



Where is All that Private Equity Money?

Business owners seeking capital will find private equity funds highly selective and discriminating.

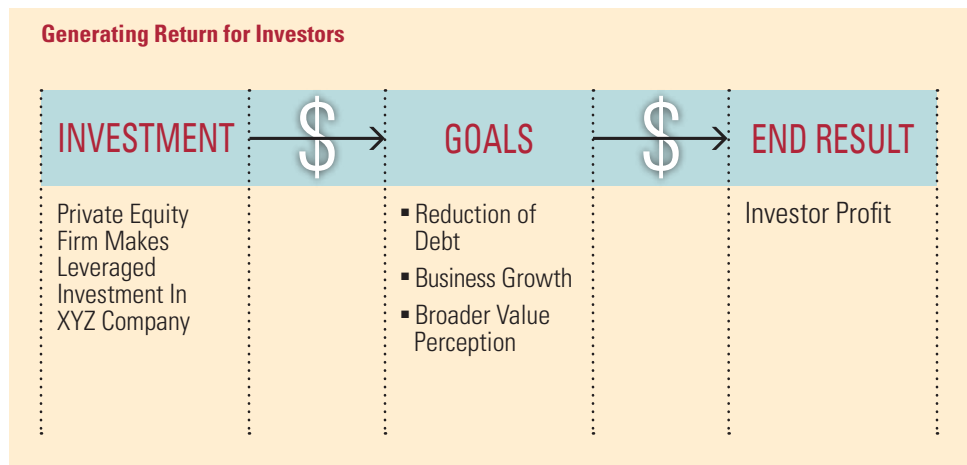
by Mark D. Working

We've written in previous issues of *INSIGHT* about the growing role of private equity investment in middle-market businesses. Many sources observe that a significant and growing percentage of middle-market private businesses are at least partially owned by private equity firms. How is it then that individual business owners can be frustrated in efforts to attract capital? The truth is that the private equity market is very specialized and fragmented. Because private equity investors are highly selective and their investment preferences vary widely, the job of finding capital for a specific company can be a challenge.

Private equity firms exist to serve their investors by originating attractive opportunities to apply capital. Their prime motivation is to earn a favorable long-term return for their investors. Firms have different strategies of finding and/or creating those opportunities, but there are some common traits of businesses that define them as attractive.

THE ROLE OF LEVERAGE

A private equity investment generates a return for investors as a result of: 1) taking on financial risk, 2) stimulating profitable business growth, and 3) arbitraging markets. When equity is invested in a business with a leveraged capital structure, equity value increases when the cash flows generated by the business are applied to reduce debt. Even if the enterprise value of the business is unchanged, when debt is reduced the value of equity increases, thereby assuring a return on the investment. Because adding financial leverage to a business increases risk, the equity investors have an opportunity to earn a higher return. Therefore, in the eyes of a private equity firm, an attractive investment candidate is one that exhibits cash flow stability and the consequent ability to support debt capital. In only the most unique of circumstances will a private equity firm fund the acquisition of a business solely with equity capital. Reliable markets for products, competitive barriers to entry and/or substitute products, and high gross margins are indicators of stable businesses that can



support debt. Even though building a better business is the ultimate objective of a private equity investor, the fundamental aspect of a leveraged buyout, which is to add financial risk to the operating risk already inherent in

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the business, and then remove it, provides a significant component of a private equity firm's return.

BOOSTING BUSINESS VALUE

In addition to the effect of reducing leverage, gains in enterprise value can boost equity value. Attractive businesses compete in markets where there is inherent growth in demand for products and/or services, either from predictable increases in basic demand or substitution for other less favorable alternatives. Growth can also be achieved through consolidation of a fragmented industry, as long as the cost to consolidate is less than the value created from combining the businesses. According to Brad Creswell of Northwest

Capital Appreciation, "fragmented industries offer a great opportunity for value creation as redundant functions are eliminated and facilities and management are used to their greatest efficiency. Some of our best returns have been earned as a result of a successful consolidation strategy led by a capable management team."

Stephen Babson, general partner at Endeavour Capital, is even more specific about the importance of management, "Management is so important to the successful growth of a business that we will pass on an investment, even within our target industries, unless there is an experienced team in place or we are bringing the team into the transaction. We look for a team that has succeeded with the business model being employed and has the capability and energy to complete the business plan. To that equation we can add the capital and strategic support necessary to clear the decks for them to move the business forward."

GREATER VALUE STRATEGY

Sometimes the result of management's good work can create a business that has characteristics that fit a new market, like the public market, or provide a critical component to a greater value strategy being pursued by another business (see Value—In the Eye of the Beholder). When that occurs, an arbitrage of sorts in business value can occur and much greater value may be realized. This is exactly

what happened in the case of Zumiez (NASDAQ: ZUMZ), when Brentwood Associates teamed up with management to expand the firm's geographic footprint by adding stores in many new markets. By expanding the reach of the business and demonstrating the efficacy of its business model, Zumiez was able to access the public equity markets at a very attractive valuation. TJ McGill, managing partner of Evergreen Pacific Partners, believes that his firm's recent purchase of Gene Juarez Salon and Spa is the kind of business platform that could result in the same opportunity for his investors.

FORMULA FOR ATTRACTING FUNDING

Because of the fragmented nature of the private equity market, there are no absolute standards that qualify a business to attract investment capital. We can say with some authority that the following formula equates to an attractive investment opportunity:



Owners of an existing business cannot change the industry conditions in which their business competes, but they should be ever vigilant in searching for opportunities to improve the nature of the business through growth or consolidation. If it becomes necessary to attract external capital to transition the enterprise to the next level, a private equity firm may deserve consideration. ♦



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ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

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