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The Leveraged Buyout of Inwido – Capital Structure

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Abstract

This work project was conducted by three students and takes the form of an Investment Committee Paper proposing the leveraged buyout of Inwido, a Sweden-based company that operates, manufactures, and sells windows and doors across Europe. The company was valued at an 8.4x EV/EBITDA multiple and is set to be acquired under an earnout, with 80% of the equity being paid at entry and 20% in 2025. Under the proposed business plan, the investment case yields an IRR of 26.3% and a MM of 3.8x. The individual contribution elaborates on the process of defining the capital structured of Inwido's LBO.

Keywords: Private Equity, Leveraged Buyout, Valuation, Window and Doors, Inwido

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Company Profile

Inwido is a leading European supplier of windows and doors. Founded in 2004 and headquartered in Malmö, Sweden. The company consists of 33 business units (independent portfolio companies) with approx. 4,900 employees. These units are divided into four business areas: Scandinavia, Eastern Europe, Western Europe, and e-Commerce. It is present in twelve countries across Europe, with operations in Denmark, Estonia, Finland, Germany, the Netherlands, Ireland, Lithuania, Norway, Poland, Romania, Sweden, and the UK.

Inwido offers a wide range of windows and doors tailored for residential and commercial applications, where the core focus lies in the manufacturing and distribution of high-quality fenestration products designed to enhance energy efficiency. As a market leader, it positions itself as a pioneer in the field of energy-efficient building components. This includes incorporating advanced materials, smart designs, and innovative construction techniques to improve insulation, reduce heat loss, and contribute to overall energy saving. By enhancing energy efficiency, Inwido differentiates itself in the market being a provider of solutions not only meeting functional needs but addressing broader societal and environmental concerns too.

Business Model & Value Creation

Inwido's strategy rests on 4 cornerstones, (1) a decentralized structure that drives customer and result focus, (2) focus on consumer-driven markets for profitable growth, (3) sustainable growth improved through acquisitions, and (4) synergies that drive structural developments.

One of the key concepts in the firm's strategy is decentralization. Each business unit is independent and makes its own decisions, tailoring its strategies based on local conditions and retaining full responsibility for business operations and financial outcomes. Given the inherent disparities among markets in the industry, with distinct variations in methods, lifestyle, regulatory frameworks, seasonal patterns, and consumer preferences, successful navigation requires a close understanding of the specific market dynamics. The revenue process involves customizing products to meet the unique demands of individual customers, often sold before the actual manufacturing process. Central support functions in Inwido provide strategic assistance in areas such as purchasing, digitization, and leadership, increasing decision-making effectiveness. The streamlined decision-making process allows the group management to remain solid, fostering insights, synergies, and economies of scale, where the outcome is an agile and efficient group that can quickly adapt operations to demand fluctuations in their markets, with supported customer relations.

Acquisitions are an important driver of Inwido's growth strategy. Evaluating potential candidates involves criteria considering factors such as profitability, local market position, and alignment with the group. With a track record of approx. 50 successful acquisitions, Inwido has gained valuable insights into fostering the growth of acquired companies within its portfolio. Synergies derived and developmental opportunities realized within the group have proven transformative for these entities. The acquisition process involves a thorough examination of mature, cash-flow generative European windows and doors companies, and their market conditions.

Product Portfolio

Inwido's 33 business units deliver a wide range of different products in the fenestration category. They cater to both the premium market as well as to the middle range and value products, while each business unit designs and produces its products, often custom-made to each client there are a few overall general features that are consistent. The biggest category is windows followed by doors, a few companies also produce conservatories and other accessories on a smaller scale. Windows are split into four main materials; uPVC, aluminum, wood, and composite. Each with its distinct benefits and features, from price, insulation, and design, and often with strong geographic preferences. Doors are produced in a wide range of materials including aluminum, wood, glass, and steel.

Management Team

The management team has been led by Henrik Hjalmarson (CEO) for the last 6 years, together with Peter Welin (CFO & Deputy CEO). Together they have restructured the operations of the senior management team, where they have brought in four Executive Vice Presidents (EVP) to be responsible for one business area each, Scandinavia, Western Europe, Eastern Europe, and e-Commerce. This allows the CEO and CFO to focus on the long-term strategy and acquisitions while the EVPs follow up on the existing portfolio companies. Mr. Hjalmarson has decided to step down as CEO and Fredrik Mueller has been recruited as successor, he is expected to start no later than May 2024. Mueller is the current CEO of Nord-Lock, a Swedish manufacturing company, and he brings M&A and consulting experience from JPMorgan and McKinsey.

