Dividend Recaps and IPO Proceeds

The Untold Story of Bain Capital's Financial Success

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In the wake of Mitt Romney's ongoing presidential campaign, the Private Equity industry has come under heightened scrutiny. After all, Mr. Romney's past and personal (financial) success are firmly rooted in this industry. As co-founder, general manager and master brain of Private Equity powerhouse Bain Capital, he helped build the industry as it is today. And, according to some of his enemies, this industry is a nasty one: Mr. Obama's campaign accuses Bain Capital of closing hundreds of stores of KB Toys (Washington Post, 07-14-2012), Newt Gingrich accused him of "looting" companies and "leaving behind 1,700 unemployed people" (CNN Money, 01-10-2012), and Rick Perry went as far as slating the whole industry by saying that there is „something inherently wrong when getting rich off failure and sticking it to someone else is how you do your business." (CNN Money, 01-10-2012).

As a consequence of this debate, there have been some recent efforts of journalists, politicians and the voting public to better understand the Private Equity industry's business model and to evaluate Bain Capital's and Mr. Romney's partake in it. A most prominent example is a recent Wall Street Journal article on the survival rate of Bain's portfolio companies (Wall Street Journal, 01-09-2012). Other examples include anecdotal evidence on individual deals Mr. Romney was actively engaged in, either showing how he destroyed jobs and killed the companies (the Democrats and Mr. Obama's camp), or showing how he built businesses and created jobs (the GOP and Mr. Romney's camp). The great pity in this discussion is that the used arguments are either strongly biased, outright false or made in the wrong context because of a lack of insight into the world of Private Equity. In contrast, Mr. Romney's big advantage is the opacity of the Private Equity industry which prevents critics from making a strong and, more importantly, more informed evaluation of his and Bain Capital's role in economic welfare contribution. As the elections draw closer the impression might arise that even informed voters still lack sufficient knowledge about Mr. Romney and his business past to fully evaluate whether or not they would want him to run their country over the next four years.

It is the goal of this article to weigh in on the discussion regarding the benevolence of Bain Capital and its contribution to economic welfare by presenting actual facts of the way Bain Capital made money from some of its investments. In particular, we will present four examples of one very specific method Bain Capital applied to generate returns for itself and their funds' investors. The examples show that Bain Capital repeatedly funded dividend payments they received from their investment companies through these companies' debt, and that they used the proceeds from the same companies' stock offerings to repay this debt. Our evidence suggests that Bain repeatedly loaded portfolio companies with debt to fund cash dividend payouts to their investors. As a consequence of this scheme – in the Private Equity lingo sometimes referred to as "Dividend Recap", short for dividend recapitalization - the investment companies were stripped off cash, highly indebted, and unable to use the IPO proceeds as investments in their operating business to grow, create jobs, and contribute to economic welfare. As this aspect of the Private Equity business model is lesser known to the general public it has so far not come up in the most recent discussion. However, we believe that it is perhaps of interest, especially when it comes to evaluating the economics by which Private Equity firms, in this case represented by Bain Capital, do business.

One thing should be clearly stressed: by no means does this study attempt to answer the question of whether or not Private Equity firms, or Bain Capital in particular, are “good” or “bad” (whatever that means!), and if they create or destroy jobs. These questions are complex and we believe that the jury is still out on it and will be for a long time to come. Instead, it is the goal of this study to present selected facts of the way Bain Capital made money from its investments.

The basics: the Private Equity business model in a nutshell

The Private Equity business model is simple: a group of business women or men collects money from outside investors (like pension funds, mutual funds, banks or wealthy individuals), and uses this money to purchase ownership stakes in public or private companies. Following the acquisition, the Private Equity managers as new owners restructure the purchased firm in a variety of ways. The goal of the restructuring is to increase the overall value of the company and thereby to increase the value of the Private Equity firm’s stake in the company. This stake can then be sold for more money than it was originally bought for – that is, given the restructuring was successful and economic value was created. Regarding the terminology: in a nutshell, ‘Restructuring’ means that the Private Equity managers turn every stone in the company to reduce costs and contemporaneously increase sales. The most popular restructuring methods are to replace pre-existing management (which might have run the company inefficiently), sell off loss-making assets (like certain products which don’t sell well), cut costs (by laying off employees or closing stores), or merging the acquired company with another company to make use of so called ‘synergies’ (like having only one IT department for two companies instead of two). To keep it simple, imagine that the ‘economic value’ which is created as a result of this process is nothing but higher cash earnings per sold product. Now, based on this nutshell business model, the Private Equity managers, company managers and all other employees of the company want the same thing: to create ‘economic value’. After all, a company which produces at lower cost and sells more products is healthier. Additionally, the Private Equity firms can sell their ownership stakes for more cash than they originally purchased it, and generate return on investments for their investors and an income stream for themselves.

