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TOO MUCH MONEY, TOO FEW DEALS?

A CONVERSATION WITH FOUR MEMBERS OF THE BUYOUT INDUSTRY

BY DAVID CAREY

Since mid-2003, private equity has enjoyed a rip-roaring run of dealmaking and profit taking. With banks and the capital markets lavishing capital on LBOs and recapitalizations, we have seen a wave of financially engineered, rich dividend payouts and quick "flips" the likes of which the industry has rarely seen.

The easy money propelled private equity to the center stage of M&A. In 2004, an unprecedented 16% of mergers and acquisitions had private-equity backing.

Venture capitalists took heart from the $1.7 billion Google Inc. offering last year, which produced billions in gains for Kleiner Perkins Caufield & Byers and Sequoia Capital.

In mid-June, Cornell University's Johnson Graduate School of Management, the university's business school, convened a panel of four experts at New York's Cornell Club, who addressed a gathering of Johnson School alumni. David Carey, a senior writer at The Deal, moderated.

Taking the industry's temper were Leonard Harlan, a founding partner of Castle Harlan Inc., a New York middle-market private equity firm; Zachary Shulman of Ithaca, N.Y.'s Cayuga Venture Fund and a lecturer at the Johnson School; Kevin Prokop, a managing director at Questor Partners, a Southfield, Mich., and New York-based private equity firm specializing in turnarounds; and Peter Gonye, an ex-investment banker who now works at Spencer Stuart, an executive search firm whose clients include Fortune 100 companies, investment banks and private equity houses.

David Carey: *With unprecedented amounts of capital flowing into the business, is too much money chasing too few deals?*

Leonard Harlan: How [much] equity would you say there is in the "overhang"—committed, but unused, equity for buyouts? Our research said that there is $100 billion to $125 billion. But let's exaggerate and say it's $200 billion.

If you look at the total equity value of the New York Stock Exchange, I think it was $18.6 trillion. If you look at the total value of the Amex, that's $435 billion and $36 trillion for the Nasdaq. And that doesn't include the equity value of private companies. Contrast that to an equity overhang of $200 billion.

Let's look at another dimension to it, the M&A world. If you took the 16% number [for private equity's share of M&A] in 2004, that might have been $44 billion [of the $240 billion of total equity financing for U.S. mergers], which means there is about a four- or five-year overhang [of uncommitted capital to annual deal flow].

The point is, I believe that it is a myth there is too much money on the equity side chasing deals.

The problem is, people in my business will buy what lenders will lend. It's not the equity that's driving this; it's the availability of debt. What's driving prices up is the stapled financings, where banks will come in with 6 times [Ebitda in] stapled financing and then say, "Put equity on top of that."

We're headed for a bit of a fall. The fall will come from the fact that many of these companies are just too highly leveraged.

Kevin Prokop: I do agree with Len that it comes down to the capital markets. Last year, in particular, I would say, our competition came as much from the high-yield capital markets as other financial sponsors. We lost out on at least two transactions I can think of to leveraged recapitalizations, where we were pricing the equity at 6 times Ebitda, and the high-yield capital markets were willing to put 6.2 times on, leaving the stub with the equity sponsors.

Certainly historical evidence would seem to indicate that we're in for a shakeout in two to three years. If you look at a lot of the high-yield volume in the past 12 months, you see a

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lot of holding-company notes that are rated CCC, CCC+.

A lot of smart money is beginning to lay the groundwork and build distressed debt capabilities for what will be a shakeout in, I believe, two to three years.

Zachary Shulman: Let me tell you quickly the VC perspective on this.

At Cayuga Venture Fund, where I'm a partner, we've invested—believe it or not, primarily in Ithaca-based companies—over $40 million in the last five or six years. Our investments tend not to be raw startups. They tend to be in more mature companies.

VC funding has actually shrunk a bit, and the overhang has gone down. The competition for deals is still strong, which is great, and you'll actually see, now, more than one term sheet going into a private company. So we're not talking bubble hype of '98 or '99. We're talking reasoned investments.

Carey: *With all the debt-financed dividends and quick-flip realizations, are buyout sponsors focusing less on classic value building? Have they become fixated on extracting money from portfolio companies rather then strengthening them financially and operationally?*

Harlan: I think that buying a business has become a commodity. Anybody can buy a business. It's

what you do with the business once you own it.

