

Wharton Private Equity Review

DIFFERENTIATION IN A HYPER-COMPETITIVE MARKET

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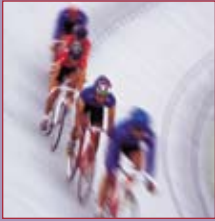
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DIFFERENTIATION IN A HYPER-COMPETITIVE MARKET



The race for deals is on in private equity. Gone are the days when firms simply did due diligence, loaded on leverage and hoped for outsized returns after selling the company a few years down the road. Today, record-setting bids and unprecedented capital inflows have created an overheated environment in which firms require new strategies to remain ahead of the pack. In this special report, produced in cooperation with students from the Wharton Private Equity Club, PE experts highlight the innovative ways firms are working to source deals, set themselves apart in an auction process and ensure performance once a deal is done. Also, industry specialists offer a close-up view of the debt markets and the hot energy market, which saw one of the largest-ever private equity proposals earlier this year.

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Private Equity Bidding Wars: When Capital-rich Funds Compete, Intangibles Win the Deal

With so much money pouring into private equity funds, competitors for deals are increasingly able to match one another when it comes to price. Clearly, valuation remains the most important part of any transaction, but in today's capital-soaked private equity environment, bidders must also come up with other, less tangible ways to set themselves apart. According to private equity experts, timing, sound strategy, operational expertise and a track record of successful deals are the new currency in a market where money is no object.

"Capital is now a commodity, so sellers are looking for anything else that the bidder is going to add," says Robert Chalfin, a Wharton management lecturer and president of The Chalfin Group, a Metuchen, N.J., advisory firm specializing in closely held companies. "Price is not the only determinant, especially if the sellers are keeping some equity."

"Capital is now a commodity, so sellers are looking for anything else that the bidder is going to add."

—Robert Chalfin, President, The Chalfin Group

Chalfin, who is the author of the book, *Selling Your IT Business: Valuation, Finding the Right Buyer, and Negotiating the Deal*, says even business owners who are selling out completely are concerned about picking new owners who will maintain the reputation of the company that they may have built from the ground up, or at least nurtured for a time. "They are going to look at the buyers' operational history to see if they will keep the business running and continue to service the customers. The sellers

frequently care about that. After [running a business for] a while, you are concerned about those things."

For companies eager to sell out completely, or parcel off 100% of a division, price is about all that matters, insists Kevin Landry, CEO of TA Associates, a private equity firm in Boston. Yet he argues that a deal based solely on price is not likely to generate the kinds of returns investors expect from private equity. Returns are driven by a private equity firm's ability to restructure a company and work with management to unlock new value, he says. "If a deal is 100% about price, why would you want to be in it?"

Three Elements of a Deal

Bob Frost, a managing director at Piper Jaffray who specializes in advising clients in middle-market mergers and acquisition transactions, says bidders compete on three elements of every deal: value, timing and certainty.

"Value is value, and people have become very aggressive [about it], particularly for high quality assets," he says. "As for timing and certainty, that's probably where firms can differentiate themselves at the margin. We certainly are seeing an environment where you can differentiate yourself in the auction process by putting yourself in a position to move very quickly and create a timeline for the seller that fundamentally gets them to a close more quickly."

To do that, he says, companies need to pull together enough resources to front-load much of the due diligence process. To the seller, that translates into greater certainty. "Sellers are focused on making sure they move forward with parties that they are highly confident will close the deal," says Frost.

He adds that industry expertise and specific experience in the sector, or related sectors, along with a

private equity firm's track record, also can lead to raising a seller's comfort level with an individual bidder. "In an auction environment, often it's the case that sellers are looking at values that are comparable, and they're really trying to pick a partner based on their understanding of the business and their understanding of the risks."

Luke Duster, director of new business development at Harris Williams & Co., an advisory firm specializing in middle-market mergers and acquisitions, estimates that about 5% of any deal is determined by intangibles beyond price. To set themselves apart from the pack, private equity firms need to act fast from the start and identify a convincing strategy that will stand out among the many bidders' proposals, says Duster. "It's important for the group to find its angle quickly and communicate that to the banker and the potential seller soon — and often — to stay ahead of everybody else."

Financial sponsors also need to emphasize their "brand," he continues. To stand out, firms need to highlight their track record and show they have added value to other companies. They also need to make clear who exactly will be involved in the deal and describe their working styles, as well as outline what in-house resources they can bring to the firm going forward.

Prepping, Wining and Dining

The next crucial step in the auction process comes during the management presentation. Duster says in today's super-competitive market, many private equity firms have spread themselves thin chasing down too many prospects. Some private equity firms may sit in on 35 to 40 presentations a year. Too often, he says, companies send junior analysts who have not had enough time to research the company and are clearly distracted.

"It's hard to prepare, especially if you're checking your blackberry during a meeting," he says. "The first impression is key. You need to come prepared to listen to the company's story and come prepared with your own story. You have to really woo management."

Duster says that too many private equity teams do not take advantage of bonding opportunities, such as asking management out to dinner the night before the presentation. "Groups that don't take that opportunity end up having a sterile relationship with the management team. Learning who they really are plays a very important role in management's decisions."

Landry of TA Associates notes that while there is room for relationships in a deal, there's not a lot of room. "You've still got to be competitive on price," he emphasizes. "They may say, 'We really like you,' but what they really like is the check."

Private equity firms often bring full teams of up to 10 people, including lawyers and accountants, to presentations. "Some companies like you to bring in a huge team to show how sincere you are," says Landry. TA usually limits its company visits to three. "We tend to bring a smaller, focused team and save the lawyers and accountants for later."

During the due diligence period, private equity suitors can also impress managers by seeking the right information in a courteous manner, even under tight deadlines, says Duster. "You have to balance demands on the management team and the time allocation," he says. "People who are able to balance that well build good rapport, and people who lose sight of that develop a reputation for being a difficult partner. If they're too demanding and focused on the wrong areas of diligence and create mountains of work around the wrong items, it shows they are missing the mark."

Seller's Market

In addition to record prices, the competition for private equity deals is altering the terms for deals in favor of sellers, says William Parish, Jr., a partner in the Houston office of the law firm King & Spalding. He recently represented a buyer who agreed to acquire a firm with no financing contingency. "Basically, we took all the closing risk," says Parish. "That's unusual. A couple of years ago, we were not seeing that."

In addition to disappearing financing contingencies, Parish pointed to other trends in deal terms that are moving in favor of sellers:

- **Reverse break-up fees:** Sellers are now able to demand penalties for buyers who fail to complete the transactions. For example, he notes, Bain Capital and Thomas H. Lee Partners agreed to include a \$500 million break-up fee in their deal to acquire Clear Channel Communications.
- **Assumption of industry risk in material adverse change conditions:** In 80% of private equity deals announced in 2005 and 2006, the buyer assumed industry risk in material adverse change closing conditions, according to King & Spalding.

- Limited indemnification: Buyers are agreeing to shorter indemnification periods, from up to three years to a year or less. Escrow amounts are now a smaller percentage of the purchase price, and some buyers are taking on representation and warranty insurance to avoid the escrow support requirement completely.

To stand out, firms need to highlight their track record and show they have added value to other companies.

Even strategic buyers are stepping up the competition with favorable terms. Traditionally, financial buyers had an advantage over buyers already working in the industry because they did not face anti-trust review. Now strategic buyers are agreeing to so-called “Hell or High Water Clauses” that guarantee they will make divestitures or take on other remedies to complete the deal.

Compensation is another area in which buyers are eager to sweeten the deal for sellers. “Management compensation is an area in which both financial and strategic buyers can get creative. Many private equity firms find this a good way to differentiate themselves,” says Duster. Compensation packages are structured on the needs of the management team and whether they want to continue to be equity partners or are hoping to sell out completely, he says.

Frost says compensation is closely evaluated by sellers, but is not a critical factor in differentiating among buyers. “I think most private equity firms understand they need to create an attractive incentive structure for management and, for the most part, people are doing that.”

A Role for Investment Banks

To help sellers choose among their many potential private equity acquirers investment bankers are growing increasingly active in the middle market. “The market has become more sophisticated in terms of the amount of capital going into private equity firms, but also the number of intermediaries out there now,” says Frost. “The market has become very efficient.”

Brian Conway, who heads the Boston technology group for TA Associates, says there has been a consolidation among investment banks in which larger firms have acquired smaller specialty boutiques. Now, individual bankers are spinning out new specialty firms that lack services such as trading and underwriting that exist at the large investment banking houses, but they offer a sharp focus on advisory services. “As a result, there are very few good companies that go unbanked,” says Conway. “I think there’s a right bank for every company. You might find Goldman Sachs selling a middle market business, or you might find a middle market firm doing it.”

