WERE 'CLUB DEALS' IN PRIVATE EQUITY REALLY A GOOD IDEA?

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One of the features of the 2004-2007 LBO wave have been well-publicized buyouts of very large corporations by syndicates of PE firms, called 'Club Deals'. (add table with examples of largest deals, their buyers and current status – get from VE). In a typical Club Deal, 3-4 of the world's leading PE Firms joined forces (in terms of capital and skills) to acquire targets of values that had not been seen since the RJR Nabisco deal by KKR in 1989. The formation of these clubs was justified by the PE Firms with the rationale that it made it possible to have access to a presently unexploited pool of target companies, i.e. those of the mega-deal size category.

The proliferation of 'Mega' Club Deals triggered a bizarre public policy debate in which PE Firms were accused of 'collusion', as forming the clubs would limit competition for possible targets and thus deprive the existing shareholders from additional gains through otherwise even-larger takeover premia. At some point, even US antitrust authorities looked into the issue.

More justified concerns have been made by the community of Limited Partners (LP). They saw Club Deals with some concern: Most LPs tried to diversify their PE portfolio through allocations to a number of GPs – and this effect was removed if now several of these GPs pooled their capital in a joint deal. In addition, many LPs appreciated the short and fast decision making processes in Private Equity,

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especially when compared to the governance of publicly traded corporations. There were worries that Club Deals brought more parties to the table and hence lead to longer and more complex decision making processes. It was easy to imagine conflicts between the different PE Firms about how to manage a joint investment, especially as many of the protagonists of these firms were well-known for their strong leadership skills – not to say Ego. The fact that participating funds in a Club Deal were often at different stages of their life and had hence conflicting interests regarding the investment horizon and optimal exit time made those conflicts even more likely to occur.

While the credit crunch basically shut down the Mega Club Deals activity, PE Firms still find themselves with a number of Club Deals in their portfolio and many investors ask themselves the question "what future performance should one expect from them"? It is clearly impossible to given an accurate answer at this point. However, a look at the historic performance of Club Deals enables us to see whether and under what circumstances Club Deals have been successful in the past. Few people are aware of the fact that Club Deals are not a new phenomenon. The first joint deals happened when LBO activity first rose on importance (list 2-3 of the first joint deals). Looking at over 10.000 US LBOs made between 1980 and 2000, we compared deals made by a single PE Firm to 'Club Deals' with respect to their suc-

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cess rate, i.e. the likelihood of a successful exit (IPO or Trade Sale) within 5 years after the acquisition.

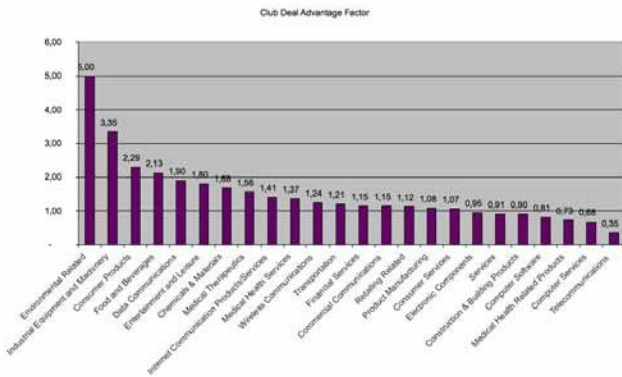

Figure 1: Club Deal Advantage by Industry

Our results clearly reveal the advantage of Club Deals. Overall, these are 30% more likely to have a successful exit within 5 years than solo-investor LBOs ($p<0.001$))1. This is consistent with the view that the acquired businesses benefit from the combined broader network and combined expertise of multiple PE firms. Moreover, we find that the size of the 'Club' has a positive effect, in the sense that the exit success rate of deals made by larger clubs increases further, in particular are the percentage of bankruptcies decreases with large clubs. This may be attributes to a more effective due diligence performed by multiple parties, or to the larger combined network of large clubs that helps create exit opportunities.

At the same time we see that Club Deals were not always the better option. As **Figures 1**[2] shows, Club Deal buyouts made in the sectors such as Environmental Related, Industrial Equipment and Machinery, Consumer Products and Food and Beverages were more than twice as successful as non-Club Deal buyouts in these areas. On the other hand, Club Deals were substantially less successful in the sectors Computer Software, Medical Health Related Products, Computer Services and Telecommunications. **Figure 2** highlights that investors not necessarily focus their club deal activity on those sectors in which club deals are most successful.

