lot of capital so that their equity stake is minimised and returns amplified. The LBO transaction is performed by a private equity firm (also called a financial sponsor) or a group of private equity firms (also called a private equity group, a consortium or a club deal), which will take ownership

(own the equity of) of the business after the acquisition has been completed. In an average LBO transaction, the PE firm purchases majority control of a firm in a mature industry, such as industrials or retail. This is different from venture capital vehicles that typically invest in young and emerging companies and do not obtain majority control as not to demotivate founders.

LBOs have attracted heated disputes and public scrutiny since the technique has been developed in 1970s in the USA (Cendrowski, 2012). At its onset, LBOs were designed as a cure for reducing agency costs through aligning management and shareholders' interests by awarding significant equity stakes to the former. LBOs emerged as important phenomena in 1980s and some predicted that they would become the predominant corporate organisational form (Jensen, 1989). According to Jensen, PE-managed firms were superior to the typical public corporation suffering from dispersed, often conflicting shareholders, low usage of debt and weak corporate governance. Jensen's proposition was that the PE firm itself showcase an array of attractive, organisational features, such as combined concentrated ownership stakes in its portfolio companies, high-powered incentives for the skilled and seasoned professionals working at the PE offices and lean, agile, effective organisation with minimal overhead cost. The PE firm applied similar set-up to each of its portfolio companies, i.e. performance-based compensation for managers, highly leveraged capital structure and active governance when PE professionals often took non-executive directorships at portfolio companies' boards.

LBOs became very popular in the USA and in the UK during the 1980s. Between 1979 and 1989, the market capitalization of public-to-private transactions in the USA itself exceeded $250 billion (Opler and Titman, 1993). Gaining on popularity, the public-to-private trend was not purely limited to the small or medium cap companies, as illustrated by a mammoth $25 billion LBO of RJR Nabisco conducted in by Kohlberg, Kravis and Roberts. However, the recession of the early 1990s caused many highly leveraged PE-companies to default and brought LBO market almost to an end (Guo, Hotchkiss and Song, 2011). Nearly 15 years later, the LBO activity broke new record levels, renewing questions about whether and how those transactions create value for their investors.

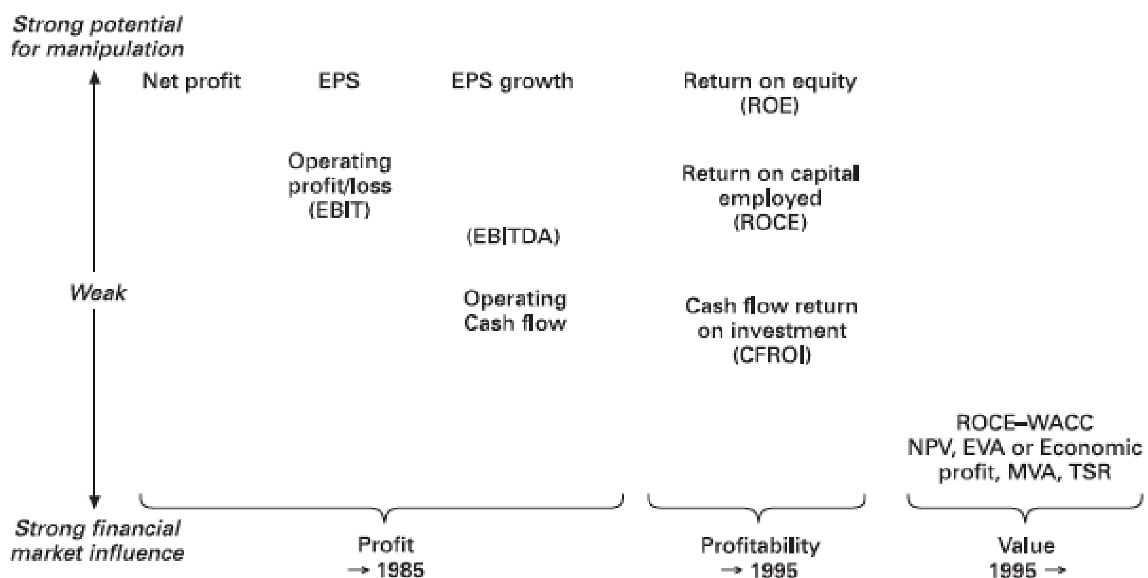
Private equity is most renowned for creating value to its investors through reducing agency costs, improving corporate governance, implementing operational efficiencies and financial engineering. However, the process of value creation is more complicated and PE funds create value for the fund investors through an array of diverse levers.

Commercial entities exist to create value for their shareholders: a pursuit that occupies executives endlessly. PE-owned firms enjoy a natural edge over their public peers when it comes to building efficient, high-growth businesses, including tightly aligned ownership and compensation models, well-planned milestones, and fewer institutional loyalties and competing distractions. They are not publicly scrutinized, they do not have to quarterly report to the Street, being left vulnerable to analysts' questioning and they are not left at the mercy of capital markets where any rumour could ruin their equity value (Couto, Divakaran and Caglar, 2012). Hence, PE-backed firms can take a long-term approach, rather than chase or manage profits on a quarterly basis. Consequently, the approach to value creation of the firms undergoing LBO is much more strategic and long-term, but also more agile and adaptable to changing environment, than in a case of their publicly traded peers that need to explain every aberration from the once set path.

2. What is value creation and how it could be achieved?

A company can create value if the return on capital employed (after tax) that it generates exceeds the weighted cost of its capital (Vernimmen, 2005). Shareholder value cannot be created into falling into such short-termism traps as managing for earning or artificial attempts at maximizing share price. Creating value has become such a topical issue in finance that a host of indicators have been designed to measure and assess it (see Figure 1).

Figure 1: Evolution of financial indicators



Source: Vernimmen, 2005

Hence, to minimise risk of manipulation, I will assess initially the value creation using the second-generation accounting indicators, by comparing returns with the capital used for its generation (Vernimmen, 2005). In that way, there will be value creation to shareholders of the firm when return on equity (ROE) exceeds cost of that equity. However, this indicator could be 'polluted' by leverage, because a company can significantly boost its ROE by efficient use of debt. Hence, I will also compare the return on capital employed (ROCE) with the weighted average cost of capital (WACC). If the latter is lower than former, the firm creates value to all its investors, i.e. both debt and equity holders.

Jaquier (2008) explains further that value is created for shareholders when a management team:

a) increases returns on existing assets through e.g. improving their efficiency or utilisation,
b) makes future investments only once the rates of return of those investments exceed the cost of capital (i.e. IRR > WACC + NPV),
c) divests any assets that do not generate returns in excesses of the cost of capital,
d) returns cash to investors in the forms of dividends if there are no more projects, which could generate returns in excess of WACC.

As a PE firm pays a certain amount at the entry for an entity it takes through LBO, and then sells that entity for a certain amount, the best measure of value from shareholder's point of view could be an increase in equity value, measured as:

Value created = Sale price - Book value of net debt – Value of initial investment

Such a broad measure allows for assessing both the success of the transaction and the relative importance of factors affecting such a success. Nonetheless, it is important to account also for time value of money, hence, the internal rate of return, calculated as:

$$IRR = \left[\frac{Equity\ value_{exit}}{Equity\ value_{entry}}\right]^{\left(1/_{Holding\ Period}\right)} - 1$$

seems to be even a better measure of value creation. Theoretically, IRR compares the value of the PE's firm stake at the entry and at the exit of their initial investment. However, IRR could have been impacted by some intermediary cash flows such as extraordinary dividends or additional follow-up investments by PE. Hence, it became an industry standard to conduct a discounted cash flow analysis, in which all cash inflows and outflows made by the GP are properly discounted. IRR is the most commonly accepted and utilised measure of return on private equity deals (Kaplan and

Schoar, 2005). Increase of enterprise value is not necessarily a good indicator for a value creation in LBO as an exited buyout might provide a significant return on initial investment, if PE only contributes equity, without improvement enterprise value, e.g. through repayment of debt (Nikoskelainen and Wright, 2007). Concluding, in the case study section, I will calculate IRR on time-adjusted basis for each cash flow received or provided by PE firm.

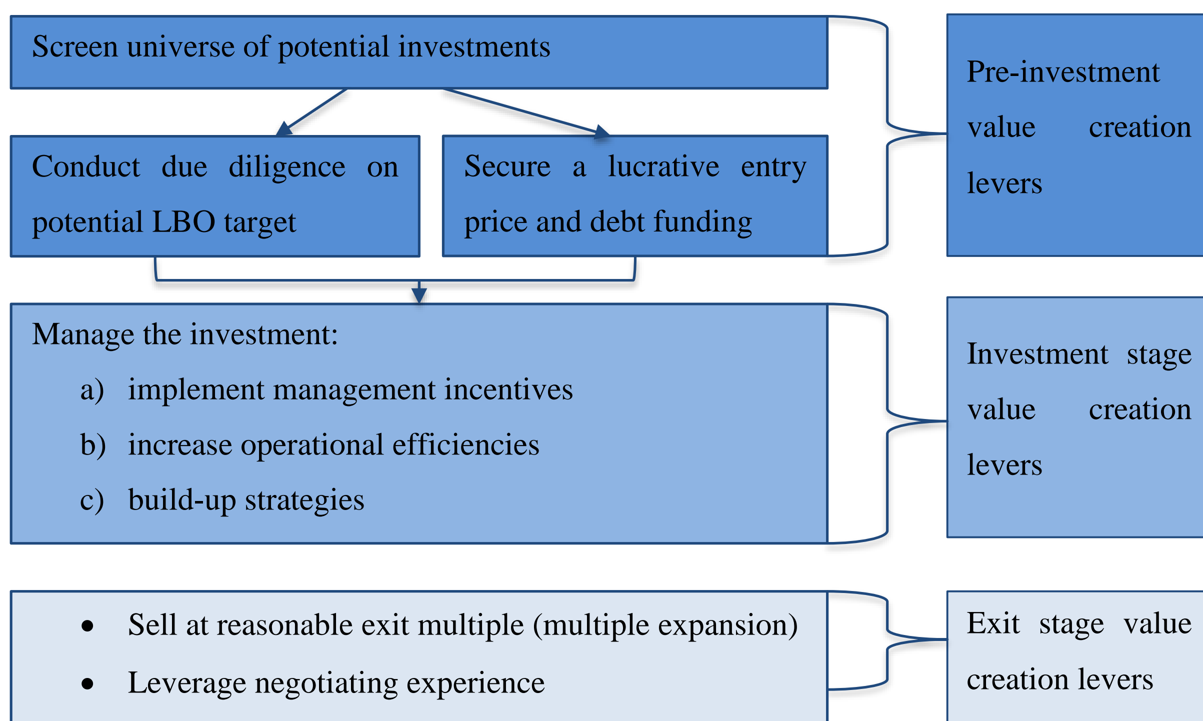
Given that value is created over the holding period, it is interesting to further decompose that creation through the extended Dupont Equation. In majority of cases, PE actions have impact on:

a) sales growth,
b) EBIT improvement through operating efficiencies or cost-cutting,
c) trading multiple expansion and relative company valuation between entry and exit date,
d) deleveraging achieved thanks to company's robust cash generation,
e) tax shield, i.e. tax savings generated through debt as interest expense is tax-deductible and hence reduces taxes paid.

Consequently, ex-, during and post-investment comparison of those elements can help to assess how PE firms have been able to create value over the holding period.

The above-mentioned constituencies could be further mapped into particular skills and actions undertaken by buyout professionals as depicted on Figure 2.

Figure 2: The levers of value creation mapped onto the private equity deal process



In this thesis, I will investigate both pre-investment, investment and exit levers that allow the PE firm to create value through LBO transaction. This comprehensive assessment will allow indicating any notable changes in the style of PE investments over recent years and shifts in importance of particular factors.

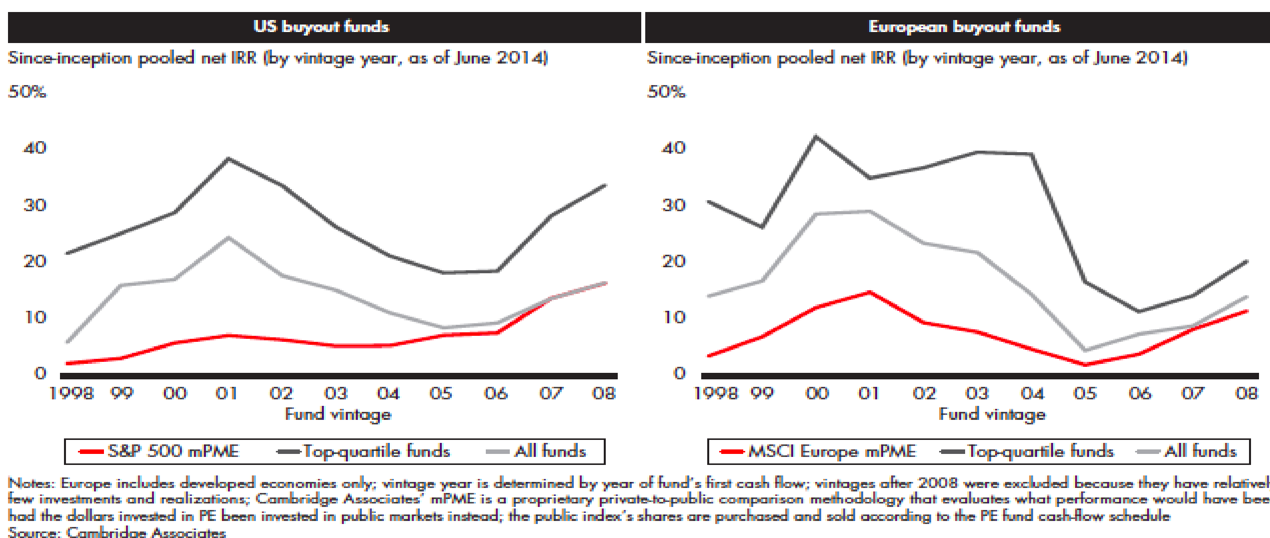
3. Short survey on studies investigating whether LBOs create values

Nikoskelainen and Wright (2007) found that LBOs create a significant value to its investors: the mean index-adjusted enterprise value (EV) IRR was 22.2% whilst the average equity IRR was 70.5% in their empirical study on 321 exited buyouts in the UK in the period from 1995 to 2004. What is more, they established that larger buyouts, i.e. those with an initial transaction value exceeding £100m, exhibited even greater returns, i.e. EV IRR of 26% and equity IRR of 173%, whilst medium sized had equity IRR of 127% and smaller buyouts achieved equity IRR of -32% (Nikoskelainen and Wright, 2007).

On the other hand, Kaplan and Schoar (2005) found out that on average, LBO funds' returns net of fees are slightly less than those of the S&P 500, analysing data set of 746 funds provided by Venture Economics. There was some potential bias in their study as the data set they used was based on voluntary reporting of fund returns both by GPs and LPs. They also noted that in their sample, there was a large difference in the returns of individual funds. For example, funds at the lowest 25th percentile show IRR of 3% whilst top 75th percentile delivered IRR of 22%.

Similarly, 2015 Bain PE report warns that PE's continued ability to outpace market cannot be any longer taken for granted as a performance edge diminished for recent vintage funds (Figure 3).

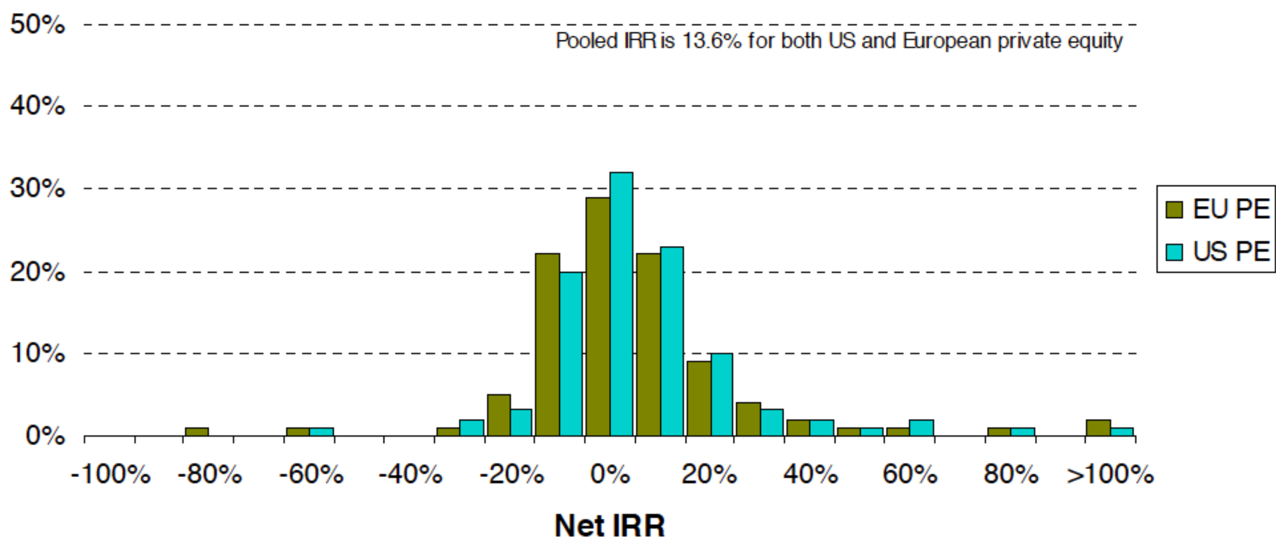
Figure 3: Historical performance of PE funds by vintage years: Europe vs. USA



For example, returns of most USA- and Europe-focused PE funds raised from 2006 to 2008 merely track performance of respectively S&P 500 and MSCI Europe, even though that funds' population had ample time to invest capital and earn returns.

Kaiser and Westarp (2010) drew attention to a wide range of returns delivered by PE firms. The pooled average performance, which means treating the cash flows from all the funds as if they belonged to one big fund, provides the weighting of the returns by size and indicates that the larger funds outperforms smaller ones (see Figure 4). Consequently, it could be possible for some of firms to gain skills and competencies and create sustainable competitive advantage over other players. To follow this hypothesis, for the case study purpose, I will look at the mid-size LBO of well-respected PE fund with a long tradition of investing.