The financial engineering has been part of Wall Street for generations. The secret sauce, which I suspect Questor and ourselves and others bring to this package, is managing the business for growth.

If we've grown the cash flow or the Ebitda, that enables us to tap the financial markets, if that's what's appropriate. But it must be predicated on improved performance.

We have one company where, in less than a year, the Ebitda has improved by some 35%. It's perfectly appropriate to [take it public. If we do,] I don't see anything wrong if all the proceeds go to the sponsors. That's not a sin.

In Australia, where we have also an operation ... if you don't take 100% of the proceeds in the IPO, it's considered poor form, because it means that there's an overhang in the market, which will depress the stock.

***Carey:** Kevin, I think Questor recapped that coal company, Pinn-Oak Resources LLC, the day you acquired it.*

Prokop: Yeah, we signed the agreement to recap it the day after we acquired it, and we actually executed the recap two months later. It's been a fabulously successful deal for us. The company didn't require the capital, so you could put a lot of leverage on it.

Shulman: On the VC side, all venture capitalists like to dream of the Google IPO. It's a wonderful story. I mean, Kleiner and Sequoia didn't sell in the IPO because they decided at the last minute the price [$85 per share] wasn't high enough, and they were smart. They bought the stock for 12 cents. It's a $4 billion profit on an investment. [The stock was trading at nearly $300 at press time.]

But the reality is that the M&A activity for venture-backed companies outpaces the IPO activity by about 10-to-1. Now why is that? Rate of return is paramount, and it is supreme for venture capitalists. We're not as concerned with longevity, in terms of being involved in a company for the longer term once the liquidity event takes place. The company is sold, and we're out.

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***Carey:** What about finding deals and dealflow? The prevalence of auctions seems to have mechanized the LBO process. Is the self-sourced, proprietary deal dead? Where are you finding your deals now?*

Prokop: Everybody says nobody participates in auctions. But investment banks would be out of business if that were true, and the reality is everybody participates in auctions.

We have 400 deals a year come across the transom. Of those, 200 fit our basic criteria. The other 200 we discard perfunctorily. They do come from auctions, investment banks, etc.

If you look, on the other hand, at the deals that we got done, a disproportionate percentage of them—I'd say 65% to 85%—consistently over the last three years come from deals that were either proprietary, that is, from friends of the fund, managers that we knew from a prior life who happened to know that a division was being spun off and brought us the deal, or from another private equity firm or from tougher auctions where they might send out 25 books and it came down to you and one or two other people.

Shulman: Of the 200 that pass muster, how many deals do you do?

Prokop: Two to three a year. Four years ago we did four, and over the last three years we've done two a year. One in a hundred is the math.

Harlan: Once again, I think we're in agreement.

But let me add to this a little bit. Corporations today, I think, are increasingly concerned about auctioning off their divisions. They want to take a rifle shot approach. They don't want to be diddled with, and unfortunately, there are people in our industry who like to diddle. What we're finding is that certain companies will come to us because of our reputation and say, "Would you like to join with one or two others in looking at a particular operation?"

There have been too many auctions in which a private equity house has bid high and then, when they get into being a finalist, they find 99 reasons why they had overbid in the first place, and they cut the price way down. Some companies who've had that experience, they don't want it anymore.

A second [source of dealflow is] auctions in which management has an influence over who buys the company. Because we've done 42 transactions in 18 years, we have a group of satisfied people who have been our partners. So in auctions in which we can access management and management has influence over or the sale, we say to them, "Why don't you talk to any of our past or present CEOs and let them tell you how we operate?"

Our constituency becomes our best salespeople. We have won a number of our companies in that manner.

Then there is the private proprietary deal that you mentioned, and in fact just today we finally got a letter of intent from a major corporation. We're the only ones talking to them—very quiet, very secret, all of that stuff. Companies want to work that way because [otherwise] it's too disruptive for their employees and their customer base.

Peter Gonye: As someone who has served a fair number of the larger buyout firms over the last several years, the holy grail is the ability of an individual to identify proprietary investment opportunities. The perception of the leading middle-market and megafund buyout firms tends to be that there are plenty of transactors—people who can execute in a consummately professional way.