Conway adds that when TA is on the other side of the equation selling companies in its own portfolio, it looks for the best individual banker with strong experience in the industry and deep relationships.

According to Landry, the rising population of investment bankers poses problems for private equity firms and drives up fees. “They’re on all sides. They’re running the auctions. They’re doing the debt financing and getting fees and sometimes they’re competing with you for deals.” In addition, he is dubious of investment banks that also have their own captive private equity wing. “You’ve got to wonder, if they’re bringing you the deal, why didn’t they take it?”

As prices soar ever higher, Wharton’s Chalfin says sellers retaining equity need to be especially concerned about how private equity firms will deliver outsized results for their investors, particularly when they are heavily leveraged.

“I think everyone is concerned about the large amounts of money private equity firms are paying,” he says. Sellers sometimes find themselves having to think about whether the buyer can really afford to pay what they are offering. “Sellers are now asking, ‘Are they competent stewards? Are they overpaying?’” ❖



From Star-power to Branding, Firms Look for New Ways to Court Private Equity Deals

The days when private equity fund

managers pursued proprietary deals at their own pace are long gone. As more investment capital flows into the market, deal makers find themselves in a scramble to court potential targets using sourcing strategies ranging from signing up marquee-name rainmakers like Jack Welch, to hiring brokers to relying on old-fashioned cold calling. According to experts from Wharton and private equity practitioners, deal sourcing techniques are becoming increasingly important as firms look for any kind of lead in the competitive market.

John Cozzi, managing director of AEA Investors, says only about 20% to 25% of the firm's deals are proprietary, with another quarter coming from affiliated funds and half from bankers. Last year, the company looked at 600 companies and invested in three. A year ago, he says, AEA would only have had to meet with 100 companies to secure three deals.

Relying on relationships and reputation are not necessarily enough to bring deals through the door, he says. "Today, you need a much more process-oriented approach."

Industry wide, only a third of respondents to the most recent Association for Corporate Growth/Thomson Financial DealMakers Survey are able to make half their deals exclusive. In most cases, private equity firms prefer a proprietary deal, but the reality is that more and more companies are hiring investment bankers to stage auctions, forcing quick decisions about transactions which fund managers fear they may ultimately regret.

"We have historically not been active in auctions," says Michael Doppelt, managing director at Bear Stearns Merchant Banking (BSMB), where he is responsible for marketing and deal-sourcing. "You

don't really build a good relationship with management that way, so you tend to not get quite as much information. That's a formula for lower returns, as opposed to cultivating people for years and having them come to you. It's much more harmonious."

Doppelt says that private equity firms need to invest in cultivating companies for the long-term, even before they think they are interested in selling. "If you take whatever business is super-hot today and knock on its door, it has most likely had pitches from 10 investment banks. You need to network early."

In most cases, private equity firms prefer a proprietary deal, but the reality is that more and more companies are hiring investment bankers to stage auctions.

Todd Millay, executive director of the Wharton Global Family Alliance, says private equity investors are teaming up with entrepreneurs they have already financed to find new deals. He gives the example of an entrepreneur who builds a successful medical supply business and sells to a private equity firm. The entrepreneur often goes on to become an investor in other medical supply companies. "The private equity firm would love to come in side-by-side in some of these other investments, because the entrepreneur knows what's going on. If a private equity firm is smart, it can turn its investments into future investment partners."

Cozzi notes that networking with managers of potential targets can be difficult. "A lot of managers don't want to meet with private equity firms because they

think we will come in there and fire them all.” AEA attempts to engage managers at different levels, from the board room to the executive suite and below, as a way to get into the company using any entrance that is open. “We go out to the company and develop relationships with people at multiple levels,” says Cozzi. “Just by having dialogue with a person you get a lot more information.”

Advisors, Stars and Private Clubs

Increasingly, companies under pressure to find deals are turning to investment banking advisors for help.

“What an M&A advisor brings is relationships,” says Kent Weldon, managing director of Thomas H. Lee Partners, who participated on a panel about mega funds at the 2007 Wharton Private Equity and Venture Capital Conference. “We who work in private equity all have a lot of years doing the same thing and we have similar financial training. When you pick an M&A advisor, you’re getting a senior person with 20 years of relationships for deal flow. That creates a channel for communication with people that takes many forms.”

Developing industry specialization is another way firms try to position themselves for potential deals, promising operational strength that will boost returns for investors.

Cozzi from AEA says his firm is often able to attract deals because of the nature of its client base. AEA was an early private equity firm founded in 1968 by the Rockefeller, Mellon, and Harriman family interests and S.G. Warburg & Co. “Ownership families like to sell to us because families are investors in the fund,” he explains.

Doppelt says Bear Stearns maintains a Chinese wall between the private equity fund and its investment banking operations. Still, there are some advantages to being part of a sophisticated banking business. “We work with other investment banks quite a bit, but our relationship with Bear Stearns is a good one,” he says. “Bear Stearns is a vast institution with tremendous resources, and we benefit from that.”

For example, private equity executives have been able to tap financial expertise at the investment

bank to price and evaluate securities as part of a private equity transaction. Doppelt adds that BSMB does deals through Bear Stearns investment bankers, but they do not represent a majority of the firm’s transactions. BSMB works with other investment banking houses, too, he says. “It’s a very competitive environment. If we’re not paying fees on the street, we won’t get services.”

While investment bankers can be useful, companies can get a better edge on deals with the use of corporate executives who sign on as consultants or special advisors. These advisors, like Welch, are often star-power names who can provide firms with deep and rich industry contacts instantaneously. Doppelt notes that BSMB hires operational partners with long experience in industry who can bring credibility to deal sourcing by demonstrating knowledge of the business. “We want to show more than some Wall Street guy sitting in front of a screen.”

The firm also has created a special fund open for high-level executives with whom BSMB would like to develop deeper connections. “We’ve limited it to c-level executives at important companies in our space as an incentive for them to have a connection to us. If they come across a deal, we will be an early call,” says Doppelt, who was about to meet with an investment banker representing a company in search of capital to make a retail acquisition. The former chief executive of the target is in the BSMB fund. “That can be powerful stuff.”

Another new trend in deal sourcing is the rise of so-called “club deals,” in which several large private equity firms band together to finance a transaction that otherwise would be so large the company would need to seek backing from the public markets.

Weldon says that many publicly traded companies are now open to overtures from private equity. New regulations following the scandals at Enron and other corporations, such as the Sarbanes-Oxley Act, are making public ownership less attractive, he said.

Activist hedge funds demanding change at public companies are also creating new sources of private equity deals, according to Weldon. “A year or two ago, we wondered if the hedge funds would become competitors and leapfrog over us in doing private equity deals. In fact, they have been a great source of transactions for us. They have a shorter horizon than we do, and as a result they are putting a lot of companies into play and forcing companies into our hands.”

Building a Brand

Developing industry specialization is another way firms try to position themselves for potential deals, promising operational strength that will boost returns for investors.

For example, BSMB, which focuses on private equity in the middle-market, has expertise in branding and consumer products, says Doppelt. BSMB's chief executive, John Howard, became interested in Seven jeans when the women in his household were all wearing them. His interest as a passionate consumer convinced Seven's management to enter into a private equity deal with BSMB.

The company's retail and global sourcing experience made also made it an attractive partner for Stuart Weitzman, the footwear company. According to Doppelt, founder Weitzman was not looking for cash but wanted expertise to expand. BSMB bought a 40% stake in the business after Weitzman asked: "How much do you need to invest so this matters to you?"

Tim Berkowitz, president and managing director of HealthPoint Capital, a private equity firm specializing in the narrow health care arena of orthopedic devices, has not only developed a highly specialized industry focus — it has also positioned itself as an information broker for the fragmented industry.

HealthPoint has its own research staff that writes regular news columns and blogs appearing on the company's web site. The site has become a go-to location for industry news about everything from public company earnings, to FDA approvals, to changing insurance reimbursement policy to technology developments.

"It is our deal engine. It creates brand recognition," says Berkowitz, adding that the founders of the firm took the unusual approach because they "did not want to be two more private equity guys eating our dinner on Park Avenue hoping for the phone to ring."

Instead, they have developed a brand for the company among orthopedic surgeons and other key sources of deal flow. Berkowitz notes that many companies in the space are small and owned by doctors working at medical centers in far-flung locations around the world. HealthPoint's web site, he contends, is now their gathering place. "There is no Silicon Valley for orthopedic devices," he points out.

When the industry convenes for conferences, HealthPoint sends a research team to compile

articles, but it also sends deal partners to meet with doctors who may someday become the source of transactions.

Berkowitz does not mind sharing information, even though that commodity is usually closely guarded in the highly competitive private equity environment. "It's a totally different approach. Traditionally, the buyout firm has a scintilla of an idea and protects it as if it is the most important piece of information there is," he says. "Our approach is to leverage our relationships with the key surgeons, management teams, distributors and medical centers to drive the growth of all our companies at once."