Figure 4: Historical distribution of PE fund returns net of fees since inception to 2006



Source: Thomson Financial Venture Economics as gathered and analysed by Kaiser and Westarp (2010)

4. Analysis of levers of value creation

4.1. Acquisition selection criteria, deep due diligence

Sourcing of PE deals evolved significantly over three decades: whilst in 1980s there was a significant number of underproductive and debt-light firms waiting for operational improvements, that was not longer a case by early 1990s (Lerner, 2009). Similarly, European economy makes life more difficult for buyout professionals as companies with solid, "collaterable" assets, such as

manufacturers, shifts towards services and asset-light operations. In general, significantly less than 1% of investment proposals received by PE managers are selected for investment (Prowse, 1998). Often, PE firms have extensive networks of contacts that can allow them to start negotiations with a potential target well before the rest of the market is aware of the opportunity (Bender and Ward, 2002). Due to pure volume of potential investments, the value creation ability of the fund depends heavily on team's capability to source the deals and shift through proposals efficiently. What is more, a particular specialisation on the industry or geography might give a PE firm an edge in knowing where and how to look for potential investment opportunities.

Whilst 90% of the proposals are rejected due to not meeting investment criteria, those that survive preliminary reviews become the subject of detailed due diligence process (DD) that can last weeks (Prowse, 1998). DD can include visits of the firm, meetings and telephone discussions with key managers, employees, customers, suppliers and creditors, consultations with lawyers, accountants, bankers, management consultants and industry experts. Such extensive DD is pivotal because not much information is publicly available and hence PE often has to create information "*de novo*" (Prowse, 1998). What is more, enhanced due diligence can include such areas as "internal control procedures, centres of expertise within the organisation and the capacity of the organization to grow and achieve projected targets" (Cendrowski, 2012). Similarly, DD can facilitate identifying red flags and issues that could undermine creation of meaningful long-term relationships between management of potential target company and PE principals. Consequently, results of extended DD can prompt PE professionals to withdraw from the bidding process.

Another explanation of sources of gains in LBO is that often those transactions are initiated by the management of those companies who have observed that their firms have been undervalued by their current shareholders. Consequently, managers organise a management buyout to obtain the firm at a discount to its real value as they can see inefficiencies that could be fixed and value to be created (Kaiser and Westarp, 2010).

4.2. Pricing negotiation and leveraging experience of prior negotiation

Many executives might be involved in buying or selling a company once in their career whilst PE professionals do it all the time, and hence they become more experienced in negotiation techniques and the overall structure and timing of the process (Bender and Ward, 2002). As their agendas are purely focused on profit maximisation, rather than vague ideas of corporate expansion or empire-

building strategies, PE firms might find easier to walk away from the deal that does not make any commercial sense and refocus their efforts on a new potential target. Moreover, the subsequent acquisitions do not have to fit into an existing portfolio of PE companies, which undoubtedly extend the universe of potential PE targets in comparison to the one that strategic buyers have to operate in.

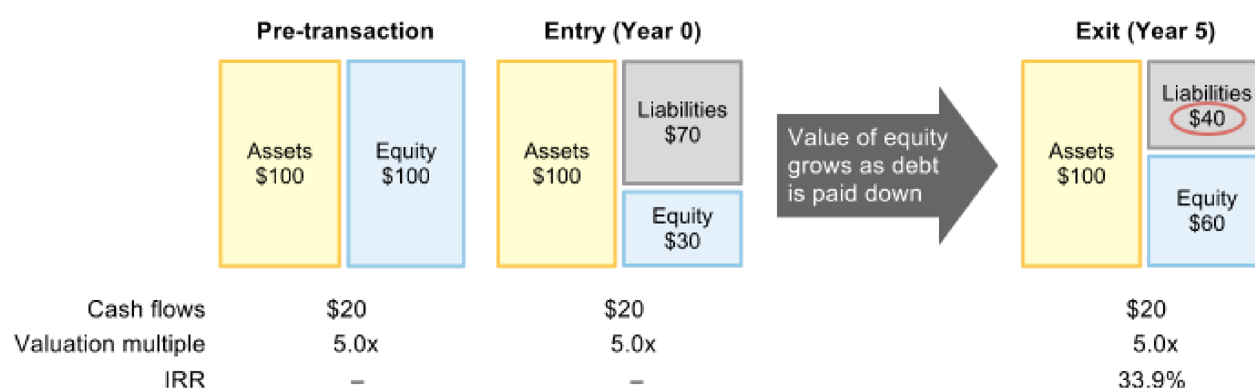
During the buyout boom of 2005 to 2007, financial sponsors, replete with cash from record fundraising, acquired numerous targets, beating strategic buyers (Cendrowski, 2012). However, after the credit crisis, the corporations became more proactive in closing the deals. Record high cash-balances and scrutiny from investors force corporations to react. In that sense, buoyant strategic M&A activity can lead to significant inflation of purchase prices, which could be detrimental for the IRR of the financial sponsors, forcing them to either increase the leverage or provide higher equity contribution. One can argue that corporations can benefit from lower borrowing costs because of their existing business and track record and also combination of the acquirer's and target's EBITDA that yield stronger lending base (Dai, 2011). On the other hand, financial buyers can only borrow against the existing business of the potential target, without any advantages of the combination. Consequently, many aggressive strategic acquirers have bought out companies at far greater pace than PE firms. For example, Pfizer Inc. has made $75 billion of acquisitions between 2008-2011, more than three times the accumulative amount of the deals performed by the top PE firm – Blackstone Group (Cendrowski, 2012).

The debt misevaluation can explain increased activity and the relative dominance of financial buyers in periods of "too low" interest rates. Whilst one can argue that each type of buyer and the target can similarly easy access the debt market, there are fundamental differences how each of them uses that access to their benefits (Martos-Vila, Rhodes-Kropf and Harford 2014). The main two differences are that a) strategic buyers have some projects they are considering combining with the target whilst PE evaluates the target on a stand-alone basis, b) financial buyers have a different corporate governance structure (monitoring technology) than strategic buyers. Financial buyers can benefit from "too low" interest rates to greater extent than strategics because the former are diversifying and hence minimizing the errors investors make. PE buyers also benefit from monitoring effect, i.e. when overvaluation reduces the perception of the moral hazard, it reduces the perceived cost of monitoring, which in turn enhances the ability of financial buyers to increase and pay more (Martos-Vila, Rhodes-Kropf and Harford 2014). In those situations, the financial buyers' supremacy in governance techniques will enable them to dominate strategics in overvalued debt markets.

4.3. Financial engineering, and impact of access to funds

Historically, leverage was the predominant way in which PE firms created value in an LBO through the use of borrowing to finance the acquisition. For instance, in 1987, banks lent to PE firms so eagerly that the latter had only contribute 7% of equity to a deal (Lerner, 2009). The amount of debt and the specific terms of the debt tranches can significantly enhance return to equity investors. Private equity used to be all about financial engineering, i.e. structuring a financial package for the enterprise value of the business as the purchaser, a PE firm, must finance both the purchase of equity capital (including any goodwill and premium paid), refinance any existing borrowings and cover the transaction costs. A key driver behind the outsized returns generated in a successful LBO is decreasing the WACC by utilising more debt, which is cheaper than the cost of the investors' equity. As the company generates cash, the debt is paid down, and in that way, the value of the equity increase and enhanced returns are generated as demonstrated on the Figure 5.

Figure 5: Illustration of value creation through cash generation causing gradual de-leveraging



Source: Macabus

The quantum of debt can range from 60 to 90% of the value of the deal (Kaplan and Strömberg, 2008). In a large buy-out, there are multiple layers of debt, mezzanine and equity that carry different risks and rewards (Gilligan and Wright, 2008). Financial institutions, such as commercial banks and insurance companies, provide PE firms with the senior debt, which comes first in a re-payment hierarchy. Second, comes subordinated debt, which could consists of high-yield (junk) bonds, issues in the name of the target company, or privately placed debt, which is usually unsecured debt with an equity conversion feature (Lerner, 2009). Hence, using financial engineering is a core skill of a successful PE professional, as she needs to assess the investment risk and design a structure, which delivers appropriate rewards (Gilligan and Wright, 2008). Nuisances

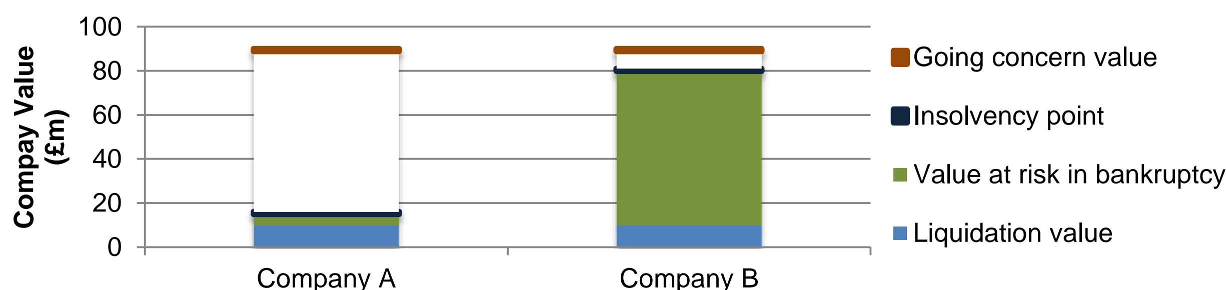
and detailed structure of mechanics is handed over to lawyers and accountants to be clarified and bulletproofed in case of any future problems.

Firstly, leverage can increase firm value through the tax deductibility of interest in the United States and many other countries such as Poland, France and UK (Kaplan and Strömberg, 2008). Such a tax shield can boost returns by increasing the cash flows available to the providers of capital through reduced tax expense (Guo, Hotchkiss and Song, 2011).

Secondly, debt creation, without retaining of the proceeds of the issue, effectively binds manager in their promise to pay out future cash flows as it creates an obligation to service periodic interests or cover debt amortisation schedule (Jensen, 1986). Consequently, debt could be an efficient substitute for dividends as by issuing debt, managers are contractually bound to pay out future cash flows in a way that cannot be accomplished by a simple dividend increase (Jensen, 1986), which is only voluntary in its nature. It is much easier for managers to cut down dividends or downsize share repurchases rather than allow companies to default on their debt obligations. Burden of debt discourages managers from spending on uneconomic, or low returns, projects as a failure to make debt service payments can put a company on an edge of bankruptcy (Jensen, 1986). Significant cash balances often lead to waste and inefficiency as managers can pursue empire-building strategies (Jensen, 1989). The control function of debt is more important in organisations that can generate large cash flows but have low growth prospects, and even more important in organisations that must shrink as they operate in mature sectors.

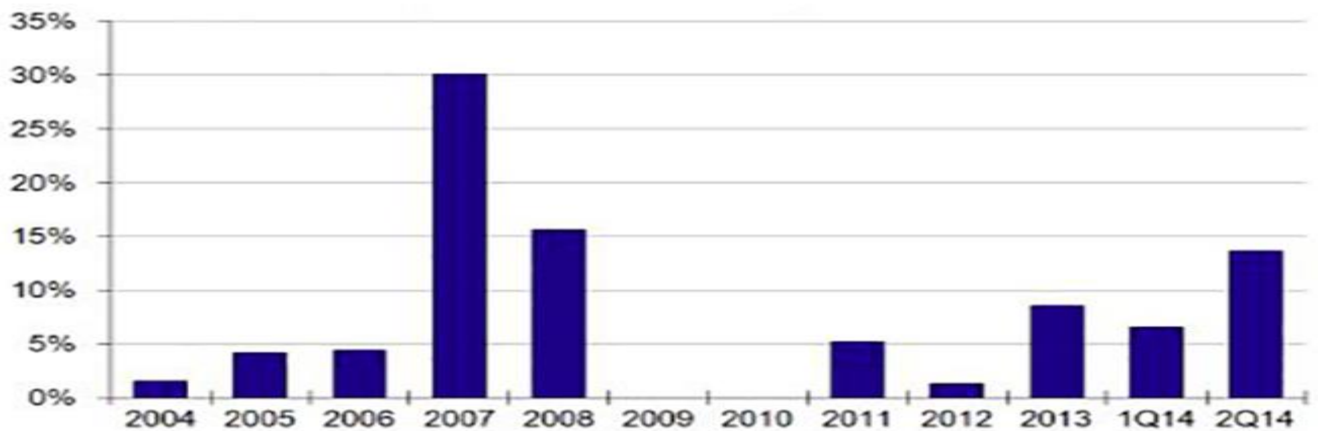
Finally, insolvency in a world of high leverage is less costly due to "privatisation effect" (Jensen, 1989). The creditors of highly leveraged company (Company B, Figure 6) have greater incentives to preserve the remaining value in case of business underperformance by quickly and effectively reorganising their claims outside the courtroom. On the other hand, creditors of a company with a small debt burden (Company A, Figure 6) will not intervene unless its value falls dramatically, and even than, they would prefer liquidation as their claims could be fully covered (Jensen, 1989).

Figure 6: Risk of bankruptcy at LBO becomes public issue quicker (Source: Jensen, 1989)



However, in an aftermath of financial crisis, the importance of the financial leverage has significantly decreased. Amassing large quantities of cheap debt, previously PE's favourite weapon, has become difficult to follow as credit markets remain tight (Figure 7). Whilst in 2007, PEs were able to secure debt quantum at 7 times EBITDA levels, lenders became more cautious since 2009.

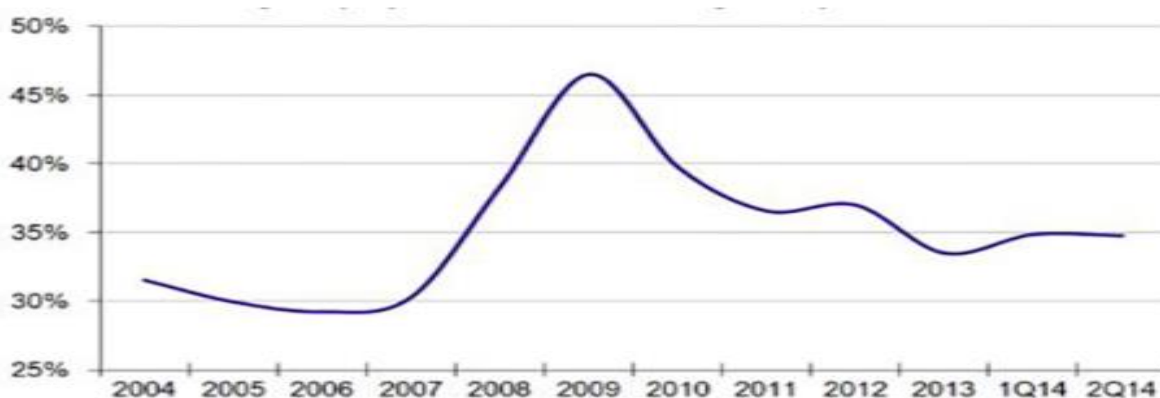
Figure 7: Share of large LBOs with leverage of more than 7x



Source: S&P, Capital IQ, LCD

From 2008 to 2012, even huge PE firms were struggling to secure large quantities of debt for their deals as equity contributions remained at all-time highs and significantly above levels seen the decades ago (Figure 8) (Cendrowski, 2012). However, in Q2 of 2014, high leverage seems to reappear again. Many market commentators note that since Q1 of 2014, structure and terms of PE financing become looser than they were earlier in the cycle, when liquidity was scarce and the economy was fragile (Miller, 2014).

Figure 8: Average equity contribution to large-corporate LBOs



Source: S&P, Capital IQ, LCD

For example, the leverage accounted for just one-third (to be precise: 33%) of value creation in inaugural research study analysing 241 PE exits and dropped to 31% in the second study assessing

701 exits completed between 1990-2013 (Perembetov and Braun, 2014). The later study revealed increasing importance of EBITDA growth and operational improvements contributing 41% to value creation, up by 10 percentage points when compared to prior results from 2009 (Perembetov and Braun, 2014). Interestingly, the leverage contributed only 29% to value creation for deals made during the last "buyout boom" (2005-2008), significantly lower than the overall sample and lower than during the years leading to the boom or "pre-boom" years (2001-2004).

Similarly, another study found that for firms sold in secondary LBO, the increased tax benefits due to financial leverage account for 29% of the return to pre-buyout capital, whilst operational improvements delivered 23% of the pre-buyout return (Guo, Hotchkiss and Song 2011).

4.4. Impact of management and managerial package on the value creation

Almost all studies find that realignment of incentives leads to value creation during LBO (Kaiser and Westarp, 2010). Management incentives at PE-backed firms are focused on a strong relationship between pay and performance, linking bonuses much tighter to cash flow and debt retirement than to accounting earnings (Jensen, 1989). One reason for increasing CEO compensation is that it could improve probability of LBO's success. Usually, firms attracting PE investments are mature, stable companies with relatively high cash flow levels. However, significant debt obligations brought about by LBOs can increase risk of bankruptcy. Peck (2004), analysing a sample of 763 LBOs completed from 1984 to 1989, finds that the occurrence of financial distress is statistically negatively correlated with the percentage of common stock options held by the CEO.

Furthermore, discussions on the management package could be an important discovery tool as a management team of LBO target typically knows more than PE firms about many aspects of target's business (Prowse, 1998). Such information asymmetry has the potential to create severe adverse selection problems for PE. However, those are mitigated by extensive due diligence and alignment of interests of managers and investors. PE managers insists that the portfolio firm's senior managers own a significant share of their company's stock and stock often amounts to a large part of manager's total compensation (Prowse, 1998; Jensen, 1989). This feature transforms CEOs as agents into CEOs as owners (Leslie and Oyer, 2009).

However, Leslie and Oyer (2009) suggest that increasing CEO equity is only one of various pieces in more complex jigsaw of enhancing managerial incentives. Through interviews, they have found out that all members of the senior management team (COO, CFO, CTO and so forth) buy-in very significant equity stakes. Typically, the top 20 to 80 managers in a LBO company participate in equity purchase, however, that could differ across industries, e.g. service firms tend to involve more managers than manufacturing plants. Surprisingly, one of PE executives shared the information of inclusion of 500 managers in the equity program. Importantly, managers purchase the equity with their own funds and hence this tool is perceived as investment rather than pure compensation. In all but the smallest buyouts, managers will be required to invest something often called 'hurt money': on par with values of their homes (Leslie and Oyer, 2009) or in the region of the greater of one year's gross salary or third of their net wealth (Gilligan and Wright, 2008). Search structures will incentivise managers to deliver the business plan and in that way, generate returns of all parties to the transaction.

Moreover, requiring managers to invest themselves help to reveal any potential downside information (Lazear, 2005). If any manager hesitates to invest, his rationales should be questioned. If the limitations are purely financial, PE firms could help. However, sometimes managers could be in possession of private information about the business future profitability and hence, they will not want to be exposed to the downside risk (Leslie and Oyer, 2009). Consequently, the extensive equity program can help to unearth otherwise unavailable information about downside risks.