The untold story behind the private equity business model

However: the nutshell business model laid out above is only half the picture. Although Private Equity firms can create 'economic value' in the companies they purchase, their primary goal is not creating jobs or making distressed companies healthier. Instead, their primary goal is to generate returns for their investors. Of course, returns can be created through restructuring companies, creating economic value and thereby increasing the value of the companies' stocks. But there are also different methods to generate returns, some of which do not directly benefit the economic value of the portfolio company. One of these methods, which is commonly referred to as 'Dividend Recap', will be described below in more detail.

Burger King went public in a May 2006 IPO. Bain Capital, Goldman Sachs, and the Texas Pacific Group had bought the company three years earlier in December 2002. As each of the three Private Equity companies held roughly a third of the outstanding shares and a number of board seats at the time of the IPO, it can be assumed that the involved Private Equity firms' managers were essentially at the helm of the company when it went public. In the years leading up to the IPO, Burger King was involved in a number of recapitalizations, i.e. transactions in which the company's (mostly debt) funding was either renewed or restructured. Among these recapitalizations were two loans incurred in July 2005 (a so called "Term Loan A" worth $250 million, and a $750 million "Term Loan B") as well as an additional borrowing made on February 26, 2006 under the same credit facility as the July 2005 loans worth $350 million (so called "Term Loan B-1"). Of special interest to us is the last borrowing, the "Term Loan B-1", which was made three months before the IPO date. According to the IPO offering prospectus and the debt descriptions therein, the proceeds of the Term Loan B-1, which at the time represented about 15 percent of the company's total assets or about a quarter of its revenues, were pooled with an additional cash amount of $50 million to pay out a dividend of $367 million to the existing shareholders. As Bain Capital held about 31 percent of the outstanding stocks at the time of the dividend, they received about $113 million in gross proceeds from the dividend payment. One interesting thing about the dividend payment is that under the original bond indenture (an indenture is the "contract" between the lenders and borrowers), Burger King would not have been allowed to pay out the dividend. To be able to do so, Burger King amended the original indenture with a special permission for this dividend payment. This effort might be a sign of how eager the Burger King owners were to receive the payment at the time.

Now, since the borrowed money was essentially given away "for free", the interesting question is: how was the loan repaid? This is where the IPO comes into play. The official SEC stock offering prospectus (made as a so called "424B-filing", available through the SEC's public EDGAR website) of Burger King states that the company issued 25 million shares at a price of

$17 a share. This equals gross proceeds of $425 million, and a stunning $393 million in net proceeds post expenses and fees. In plain English: by going public, Burger King raised almost $400 million in cash. How would this money be used? Classic finance theory would tell you that companies raise this money to make investments with a positive net present value, i.e. spending money on projects that return more than the initial cost of the project. This is a noble goal, companies and whole economies grow based on this notion. Yet, Burger King didn't exactly do that. On page 28 of the offering prospectus, Burger King explains that "We expect to use a significant amount of the net proceeds to repay $350 million in outstanding amounts under the term loan A and the term loan B-1 […] that were incurred to finance, in large part, the February 2006 dividend of $367 million, which was paid principally to the private equity funds controlled by the sponsors […]." The report goes on to say that "As a result, a significant amount of the proceeds of this offering will not be invested in our business." Connecting the dots on these various financial transactions goes to show that Burger King performed a simple cash exchange: obtaining cash through a loan (in this case a syndicated loan made, among others, by JP Morgan Chase, Citigroup, Bank of America, Wachovia, and RBC Capital Markets), paying out this cash to the invested Private Equity firms (Bain Capital, Goldman Sachs and Texas Pacific Group), selling own shares through an initial public offering, and using the cash from these share sales to repay the loan.

