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China or India: Which Is the Better Long-term Investment for Private Equity Firms?

India and China are both vast countries just opening to development, filled with opportunity and risk for private equity investors. Inevitably, the two countries' rising economic fortunes invite debate over which offers the better climate for investment.

At first glance, India might not seem the safer bet, with its pitted roadways, tainted water and visible, widespread poverty. Yet those outward signs obscure solid underpinnings for economic growth, including a democratic government, a strong education system, widespread knowledge of English and a deep pool of expatriates experienced in Western businesses, according to Wharton faculty and experts in emerging market private equity.

> "Clearly there are enormous private-equity opportunities in both countries."
> —Jeremy Siegel, Professor of Finance, Wharton

Cheap labor and foreign direct investment have made China the world's manufacturing powerhouse under a government that has embraced Western-style capitalism. China has provided spectacular private-equity returns in recent years, but, the experts note, weaknesses in China's legal system and the possibility of political instability remain concerns for investors.

"Clearly there are enormous private-equity opportunities in both countries," says Wharton finance professor Jeremy Siegel.

Valuations Matter

As for the better investment climate long-term, Siegel sides with India. He says the country's "soft" attributes, such as a democratic government and a free press that is rooting out corruption, outweigh China's more impressive investments in "hard" infrastructure such ports, plants, and transportation systems.

Siegel notes that he is also concerned about China's system of "guanxi" in which business is conducted more through elaborate networks of relationships than on merit. The willingness of Americans to let an entrepreneur succeed, regardless of his or her social or political connections, has been the cornerstone of U.S. economic success, he points out. "People with Chinese connections can do a lot, but I'm cautious about the whole question of whether the contracts written would be upheld with the wider amount of certainty that they would in India."

That said, Siegel adds a final twist that might steer investors toward China, at least in the near-term — relative valuations. India's Sensex 30 — that country's version of the U.S. Dow-Jones Industrial Index — broke through 10,000 in February, up from 3,300 in December 2002. The price-to-earning ratio for India stocks is 21, while Chinese stocks on the Hong Kong Exchange are selling for 15 times earnings. In private equity, firms invested $2.3 billion in India in 147 deals last year, up from $1.6 billion in 68 deals the prior year, according to Venture Intelligence India.

"India's edge is no secret and future returns will not match the stellar gains of the last three years," Siegel states.

Vivek Paul, a partner at Texas Pacific Group and vice chairman of Wipro, the Indian technology and services firm, is also focused on valuations. He notes that while Chinese private equity investors are now enjoying an uptick, they have weathered earlier declines. Indian investors have yet to taste a downturn. "You have a more realistic hands-on valuation in China. In India it's only been up for the last three years."

A False Debate?

Paul believes that the major difference in investing in India and China lies in the industry sectors. In China, he says, deals flow across multiple industries, from auto dealer consolidation, to cell phone gaming companies, to medical leasing, while in India the focus is almost entirely on technology and services. India is developing some retail financial service businesses, he said, but China's consumer economy is more advanced.

His concerns for the markets are not tied to either country. He says that emerging market premiums are low relative to historic levels, creating systemic risk if economic collapse in another part of the world creates a contagion effect.

Rahul Bhasin, managing partner of Baring Private Equity Partners, believes that despite differences in the two countries, both will continue to benefit from globalization. "There has been a lot of hullabaloo about off-shoring and outsourcing, but the bottom line is, it is a globalized world," he says. "People will work harder for less in markets like India and China, and you are going to find most production work moving to these countries. There will be a shift in consumption globally from what is the developed world into the underdeveloped world. And it will happen faster than it has ever happened before."

The debate over which country is the better venue for investment is less important than knowing how the strengths and weakness of each nation would impact a specific investment, according to Stephen Sammut, Senior Fellow and Lecturer in Wharton Entrepreneurial Programs and Health Care Systems. Sammut made his comments while moderating a panel discussion titled "China vs. India: The Smarter 5-Year Investment" at the Wharton Private Equity Conference.