Historical Financials

Despite turbulent years with the COVID-19 pandemic and the Russa-Ukrainian War, Inwido has shown proven stability over economic cycles. Revenue has consistently increased, with a 5Y CAGR of 8% and a 9Y CAGR of 9,3%. Despite a negative trend with higher COGS relative to sales, leading to a slight decrease in the gross margin in 2022, operating EBITDA margin and profit margin grew at a 2.6% CAGR and 10.7%, respectively. Inwido's liquidity position is currently very strong, with a current ratio of 1.3x. cash and equivalents grew at a 26% CAGR since 2017 and net debt decreased significantly, at a -14% CAGR since 2017. Increasing profitability and decreasing net debt led to a consistent decrease in the Net Debt/EBITDA Ratio, making Inwido more resilient against economic uncertainty and higher interest rates. The Cash Conversion Cycle has decreased significantly to 5.5 days in 2022 due to supply chain finance, lengthening their payment terms due to a bank paying the suppliers, and deferring

Inwido's payments. Maintenance CapEx is relatively stable every year, while strategic CapEx fluctuates due to differences in acquisitions from year to year. Free cash flow to the firm has been positive for the past 5 years except for 2018, however, this was largely due to this year's intense M&A activity. Free cash flow to equity was negative in 2018, again due to the high CapEx, and in 2021, due to the company's highest debt repayment in the past ten years. Still, Inwido's significant cash balance growth indicates that the company's free cash flow is resilient enough to accommodate for years when cash is under more pressure, be it due to greater than usual M&A activity or debt repayments. High and stable cash flows, low debt, and an assetheavy balance sheet make Inwido a robust LBO target from a financial perspective.

Market Overview

Market Size, Growth Drivers & Trends

The European Windows & Doors market was estimated to have amounted to $61 billion in 2022 and is forecasted to grow at a 4.13% CAGR until 2028, reaching a size of $78 billion (Arizton Advisory & Intelligence 2023). There are three key trends in the window and door industry: energy efficiency, smart technology, and e-commerce. Due to higher inflation, decreased disposable income, and decreased consumer sentiment, consumers are more and more conscious about their energy consumption and where to save money. In Norway, 39% have reported that they plan to invest in triple-glazed windows, and 50% in Sweden plan to invest in solar panels in the next 10 years (Inwido Annual Report 2023), clearly showing consumer preference and the importance of energy savings. The interest in smart windows and doors that are monitored through your phone and connected to the rest of the house is another trend among customers that offers more convenience and enhanced security. The shift toward e-Commerce has hit the fenestration industry where more and more customers prefer to buy windows and doors online. This offers wider availability and an easier shopping experience.

The main growth drivers for the window and door market are the construction of new buildings and renovation. Construction of new buildings, both commercial and private is the largest driver, this is again driven by two main factors: population growth and economic cycles. As areas get more populated more buildings are built, and more windows and doors are needed. However, this is cyclical as more is invested in construction during strong economies and there is a slowing in new building during economic downturns. The other main driver, renovation & retrofitting accounts for c.70% of Inwido's sales. Due to consumer demand for energy savings, together with government incentives, there is a huge increase in demand for shifting old insulated windows and doors with new, better-insulated, and energy-saving windows. The EU considers this one of the pillars of the fight against climate change and incentivizes consumers to renovate their existing houses. Incentives are also given by local governments. In Ireland, consumers get EUR 1,500 – 4,000 for changing windows and doors, and Scotland is giving loans of up to EUR 5,000 for home renovation (Inwido 2023).

Market Segmentation

The fenestration market can be segmented into two main segments, windows, and doors. Window sales are projected to grow at a 4.3% CAGR between 2022 and 2028, and doors to grow at a 2.7% CAGR between 2021 and 2027. There are two end-use segments, residential and commercial, residential is projected in 2022 to make up for 64% of market revenues. Installation is also an important criterion, splitting the market into new construction and renovation, with 60% of the demand for windows and doors in Western Europe and 55% in Eastern Europe currently coming from the renovation space. In terms of production materials: aluminum is a strong and lightweight material and particularly suitable for larger windows and doors; composite materials are made using two or more materials, usually timber clad with aluminum; uPVC is robust and easy to clean and is especially used in the renovation; finally, timber windows and doors can be made from softwood or hardwood. The market can also be segmented into geography, with Germany being projected to be the largest European market as of 2023, followed by Turkey, the UK, and France (Ceresana Market Research, 2021).

Competitive Landscape

The competition in the fenestration industry is heavily associated with its fragmented characteristics, with approx. 5,000 different window and door companies in Europe. Mostly being small privately owned serving their local markets. While all these compete for the same customers as Inwido's business units we have decided to only compare Inwido to similar companies of size, revenue, and geographic reach. The main competitors are chosen together with Inwido's EVP of M&A and through our evaluation and analysis. In comparison, we note that Inwido is on the larger side with EUR 895m in revenue in 2022, while the largest competitor JELD-WEN had EUR 1,221m of revenue in Europe, and the smallest, NorDan, had EUR 176m. Looking at the performance metrics, Inwido outperforms the average on many metrics with an EBITDA margin of 14.2%, the lowest Net Debt/EBITDA at 0.6x, and the lowest Cash Conversion Cycle at 5 days for 2022.

Investment Thesis

As previously stated, the European windows and doors market is facing interesting growth opportunities as the need for a green transition is growing across all societal levels, where solutions are targeted at replacing the existing building stock that is largely energy inefficient. In addition, Inwido operates in a highly fragmented market creating opportunities for acquisition-driven growth both in existing and new geographies. These factors were crucial determinants guiding the decisions to create additional value following the transaction.

