



Ducati and Texas Pacific Group – A ‘Wild Ride’ Leverage Buyout

Introduction and Recommendation

Due to Ducati’s strong turnaround potential and other revenue opportunities under new management, proposed deal structure, and Italy’s developing public equity market, we

recommend that the Texas Pacific Group go through with the purchase of Ducati, at a price between 400 – 500 billion Lira.

Strong Turnaround Potential and Other Revenue Opportunities

The name Ducati has long been associated with the street bike market segment. Like Harley Davidson with cruisers, Ducati's domination of street bike racing has elevated its name to the very top of the >500cc market. Despite the great name, Ducati has lousy management. Ducati's parent company, Cagiva, had diversified into too many areas, decreasing value by intertwining businesses' financial statements and presenting a lack of visibility into divisional profits. As a result, Ducati had 180 billion in debt by 1995 and negative retained earnings. In 1996 Ducati had a disproportional world market share given its success in World Superbike Championships, a reputation for having top tier motorcycles and incredible engines and a long waitlist for its products. From the financial perspective, Ducati had a ROIC of 5% in 1996. With a WACC of 8%, Ducati earned an EVA of *negative* 14 billion Lira, delivered an EBITDA margin of 12% (prior year was 20%) and had SG&A expenses of 23.1%. **EXHIBIT 1.** Motorcycle volume growth decreased 32.7% from prior year to 13,480 in 1996, with outstanding orders in Europe of 5,600 units. By March 1996, a countless number of bikes missing one part were sitting in the shop because Ducati's suppliers either stopped providing the part or were bankrupt because they were not getting paid. Better management of working capital requirements was in dire need for Ducati to avoid bankruptcy. Yet Ducati has very strong manufacturing fundamentals and a high level of standardization of its engines. Injections of working capital would to a great extent help turn the operations around.

Working capital additions decreased in 1996 by 0.9 Billion Lira. **EXHIBIT 2.** A steady increase of 13% in 1998 and 1999 and 20% from 2000 through 2003 in net working capital requirements will allow production to increase and will reduce the inventory, allowing for more bikes to leave the shop. Forecasted increase in Net Working Capital for 1997 was 1.2 Billion, with additional requirements of 52 billion by 2003. Inventory days sales will see a reduction to 67 by 2003, from 113 in 1995. In addition, Ducati can capitalize on its brand by selling replacement parts, motor clothes and mechanical accessories. We assumed a conservative gradual ramp up of “Other Revenues” to 3% of motorcycle revenue, which adds an additional 22 billion to revenue in 2003.

Proposed Deal Structure and Valuation

To fund the increase in net working capital and allow for solid management to take over Ducati, the deal was structured as an asset sale. TPG estimated the Ducati trademark to be worth around 200 billion Lira, with the remaining assets on the books for 175 billion Lira in 1995. They estimated that they would need to pay off the outstanding accounts payable of 10 billion and increase production capacity by 4.6 billion and other expenditures by 8.3 billion in 1996. **EXHIBIT 3.** Capital expenditure requirements for 1997 through 2003 are shown in the same exhibit. They propose a 2:1 Debt/Equity structure, with D/E ratios gradually declining as senior debt is expected to be all paid back by 2003.

In valuing what the firm is worth, we first discounted back its future cash flows from 1997 through 2003, and included a terminal growth of 4% (in line with motorcycle market growth and Italy GDP growth). We discounted Free Cash Flow to the Firm at a

weighted average cost of capital reflective of the firm's future capital structure on an annual basis. **EXHIBIT 4.** Our assumptions are a risk free rate equal to Italy 10 year Bond rate of 6.74%, Beta equal to comparative pure motorcycle company (Harley Davidson) of 1.09, and a market risk premium for Italy of 6% (Demodaran Online). We got a PV of 557.9 billion. From the value-creation perspective, return on invested capital is forecasted to surpass 30% by Y2K and EVA turns positive in 1997 and accelerates from there on. We also looked at the seven sources of growth for the new company to back up our valuation. Based on growth estimates and breakdown **EXHIBIT 5**, we estimate sustainable growth of 6%, mostly attributed to volume increases as production becomes more efficient. In detail, volume growth stabilizes around 5.5% by 2003 and seems sustainable, pricing growth is nonexistent, and revenue from potential new products contributes another 0.5% growth. Although the company envisions cost cutting, we do not believe it is a sustainable source of growth in the long run. Using the PEG Hurdle Rule, we derived a purchase price of 620 billion Lira **EXHIBIT 5.**

Italy's Developing Public Equity Market

The recent flood of IPO activity, coupled with a 10-year CAGR in Italy's Domestic GDP growth of 8% (compared to 7.1% in the US), provides favorable economic conditions for Ducati. Italian Lira has been strengthening against the dollar and the Italian Equity Market Index has seen a 15% increase during the period from 1990 to 1996. In addition, favorable tax treatment for firms listing in 1994 and 1995 might extend to future years. Halpern and TPG have three options here: They could Buy, Sell or Hold. By selling (passing up the deal), TPG would give up a Return on Invested Capital less Cost of

Capital of 23% by 2003. It would truly be a missed opportunity for them because they have the right experience in turnaround buyouts to make it happen. By Holding (waiting to do the deal), the company could go into bankruptcy. If this happens, it could get held up in Italian courts for up to four years, and TPG would have a lost opportunity to invest at the right time. By waiting, they would also run the risk of other groups' courting the Castiglioni family, which would drive price up. In our opinion, Buying is their best option.

Conclusion

Despite problems with the Castiglioni family and their elusive negotiation practices, TCG should buy Ducati. The company is worth between 500 and 600 billion Lira, 100 billion above the proposed purchase price. Due to Federico Minoli's experience with turnaround companies, we felt that he is able to institute great management. Provided operational efficiency is achieved through an increase of net working capital and other non bike revenue, EVA will increase to 112 Billion by 2003, and EBITDA per motorcycle will see 100% growth from 1.9 billion in 1997 to 3.8 billion in 2003. The deal structure allows for 2:1 Debt/Equity breakout, with the debt level gradually declining and all senior debt financing paid back by 2003. Lastly, Italy's equity market is ripe for IPOs and an IPO of Ducati will further increase value for TPG.