Appendix vi: hertz corp. case study essay sample

ASSIGN
BUSTER

Overview: The Hertz buyout is one of the largest private equity deals. It drew criticism in the media and from union members, after the company's new owners paid themselves $1. 3 billion in dividends not long after the transaction closed and ultimately financed the payments by selling stock to the public. The company has realized hundreds of millions of dollars in improved financial results annually, but also has cut thousands of jobs as it has sought to make operations more efficient. Figure 7 provides an overview of the LBO transaction, including a time line of key events. Background: Hertz says it is the world's largest general use car rental company, with approximately 8, 100 locations in about 145 countries. Hertz also operates an equipment rental company with about 380 locations worldwide, although car rentals accounted for 80 percent of 2007 revenues.

Ford Motor Co. had purchased an ownership stake in Hertz in 1987 and purchased the company outright in 1994. CD&R executives said that the firm emphasizes making operational improvements in companies it acquires. The firm has long had an interest in multilocation service businesses, they said, as evidenced by investments including Kinko's and ServiceMaster. The Carlyle Group is one of the biggest private equity firms and says it has demonstrated expertise in the automotive and transportation sectors. Its investments include Dunkin' Brands, AMC Entertainment, Inc., and Grand Vehicle Works, which provides products and services to truck fleets and recreational vehicle users. Merrill Lynch Global Private Equity is the private equity arm of Merrill Lynch & Co.

The acquisition: In 2000, CD&R began exploring acquisition targets in the car rental industry. It analyzed a number of firms before targeting Hertz because

of its industry-leading position. In addition to having strong brand recognition, Hertz was the leader in airport rentals, and its equipment rental division provided diversification. CD&R also had an interest in “ corporate orphans,” that is, units of large corporations that are not part of the company’s core operations, and thus may not receive sufficient management attention. CD&R viewed Hertz as such an orphan, with significant room for improvement as a result. Beginning in 2002, CD&R regularly approached Ford about acquiring Hertz, CD&R executives said. They explained that Ford was skeptical about CD&R’s GAO-08-885 Private Equity ability to finance the acquisition and operation of Hertz, which is capitalintensive due to its large holdings of cars and equipment. By 2005, Ford was experiencing difficulty in its core auto manufacturing business and decided to divest Hertz. Ford took a two-track approach to doing that, simultaneously pursuing an initial public offering (IPO) of Hertz, as well as a bidding process for the outright sale of the company. Given the size of the potential deal, CD&R needed partners, executives said.

Like many other private equity firms, CD&R has restrictions on how much it can invest in a single entity and buying Hertz on its own would have meant exceeding this “ concentration” limit. Thus, CD&R partnered with two other firms—the Carlyle Group and Merrill Lynch Global Private Equity. Carlyle officials said they too had been interested in Hertz for some time and were attracted by the strong brand and orphan status. The two firms agreed to a partnership, with CD&R as the lead firm with operational control. Both firms had worked previously with Merrill Lynch’s private equity fund, and they invited the company to join the two firms. In September 2005, after several

rounds of bidding, Ford agreed to sell Hertz to the consortium. CD&R executives described the bidding process as difficult and competitive, with two other groups of leading private equity firms participating. Ford's investment bankers managed the process and pitted the competing bidders not only against each other but also against the prospect of an IPO.

During bidding, CD&R stressed to Ford that a direct sale would provide a higher price, more certainty, and more cash than an IPO. Eventually, Ford went for the private sale, in a deal valued at $14. 9 billion, which included $5. 8 billion of corporate debt and $6. 8 billion of debt secured by the company's vehicle fleet. At the time, it was the second largest leveraged buyout ever done. The private equity firms invested $2. 3 billion, with each contributing an approximately equal amount, to acquire ownership of all of Hertz's common stock. Strategy and implementation: Even before acquiring Hertz, CD&R had identified three main areas for improving Hertz's operations: the off-airport market segment, high expenses in European rental car operations, and widely varying performance among individual branch locations.

According to CD&R executives, Hertz had significantly increased its number of off-airport locations, for example, but was losing money. So the firm decided to close some poorly performing offices. In Europe, CD&R identified overhead expenses, such as sales and administrative costs, which were several times higher than in the United States and thus would be a target for change. After the buyout, the consortium helped Hertz management develop operational and strategic plans and implemented a new management compensation method, according to Carlyle executives. The plans included,

for example, efforts to increase market share in the leisure segment and to improve buying and managing of vehicles. Carlyle executives said hiring a new chief "executive in mid-2006 was critical to implementing the plans. The new Chief Executive Officer came to Hertz with a background in process improvement and industrial management after working at General Electric Co. and serving as the Chief Executive of auto parts supplier Tenneco. To target price-sensitive and leisure customers, Hertz began offering discounts to customers making online reservations and using self-service kiosks.