Renovation segment

The ongoing energy crisis in Europe, and high energy prices, have placed energy efficiency improvements increasingly high on the agenda. While this creates opportunities for Inwido, given that windows and doors have a significant impact on energy saving, it, more importantly, increases the pace of the green transition, and this is where Inwido has the potential to contribute to a better world. A green transition within the European construction sector will be one of the fastest ways to alleviate the energy crisis and mitigate carbon dioxide emissions from buildings. This coupled with the EU's renovation wave, aiming to improve energy efficiency, boost the economy, and deliver better living standards for Europeans, will be a major growth driver as Inwido already has a reputation as one of the pioneers in energyefficient fenestration products. Despite an increasing demand for energy-efficient products, there is still limited consumer knowledge regarding the impact of windows and doors on domestic energy usage that must remedied. Providing energy calculators on each business unit's website will enable consumers to understand the effect energy-efficient windows and doors have on their household consumption. To fully grasp the coming renovation wave and customer demand for sustainable products, accelerated investments in existing business units requiring additional resources to innovate their product portfolio must be made to ensure a competitive position in the renovation segment. As renovation currently accounts for 70% of Inwido's sales, it is projected to have a major impact on both organic and inorganic revenue growth through acquisitions of companies with capabilities and competitive advantages in the renovation market.

<u>Buy & Build</u>

Considering Inwido's asset base, liquidity, and cash generation, highly fragmented markets create opportunities for European consolidation enabling both superior growth in existing markets and further diversification of the firm's revenue streams. Initially, five targets were identified all sharing common characteristics of being profitable companies operating in the European windows and doors industry. Specific focus was directed towards Scandinavia and Western Europe given the strategic fit and favorable market conditions. In addition, we have assumed acquisitions of three more companies, all sharing characteristics with the five identified targets. The first add-on acquisitions, namely *McMullanODonell* (IR) and *Nordvestvinduet* (NO), will occur in the first year of the investment period, i.e., in 2024, with the ambition to strengthen Inwido's position in the British Isles, as well as providing additional competitive advantage in the production and selling of energy efficient wood products in Scandinavia and across Europe. The third and fourth add-on acquisitions will happen in 2025, being the purchase of *Whiteline*, the largest independent fabricator of uPVC windows and doors in southern England, as well as the acquisition of *Profialis*, the largest company among them all and the first add-on investment in the newly entered market France, after initially entering through the E-commerce platform. The acquisition of the British uPVC specialist *Garrard Windows* will take place in 2026 together with a smaller niche add-on investment in Denmark, followed by the two last acquisitions in the UK and France that will occur in 2027. The intense acquisition strategy of British companies with competitive advantages in rapidly growing energy-efficient products will enable an accelerated consolidation of the growing UK market, as well as achieve a stronger competitive position in the renovation segment (specifically, favorable EU Green Deal subsidies in Ireland). Valuecreating M&A in Norway and Denmark will strengthen the current market share in Scandinavia (principal markets) focusing on premium and niche expertise. Lastly, acquisitions in France will enable accelerated market penetration through acquisition-driven growth strengthening the business units and Inwido's market position in the French market. Moreover, through the realization of cost synergies provided by Inwido's stronger negotiation power with suppliers, targets will be able to improve their operating efficiency reducing the cost of raw materials (usually 50% of total COGS) by 10%. The acquisitions will be financed with cash, at an EV/EBITDA multiple of 5.5x, based on past acquisitions made by Inwido in the same markets.

Internationalization

To accelerate the process of European consolidation, internationalization will play a critical role. Five target countries were identified considering factors such as market size, renovation potential, GDP per capita, and strategic fit. While Turkey and Russia are the countries with the largest market size, the current high levels of political, legal, and reputational risks hinder any sustainable growth potential there. Italy and Spain are reasonably large markets, and both have high projected growth. However, France has arguably more potential: it is a larger market still with good growth prospects, has a higher GDP per capita, and is closer to Inwido's current geographic scope. It also has a high expected renovation market CAGR, with a large portion of houses requiring renovation and an implemented government renovation program to promote energy efficiency. In addition, the French market is heavily fragmented, favoring consolidation. The first part of the internationalization strategy is to leverage Inwido's existing e-Commerce platform to establish a new French brand under the JABS Group and distribute to France from the existing production facilities in Eastern Europe. In line with Inwido's approach in the past, operating expenses such as marketing and setting up the online platform will be outsourced to a local company familiar with the French market. This will enable a less risky, more cost-efficient, and customer-centered entry into the French market. The second part of the strategy is the acquisition of Profialis, a player with a solid presence in the market, and a second acquisition in 2027, to boost market penetration. Incorporating M&A into the strategy will allow us to build on Profialis' existing local market knowledge and resources.

As for projections, Inwido's e-commerce strategy in Germany was used as a benchmark. The company entered Germany in 2015, and revenues have been growing at roughly 33% CAGR since 2018. It was assumed that market share growth through e-Commerce would go at the same pace as in Germany. In addition, the acquisition of Profialis will result in a significant revenue increase every year, contributing to SEK 867m yearly revenue by 2029.