The Old-fashioned Way

A final strategy to drum up private equity deals is at least as old as door-to-door encyclopedia sales: cold-calling. Brian Conway, a managing director at TA Associates who prefers to call the strategy "investment origination," says three-quarters of the investments the firm has closed have been originated by TA.

Conway stresses the firm does not exactly knock on doors like a private-equity Fuller Brush man. The firm organizes its staff around industry groups, and within those groups analysts look for sectors that seem most promising. Within finance, for example, TA has built expertise in financial technology with two partners and 15 investments in that sector. Then, within each sector, TA burrows deeper into specific segments. For example, within the area of financial technology there are plays to be made in back-office automation, credit derivatives or foreign exchange.

"We look and find the leaders in each segment," he says. "We're well prepared and have a reason for wanting to call on a company." Often, he says, TA is the first private equity firm that has ever approached the company. Many times it takes years of informal visits to learn about the company before a deal is done.

"We don't think that makes the relationship proprietary," he says, but if a transaction does come up, TA generally has more information about a company than competitors and is better able to make an offer that it can live with long-term. "I think the [current] market requires [firms to] come in on an investment-banking timetable, learn a business, understand it and then pay the highest price with the most certainty of close. I question whether that is a long-term strategy that is sustainable." ❖



Operating Partners Promise Performance and Higher Returns, but Do They Always Deliver?

According to a 2007 Association for

Corporate Growth/Thomson Financial survey, private equity professionals see lower returns as the greatest threat looming over them — more so than competition from other firms and hedge funds. For many, a way to avoid that problem is to install so-called “operating partners” — senior-level executives with industry expertise — at portfolio companies. Panelists at the 2007 Wharton Private Equity and Venture Capital Conference and others in the industry say that operating partners with experience running plants and facilities, and rolodexes full of industry contacts, can boost profits and feed higher returns.

“The financial markets are largely commoditized. One firm can’t get much more debt than any other firm,” notes Scott Nutall, a partner at Kohlberg Kravis Roberts who was a panelist at the Wharton conference. “All of us focus on deal sourcing, but the real way to generate returns is to improve the business post-purchase.”

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—Scott Nutall, Partner, Kohlberg Kravis Roberts

Any improvement in operations that leads to higher profits is magnified through the leverage in private equity. In a *Newsweek* article titled, “The Enigma of Private Equity,” financial columnist Robert Samuelson cites a hypothetical example of two companies with \$10 million in annual profits that are bought for 10 times that, or \$100 million. The private equity buyer spends \$30 million and borrows \$70 million.

At one company, “profits don’t increase,” Samuelson writes. Five years later, it earns \$10 million annually, “but the profits have been used to repay \$30 million in debt.” If the company is then resold for the same \$100 million, the private equity firm has doubled its original investment of \$30 million, he notes. It uses \$40 million to repay the remaining loan and is left with \$60 million.

At the other company, improvements in operational performance increased profits to \$15 million after five years. When that company is sold for 10 times profits, the price is \$150 million. “After repaying the \$70 million loan, the private equity firm has \$80 million — nearly triple its original investment,” Samuelson explains.

“Skin in the Game”

According to Nutall of KKR, long-time private equity professionals tend to have backgrounds in transactions and finance. Traditionally, private equity firms focused on the financial structure of a deal, then hired outside consultants to orchestrate an operational plan. The consultants would come into the company, write a report, send a bill and leave.

“That didn’t do a lot for us,” Nutall says. “They didn’t have skin in the game.” KKR responded by building its own in-house consulting team of senior executives with operational experience to work with management in portfolio companies. The operational partners have experience running plants and businesses, and receive the same incentives as KKR’s deal-making partners.

Peter Clare, managing director of The Carlyle Group and another conference panelist, says that with increased competition for deals bidding up valuations, operational improvements are more important than ever for companies hoping to continue

to deliver above average returns for their private equity investors.

“We’ve developed both in-house and loose networks of operations executives who will participate in due diligence and may end up running a company or serving as an executive chairman,” Clare says. “Industry expertise helps us set the plan accurately and focuses [us] on what is achievable in the shortest amount of time possible given the competitiveness of our business today. It is fundamental to what we all do. It’s a big reason for our ability to generate returns that are above overall equity markets.”

No Single Formula

Some large private equity firms have hired marquee names as operating partners and consultants, including Louis V. Gerstner Jr., former chairman of IBM who is now chairman of Carlyle; General Electric’s former chief executive Jack Welch, who is now at Clayton, Dublier & Rice; and former Treasury secretary Paul O’Neill, who is now a special advisor to The Blackstone Group.

James Quella, senior managing director and senior operating partner at Blackstone, notes that there is no single formula for companies that choose to use operating partners. “There’s diversity among the models and an absence in some firms of a deep bench of operational people. However, the trend overall has been unequivocally in the direction of bringing in executives and executive consultants who have a lot of experience in operations.”

Blackstone’s model, which is also used in various forms at many other firms, is to organize deal teams around industry sectors to bring a depth of understanding about operations and key players in the industry to transactions. The industry orientation helps with deal sourcing, but it also can provide a better sense of how much potential upside can come to a transaction through operational improvements.

At KKR, operational executives also serve on deal teams and can provide enough understanding of a potential investment to justify a higher price that will give the firm a leg up in the bidding wars. “It’s something that will continue whether it’s within the firm or a consulting approach, and more firms are doing it,” says Nutall.

Blackstone has a network of executives it can call on to help with the operational issues. “What we have is a bench of partners who have had deep CEO-level experience in running companies in an industry, and they will provide insight and guidance and counsel not only in industry dynamics but also operational

improvement,” Quella says. Blackstone keeps about 10 to 15 of these senior-level executives working with it on industry opportunities and sourcing — including big names such as O’Neill and David Verey, former chairman of Lazard Freres in London.

Bain Capital, founded 23 years ago by former consultants from Bain & Co., has been using operating partners for more than 15 years and has one of the industry’s largest stables of dedicated, in-house operations-oriented professionals to partner with and help portfolio companies. Bain now has 30 operating professionals, double the number from 18 months ago.

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Bain Capital managing director Steve Barnes says the firm’s model is a blend of consultants and operating professionals with several years of experience. In addition, the firm uses outside consultants to leverage the time of management and the Bain team on strategic issues. “Our heritage is deeply rooted in a consulting and operating background. The original thesis was to have professionals who understand strategy and what it takes to get things done within a company. That way we would do a better job of selecting assets and a better job with the assets once we owned them in our portfolio,” says Barnes.

Deep Capability

Blackstone has a core group of staff known as the “portfolio management team.” Headed by Quella, members of this team have operating specialties that are organized not around industry expertise, but around business capabilities that can be deployed across all the companies in Blackstone’s portfolio. For example, the portfolio management team has people with expertise in supply chain issues, pricing, sales force management and revenue initiatives. Blackstone even has a full-time person dedicated to the Lean Six Sigma management training program.

“Each of these people has industry experience, but we also want them to have deep capability along what we would say is a functional area,” Quella explains. The team also makes an impact on operations by consolidating functions across companies in the portfolio. For portfolio companies that want to participate, Blackstone offers shared purchasing of goods and services that could boost a portfolio company’s performance and provide better returns for investors.

Blackstone is now in the process of hiring a medical benefits and cost expert to help portfolio companies procure health care services, which total more than \$3 billion a year. Health care is the fastest-growing cost item for the firm’s portfolio companies, which in the aggregate have \$85 billion in annual revenues.

“It may be that we can accomplish things for our portfolio companies that they can’t accomplish on their own,” says Quella. “It’s not to take benefits away. The goal is to improve the cost efficiency.”

According to Quella, operating partners can also contribute to the debate over whether to take on a deal or not. They add a dimension of insight and experience on the scope and implication difficulty of projected operational improvements. Deals otherwise not affordable can become attractive, he says.

“Uber-CEOs” and Other Problems

Quella notes that some operating partner models can be recipes for disaster. “I’ve seen models where there is an ‘uber-CEO.’ The private equity firm takes an ex-operations guy and puts him in on top of the management team and there’s a lot of friction. Adding operational expertise to management requires strong people skills on all sides, he says. “It’s not just a question of how to do Six Sigma, it’s a process of winning hearts and minds. I’ve seen ex-operating executives come in and announce, ‘I’m here, and I’m in charge.’ That doesn’t work very well, particularly if you have a strong management team. There’s a delicate balance between support, guidance and learning to add value, versus control, authority and friction. That’s a balance we take very seriously.”