How can this transaction be interpreted? Although legally impeccable, from a purely economic welfare perspective these transactions are difficult to evaluate. It is common knowledge in the finance community that private equity firms pay themselves one-time cash dividends before exiting their portfolio companies. Both stock- and stakeholders seem to generally accept this practice. And per se, this part of the transaction is economically justifiable. The Private Equity firms are (most of the time sole) owners of the companies and can do with them whatever they deem right or necessary. Paying a dividend is part of the going concern process of any company, all Fortune 500 companies do so on a regular basis and many investors rely on these payments to make their investment financially worthwhile. However, dividends are usually paid for by excess cash: the company generates revenues, pays all costs, pays taxes, makes investments in new projects and uses the remaining cash to pay their owners a dividend. As Burger King itself notes in the (same!) share offering prospectus: post IPO dividends to the shareholders of the newly issued common stock "[…] depend upon such factors as earnings levels, capital requirements, our overall financial condition and any other factors deemed relevant by our board of directors." (Section "Dividend Policy", page 28). In plain English: we'll only pay a dividend if there's enough free cash to do so. This statement seems strange as it could very well be argued that funding a dividend through a loan is almost contradictory to that. Also, are dividends for Private Equity firms governed by a different set of rules than dividends for post IPO stockholders? But there's even more to that: not only do the "new" shareholders receive their dividend only if Burger King's board of directors deems the company fit enough to hand out such cash, the money these new post-IPO shareholders pay for the newly issued shares is directly used to repay the loan which was originally used to pay the pre-IPO shareholders (the Private Equity firms) their dividend. As stated above, the major economic goal of any IPO is to obtain cash which can be invested in profitable projects which in turn help the company (and the economy as a whole) grow. As Mitt Romney himself once put it: the business approach of Bain Capital was to "try to build a business" (Wall Street Journal Online, wsj.com, 01-09-2012). Without judging what exactly it was that Bain Capital did as part of the Burger King investment, "building a business" is perhaps hard to argue for.

Bain did the exact same transaction in three additional IPO companies they were invested in over the years 2004-2006. First, there was Domino's Pizza in 2004. Bain Capital was the majority owner of the pizza chain, holding 64.2 percent of all stocks. The IPO took place in July 2004 and generated net proceeds of $119.3 million. As in Burger King, the stock offering prospectus (the 424B filing) states that these proceeds were used to pay back $109.1 million in debt (a so called "8 ¼ percent senior subordinated note" – a corporate bond). This bond was issued on June 25, 2003, about a year before the IPO. The official notice of this bond offering (a so called "8-K filing", another official SEC document publicly available through SEC EDGAR) states that almost half of the proceeds from this recapitalization ($188.3 million of a total volume of $403 million) are used to pay a one-off dividend to the existing shareholders at the time. As Bain Capital held 64.2 percent, the math can be done: Bain got paid an approximate $120 million. The second case is Innophos Holdings, an IPO from November 2006 in which Bain Capital held 98.5 percent of the shares. $86.3 million were raised from the IPO and, along with additional cash of $47.1 million, used to repay the $120 million of a "Floating Rate Senior Note" issued in February 2005 which funded a payment to the shareholders of so called "Class L Common stock". The IPO prospect tells us: that's Bain Capital.

Dividend Payments and Sources of Funds:

	Burger King	Domino's Pizza	Warner Music	Innophos
Net IPO Proceeds 1)	$393 million	$119.3 million	$517 million	$86.3 million
Dividends Paid to pre-IPO Shareholders	$367 million	$188.3 million	$472 million (labeled as "return of capital") 2)	$115.6 million
Debt Used to Fund Dividends	Loan: ("Term Loan B-1") under existing credit facility on February 26, 2006 worth $350 million	Corporate Bond: ("8 ¼ senior subordinate note") issued on June 25, 2003 raising $403 million (actually $400.1 million after expenses)	Corporate Bond: ("Floating Rate Senior Note", "Floating Rate Senior PIK Note" and "Senior Discount Note") issued on December 23, 2004 raising a total of $700 million.	Corporate Bond: ("Floating Rate Senior Note") issued in February 2005 raising $120 million (actually $115.6 million after expenses)
Interest on Debt Used to Fund Dividends	Approx. $5.7 million 3)	Approx. $1.1 million 4)	Approx. $14 million 5)	Approx. $13.1 million 6)

1) Gross IPO proceeds without all fees and expenses (as stated in the stock offering prospectus)

2) In more detail, here's how it works: they pay a dividend on the Class L Common Stock of $422 million and pay an aggregate of $50 million in dividends
on the Class L Common Stock using the proceeds from the offering of the Holdings Notes, of which $42.5 million was paid on March 28, 2005 and the remaining $7.5 million will be distributed to the Investors prior to this offering (page 44 in the prospectus)