The fact that firms reward middle managers through promotion rather than annual bonuses leads to a strong organisational bias towards a creation of the new positions, which promotion-based reward system needs (Baker and Wruck, 1989). Consequently, managers have incentives to grow their organisations beyond their optimal size (Jensen, 1986), just to created needed vacancies. Pursuit of ideal of corporate growth and public prestige often forces executives to open new offices or expand globally regardless of the economic benefits of such decisions. Jensen, 1989 puts it: "rare is the CEO who wants to be remembered as presiding over an enterprise that makes fewer products in fewer plants than when he or she took office". On the other hand, PE firms awards stock compensation also to their middle managers. According to Kaplan (1989), business unit chiefs held a median equity position of 6.4% in their unit whilst looming and public companies CEO help only 0.25% of his company company's equity. When counting all sources of compensation, the salary of LBO business unit manager was almost 20 times more sensitive to performance than that of typical public company manager (Kaplan, 1989).

One can argue that nowadays managers of publicly trade corporations are also incentivized through increasing equity stakes through stock options and hence PE might be loosing its competitive edge (Cendrowski, 2012). 51% of the average S&P 500 CEO's pay package in 2000 was attributable to stock options, which represents a significant increase from just 27% in 1992 (Murphy, 2002). Similarly, 80% of executives were granted some form of stock options, which exhibits a significant improvement from just 20% in 1960 (Frydman and Saks, 2010). However, stock options are different from the equity incentives offered by PE firms in multiple ways. Firstly, by their nature, stock options could be exercised at any point after they are vested, whilst the managerial equity stake in LBO can only be liquidated after the PE successfully exited the investment (Cendrowski, 2012). Consequently, stock options allow managers to optimize their gains through period much shorter than in a usual PE deal. Secondly, the managerial equity stakes in the PE deal are generally much larger, even by 10 to 20 times, than the pay packages offered by comparable public companies (Jensen, 2007). Hence, with such large equity stakes, the managers of portfolio companies are heavily exposed to potential upside and can more easily influence their remuneration by enhancing value of the company. In words of Alfred Dunlap, CEO of Lily Tulip Corporation that underwent LBO in 1980s, when the management has a strong equity position: "there is no difference between what is good for management and what is good for shareholders" (Gilpin and Purdum, 1985). Consequently, the executives are not afraid to make challenging decisions without regard to the firm's history, such as ceasing production of a product sold for decades or closing a business unit bleeding of cash (Cendrowski, 2012).

Where agreement cannot be reached between the PE firm and management of a target company on an equity split, the potential solution is a performance ratchet, i.e. a mechanism that makes the level of management's equity share dependable on the achievement of certain objectives, such as the IRR achieved by the PE fund on the exit (Gilligan and Wright, 2008). One can distinguish two kinds of ratchet; namely: a) positive ratchets that enlarge the management's equity stake if certain goals are accomplished; and b) negative once that reduce that stake in case of not attaining the objectives. However, PE should pay attention when structuring those incentives because taxation of ratchets could be complicated (Gilligan and Wright, 2008).

4.5. Operational improvements such as EBITDA margins' improvements

In recent years, operational improvements became more important in generation of value for investors. Over the years, many of the top global PE firms have created and persistently enhanced their in-house operations' expertise to gain an edge in specific geographies and industries (Mezias

and Amijee, 2014). Some of the most recognised PE firms started their existence with the explicit emphasis on operations, for example, at Carlyle, two of three co-founders, William Conway and Daniel D'Aniello had substantive operational experiences. Following the trend, other players established dedicated units to service they portfolio companies. The prime example is KKR Capstone employing 50 full-time operating professionals dedicated to supporting KKR deal teams and portfolio companies. Interestingly, KKR Capstone teams are working on KKR's portfolio company investments through the entire life cycle of the asset, from helping investment teams during due diligence to identifying operational value creation opportunities and then supporting boards and management teams to develop 100 day value creation plans (KKR website). Their expertise includes transformational change and developing cross-products programmes.

Perembetov and Braun (2014) demonstrates that operational improvements remain the key driver of value creation, e.g. unlevered returns comprising operational improvements and the exit multiple effects accounted for 69% of value creation, up to two percentage points since the first study done by the same organisation in 2009 (Perembetov and Braun, 2014). Moreover, the operational alpha was a main driver of returns in 2005-2008 deals (Perembetov and Braun, 2014). While EBITDA contribution to value creation was 31% for pre-boom deals, it increased to 40% for boom-year deals. This shows that the levers of value generation significantly shift from pure financial engineering to making business more efficient and improving its profitability.

Operational improvements, such as total factor productivity

LBOs are a useful mechanism for enhancing economic efficiency due to improved monitoring environment. Namely, following LBO, senior management exercise more diligence towards operational efficiencies as they have their own wealth at stake. Moreover, there is more scrutiny of management from other stakeholders, e.g. PE investors require detailed information, monthly reports and board representations from their portfolio companies whilst debt providers closely monitor observance of covenants (Harris, Siegel and Wright, 2005). Consequently, managers are forced to seek out more efficient uses of the factors of productions. To test that hypothesis, Lichtenberg and Siegel (1990) conducted assessment of 19,000 must large manufacturing plants for the years 1972-1988. They found that MBO plants had higher the total factor productivity (TFP) then representative establishment in the same industry before they changed owners. However, they also noted significant improvements in TFP after the MBO, which were not attributable to reductions in R&D, capital investment, wage reductions or layoffs of blue-collar personnel. Similarly, Harris, Siegel and Wright (2005) have found that MBO plants experienced a substantial

increase in productivity after a buyout utilising sophisticated econometric techniques on a sample of 35,752 UK-based establishments, utilising data from the Annual Business Inquiry Respondents Database. Namely, MBO plants become 70.5% more productive after an MBO in the short run and 90.3% in the long run. Lichtenberg and Siegel (1990), Harris, Siegel and Wright (2005) found that MBO plants were less productive than comparable plants before the transfer of ownership whilst productivity improvements were pervasive across industries. They suggest that the improvement in economic performance maybe caused by new owners or managers efforts to reduce the labour intensity of production through the outsourcing of intermediate goods and materials. MBO plants generate significantly less output in their post-buyout period and downsize their workforce even more rapidly and efficiently than their comparable peers.

Employees' discretion and motivation

Delayering of workforce and increased employee discretion significantly contribute to EBITDA improvements in LBOs. Lichtenberg and Siegel (1990) findings suggest that during LBO, management substitutes compensation for some share options or bonuses even in respect to production workers. Their findings show that the ratio of workers' production increases. In more recent study on sample of 1,959 UK firms and 27,263 employees, Amess, Brown and Thompson (2007) suggest that for MBO firms, employees' discretion is greater and the probability of higher discretion occurs more frequently where there is a higher proportion of craft and skilled service employees. Employees of MBO entities have a higher level of discretion over their practices, especially in case of craft and skilled service labour. In that sense, MBO reduce hierarchy and the amount of supervisory staff, which increase employees' span of control and their discretion. Decentralisation of control via delayering has the potential to improve productivity by reducing control loss and transaction costs. Aghion and Tirole (1997) provide two advantages of delegating the power to actions. Firstly, delegation equips an agent with initiatives or incentives to acquire information, which decreases the principal information overload. Secondly, it enables the agent's participation in a contractual relationship when simple overruling by the principal would 'hurt' that agent. Caroli and van Reenan (2001) found significant substantial productivity returns in cases of reorganisation, including delayering, in French and UK manufacturing firms.

Effective monitoring and improved corporate governance

The governance structure and the actions driven by it lie at the heart of vale creation in PE (Lerner, 2009). Financial leverage allows private equity investors to control the majority of stock, which they would be unable otherwise to achieve. Such concentrated ownership facilitates their ability to monitor and control strategy of their portfolio company through an active presence on the board of directors (Nikoskelainen and Wright, 2007). According to Peck's study on 763 LBOs (2004), the percentage of non-executive members of the board might have impact on performance and value creation during the LBO. As the percentage of outsiders on the board increases, and the board becomes smaller yet more effective, the board is more likely to monitor and discipline managers through removing them from their offices or lowering their compensations. She also concludes that having smaller, more independent boards can be as good disciplining tool as tight debt terms (Peck, 2004). Consequently, transparent corporate governance and disciplined, qualified board powerful enough to adjust managerial compensation can make LBO more successful.

PE firms are very dexterous at devising strategic plans and executing them vigorously. PE professionals often introduce regular monthly, and in some cases even weekly, reporting mechanism into their portfolio companies in order to timely identify any performance defects (Cendrowski, 2012). In the words of Gerald C. Meyers, Chairman of American Motors Corporation “”Change can be guided, and the pace of it can be quickened or slowed; to influence change, you must anticipate events and move to dominate them” (Meyers, 1986). Thanks to the prompt identification, and in many cases even pre-emption of issues, the problems are brought up to the forefront, a timetable for remediation is established, and solutions delivered quickly.

Similarly, PE professionals force management of its portfolio companies to adhere to cash discipline, which is crucial for the success of the deals. Dick Boyce, a partner at Texas Pacific Group (TPG), warns that many companies not used to high leverage pay little attention to proper cash management and hence, TPG requires them to file weekly flash reports on results and manage their cash cycles (Bradford, 2006). Boyce noted that TPG also does forward-looking reporting, e.g. getting feedback on a catalogue from the consumer panels before inventory was ordered allowed managers to predict top sellers 90% of the time and saved the company from stock-outs on very popular items (Bradford, 2006). It made a real difference to shift from the rear-view mirror focus to thinking about best predictors of the future.

The other great example of collection and processing of information is the Blackstone's automated web-based reporting system that is used by all its portfolio companies to feed information back to PE firm (Bradford, 2006). Those pieces of reporting are then analysed centrally facilitating detection of trends and leading indicators also for other companies in its portfolio. In that sense, changes are controlled and managed and do not escalate unnoticed.

Capex and R&D

The critique about the effects of buyouts on R&D and capital investments is badly placed (Jensen, 1989). To begin with, the usual candidates for LBOs: the low-growth, stable cash-flows companies do not invest heavily in R&D. Lichtenberg and Siegel (1990), in their study on data from the Bureau of the Census's surveys about research activities prior to and after the transaction on a sample of 43 LBOs, show that R&D as a fraction of sales increases at the same rate in LBOs as in they comparable public peers.

Historically, tangible assets such as buildings or inventory represented the core of value of a company. However, over the past decade, intellectual property (IP) became an important part of strategy corporate planning and its successful evaluation can significantly impact the ultimate enterprise value (Cendrowski, 2012). As PE firms need to become more dexterous in optimal utilisation of the company's current assets and maximisation of the development of new assets, once neglected, IP has become a focal point for those objectives. While patterns may not be the only way for improvement of a bottom-line, its proper development and management may significantly enhance value of the company through licensing agreements or laying traps around a competitor's technology.

For example, Lerner, Sorensen and Stromberg (2008) found no evidence that LBOs decrease innovation and development activities, investigating 495 firms that received PE investments between 1983 and 2005. Moreover, private equity-backed organisations do not experience a decline in patent originality and generality, which is a good proxy for the fundamental nature of the research as well as those patents filled during LBO years are more frequently cited. However, Lerner, Sorensen and Stromberg (2008) notes that patent portfolios of firms become more focused during PE investment period on the historical core strengths of the firm and the most important and prominent areas of companies' innovative portfolios. This is motivated by the fact that a large patent portfolio that fails to cover any commercially significant products has only limited value, which is in a sharp contrast with a single, yet industry-recognised patent that covers a wide class of

commercially viable products that can a bedrock for a monopoly for an entire business for up to 20 years (Cendrowski, 2012).

Cendrowski (2012) suggests the introduction of work logs and records of inventions coupled with motivational tools such as patent recognitions and monetary rewards can enhance innovation and further promote development of IP assets in undergoing LBO firms. Similarly, a layman explanation of the pattern process will justify an extra level of paperwork required from employees to capture nature of IP asset. Alternatively, the responsibility for development and commercialisation of the patent assets may be ceded on a designated business unit so that the people with the most direct knowledge about the patented technology can exploit the asset.

Divestments

Divestments can have significant effect on the value of a divesting LBO company (Easterwood, 1989). To generate cash flows and quicker repay debt liabilities, PE could divest unprofitable business lines, sell non-core assets or close cash-hungry operations (Cendrowski, 2012). Management in a PE deal will be better able to execute radical moves over cash "bleeders" in PE-backed company than at the public company because such management is mostly driven by value creation rather than sentiments and has very strong objectives in mind (Cendrowski, 2012). Also, the public scrutiny and media attention might be far less daunting in case of private company rather than the listed one. However, both Smith (1990) and Liebeskind et al. (1992) show that operational improvements of private equity-owned companies are more motivated by improved management rather than the realignment and streamlining of core businesses through divestments of ancillary, non-essential assets or divisions (Cendrowski, 2012).

Cutting costs

During the buyout boom in 1980s, many commentators condemned PE shops for mercilessly slashing costs at portfolio firms in a quest to increase exit multiples and improve EBITDA's values (Cendrowski, 2012). The good example of a cost cutting strategy could be Albert J Dunlap, who as CEO of Lily Tulip Corporation under KKR-led LBO, "fired most of the senior managers, sold the corporate jet, closed the headquarters and two factories, dumped half the headquarters staff, and laid off a bunch of other workers. The stock price rose from $1.77 to $18.55 in his two-and-a-half-year

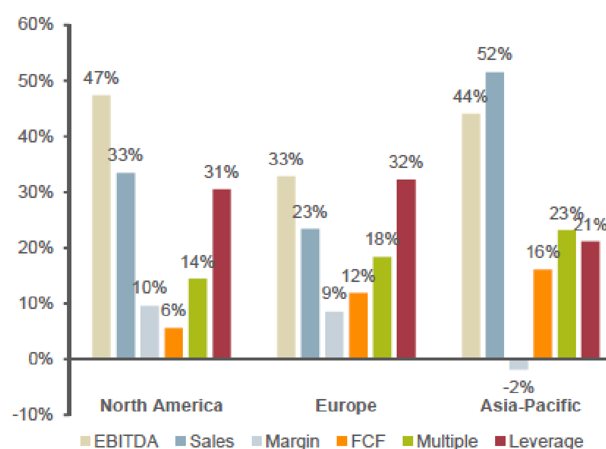
tenure" (Plotz, 1997). Thanks to draconian cost cutting, Dunlap was able to consolidate operations and return the company to profitability.

4.6. Sales price negotiations and finding the right buyer

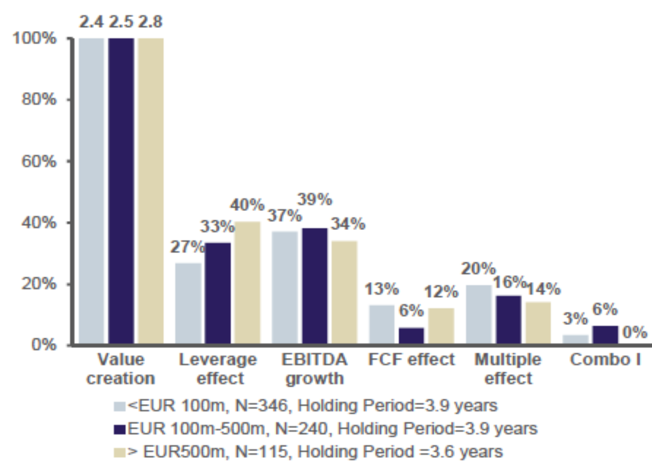
Often, the financial sponsors are able to sell their investments at much higher trading multiple than they bought it. Value creation from an improvement between acquisition and exit multiples, also known as the multiple effect, contributed 18%, down 1 percentage point from the 2009 study (Perembetov and Braun, 2014). However, it should be noted that the multiple effect is both driven by pure market movements as well as internal factors such as asset quality improvement due to GP's ownership. 60% of multiple expansion was due to GP-driven multiple expansion whilst 40% was motivated by changes in the valuations of comparable public market benchmark companies (Perembetov and Braun, 2014). The median entry multiple for private equity deals was 10% lower then that of public peers, whilst the exit multiple was just 1% lower than the benchmark multiple at exit (Perembetov and Braun, 2014). GPs can increase exit multiples through such techniques as gaining market share, institutionalisation, brand creation and diversification of customer base.

Figure 9: Contribution of various drivers to value creation: comparison by region and LBOs size

Value creation drivers by region



Comparison of value creation drivers by size



Source: E&Y report

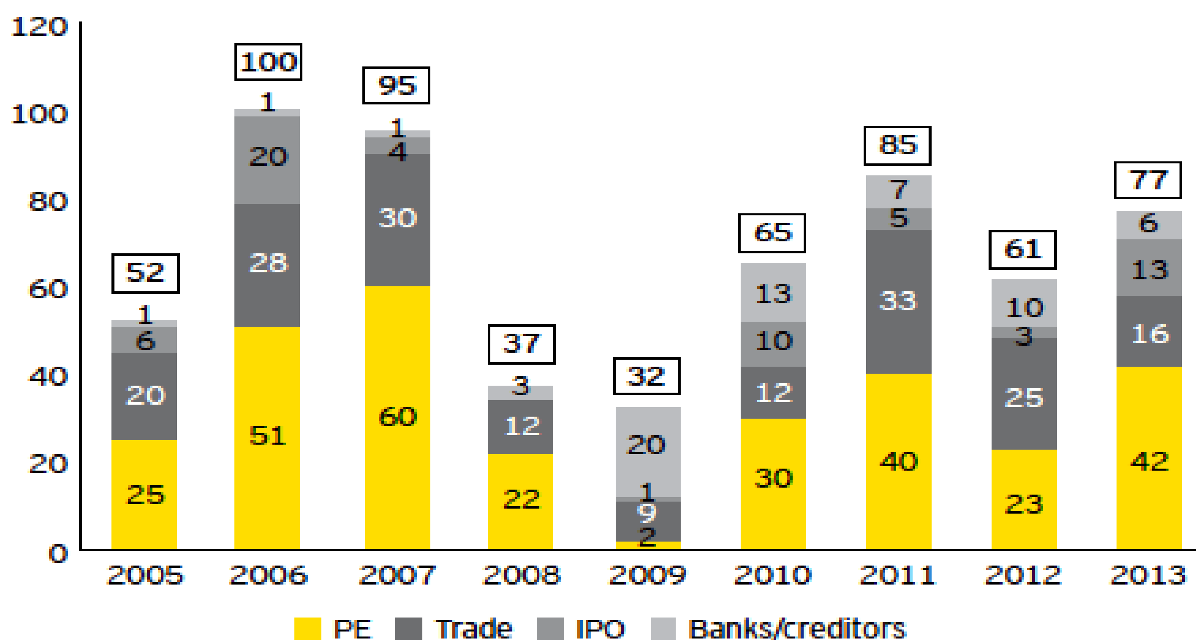
Similarly, Acharya et al. (2013) analyses the multiple expansion between entry and exit dates in their study on 395 deals from 48 funds covering 1991-2008 period. In that study, the median entry EV/EBITDA multiple is 6.5 whereas the corresponding exit multiple is 7.9, which indicates that on

average and assuming stable or increasing EBITDA, PE secured improved market valuations at the exit (Acharya et al., 2013). Similar results were achieved by Kaplan in 1989.

