PER STRÖMBERG

EQT's bid for Scandic

On a dark and cold winter afternoon in January 2007, the investment advisory team at the Swedish private equity firm EQT Partners, was sitting in their office at Linnégatan in Stockholm, preparing for the upcoming meeting in the investment committee. A few months ago, EQT had been contacted by an investment bank, Citigroup, who wondered whether the firm was interested in participating in the auction for Scandic Hotel, a well-known Scandinavian hotel chain. Scandic was currently part of the international hotel company Hilton, who had recently decided that they no longer wanted to own it, and hired Citigroup to help them with the sale. As was customary in these sales processes, Citigroup put together an Investment Memorandum, which was sent out a number of potential buyers, which included both other industry players as well as private equity firms like EQT. The IM raised EQTs interest, and Scandic could be an ideal investment for the new fund they had just raised, EQT V. Based on the information, and consultations with industry experts in their network, they decided to submit a first-round indicative bid for the company. This bid was sufficiently attractive that EQT was invited to participate in the second round, where they would have to submit a binding bid for the company. Although EQT was not sure who else would be participating in the second round, they suspected that the competition mostly included other Swedish and European private equity funds, like themselves.

After making it to the second round, the EQT deal team had worked intensely with due diligence in the last few months, trying to find out as much as they could about the investment potential of Scandic. They had hired advisors for commercial, financial, and legal due diligence, who together with EQT's deal team had carefully scrutinized the documents in Scandic's data room. EQT's deal team had also spent considerable time meeting with Scandic's management, together with EQT industrial advisor Vagn Sørensen, trying to develop a business plan for the company going forward. Now it was time to make the final decision on whether to submit a binding, second-round bid for the company, and what this bid should look like.

There were many potential issues to consider. What were the future business prospects of Scandic? The last few years the economy had done very well, but the hotels business was quite cyclical. What would happen to the company once the business cycle turns? Given the competition from other well-capitalized private equity firms, would a winning bid still allow for a good enough return to the investors in EQT V? This would heavily depend on EQT's ability to develop a business plan that would unlock significant value in the company, which in turn was dependent on having a superior ability to add value to Scandic by using their unique knowledge and networks in the Nordic market. In order to evaluate the deal, EQT would have to become comfortable with financial projections taking into account both expectations about the future development of the hotel market as well as the operational improvements that could be achieved. One complication was that Scandic had been a subsidiary of Hilton, and historical data might not be so indicative of how Scandic would perform as a stand-alone firm. Finally, they would have to decide how their bid would be financed. Usually, EQT would finance acquisitions with 30% to 50% of the bid with equity from their fund, and the rest with debt from banks and mezzanine or bond investors. The last few years had seen very active and liquid bond markets, so obtaining debt should not be a problem. But debt financing would be equally accessible for EQT's competitors in the auction, which was likely to push up the price they would be willing to bid. How far should EQT push the leverage in the deal, to be able to increase their bid and still reach a satisfactory return on the investment? And, most importantly, what should EQT bid for the company? Should they increase their previous bid, or maybe lower it?

Scandic Hotels

Scandic's origins

In 1963, Esso Motor Hotel opened in Laxå, in the province of Närke in Sweden. The idea was to capitalize on the recent increase in car travel over the last decade, both for business and pleasure. Motels had been around for a long time in in the U.S., but were a novel concept in Europe at the time. The Laxå motel turned out to be successful, leading to more motels being started, and by 1972 the chain had grown to 59 hotels, located all over Europe. Esso Motor Hotel decided to sell their hotels outside of Scandinavia, and the remaining 32 hotels, five of them in Norway and Denmark, formed the largest Swedish hotel chain.

In 1983, the company was sold to a Swedish consortium, headed by the investment company Ratos, and was renamed as Scandic Hotels the following year. Having bought out the rest of the consortium in 1985, Ratos embarked on an expansion strategy, resulting in Scandic starting a number of new hotels, including their first hotel outside of Scandinavia in Koblenz, Germany. The expansion was halted in the early 1990s when the Nordic economies went into a recession following the Gulf war and the Nordic banking crisis. Focus instead turned on increasing profitability and efficiency in the existing hotels, which Scandic was able to achieve successfully with the help of a new management team.

Having weathered the crisis, Scandic returned to its expansion strategy a few years later, and acquired the Swedish hotel chain Reso Hotels in 1996. Later the same year, Scandic conducted a successful initial public offering in Stockholm, thus becoming the first listed hotel operator on the Stockholm Stock Exchange. Following the IPO, Scandic expanded into Finland, through the acquisition of Arctia Hotels, and also established hotels in Estonia. In 2000, the expansion was crowned by the acquisition of the Swedish hotel chain Provobis. The acquisition made Scandic the largest hotel operator in the Nordic countries, with 154 hotels, 7,350 employees, and revenues of SEK 6 billion (€680 million).

Hilton decides to acquire Scandic

On April 23, 2001, Hilton International made a successful bid to acquire Scandic for £612 million (SEK 8.9 billion, € 982 million) in stock and cash, representing a 31% premium to the pre-bid stock price. Ratos, the largest shareholder, agreed to sell their shares, and other shareholders followed, leading to Scandic delisting from the Stockholm Stock Exchange and becoming a division of Hilton International. Ratos was reported to have booked a profit of SEK 1.7 billion when selling their shares.[i]

Hilton International (subsequently renamed Hilton Group Plc) was a UK-based company listed on the London Stock Exchange. Hilton International had the exclusive right to operate Hilton hotels in all regions outside of the United States. In addition, it owned the U.K.-based betting and gambling company owned Ladbrokes, which was a gambling and betting company primarily operating in the U.K. The current business originated from Ladbrokes having acquired the non-U.S. operations of Hilton in 1987.

The Scandic acquisition nearly doubled the size of Hilton International's hotel operations. When asked to explain the acquisition, Hilton International's CEO, David Michels, stated that "[Hilton has] declared over the past year that we intended to get Hilton more into Europe, so this is the first step in doing just that…We're likely to do more deals in Europe in the future [and] plan to cover as much of Europe as possible."[ii] Stock market analysts were generally positive on the deal, commenting that Hilton "had done a good deal at a cheap price."

Indeed, Hilton had been under-represented in the Nordic region compared to other European markets, and Scandic was viewed as an ideal candidate for Hilton's Nordic expansion. Apart from having a strong historical financial performance, Scandic was a well-recognized brand, with a dominant market position, and similar to Hilton it focused on the business segment. Hilton had identified synergy benefits of £17m from the takeover, including £8m in cost savings, from eliminating overhead, and an additional £9m from "revenue enhancement initiatives" through cross-selling and marketing efforts. The latter would be achieved by giving Scandic access to the HHonors loyalty program and Hilton's global reservation system. Hilton International would rebrand 37 higher-end Scandic hotels (20 of which were located in the Nordics) into 5-star "Hilton" hotels. The remaining hotels, which were in the 3-4 star segment, would keep the Scandic name. The Scandic brand would be promoted as Hilton's mid-market brand, alongside "Holiday Inn" and "Hampton Inn".