Kevin Landry, chief executive of TA Associates, is not a believer in operating partners. “We don’t have [them],” he says. “We expect everyone here to be a complete player.” Partners at TA follow the more traditional private equity design in which accountability for results lies with the partners who find the deal, conduct the due diligence, structure the transaction and serve on the board. “If a company

becomes a problem, then it’s his or her problem. We might bring in some people [from] industry who can be helpful on the board, and maybe even active board members, but we’re not going to have people here that we would call operating partners.”

Landry says that if a target company’s management needs so much help that a financial sponsor needs to bring in an operating partner, he steers clear of that company. “We’re trying to invest in good companies. If a company needs an operating partner, then there’s something wrong.”

Douglas Karp, managing partner of Tailwind Capital Partners, advised the Wharton conference participants to choose operating partners with care. “The executive we look for is a unique individual, not somebody who is looking for a job.” A big name coming from a large company is not always the best choice to run a smaller company or business unit for a private equity firm, he points out. “We’re looking for a committed executive who may have run a larger business and had success, but also understands how to operate in our size of business with fewer resources. We have seen executives who were successful at a big company but didn’t make the transition.”

John Cozzi, managing director of AEA Investors, is also cautious about imposing an operating partner on portfolio companies. “The concept is enticing, but it’s very difficult to get right. You’re asking someone who is an all-star player to go in and become a coach. We’ve wrestled with finding the right mix of people who don’t have the ego or the need to have their hands on the steering wheel.” ❖



Private Equity Firms Discover Electricity — and Lead the Charge for Energy Investment

Earlier this year, a consortium of private

equity firms led by Kohlberg Kravis Roberts banded together to acquire TXU Corp., the Texas utility company, for \$32 billion in one of the largest private equity deals ever proposed. According to private equity experts, a new regulatory climate in some energy sectors and innovative derivatives smoothing volatility are drawing attention to energy, along with a macro-environment in which emerging economies demand a growing share of the world's energy resources. Meanwhile, other firms are making investments throughout the sector, including funds established to finance infrastructure and others dabbling in alternative energy.

"I would say this has been the most active period for private equity involvement in energy I've ever experienced. There's a lot of competition for deals that are out there, and there seems to be interest in just about all sectors of the energy industry," says Jim Dillavou, who leads the national energy and utilities practice at Deloitte & Touche in Houston, Tex.

While energy encompasses a range of businesses with widely varying profiles, a survey by the Association for Corporate Growth and Thomson Financial predicts that energy will be among the top three sectors for deal-making in the coming year, behind health care and life sciences, but ahead of business services.

Demand for energy is expected to keep growing. According to the U.S. Energy Information Administration, despite world oil prices that are expected to be 35% higher in 2025 than was projected in 2005, world economic growth continues to increase at an average annual rate of 3.8% over the period through 2030. Total world consumption of marketed energy is expected to expand from 421

quadrillion British thermal units (Btu) in 2003 to 563 quadrillion Btu in 2015, and then to 722 quadrillion Btu in 2030 — representing a 71% increase.

Now within Reach

When Jonathan Farber, cofounder and managing director of Lime Rock Partners, a private equity firm specializing in energy, started the company in 1998, there were just five or six other private equity firms in the energy business with about \$2 billion worth of capital invested. Now, there are 15 to 20 competing firms with \$30 billion invested in the industry.

"It was very rare, to the point of never happening, that generalist private equity firms would dip their toe in the water of the hard-core energy space," says Farber. "Firms didn't look to oil and gas as an appropriate place to invest."

A survey by the Association for Corporate Growth and Thomson Financial predicts that energy will be among the top three sectors for deal-making in the coming year.

Now, some of the biggest names in private equity — Kohlberg Kravis Roberts and Texas Pacific Group — are teaming up to buy TXU. Dillavou says the new interest in energy is driven by the volume of capital pouring into private equity overall. At the same time, he says, investors are deciding they want to be more involved in this key segment of the economy, particularly following the recent rise in commodity prices. Meanwhile, capacity shortages in

many markets make energy an appealing sector for private equity investors, at least for the near future.

“There are a lot of opportunities, and some that didn’t look that attractive a few years ago look much different today,” says Dillavou.

Wharton professor of business and public policy Matthew White says the enormous capital requirements of most energy investments have, until now, been beyond the reach of private equity firms. Now, with so much money pouring into private equity funds, deals on the scale of the TXU transaction are possible.

Regulatory Uncertainty

White adds that private equity movement into the electricity and gas markets remains difficult because these parts of the energy business have a lot of regulatory and political oversight. “The rules of the game are changing substantially over time. Deregulation in electricity and gas continues in fits and starts, and a lot of it is at the state level. There’s a great deal of uncertainty about the reward to investors, and that will give any set of investors pause during due diligence,” says White. “One might look at this and say there are greener pastures elsewhere — at least until the regulatory environment becomes a little more transparent.”

Wharton’s Matthew White says the enormous capital requirements of most energy investments have, until now, been beyond the reach of private equity firms.

Pulling off a change of control in this area is very difficult given the political approvals that are necessary, according to White. New Jersey regulators balked when publicly held Exelon, of Chicago, attempted to take control of Public Service & Gas in their state. Private equity firms have hit similar roadblocks. In 2005, regulators prevented a \$1.25 billion bid for Portland General Electric Co. over concerns about potential rate increases and the short-term nature of TPG’s investments. Arizona regulators refused to sanction a buyout of UniSource Energy Corp. in 2004 by a group of investors that included KKR, J.P. Morgan Partners and Wachovia Capital Partners.

The private equity firms bidding for TXU have already aligned themselves with environmental groups and have pledged they will not sell the company for at least five years in an attempt to fend off opposition that began to boil up in the Texas statehouse within days of the announcement. “Change in corporate control at this level is fraught with regulatory uncertainty and a need to appease a broad array of political constituents,” says White. “It’s a daunting prospect.”

At the same time, Dillavou notes, the repeal of the Public Utility Holding Act in 2005 is expected to encourage private equity investment in energy because it eliminated numerous restrictions on ownership, particularly in electricity. “We’ve seen some activity as a result of the repeal, although maybe not as much as some expected, but a lot of people think it could be coming.”

Risky Pipeline

White says that it will be interesting to see if private investment begins to flow into exploration and oil field service firms. “Private equity at that level would be one more source of capital for a fairly risky line of business.”

Farber of Lime Rock Partners believes the business is likely to remain highly volatile because the capital spending cycles don’t match up to the price signals the market sends out daily. If the market needs more capacity, it can take years to find new sources of energy and construct additional pipelines and processing plants. If companies build excess capacity, the price remains low for years, stifling new investment until an acute shortage drives prices up again.

“The nature of the industry is that it can’t remove or add capacity on a dime,” says Farber. “That still hasn’t changed and can’t physically change.” Indeed, he argues, industry volatility has grown worse as the easiest exploration targets have been exploited. “Now, we’re moving into areas with greater political challenges, like Sudan, or technical challenges like deepwater offshore drilling.”

Bill Macaulay, chairman of First Reserve Corp., a 25-year-old private equity firm focused on energy, notes that while activity in the sector is up, it still lags behind other industries that are attracting record private equity investment. In the U.S. and Europe, private equity activity as a percentage of all merger and acquisition transactions is around 20%, while in the energy sector it remains below 5%. “It is still difficult to put leverage on [companies] in

the energy business given the volatility of the commodity prices,” he says.

Opportunities for Entry

Over the long term that may change, and already new mechanisms to hedge against swings in commodity prices have made leveraged investment in energy easier over the past five years. Macaulay notes that, in particular, hedging in electrical power has made that piece of the energy business more attractive to private equity firms.

The spectacular collapse of Enron has also had an impact on private equity involvement in energy, says Dillavou. “After Enron, energy investment dried up for a while, and everyone’s stock price was hurt. That opened up opportunities for private equity to step in and we saw some spectacular returns on investment for people who were able to pick things up on the cheap.” In 2004 a consortium of TPG, KKR, The Blackstone Group, and Hellman & Friedman bought Texas Genco, a power generation company, for \$3.7 billion. A little more than a year later, they sold it to NRG Energy for \$5.7 billion.

According to Dillavou, the rise in infrastructure funds also gives private equity investors a way to participate in the energy industry. The Macquarie Bank, Goldman Sachs and JP Morgan all have created infrastructure funds, he notes. “That is a different profile than the historical private equity investment because of the long-term horizon for the investment,” he adds. “The investor is trying to take assets that historically have earned a steady but sleepy return, and increase the return from additional leverage with relatively low-cost, long-term debt and add-on investments. The return is enhanced by the management fees and the ability to profitably sell down its ownership interests in the fund over time.”

Dillavou also points out master limited partnerships provide an exit strategy for private equity investments that is unique to the energy sector. The master limited partnership allows earnings to flow to investors in a partnership form in a public environment and only be taxed once. “We have seen private equity firms come in and make investments in companies they believe would have a future existence as a master limited partnership,” he says.