"The view of the two countries as being rivals in a war to procure more investment capital for either buyouts or venture capital is an entirely incorrect way of framing or charting what's going on," Sammut pointed out. "In fact they represent extraordinarily different markets on many levels."

First, he said the nature of entrepreneurship in India is different than in China because large numbers of Indian entrepreneurs have been able to work abroad as expatriates in many roles. "This will be manifest in the kinds of businesses they develop, particularly in information technology, and the pace with which they're going to be able to have technologies migrate from India." He also said India has an advantage in healthcare including biotech, pharmaceuticals and telemedicine, but he expects China to catch up rapidly.

The true promise of both nations, he added, lies in developing their internal markets. "There are rapidly emerging middle classes in both countries, hundreds of millions of people who are going to seek the same kind of standard of living as everyone else in the world," he said.

Bullish Long Term

Other panelists working in private equity in India and China laid out pluses and minuses in the two markets during the Wharton conference, which was titled "Driving Returns: Value Added Investing."

Mukund Krishnaswami, managing director of Krilacon Group, an investment firm based in New York and Philadelphia, agrees with Siegel about the current investment climate in India. "Long term, I'm a very big bull on India. India is a country where they've done so much wrong in the last 45 years. Yet despite all that there's so much that is good going on that if they just get it right, the opportunities [will be] fabulous in 25 years," he said. "In the short-term, I'm quite a bear. I think the risk premium just isn't there in most assets to be spending a lot of money [in India] today."

Krishnaswami advised investors to follow the broader economy, not the trends that are hot today, including information technology or real estate. "Look for derivative areas of economic growth and take a 12- to 25-year horizon. Those who do will be fairly compensated for the risk they're taking."

Panelist James Hahn, CEO of Global Venture Network and managing partner of China Private Equity Partners with operations in Hong Kong, said an overflow of foreign capital could hurt private equity returns in China, but he does not see that happening until after the 2008 Olympics or the Shanghai World Expo in 2010.

Chinese companies with good management are growing at a rate of 30% internally and 30% globally, Hahn said. "A good company operating in a good macro is a formula for success." He said there are at least 3 million privately owned companies in China. Of those, his firm believes 300,000 would qualify to list on NASDAQ or NYSE today. One percent of them, or 3,000 companies — "jewels" that have sound management — comply with Sarbanes-Oxley, and could be scaled up.

Hahn noted that his firm invests only in companies with management that operates under U.S. rule of law and accounting standards. "We will spend time with any Chinese CEO who has made the first step by showing his or her commitment to the process by having the company audited under U.S. GAAP rules. We are betting on the current quarterback."

He said that while returns for the best performing 10-year private-equity funds from 1986 to 2003 were 12%, and 11.9% for hedge funds, the maturation of U.S. private equity is now generating mediocre performance mimicking money market returns. Many U.S. investors are happy to find a 5% return, he noted. In China, today, the average investment is $5 million for a 30% stake in a Chinese growth company grossing $10 million with net income of $3 million and a pre-money valuation of $15 million, or 5 times net income. Comparable U.S. public companies in the same high-growth sectors such as healthcare, media, and education are trading at price-to-earnings ratios of 25 times. Buying low and selling high has delivered a minimum return of 100% a year for a five-year, $100 million size fund in China, said Hahn.

"This 'PE arbitrage' has delivered extraordinary performance. We're achieving that and everybody we know in China is achieving that," he said. "It's just the way things are today until the markets become more efficient."

Xiaojun Li, principal at IDG Venture Investment, remarked that he is bullish about China over the long-term because of its growing middle class and potential as a consumer market. He pointed out there are more Internet users and engineers in China than any other country, and that China also has a strong entrepreneurial culture. "You need to be patient," he said.

Li added that although some analysts have predicted China will eventually rival India in the service sector, he does not see that happening. He said that while there is some outsourcing of services for Japanese companies in China, manufacturing will remain China's key sector.

Evolving Capital Markets

Conference panelist Seth Freeman, co-founder and CEO of EM Capital Management, described how in India his firm uses quantitative tools to sift through the country's 7,000 listed companies in search of opportunities. Freeman noted that in India, many listed companies act more like privately held firms because they are under tight control, usually by founders.