Following the merger, Hilton had only limited success with this strategy. After the tech stocks crash, followed by the 9-11 terrorist attacks in the U.S., the world economy went in to a recession in the early 2000's, and the Nordic hotel markets experienced a significant downturn. Realized cost synergies and hotel re-branding benefits could not compensate for the drop in demand, and Scandic's earnings fell significantly in 2002 and 2003, while revenues in 2004 stayed flat. (Exhibits 7-9 shows Scandic's financial performance from 2003 through 2006).

Scandic ended up halting its previous expansion strategy, to instead focus on increasing profitability in existing hotels. Apart from the challenging economic environment, there were two more reasons holding back expansion. First, Hilton was reluctant to expand through the lease model, which had been Scandic's primary mode for operating their hotels. Second, the Scandic brand ended up competing with Hilton's other mid-market brands, which made it difficult to expand Scandic outside of the Nordic region. As a result, Scandic shrank its operations from 154 hotels before the 2001 acquisition, to 132 hotels by the end of 2006.

Hilton decides to sell Scandic

On December 29, 2005, Hilton Hotels Corporation (HHC), the operator of Hilton in the U.S., re-acquired the Hilton's non-U.S. hotel operations from Hilton Group Plc for £3.3 billion (or $5.71 billion). The acquisition made HHC the worldwide owner of the Hilton brand, and the world's fifth largest hotel operator in number of rooms. Having exited the hotel business, Hilton Group Plc changed back to their old name Ladbrokes plc, and focused on their betting and gambling businesses.

After the acquisition, HHC did a thorough review of its global brand strategy, and decided to roll out its "Hampton Inns" mid-market brand outside of the U.S. Hampton Inns was operating in the same 3- and 4-star segment as Scandic, but Hilton realized that rebranding Scandic to Hampton Inns in the Nordic markets destroy significant brand value. Also, HHC had taken on significant amounts of debt to finance the Hilton International acquisition, and needed to sell assets to reduce its debt levels.

As a result, HHC decided that the best course of action was to divest Scandic, and Citigroup was hired as an advisor in this sale. To solicit bidders for the auction, Citigroup prepared a 250-page Investment Memorandum, which was sent out in October 2006 to a number of strategic and financial investors. One of these investors was the leading Northern European PE firm EQT.

EQT

Origins

The initiative to start EQT came from the Swedish Wallenberg family, who had been a dominant business owner in Sweden for more than a century. Through their investment company Investor AB (which was publicly traded, but controlled by the family) and various foundations, they were the largest shareholder of a number of well-known companies such as Ericsson, ABB, Stora-Enso, Electrolux, SE-Banken (SEB), and Atlas Copco. The Wallenberg family was convinced that the valuable industrial networks and contacts they had developed over the years would provide a unique edge for investing in private equity. As a consequence, Investor AB and SEB, with the help of U.S. based PE firm AEA Investors, established a private equity firm, EQT Partners AB, in 1994.[*] The firm's investment advisory professionals, with managing partner Conni Jonsson, became co-owners of the new PE firm, which was based in Stockholm, Sweden. (See Exhibit 1 for biographies of selected EQT professionals.)

The following year, EQT raised its first PE fund, EQT I, focusing on buyouts of Swedish companies. Founders Investor AB, AEA, and SEB provided the bulk of the SEK 3.2 Billion fund commitment. EQT I turned out to be spectacularly successful, which enabled the firm in 1998 to raise a second buyout fund, EQT II, as well as two more funds focusing on Denmark and Finland. These funds also ended up delivering very strong returns. Based on their impressive track record, EQT were able to raise more buyout funds, as well as a turnaround fund, a mezzanine fund (investing in subordinated debt), and two PE funds focusing on investments in the Greater China region. (See exhibit 2 for EQT's fundraising 1994-2006.) By 2007, the firm had grown to be the largest private equity firm in Northern Europe, with close to 100 employees and offices in all Nordic countries, several offices in Continental Europe, and Asian offices in Hong Kong and Shanghai.

Buyout fund structure

Most European and U.S. buyout funds were at the time organized as Limited Partnerships, usually based in an off-shore location, where the fund would not be subject to tax on capital gains

[*] Investor AB eventually bought out SEB and AEA in 1998.

and dividends. Common jurisdictions for European buyout funds at the time were the British Channel islands Jersey and Guernsey. The reasons for the off-shore location was to avoid investor double-taxation, since the investors in the fund would pay capital gains tax on their investment gains in their home countries as they received distributions.

A Limited Partnership has two types of owners, Limited Partners (LPs) and General Partners (GPs). In the case of private equity funds, the Limited Partners are the outside investors in the fund, the majority of which are institutional investors such as pension funds, insurance companies, foundations, and asset management companies. The General Partner is responsible for managing the fund. In practice, the General Partner hires the private equity firm (the "Advisory Company"), such as EQT Partners AB, to give advice on the investments of the fund. In the typical case, the General Partner would also be owned by the partners and other key employees of the private equity firm. Hence, the key investment advisory professionals also have a significant a stake in the success of the fund, which helps align the interest with investors.   (In EQT's case, Investor AB, being a founding investor, also held an ownership stake in the GP, and it was also a key LP in EQT's funds.)

Although the LPs provide most of the fund commitment, the GP is required to contribute at least 1% of the funds, to be able to achieve Limited Partnership status. In practice, the GP commitment is often higher, and sometimes even 5% or more. As a result, the PE investment advisory professionals would normally have a substantial fraction of their own wealth invested in the. LPs typically look favorably upon a large GP co-investment, since it provides better incentive alignment between investors and the investment advisory teams (in addition to the "carried interest," described below).

In the standard PE fund set-up, the Limited Partnership is dissolved after ten years, which implied that all portfolio companies should be divested at this point. Usually the fund can be extended for an additional two to three years, upon approval from the LPs, which is not uncommon. The beginning of the fund life, called the investment period, usually lasts for six years. During this time the GP could call on the LPs commitment in order to invest in new portfolio companies. After the investment period, GPs could only draw down on the commitment in order to fund follow-on investments in existing portfolio companies, and to cover management fees.

The evaluation of portfolio company investments is led by the investment advisory professionals in the advisory company, who typically present their proposals to an investment committee, consisting of the advisory firm's partners. The investment committee then decides whether to support the investment. The GP has their own board, consisting of independent board members not affiliated with the advisory company. The GP board makes the final investment decisions, where the recommendation by the investment committee at advisory company is taken into account. Most of the time, the GP board typically follows the recommendation of the advisory company, but the board has a significant governance function and could be of another view or can make modifications to the investment proposal. Clearly, though, an LPs decision to investment in a fund would take into consideration their assessment of the people making the investment recommendations at the advisory company. Most Swedish PE firms had advisory companies based in Stockholm, while the GP board would be situated in the jurisdiction of the GP, e.g. Jersey or Guernsey.