Alternative Energy

Another potential area for private equity investment in energy is alternative technologies, although this area remains highly speculative and difficult for most private equity firms.

“There is tremendous potential there, but in our view — to date — most alternative energy investments need to either have a government mandate, such as tax subsidies, or other government assistance if you’re going to have a significant change in the technology to make it truly economic,” says Farber.

Macaulay explains that alternative energy investments may be attractive for smaller firms or venture capitalists, but they are unlikely to attract classic buyout artists because there is often little, if any, cash flow to pay down debt. “The other important thing to remember is that alternative energy is extremely price sensitive,” he says. “You need high prices to justify almost any alternative.”

When it comes to energy, some of the concerns about too much capital driving private equity investment are dampened because the sector has, at least so far, been less attractive than other industries. But for firms focused on the energy space, there is a larger force to be reckoned with, says Macaulay.

“We still have competition from the major oil companies, and if you roll forward, the national oil companies are a much bigger new competitor to [a firm] like First Reserve than the leverage buyout concerns,” he says. Macaulay points to Saudi, Russian and, more recently, Indian national champions as major competitors, desperate to tie up resources to meet demand at home. “Those companies are much more of a factor in our industry in competing for deals than the buyout shops.” ❖



Lender Roundtable: Outlook on Debt Markets

In March, members of the Wharton

Private Equity Club (WPEC) coordinated a roundtable discussion between four influential lenders to talk about the currently robust debt markets, the impact of hedge funds and other new entrants, trends in the sub-debt markets, as well as advice for firms looking to differentiate themselves from the competition, among other topics.

Jerome Egan (WG'01) is a senior vice president at TCW/Crescent Mezzanine, a Los Angeles-based mezzanine provider with approximately \$4.7 billion of capital under management. TCW typically invests in senior subordinated notes with equity upside (obtained through warrants or equity co-investments) in connection with sponsored LBO transactions. Its typical investment size is approximately \$80 million, but it can commit up to \$400 million for any given transaction. TCW invests across industries.

Jeff Foley (WG' 99) is a director in Wachovia Securities' Leveraged Finance Group, a leading provider of leveraged finance solutions, including senior debt, second lien, mezzanine, and high yield products serving both financial sponsors and traditional large and middle market corporate clients.

J. Gardner Horan is a senior vice president in GE Commercial Finance's Global Media & Communications Group. With over \$7 billion in assets under management, GE's Global Media & Communications Group offers a wide range of financing solutions to middle market and large cap media, communications and entertainment companies ranging from \$20 million to over \$1 billion. These include senior secured debt, mezzanine and high yield, second lien, and equity co-investments.

Jeff Kilrea serves as the co-president of CapitalSource, Inc. CapitalSource (NYSE: CSE) offers a wide range of financing solutions, including senior term loans (first and second lien), asset-

based revolvers, mezzanine financing, and equity co-investments. CapitalSource targets middle-market companies that generate EBITDA between \$5 million and \$35 million on an annual basis. It can arrange transactions up to \$200 million.

WPEC: In your opinion, what are the primary factors that have led to today's robust debt markets?

JK: The robust debt markets are being driven, in my opinion, by one primary factor: market liquidity. There is a glut of capital in the market today from CLOs (Collateralized Loan Obligations), BDCs (Business Development Corporations), Hedge Funds, new Commercial Finance companies and Regional Banks, not to mention significant capital from PEGs (Private Equity Groups) anxious to deploy capital as they seek their next round of fund raising. From a debt perspective, some of these new or alternative sources of capital did not even exist 5 to 10 years ago. From an equity perspective, the opportunity for higher returns generated by PEGs has increased the dollars committed to this sector from endowments, pension funds and other investors, which also has contributed to the debt markets.

JE: I think today's debt markets have been largely driven by the interest rate environment as well as the enormous amounts of capital that have been raised by buyout firms. Just as equity sponsors have pushed the envelope on purchase price multiples, so have lenders done with leverage and the pricing on that leverage. In our space and with the investment sizes we deal with, the high yield market is our primary competitor. Spreads are tighter now than ever, making mezzanine a less competitive option. However, many sponsors still prefer large "private high yield" issues because mezzanine providers can be more flexible on call protection and other features, making it a more flexible security from the sponsor's point of view.

GH: Low default rates have been a key factor. I don't have the exact numbers on hand, but I believe they are approaching 45-year lows. This has kept losses off of the books, which has made it easier for institutional investors to raise money. This, in turn, has increased liquidity and pushed yields down. Companies are less likely to default with lower rates. It's a cycle.

JF: The primary factor driving the robust market conditions, particularly in the leveraged loan market, is the market liquidity from the continued fund raising by CLOs and other institutional investors. Despite record M&A activity, the demand for new paper continues to outstrip supply, resulting in favorable pricing and structures from an issuer perspective. As previously mentioned, low default rates are another important factor driving the current environment.

WPEC: *The question on everybody's mind — how long are the good times going to last? What external factors do you believe will lead to an eventual softening?*

GH: We think the debt markets will start to tighten towards the end of this year or the beginning of 2008. Eventually housing and manufacturing weakness will take its toll on the economy and filter down to the credit markets. However, several factors such as covenant-lite deals could delay this tightening. As always, industry specific issues will also come into play. For instance, in the media space, advertising dollars from the 2008 presidential election may offset weakness in the broader advertising markets.

JK: It is difficult to predict how long the good times will last, but some type of underlying market correction will be necessary to curb the current enthusiasm. The correction could come in the form of an increase in the interest rate environment, which will impact debt service capabilities and debt leverage of borrowers interested in making acquisitions. The correction could also result from material credit agreement defaults by borrowers in the credit markets, which should lead certain lenders, either temporarily or permanently, to exit the business. Many of the new competitors have not experienced the inevitable cycling of the credit markets so it will be interesting to witness their behavior in a challenging credit market.

JE: If or when the defaults start to occur, then we'll see discipline re-enter the market. There are also many questions regarding what rights holders of second lien paper will have in a default. I also believe that if or when default rates increase, buy-

out firms will realize that their capital structures are made up largely of hedge funds with a "loan-to-own" mentality.

JF: While we have seen some volatility in the high yield market over the past few weeks following the pull back in equities, we believe that the favorable outlook for the economy coupled with the strong market technicals should result in a continuation of the robust financing market in the near term. I would agree with others that the key driver to a pull back in the debt market over the long-term will be a material increase in default rates. Additionally, a continued correction in the equity market would likely result in a debt market correction.

WPEC: *A lot has been written about how the private equity industry has become more competitive over the last few years, but the debt markets have also become more competitive — how have new entrants (BDCs, hedge funds, etc.) changed the market?*

JE: The vast amounts of capital raised by hedge funds and second lien funds have fundamentally changed the financing landscape. As long as there is such a significant amount of available capital, there'll be intense competition. Financing sources need to figure out a way to distinguish themselves. Relationships with the sponsors become extremely important.

"The primary factor driving the robust market conditions, particularly in the leveraged loan market, is the market liquidity from the continued fund raising by CLOs and other institutional investors."

—Jeff Foley, Director, Wachovia Securities' Leveraged Finance Group

JK: The competition from new entrants has certainly fueled an aggressive pricing and leverage environment. Over the past year we have experienced tighter credit spreads, increasing leverage multiples, and reduced fees for lenders. Typically, I would say this movement is contradictory, but competitive forces, market liquidity and the desire for asset growth continues to drive this phenomenon.

GH: In addition to hedge funds entering the market, we've seen the larger banks (JP Morgan, CSFB) move down into the middle market. This has

increased competition and changed the structure of some of the middle market deals — they are starting to resemble large cap deals in terms of covenant restrictions, acquisition baskets, etc.

JF: With the new entrants to the market, deals continue to be structured more aggressively in terms of higher leverage, less restrictive covenants and lower pricing. Additionally, we have seen more mezzanine investors working directly with sponsors to arrange a syndicate of mezzanine financing and eliminate the need for an arranger. Delivering real time updates on the financing markets combined with proprietary acquisition and financing ideas are important points of differentiation among firms.

“It is difficult to predict how long the good times will last, but some type of underlying market correction will be necessary to curb the current enthusiasm.”

—Jeff Kilrea, Co-President, CapitalSource, Inc.

WPEC: As mentioned, it seems that covenants have gotten much less restrictive, particularly at the high end of the market. Have you had to become more competitive on covenants?

JK: Covenants are just another dynamic in this aggressive marketplace. “Covenant-lite” deals (limited to incurrence tests) are popular for larger market transactions. In the middle market lenders have gotten much more aggressive on covenants. Transactions are typically limited to two or three financial covenants (fixed charge, leverage and interest coverage). A lot depends on the deal, whether earlier stage or mature, how the covenant package will be structured.