"I think the global private equity investor really has to dig deep to understand the motivation of the founder-managers," said Freeman. "Our strategy is find and choose companies that are willing to embrace global corporate governance and other buzzwords that will create more liquidity in their stocks."

Freeman said Singapore has set out to become for India and surrounding countries what Hong Kong has been to China. "There are other Asian investors clamoring to get involved in India, as well as the Japanese who are becoming increasingly interested."

During the World Economic Forum in Davos, India made an all-out push to promote itself as a business-friendly environment for investment. In a move that seemed timed to coincide with the forum, the government lifted limits on foreign direct investment. The most notable change was in the retail sector where outside firms selling a single brand, such as Nike, will be allowed to own a majority stake in Indian stores. The cabinet also decided to lift the limit on foreign direct investment for the development of airports, mining for diamonds and other precious stones, and power trading.

Still, India trails far behind China in foreign direct investment, with just $5.3 billion in 2004 compared to $55 billion invested in China. "Foreign direct investment has been slow in India compared to China, and they are interested in getting that up," according to Siegel.

Local Partnerships Are Key

One stumbling block has been property rights. While the Indian legal system offers more protection of property rights than China, it does not do so with great speed, said Krishnaswami. "India has exceptional property laws," he said, "but if you have to enforce them you're dead." Krishnaswami said a court case takes seven to 10 years to complete. Bankruptcies can take three to four years.

Freeman said in this environment local partnerships are crucial. "You really have to know who you are getting into business with. If the locals don't have confidence in the local legal system, it's crazy to think that foreigners will," he said. "Local market expertise is critical. To be successful you can't overlay your U.S. or Western European private equity experience in these markets."

Li noted that despite China's reputation as a haven for intellectual property pirates, the country is now taking those complaints seriously. "My long-term prediction is that intellectual property protection is going to get better," he said.

Both countries have recently signed onto the World Trade Organization's Agreement on Trade-Related Aspects of Intellectual Property Rights, or TRIPS accord, but Sammut said it is too soon to tell how soon the emerging countries will comply. "Both countries have had very rapid changes in the underlying policies and laws that make Western-style transactions possible. Both have only recently embraced TRIPS, so the judicial infrastructure is going to have to evolve quickly. If the Western experience is a prologue, it's going to take a decade or more for that to reach functional maturity."

Venkateshwaran Raja, India head of Deutsche Bank Real Estate Opportunities Group, said that until the Indian government began to liberalize financial rules, including limits on foreign investment in the early 1990s, the country's real estate industry languished. Since then, sustained economic growth, a decline in interest rates and a growing middle-class employed by the service sector have created a real estate boom.

"In the last 10 years there has been a confluence that is making the real estate market exciting now," said Raja. "In the last few years, as government loosened the barriers of entry to real estate, combined with a supply of funds from domestic and foreign sources, the level of quality in the market has increased."

Real estate is cyclical, he stressed, and predicted a correction will take place, but he said India is not vulnerable to the kind of real estate crash experienced in the United States after the 1980s building glut. "Growth in the real estate market may appear disorganized from the outside," he said, "but there has been progress internally."

Meanwhile, in China, members of the Shanghai banking regulatory administration have suggested excluding real estate loans from government control measures initiated last year to cool the property investment sector. Last year, bank financing for real estate, which accounts for nearly 50% of the banks' credit business, dropped 80% from 2004 levels. At the same time, overseas banks increased their real estate credit business by 14.4%.

Banking and finance are a critical concern for private equity investors in both developing countries, according to the Wharton conference panelists. Freeman said he is optimistic about the future of banking in India and said it is likely to become like Mexico, where a large number of banks are owned by foreigners. "That puts pressure on the local banking system to take more proactive steps to keep their books clean. You'll see more Chinese and Indian banks wanting to attract foreign banks over time...and that will change competition in the local banking system."

Hahn said the financial structure in China suffers from a lack of mid-tier capital providers, and big Wall Street firms are not interested in smaller deals in China that don't generate massive fees. "The optimum size of a foreign private-equity fund in China today is $200 million," he said. "There are mega-billion-dollar hedge funds flocking to open an office in Hong Kong, but they are unable to deploy their capital efficiently."