The GP is compensated in two ways. First, the GP charged a management fee, intended to cover the on-going management of the fund, primarily to pay the advisory company for its services and to cover fees in connection with transactions. A typical management fee in the European buyout market at the time was around 1.75%, which was charged on committed capital during the investment period and on invested capital (at cost) thereafter. Second, the GP shares the profits of the fund, defined as the value of exited portfolio companies minus the investment and management fees). This profit share, called "carried interest", was equal to 20% for the vast majority of PE funds. In order to receive the 20% carried interest, the most common arrangement was that LPs first had to be paid back the amount they had invested in the fund, plus a guaranteed return, called the "hurdle rate". The standard hurdle rate in the private equity market had been 8% per year since the late 1980's. In the end, any carried interest would eventually end up as capital income for the ultimate shareholders of the GP, including the key investment advisory professionals in the PE firm.

EQT's investment processes and philosophy

EQT's stated business idea was to "invest in good companies across the world with a mission to help them develop into great and sustainable companies." Apart from delivering strong returns to their Limited Partners, EQT took pride in the fact that their portfolio companies had increased the number of employees by 11%, sales by 8% and earnings by 11% annually during the EQT Equity funds' ownership. As a result, almost all of the return on EQT's past investments could be attributed to operational improvements such as increased sales and efficiency gains. (See exhibit 3 for some recent buyout transactions of EQT.)

Although many PE firms used industrial advisors, EQT was particularly known know for this. EQT's network consisted of more than 250 independent industrial advisors, who were typically seasoned top-level managers with experience from different industries and regions from around the world. The industrial network also included entrepreneurs and former politicians, who could with relevant skills in the various ownership phases. The Industrial Advisors assisted in identifying and evaluating attractive investment opportunities, took positions on the portfolio company boards and supported the companies' development throughout EQT's ownership period. The Industrial Advisors worked closely with EQTs buyout professionals, called the "Equity Team."

The EQT Equity Team consisted of about 60 investment advisory professionals based in Amsterdam, Copenhagen, Helsinki, Munich, Oslo, Stockholm and Zurich. By maintaining a "local-with-locals" presence, these "Investment Advisory Professionals" believed they were uniquely positioned to analyze companies and the markets in which they operate, and to develop proprietary investment opportunities. The equity team, in collaboration with the EQT Industrial Advisors, sought to identify potential control or co-control equity investments in companies with strong or improving market positions, a significant potential for top-line and earnings growth and an engaged management team. Targeted companies should have the potential for improvement and value creation by investing in growth, in performance improvement, and active participation in industry consolidation through add-on acquisitions. The typical equity investment opportunity of EQT's funds ranged between EUR 100 million and EUR 600 million.

Once a portfolio company had been acquired, EQT appointed a Board of Directors with an EQT Industrial Advisor with relevant management background as the chairman, and other board members being other sector/industry specialists from the Industrial Network. One EQT Equity partner would typically also sit on the board, while members of portfolio company management would not be on the board. The role of the Board of Directors was to define and monitor strategic plans, appoint the portfolio company CEO and ensure that management got the appropriate support and resources to run the portfolio company in an efficient, responsible and accountable manner.

EQT also worked with a more informal forum called the TROIKA, consisting of the Chairman, the EQT Equity partner and the portfolio company CEO. The role of the TROIKA was to work closely together on an informal and continuous basis and is a sparring partner to the CEO, giving advice and support on different topics such as operational or strategic issues. The TROIKA also kept the owners updated on the business and progress.

Incentives were central to the investment model, and portfolio company managers and board members invested significant amounts (relative to their wealth) in the buyout transaction, alongside the EQT fund.

EQT V

If EQT would win the auction for Scandic, it would end up as a portfolio company of EQT V, the firm's latest buyout fund. EQT V had a final close at the end of 2006, obtaining total commitments of €4.25 billion (well above its €4 billion target), which made it the largest buyout fund raised so far in Northern Europe. Limited partners in EQT V included Nordic and international pension funds, fund-of-funds, insurance companies, and foundations. (See exhibit 4 for some selected limited partners of EQT V.) Investor AB was still the largest investor in the fund, with a €500 million commitment. Investor AB would also obtain a fraction of the management fees and carried interest from the fund, since it still owned about 30% of the advisory company EQT Partners AB (with the rest being owned by EQT partners and investment advisory professionals). The strategy of EQT V was to invest in high-quality, market-leading, medium-sized to large companies in Northern and Central Europe with significant value-creation opportunities.

Scandic and the Nordic Lodging market in early 2007

The Nordic Hotel market

The Nordic hotel market was estimated to €5.5 billion in 2006. Out of these revenues, lodging accounted for €4.2 billion (75%), and food and beverage for the remainder. Sweden was the largest Nordic market, accounting for 35-40%, followed by Norway with about 30%, and Denmark and Finland sharing the rest. The business segment accounted for 60% of the total market and the leisure segment for 40%.(See Figure 1 for some statistics on the Nordic hotel market.)

The Nordic hotel market was expected to continue to grow at 4-5% per year over the period 2006-11. The strong growth expectations were driven by several factors. The business cycle in the Nordic countries was expected to be strong, due to strong public finances. The Nordic market also had a relatively high fraction of multinational and global companies and were therefore expected to benefit from the continued globalization trend. Finally, there was a strong secular growth in travel and tourism, and the Nordic market had a good demographic structure to benefit from this trend.

Out of the 4-5% expected growth, 2-3% was driven by a projected increase in the number of room nights, and 2% from higher expected room rates. The supply of new hotel rooms was expected increase at a rate slightly below demand growth, at 1.5-2% per year, which was expected to result in improving occupancy ratios across the region.

The key KPIs used to evaluate a hotel (or portfolio of hotels) was (1) the occupancy rate, i.e. the average fraction of rooms sold in a given day; (2) the average room rate, or ARR; and (3) the average revenues per average room, or RevPar. The RevPar for a given hotel was simply the product of hotel's occupancy rate and its ARR. Although room sales were most important for hotels, and also had the highest margins, hotels also had meaningful revenues from food and beverage sales, and some minor fee revenue from things like telephone, TV, and parking fees. See exhibits 5 and 6 for a breakdown of revenues and costs for a typical hotel in the Nordic market.

The growth of the hotel market was closely tied to overall GPD. The expected growth in nominal terms was about the same as GDP, but volatility was higher, leading to a considerable cyclicality. Historically, ARR, occupancy rates, RevPar, and overall growth in hotel nights had been highly correlated with annual GDP growth. Past data indicated that high-end, 5-star hotels were particularly cyclical, while 3-4 star hotels had a relatively less volatile revenues. (See figure 2 for some statistics on hotel market cyclicality).

Scandic in 2007

By January 2007, Scandic was the leading hotel operator in the Nordic region in terms of rooms, and operated a total of 132 hotels in the 3- and 4-star segment. In the last fiscal year, Scandic's total revenues amounted to €660 million, having grown at a CAGR of 5.6% per year from 2003 to 2006. Scandic's EBITDA margins had grown from 9.4% to 12.4% of revenues over the same period. (See exhibits 7-9 for Scandic historical financials.)