Forecasts & Business Plan

Inwido's revenue forecasts rely on the market analysis of specific growth drivers and trends of each individual market where the company has its operations. Due to local markets, forecasts have been conducted per country and not per business area. The overall top-line revenue growth is forecasted by splitting standalone and incremental revenue. Standalone revenue forecasts mainly reflect current market expectations with a 4.5% CAGR ('23-'30). Conservative organic growth rates have mainly been applied in Inwido's principal markets in Scandinavia and Eastern Europe to capture the economic downturn, particularly hitting the construction industry, resulting in declining standalone revenue in 2023 and 2024 (besides from Denmark and Poland). Inwido has a relatively high proportion of sales to new construction in Sweden and Finland, thus the largest decline in those markets, even though renovation dominates when looking at the entire group. Strong outlooks for the renovation segment strengthened by the European Green Deal policy are the main growth drivers. Together with the internationalization strategy, a more geographically diversified portfolio enables Inwido to exploit the renovation wave at larger scales, as well as decrease its operational risk associated with local sentiments and individual performances of the Group's business units. Furthermore, it allows capitalization on regional trends and momentum of specific portfolio companies, mainly identified in the British Isles and Germany (note: only e-Commerce operations in Germany). Incremental revenue forecast accelerated by the *Buy & Build* strategy will have a total CAGR of 37.6% ('24-'30), mainly coming from large acquisitions in the British Isles and France. At the exit in 2029, the UK, France, and Denmark will be the markets with the largest revenue contribution driven by strong projections of both organic and inorganic growth. As for the bottom-line forecasts, a gross margin improvement will stem from cost synergies realization associated with the acquisitions of selected target companies. Inwido's size and greater negotiation power with suppliers will reduce the cost of raw materials.

OpEx will remain similar in proportion to revenues as Inwido is perceived to have sufficient competencies in the present management group. A slightly higher fraction of sales will be targeted to R&D expenses, to provide for investments in energy inefficient business units to enable greater capitalization of the growing renovation segment. In the end, organic EBITDA growth will mainly come from the strong continuation of organic revenue growth in both principal and secondary markets. Inorganic EBITDA growth will come from the acquisition of target companies in Denmark, France, Ireland, Norway, and the UK, which will be implemented between 2024-2027, allowing Inwido to immediately capture value from add-on acquisitions. FCFF is expected to grow from SEK 708m in 2023 to 1,918m in 2029, at a CAGR of 18% during these 6 years. CapEx is the main factor dictating the free cash flow development in the forecast period, it is split between maintenance CapEx and strategic CapEx. Between 2024 and 2027 c. 65% of the forecasted Capex will come from strategic, associated with acquisitions of subsidiaries. This has a negative impact on the FCFF as it is a cash expense and all planned acquisitions are expected to be paid in cash, resulting in a slight decrease in FCFF until 2025, before it increases again. Acquisitions and therefore CapEx is expected to slow down after 2027, due to a shift in focus towards an exit and planned debt repayments.

Valuation

Inwido is valued at an EV/EBITDA multiple of 8.4x which gives an enterprise value of SEK 11,069m. This is calculated using three valuation methods, a Discounted Cash Flow model (DCF), Comparable Transaction Analysis (CTA), and Comparable Company Analysis (CCA). The DCF yields the highest valuation at 19x using the Gordon Growth Terminal Value approach, with a terminal growth rate of 1,5%, and WACC of 8,4%. DCF using exit multiple for terminal value of 8.4x EV/EBITDA yields a multiple of 15.4x. CTA is done by comparing recent transactions of similar companies and analyzing their purchase multiple. Companies have been selected on size, location, financial metrics, and time of transactions. This gives a multiple of 8.4x and represents a realistic purchase price as it includes premiums paid in the past. CCA looks at other peers, chosen based on similar criteria as CTA, and current trading metrics, and suggests an EV/EBITDA of 8.1x. Looking at the transaction price of peers, current trading levels, and the value of our predicted cash flows, we believe that Inwido can be acquired at a multiple of 8.4x which results in a total enterprise value of SEK 11,069m.

LBO Model

Capital Structure:

The credit market today is particularly challenging, with record-high inflation having led to increased interest rates around the world. According to professionals in the Swedish bank and private equity environment, interest spreads on bank debt range between 400 and 600bps, depending on firm-specific factors. In Inwido's case, since it is a large company, with SEK 9.2b in revenue and 1.3b EBITDA at entry, size is a factor that should drive the spread down. Its leverage level should also inspire confidence in banks since it has strong liquidity and solvency ratios. However, two factors that could weaken negotiations and drive the spread upward are low diversification linked to the fact that, even though Inwido's sales are widespread across Europe, they are still very much dependent on fenestration products, and the challenging macro environment featuring high-interest rates and inflation. In conclusion, given Inwido's size, leadership across several markets, cash generation, strong solvency, and liquidity, it should be possible to rely on cheaper, senior bank debt from major Swedish banks to achieve the desired returns rather than resort to more expensive, subordinated debt. In the end, the chosen capital structure includes 3 senior debt facilities, TLA (amortizing) priced at 3m SOFR + 425bps, TLB (bullet) priced at 3m SOFR + 480bps, and TLC (bullet) priced at 3m SOFR + 525bps, amounting to a total of SEK 5,798m, 4.4x EBITDA. Equity includes a Fixed Return Instrument of SEK 5,008m, with a 10% PIK element accrued annually. Ordinary shares are split between an institutional strip of SEK 730m and a Sweet Equity instrument of SEK

30m, vesting to 4% of total ordinary shares. Total equity contribution is thus SEK 5,769m (4.4x EBITDA). The buyout is structured with an earnout, investing 80% of the equity at entry and 20% in December 2025 if the EBITDA margin recovers to 2022 levels after predicted declines in '23 and '24. This creates alignment in the incentives between management and the fund.