Note the Exits

At the Wharton conference, Sammut stressed the importance of an exit for all private equity investments. He said Indian companies are more strongly linked to U.S. firms than their Chinese counterparts, noting a large number of Indian companies that are co-based in the United States. Investors in these firms can exit through a U.S. sale or initial public offering. Chinese firms, he said, may replicate this pattern in the future.

Krishnaswami noted that while it is easy to invest in public companies in India through transactions that are similar to a purely private deal, it can be difficult to exit. The Indian public markets, he said, lack liquidity and many Indian companies are thinly traded in markets controlled by powerful local brokerages. "It's tough to get out of even a public company," he remarked.

Banking and finance are a critical concern for private equity investors in both developing countries, according to the Wharton conference panelists.

The Indian market did show its ability to absorb some exits, however, when the international private equity firm Warburg Pincus sold a $560 million stake in Bharti Tele-Ventures, India's largest publicly traded mobile telephony company, last year. The transaction, on the Bombay Stock Exchange, was the largest block trade ever on the Indian market. It was also consummated in a breathtaking 28 minutes, prompting stock market observers in India to remark on the unexpected depth and maturity of their equity markets.

Hahn pointed to a number of successful exits by Chinese firms. Chinese venture capitalist Golden Meditech invested $5 million in China Medical Technologies, which went public in August 2005 on the NASDAQ. That $5 million investment is now valued at $280 million, an estimated return of 70 times its investment in 30 months.

But private equity is no different than any other investment in which returns are nothing without risk. Sammut asked the panelists what unexpected or unlikely events could rock the markets in India and China.

Li pointed to healthcare or the environment as possible trouble spots for China. Krishnaswami, too, pointed to environmental concerns in India. "The problem in India is not political," he said. "It's clean water."

Hahn said the greatest risk to China is a collapse on Wall Street that could come as a result of any number of potential problems, including a U.S. real estate bubble, healthcare crisis, a rapidly aging population or a sustained decline in innovation. "If the U.S. stock market loses value and this affects global valuations including those in China, then we all lose."

Demographics will also shape the future of India and China, as increasingly aging populations loom over the economies of North America, Europe and Japan, according to Siegel. China's one-child policy will cause it to age more rapidly than India, leaving China to face the problem of too many retirees supported by a shrinking pool of workers. By mid-century, India's most populous age group will be 40 to 50, while in China it will be 55 to 65, Siegel notes, citing United Nation figures.

Sammut said the key to successful private-equity investments in both countries depends less on what happens in New York, London, or other financial capitals than in dusty, developing villages in both India and China. "The wild card is how quickly their own internal markets will develop."

And in an increasingly complex world, evolving at an ever quickening pace, any gap between the two is not likely to last long. "In certain sectors [India] is probably a more inviting place for investment at the moment," said Sammut, "but the gap over China in the business context will not be meaningful for much longer." ❖

The End of Oil? Venture Capital Firms Raise the Profile of Alternative Energy

In President Bush's State of the Union address on January 31st — in which famously declared that "America is addicted to oil" — he touted alternative energy as the answer to the country's dependence on foreign oil, especially since much of it is imported from unstable nations. To that end, he promised a 22% increase in clean-energy research at the Department of Energy in an attempt to change the way the country powers its homes, offices and automobiles. He hopes to accomplish that through zero-emission coal-fired plants, revolutionary solar and wind technologies, and clean, safe nuclear energy.

Bush is not the first to dramatically raise the profile of new energy sources. In fact, three of the hottest initial public offerings in 2005 were in alternative energy, more specifically in the solar power segment — companies that convert sunlight to electricity. Other smaller, privately held companies in various alternative energy pockets — from solar to wind power and biofuel — are hoping for similar blockbuster returns in the capital markets, and venture capital firms are fattening them up with equity infusions in preparation.