Scandic had a very strong market position in the Nordic countries. With 22,000 hotel rooms, Scandic was the number one hotel chain in the region and had almost twice the number of rooms as their closest competitor, Choice Hotels. Scandic was slightly behind Choice in terms of number of hotels. A recent survey also showed that Scandic outperformed all European competitors except for one in terms of brand recognition, with a recognition rate of 43% among international business travelers. Scandic's market position was particularly strong in Sweden and Denmark, where it had the clear number one position. In Finland, a market dominated by the top 3 players, it held the number 3 position. Scandic's market position was the weakest in Norway, where it was only the 7th largest hotel chain, with a considerably smaller market share than the local leaders Choice, Rica and Rezidor SAS. Scandic's profitability were also the lowest in Norway, with EBITDA margins of around 8%, compared to 17% in Sweden, 18% in Finland, and 12% in Denmark. (See figure 3 for a description of competitors and market shares in the Nordic hotel market, and exhibit 10 for competitor hotel rankings.)

At the beginning of 2007, Scandic operated 122 hotels in the Nordic region and another 10 hotels located in Belgium, the Netherlands, Germany, Estonia and Lithuania. Scandic focused on three to four star full-service hotels with conference and leisure facilities, and hotels were typically located either in city centers or in close proximity to airports and major road networks. 60% of Scandic's revenues came from business and meeting travellers and 40% from leisure travellers.

Customers consisted predominantly of domestic and intra-Nordic travellers, who accounted for 70% of revenues. It had a particularly strong presence in the Nordic capitals, with 16 hotels in Stockholm, 6 in Copenhagen, 8 in Helsinki and 6 in Oslo. Although these hotels represented only 27% of Scandic's hotels in terms of numbers, the capital hotels accounted for 45% of sales and 53% of EBITDA in 2006.

The average Scandic hotel had 185 rooms, which was larger than the hotels of their main competitors. The RevPar in 2006 was €57.5, based on an ARR of €88.5 and an occupancy rate of 65%. These KPIs were well above the average for the Nordic hotel market, where the average RevPar was about €10 lower. Scandic's RevPar had increased significantly over the last four years, partly due to the improved economic environment leading to higher occupancy rates, but also thanks to Hilton undertaking a significant refurbishment CAPEX program with the objective of upgrading the overall portfolio. As a result, Scandic had reduced the number of substandard rooms by 40% and doubled the number of superior standard rooms, resulting in a higher ARR. (See exhibit 11 for Scandic's RevPar by region.)

The vast majority, 92%, of Scandic's hotels under lease contracts, with the remainder being either wholly owned, managed or franchised. Compared to other hotel chains, the lease share was unusually high, while the share of franchising or management contracts was unusually low.[†] About 30% of Scandic's leases had fixed rent, while 70% had revenue-based rents, where rent was determined as a percentage of revenues, sometimes with a minimum payment. The trend in the Nordic market was that hotel operators increasingly signed revenue-based based leases with a fixed minimum payment of 60-80% of the expected rent. The typical lease term was between 10 and 15 years. Leasing rents had been increasing in recent years, and this trend was expected to continue. Scandic had 37 lease contracts up for renegotiation before the end of 2010.

Most of Scandic's revenues came from hotel room fees, accounting for 69% of total revenue and 86% of total profits in 2006. Food and beverage sales accounted for 29% of total revenue but at lower margins, contributing with 12% of the Scandic's profits in 2006. Similar to other hotel operators, Scandic had experienced the cyclicality of the hotel market in the past downturns, but the 3-4 star hotel segment it focused hotels on had proved to be less cyclical than the higher-end hotel

[†] In a management agreement, the chain basically provides all same services as they do in a franchise agreement, such as brand, reservation system etc., but on top of this the chain also operates the hotel, making all the day-to-day decisions on behalf of the owner. Another difference is that in a franchise agreement, fees are collected on a room revenue basis, while in a management agreement; fees are typically collected on based on total revenues as well as on the bottom-line profits.

segment. In addition, Scandic had experienced less sensitivity to cyclical downturns in the past, compared to their same-segment competitors Choice and Rica.

Scandic's main distribution channels included customers directly calling the hotels (62% of revenues), customers routed through call centers (13% of revenues), reservations on the web (10% of revenues), and business coming from travel agencies and traditional global booking systems (15% of revenues). When a customer reached Scandic through one of these distribution channels, the request would be fed into Hilton's centralized reservations platform known as Hilton Reservations and Customer Care (HRCC). Scandic payed a fixed fee to the Hilton parent company for each booking made in the system. Once Hilton had sold the company, however, HRCC would no longer be available to Scandic, and the company would have to develop its own reservation platform.

Loyalty programs were considered an important marketing tool in the hotel industry to ensure repeat business, particularly among business customers. In a loyalty program, customers would collect points that they could use to buy services from the hotel, such as additional hotel nights, meals, and travel packages. Also, customers accumulating enough points would be upgraded to elite status, entitling them to extra services and free upgrades. Repeat guests formed a significant proportion of Scandic's revenue and almost 40% of its guests (by room nights) were members of their loyalty program. After Hilton acquired Scandic in 2001, the old loyalty programme "Scandic Club" was terminated, and its members were transferred to Hilton's "HHonors" program. Now when Hilton was to divest the company, Scandic would have to reintroduce their "Scandic Club" program. How many HHonors members would actually be transferring to Scandic Club was uncertain at this point. One positive sign was that more than 90% of the HHonors points earned at Scandic hotels were actually redeemed at a Scandic hotel (rather than another Hilton hotel), indicating that it would be in the interest many Scandic customers to transfer.

EQT's assessment of Scandic

An investment in Scandic would be EQT's first foray into the hotel market, although they had previously invested in travel-related business, such as the travel catering company SSP. Still, as was customary for EQT, they reached out to their industrial network to find someone with deep knowledge about this particular industry. As EQT started considering a bid for Scandic, they engaged one of their industrial advisors, Vagn Sørensen, to evaluate the investment together with members of EQT's Stockholm-based buyout team. Vagn Sørensen had extensive experience in the travel industry, and had formerly been an executive at SAS and Austrian Airlines. (See exhibit 1 for a biography.) If EQT ended up acquiring Scandic, the plan was that Sørensen would also become chairman of the company's board. In addition, EQT engaged several external advisors to assist in due diligence, including the management consulting company Bain, the accounting firm KPMG, Swedish law firm Vinge, and Handelsbanken Corporate Finance for investment banking advice.

Key investment attractions

Throughout the due diligence process, EQT had identified what they believed were the key attractions of this deal.

First, EQT had a preference for investing in markets with good growth prospects, and everything else equal tried to avoid declining industries. EQT believed the hotel market was attractive overall, given its size and long-term expected growth of 4-5% per year. This assumption was obviously relying on the continued economic growth in the Nordic region, and the cyclicality of the business was a risk that would have to be assessed and handled.

Second, EQT preferred to invest in companies with a leading position in their market. As the leading Nordic Hotel chain with a market share of 19% of total hotel rooms, and strong brand recognition, Scandic seemed to fit this criterion. EQT also liked the fact that Scandic had a high fraction of repeat guests, many of whom were members of the loyalty program. Apart from being a sign of the strong brand, this should also make revenues more stable and predictable.