Large buyouts usually have more exit options as they can consider an IPO or a sale to either industrial buyer or secondary LBO. The diversity of exit options, and often competition involved in bidding can increase their chances of securing acceptable returns to investors at exit (Nikoskelainen and Wright, 2007). What is more, the holding period is negatively related to size, which might indicate an opportunistic nature and timing capabilities of PE exiting larger buyouts (Nikoskelainen and Wright, 2007).

A sale to a corporate acquirer, also known as a trade sale, or secondary LBO, i.e. a sale to another PE firm, have been the most common form of exits in Europe (see Figure 10). The UK has an edge over the other European countries in terms of exit valuations thanks to its well-developed capital markets (Lerner, 2009). Even if a financial sponsor sells a company to an acquirer, the option of public listing helps to secure an attractive sales price as it constitutes a valid, executable alternative (Lerner, 2009).

Figure 10: Number of PE exits by exit route in years 2005-2013



Source: E&Y report

Successful exits are essential to insure attractive returns for investors. However, considerations around the timing and method of exit exceed realms of pure investment strategy (Lerner, 2009). For example, PE professionals need to ponder about such questions as: where is the PE firm in its

fundraising cycle, how well has the fund containing that particular company performed, how does the business environment or IPO market impact the potential exit route. Consequently, the exit decision needs to be taken on the cross-roads between factors specific to the portfolio company as well as those unique to the fund and PE firm (Lerner, 2009). For example, market and company specific factors might suggest extending holding period to continue an accretion of value, whilst the sale is forced by the vintage year of the fund and quickly approaching fundraising process for a new fund. The interplay might cause even more tension in a case of a club deal.

5. Case study structure – Poundland

5.1. Background of the company

Source: Poundland annual reports, IPO Prospectus, brokers reports

Poundland is the largest single price value general merchandise (VGM) retailer in Europe by both sales and by a number of stores. Since starting out as a single-location store in 1990, Poundland has grown to operate a network of over 500 stores across the UK and Ireland. Shops are situated in busy locations, typically with high footfall, across a mixture of high streets, shopping centres and retail parks and are all managed on a leasehold basis. Consequently, Poundland does not own the real estate and does not have significant capital expenditures with regard to operating the stores. Poundland delivers amazing value to its customers at the single price point of £1 thanks to its low cost, reliable sourcing and efficient business model. In September 2011, Poundland entered Ireland under the ‘‘Dealz’’ fascia and it sells the vast majority of its products for €1.49. The Irish operations became profitable in its first full year of operation.

Poundland is headquartered in Willenhall, West Midlands, and employed on average 11,757 people in the 2013 financial year, of which approximately 70% were employed on a part-time basis, which allows flexibility of the cost base. Poundland has three distribution centres: two in the Midlands and the third, opened in late 2014, in Harlow in the South East of England to replace the existing temporary facility. Poundland’s distributions and logistics network also consists of four cross-docking facilities, located in Scotland, the North East of England, Ireland and Northern Ireland.

Poundland is managed by a strong, entrepreneurial team with significant retail experiences and a proven track record of successes. According to Poundland statistics, it conducted 4.9m transactions per week in financial year 2014 (increase of 11.4% from prior year) whilst average store on served circa 10,000 customers per week. The average spend per transaction increased by 2.5% from prior year to £4.55. Poundland is a price-driven, volume-fuelled business offering a comprehensive array of products across 17 categories, including household goods, grocery, impulse, health and beauty. The average Poundland store carries approximately 3,000 core range SKUs including over 1,000 third-party branded products. Third-party branded products account for over 30% of SKUs in the average Poundland store offering and drive the majority of sales (approximately 63% of total sales in the 2013 financial year), with popular brand names such as Cadbury, Mars, Heinz, Nestle and Colgate representing an important footfall driver. Poundland also has strong in-house product development capabilities, offering over 50 own label brand families, which typically have higher margins than third-party branded products, including Silk Soft paper products, Sweet Heaven confectionery, Kitchen Corner, Allura (Health & Beauty), Beautiful Garden and Toolbox (DIY). The products range is continuously refreshed with around 200 new products introduced every week. This helps to attract footfall to the stores, as the customers value the treasure hunt appeal.

Poundland has built strong brand recognition. For example, in a recent survey conducted by YouGov, Poundland scored 95% prompted brand awareness, significantly above its key competitors in the UK VGM retail market and in line with large UK grocery chains. The brand and product offerings appeal to an increasingly diverse range of customers, with approximately 22% of Poundland's UK shoppers being from the affluent AB socio-demographic group (upper middle and middle class) based on a survey conducted in 2013. As consumer spending in the UK increases with improvement of economic situation, discretionary expenditure may grow, which could lead to higher like-for-like sales growth. Even if household revenues increase, it is unlikely that the value retail trend will be reversed and the change brought about is of a structural nature. This is illustrated on the example of the USA – more mature VGM sector, that has shown considerable resilience and continuous growth during booth good and bad economic times. Poundland takes pride about its suppliers' strong relationships whilst sourcing approximately 80% of its purchases on a value basis from UK based suppliers in the 2013 financial year, with almost all primary manufacturers of Poundland's products supplying directly. Poundland collaborates closely with manufacturers to develop tailored and exclusive products to offer a relevant and attractive value offering at the single price point. It has continued to extend its supplier base and sources and develops products on a global basis. Poundland's sourcing office in Hong Kong is a focal point of its buying strategy, with

particular emphasis on new product development, and general merchandise products in particular, logistics and product quality assurance and control.

5.2. Sector

Poundland is a UK-based retailer, operating within the special niche called the value general merchandise (VGM) retail market. Some of VGM retailers operate as single price retailers, e.g. Poundworld, 99p stores, whilst others offer goods at varied, yet discounted, price levels, such as Home Bargains, Poundstretchers and Wilkinsons. Despite the significant growth at a CAGR of 15% from 2007 to 2012, the VGM accounted for only 2.8% of the overall general merchandise market in the UK in 2012 (PwC report). Poundland is the market leader in the UK single price segment, both in respect to amount of sales and the number of stores. It has twice as many stores as its nearest single price competitor – 99p (Poundland Prospectus). In addition to the seven chain retailers, there are a number of independent value general merchandise stores operating at both single price and multi-price price points.

Three types of business could be identified in the VGM retail market in the UK:
1) national single price value retailers : Poundland, 99p Stores, Poundworld,
2) national multi price value retailers : B&M, Home Bargains, Poundstretcher, Wilkinson's,
3) independent value retailers.

5.3. Timeline of the company

- Founded in 1990 by opening its first store in Burton-upon-Trent
- Continued growing throughout the early 1990s, with six stores by December 1991 and a further seven in 1992
- 1996 - opened the Hong Kong office to provide direct support to its sourcing operations
- 2002 - Poundland was acquired by funds advised by Advent International plc.
- 2005 - a second distribution centre was opened in 2005 in Springvale in the West Midlands, bringing combined capacity to approximately 500,000 square feet
- August 2006 - Jim McCarthy joined Poundland as its Chief Executive Officer
- 2006 - Nick Hateley joined Poundland as its Chief Financial Officer

- 02 May 2010 – Advent International sold Poundland (through selling the majority of shareholding of Poundland Holdings – the ultimate parent of Poundland Limited) to Warburg Pincus for £200m
- September 2011 - Poundland successfully entered Ireland under Dealz fascia
- 2012 - Andrew Higginson was appointed as Chairman, replacing Colin Smith who became a Non-Executive Director. Mr Smith retired from Poundland immediately before IPO
- 2012 - Poundland opened its third distribution centre, currently a temporary facility, taking the total combined capacity to approximately 700,000 square feet
- 12th March 2014 - announcement of offer price and allocation for the IPO
- February 6th 2015 - Poundland announced a proposed acquisition of 99p Stores; shares were up 17% post announcement, showing warm market reception to the deal
- February 10th 2015 – Warburg Pincus placed 35m of shares (14% of total, sold at February 11th) through private placement priced at 405 p per share

5.4. Was the value created? IRR calculation

Warburg Pincus bought Poundland in May 2010 for £200m, and floated in March 2014, hence in the calculation of IRR I used appropriate discount periods to take into account. There was no exceptional dividend paid out from Poundland to WP hence no cash flows were noted in 2011-2013. The acquisition was financed by two term loans:

a) term loan A of £30m, repayable in semi-annual instalments over a period of 6 years,
b) term loan B of £35m, repayable in one instalment in August 2017.

Figure 11: IRR calculation for Warburg Pincus

	Mar/2010	Mar/2011	Mar/2012	Mar/2013	Mar/2014	Feb/2015	Mar/2015
EV (£ '000)	200,000	223,598	279,193	305,190	760,879		
EBITDA (£ '000)	28,265	31,600	39,457	43,131	51,816		
EV / EBITDA multiple	7.08 x	7.08 x	7.08 x	7.08 x	14.68 x		
Net debt (£ '000)	14,660	30,212	23,120	4,939	10,879		
Equity value (£ '000)	185,340	193,386	256,073	300,251	750,000		
Debt financing (£ '000)	65,000						
WP cash flows (£ '000)	(135,000)	0	0	0	368,069	141,750	161,100
Discounted WP cash flows	(135,000)	0	0	0	85,873	23,351	25,745
Discount period		0.83	1.83	2.83	3.83	4.75	4.83
IRR	46.18%						

Both loans accrued interest at LIBOR plus agreed margin, however, the exact percentage was not disclosed publicly. The company also arranged the revolving credit facility of £25m in case of any needs.

During IPO, WP sold 117.4m of Poundland shares at 300 pence each, taking its investment from 77% to 30.4%. In February 2015, WP sold further 14% of total Poundland shares through private placement achieving reasonable valuation of 405 pence per share (35% increase vs. IPO price; 3% discount vs. closing price of 417 pence the pre-day before placement exercise).

Figure 12: Share price of Poundland as per gradual shares sales by WP

	Mar/2014	Feb/2015	Mar/2015
Shares sold by WP (m)	122.7	35.0	41.0
Price (£ p)	300	405	393
Total value (£ '000)	368,069	141,750	161,100

The current stake of 16.4% is valued at March average price (last column in the table in Figure 12), which is rather conservative assumption, given the strong positive market reaction to the proposed acquisition of 99p Stores. So far, WP managed to create significant value to its investors, delivering the IRR of 46.18% (Figure 11), assuming the exit from the last stake at 393 pence per share.

5.5. Main drivers of value creation

In case of Poundland, WP created value for the investors mainly through growing sales (contribution of 39.2% to value creation) and securing better exit than entry multiple (42.6% of value created) as depicted on Figure 13. The calculation took into account the Enterprise Value as calculated on 12th March of 2014, i.e. time of IPO, and do not take into account further incremental IRR improvements steaming from spreading out the sale of the stake because those incremental improvements, as we discuss below, are more of tactical nature and their steam from other factors than pure operations of the business. Given that they will take place in future, they are of highly speculative nature. When establishing the leverage and indebtedness, the values were taken from the group account as most of the debt has been placed at the holding company level.

Rather interestingly, tax shield and deleveraging contributed less strongly than pure operational improvements (22.1% in total) to the equity value improvement. This is in the sharp contrast to the

usual LBO deals, which mainly relied on financial engineering, and the way that Advent International created value through primary Poundland LBO.

The strikingly negative EBITDA improvement of 3.8% to value creation could be attributed to the intensified competition in the sector, with one of the main competitors making losses.

Figure 13: Key drivers of value creation of WP's investment in Poundland

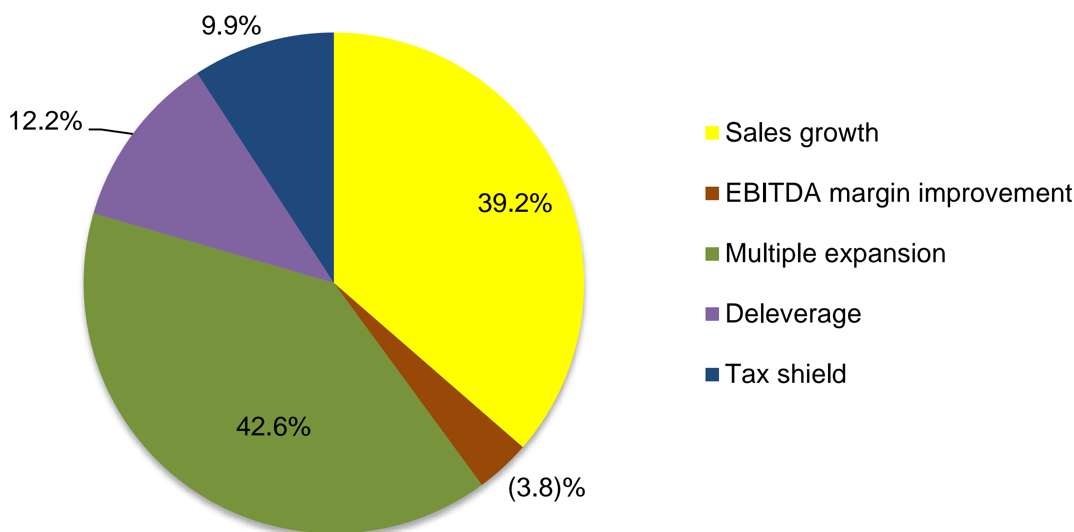
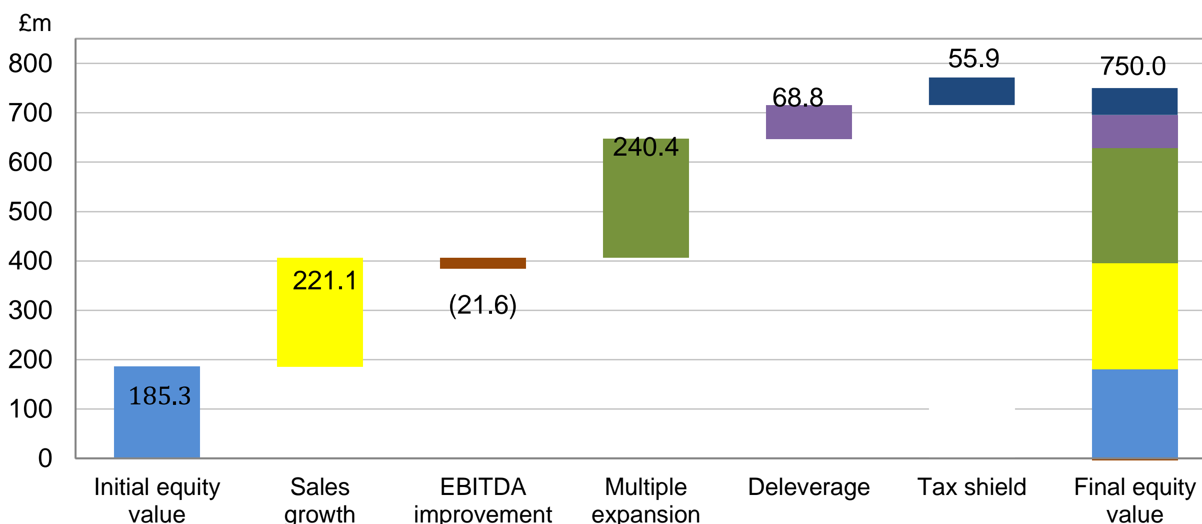


Figure 14: Equity bridge showing main drivers of value creation



As shown by equity bridge, as depicted on Figure 14, multiple expansion and sales growth had the biggest impact on equity increase in WP's investment in Poundland, almost tripling initial equity value in absolute terms.

5.6. Financial Analysis of the company

As previously discussed, I will analyse value creation by comparing ROE to cost of equity and ROCE to WACC. In case of Poundland, ROE delivered increased between 2010 to 2014, and exceeded cost of equity in all years, as shown on Figure 15.

Figure 15: ROE Analysis of Poundland between 2010 to 2014

	2010	2011	2012	2013	2014
NI / Revenues	2.55%	2.22%	2.24%	2.48%	2.73%
Revenues / Assets	4.62 x	2. x	2.26 x	2.36 x	2.72 x
Assets / Equity	2.13 x	1.89 x	1.99 x	1.86 x	1.97 x
ROE	**25.1%**	**8.4%**	**10.1%**	**10.9%**	**14.6%**

(1) The actual 2014 net income was lower by £11.3 m due to one-off expenses connected with the IPO and strategic initiatives. Hence, to keep the years comparable, net income has been adjusted by after tax value of £11.3 m. If no adjustment has been made, NI/Revenue would be 2.63% and ROE would amount to 14.1%. Similarly, one-off expenses, such as opening of new distribution centres have been excluded from net income to facilitate comparison between subsequent years. The group accounting reorganisation after WP's LBO resulted in a high decrease in ROE from 2010 to 2011, mainly due to increase in value of share capital and creation of goodwill an acquisition.

Figure 16: Qualitative analysis of Poundland's β level

	Fixed costs	D/E	Cyclicality	Earnings' growth	Confidence & understanding in business model
Contribution to β	0	0	0	+0.3	-0.4

Poundland's β is estimated at 0.9, due to:

1) low breakeven point and stable cash flows, which implies low β similarly as for mass-market service retailers,
2) low leverage, and hence low financing costs,
3) high resilience of VGM business sector to potential economic downturns,
4) high forecasted earnings growth (with 2010-2014 CAGR sales growth over 18% , and forecasted 8% in next 3 years) potentially increase β level,
5) impressive quality of management and the clarity and quantity of information the market has about Poundland, combined with clarify of disclosures and constant accessibility of management for brokers, reduces β. Similarly, uncomplicated and easy to comprehend business model further decreases β estimate.

Hence, the cost of equity is estimated at 7.5% (risk free rate 3%, β of 0.9 and equity risk premium of 5%). Comparing cost of equity of 7.5% to ROE achieved from 2011 to 2014, it can be concluded that Poundland managed to create value to its equity investors in all years of WP investment.

Similarly, in all years between 2011 to 2014, Poundland delivered ROCE higher than its WACC, and hence was able to create value to all its investors. Interestingly, cost of debt before-tax is surprisingly higher than cost of equity in years 2012 and 2014. Potential explanation is the fact that WP financed its acquisition mainly through bank loans, apart from the equity, and given that Poundland does not have much PPE, it might have been difficult to obtain loan secured by collateral.