2 The Club Deal Advantage is the factor by which club deals on average lead to a more successful exit than non-club-deals

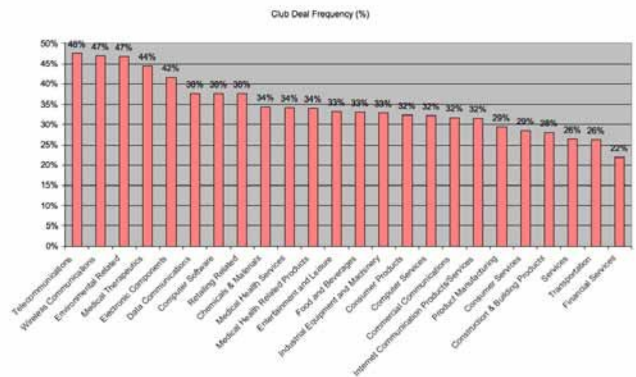

Figure 2: Club Deal Frequency by Industry

Similarly, Club Deal buyouts made in Missouri, Michigan or California more than twice as successful as non-Club Deal buyouts in these states, while Club Deals made in Connecticut, Tennessee, Wisconsin or Colorado were substantially less successful than non-Club Deals (**Figure 3**). It is further interesting to observe that Club Deal buyouts were particularly more successful than non-Club Deals during years that precede times of economic downturns. **Figure 4** shows that this holds true, for example, for the deals made in 1988, 1989 and 1999. This suggests that buyouts may benefit from their investing 'Clubs' in the current environment as well.

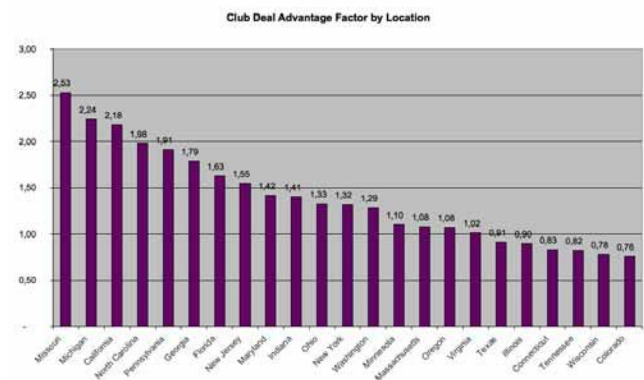

Figure 3: Club Deal Advantage by State

However we also observe that the very large buyouts do not benefit from the positive effect of the 'Club' investing. This finding is of particular relevance as the recent wave of Club Deals took place in the mega deal-size category. If the positive effect of club deals diminishes when deals become too large raises some concerns about their expected performance. It is also interesting to observe that 'Star Firms', i.e. PE Firms with a superior average historic exit

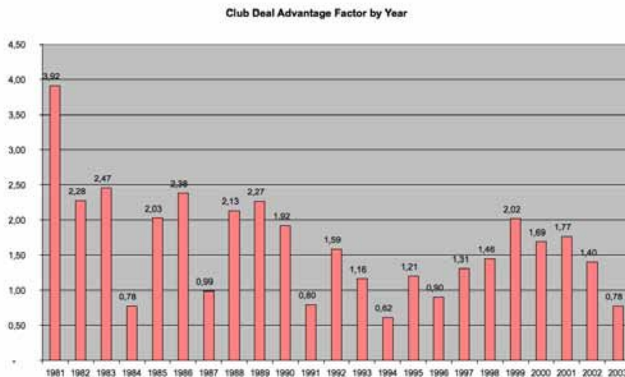

Figure 4: Club Deal Advantage by Year of Investment

success rate fail to benefit from Club Deals. It seems as if the best PE Firms are better of making deals alone and without the watered-down decision making processes that take place when less sophisticated investors are also sitting at the table.

In a last step, we analyzed the impact of making club deals on the performance of the investing PE funds. In general, fund performance is correlated with exit success rates, but the relationship is not perfect. Surprisingly, we observe that having a higher proportion of club deals in a fund does not increase the fund's performance – despite the higher ration of successful exits. In other words, equity investors do not benefit from the club deal effect. This may be an indicator of coordination problems around the exit decision between the different funds. For example some funds may be pushing for a pre-mature exit (due to pressures related to the funds' life-cycle), so that the exits are less profitable for the PE firms.

In summary, we find that club deals are good for the acquired businesses as they increase the likelihood of a successful exit. However, these advantage does not apply to all deal types and in particularly not to the very large transactions. It is also noteworthy that club deals do not increase fund IRR, which may be an indicator of coordination problems between the investing funds.

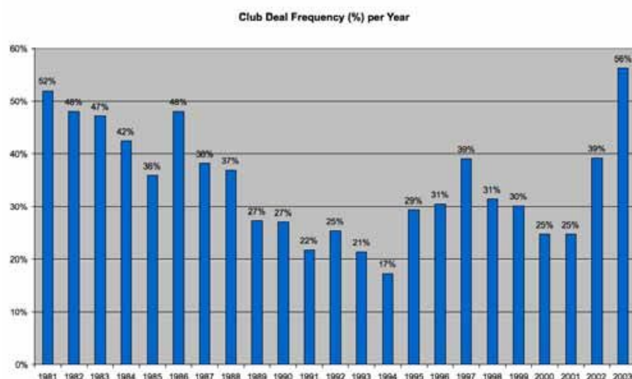

Figure 5: Club Deal Advantage by Year of Investment

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