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INVESTMENT BANKERS

INSIGHT
PERSPECTIVES ON THE CAPITAL MARKETS
REPRINT
SPRING 2010

Private Equity Update: The Tale of Two Cities

PE firms are developing new strategies, and private business owners should take note.

by Mark D. Working

Private equity firms are in a bind. The industry has been built on the twin pillars of control and leverage. Investment returns have traditionally come from a leveraged purchase of a business, followed by modest business growth, and then application of the cash flows to deleverage the balance sheet, culminating in the re-sale of the business to harvest the value. Returns from this formula have recently become more difficult to cultivate. As a result, private equity firms are changing their business models. For private business owners, these changes are potentially meaningful and should stimulate a fresh look at the prospects for taking on a partner and revitalizing the balance sheet.

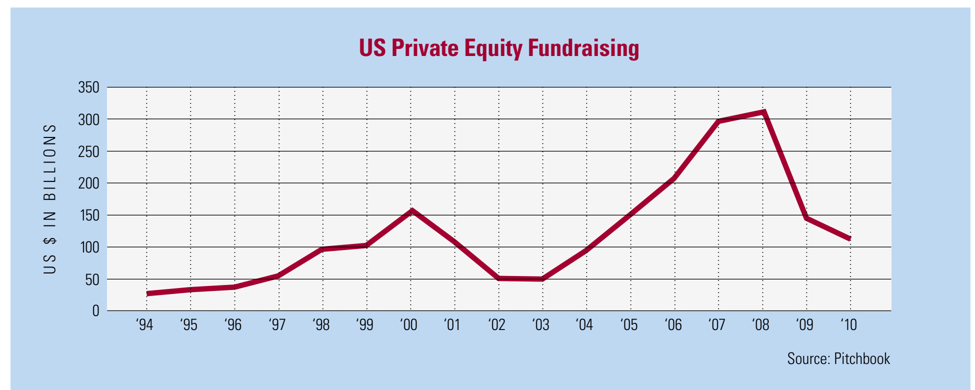
THE CURRENT STATE OF THE PRIVATE EQUITY UNIVERSE

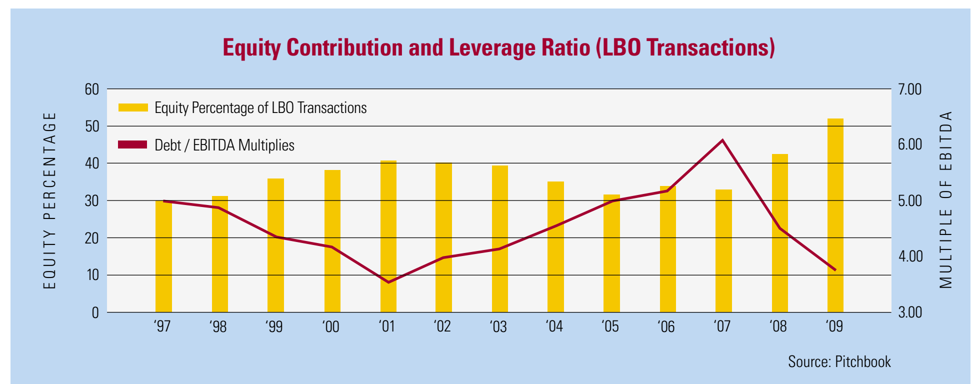
The four highest fund-raising years ever for the private equity industry were 2005, 2006, 2007, and 2008. Fund raising dropped off the table in 2009.

Armed with ample reserves and compliant lenders, private equity-led buyout transactions ballooned in the 2006-2008 period, peaking in 2007 at almost 25% of all mergers and acquisitions activity, followed by a crash in 2009 to the lowest volume in 10 years.

During the robust years of 2006-2008, financial leverage applied to transactions reached its zenith, thereby diluting the usage of the equity raised, leaving an unprecedented glut of undrawn private equity firepower.