Figure 17: ROCE and WACC analysis of Poundland between 2011 to 2014

	2011	2012	2013	2014
EBIT after tax / Revenues	2.48%	2.24%	2.48%	2.73%
Revenues / CE	3.21 x	3.97 x	4.28 x	5.06 x
ROCE	**8.0%**	**8.9%**	**10.6%**	**13.8%**
WACC	7.8%	7.8%	7.5%	6.7%

	2011	2012	2013	2014
Cost of debt before-tax	6.54%	8.76%	7.02%	8.83%
Cost of equity	7.50%	7.50%	7.50%	7.50%
D / E	34.22%	24.71%	18.95%	4.89%
WACC (1)	**7.83%**	**7.82%**	**7.51%**	**6.72%(3)**
WACC (2)	7.15%	7.43%	7.46%	7.49%

(1) Due to the high cash balance, earning very low cash interest, i.e. between 0.53% in 2012 to 1% in 2014, WACC was calculated as weighted average of cost of debt after-tax plus cost of equity minus interest received on cash, instead of usual net debt approach that could have artificially lowered the WACC.

(2) WACC calculated on net debt approach.

(3) Significant drop in WACC is due to £750m market value of equity whilst in prior years equity was valued at entry multiple (see Figure 11).

5.7. Value creation under WP

Entry multiple

As shown above, Warburg Pincus managed to gradually exit Poundland investment at much higher EBITDA multiple than its purchase multiple in 2010. Consequently, I will further investigate whether multiple expansion was only an overall industry phenomenon, good timing or favourable industry conditions at time of purchase by comparing Poundland to its peers both in 2010 and 2014.

Potentially, Warburg Pincus was able to secure attractive price because it swooped on and sealed a deal with an all-equity offer even before any auction has started. Valuations of discount chains have been also affected by demise of Woolworths, which illustrated that retailers are heavily susceptible to economic downturns, which was not previously seen as such an obvious phenomenon.

Another potential explanation for good price secured by WP is the fact that Advent International could have become impatient about exit as the fund, Global Private Equity IV, was approaching its potential closure year in 2008 given that it has been initiated in 2001. Zephyr noted quite a few aborted attempts by Advent of earlier exit from Poundland investment, from rumoured intent to auction the business in September 2008 to plans for IPO later that month. However, it seems both have been complicated by Lehman's collapse and turmoil on the financial markets. Hence, once approached by WP in 2010, Advent was willing to sell the business on 10x EV / FY 2009 EBITDA multiple. Given that the sale was sealed in May 2010, i.e. just two months after closing FY 2010, and 50% increase in EBITDA from 2009 to 2010, the business should be valued on forward-looking, and quite easily estimable at time negotiations FY 2010 EBITDA of £30m, which gives multiple of 6.6x EV / FY 2010 EBITDA multiple. However, most reports quotes EV/ EBITDA multiple of 10x, which would give a fair value to Poundland vis-à-vis its peers.

Despite VGM sector being (alongside e-commerce) one of the fastest-growing categories within retail in the UK, and Europe, Poundland did not have any directly quoted peers on any of the European exchanges at time of Advent's sale to WP. However, some VGM listed players existed already in the USA. Consequently, I will compare Poundland to both its USA peers and some large cap UK and USA general merchandise retailers.

Figure 18: Trading multiples at 2010 – time of WP entry

	Poundland	Costco	Dollar Tree	Dollar General	Tesco	Sainsbury's
2009 Sales	£ 510 m	$ 78,650 m	$ 5,231 m	$ 11,760 m	£ 54,327 m	£ 16,782 m
2008-2009 Revenue growth	20.2%	10.2%	12.6%	16.9%	14.9%	7.8%
2009 EBITDA margin	5.9%	7.5%	12.8%	10.6%	7.9%	6.2%
Country	UK	USA	USA	USA	UK	UK
EV / 2009 EBITDA multiple		9.8 x	7.3 x	8.8 x	10.2 x	7.2 x
EV / 2010 EBITDA multiple		10.8 x	8.2 x	8.5 x	9.2 x	6.5 x

It seems difficult to compare, VGM US-listed players, i.e. Dollar Tree and Dollar General, to Poundland due to their ability to achieve significantly higher EBITDA margins. On the other hand, they have slightly lower historic revenue growth, but this could be driven by the fact that they

existed for longer time than Poundland and could be entering a mature phase of their operating cycle. From the peers I identified, the average for EV / 2009 EBITDA multiple is 8.6x while EV / 2010 EBITDA multiple is 8.4x. What is more, Poundland has lower EBTDA margin than other peers, hence, valuation at rather lower end of the range, around 7 x could have been still fair. Consequently, it could be argued that WP bought Poundland at good time but the purchase offer given is still within a reasonable range, taking into account the universe of comparable companies.

Figure 19: Trading multiples at 2014 – time of partial WP exit through IPO

	Poundland	Dollar Tree	Family Dollar	Dollar General	Dollarrama	Tesco	Sainsbury's	Five Below
FY 2014 Sales	£ 998 m	$ 7,840 m	$ 10,489 m	$ 17,504 m	$ 2,065 m	£ 63,557 m	£ 23,921 m	$ 535 m
2013-2014 FY Revenue growth	13.3%	6.1%	0.9%	9.2%	11.1%	0.0%	7.1%	27.7%
2014 EBITDA margin	5.4%	12.3%	7.1%	12.2%	19.5%	-5.9%	5.9%	14.1%
Country	UK	USA	USA	USA	Canada	UK	UK	USA
EV / 2014 EBITDA multiple	17.6 x	8.7 x	8.5 x	9.2 x	14.0 x	6.3 x	6.1 x	28.7 x
EV / 2015 EBITDA multiple		7.8 x	7.9 x	8.9 x	12.4 x	6.3 x	6.1 x	21.1 x

Analysing EV / EBITDA trading multiples for 2014, one can notice that more VGM peers floated both in the USA and Canada. One of them, Five Below, trades at very high EBITDA multiple, however, that business is only to some extent comparable with Poundland as Five Below has twice higher revenue growth, both achieved and forecasted than Poundland, and also 2.5 times higher EBITDA margin. Hence, Poundland is more comparable to approaching maturity Dollarrama and Dollar General. On the average, VGM retailers trade at EV / 2014 EBITDA multiple of 13.8x and EV / 2015 EBITDA multiple of 11.6x, which is uplift of 64% and 38% from 2010 multiples. 8.4x. On the other hand, British general retailers, such as Tesco and Sainsbury's are trading at lower multiples than in 2010, which may suggest changes in economic climate and intensifying competition between retailers.

Concluding, it is unlikely that Poundland high exit multiple is solely driven by an overall increase in sector multiples. Only Five Below is able to achieve significantly higher multiples than 2010 VGM industry average. If we exclude Five Below from the peers' universe, the potential valuation will be at much lower multiple, i.e. 10.1 x for 2014 and 9.3x for 2015. Consequently, it could be inferred that there were some business specific factors that allow it to achieve significantly higher than industry multiple of 14.6 x (on adjusted for one-off events EBITDA basis, and 17.7 x multiple on as non-adjusted EBITDA basis).

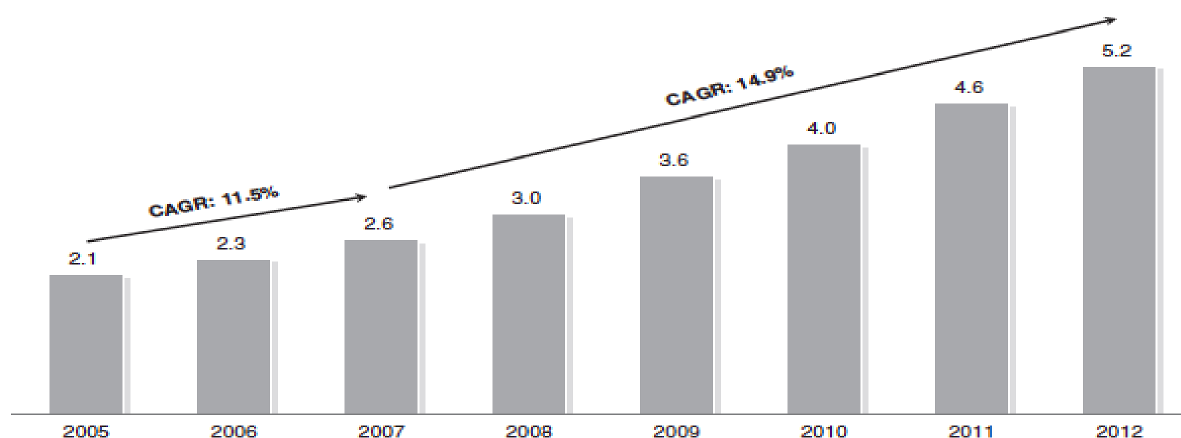
Leverage

Overall, the debt level used by WP to purchase Poundland is very moderate. Combined debt, both at company and holding level, did not exceed 35% of value of total investment and amounted to circa 2x 2010 EBITDA, which is extremely prudent level for the LBO. Such a decision could be driven by the fund specific ideology of investing as WP often buys with low leverage and also takes minority stakes. In years 2010-2014, Poundland has delivered strong cash flow generation and conversion and reducing net debt, with £47.5 million of operating cash less maintenance capital expenditure, generated in the 52 weeks ended 1 April 2012, representing cash conversion of 120% as a percentage of underlying EBITDA. 2013 delivered cash conversion as a percentage of 82.7% as Poundland heavily invested in the planned stock build up for the temporary distribution center in Hoddesdon that opened in the summer of 2012.

Operational improvements

During WP's investment, Poundland experienced a strong revenue growth with 18.3% CAGR increase from 2010 to 2014 (see Figure 21). The total retail market in the UK was valued at £310 billion in 2012 and grew since 2007 at a CAGR of 2.8% (Planet Retail, Poundland Prospectus). However, as shown on the Figure 20 below, the VGM sector, in which Poundland operates, is fast growing with a CAGR of 15% since 2007 (PwC report). Consequently, with a 2010-2014 CAGR of 18.3%, Poundland has overgrown both the general UK retail sector and a specific niche of VGM within which it operates.

Figure 20: Net sales (£bn) of UK value general merchandise market from 2005 to 2012



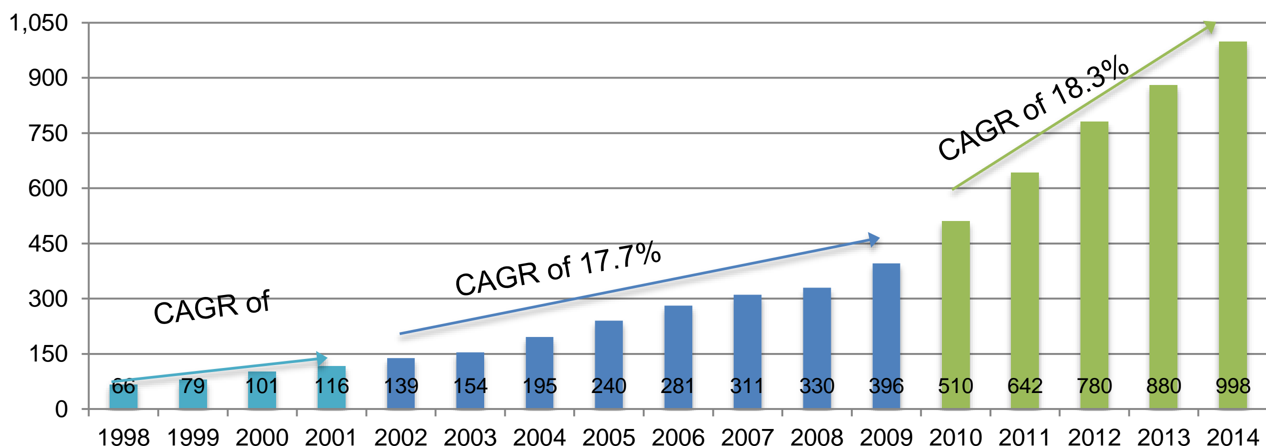
Source: PwC, "The UK Value General Merchandising Market", November 2013

Note: Includes the following retailers: Wilkinson, Home Bargains, 99p stores, Poundland, B&M Bargains, Poundstretcher, Poundworld

While Poundland gained many new customers during the difficult economic times, market research suggests that many of them come from the higher socio-demographic groups and will continue to shop in Poundland even when their financial situation improves (PwC report). According to Poundland's survey, 22% of UK customers in 2013 were from the affluent AB socio-demographic group (Poundland Annual Report 2014).

The emphasis on growth of revenues is driven by the fact that Poundland is a volume-led retailer. As its CEO explains "it's all about volumes, not percentages" (Better Retailing, 2011). Hence, there are gold products with high margins and high volumes, such as fizzy soft drinks and bronze products, with very low margins but extremely high volumes, such as Maltesers. None products sold are leftovers or short dated, as Poundland receives good pricing from its suppliers due to pure volumes it trades and different pack sizes.

Figure 21: Analysis of revenues from 1998 to 2014



The strong historical growth of VGM sector was underpinned by intensive store roll out, as the total number of shops more than doubled from just 1,058 in 2007 to 2,209 in 2012. Similarly, strong Poundland's revenue growth was mainly driven by doubling the number of shops operated from 263 shops existing as of 28th March 2010 (2 months before WP buy out of Poundland in May 2010) to 528 shops as per last published financial results of 30th March 2014.

Revenue generated per shop decreased slightly from £1.94m per shop in 2010 to £1.89m in 2014. This shows that there is no significant cannibalisation between existing and newly opened shops and illustrates Poundland's strong capabilities to identify strongly performing locations.

Figure 22: Analysis of revenues and profits vs. an increasing number of stores

	2010	2011	2012	2013	2014
Revenues (£ '000)	509,791	641,522	780,147	880,491	997,803
Growth		26%	22%	13%	13%
# of Shops	263	327	389	458	528
Growth		24%	19%	18%	15%
Revenues / Shops (£ '000)	1,938	1,962	2,006	1,922	1,890
Profit / Shops (£ '000)	62	44	45	51	68

Whilst some investors could argue that targets for new shops opening might be not solely motivated by economic sense and the shops are located in too close vicinity, Poundland's management team looked for professional help in assessing the new locations. Hence, quite interestingly, Poundland used a retail-specialised consulting firm – Javelin Group - to design the next phase of store roll-out to be implemented from 2014, and aiming at opening 500 new stores. The consultancy built a comprehensive model assessing store performance to derive at a list of prioritised areas.

Figure 23: Sales KPI analysis between VGM retailers in FY 2013

	Year	Sales (£m)	VGM market share	Stores #	Sales density (£/'000 sq. ft.)	Av store size ('000 sq. ft.)	2010-2013 CAGR	
							sales	space
Wilkinson	Jan-13	1,530	28.0	372	234	17.6	-0.6	3.4
TJ Morris	Jun-13	1,058	19.4	315	353	9.5	21.5	23.3
B&M	Mar-13	993	18.2	331	228	13.2	32.5	31.9
Poundland	Mar-13	880	16.1	458	452	4.3	20.0	22.3
Poundstretcher	Mar-13	368	6.7	422	132	6.6	3.9	7.9
99p stores	Jan-13	341	6.2	217	297	5.3	23.0	20.9

Source: Retail Week Knowledge Bank, Companies House, Jefferies

Whilst once can argue that lack of improvement in terms of sales per store is unsatisfactory, it should be noted that Poundland is a definite leader in its niche in respect of sales density. This could be partially explained by the lower average store size. The high sales density can allow for better EBIT margins, however, the limited space could halt overall revenue growth. Hence, it is possible that Poundland will be relocating to larger stores, potentially located in retail parks. Even though retail park stores suffer from lower sales densities, they deliver better gross profit per square feet as they have a greater non-food portion in the sales mix. As per management statements, they will put a significant emphasis in the next phase of stores openings on the retail park stores because they tend to be more profitable and have a higher average transaction value (Poundland, Annual Report

2014). The move to larger stores will enhance the customer experience through wider aisles and ability to present larger range of products. Past track record shows that new openings significantly contributed to overall sales growth, as space 2010-2013 CAGR of 23.3% is commensurate with sales 2010-2013 CAGR of 20.0% whilst some competitors experience lower sales CAGR than space CAGR (e.g. Wilkinson and Poundstretcher).

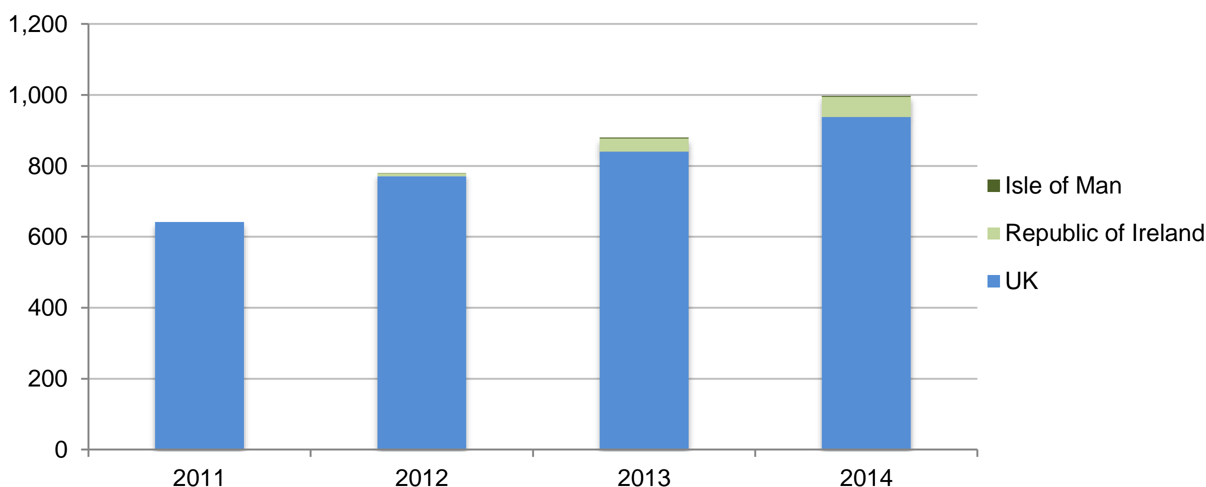
Figure 24: Analysis of Poundland's different store sizes and sales density

Key stores KPIs (FY 13)	High Street / Shopping Centres	Retail Parks	Average/Total (excl. Dealz Ireland)	Dealz Ireland
Av. Store size (sq. ft.)	5,037	6,157	5,095	6,195
No. of stores	408	24	432	26
Gross av. Sales/store/week (£'000)	45.2	49.3	45.5	46.6
Gross sales density	467	417	464	391

Source: Oriel Securities estimates (report from May 2014)

To further stimulate sales growth, in 2011, Poundland rolled-out its European expansion with introducing its new fascia "Dealz" in Ireland. Using a new brand name enabled Poundland to trial a new business model, i.e. in contrast with Poundland, Dealz has a hybrid business model with 90% of products marketed at €1.49 and 10% at other price points. Interestingly, multi price point accounts for about 7% of sales with a peak of 9% at Christmas.