Returns

Under a holding period of 6 years and no multiple arbitrages, exiting in 2029 at an 8.4x EV/EBITDA multiple, the investment case yields a money multiple of 3.8x and an IRR)of 26.3% for the fund. EBITDA in 2029 is projected to be c. SEK 2,688m, leading to an enterprise value of SEK 21,395m at exit. Net Debt amounts to a negative SEK 601m, thus, total Equity proceeds amount to SEK 21,996m. Management will receive proceeds of SEK 460m, corresponding to a 15.1x MM and an IRR of 57.3%. The main source of value creation is cash generation achieved through the deleveraging effect, amounting to SEK 5,312m. Inorganic and organic revenue contributions are SEK 5,045m and SEK 3,712m respectively, due to growing operations in Inwido's principal and secondary markets capitalizing on the European renovation wave and the *Buy & Build* strategy. Finally, SEK 2,655m of value results from EBITDA margin expansion, stemming from increased synergies and economies of scale associated with M&A and the further consolidation of the European market.

Exit

After evaluating four different exit opportunities, we have found three feasible options, all with their pros and cons. Selling to a strategic buyer is considered the best option due to its high valuation and value of potential synergies. Potential buyers might be industrial manufacturing companies who seek to enter vertical into the window and door industry, or other larger window and door manufacturers who want to strengthen their foothold in Northern Europe. Inwido's expected large size limits potential buyers, but we have found two promising candidates, French Saint-Gobain, and Swiss Holcim. Both have done recent acquisitions of around EUR

2b, the expected value of Inwido at the exit, and both have portfolio companies that operate in the fenestration industry with opportunities for synergies. A secondary sale to another private equity firm is another potential exit, an expected faster and cheaper exit, but often at a lower valuation. Interest from potential buyers is expected to be high as Inwido's cash flow is high and stable with a leveragable balance sheet in a continuously fragmented industry that has consolidation potential. PE funds with the potential of a large equity ticket are needed and we have found CVC and EQT as potential buyers due to their large funds size, previous acquisitions, and expertise in the industry. The last potential exit option is an IPO in the Stockholm Nasdaq Stock Exchange. Inwido will be a highly attractive IPO case and would most likely attract both local and international investors. This is however very dependent on market timing, but an exit on the top of a cycle has the potential to deliver very high returns.

Due Diligence

To validate the analysis and assumptions made in this ICP, thorough due diligence should be conducted in the commercial, financial, operational, and ESG fields. Commercial and operational DDs should assess the strategic fit, operational capabilities, and growth potential of our proposed M&A targets; as well as the French market's competitive landscape and Inwido's ability to integrate it into the existing e-commerce supply chain. These points are critical for the success of the *Buy & Build* and Internationalization strategies, respectively. A financial DD is also essential to validate the assumptions made in the forecasts and evaluate the impact that both market trends and the Investment Thesis strategies will have on the business plan. Finally, it's important to conduct an ESG DD into the impact that national and EU incentives to improve the energy efficiency of buildings will have on consumers and businesses. An essential part of the Investment Thesis rests on the hypothesis that these incentives will become increasingly relevant, boosting demand for energy-efficient windows and doors as well as allowing Inwido to capitalize on this trend and, through Green

Transition, *Buy and build* and Internationalization, further consolidate its position in the European fenestration market.

Individual Contribution

Francisco Sim Sim

Introduction

This individual contribution begins with an overview of the private equity market and particular financing trends that have influenced capital structures and, consequently, deal activity in 2023, namely the growth of private credit. This outlook is followed by a practical deep dive into the factors that influenced the determination of the capital structure used in the proposed leveraged buyout of Inwido AB described in the Group Contribution section of this Work Project.

Private Equity Landscape in 2023

The global private equity market in 2023 has been marked by a significant slowdown in deal activity as the macroeconomic environment, characterized by both high inflation and high interest rates, has hindered many private equity funds' ability to carry out their typical large, highly leveraged transactions. This has triggered a shift in the way capital structures are determined in PE deals.

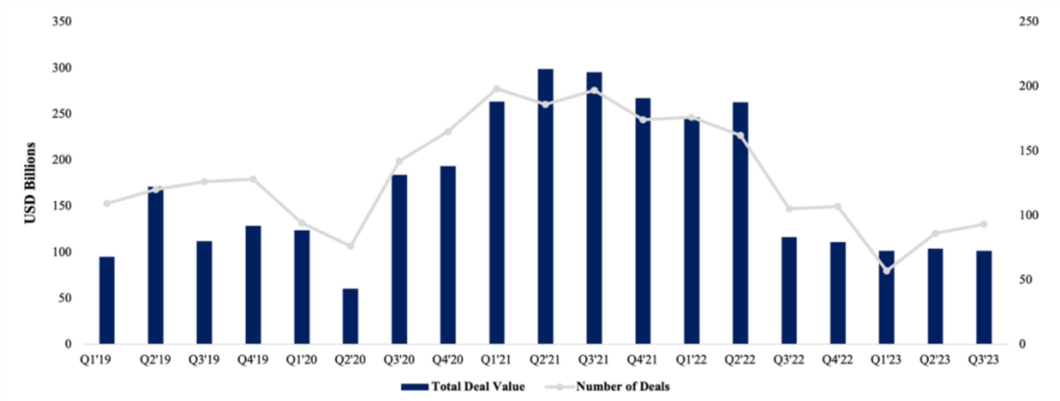

Figure I – Quarterly private equity activity between 2019 and Q3 2023 (Adapted from "Private Equity Pulse: Five takeaways from Q3 2023")