JE: Covenant-lite deals have become quite common. We have a couple key covenants we insist on, but otherwise we usually go with the market and trust the sponsor to act appropriately, even if they’re not contractually required to do so.

GH: We think that covenant-lite deals are a temporary market offering. I’m not sure they are going to be around in nine months. They are definitely hot right now though. Issuers who generate greater than \$50 million in EBITDA who are looking to come to market over the next few months will most likely

get pitched covenant-lite deals. That EBITDA threshold is decreasing on a regular basis.

JF: After only \$5.9 billion of covenant-lite transactions in 2005 and \$27.5 billion in 2006, 2007 has seen an explosion in the volume of covenant-lite transactions, with over \$32.0 billion issued year to date. Over the past month, almost every meeting I have had with a client has included a discussion of covenant-lite structures. Not only has the current market resulted in these structures with one or no maintenance financial covenants, we have also seen significant loosening in many other covenants, such as acquisition baskets, debt incurrence baskets and restricted payment capacity.

WPEC: What current trends are you seeing in the sub-debt markets? Is the pendulum swinging back towards mezzanine from second lien as a result of the higher interest rates in the past few years?

JE: The mezzanine market has definitely experienced a resurgence in the past year, largely due to second lien financing becoming less competitive as interest rates have risen. I also think some sponsors are realizing the positive economic times can’t last forever and so are becoming more sensitive to who is in their capital structure — a highly syndicated second lien group or one mezzanine provider with whom they have a good relationship. This is particularly true in the case of highly leveraged deals where the first one or even two years are forecasted to be extremely tight on a free cash flow basis.

JK: For a period of time earlier this year, credit spreads for second lien and mezzanine financing were sizable: possibly 200/300 bps. With an increase in LIBOR and tightening of the second lien market, we have seen an increase in mezzanine debt in transaction structures. This has also been driven by an increasing leverage marketplace where we have seen more aggressive structuring, 4x/6x/6.5x with HoldCo PIK Notes, necessary to help PEGs finance LBOs.

GH: We’ve also seen mezzanine providers get more active over the past year by lowering their pricing to the low to mid-teens. They’ve also shown a willingness to take larger tranches as a way to differentiate themselves. Much of this is generated by the type of investor taking the mezzanine debt. Hedge funds that are typically in second lien tranches are open to unsecured sub-debt to obtain enhanced yields (generally by 2% or 3%). These deals are structured similarly to second lien financings, excluding the security. More traditional mezzanine investors will generally have higher yield requirements and more restrictive terms (i.e., non-call periods, etc.).

JF: The mezzanine market has been very attractive for issuers over the past year as alternative to both second lien and high yield tranches. As compared to second lien, issuers frequently view mezzanine as more patient capital and as mezzanine coupons have trended lower and LIBOR has trended up, pricing is more competitive. Also, as mentioned by others, with the increase in tranche sizes for mezzanine, we have seen mezzanine with “bond-like” covenants and favorable call structures replace some volume in the high yield market.

WPEC: To follow up on Jerome’s comment — have private equity firms become more adamant about who ultimately holds their debt? Furthermore, has this changed the amount of paper you are looking to hold?

JK: Balance sheet management is always something of interest from a lender’s perspective. Even in this frothy market our hold sizes continue to be in the \$20 to \$30 million range, depending on deal size and PEG preference. PEGs are more interested in who is holding their paper, and it certainly has bearing on who is awarded debt mandates. PEGs want to see their relationship lenders hold more meaningful positions and bank groups don’t want to see one or two lenders of a syndicate (for a middle market transaction) control voting. Most PEGs, unless necessary, don’t want to see hedge funds leading their deals because of the portfolio management uncertainty or loan to own reputation.

GH: I think the general trend has been for relationship banks to hold less, but we try to hold more to further develop the relationship with the sponsor. Who ultimately holds the debt has become more of an issue in the middle market. Issuers can get good terms from a wide range of institutions so many of them don’t want to take the risk of having hedge funds in their syndication group.

JF: The answer varies by private equity group, but if I were to try and generalize, for broadly syndicated transactions we have seen less focus on the final hold positions for the lead arrangers and more focus on allocations to second lien and mezzanine markets. Also, for mezzanine financing, most private equity firms have strong preferences on who is approached for mezzanine opportunities.

WPEC: An industry perception exists that the “mega funds” receive premium terms on their deals because of their brand name and relationships. Does such a premium exist in the middle market? How much does a firm’s brand name and your relationship with that firm matter when securing debt

for a new transaction or working out a difficult situation with an existing company?

JK: In middle market transactions, I am not sure that either proprietary deal flow or sponsor preferences exist. A PEGs “brand” name may add some cache to the process, but with so much PEG money chasing middle market deals, and recognizing that most PEGs are well banked, I-Bankers and intermediaries can afford to widen the net when representing companies in the sale process. From a debt perspective, I think relationships are important when PEGs are looking to secure financing for their acquisitions. This relationship may be worth 25 bps or a last look at a transaction, which certainly is representative of the increased competition for deals. Relationships are built at the front end, but solidified and maintained based on certainty of execution and delivery. Credibility is key, and that includes behavior from a portfolio perspective. Not all deals go as we all hope and there will inevitably be difficult discussions at some point. Rational thinking is part of relationship building, and PEGs value lenders that act as true partners.

“The best advice I can give [to sponsors] is to understand the investor base and communicate.”

—J. Gardner Horan, Senior Vice President,
GE Commercial Finance’s Global Media &
Communications Group

JE: I don’t think the middle market gets anywhere near the terms that the mega-funds get. We definitely go into a deal with a middle-market sponsor with different expectations than when we invest with a mega-fund.

GH: Relationships and reputations are important in the middle market – a well known operator in the space certainly helps syndication. Lenders will stretch further for groups who have a demonstrated track record in a certain industry.

WPEC: Have any of you participated in the growing buyout markets outside the United States? What are the primary differences that lenders must consider in these transactions?

JE: We invest globally, mainly in Europe and Australia. The primary differences with the U.S. relate to creditors’ rights if things go badly for the

company. The bankruptcy rules are significantly different in other parts of the world, most of which follow “strict priority,” which greatly lessens the ability of subordinated lenders to have their voices heard in a restructuring.

JK: Last year we opened an office in London and are looking to capitalize on the growing European LBO marketplace. The European marketplace is different from the States and we have encountered numerous legal challenges. Given the flow of dollars from U.S. PEGs into Europe, we view this as a tremendous opportunity, but recognize this effort is still early stage. We have been primarily a participant in other people’s deals to date, but believe we have our first agency role locked up.

WPEC: Do you have any general advice for sponsors when they are dealing with a company that has not performed well and may need to restructure? What can a sponsor do to improve its chances of a successful outcome?

“The vast amounts of capital raised by hedge funds and second lien funds have fundamentally changed the financing landscape.”

—Jerome Egan, Senior Vice President, TCW/
Crescent Mezzanine

GH: The best advice I can give is to understand the investor base and communicate. Issuers and sponsors who fail to communicate can leave a bad taste in investors’ mouths, which will ultimately affect their willingness to bend on certain issues. Be responsive to information requests. Sponsors who keep the lender group informed fair better than those who do not.

JK: I agree. The best advice I have for PEGs that have troubled situations is maintain an open and honest dialogue with your lender. No one wants to be surprised. Don’t limit communication to good news. Communication of bad news and a clear plan to seeking a solution is the best course of action. This does not insure a positive outcome, but working together with your lender and keeping all parties apprised is the favored approach.

JE: A sponsor needs to do the right thing. Whether that’s putting in new money or working in partner-

ship with the company’s creditors, or even handing over the keys to the company — it’s those sponsors that maintain their reputation for acting properly that keep financing sources interested in doing their deals.

JF: I agree with all the points made. Open and honest communication is critical.

WPEC: Have your views on dividend recaps changed in the current environment?

JK: We have done our fair share of dividend recaps and will continue to evaluate them, but pushing the leverage envelope in order to pay dividends is not necessarily something that interests us. Dividend recaps can be a means of retaining solid performing assets in the portfolio. I do like to see PEGs with some level of monetary commitment post recap. While there is still risk, it offers a little added comfort knowing the PEG still has principal exposure.

JE: We will not finance a dividend recap. We believe strongly that the equity sponsor needs to have risk capital in the deal. We’ve passed on many dividend recaps that have done very well the past few years, but our belief hasn’t changed that it’s a fundamentally bad investment.