The industry's chief problem is relentless pressure to put money to work in an environment where attractive investments are scarce. There is simply a smaller universe of target businesses, particularly in cyclical industries where demand and earnings have waned. The compulsion to invest in spite of the absence of compelling opportunities is driven by the basic structure of private equity funds. Investors don't actually invest in a fund; they commit to provide funds on demand for a fixed period of time, typically four to five years. If sponsors are unable to put that capital to work during that time, the commitments lapse. Sponsors draw a management fee based on total commitments, drawn and undrawn. Once the initial investment period expires, fees are solely predicated on actual invested dollars, valued at market. Failure to find a home for committed funds within this initial period can have a negative effect on the sponsor firm. In addition to suffering questions about the value of the firm's proprietary deal flow, erosion of firm revenue may thereby jeopardize its ability to find and close new opportunities and manage its existing portfolio.





The second challenge is the fateful combination of imprudently high leverage employed on investments in the peak years and continuing economic malaise. These are the key ingredients to an extended period of disappointing investment returns.

A third problem–"if I call, will they answer"–was front and center for private equity firms just a year ago, but seems to have faded with time. Back then, there was genuine concern that some fund investors might default on their capital call commitments in spite of the punitive consequences of defaulting. Failure to meet a capital call typically results in the loss of interests in prior fund investments. Investment market stabilization, together with a rebound in the value of institutional equity portfolios, has resolved this fear for the most part.

THE TALE OF TWO CITIES

Because private equity and American business and industry are so tightly intertwined, the forces of creative destruction unleashed by the financial crisis continue to take a heavy toll on private equity investments. For a fund that competed aggressively for opportunities during the buyout boom and is now shackled by underperforming portfolio companies, there is a magnified urgency to put new money to work in an effort to average out losses. The firm also has to be concerned that, depending on the condition of its portfolio, investors who have lost confidence in

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the investment strategy have no real downside to defaulting on future capital calls, potentially putting the firm out of business.

Those funds with a long-term track record over multiple funds are better situated to withstand diminished returns in their current portfolios, but still face mounting pressure and competing objectives. As with the pitcher about to face mighty Casey late in an important baseball game, he hears from his coach, "don't give him anything to hit, but don't walk him." The private equity firms hear from their investors that they want prudence, but wonder why they are paying fees when no investments appear. Many private equity firms have little to show for themselves in the last 18 months.

The bottom line is that there is a great desire to put a lot of money to work.

REDEFINING INVESTMENT STRATEGIES

As with all industries, private equity fund managers have been reevaluating their business models. For quite some time, the dominant private equity formula for success has been to acquire controlling interests in stable, but modestly growing businesses, then add substantial financial leverage in the process, and, finally, permit the passage of time. With modest growth, the business works down its acquisition debt. The growth leads to increased enterprise value as well as a greater proportion of that value accruing to equity. A sale of the business at a later date delivers an attractive return on equity to the firm and its investors.

A recent study by the Boston Consulting Group comes to the conclusion that private equity firms have earned the greatest returns as the result of "operational value creation", not financial leverage. Making good strategic business decisions trumps the effect of financial leverage and with a lower degree of risk. Fundamentally, the private equity industry understands this and is adjusting. Although banks and the public bond market are loosening up and providing acquisition financing again, we've noticed a change in approach by private equity firms.

- More private equity firms are using operating partners, former or current managers of businesses, to assist in evaluating companies and business strategies;
- Due diligence is directed towards operational improvements and business strategy; and
- Investment is going into companies as well as to owners of companies.

This latter trend suggests a slight movement towards the venture capital model in which capital is employed to achieve operational goals.

Private equity firms are more concerned now with becoming involved with winning strategies and management and less concerned with control. A successful business that can benefit from some additional capital will attract minority equity as a partner.

WHAT THIS MEANS TO THE PRIVATE COMPANY OWNER

Whether we are observing a trend or simply a temporary technique to widen the net for investment opportunities will play itself out over time. In the interim, private companies can avail themselves of a capital partner that will provide funding for both ownership liquidity and growth without adding overwhelming leverage.

Recognize that private equity firms have an objective of delivering an investment return to their investors. The value proposition must be clear and clearly articulated. Due diligence will include a greater scrutiny of operating plans prior to making the investment and, after closing, pressure to achieve objectives.

Choosing a partner is a more complex decision than selling a business. First impressions might not yield an accurate assessment. While selling is often mostly a function of price, taking on a partner is a more personal decision. It is important to understand the fund's history, its current and future status, and the personalities of the principals under different conditions. An advisor who specializes in this market can be very valuable. ❖

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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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