The slowdown in deal activity can be seen above in Figure I, and to a large extent it can be attributed to the fact that, in response to the challenging macro environment, traditional lenders (e.g., regional commercial banks) have become less flexible in their lending standards, demanding lower leverage and higher equity stakes, as well as higher interest rate spreads and stricter debt covenants. Since high leverage is a key driver of returns in leveraged buyouts, the increasingly limited and expensive access to credit has hampered the ability of these types of transactions to deliver the internal rate of return demanded by limited partners, thus leading to the reduction in private equity deals' size and volume. As a result of the increasing difficulty in executing traditional leveraged buyouts, many funds have had to focus more on smaller transactions requiring less leverage, such as add-on acquisitions or corporate carve-outs, as parent companies seek to optimize their operations by selling non-core segments or assets to institutional investors.

Private Credit: a Solution?

<u>Private credit as an alternative to traditional bank financing</u>

In the context of the tighter lending conditions imposed by traditional lenders, private debt facilities offered by alternative lenders (many of which are also active in the private equity space, such as Blackstone and KKR) have been growing as alternative financing solutions in private equity deals. Private credit can offer PE funds the high leverage levels they need to achieve the target returns in their buyouts, granted at higher interest rate spreads, but also at more permissive covenants. Blackstone reported that private credit made up 86% of the loans for leveraged buyouts between January and November 2023 (Zidle and Bock 2023). In addition, it reported that the current average interest coverage ratio in the private credit market was 1.5x, with 17% of the borrowing companies at a ratio "below 1.0x when assuming current base rates" (Zidle and Bock 2023). It would arguably be very difficult to agree on ICR covenants at these levels for traditional, senior bank debt facilities.

The growth of mezzanine financing

One of the forms of private credit that has grown significantly in 2023 is mezzanine financing. In October 2023, Reuters reported that, according to data from Preqin, "$41 billion in assets [had been] raised for mezzanine funds so far in 2023 (…) 54% above the entirety of 2022" (Guilford and Unmack 2023).

Mezzanine is a type of debt financing that is usually junior to senior debt but senior to equity, and which may in some instances give the lender the right to convert the debt into an equity stake in case the company defaults. As a form of subordinated debt, mezzanine is usually priced at higher all-in interest rates and may include a PIK (payment-in-kind) element, in addition to the cash interest component. While the cash interest would be paid by the borrower according to a standard interest payment structure (e.g., monthly or quarterly), the PIK interest would instead accrue (say, every month), be added to the principal balance and only be paid with the outstanding principal at maturity or at other pre-defined dates agreed on by the borrower and the lender. This way, borrowers have the ability to free up cash in the short-term by shifting part of their interest payments to future points in time.

In conclusion, while mezzanine debt is associated with higher interest payments, as long as using it does not compromise the overall debt covenants and conditions, it can be an alternative for PE funds to increase leverage, and consequently returns, in their buyouts in cases where banks are no longer comfortable lending further capital.

Unitranche structures

In October 2023, S&P Global reported that unitranche debt has been gaining relevance among private lenders. Unitranche debt is a financing structure that combines both senior and subordinated loans into a single debt facility. The interest rate on this facility is usually a blended rate that should lie between the senior and the subordinated loans' respective rates. This type of structures is more common among private lenders, rather than traditional commercial banks, and provides borrowers with the simplicity of being subject to a single loan agreement, with a single set of covenants, interest rates, amortization schedules and prepayment conditions, while having access to different types of loans. Borrowers negotiate the loan agreement with a single entity, which should enable them to close negotiations more quickly and face lower transaction costs and financing fees. In addition, unitranche debt gives borrowers access to amounts of financing greater than those they would have been able to negotiate with a single bank or private lender.

On the other hand, unitranche facilities may include what is known as a call protection, a mechanism by which borrowers are impeded from making debt repayments before a predefined date. This mechanism is used by the lenders, for example, a credit fund, to mitigate prepayment risk, since by locking the borrower to the amount of outstanding debt will result in guaranteed interest payments for a minimum number of years. Therefore, while unitranche structures may be beneficial to reduce transaction costs and speed up the closing of deals where different types of debt are required, it is important to negotiate covenants appropriately with lenders in order to ensure these "cost savings" will not later be offset by higher interest payments as a consequence of any potential call protection mechanisms.

The LBO of Inwido: Debt Schedule

The debt portion and respective conditions in Inwido's LBO were determined based on the maximum leverage the company could take while being able to fulfil all debt covenants throughout the holding period, assuming the business plan went according to the pessimistic bank case, and still achieve a reasonable IRR and money multiple. One of the crucial steps in defining the capital structure was to evaluate whether it would be possible to use solely cheaper, senior bank debt rather than having to rely also on more expensive, subordinated forms of debt (e.g., mezzanine). In order to do this, it was necessary to analyse the leveraged credit market in Europe and, more specifically, in Sweden, as well as the impact that Inwido-specific factors would have on the credit conditions.