Third, EQT would typically keep existing management when they acquired a company, at least as long as they continued to perform. One reason for this was that a buyout involved a lot of strategic and operational change in itself, especially early on in the PE investor's ownership, and changing management would add too much additional turmoil at this point. EQT had done an extensive assessment of Scandic's existing management team, including personal meetings and reference checks, and they concluded that the company's overall management team was experienced and had a long track record with the company. One important caveat in this case, though, was that the Scandic's current CEO, Jean-Paul Herzog, would move on to a new position at Hilton and not be continuing with the company under the new ownership. This was obviously not ideal, but EQT had identified what they believed to be a strong CEO candidate, Frank Fiskers. Fiskers was currently part of the Hilton management team in London, and had been head of Sweden for Scandic for two years following Hilton's acquisition, so he knew the company well. Also, he had extensive hotel experience, and had spent 16 years at SAS Rezidor before joining Hilton in 2001. Although his move to Scandic would have to be kept strictly confidential, EQT had been able to involve Fiskers in the due diligence process, and he had signed off on EQT's operational plan.

Fourth, for an investment to be successful, there had to be room for additional operational improvements in the company, which a transfer of ownership to EQT would enable. EQT believed this was the case for Scandic. One reason for this was that Scandic had not been able to realize its full potential under Hilton ownership, particularly with respect to the constraints in growing and establishing new hotels. Under EQT's ownership, Scandic would be able to expand again. One way would be to undertake additional add-on acquisitions of other Nordic hotel chains that could be merged with Scandic. The EQT investment team had already identified what they believed to be the most promising targets in Norway and Finland, which would considerably strengthen the company's position in this markets. Besides larger acquisitions, Scandic planned to add new hotels continuously to maintain their market share. In addition, they saw considerable potential in expanding Scandic into new neighboring markets, such as Eastern Europe. The Eastern European hotel markets were growing rapidly, but there was still a scarcity of brand-name hotels with Western standard rooms and service. Many new hotels were currently being built in these markets, which should make it easier to expand through leases or franchise contracts. Scandic's existing operations in the Baltics would also provide a platform for expansion.

There were also opportunities to increase profits of existing operations. Although Scandic's management had recently initiated a number of revenue-enhancing initiatives under Hilton, but most of these were not fully implemented yet. Scandic had just started implementing a simpler, two-tier pricing strategy, which had already started to improve both room rates and occupancy. The company had developed a new "clustering strategy", which involved consolidating individual hotel departments, improving cross-selling across hotels, and increasing efficiency in inventory management. A new internet-based revenue management system had also been implemented recently, which was able to generate different rates depending on changing market conditions over time. Finally Scandic had started adding small convenience stores in hotel lobbies, which could drive additional revenue in the future. These initiatives had shown considerable promise, and would be expected to lead to higher revenues and profits in coming years.

Investment risks

EQT had also identified some important risks that would have to be mitigated.

The most important concern was the cyclicality of the industry. The economy was probably near the peak of the cycle, and the hotel industry was likely to be hit significantly in a downturn. In addition to cyclicality, the hotel industry was also sensitive to event risks such as 9/11, which could lead to dramatic drops in travel. This was relevant not only for the profitability as such, but also important from a capital structure perspective. EQT would use a considerable about of debt funding for the deal, and a drop in probability could put the company in financial distress, with a risk of default or bankruptcy. Because of this, the EQT deal team had spent considerable time analyzing the sensitivity of Scandic to the business cycle, using data from past economic downturns. Their analysis indicated that Scandic was likely less cyclical than the average hotel chains, partly because they operated in the less volatile 3-4 star segment, but even in this segment Scandic had performed relatively well in past downturns compared to peers. One advantage for Scandic was its relatively high degree of geographical diversification across the Nordic region. Moreover, the supply of new hotel rooms in the market was expected to be relatively low in the coming years, which lowered the risk of overcapacity following a market downturn. EQT also considered the various tools the company had at their disposal to weather a downturn. One tool was to be able to quickly reposition the hotel in a downturn, and the new revenue-management system would be helpful in this regard. Scandic's reliance on variable-rate leases was also a positive, since this lead to some automatic cost adjustment as revenues declined. It would also be possible to lay off some of the staff, close down parts of hotels to save on heating and servicing, and cut marketing costs and room maintenance expenditures, although this would have to be balanced against negative longer-term effects on growth. EQT's conclusion was that even though cyclicality would remain a key risk, this risk could probably be handled, and was not enough of a reason to offset the attractions of the deal.

A second concern was transition issues in carving Scandic out of Hilton. The old "Scandic Club" loyalty program would have to be re-introduced. Fortunately, the infrastructure for the old program was still in place, but some development was needed since systems were currently integrated with Hilton's systems. Also, there was a risk of losing customers during the transition period. Scandic would also have to invest in a new reservations platform, since they could no longer use Hilton's HRCC system. When EQT looked closer at these issues, however, they also discovered that there was a significant cost savings potential in moving to new systems as well, since they had not been run in a cost efficient manner. These cost savings were estimated at around €4 million per year, once these investments had been made.

Third, there was obviously some uncertainty in the ability to execute on the new growth strategy. Scandic had currently a very modest growth pipeline, and ramping up growth could be challenging, for example when it came to finding attractive lease opportunities. Moreover, there a substantial number of lease contracts were up for renegotiation in coming years, which could negatively impact rent levels. Finally, CEO would be new, which was a risk in itself, and although management was experienced, their ability to execute on this demanding new strategy was unproven.

EQT believed they had an edge relative to other potential buyers, in successfully executing this strategy, however. As far as they new, there was no other hotel chain bidding for Scandic, which meant that none of the bidders had any synergy benefits compared to EQT. Scandic's competitive advantage was its strong position in the Nordic region, and EQT had very strong networks in this region, which would provide the company with valuable access to business partners, such as real estate developers, hotel owners, and suppliers. Scandic's management had also indicated that they preferred a regional investor. In fact, EQT's network advantage had already helped them identify what they believed to be outstanding Chairman and CEO candidates, and the firm's access to high-quality management candidates with industry experience would continue to be a comparative advantage going forward.