3) Calculated using the 6.5 percent interest rate as stated in the offering prospectus (page 28) for the period 2006/02-2006/05, multiplied by the outstanding debt amount of the loan

4) Taken from the stock offering prospectus (page 23)

5) "Floating Rate Senior Note" taken from the stock offering prospectus (page 32, footnote 5), "Floating Rate Senior PIK Note" taken from stock offering prospectus (page 32, footnote 5). Total costs for "Senior Discount Note" are unclear: interest rate is 9.5 percent, but cash interest payments are only made starting on 12-15-2009, i.e. after the Private Equity firms ended their investment in the company

6) Taken from the stock offering prospectus (page 43)

A more complicated version of the same method was used in the last case, Warner Music Group. The IPO was in May 2005, Bain held 20.8 percent of the stocks before the public offering. The IPO netted $517 million in cash. It was used to pay back debt which had been incurred to pay cash to the investors, including Bain Capital. The prospectus reads: "Warner Music Group Corp. intends to contribute all such net proceeds to Holdings as an equity capital contribution. Holdings will use all of these funds and an amount of cash received as a dividend from Acquisition Corp. to redeem all outstanding Holdings' Floating Rate Senior Notes due 2011, all outstanding Holdings' Floating Rate Senior PIK Notes due 2014 and 35% of the aggregate principal amount of the outstanding Holdings' 9.5% Senior Discount Notes due 2014, including redemption premiums and interest obligations through the anticipated dates of redemption." Basically, what is described here means: (1) Warner Music Group goes public, (2) the only business of Warner Music Group is to fully own a company ("Holding") which in turn fully owns another company ("Acquisition Corp.") which in turn bought Time Warner's music business division in 2004, (3) the $517 million in cash made through the IPO are given from Warner Music Group to their wholly owned subsidiary "Holdings", (4) "Holdings" uses this money, along with some other cash they get from the third involved company, "Acquisition Corp." to repay three different corporate bonds which are jointly worth $700 million. What was the purpose of these bonds? Issued on December 23, 2004 the cash from the bonds was paid out to investors. Some of the money was used to repurchase shares from investors ($209 million), some of it ($472 million) was used to pay a "return of capital" (page 5 in the 424B filing), and some was just "distributed" to shareholders. You see the difference here: instead of paying flat out "dividends", they resort to calling it "return of capital" payments and "distributions". But even though the wording might be misleading – after all, a return of capital could also mean a redemption of the shareholders' stocks – what they pay out and label as "return of capital" is simply a dividend (as stated on page 44 of the prospectus). Regardless of what you call it, Bain did nothing else than loading a company with $700 million in debt, repaying the debt with the IPO proceeds, and hence using neither the debt proceeds nor the equity proceeds to advance the company's business.

In evaluating these transactions it cannot be disregarded that debt usually comes at a cost: interest payments. All official documents filed with the SEC contain the interest payments made for the above mentioned bonds and loans. Making a conservative estimate of the joint payments the companies had to make to all debt lenders shows that the dividends to the Private Equity investors cost the companies a combined $33.9 million. A stunning sum, given that the costs for the IPOs which were needed to repay the debt are not even included in it.

Finally, we can come back to the actual financial success of Bain Capital and the role that the "Dividend Recap" schemes played in it. As described in the nutshell business model above, Private Equity firms generate investor returns through the sale of the ownership stakes they hold in their investment companies. So, to which degree do the dividend payments actually contribute to the overall return that Private Equity firms make from their investments? Although Private Equity firms don't publish the exact return numbers from their investments, we can make an educated guess about the cash generated from the share sale transactions. Collecting and running the numbers on mandatory SEC data of Bain's post-IPO share sales tells us: for Burger King, Bain generated an estimated $747 million from all share sales at and after the IPO. For Domino's Pizza, Warner Music and Innophos, the estimated share sale proceeds were $437.7 million, $198 million and $261.6 million, respectively. This means that the dividend payments contributed strongly to the overall cash which was made from these investments (of course we don't know anything about the purchase price, associated costs, taxes etc. so that we forego an analysis of the return the investments yielded). For Burger King, the dividend was about 13 percent of the overall cash, for Domino's Pizza it was 21.6 percent, for Warner Music it was about 33.1 percent and for Innophos it was 30.3 percent. In conclusion it can therefore be said that the Dividend Recap schemes contributed strongly to the financial success of Bain Capital.