GH: Dividend recaps have grown dramatically over the past three to six months. With so many sponsors currently raising new funds, the need for monetization or partial monetization has increased. Generally, the debt markets will go a bit deeper in the capital structure on an acquisition vs. a recap of the same business. This is due to the validation of value that is provided with an acquisition. In a recap, market value of a business is more subjective. That being said, this is still a great time for sponsors to pursue a recap.

JF: Another sign of the robust financing markets has been the volume of dividend recaps over the past year. The leveraged loan market (first and second lien) has been very receptive to dividend transactions with very little, if any, discount to the comparable LBO leverage multiples, especially for known issuers with proven track records. We have also seen a significant surge in volumes in the high yield and mezzanine markets for holding company dividend transactions. Many of these have been issued with favorable call structures and used to pre-fund a dividend ahead of an IPO or other exit opportunity.

WPEC: Finally, do you have any advice for private equity groups trying to differentiate themselves in an increasingly competitive industry?

JK: Knowing your particular sectors of expertise cold is an important step when it comes to differentiation. This will help with the sourcing of deal flow and raising of capital. Whether the PEG is sector specific or has certain Partner specialists in a more generalist setting, it is my opinion that these groups are the most productive and spend time on deals they have a higher percentage of winning. It also makes the debt raise somewhat easier as well.

JE: I agree. Sponsors need to stick to their areas of expertise. Some are very good at retail, some at financial services, etc. Today, many buyout shops who find themselves with so much capital invest in industries they have no experience in.

“Knowing your particular sectors of expertise cold is an important step when it comes to differentiation.”

—Jeff Kilrea, CapitalSource

GH: Tough question. I agree that in-depth knowledge of a sector goes a long way towards differentiating a group. This knowledge can stem from either past deals in the space or from an operating partner or advisor who used to work in the industry. These factors help create a sense of camaraderie and show a commitment to getting the deal done. When acquiring a division of a larger company, it is important to be considerate of the public relations issues that are present for the sellers in such a transaction.

JF: Develop key areas of knowledge and expertise and then develop relationships with management teams and bankers in the sector. Work with these bankers and management teams to deliver proprietary, value added acquisition ideas for new platform companies and add-ons to existing portfolio companies. ❖



Case Study in Effective Private Equity Differentiation: Arcapita's Acquisition of Church's Chicken

Editor's Note: *The following case study was researched and written by members of the Wharton Private Equity Club.*

Developing competitive advantage in

private equity often takes time. Some firms might patiently study a market niche for a number of years, for example, before a great potential investment comes along. Meanwhile, the edge they've gained puts them in the best position to capitalize on the opportunity, while others are left scratching their heads. A close look at Arcapita's 2004 acquisition of Church's Chicken provides insight into how firms can develop a competitive advantage, and how that advantage can be exploited when all the right pieces fall into place.

There was very little sponsor interest in the restaurant space at the time Church's entered the market.

In mid-summer 2004, when AFC Enterprises (AFC), a franchisor and operator of various restaurant concepts, publicly announced that it had hired Bear Stearns to help it explore strategic alternatives as part of an ongoing effort to enhance shareholder value, little attention was paid by the private equity community. AFC shareholders were unhappy with the company's performance and management felt that the company needed to refocus its concept portfolio. At the time, AFC owned restaurant concepts as broad as Cinnabon and Seattle's Best Coffee, in addition to two different chicken concepts — Popeye's and Church's Chicken.

Since these two businesses competed with each other in many markets, one of AFC's first strategic decisions was to sell Church's and center its efforts on opportunities with the Popeye's business. Because the business would be competing directly with Popeye's, however, there were inherent conflicts in the sales process, and many of Church's strengths were downplayed in the selling memorandum. The marketing pitch did not convey clear opportunities for operational improvement or growth and, as a result, market reaction to the deal was not positive.

A "Value Leader"

Founded in 1952 by George Church Sr. in San Antonio, Tex., Church's is the fourth-largest operator and franchisor of chicken Quick Service Restaurants (QSRs), with more than 1,600 restaurants in 30 states and 16 countries. Church's is a highly recognized brand name in the QSR sector, with a reputation for being the "value leader" in the chicken category. With over \$1 billion in annual system-wide sales, Church's serves traditional Southern fried chicken in a simple, no-frills setting with a focus on providing complete meals at low prices for value-conscious consumers.

Approximately 20% of Church's domestic stores are company operated, with the balance franchised across 29 states. International locations are all franchised. Within the United States, the majority of Church's locations are positioned as neighborhood restaurants located in urban areas within easy reach of the company's lower-income, value-seeking customer base. Customer demographic research indicates that Church's restaurants are disproportionately popular with minorities.

Above-average unit economics, simple operating systems, quality menu offerings, and an expanding customer base make Church's an attractive franchise opportunity. The restaurants have a distinctive appearance and feature bright colors, promotional window clings and a unique logo that can be spotted from far away. Flexible square footage requirements enable Church's restaurants to fit into a variety of traditional and alternative venues, thereby expanding the breadth of channels to access customers. Restaurants range in size from 650 to 3,000 square feet and service dine-in, carry-out, and drive-through segments.

Industry Know-how

The commercial foodservice industry is one of the largest sectors of the nation's economy, generating over \$400 billion in annual sales and representing nearly 4% of U.S. GDP. In addition to its size, however, the industry is highly competitive, operationally intense and faces fickle consumer demand as a result of changing taste patterns and dietary trends. Consequently, most private equity firms had historically shied away from the restaurant space in search of higher margin, more dependable businesses that could be more easily leveraged. Despite AFC's preference for a financial buyer, there was very little sponsor interest in the space at the time Church's entered the market.

While there was little broad market interest, Arcapita, an Atlanta-based private equity firm, was intrigued by the company's simple concept, limited menu, and international footprint. Stockton Croft, a director at Arcapita, had participated in a successful investment in the restaurant sector a few years earlier and had built a strong base of industry knowledge and contacts from which to draw. As a result, he was able to spot several specific issues within the operations of Church's that could likely be addressed to enhance value. In addition, he had developed some experience with sale-leaseback deals as a means of averaging down acquisition multiples in an effort to enhance returns and was impressed by the real estate portfolio held by Church's. (A sale leaseback is a transaction in which the owner of a property sells that property and then leases it back from the buyer. The purpose of the leaseback is to free up the original owner's capital at a high multiple relative to the overall acquisition, while allowing the owner to retain possession and use of the property.) Given the favorable property values in the real estate market, Croft saw the opportunity to take advantage of certain real estate-

heavy companies such as Church's that could be purchased for low multiples once a sale-leaseback transaction was considered.

At the time Church's hit the market, Harsha Agadi, a foodservice industry veteran with more than 20 years of experience at various restaurant and foodservice companies, was working as an Industrial Partner with Ripplewood Holdings, LLC, a \$4 billion private equity firm. Agadi had significant management experience at restaurant/foodservice companies such as Domino's Pizza, Tricon Global Restaurants, Kraft General Foods and Little Caesar Enterprises. Over a ten-year period, Agadi was responsible for opening over 2,000 stores for two competing brands in over 50 countries. He also had specific experience in launching U.S. restaurant brands in overseas markets with repeated success, as well as leadership experience in restructuring and repositioning companies for rapid growth. His most relevant experience for the Church's deal came from his employment with Little Caesar Enterprises from 1996 to 2000, where he served as president and chief operating officer. In this capacity, Agadi was responsible for the \$2 billion Little Caesars restaurant chain with 4,500 locations across 22 countries, which catered to a similar demographic base as Church's.

Atlanta-based Arcapita was intrigued by the company's simple concept, limited menu, and international footprint.

At Ripplewood, Agadi had looked at 30 or 40 different restaurant deals. He was particularly interested in finding a regional player that he could eventually grow into a national brand. He also wanted a company with a burgeoning overseas footprint whose concept was easily transferable to other countries. Importantly, the concept also needed scale, with at least 1,000 locations that had proven successful in a number of different markets. Although Church's fit this criteria, Ripplewood had begun to expand its deal size, and Church's was unfortunately too small an investment for Ripplewood's portfolio. With Ripplewood's blessing, Agadi began to seek another private equity firm that might be interested in partnering with him to pursue a deal with Church's. As luck would have it, he came across an article about Arcapita in a Duke University alumni newsletter, and cold called the firm to strike up a relationship.

Founded in 1997 and based in Atlanta, Arcapita is a private equity firm that invests in middle-market companies with strong management teams, innovative products, and leading market positions. Current and past investments span a range of industries including consumer products, foodservice, manufacturing, health care, specialty retail, and technology-enabled products. Since 1997, Arcapita has invested over \$800 million of equity in 13 transactions, which had a combined total transaction value in excess of \$1.4 billion.

It was clear that numerous, subtle changes would have a large impact on the company's business.