100-day plan

EQT's experience was that the actions of the management and board immediately after an acquisition were absolutely crucial for the future success of a buyout transaction. For this reason, EQT always developed a "100-day plan" of the things that the portfolio company management should achieve for the first three months. During the last few weeks, Vagn Sørensen had developed a detailed 100-day plan for Scandic, which included

- Prioritize pipeline of available and expected leases as well of re-branding opportunities, and execute the best ones
- Analyze all possible non-organic growth options with a view to establish a growth strategy
- Develop plan for roll-out into the new geographies in Eastern Europe
- Develop a list of actions to achieve €30 million of revenue enhancement and €10 million of cost savings, and prepare a plan for implementation.
- Develop and perform a powerful stand-alone Scandic marketing- and branding-plan
- Decide on the final concept and plan for the re-launch of Scandic Club.
- Analyze and make critical decisions as to future reservations platform and a possible replacement for Scancom
- Drive the Hilton separation project with highest priority (mainly IT, purchasing, call-center)
- Initiate a detailed management assessment
- Develop targeted and attractive incentive schemes for management and other relevant key employees with the ambition to create a performance culture in the entire company
- Plan a project to optimize working capital

Deal structure

EQT had been working for some time to secure debt financing for the deal, and were in detailed term sheet discussions with four different banks, who would provide senior secured loans, as well as with three mezzanine providers, who would provide junior debt (possibly in combination with an equity investment). The current financing plan involved €450M in bank debt, at an expected interest rate of 6.75-7.00%, and €150 million of mezzanine debt, which would likely have a cash interest if 5% and a pay-in-kind (PIK) interest of 4%. The PIK interest part would not have to be paid in cash, but would instead increase the face value of the mezzanine debt by 4% per year (i.e. next year, cash and PIK interest would be based on this higher face value). With this debt structure, Scandic's leverage would amount to close to 7 times expected 2007 EBITDA. This was a fairly high amount of leverage, especially for a cyclical company, but in order to be able to bid competitively and at the same time ensure sufficient returns to their investors, EQT believed these leverage levels were needed. Moreover, the PIK interest and relatively beneficial amortization and covenant conditions on the debt should make this capital structure feasible, even in an economic downturn.

Most of the remainder of the financing would be provided by EQT V, which would provide the equity for the deal. How much equity EQT V would have to invest would obviously depend on the price that EQT ended up paying if the won the auction. (In addition, expected transaction costs to advisors and banks amounted to 22 million.) See exhibit 13 for a tentative deal structure. In making the decision of how much equity to provide (which would largely be a function

As was customary in buyout transaction, a major part of the equity investment would be provided in the form of a shareholder loan from EQT V to the company, which would only have a PIK interest. There were two reasons for this. First, EQT wanted management and board members to invest in the equity of the deal, alongside EQT. In a typical buyout, management would own 10% of the common equity. But in order for management to be able to afford this investment, the common equity tranche would have to be small enough. Management investing its own money in the deal was a central part of EQT's investment model. In order to achieve a fundamental transformation of the company and execute a highly ambitious business plan, EQT believed monetary incentives were crucial for motivating management. Management's higher share of common shares made management's equity investment more risky than EQT's investment, but with considerably higher upside. Second, the PIK interest on the shareholder loan was deductible for the company, which would lower the overall corporate tax payments.

Pro forma financials

The EQT deal team, in close cooperation with Sørensen and Scandic management had spent considerable time developing a detailed business plan and financial projections for Scandic over the next few years. Bain and KPMG had also assisted in this process, helping to verify and challenge the various assumptions about growth, margin improvements, and investment needs. One area that was particularly important and complex was to estimate an adjusted 2006 EBITDA, given new information about Scandic's performance since Citigroup's Investment Memorandum was written, as well as estimating the cost structure given that Scandic would be separated from Hilton. EQT estimated that pro forma 2006 EBITDA would actually be considerably higher given these adjustments (see figure 5).

Exhibits 14-16 contain EQT's base-case income statement, cash-flow statement, and balance sheet for Scandic during for the coming years. In addition to the base-case projections, EQT had developed a downside case, assuming a cyclical downturn similar to the one experienced in 2001-2003, as well as an upside scenario where under more favorable market conditions and successful execution of the strategy. These projections were important both to assess the returns to EQT under different bid levels, as well as to assess the feasibility of the capital structure and make sure Scandic could meet debt payments and covenants.

Exit

EQT V, which would be investing in Scandic, was a newly raised fund, so EQT could potentially hold on to this investment for almost ten years if needed. Still, EQT's ideal scenario would be able to exit the company in 4-5 years, assuming the new strategy had been successful resulted in higher revenues and profitability. On the other hand, it was not unlikely that exit could be delayed two years or more in a less favorable scenario.

EQT put considerable effort in planning an exit, and believed that their portfolio companies "should always be for sale" if the right buyer showed up with a sufficiently attractive bid. As a dominant player in its region with a strong brand name, and a history of being publicly traded in the past, a future Initial Public Offering was definitely an option. Another good sign was that Rezidor SAS had successfully been taken public in 2006. On the other hand, the feasibility of an IPO would depend on the state of the public equity markets at the time of exit.

Scandic could also be an attractive acquisition candidate for another hotel chain, either an international player wanting to establish itself in the Nordic market, or one of the local chains looking to acquire a dominant market position. Such an acquirer, however, would face similar problems that Hilton had regarding branding and growth. Also, the synergies for an international hotel chain probably somewhat limited, given the Scandic's high regional concentration. EQT thought that Scandic would be a more attractive target for a strategic bidder if they were able to successfully grow outside the Nordic market.

Finally, Scandic would probably be an interesting investment for another private equity player, given its stable and dominant market position, and the fact that there was likely continued growth and expansion potential even after EQT's ownership period. The valuation in a secondary buyout would be dependent on the state of credit markets at the time of exit, however.