<u>The Contribution of Dividend Recaps to Bain's Financial Success:</u>

	Burger King	Domino's Pizza	Warner Music	Innophos
Bain Ownership Stake 1)	31 %	64.2 %	20.8 %	98.5 %
Pro Rata Dividend Received by Bain 2)	Approx. $113.7 million	Approx. $120.9 million	Approx. $98.2 million	Approx. $113.9 million
Proceeds from Sale of Ownership Stake 3)	Approx. $747 million	Approx. $437.7 million	Approx. $198 million	Approx. $261.6 million
Percent of Dividend in Total Cash Earnings from Investments 4)	13.1 %	21.6%	33.1 %	30.3 %

1) The ownership stake numbers are taken from the stock offering prospectus as filed with the SEC and published on the SEC website

2) The pro rata dividend payments are the percentages of the overall paid out dividend (the dividend paid as part of the "Dividend Recap Scheme" only) Bain received in accordance with its ownership stake

3) The proceeds from the ownership stakes are calculated using the volume and price of each share sale transaction of Bain Capital in which Bain sold shares in the respective companies either at or following the IPO (obtained through S-4 filings of the SEC)

4) The percent of dividend in total cash earnings from Investments is calculated as the percentage of the "Dividend Recap"-dividend of the overall cash proceeds from the transaction (proceeds from sale of ownership stakes plus the dividend)

All numbers are conservative estimates as we do not include other dividends, pay-outs or fees Bain Capital might have received as part of their investment in the companies.

What does that tell us?

So, what do all these numbers and figures tell us? Or, more importantly, what do they tell us about Mitt Romney and Bain Capital? For a start, it should be noted that all of the above mentioned deals took place after Mitt Romney left the active management of Bain Capital. Mr. Romney himself was most probably not involved in the deals and did not partake in any of these activities. However, it should also clearly be noted that in spite of Mr. Romney's lack of active involvement in these deals, there are clear indicators that he benefitted from them financially. Mr. Romney himself and his wife Ann's Trust Fund had been invested in those exact Bain Capital-run funds that financed the acquisitions of the mentioned portfolio companies. Consequently, all profits the portfolio companies generated - of which the dividends were part of - were distributed to the funds whose money purchased them. As Mr. Romney was an investor in these funds, he therefore directly benefitted from the special dividends.[1] So, at least a part of Mr. Romney's personal wealth can be attributed to these transactions.

Finally, it should be stressed that it was not only Mr. Romney who came under attack in the recent debate for being 'Private Equity', but the industry as a whole. Based on the presented evidence, some of the criticism the industry faced was perhaps justified – even though it was slightly misdirected and based on wrong or misleading facts. The Private Equity industry is about generating returns for their own investors. At times, these returns are not generated solely from growing companies or building businesses. However, in a full-fledged evaluation of these transactions and the industry as a whole it must also be borne in mind that public and private pension funds, sovereign wealth funds and insurance companies are also among the group of Private Equity investors. The generated investor returns therefore also benefit 'public' money and retirement savings.

[1] The IPO filings contain the names of the Bain Capital-run and -managed funds that held the stakes in these corporations. At Innophos, for example, the names of the Funds were "Bain Capital Fund VII LP" and "Bain Capital Fund VIII LP". Pairing these filings with two additional (publicly available) sources allows us to determine which of these funds Mr. Romney invested in. The Massachusetts State Ethics Commission published two reports in 2001 and 2002 which list all personal assets held by Mr. Romney at the time. Among these assets are stakes in the Bain Capital Funds IV (16.5 percent), V (5.15 percent), VI (4.59 percent – the fund owning Domino's Pizza), and VII (4.059 percent – the fund owning Burger King, Warner Music and Innophos). Another document, called the "Executive Branch Personnel Public Financial Disclosure Report" from the years 2006, 2010 and 2011, confirms that Mr. Romney and/or his wife Ann's Trust Fund also held stakes in the funds in these years. Combining the IPO prospectuses with these filings shows the connection between Mr. Romney's personal wealth and the special dividends of the portfolio companies. He most directly benefitted from them in the case of Burger King, which paid out the dividends in 2006 – a year in which Mr. Romney held shares in the respective fund the dividend was paid out to.

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