A week after his initial call, Agadi found himself in Arcapita's offices discussing the potential acquisition of Church's. From Arcapita's standpoint, it was clear that Agadi brought a lot to the table. His experience in the restaurant business, particularly in multi-national companies that targeted a similar demographic as Church's, would perfectly complement Arcapita's vision for the future growth prospects of Church's, both within its current core customer base as well as in international markets. Agadi and Arcapita agreed to work together in executing a plan for due diligence and vetting the investment thesis.

Clear Opportunities

After reading through the Church's material, it was clear to Agadi that there were numerous, subtle changes that could be made to the company that would have a large impact on its business. Agadi and Arcapita shared the idea that good private equity investments require a clear set of fundamental objectives for the long term as well as a number of operational improvements that could be pre-determined from the outset. In this sense, both parties saw a significant amount of "low-hanging fruit" as well as opportunities to enhance long-term strategic value within Church's business.

Certain opportunities were obvious to Agadi. For example, Church's was the only fast food chain he had ever seen that had free-standing restaurants but did not have sandwiches on the menu. This was a obvious omission to him; people like to walk into a quick service restaurant and walk out with a

sandwich. More importantly, Church's was the only chicken-focused QSR that served only one style of chicken. Because of its ownership of Popeye's (which is focused on spicy chicken), AFC intentionally prevented Church's from launching a spicy chicken product in deference to the Popeye's business. Agadi viewed these menu deficiencies as a silver bullet. While the benefits of adding spicy chicken and sandwiches to the menu might be difficult to quantify, he believed that these changes could be a tremendous boost to sales.

Church's was not trying to be all things to all people, and both Arcapita and Agadi liked its focused, simple concept and limited menu. Based on his own experience with restaurant concepts, Agadi was also impressed with Church's ability to sustain its brand. Despite how unforgiving and fickle the American consumer can be, and how even the mightiest brands can fall out of favor over time, Church's had managed to survive for over 52 years, which spoke to the power of the brand and to the sustainability of the fried chicken product in general.

After an initial meeting with Church's management, other necessary changes became evident. Management had unfortunately been operating in an ownership structure that had kept their hands tied. Because Church's was part of a larger public company, management had not been allowed to make the big, structural changes sometimes necessary to thrive as an independent company. In addition, AFC had transferred much of Church's cash flow to Popeye's, reinvesting very little in the business. As a result, AFC's ownership in Popeye's was handicapping Church's growth and preventing strategic decisions that would have maximized value. In response to these restrictions, management's strategy had focused on growing Church's light users by offering salads and wraps, as opposed to catering to heavy users who preferred the traditional chicken products. This strategy was so ingrained among Church's management that Arcapita felt new leadership would be necessary in order to reinvigorate the company with a fresh perspective. As far as Agadi was concerned, the management team's passion for the Church's concept was much less than he had seen at other successful brands.

Another important benefit that both Agadi and Arcapita saw was the strength and loyalty of its well-defined customer base. Interestingly, Church's has demonstrated particular appeal among several high-growth ethnic groups within the U.S. African Americans and Hispanics show the highest loyalty

to the brand and are the most frequent consumers of the company's products. The Hispanic population, which already represents the largest minority group in the U.S., is projected to reach approximately 48 million by 2010, an increase of 23% from 2002. The African American population is projected to grow by 5.6% to approximately 41 million by 2010. As the brand of choice for these two high-growth ethnic demographic groups, Church's had a tremendous potential for expanding its customer base and driving sales growth in both new and existing markets in the U.S., while continuing to focus on international expansion abroad.

Improving Operations and Management

Convinced of the low hanging fruit, Arcapita and Agadi wrapped up their due diligence process and developed a strategic plan that they could implement from day one. Arcapita would name Agadi CEO of Church's, and together they outlined their management vision. In an effort to strengthen and grow the Church's concept, Arcapita developed a targeted list of key business strategies on which they would focus. The vision for Church's was to become the consumer's first choice for high quality, great tasting chicken and the potential franchisee's first choice among QSR concepts. Among other efforts, they planned to focus on improving operational efficiencies, strengthening management, expanding internationally via the franchise network, and increasing domestic market penetration.

In December of 2004, Arcapita purchased Church's from AFC for \$390 million. In addition to the equity provided by Arcapita, the deal was financed with \$155 million of private high yield notes led by SunTrust, a \$161.5 million sale leaseback of real estate by Fortress Investment Group, and a \$7 million subordinated seller note. Croft's initial hunch about Church's real estate proved true, and most company-owned locations were sold and leased back to effectively average down the purchase multiple.

Immediately after closing the deal, Agadi began changing the management team and reworking the culture of firm. The top seven executives were all replaced. The prior management team had been scattered across the country, with many commuting great distances to headquarters in Atlanta. Agadi stressed the importance of a local, dedicated management team, and insisted that all new hires live in Atlanta and work at headquarters.

Due to the depth of Arcapita's due diligence process, Agadi started with a clear plan of changes to

be implemented over the next 365 days. He also determined which stores were inefficient and needed to be cut. Throughout the due diligence process, he felt that Church's expense structure was severely bloated and he aimed to immediately reduce costs. This was especially important because of the inherently low margins in the value chicken segment. When selling two pieces of chicken for \$.99, every penny counts. One of the more noticeable expense improvements concerned Church's pre-existing corporate outsourcing contracts. By switching to new providers and outsourcing the entire IT infrastructure to a firm in India, Church's saw 50% annual cost savings for IT. Agadi also outsourced the firm's internal accounting effort to India, saving the firm an additional 50% in accounting-related administrative expenses.

A Competitive Franchise Model

Church's also made a demonstrated effort to improve its franchise model. Because the company's growth largely depended on selling franchises to expand, it was necessary for Church's model to be at least competitive with the other options available to potential franchisees. Upon studying the model in place, Agadi and Arcapita found that the economics for franchisees simply were not working. Franchisees look to the parent to provide great products and effective marketing and expect to leverage the larger supply chain to decrease costs; otherwise they would open as an independent store. In addition, franchisees must be able to justify the initial investment it takes to open a store by comparing the growth potential and cash-on-cash returns to other franchise opportunities.

A store opening in Mexico was one-third the cost of a store opening less than 200 miles away in California.

By studying franchisee costs, Arcapita found that a store opening in Mexico was one-third the cost of a store opening less than 200 miles away in California. As a result, Church's standardized the best opening model for franchisees and brought the costs of opening a store down significantly by reducing necessary square footage and lot size. The net effect of these changes has been more efficient pre-assembled stores, lower franchisee capital investment, and ultimately higher cash on cash

returns. The average payback period for a Church's franchisee today is less than three years. The principle behind most of these changes was the realization that Church's customers do not care about the size of the lot or having extra seats in the restaurants as long as the service is quick and the product is cheap and flavorful. As a result of the store reconfiguration, Church's now has the highest sales per square foot in the QSR chicken segment.

Over the next few years, the company plans to continue its focus on improving margins and effectively reinvesting in the business.

In addition to the structural and cultural changes put in place, Church's also made the menu changes that Agadi felt were necessary. The spicy chicken product quickly proved to be a runaway success. In fact, the product was so successful that it now accounts for over 20% of sales, further highlighting the restraint that Church's management was experiencing under its prior owner.

"Enhanced Performance"

Agadi doesn't view Arcapita's investment in Church's as a turnaround. As he puts it, the transition was simply "carefully orchestrated enhanced performance." The changes put in place to date have had a positive impact on Church's operations, culture, marketing and sales efforts. Stores are now operating at an increased speed of service, with an improved menu, enhanced food cost reporting systems, and more effective guest feedback mechanisms which have fostered the creation of a performance scorecard for each store. As far as culture is concerned, employees report feeling liberated from a controlling parent and no longer feel second tier to Popeye's. Franchise owners are happy with new standardized systems and best practices, high ROIC from new restaurants, and Church's re-image program.

Moving forward, Arcapita does not expect a lot of structural changes. With a healthy domestic franchise market, the firm is aiming to continue to push for aggressive restaurant growth around core markets. Internationally, Church's is looking to continue its growth in current country markets, while also pushing into China, Russia, and India. In fact, growth today is balanced evenly between domestic and international markets. Although Church's generates

significant free cash flow to pay down debt, the lack of required amortization under the company's debt structure has allowed Church's to reinvest most of its cash flow to continue its aggressive store build out and to keep the existing stores clean and up-to-date. According to Agadi, Church's has spent more on capital expenditures in the past two years than they had in the prior ten. Over the next few years, the company plans to continue its focus on improving margins and effectively reinvesting in the business.

While serendipity played a part, there is little doubt that the competitive advantage created through Arcapita's local knowledge of the Church's brand, Croft's experience in the restaurant sector and with sale-leaseback transactions, and Agadi's in-depth operational experience in the restaurant industry allowed Arcapita to identify an opportunity that other financial buyers overlooked. ❖

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