Figure 25: Increasing contribution to sales coming from international expansion



Sales in £m per FY	2011	2012	2013	2014
UK	641.5	770.9	840.2	938.2
Republic of Ireland	0.0	8.3	37.6	56.6
Isle of Man	0.0	0.9	2.7	2.9

Apart from the different pricing policy, Dealz's customer proposition is akin o Poundland's with the average store carrying about 3,000 core range SKUs including over 1,000 third-party branded products. At the end of December 2013, the group operated 33 Dealz stores (including 1 store in the Isle of Man and 1 in the Orkney Islands), and in July 2014 opened its first Spanish store (see Figure 25 for sales breakdown).

Poundland's EBITDA margins have been around 5% for the past three years, showing strong resilience despite the rapid revenue growth and increasing competition. However, they are much lower than those of US peers, potentially showing the differences in consumer markets of those two countries. Due to single price pricing strategy and inability to adjust for potential inflation, Poundland's monitoring and management of fixed and variable costs is crucial to improve its operating margins. Staff and rent costs have increased in line with Poundland's store roll out scheme. The slight improvement in underlying EBITDA margin (by 0.6 p.p.) was driven by the operational leverage within the business and continued investment in both headcount and infrastructure ahead of the expected growth in the number of stores.

Figure 26: Poundland's EBITDA development from 2011 to 2014

	2011	**2012**	**2013**	**2014**
EBITDA (m)	31.6	39.5	43.1	42.8
Growth		25%	9%	-1%
EBITDA margin	4.93%	5.06%	4.90%	4.29%
Growth		3%	-3%	-12%
Underlying(1) EBITDA (m)	31.1	38.7	45.4	54.0
Growth		24%	17%	19%
Underlying(1) EBITDA margin	4.85%	4.96%	5.16%	5.41%
Growth		2%	4%	5%

(1) Underlying EBITDA excludes one-off expenses, such as openings of new distribution centres, strategic initiatives (e.g. international expansion, e-commerce), costs connected with IPO and group restructuring.

Poundland's profitability was possible by introducing new higher margin branded and developing own label products, effective monitoring existing SKUs and discontinuing low margin products, re-engineering pack sizes, moving sources of supply to lower cost economies and renegotiating with suppliers. Poundland offers over 50 own label brand families, such as Sweet Heaven confectionery, Kitchen Corner, Allura (Health & Beauty) and Beautiful Garden and Toolbox (DIY). It is estimated that they can average gross margin of 48% (vs. 30% for branded) and account for 37% of total sales (Grzinic, 2014; Poundland 2014 Annual Reports). Poundland's own label products are a key differentiator from its competitors and help to drive an increase in overall profits.

Whilst cost-cutting through lay-offs is listed as one of PE practices to derive at better EBITDA margin, this is not the case for Warburg Pincus' investment. From 2010 to 2014, the number of Poundland's selling and distribution employees increased by 92%, which is commensurate with the fact of doubling the number of stores. Similarly, the HQ and administration headcount has not been decreased. Significant cost-advantage of Poundland is derived by the fact that workforce is very flexible and adjustable, with 70% of employees working on part-time basis.

Interestingly, Poundland promotes widespread share ownership to enhance employees' motivation and nurture long-term interest in company's growth. On its IPO, it made a number of awards under the Poundland Company Share Option Plan (CSOP) and the Poundland Restricted Share Plan (RSP), to selected managers (Poundland Annual Reports 2014). For example, the RSP provides for the grant of share awards which vest after three years subject only to continued employment. The importance of aligning employees and shareholders' goals during PE investment is clearly illustrated through Poundland's shares awards at its IPO. More specifically, on IPO, awards were made to 55 senior managers under the RSP and around 550 management grade employees (including approximately 400 Store Managers) under the CSOP. The complexity of the scheme is augmented by the fact that in general, differences arise in quantum and structure of remuneration for various categories of employees in the Company from the development of remuneration arrangements that are market competitive. However, the number of awards and complexity is nothing extra-ordinary as explained in research paper by Leslie and Oyer (2009).

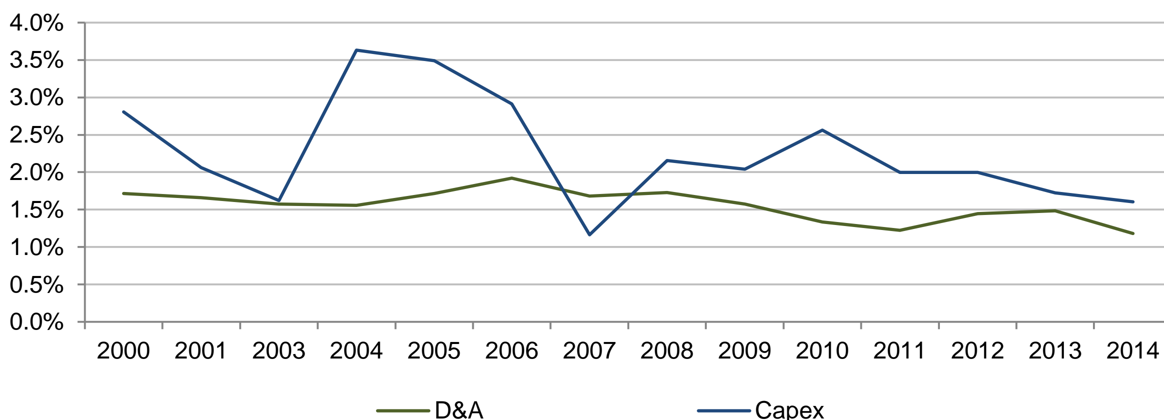
Figure 27: Number of employees and costs associated from 2010 to 2014

	2010	**2011**	**2012**	**2013**	**2014**
Overall number of employees	6,702	8,602	10,020	11,735	12,806
Administration	223	253	287	313	355
Selling and distribution	6,479	8,349	9,733	11,422	12,451
Aggregate payroll costs (£ '000)	78,180	97,529	112,079	126,309	143,710
Cost / employee (£ '000)	11.67	11.34	11.19	10.76	11.22

Whilst Poundland's management treats multi-price "Dealz" fascia as a trial, there are some examples from overseas companies that have shifted away from a single price point, which enabled them for significant EBIT improvement. For example, American cases of Dollarrama and Dollar Tree which shifted to multiple price points, might be an illustration how Poundland could further achieve better EBIT growth through another twist of introducing wider products' range (Oriel Securities, May 2014).

During WP investment period, Capex as % of sales slightly declined. However, it should be noted that generally, Poundland's business model, which has in its center use of operating leases for the new shops openings require little Capex. Poundland's estate is generally modern and well invested, with approximately 40% of its stores having been opened in the last three years. It is worth noting that the distribution capability of the business following the completion of the logistics overhaul will be 750 stores, which gives sufficient capacity for another 4 to 5 years of expansion before any more Capex is required on the distribution network. Hence, even though in general the level of Capex are rather low, brokers note that, unlike some of its peers, Poundland has clearly invested sufficiently ahead for future growth (JP Morgan, April 2014). It is also important that the average payback on stores is 12 months, which is rather short time for a retail investment. The level of return on investment is a function of the rapid maturity profile of each newly opened store and relatively low costs of store development.

Figure 28: Poundland's D&A and Capex as % of sales BITDA development from 2000 to 2014



Average as % of sales	2002-2010	2011-2014
D&A	1.64%	1.33%
Capex	2.45%	1.83%

Management changes and incentives' packages – analysis of alignment between shareholders and management

At time of WP's investment, Poundland already had a very strong management team with significant experience of high street and convenience retail throughout the senior management team. Jim McCarthy (CEO) and Nick Hateley (CFO) joined from Sainsbury's Convenience in 2006. As depicted on Figure 29, both directors and members of senior management hold significant ownership stake in the company during WP's investment, which helped to align their motives with those of WP and other shareholders.

Figure 29: Analysis of Management Package at time of Poundland floating (Source: IPO Prospectus)

	Following reorganisation and immediately prior to admission		Immediately following admission		shares sold	
	# of ordinary shares (OS)	% of issued OS capital	# of ordinary shares	% of issued OS capital	#	as % of initial shares
Directors						
Andrew Thomas Higginson *(Chairman)*	2,387,056	0.95%	1,432,234	0.57%	954,822	40%
James John McCarthy *(CEO)*	16,113,747	6.45%	9,668,249	3.87%	6,445,498	40%
Nicholas Roger Hateley *(CFO)*	7,012,296	2.80%	4,207,378	1.68%	2,804,918	40%
Richard Lancaster *(Trading)*	1,852,355	0.74%	1,111,413	0.44%	740,942	40%
Members of Senior Management						
David Coxon *(International Development)*	3,832,565	1.53%	2,299,539	0.92%	1,533,026	40%
Tim McDonnell *(Operations)*	3,506,138	1.40%	2,103,683	0.84%	1,402,455	40%
Craig Bales *(Property)*	3,506,138	1.40%	2,103,684	0.84%	1,402,454	40%
Andy Monk *(Supply Chain)*	2,983,855	1.19%	1,790,313	0.72%	1,193,542	40%
Mark Powell *(HR)*	942,624	0.38%	754,100	0.30%	188,524	20%
Mike Gray *(IT)*	942,624	0.38%	754,100	0.30%	188,524	20%
Jinder Jhuti *(Company Secretary)*	246,970	0.10%	222,273	0.09%	24,697	10%

All nine senior managers but one, including CFO and CEO, have been working for Poundland before WP's investments. This means that they were familiar with LBO process, given that they completed one with Advent in 2010. That fact could be very helpful to WP as the PE firm had an opportunity to work with the team understanding the rigour connected with being under PE investment. Consequently, the monitoring process probably was much smoother as directors were aware of PE mechanisms.

Furthermore, all senior managers, except directors responsible for property and IT, had significant experience in retail and convenience sector, working for such companies as Somerfield Stores, Fat Face, Minit Group, Sainsbury and Wm Morrison Supermarkets PLC. Interestingly, Poundland has a special director responsible for its property, which is probably motivated by the ambitious and wide roll out scheme that requires expertise in real estate sector. It is impressive that Property Director, who joined company in 2004, had not only over 20 years of experience in commercial property but also sold its own business, a niche retail agency to Lambert Smith Hampton.

The fact that management went through secondary LBO also explains rather high ownership stakes that they took, as they collectively owned 17.32% of Poundland before IPO. The exact amount invested by particular senior managers is not publicly disclosed but on basis of IPO prospectus and 2009-2011 annual reports, we can definitely conclude that each of their investments exceeded significantly usual 2-3 multiple of their annual salaries, and could have been a significant part of their estate. This could show both their great confidence in Poundland's business model as well as skilful use of management co-investment as a key tool curing an agency problem, used by WP. Similarly, Poundland's senior managers had to hold on to shares for longer periods, i.e. they did not sell majority of their shares immediately at IPO, tendering only up to 40% of their stakes. However, it is possible that some of directors were not interested in selling higher stake at IPO

In the whole PE investment story, the role of CEO is very important and Poundland has been no exception. McCarthy worked over 40 years in retailing, including eight years as CEO of T&S Stores. He developed the latter into a chain of more than 1,000 outlets and subsequently sold to

Tesco in 2003, becoming a millionaire at age of 47. While it is unclear how much he invested in Poundland and how much he gained in form of long-term incentive plans and share options, he confessed that he reinvested more than the norm, i.e. several millions, while Avdent exited its LBO and WP bought Poundland in 2010 (Graham, 2011). It is rather uncommon for CEO to go through the secondary LBO, given a quite significant success of the first one, and the prior sale of the other business he was CEO of. However, McCarthy explains that he did not want to slow down after all successes, being driven by insecurity and a desire to achieve (Graham, 2011). During the interviews, he comes across as a real player, which is the best depicted in his quote "you need to be clear about where you want to take the business, and work hard with your team to put in place those things to get you there. Even if your vision is flawed, if you have the passion and the implementation skills, you get there" (Graham, 2011). His excellent skills have earned him multiple awards. Consequently, it is quite fair to say that his experience and drive could have been fundamental to Poundland's success.

EBITDA multiple expansion at the exit

From the big-picture analysis of value creation drivers, we initially concluded that 42.6% was driven by EBITDA multiple expansion (see Figure 13). Leaving aside discussion on which multiple should be used at the entry, there are two other alternative explanations for the multiple EBITDA expansion phenomenon in this case, namely it could be suggested that in fact, the EBITDA multiple expansion is largely driven by:

a) the general improvement of multiples in the industry,
b) company specific improvements in valuation due to its improved margins, exceptional growth rate and business model strengths.

As depicted on Figure 30 and previously 19, the IPO offer price was set at the top of the possible range, far exceeding the one suggested by comparable trading companies. This could have been driven by business uniqueness in the UK market, strong growth potential and great IPO story, all of which will be discussed in the next section.

Figure 30: Peer comparison for EV/2014 EBITDA multiple

Name	FY1 EV/EBITDA
UK	
Booker Group Plc	17.2x
Dunelm Group Plc	14.1x
Findel Plc	11.9x
Home Retail Group Plc	5.3x
JD Sports Fashion Plc	7.1x
Kingfisher Plc	8.9x
Majestic Wine Plc	10.3x
N Brown Group Plc	12.8x
Sports Direct International Plc	15.4x
SuperGroup Plc	13.9x
WH Smith Plc	8.5x
Average	**11.4x**

US	
Costco Wholesale Corp	11.4x
Dollar General Corp	8.8x
Dollar Tree Inc	8.5x
Family Dollar Stores Inc	8.7x
Five Below Inc	21.1x
Ross Stores Inc	8.5x
TJX	9.5x
Average	**10.9x**

Source: Thomson Reuters

5.8. IPO – unexpectedly favourable exit

On 12th March, Warburg Pincus partially exited from Poundland by selling shares through IPO on 12th March 2014 at £3 per share, and reducing its stake from 77% to 30.4% (as over-allotment option was exercised). JP Morgan and Credit Suisse acted as Joint Global Co-ordinators, Joint Sponsors and Joint Bookrunners, whilst Rothschild acted as a Financial Adviser to the company.

Usually, PE firms choose a trade sale or secondary LBO as preferred method of exit (Figure 10). There were some market rumours about CVC Capital mulling over a potential bid for Poundland. However, it is possible that high valuation of Poundland at its IPO (20 times its profit figure) put the company beyond the reach of any potential financial sponsors. In the first half of 2014, 37 entities, including 12 consumer and retail business, received listing on LSE Main Market. The strong appetite for listing highlights the fact that in the first six months of 2014 alone, there were 18 fewer IPOs than in whole 2013 (Henderson, 2014). However, performance of IPOs has been mixed and hence, many companies either cancelled or stalled plans, whilst some of PE houses exited through trade sale rather than IPO that they had previously planned.

Selling shareholders included funds advised by WP, certain directors, members of senior management and the ESOP trustee. Each of sellers agreed to customary lock-up arrangements in

respect of shares not tendered. The offer was directed to certain institutional investors in the UK and outside of the USA, whilst in the USA was targeted at only Qualified Institutional Buyers. According to the press, the list of investors was mainly restricted to City institutions and the book was covered by more than 15 times, showing that the shares were highly demanded and the IPO was of a great success.

IPO tactics

Use of proceeds from IPO is often a crucial piece of a jigsaw helping investors to decide whether to take part in it. Whilst IPOs aiming at helping to propel growth and raising funds for investments are perceived favourably by potential investors, the ones that only want to repay debt could be less attractive. In the present case, the IPO did not directly benefit Poundland as the company did not receive any proceeds pursuant to the global offer. According to the IPO Prospectus, the rationales given behind the purposes of the IPO were rather on the diversification and liquidity angle, such as:

- enable the selling shareholders to partially monetise their holding, also allowing for a liquid market for their shares going forward;
- diversify the shareholder base;
- enhance Poundland's profile with investors, business partners and customers;
- further enhance the ability of Poundland to attract and retain key management and employees; and enable access to capital markets if necessary for future growth.

Sale story

Even if Poundland did not benefit directly from its IPO, potential investors were could have been persuaded by the very strong sale and growth story for the business. According to research, the revenue growth seems to be sustainable in the long term as Poundland have the potential to operate over 1,000 stores in the UK itself ("Poundland UK and ROI location Planning", Javelin, November 2013). Poundland explains that it is possible to operate a few shops in each other vicinity, giving examples of such cities as Glasgow with 4 stores in the city centres, Edinburgh

(3 plus 1 in Leith) and Birmingham with 3 centrally located shops, which all trades together. The strong growth potential is also supported by the fact that Poundland is significantly underrepresented in parts of the UK, notably South East, London and South West, despite its broad national network. Some brokers estimate that additional 92 stores are needed to bring those regions at equal footing in terms of the number of stores per head of population (J.P. Morgan, April 2014). Similarly, management notes that there is a potential to increase revenues through upsizing or relocation of some older stores, estimated as 115 stores as at 31 March 2013, that are 4,000 square feet or less. The directors explains that approximately half of these stores are undersized for their local catchment area market and should be either re-sited or extended to reach optimum space.

Furthermore, increasing own-label penetration and popularity should allow modest increases in margins over the next five years. Another avenue for increasing revenues would be setting up e-commerce division. Similarly, investors confidence could be boosted by such factors as Poundland's strong logistics capacity and experienced management led by Jim McCarthy.

Board preparation

Usually, there is a significant difference in the structure of the board, including implementation of rules set out in the UK Corporate Governance Code. The Chairman is usually brought in ahead of the float as it happened in this case because skills required to stir listed company board differ significantly from those helpful in case if private or PE-owned companies. Good prior chairman's reputation and expertise can enhance company's credibility amongst investors (Henderson, 2014). In that fashion, in 2012, Poundland appointed Andrew Higginson, who was a senior executive at Tesco and also performs role of non-executive director of BSkyB, the owner of Sky News. Also other member of non-executive board both complemented and provided good challenging team for existing management.