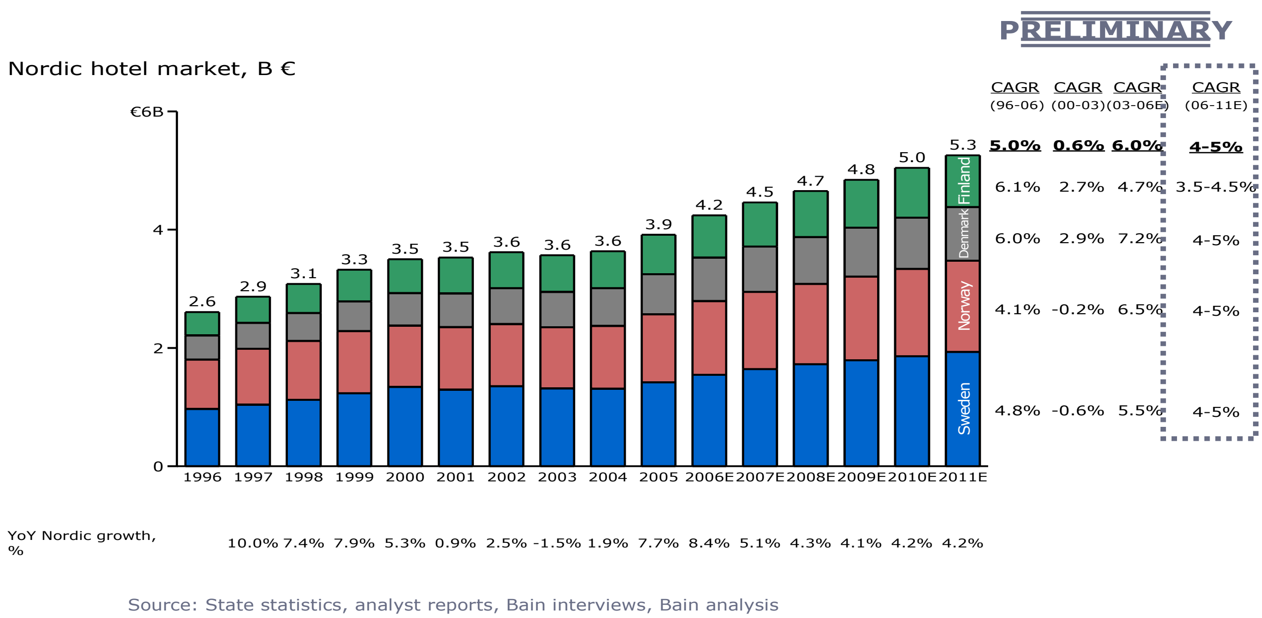
Valuation and returns

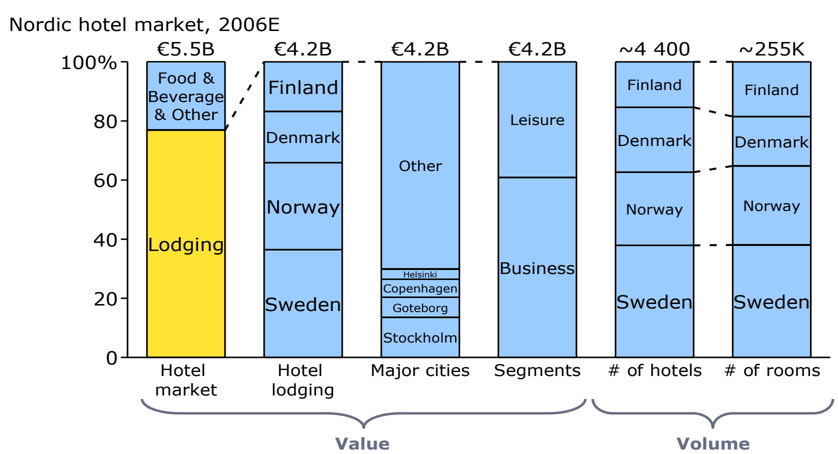
The most important decision for EQT at this point was what price they should offer in the second-round. Using the pro forma scenarios, the EQT team had estimated returns, focusing on IRRs and multiples, given various assumptions about transaction price, exit valuation, and exit timing. One important input to this analysis was the price that EQT would be able to sell the company for in an exit, which in turn would depend on how companies like Scandic were valued in the market. EQT had constructed a set of publicly traded peer companies for this purpose. (See exhibit 17.) Peers were currently trading at an enterprise value (EV) between 12 and 17 times 2006 EBITDA, with an average of 14.7. Using expected 2007 EBITDA, the corresponding peer valuation was an average EV/EBITDA of 12.9. Because of the cyclicality of the industry, valuations in public markets fluctuated considerably over time, however, and valuations at cyclical low-points had historically been around 8-10 times last years EBITDA. For this reason, EQT felt they should be conservative in their exit valuation.

In addition to public valuations, EQT had also compiled data for a set of buyout and M&A transactions in the hotel industry over the last 6 years. In these past transactions, valuations had varied widely, depending on year, location, and specific deal conditions, but the median EV/EBITDA multiple paid was around 11. (See exhibit 18.)

Given this information, the question was what EV EQT should be willing to bid. Limited partners typically had expectations of IRRs on their private equity investments in the range of at least 15-20% IRR net of fees. To cover the GPs management fees and carried interest, an fund would probably have to target returns of 20-25% before fees on their investment. Given this, EQT now felt that they would probably have to lower the bid compared to the valuation they offered in the first round. But what should this bid be, given that it both had to be high enough to win the auction, but low enough to ensure that this was a good investment for EQTs limited partners?

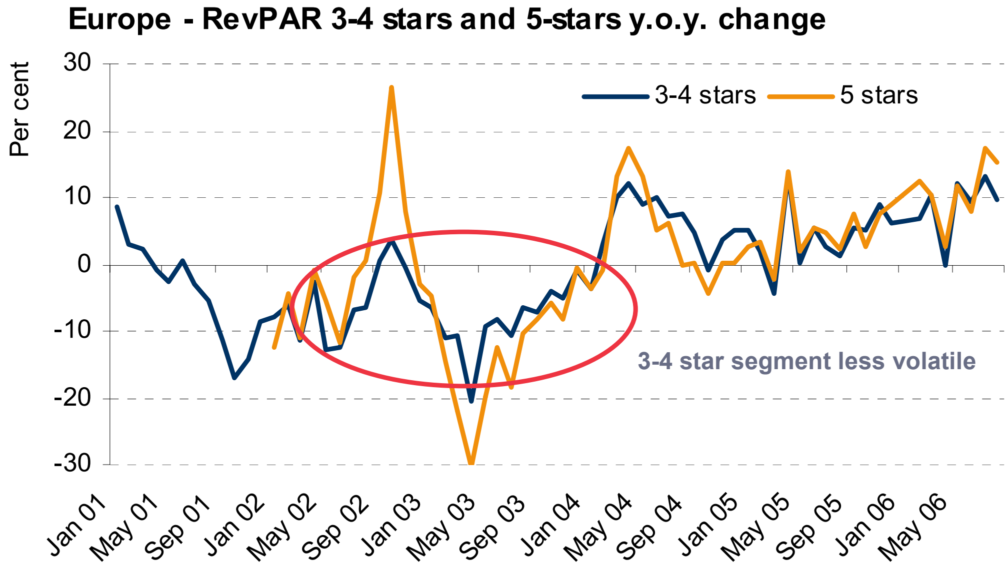
Figure 1 Growth of the Nordic hotel market





Source: EQT Investment Committee Presentation, January 2007.

