ARMACELL - SCOTTO PARTNERS

LBO: WHAT ROLE FOR **MANAGEMENT IN THE NEGOTIATIONS?**

Armacell was recently taken over by PAI Partners and Kirkbi A/S as part of its fifth LBO, the third since the company's current CEO took up office. While certain factors can influence the situation, such as the top executives' track record and their weight in the capital, this kind of transaction demands real involvement by management.

INTERVIEW WITH
Patrick Mathieu, CEO, Armacell, and Isabelle Cheradame, Partner, Scotto Partners.

Armacell is an international firm specialising in thermal insulation materials, generating €650 million in revenue. It was recently taken over by PAI Partners and Kirkbi A/S as part of its fifth LBO, the third since you became the Group's CEO in 2012. What are the keys to a successful LBO?

Patrick Mathieu: An LBO will be a success if both the entry and exit are successful. But, for the exit to be a success, you need to start preparing for it at entry. Above and beyond the business plan, a whole set of scenarios that could upset the exit - such as a capital increase for instance - must be taken into account. Clear rules need to be defined with the shareholder fund. In this respect, advisors to assist the chief executive and shareholder-managers are vital.

Isabelle Cheradame: One of the main risks facing a chief executive, particularly in a primary LBO, is underestimating the complexity of the process, from the plan to sell the business through to closing the deal with a fund. This is often a period in which they get little sleep, because they must continue to run the company while conducting the process. If they are not prepared, the situation can be tricky to handle.

What exactly should the CEO expect?

P. M.: Very briefly, there are three, very different stages in the process. First, an agreement must be reached with the existing shareholder on the "equity story" to be told to potential buyers. At that point, the selling fund and the CEO's interests are generally more or less aligned. Then comes the time to select a fund out of the potential buyers, and their interests differ. While the owner fund wants to maximise its return by selling off the investment at the highest price, the CEO, who will remain in office, is in a tricky position: they must remain loyal to the majority shareholder, but they must also ensure that the valuation is justified. Otherwise, the company will be burdened with excessive debt which will weaken its business model. Once the future shareholder has been chosen, the final negotiations can begin.

During these different stages, does the CEO have a say?

I. C.: It all depends on the weight management carries in the capital and/or its ability to prove that its track record was an asset in the transaction's success. In the case of a sale, top managers really are the best "reps". In this case, the seller will be encouraged to opt for a concerted sale process.

P. M.: As a CEO has a duty of loyalty to the majority shareholder, as mentioned above, it is difficult for them to be involved early in the process. They generally get

to have a say and present their arguments towards the end.

If the seller receives several firm bids, what objective indicators, if any, are used to choose the right fund?

P. M.: During the three sales I've experienced at Armacell, around fifteen funds have generally shown interest. When the seller receives firm offers, I have seen from experience how complicated it is to compare them. It's also difficult to tell whether one fund will be the best one to support us through the next LBO. There have been many transfers between private equity fund teams in recent years. So, whether the management company is European or American, their approaches today are often very similar.

I. C.: In the past, the approaches taken by these American and European funds did differ. Although this is less the case now, different funds do have different "corporate cultures". Today, the fund's size is a more important factor: the bigger it is, the more safeguards it will tend to want, under pressure from its own investors, its Limited Partners (LPs). And this can ultimately be an advantage for the CEO.

P. M.: It is true that LPs now tend to carry out more thorough due diligence, and particularly to ask for references about the current and past management of their investments by large funds. Therefore, the bigger the fund, the more concerned it is about its reputation. In this case, with the right guarantees, the CEO can be more confident about the future cohabitation.

What other criteria can a CEO rely on?

P. M.: I personally pay particular attention to the time each bidder spends on the buyout process. Some funds really try to understand the company's business in detail. Others, however, simply outsource this analysis to their service providers. This should sound the alarm bell for the CEO. Not all funds work in the same way, and the differences can quickly be seen.

I. C.: To me, it is vital to draw up a term sheet during this stage, in order to clarify a fund's position and philosophy. This is a contractual document, so it also ensures that verbal promises will be fulfilled after the closing. It therefore helps to avoid misunderstandings and disappointment.

It takes several months from a group being put on sale through to its takeover by a private equity fund. Isn't this time-consuming process sometimes detrimental to the actual running of the company?

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Above: Isabelle Cheradame, Partner, Scotto Partners, and Patrick Mathieu, CEO, Armacell.

P. M.: The time between the moment the company goes on sale and its takeover by the new majority shareholder is usually quite long, generally several months. If the whole management team takes part in each step in the process, there is indeed a risk of partly neglecting the running of the business with potential impacts on results. This would be a very problematic scenario if it led to a lower performance during the first year after the LBO than forecast in the business plan. This situation can jeopardise both the company and its staff. To avoid the pitfall, only my CFO and I are involved in the transaction from start to finish, so that the other managers can focus exclusively on operations for as long as possible.

What is your position as regards management's participation in the group's capital?

P. M.: Several factors are important in this respect, particularly the size and culture of the company. Armacell has around thirty shareholder-managers. I am not in favour of the very French tendency to have a lot of shareholder-employees. The more there are, the lower their individual investment is. So, at best, the company's managers can only expect a small return and, in the long run, it can affect their motivation to achieve or exceed the targets set. To my mind, there is little point having a lot of employees who hold a capital stake because, given the limited size of their holding, they play a completely passive role in the company's governance. Lastly, over the duration of an LBO, these shareholder-managers regularly change. As these situations are never easy to manage, I think it's better to reduce the likelihood of having to deal with them by opting for the smallest possible internal shareholder base. At Armacell, I have always tried to involve people whose responsibilities mean they will have a real impact on profit and loss.

I. C.: On top of the company's size and culture, this also depends on the business sector and the social environment. In France, I think people expect value creation to be shared as much as possible. It also depends on how willing managers are to invest their own money, and this differs considerably from one country to another. It is interesting to note that in France, groups often have fifty or a hundred investor-managers, compared to only ten or twenty elsewhere. The effects that Patrick mentioned are important and we discuss the pros and cons in advance, so that the CEO can make the right decision for the organisation.

Between managers who don't necessarily understand all the ins and outs of an LBO, those who have little money to invest and the others, what must a CEO do to convince them?

I. C.: First, it's important to remember that, legally speaking, a CEO may not take the initiative of encouraging certain employees to become shareholders. In this context, it is complicated, not to say dangerous, for the CEO to present the potential gain (which can sometimes be very high) and therefore the financial advisability of such an investment. And simply explaining the risks of losing money and the tax aspects is neither motivating nor reassuring.

P. M.: To remain objective, I use legal and financial advisors to present the advantages of investing and the various risks inherent in the investment. After that, the approach will differ depending on whether the manager is a first-time investor or already a shareholder. In the case of a first-time investment, at Armacell, we limit the amount to three months' salary. For managers who reinvest, they generally allocate half of the net gain made on the previous LBO. That way, they can show that they are prepared to be fully involved in the company's next development stage and hope to receive a significant share in the profits if the business plan is achieved.

I. C.: It's important to build a management package that makes employees feel confident. Insofar as they invest a part of their own money, they must be convinced that the gain is within their reach, but the package must also meet the demands of a sponsor: there can be no guarantee of a gain for managers, which would also raise tax issues. It's all a question of striking a balance.

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