Offer price – valuation

To assess reasonableness of share price offer, I use both multiple valuations and a three-stage DCF. My specific DCF forecasts are to 2017, with a five-year soft landing period to 2022 where the growth rate is phased-out to 2.0%, followed by maturity from 2022 onwards with perpetual growth rate of 2.0%. Generally, DCF takes rather conservative, sensible assumptions, increasing 2014 revenues c£1bn to £2bn in 2020. In the UK, Poundland has significant market potential to at least double its store park, which with modest like-for-like sales makes that segment itself a £2bn market. Similarly, international expansion can greatly contribute to revenues' growth. Dealz in Eire should hit maturity at c70 stores with sales of £150-200m by 2024E, so it would be reasonable to assume that the expansion into Europe can generate sales of £400-500m by 20242, i.e. 25-30% of the potential in the UK. EBITDA margin is kept cautiously at 5.1%, whilst EBIT is 3.6% - both below current levels. It is unclear how much more of operational leverage is there to realize, and hence, the sensitivity tables for EBITDA margin has been created to further support an analysis of offer price range. Giving the need to nurture expansion, Capex is slightly increased to 2.0% from 1.8% of 2010-2014 historical average. D&A has been kept at 1.5% in line with historical trends. The UK statutory tax rate has been applied to all years, assuming that Poundland will not try to relocate in future to Ireland or any similar tax-beneficial regimes. WACC is kept at 6.7% as calculated per Figure 16 in the section dedicated to the value creation. This is rather a low level of WACC, but as explained before is derived from low cost of equity. Similarly as for EBITDA margin, a proper sensitivity analysis has been conducted.

Concluding, on basis of conservative growth assumptions, Poundland's share price could be valued at 466 pence on the day of IPO, which indicates potential upside of 55% in comparison to tender offer price of 300 pence per share. The suggested price rage is between 386-589 pence. The price is heavily dependable on both WACC and EBITDA. 1% increase in WACC, whilst other things kept constant, can drive price down to 346 pence (28% decrease in initial valuation). Similarly, 1% decrease in EBITDA margin can reduce target price to 347 pence. Consequently, potential investors should vigilantly monitor the sector, given the intensifying competition both from other VGM and general retailers.

Figure 31: Calculation of share price through DCF

Perpetual Growth rate	*2.0%*	*Valuation date*	*14/03/14*
WACC	*6.7%*	*First closing date*	*30/03/15*

Assumptions
Calculations

	Actual		Projected			Soft Landing				
£ '000	***2013 a***	***2014 a***	***2015 e***	***2016 e***	***2017 e***	***2018 e***	***2019 e***	***2020 e***	***2021 e***	***2022 e***
Revenues	880,491	997,803	1,146,476	1,324,179	1,533,400	1,733,355	1,911,544	2,055,292	2,153,124	2,196,186
Growth	*12.9%*	*13.3%*	*14.9%*	*15.5%*	*15.8%*	*13.0%*	*10.3%*	*7.5%*	*4.8%*	*2.0%*
EBITDA (underlying)	45,450	54,029	58,470	67,533	78,203	88,401	97,489	104,820	109,809	112,006
EBITDA margin	*5.2%*	*5.4%*	*5.1%*	*5.1%*	*5.1%*	*5.1%*	*5.1%*	*5.1%*	*5.1%*	*5.1%*
D&A	(13,080)	(15,096)	(17,197)	(19,863)	(23,001)	(26,000)	(28,673)	(30,829)	(32,297)	(32,943)
% of revenues	*1.5%*	*1.5%*	*1.5%*	*1.5%*	*1.5%*	*1.5%*	*1.5%*	*1.5%*	*1.5%*	*1.5%*
EBIT	**32,370**	**38,933**	**41,273**	**47,670**	**55,202**	**62,401**	**68,816**	**73,991**	**77,512**	**79,063**
EBIT margin	*3.7%*	*3.9%*	*3.6%*	*3.6%*	*3.6%*	*3.6%*	*3.6%*	*3.6%*	*3.6%*	*3.6%*
Taxes (statutory)	(8,034)	(9,556)	(9,493)	(10,964)	(12,697)	(14,352)	(15,828)	(17,018)	(17,828)	(18,184)
Tax Rate	*24.8%*	*24.5%*	*23.0%*	*23.0%*	*23.0%*	*23.0%*	*23.0%*	*23.0%*	*23.0%*	*23.0%*
NOPAT	**24,336**	**29,377**	**31,780**	**36,706**	**42,506**	**48,049**	**52,988**	**56,973**	**59,685**	**60,878**
+ D&A	13,080	15,096	17,197	19,863	23,001	26,000	28,673	30,829	32,297	32,943
- Capex	(15,181)	(16,017)	(22,930)	(26,484)	(30,668)	(34,667)	(38,231)	(41,106)	(43,062)	(43,924)
% of revenues	-1.7%	-1.6%	-2.0%	-2.0%	-2.0%	-2.0%	-2.0%	-2.0%	-2.0%	-2.0%
- Change in WC	5,666	(10,697)	(9,172)	(10,593)	(12,267)	(13,867)	(15,292)	(16,442)	(17,225)	(17,569)
% of revenues	1%	-1%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%
Cash Flows	**16,569**	**39,153**	**35,220**	**40,679**	**47,106**	**53,249**	**58,723**	**63,139**	**66,144**	**67,467**
Discount period			1.04	2.04	3.04	4.04	5.04	6.04	7.04	8.04
Discount Factors			0.93	0.88	0.82	0.77	0.72	0.68	0.63	0.59
Discounted Cash Flows			**32,914**	**35,629**	**38,668**	**40,965**	**42,340**	**42,665**	**41,889**	**40,044**

		as % of EV
Sum of Dicounted CFs	315,115	27%
Terminal Value	869,046	73%

Implied EV	1,184,161
Net Debt	19,337
Equity Value	1,164,824
Outstanding Shares (m)	250
Implied Share Price (p)	466
Offer price	300
Potential Upside	*55%*

Share Price Sensitivity Analysis

Implied WACC / Perpetual Growth Rate	**1.0%**	**1.5%**	**2.0%**	**2.5%**	**3.0%**
5.7%	484	535	600	686	803
6.2%	434	475	525	589	673
6.7%	393	426	**466**	515	578
7.2%	359	386	418	457	506
7.7%	330	352	379	411	449
8.2%	305	324	346	372	403

Implied WACC / EBITDA margin	**4.1%**	**4.6%**	**5.1%**	**5.6%**	**6.1%**
5.7%	448	524	600	677	753
6.2%	392	458	525	592	659
6.7%	347	407	**466**	525	585
7.2%	311	365	418	472	525
7.7%	282	330	379	427	476
8.2%	257	302	346	390	435

First day and month trading

On its first day of trading, Poundland's stock achieved a high of 401p, a 34% increase and closed at gain of 23.3% versus the initial float price. This actually should not have been a surprise given that IPO was 15 times over-subscribed. Poundland has been priced at the top of its range, and as one of the few retailers floated in 2014 since then experienced mainly upward trend of its share price.

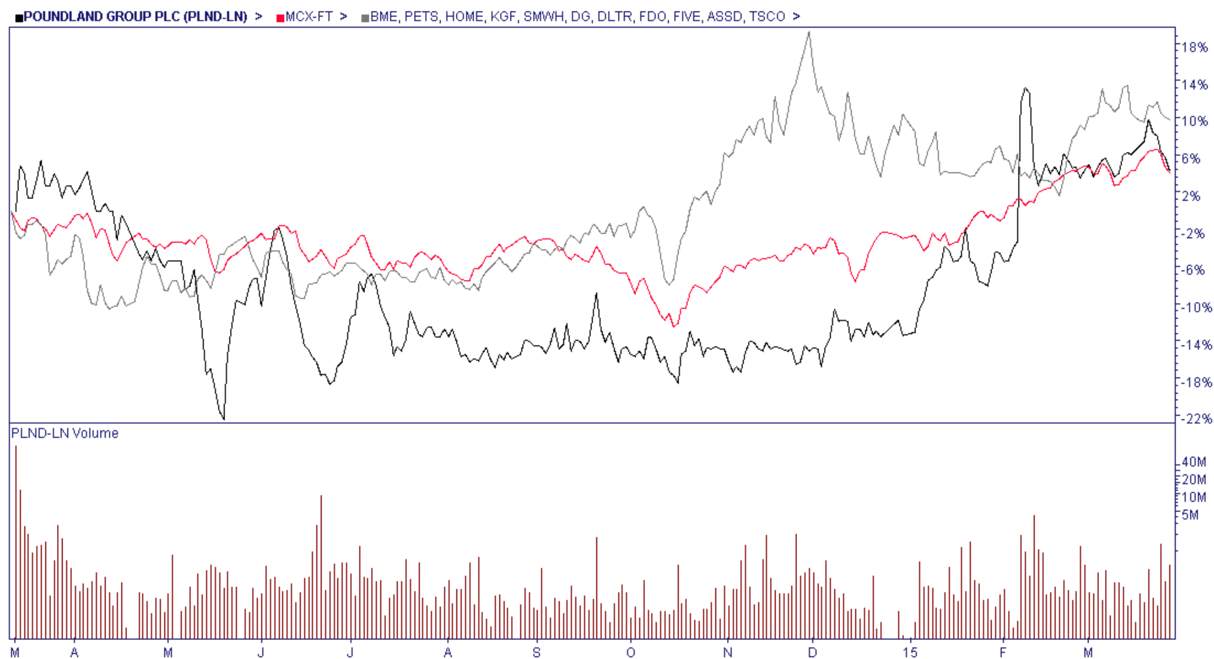
Poundland is in a sharp contrast with Pets at Home, a specialty retailer for pet lovers backed by KKR, that did not receive that much of kick from the market from its IPO even though it has been floated at mid-range of intended range. Both businesses were snapped by PE firms in 2010 and then floated at the same day at LSE. However, Pets at Home was significantly more leveraged and significant part of IPO proceeds was consumed to repay debt and cover transaction costs. In fairness, KKR had to use significantly higher amount of debt as they were forced to compete in the bid process with other interested parties, which drove EBTIDA multiple to 12x. Hence, KKR had to finance half of the acquisition through loans and other form of debt. Later, it used financial engineering to pay itself dividend recapitalization of £135m, significantly leveraging Pets at Home. Consequently, in this case, the superiority of WP's approach has clearly been demonstrated by the return on investment it got when it listed Poundland (as per calculation above over 46% or 5.0 times cash on cash) and stability of the price it has achieved. On the contrary, KKR achieved cash on cash return of 1.8x and it is faced with failing shares' price.

Figure 32: Poundland's performance versus those of other retailers that listed in 2014 at LSE

Company name	Intended price range (p)	Float price (p)	Valuation on float (£m)	Share performance (%)		
				1 day	1 week	1 month
Poundland	250-300	300	750	23.3	27.3	23.3
Pets at Home	210-260	245	1,175	-2.9	0.4	-14.3
Patisserie Holdings	170-200	170	170	13.5	17.6	20.0
Just Eat	210-260	260	1,456	8.8	-3.8	-11.5
Card Factory	225-300	225	767	-10.7	-12.0	-6.7
B&M European VR	230-290	270	2,700	8.1	5.6	-0.7

Since then the stock's performance has been rather volatile, with the stock having fallen 30% to a low of 284p and subsequently having partly recovered. However, many brokers note that Poundland's volatility has been more market risk/IPO driven than Poundland specific (Mees, 2015; Gulliver, 2015).

Figure 33: Poundland's performance to date versus index of other retailers and MCX-FT



Over-allotment right

As a stabilisation manager on behalf of the banks' syndicate, JP Morgan has been granted an over-allotment / green shoe option by WP funds of sale of additional 15% of ordinary shares. A green shoe option can facilitate price stability of a security following its issue because the underwriter has the ability to increase supply and smooth out price fluctuations when demand increases.

5.9. Post-IPO

Poundland's plans to acquire 99p stores

On 6th February 2014, Poundland has announced the conditional acquisition of its UK rival - 99p Stores for an enterprise value of £55 million, likely to be funded by a combination of debt, sourced through existing RCF lines, and equity. The purchase price values 99p Stores at 9.0x trailing FY14A EBITDA and is expected to be earnings accretive following integration. The acquisition, which is conditional on CMA approval, would cement Poundland's leading position in the UK single price retail sector, increasing its UK footprint significantly from 534 to 783 stores on a pro-forma basis.

99p Stores is a family-owned business launched by entrepreneur Nadir Lalani in 2001. Its 251 stores are located mainly in southern and central England, which makes it complementary in terms of geographic coverage to Pound and. 99p opened its first store in Scotland in June 2013. It also operates a multi price fascia called Family Bargains, of which there are 25-30 locations. As could be seen at Figure 34, 99p Stores has much lower EBITDA margin than Poundland and made losses for last two years.

Figure 34: 99p Stores 2012-2014 statutory accounts

£ in millions

	Feb-12	Feb-13	Feb-14
Revenue	270.2	341.5	370.4
Adjusted EBITDA	**10.91**	**4.96**	**6.12**
Margin	*4.0%*	*1.5%*	*1.7%*
D&A	3.57	5.08	5.73
Adjusted EBIT	**7.34**	**(0.13)**	**0.40**
margin	*2.7%*	*0.0%*	*0.1%*
PBT	7.19	(0.58)	(0.73)
Tax	2.08	0.05	0.13
Net Income	**5.11**	**(0.63)**	**(0.86)**
Net Debt *	**7.70**	9.66	**19.95**

Source: Company reports. * Net debt calculated bank loans and overdrafts less cash.

Financing

The consideration of £55 million for 99p Stores includes debt assumed. At February 2014, 99p Stores had net debt of £20 million. The purchase would be financed by £7.5 million of new Poundland shares issued to the vendors and £47.5 million of cash, which would be funded by the issuance of equity through a placing and drawdown on its £55 million RCF. The ratio of debt and equity has yet to be determined. Discussions have already been initiated with the CMA. Public consultation will begin immediately and this is expected to take 'at least two months'.

Contribution to Poundland's business

According to management, the potential deal synergies could be worth 3-4% of sales and that, if all 251 stores are successfully converted, the deal could be 25% accretive to EPS by FY18. (see Figure 35). Combination of businesses could render impressive results as 99p Stores' customers will benefit from better choice, value and service with the introduction of Poundland's offer. The cost synergies could be mainly driven by economies of scale.

Figure 35: Estimate of accretion value

	2016e	**2017e**	**2018e**
Poundland	1,253.4	1,383.1	1,516.2
99p Stores	396.7	408.6	420.9
Disposals due to antitrust	0%	0%	0%
New group sales	**1,650.1**	**1,791.7**	**1,937.1**
Cost synergies	4.0	10.2	16.0
EBITDA- Poundland	67.7	74.2	82.5
EBITDA- 99p	10.3	16.8	22.7
Group EBITDA	**78.0**	**90.9**	**105.2**
Margin	*4.7%*	*5.1%*	*5.4%*
EPS	**16.79**	**19.95**	**23.41**
Old EPS	15.74	16.94	18.59
Accretion	**7%**	**18%**	**26%**
New FD shares	252	252	252
ROIC	**7%**	**16%**	**25%**

Source: Morgan Stanley Research estimates

According to Poundland management, 99p Stores have a sales density circa 18% lower, which implies significant revenue synergies as the stores get converted into Poundlands. The 380bps

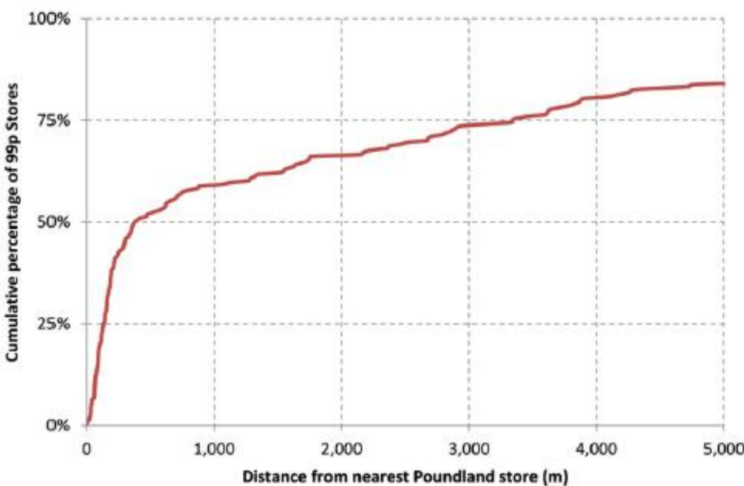
margin differential between the two businesses also implies attractive cost synergies. However, synergies could be heavily affected by any disposals demanded by the CMA.

Given the poor 99p Stores performance in last two years, the market reaction seems to be too enthusiastic. The investors should question whether the arrangement is indeed a great bargain or a well timed sale by a founder. There could be some benefits from increased scale and best practices (Poundland's sales densities are 18% above 99p Stores'), but the larger industry backdrop and possibility of cannibalization pose a significant risk.

Store overlap

Based on the sample of just over 200 stores of 99p Stores, which amounts to about 80% of their locations, Morgan Stanley estimates that approximately 25% of 99p Stores are within 150 metres of a Poundland and 50% are within about 400 metres (see Figure 36). This suggest an extensive close-down process after the successful acquisition due to significant cannibalisation potential between 99p Stores and Poundland.

Figure 36: Analysis of store overlap



Source: Company data, Morgan Stanley

WP's sale of further 14% of Poundland

On 10th February 2015, WP sold 14% of its stake after acquisition announcement and to institutional investors through private placement at 405p per share. Initially, WP aimed at selling only 10% of Poundland's shares, which was subsequently extended to 14% as strong demand was shown by institutional investors. Consequently, WP was able to further exit Poundland investment at premium of 35% over initial IPO offer price, expressing both warm reception to takeover of 99p Stores and overall Poundland's prospects. This begs a question if proposed acquisition of 99p Stores was not merely a trick to boost share price and allow WP to exit the investments, achieving better returns.

CMA's decision on anti-trust

At time of announcement of 99p Stores, Poundland's management estimated that the combined businesses would only have a 0.4% share of the retail market, however, the definition of 'the market' applied by the CMA itself had been very narrow. According to that regulator, the deal would affect 80-92 local areas. Consequently, following CMA's decision, Poundland was faced with 3 possible solutions:

1) it could make sufficient changes to satisfy the CMA in time for the April 16th deadline,
2) it could request a Phase 2 investigation,
3) could withdraw from the deal.

Option 1) will require closure of circa 80 stores, almost 30% of the 99p sore estate, which could be very expensive due to the leases. Second possibility could be expensive given fees. Option 3) although at the first sight unattractive, potentially has benefits in leaving a weak competitor in a tougher position.

The biggest surprise of CMA's decision was the treatment of pound-stores as essentially a separate group to the multi-price discounters, given the vast overlap in products sold. Although consolidation in this sub-market remains a possibility, this stance does make it difficult to see where it comes from.

Following CMA's decision, Poundland had only one week to suggest significant undertakings, or ask for a referral to the lengthier Phase 2 process. It chose the latter, hence the results are yet to be seen whilst the stock price already bumped back to , with the their undisturbed level before the original announcement (357p on 5th February).