Credit market analysis

In July 2023, Fitch reported that the average spread on leveraged loans in Europe for "BB" companies was 3.65% and for "B" companies it was 5.32%. Inwido does not have a credit rating available but JELD-WEN's and Masonite's S&P credit ratings in 2023 were "BB-" and "BB+", respectively. These two companies are much larger comparables (a factor which should drive interest rate spreads down) but both have weaker solvency positions (a factor which should drive spreads up), with Debt-to-Equity ratios c. 3x that of Inwido's. Due to lack of more specific data, assuming Inwido's rating would lie within the "BB" and "B" range, the company should be able to negotiate a spread roughly between 350-550bps on leveraged debt facilities. Furthermore, according to professionals in the Swedish bank and private equity environment, usually on top of a 3-month SOFR variable rate, interest spreads on bank debt currently range between 400-600bps, depending on firm-specific factors.

Margin-influencing factors

In Inwido's case, seven factors that would have an impact on the interest rate spread were identified and evaluated. Regarding firm size, since it is arguably a large company considering how fragmented the fenestration market is, with SEK 9.5bn in revenue and SEK 1.3bn in EBITDA as of 2022, size is a factor that should drive the spread down. The company's leverage level should also inspire confidence in banks, since it has strong liquidity and solvency positions (Current Ratio of 1.3x, Cash Ratio of 0.6x and Net Debt-to-EBITDA at 0.6x in 2022) which have been increasing throughout the past ten years. Regarding the firm's free cash flow to the firm, its historically strong free cash flow generation, driven by growing revenues (both organic and inorganic), and increasing margins should drive the spread down as well. The company's experienced management team with a proven track record of success, as well as a large asset base that includes production facilities and distribution centers in 32 locations across Northern, Western and Eastern Europe should both also drive the spread down.

On the other hand, factors that could weaken interest rate negotiations and drive the interest rate spread upward are: firstly, low diversification, linked to the fact that even though Inwido's sales are widespread across the Nordic, Western and Eastern European markets, they are still very much dependent on fenestration products; and, secondly, the challenging macroeconomic environment, characterized by high base interest rates, high inflation, a decrease in consumers' disposable income, and a generalized uncertainty regarding how these factors will play out in the future.

Subsequently, given Inwido's size, leadership across several markets, and cash generation, as well as its strong solvency and liquidity, it should be possible to rely solely on cheaper, senior bank debt from the major Swedish banks (e.g., Nordea, Handelsbanken or Swedbank, which have experience in financing similar transactions in Sweden) to achieve the target returns (in the investment, base and bank cases) rather than resort to more expensive, subordinated debt issued by private debt funds, for example. Inwido's company status was assumed to allow for the negotiation of a spread below 550bps.

<u>Final LBO debt schedule</u>

Before determining the final debt schedule, it was necessary to define what covenants the senior debt would be subject to, in order to check if the forecasted business plan was robust to the extent that Inwido's cash flow generation was high enough to guarantee compliance with all covenants. In addition, compliance had to be guaranteed not only in the Investment Case business plan but also in the bearish, Bank Case business plan. Once again, since only senior, bank debt is being used for the transaction, the main covenants had to be relatively conservative, and were defined as follows:

- Cash Cover Ratio *(Free Cash Flow to the Firm/Interest Payments + Debt Repayments)*: should remain above 1.0x throughout the entire holding period;
- Interest Coverage Ratio *(EBITDA/Interest Payments – Interest Income)*: should remain above 2.5x throughout the entire holding period;
- Net Debt/EBITDA: should remain below 3.75x throughout the entire holding period.

After a careful analysis, the chosen capital structure included the following three senior debt facilities, in order of seniority: a Term Loan A of SEK 2,635m priced at 3-month SOFR + 425bps, a Term Loan B of SEK 1,845m priced at 3-month SOFR + 480bps, and a Term Loan C of SEK 1,318m priced at 3-month SOFR + 525bps. TLA has a maturity of 7 years and will be amortized according to the following schedule: 10% in 2026, 15% in 2027, 25% in 2028, 30% in 2029, and 20% in 2030. Both TLB and TLC have a maturity of 8 years and are not amortizing, meaning they will be paid in bullet at maturity. In the end, total debt amounts to a total of SEK 5,798m (4.4x EBITDA), which represents 50.1% of the total sources of funds.

In addition, it is relevant to highlight that the SOFR rates used in the LBO model are the rates implied by the Chatham 3-month SOFR forward curve. The basis for this decision was that it would be relevant to simulate how the variable rate might change throughout the holding period rather than assume a fixed rate every year. Since the forward curve can be used for the purpose of estimating future interest rates (naturally, based on market conditions today), it was considered a reasonable source to base the model's projections on.

Under the outlined debt conditions and given the forecasted business plan, the main credit statistics for the Investment and Bank cases are summarized in the tables below:

	2024	2025	2026	2027	2028	2029	2030
Investment Case							

Ending Cash Balance	1 318	1 516	1 987	2 637	3 456	4 291	5 552
Cash Cover	1.3x	1.4x	1.6x	1.7x	1.7x	1.6x	2.4x
Interest Cover	2.9x	3.9x	4.6x	5.6x	6.7x	8.7x	12.7x
Net Debt / EBITDA	3.2x	2.5x	1.8x	1.1x	0.4x	-0.2x	-0.9x
Bank Case							
Ending Cash Balance	1 274	1 381	1 686	2 067	2 528	2 963	3 782
Cash Cover	1.2x	1.2x	1.4x	1.4x	1.4x	1.3x	1.9x
Interest Cover	2.6x	3.3x	3.8x	4.4x	5.0x	6.2x	8.4x
Net Debt / EBITDA	3.6x	3.1x	2.3x	1.7x	1.0x	0.4x	-0.3x