Carlyle executives said that to reduce the cost of its fleet, Hertz increased the share of cars that it buys, rather than leases, from manufacturers. (Owning is cheaper, because with a lease, the manufacturer must be compensated for the residual risk of disposing of a rental car once its service lifetime is up.) As part of efforts to increase efficiency, Hertz relied on employees to generate ideas. For example, workers identified ways to improve cleaning and processing of rental cars upon their return, Carlyle executives said. Changes in compensation were designed to better align the interests of management and shareholders. For example, Hertz provided more than 300 employees an opportunity to own stock in the company, based on revenue growth, pretax income, and return on capital. Results: Hertz’s financial performance has improved in some areas since the buyout. Revenues have continued to grow steadily, as they did under Ford’s ownership, with an increase of 16 percent from 2005 to 2007. Cash flow, as measured by a common industry benchmark of earnings before interest, taxes, depreciation, and amortization, grew by about 25 percent, from $2. 8 billion in 2005 to $3. 5 billion in 2007.

Hertz’s operational improvements can be seen in its direct operating expenses as a percentage of revenues, which declined from 56 percent in 2005 to 53 percent in 2007. Net income, however, fell below preacquisition levels, although it is growing. In 2005, net income was $350 million, but this declined to $116 million in 2006, before improving to $265 million in 2007. The lower earnings reflect higher interest payments stemming from debt used to finance the acquisition. In September 2005, before the acquisition was completed, Hertz’s total debt was $10. 6 billion, and this balance increased to $12. 5 billion by the end of 2005, after the deal closed. Consequently, net interest expense rose from $500 million in 2005 to $901 million in 2006 and $875 million in 2007.

These amounts represented 6. 7 percent, 11. 2 percent, and 10. 1 percent of revenue, respectively. At the same time, however, Hertz’s new owners have used the increased cash flow to pay down the debt. As a result, total debt decreased by $555 million from 2005 to 2007. To help cut costs, Hertz has reduced its workforce by about 9 percent since the end of 2005. After the private equity consortium acquired Hertz in late 2005, the company had about 32, 100 employees, with 22, 700 in the United States. By the end of 2007, total employment had decreased to about 29, 350, with 20, 550 in the United States. Most of the reduction came following job cuts announced in 2007 that the company said were aimed at improving competitiveness. It said "the reductions were aimed at eliminating unnecessary layers of management and streamlining decision making. According to CD&R, 40 percent of the lost jobs came in the equipment rental business, which fluctuates with the construction cycle. Further workforce cuts are planned, as

Hertz has said the company has completed agreements to outsource functions including procurement and information technology by the end of the third quarter of 2008.

In June 2006, 6 months after the acquisition, Hertz borrowed $1 billion to pay its private equity firm owners a dividend. Five months later, Hertz made an IPO of stock, raising $1. 3 billion, and used the proceeds to repay the $1 billion loan and to make another $260 million dividend payment to the private equity firms. The dividends drew criticism, such as in the media and from union members, for their size, and the IPO, coming less than a year after the acquisition, drew criticism as a " quick flip" transaction. For example, Business Week magazine, in an article describing what it called private equity firms' " slick new tricks to gorge on corporate assets," singled out dividend payments as a " glaring" sign of excess and cited the $1 billion Hertz dividend. Carlyle and CD&R executives said a desire to return funds to the private equity firms' limited partners and uncertainty whether the IPO would actually be completed as planned, spurred the June dividend. Banks were willing to loan money at attractive rates to fund the dividend, they said.

As for the timing of the IPO, the executives explained that Hertz's performance turned out to be better than expected, while at the same time, market conditions were attractive. It can often take 3 years or more to exit a buyout through an IPO and subsequent secondary equity offerings, one executive said, because public investors are often unable or unwilling to purchase more than a portion of the shares held by private equity owners in a single offering. This long horizon, coupled with Hertz's financial performance, convinced the private equity firms to proceed with the IPO.

Hertz’s stock debuted at $15 per share, peaked near $27, and more recently has been in the $13 range. The decline has generally been in line with the performance of other large, publicly traded car rental companies. Exit: After the IPO, the three firms retained an ownership stake in the company of 72 percent, which Carlyle and CD&R executives said demonstrated that there was no “ quick flip.” In June 2007, the firms completed a secondary offering of their Hertz shares, selling $1. 2 billion worth of shares, and leaving them with a 55 percent ownership stake. Executives of one of the firms said three or four more such offerings are likely.