5.10. Comparison to Advent International LBO of Poundland and value creation

IRR calculation

Advent International (Advent) bought Poundland Limited for circa £44m in June 2002. According to Poundland Holding Limited Annual Reports for 2003, the cost of acquisition of Poundland Limited was £44.1m, which included increased working funds for the group. The deal was funded by the issue of share capital of £3.9m, a loan from funds managed by Advent International of £28.2m, a term loan of £12m from Bank of Scotland and deferred consideration of £4.9m. Quite interestingly, both the Advent loan and the term loan from Bank of Scotland were to be finally repaid in June 2009, assuming maturity of up to 7 years, were in fact, Advent managed to exit its investment in 2010. This could have significantly impact Advent willingness and increased urgency for the exit in 2009-2010, which explains rather low EV/ EBITDA multiple at the exit date (as discussed in the sections on WP's LBO).

Figure 37: IRR calculation of Advent's investment

	Dec/2001	Jun/2002	Mar/2003	Mar/2004	Mar/2005	Mar/2006	Mar/2007	Mar/2008	Mar/2009	Mar/2010
EV (£ '000)	44,111	44,111	44,111	74,644	78,232	47,117	56,693	88,575	116,483	200,000
EBITDA (£ '000)	5,706	n/a	6,836	11,568	12,124	7,302	8,786	13,727	18,052	28,265
EV / EBITDA multiple	7.73 x	n/a	6.45 x	6.45 x	6.45 x	6.45 x	6.45 x	6.45 x	6.45 x	7.08 x
Net debt (£ '000)		10,624	8,603	7,930	39,335	31,171	34,568	25,460	19,503	14,660
Equity value (£ '000)		33,487	35,508	66,714	38,897	15,946	22,125	63,115	96,980	185,340
Advent cash flows (£ '000)		28,200	0	0	30,000	0	0	0	0	160,000
Discounted WP cash flows		(28,200)	0	0	8,724	0	0	0	0	19,485
Discount period			0.83	1.83	2.83	3.83	4.75	4.83	4.83	4.83
IRR		54.64%								

Similarly as in case of Warburg Pincus, Advent did not pay out any special dividends to itself during the investment period. However, Advent mainly financed its investment in Poundland

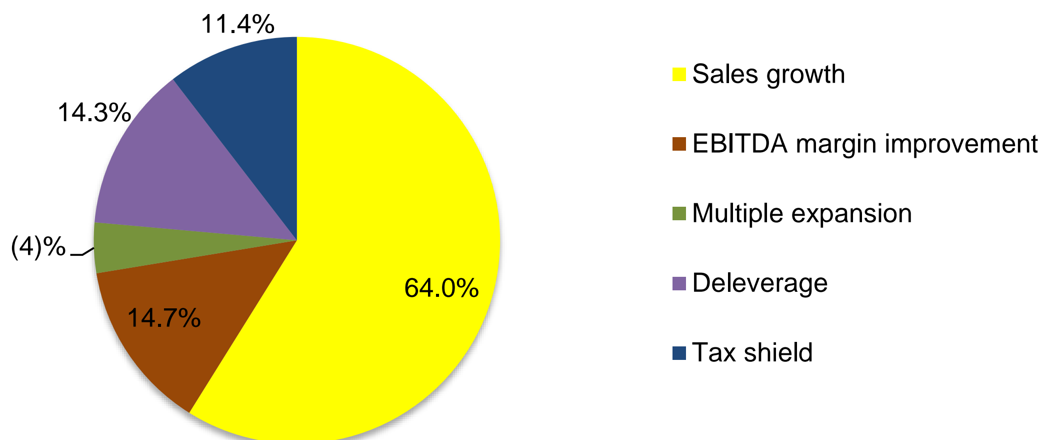
through loan notes with capital and 6% interest element that were to be repaid at earlier of future re-financing or June 2009. In 2005, Advent's loan notes in Poundland were substantially repaid by an estimated sum of £30m (vs. £36m of outstanding accrued interest and principal). Such transaction is called a leveraged recapitalisation ('recap') and requires the company that went under LBO to re-borrow debt previously repaid and/or increasing borrowings. Those borrowings are used to either repay, restructure financing structure, which may entail repayment of the private equity investment in loan-stock and/or preference shares. In general, repayment of loan-stock is more tax efficient than payment of dividend as the former is tax-free whilst the latter incurs 25% of tax liability. In that way, by increasing deleverage, PE firm can significantly boost IRR by accessing returns at much earlier date than the actual exit date. The technique is especially useful in cases when the exit has to be postponed or the company has low debt level.

Consequently, when calculating IRR, I took into an account initial investment made in June 2002, partial repayment of share loans in 2005 and cash-in that happened in 2010 when Advent sold Poundland to Warburg Pincus for EV of £200m. In a case of the initial investment, it is not publicly available what was the exact split between equity and debt-financing, hence, I took values as disclosed in Poundland Holdings Limited annual reports for 2003, which are the best estimate. Similarly, the exact value of loan notes repayment is not clear, but I took the best estimate on the basis of increased indebtedness as per accounts in 2005. Overall, Advent's IRR was 54.64% (Figure 37), which is 8.5% higher than WP's IRR of 46.18% (Figure 11).

Attribution to different drivers

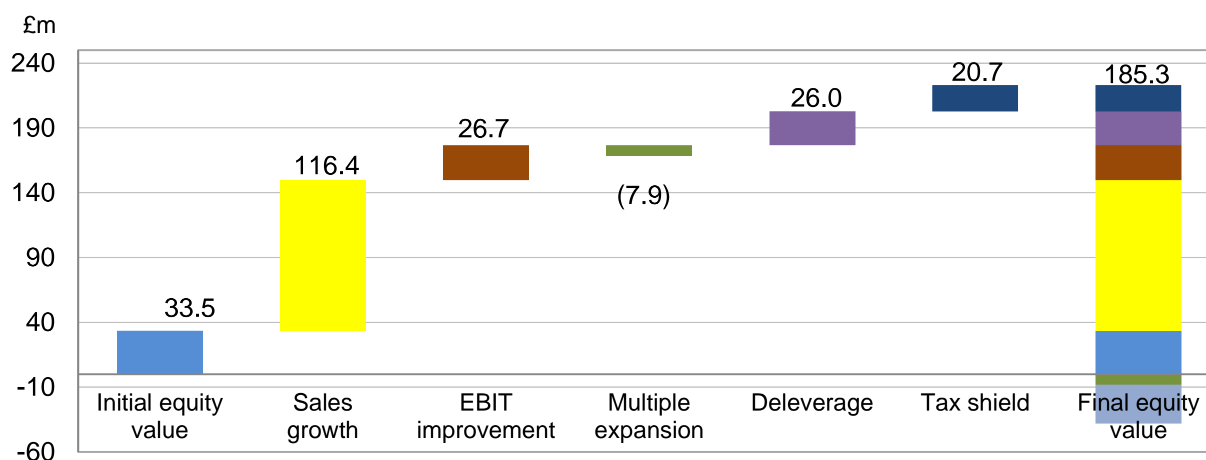
Similarly as in case of WP, 64% of value was created through growing sales as depicted on Figure 38. The second highest driver was financial engineering, contributing 25.7%. However, that number is on a rather conservative side as the actual debt mix and an extent of a recap in 2005 were not fully disclosed and some assumptions have been made to quantify those values. It is possible that financial engineering could have contributed up to 40% of value creation, depending on the actual equity split at time of exit and debt usage through the transaction. Consequently, Advent's technique is in contrast with a WP's rather cautious approach to debt.

Figure 38: Key drivers of value creation of Advent International LBO of Poundland



Negative multiple expansion could be attributed to the fact that Advent had to exit the investment due to fund portfolio constrains. The Global Private Equity IV, $1.9bn fund that hold investment in Poundland, approached its maturity as it was started in 2001. In 2010, the fund approached 9th year since its vintage year, which is rather on the lengthier side for that size of the fund. Potentially, the general negative sentiment at the financial markets, could have forced Advent to sell, even the price was not fully satisfactory.

Figure 39: Equity bridge showing main drivers of value creation of Advent International LBO of Poundland



As shown by the equity bridge illustration, Figure 39, sales growth and financial engineering had the biggest impact on equity increase in Advent's investment in Poundland, almost increasing initial equity value by five times in absolute terms. It should be borne in mind that overall value

created was in an excess of final equity value, as the 2005 recap leaked some value created from the company as the cash received from increased leverage has not been retained but rather paid out to the fund that hold loan notes in Poundland.

Group Structure

On 5 June 2002 Poundland Holding Limited acquired Poundland Willenhall Limited, which subsequently acquired Poundland Limited on 11 June 2002. Following Advent International acquisition of Poundland Limited, the group had three main companies:

a) Poundland Holdings Limited – the holding company of the new group where the external debt has been placed,
b) Poundland Willenhall Limited – a wholly-owned subsidiary of Poundland Holding Limited, which holds the investment in Poundland Limited,
c) Poundland Limited is the main trading company of the group and accounts for all the retail activities of the group.

That kind of structure is typical for LBOs, and depicts how holding companies are used for establishing debt repayment hierarchy and protecting PE funds. In that way, the PE firm is not directly exposed to the investment, but only to the extent it invested through the fund, which subsequently either holds equity or the loan notes in the holding company.

Financial Analysis

Unlike in case of WP, Poundland under Advent's LBO shows fluctuating level of ROCE and ROE, mainly due to increasing indebtedness in 2005 and operational losses in 2006 and 2007. The leverage effect on ROE is only visible from 2009, probably due to high level of interest repayments incurred in preceding years.

Interestingly, both profit margin and assets turnover increases during LBO with the latter showing the most significant improvement. On the other hand, the leverage peaks in 2006, just

after recap, and since then gradually decreases, showing strong cash-flow generation capabilities of Poundland (see Figure 40).

Figure 40: ROE and ROCE Analysis of Poundland between 2003 to 2010

	2003	2004	2005	2006	2007	2008	2009	2010
NI / Revenues	2.09%	1.58%	0.89%	-0.74%	-0.39%	0.57%	1.20%	2.55%
Revenues / Assets	1.93 x	2.75 x	3.04 x	3.35 x	3.85 x	3.84 x	4.41 x	4.62 x
Assets / Equity	2.63 x	2.03 x	2.68 x	3.18 x	2.74 x	2.36 x	2.23 x	2.13 x
ROE	**10.6%**	**8.8%**	**7.3%**	**-7.9%**	**-4.2%**	**5.1%**	**11.9%**	**25.1%**
EBIT after tax / Revenues	2.09%	2.87%	2.30%	0.49%	0.88%	1.72%	2.01%	2.88%
Revenues / CE	2.27 x	3.2 x	3.61 x	4.87 x	4.93 x	4.8 x	5.1 x	5.91 x
ROCE	**4.7%**	**9.2%**	**8.3%**	**2.4%**	**4.3%**	**8.2%**	**10.3%**	**17.0%**

Leverage

The repayment of debt created 14.3% value during LBO. Deleverage was mainly possible thanks to strong cash generation in 2008-2010, which is illustrated by healthy both interest and debt coverage ratios (Figure 41). At the onset of LBO, the PE firm did not use significant debt, as it only amounted to roughly 30% of overall transaction. However, the exact nature and funding of loan notes is not fully clear at it is possible that loan notes could have been covered to some extent by debt taken at the holding company level, which has not been disclosed in Poundland Holdings Limited's accounts.

Figure 41:Key debt KPIs for Advent's LBO of Poundland from 2003 to 2010

Ratios	2003	2004	2005	2006	2007	2008	2009	2010
Total debt / EBITDA	1.76 x	.95 x	3.24 x	4.73 x	3.94 x	2.2 x	1.21 x	.71 x
EBTDA / cash interest	3.52 x	4.61 x	3.6 x	1.95 x	2.23 x	3.62 x	5.62 x	16.63 x
EBTDA - capex / cash interest	2.02 x	1.78 x	1.11 x	-.24 x	1.31 x	1.74 x	3.1 x	8.94 x

On the basis of publicly available data, it could be concluded that as the company continued to generate cash, it has been taken through recap, which hiked the debt level in 2005 and put the

company in some difficulties in 2006 as shown by negative interest coverage ratio once Capex is deducted from EBITDA.

Overall, this LBO is not highly sophisticated in terms of debt usage in case of both PE firms. This could be motivated by its rather small size, as bonds became accessible only for the companies trying to raise over 200

Operational improvements

Similarly as in case of WP, during Advent's LBO, Poundland experienced significant revenue growth with CAGR of 29.8%, is 11.5 p.p. higher than revenue growth between 2010-2014. The high growth during Advent's investment could be underpinned by the fact that Poundland at that stage was early in its business cycle, whilst it has become entering maturity under WP.

Comparable to WP, the main driver of revenue growth in a case of Advent was openings of new stores. During 7 years of investment, Poundland more than tripled number of stores, from 80 in 2003 to 263 in 2010. The revenue per shop improved by 25%, i.e. from £ 1.5m / year in 2003 to £ 1.9m / year in 2010, which shows significant improvement in comparison to WP (see Figure 42). The potential hypothesis for the fact that in 2003-2010 years, it was much easier to find appropriate locations for Poundland stores and their overall density was not that high as in the subsequent years.

Furthermore, Advent was able to improved EBIT margin from 3.1% in 2003 to 4.2% in 2010. The fluctuations in EBIT are due to various capital expenditures and stock issues. For example, in 2006, Poundland incurred £1.6m of exceptional items costs due to the write down in the value of old legacy stock held at the year-end, which subsequently was sold at a loss post year-end. Events like those show the importance of proper inventory management in the retail business.

Figure 42: Key revenue KPIs for Poundland between 2003 to 2010

	2003	2004	2005	2006	2007	2008	2009	2010
Revenues (£ '000)	124,154	195,453	239,918	281,223	310,657	329,671	396,188	509,791
Growth		57%	23%	17%	10%	6%	20%	29%
# of Shops	80	101	121	147	152	167	207	263
Growth		26%	20%	21%	3%	10%	24%	27%
Revenues / Shops (£ '000)	1,552	1,935	1,983	1,913	2,044	1,974	1,914	1,938
Profit / Shops (£ '000)	32	31	18	(14)	(8)	11	23	49
EBIT margin	3.1%	4.4%	3.3%	0.7%	1.1%	2.4%	3.0%	4.2%
Growth		39%	-23%	-80%	70%	112%	23%	41%

Similarly as in 2010-2014 years, openings of new stores triggered an increase in number of employees. From 2003 to 2010, the number of employees almost tripled, which is commensurate with the extent of new shops opening (as their number also tripled). Consequently, neither Advent nor WP fits into myth of the PE firms that perform extensive redundancies during LBOs. Furthermore, Advent increased average salaries to its employees during LBO (see Figure 43), which could have boosted their performance as suggested by literature review (pp. 22-23).

Figure 43: Key employees' KPIs for Poundland between 2003 to 2010

	2000	2001	2003	2004	2005	2006	2007	2008	2009	2010
Number of employees	2,110	2,462	2,452	3,022	3,515	4,197	4,540	4,663	5,474	6,702
Administration	117	110	130	142	185	184	207	205	221	223
Selling and distribution	1,993	2,352	2,322	2,880	3,330	4,013	4,333	4,458	5,253	6,479
Aggregate payroll costs (£ '000)	19,169	22,262	24,860	29,909	37,285	44,481	49,205	53,168	63,265	78,180
Cost / employee (£ '000)	9.08	9.04	10.14	9.90	10.61	10.60	10.84	11.40	11.56	11.67

Management changes and packages

During Advent International's LBO, Poundland doubled an overall number of directors and brought multiple highly experienced execs. Those changes were crucial for growing business through product diversification and store expansion as those executives have brought needed experience and expertise.

On the day of the change of ownership of Poundland, 11 June 2002, Steve Smith – one of the co-founders of the business resigned from the role of director. On the same day, Colin Smith (not

related to Steve Smith) joined the Board as its Chairman, brining extensive retail experience from his position of CEO of Safeway Plc. In 2003, Cathy Ferrier joined as Trading Director and became responsible for buying, merchandising and promotions. She brought over 20 years of retail experience earned at the Burton Group, WHSmith and the Walt Disney Company where she was European vice-president for consumer products. However, she remained in the post only for a year. In 2004, Jim Maclachlan and Craig Bales joined the board as respectively Retail Operations Director and Property Director.

Major changes took place in 2005-2006 when Dave Dodd stepped down from the CEO and became Deputy Chairman, and finally resigned from any post at Poundland in May 2006. Jim McCarthy was appointed CEO in August 2006. He joined from J Sainsbury's plc where he most recently had served as Managing Director of Convenience. Before, he built up T&S Stores that were subsequently sold to Tesco Plc in January 2003.

Nick Hateley succeeded Rob Adams, Finance Director, in November 2006. Hateley had over 20 years experience in finance and business improvement gained at PwC, Accenture, Sainsbury's and Lucas Industries Plc. In October 2005, David Coxon joined the group as Buying and Merchandising director, having previously worked at Kwik Save and Allied Domecq, Mint group and Somerfield. The sales growth would not have been possible without such a seasoned team.

6. Conclusions

As has been indicated in the introduction, the purpose of this paper was to identify drivers of value creation in PE investments and then conduct case study to see how those drivers are identifiable in reality. In Section 4, I developed a theoretical framework, dividing drivers into pre-deal, during deal and post-deal levers, which I investigated on the basis of publicly available data in Section 5.

The main conclusion from both case studies and literature review is that operational improvements become more and more important in the LBO value creation process than it used to be. Whilst increased leverage boosted Advent's IRR through recap, it could be equally argued that low level of indebtedness allowed WP to secure highly attractive exit price at Poundland's IPO. Whilst it seems that both PE firms benefited greatly from the high sales growth potential of Poundland, it is interesting to note that a retailer managed to grow its revenues at double digit for over 15 years.

LBO transactions greatly reduce agency problems, through regime of debt and alignment of managements' and shareholders' incentives, and in that way, create value to investors. As both PE firms' cases depicted, the management team, and its proper compensation, is a crucial driver of a potential success. It is not only about the figure of CEO, but equally other directors are important. Their significance is even more visible when the LBO company plans to float, as both executive team and NEDs are scrutinised by potential IPO investors.

Limitations and propositions for future research

Whilst this paper managed to debunk some myths around mechanisms and strategies utilised by PE firms, I realise that making conclusions based at example of just one firm that underwent two LBOs contain many shortcomings. However, during my literature review, I noted that many researchers already use numerous databases to conduct empirical research on high number of LBOs. Those results often average well-performing and terrible PE firms, over concentrating on pure numbers. Consequently, I believe that the good way forward is to further investigate key success factors of why well-performing funds continue to deliver their success. Such investigation could take form of both numerical and descriptive studies.

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