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To say the stock markets are jumpy as I write this commentary is to put it mildly. Our world capital markets remain tender, and we have significant reasons to question the underlying bases upon which our modern economy is built. However, essentially unrelated to the deeper questions of sovereign debt and the potential effects of crushing future obligations, we see bank balance sheets in much better shape than a year ago. This is, of course, due to the exceptionally modest cost of funds, although loan demand remains weak. As a result, we see some bits of acquisition work starting to sprout. We therefore set our central topic in this issue as buy-outs. How can we begin to think about doing the process in better ways? What are the lessons learned from the last several years? How can we best avoid the difficult traps that may lie ahead?

We start this issue with a case study of a family business purchased by a private equity firm, and we are taken through the difficulties and successes that followed. Achleitner, Herman, Lerner, and Lutz tackle two explicit issues: 1) the question of governance structure, and whether the loss of the natural alignment of managers and owners in a private firm is offset by the wider input provided by board members from private equity; and 2) the question of mismatched time horizons, between the private equity firm seeking a medium-term exit and the family members desiring long-term ownership. This is not a theoretical article, and the company profiled, Messer Griesheim, is reviewed in detail. Can you speculate how they made this tricky deal work?

So how do private equity buyers create value? This is a reoccurring theme any time we look at successes. Without a clear understanding of how the good result was achieved, we will have a tougher time obtaining success next time. Steven Minns looks at a sample of firms and develops seven approaches that private equity owners took to increase value. These range from making no changes to all manner of actions, such as entering new markets, expanding into new geographies, divesting non-core assets, further developing core brands, and so on. The article shows which worked and which didn't. What strategies do you use?

When you purchase a company, how much "margin of safety" do you price into your offer? Ever wonder how much Warren Buffett prices in? Joseph Calandro, Jr. starts with a classic Graham and Dodd valuation, compares this to the price paid, and then takes us through several other methods of valuation. Do you want to price a deal they way Buffet does? This piece may help you think about the process.

Here's another way to price an acquisition, using a model that is commonly selected to value illiquid loans and applying it to illiquid (i.e., non-public) companies. Engelmann and Kamga-Wafo use discounted cash flow to calculate a risk adjusted return on capital for an illiquid private investment. The idea behind the calculation is that risk is measured as the capital that may be needed to cover unexpected losses. This is, of course, exactly what we all think about as we review projections of portfolio companies. We worry not what happens if the projections are met, but rather how bad will it be if the projections are missed.

What happens when you have to get out of an investment in a portfolio company when capital markets are in disarray? How bad did it get after Lehman Brothers failed? Baumeister and Muelke look at secondary sales after the recent financial crisis in Germany and detail the path of these exits over a longer period of time. Data from 1996 forecasted through 2010 are provided to gauge the number of exits in Germany, and these data provide an interesting picture of the long-term trend. Do you want to guess how far these sales have fallen from their 2008 peak?

We conclude this issue with the second installment of Braendel and Chertok's encyclopedic collection of legal terms, in this case centered on investor protections and governance. Given that you will indemnify your general partners against certain "bad acts," that you will regulate via the terms of the contract the extent to which a limited partner's default triggers damages to the fund, that you will disclose all conflicts of interest, and that you worry about what constitutes an "overly broad" waiver, a detailed knowledge of the language of the law is central to running a successful fund. Use this article as a test of your vocabulary on—and more importantly your understanding of—the legal side of the private equity business.

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