What is lacking are individuals who bring

either exceptional domain knowledge or who can think in a creative way and can see trends before others do—those opportunities to do a quick IPO three months or nine months out of the block. Those don't come because all of a sudden Ebit has doubled or tripled. It's because firms have had the courage and the foresight to invest in a category before it turns itself around, as an example. They see things that other investors don't see.

Shulman: In the venture world in Ithaca—it's almost like an oxymoron, right?—proprietary dealflow is what we're all about. We're the only venture fund in Ithaca. All of our deals are proprietary, and 90% of the companies that we've invested in are Cornell technologies.

Do we pull in other investors? Sure. We just did a deal with **Draper Fisher Jurvetson** where little Ithaca-based Cayuga Venture Fund was the lead and DFJ is the co-investor. That's because Cornell spins out a lot of good stuff.

How do we get our deals? We walk the halls of the engineering school, the nanotech center. We talk to professors. I have a meeting on Friday with a professor who's doing some really cool stuff. Nothing that we'd look at for two years, but we start the process very early.

Carey: Let's open it up to the audience.

Audience member: *What happens if a company acquired in a "club" deal runs into trouble and co-investors don't agree about how to turn it around?*

Prokop: That's a great question, and that's what hasn't been tested. A lot of these club deals have not been through trying times, and that's when governance gets sticky. Six versus six on a 12-person board is fine when times are good and the company is hitting its plans. But when you're in default and a hedge fund has bought your term B paper and they're saying you didn't deliver your financial statements on time so we own the company, then you've got an issue.

That's where governance will really get tested. We'll see over the next two to three years how it works out.

Audience member: *From deal to deal and industry to industry, I see a wide range in valuations, in cash flow multiples, from 6 times to 11 times. How do you figure out the right multiple?*

Prokop: It's not elementary at all. It comes down to a distribution of potential returns. What are the risks associated with the deal? And what is the upside? What factors can influence the outcome?

It's actually not nearly so analytical [that you can] model it as a simultaneous equation. It comes down to business judgment.

Harlan: We try to buy companies for 6-1/2 times or less of Ebitda. We're pretty strict about that. So there have been times when we've just not been in the market. Last summer, we bought three companies within three weeks, all at 6-1/2 times or less. We haven't bought anything since. We've got a huge inventory of opportunities right now, but there was a period of time really where things were running up and we weren't going to chase it.

I think that's an important discipline for people in our business: not to get caught up with the froth and chase deals for the sake of putting money out.

Audience member: *Hedge funds have been taking a visible role in private equity. What is your reading of that?*

Harlan: There are a bunch of vultures out there called the hedge funds, and they're waiting with bated breath to buy out all this debt and take over these companies. Whenever the banks wind up with a loan that's in some kind of troubled waters, they immediately write it down and sell it off to one of these hedge funds. And the hedge funds in turn say, "Aha! Got you! You broke covenants, we want the business."

So we've got a very perverse activity on the lending side, and that is a problem for many of us in our business. We've got a new breed that I believe panics rather early and easily.

Audience member: *What do you see as the opportunities, and the risks, of emerging markets?*

Harlan: We went through that kind of analysis in '98, and we ultimately settled on Australia, which is certainly not an underdeveloped nation. We wanted to be in a country with a rule of law, which didn't have a sovereign risk or political risk. Where we had perfected financial markets and where we had an entrepreneurial class.

I think that set of criteria is extremely useful as you start to look around the globe. One of the big issues in some places is: How do you get out of your deal? The easiest thing is to invest; the difficult thing is to be able to get out, have an exit and make money.

I think that is very, very tricky in places like India, China, Latin America.

Prokop: I wouldn't underestimate the importance of what Len said about the entrepreneurial class. Or, more broadly, the culture of the country in which you're investing. We've done a few deals outside the United States, and the hardest thing for us in those deals has been bridging the cultural gaps. A lot of the times, you're talking past each other because you don't share common perceptions about how to run a business or what's appropriate to do in order to run a business, or what are appropriate steps to take if something shouldn't happen the way you'd hoped. ■

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