Figure 2 Hotel market cyclicality



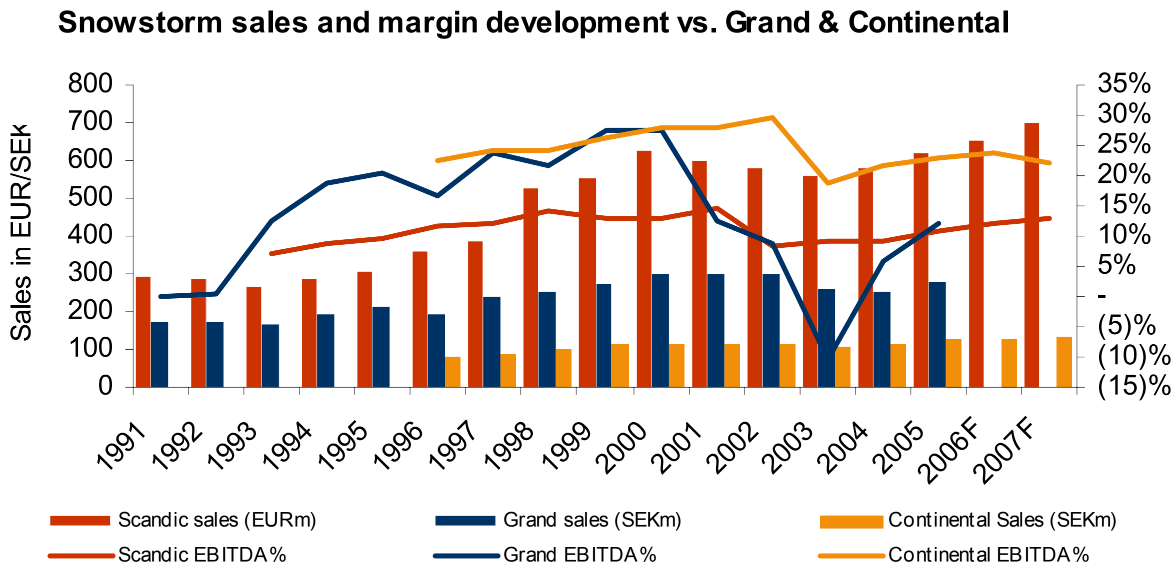


Figure 3 Nordic hotel chains, overview

Overview of hotel chains' operations in the Nordic countries

8 pan-Nordic and 12 local hotel chains hold approx. 50% of the Nordic market

Hotel chains with operations in several Nordic countries
- **Choice Hotels** (151 hotels, Petter A. Stordalen)
- **Scandic Hotels** (119 hotels, Hilton Hotels)
- **Best Western** (107 hotels, franchisees)
- **First Hotels** (52 hotels, Asmund Haare & Family)
- **Rica Hotels** (82 hotels, Jan E. Rivelsrud)
- **Norlandia** (49 hotels, 60% owned by Adolfsen brothers)
- **ParkInn Hotels** (22 hotels, 11 owned by Rezidor, 11 owned by Winn Hotels)
- **Radisson SAS** (70 hotels, owned by Rezidor)

Norway
- Euro Hotels (25 hotels)
- **Thon Hotels** (45 hotels, Olav Thon)
- Norske Konferansehoteller (26 hotels, co-op)

Denmark
- **Arp-Hansen Hotels** (10 hotels, Arp-Hansen family)
- **Cab Inn** (5 hotels, Niels Fennet)

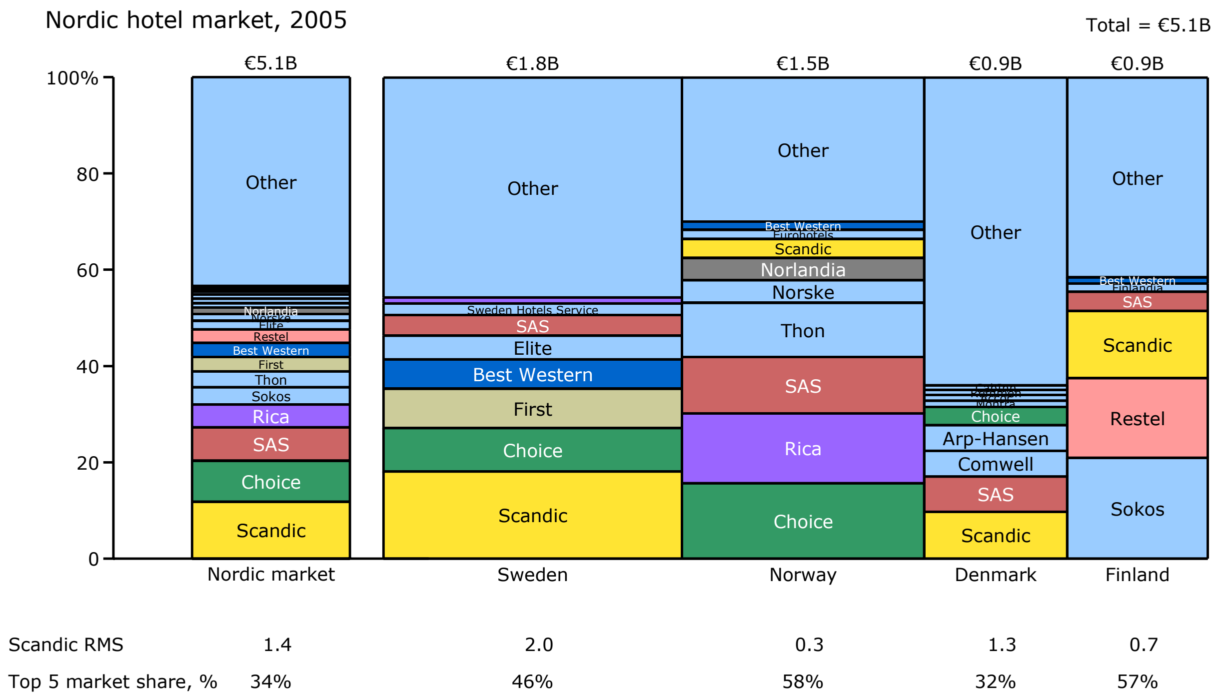
Finland
- **Sokos Group** (38 hotels, co-op)
- **Restel** (45 hotels, co-op)
- **Finlandia Hotels** (32 hotels, individually owned hotels)
- Lomaliitto (28 hotels, association with members such as cities and various unions)

Sweden
- **Elite Hotels of Sweden** (17 hotels, Bicky Chakraborty)
- **Winn Hotels** (12 hotels, 11 ParkInn & 1 Winn Hotel ~60 private owners and staff)
- **Ibis Hotels** (18 hotels, Accor SA / franchisees

Note. International high-end hotels excluded

Source: EQT Investment Committee Presentation, January 2007.

Figure 4 Nordic hotel chains, market shares



Source: EQT Investment Committee Presentation, January 2007.

Figure 5 Estimate of Scandic's pro-forma EBITDA

Pro-forma EBITDA

2006 Pro-forma EBITDA is €86.1m

	2006	Comments
EBITDA per IM	**78.0**	
Trading update	10.6	
	88.6	
Normalisation adjustments		
December 2006 normalisation	(5.8)	
PwC normalisation adjustments	0.6	
KPMG normalisation adjustments	1.7	KPMG adjustments less Sergel Plaza license fee included below
Elimination of GSB	(0.8)	Support office income from Hilton
Normalised EBITDA (incl. Sergel Plaza)	**84.3**	
Portfolio adjustments		
Elimination of Sergel Plaza EBITDA	(3.3)	Conversion of Sergel Plaza to management contract
Future Sergel Plaza management fee	0.8	
Karlstad management contract	0.2	New management contract signed in Dec 2006
Normalised EBITDA (after portfolio adjustments)	**82.0**	
Standalone adjustments (100%)		
Hilton Honours saving	3.5	Saving as a result of operating own loyalty programme
Hilton Reservation System saving	3.0	Saving as a result of operating own reservation system
Hilton franchise fee	(0.8)	Future franchise fee for operating the 3 Hiltons
IT	(2.2)	Ongoing IT cost increase due to operating reservation system
Rate & content	(0.2)	Cost of 2 additional employees required to upload room rates
Group finance charge	(0.5)	Adding treasury and group accounting functions
Cost savings	1.3	Potential cost savings identified by management
Pro-Forma EBITDA	**86.1**	
Total Proforma Adjustments	(2.5)	

Scandic stand-alone cost saving adjustments verified by KPMG. From 2008 and onwards this EUR 4.1 M saving is assumed to have full impact on the EBITDA. However for 2007 we have assumed full costs with minor savings resulting in a total negative effect of EUR 2.4 M

Endnotes

[i] ”Hilton köper Scandic,” *Dagens Industri*, April 23, 2001.
[ii] ”Hilton makes quantum leap in £612m Scandic hotel buy,” *The Guardian*, April 24, 2001.