Table I – Credit Metrics Summary for the Investment and Banks cases of Inwido's LBO (Table by Author)

The LBO of Inwido: Equity Schedule

Sweet Equity, Institutional Ordinary Shares and the Fixed Return Instrument

Once the maximum amount of leverage this transaction could take on had been established, it was crucial to structure the 49.9% equity portion of the LBO in a way that would ensure high returns for the fund but also provide the management team with adequate incentives in order to promote an excellent performance on their part. Therefore, ordinary shares were to be split between an institutional strip of SEK 730m and a Sweet Equity instrument of SEK 30.4m, which is 4% of total ordinary shares. It is important for the fund to be included in the Ordinary Shares portion so as to inspire confidence in management and reassure them that all equity proceeds will not go to the fund's Fixed Return Instrument, which is senior to ordinary shares, in case the investment does not go as expected. With the proper management incentives in place and Ordinary Shares totalling an amount of SEK 761m, the remaining SEK 5,008m of equity were assigned to the Fixed Return Instrument, which included a 10% PIK element accrued annually. The total equity contribution thus amounted to SEK 5,769m (4.4x EBITDA).

Earnout:

Before finalizing the LBO's capital structure, it was relevant to analyse whether a part of the purchase consideration should be paid under an earnout structure, contingent to Inwido achieving a pre-defined performance goal. Earnouts are a valuable mechanism to include in buyouts because they are a way to mitigate certain risks associated with the target's future performance, while at the same time increasing an investment's IRR. In Inwido's LBO case, the business plan's main risk is arguably the threat that the current negative macroeconomic environment continues to hinder consumers' disposable income and thus demand for fenestration products for a longer period of time than anticipated. The business plan contemplates that, after a 4% decrease in Operating EBITDA in 2023, 2024 results should reflect a slight recovery, with Operating EBITDA returning to a level slightly higher than in 2022, with a growth of 1.7% relative to '22. Operating EBITDA margin, however, is only forecasted to recover to 2022 levels by the end of 2025, when it reaches 14.7%.

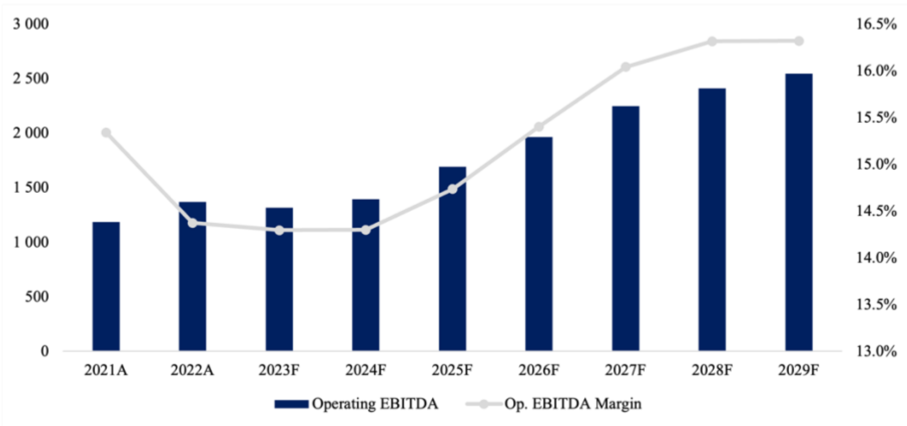

Figure II – Inwido's actual (2021-2022) and forecasted (2023-2029) Operating EBITDA and respective margin (Graph by Author)

In the end, in order to mitigate part of the risk, namely the macroeconomic risk, associated with Inwido's LBO, the acquisition will be structured with an earnout, investing a relatively high 80% of the equity amount at entry in January 2024, and the remaining 20% in the end of 2025, considering the recovery of the Operating EBITDA margin to 2022 levels after the predicted declines in 2023 and 2024. In addition, a consequence of this earnout is the fact that, while the fund's IRR would be equal to 24.6% before it was implemented, it would instead be equal to 26.3% under the proposed 80/20 structure, making it a more attractive investment, especially for more IRR-centred limited partners since at exit in 2029 proceeds, and thus the MM, are the same in both scenarios.

Conclusion

As has been discussed in this Work Project, private equity funds were under pressure during 2023 due to the challenging credit market, which hindered deal activity by making it more difficult to execute highly leveraged transactions. However, historically profitable companies operating in growing markets with opportunities for consolidation, with strong and stable cash generation, and a leverageable balance sheet, among other traits, will always make for attractive LBO targets. Inwido has met these criteria in the past and, under the investment thesis proposed in this Work Project, it is expected to continue to do so in the next five to seven years. Despite the challenging credit market, given the company attributes mentioned previously, as well as a strong management team that has proven track-record of competence and valuecreation, the LBO of Inwido is assumed to be able to rely solely on senior bank debt, at 4.4x EBITDA. In addition, to mitigate macroeconomic risk and increase the internal rate of return for the fund, the investment will be structured with 80% of total equity (4.4x EBITDA) being paid at entry at the start of 2024 and the remaining 20% at the end of 2025. In conclusion, the proposed leveraged buyout of Inwido would be executed under a strong business plan and a balanced capital structure, yielding an IRR of 26.3% and a MM of 3.8x at exit in December 2029.

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