Among the early movers in the sector is Kleiner Perkins Caufield & Byer's John Doerr, a high-profile venture capital investor in Silicon Valley. Doerr, recognized for astutely investing in Google before it went public, said at a recent energy conference in Palo Alto, Calif., that the single largest economic opportunity of the 21st century would be a segment known as clean technology. KPCB has backed a handful of clean tech companies already, including Miasole, a San Jose-based solar technology firm. Former U.S. Secretary of State Colin Powell is counted among KPCB's general partners.

Doerr is not alone in his bullish stance on clean technology, even though it remains an emerging sector that only evolved into an investment category four years ago. The definition is broad and includes environmentally friendly companies that improve operational performance, productivity or efficiency while reducing costs, inputs, energy consumption, waste or pollution. Essentially, that boils down to wind power, solar energy and fuel cell technology.

Alternative energy is the energy component beneath the clean technology umbrella. It includes solar, wind power, fuel cell technology, biofuels and others energy technologies that promote an economic and environmental benefit. The energy component is the fastest growing within clean technology and comprises upwards of 70% of investments in the industry, according to Tucker Twitmyer, managing partner with Philadelphia-based EnerTech, a

> Three of the hottest initial public offerings in 2005 were in alternative energy, more specifically in the solar power segment.

venture capital firm focused on energy technologies. Twitmyer was among a group of venture capitalists who participated in a panel discussion about clean technology at the Wharton Private Equity Conference held in January.

Not to be outdone by the record profits, the conventional oil and gas industry is raking in compliments of record-high commodity prices, venture capital firms have latched onto clean tech as an entry point into energy. According to Nicholas Parker, co-founder and chairman of Cleantech Capital Group, a research firm based in Ann Arbor, Mich., "The reason [clean technology] jazzes venture investors more than other areas is that it doesn't require huge project financing."

Typically, returns in clean tech are in the 20% or higher range. Even so, not every alternative energy opportunity is suited for venture capital. Biomass energy — energy from plants and plant-derived materials — requires facilities that are more capital intensive, and some wind projects do not have risk/return profiles that are ambitious enough. Solar energy, on the other hand, is among the hottest spots for venture capital. "Solar is a swing for the fences VC play," explains Parker, noting that it "is growing faster than wireless at its fastest adoption rate."

A Perfect Storm

Several catalysts taken together create a perfect storm scenario for clean technology investing. Lofty commodity prices are not the sole driver, but they certainly help as high-energy costs make alternative energy sources that much more appealing. In addition, talent and technology have improved in recent years. "There's a convergence of technology, entrepreneurship and demand driving investment capital" into the space, explains Parker. And, as the industry matures, clean technology investments will draw closer to their exit plans — the ultimate goal for investors.

Venture capital firms, historically strong backers of the technology industry, are at an advantage because they have already gained expertise in traditional technology that can be applied to the clean technology sector. "It's about using the intelligence already in the system," says Parker. For example, the semiconductor sector is an area of expertise for venture capital, and solar power is predominantly wafer and silicon manufacturing (although the industry is moving away from silicon and towards plastics).

Venture capital has been investing in clean technology for years — even before the Energy Policy Act was signed into law in August 2005 or the President's alternative energy push was outlined earlier this year — but never before has the window of opportunity appeared more robust. According to the 2006 Cleantech Venture Capital Report on North American venture capital investing, devotion to the clean technology segment is on the upswing. During the dot-com bubble era of 1999-2001, up to 3% of all venture capital was carved out for clean tech investments. That commitment inched up to 5-6% from 2002 to 2005. By 2009, the report suggests it will jump to 10% of all VC investment activity. That amounts to between $6.2 billion to $8.8 billion invested as venture capital firms go to the markets to raise capital in an estimated 1,000 rounds between 2006 and 2009.

EnerTech's Twitmyer says his firm is beginning to reap the rewards of earlier investments. "Over the course of the firm's history we have had 13 successful exits and appear to be well on our way to many more. Of our 22 active portfolio holdings, a number have profitable commercial operations and several more are trending that way. A few have been approached by public companies and several are in discussions with bankers about the appropriate time to access the public markets," he says.

Seeking Mature Markets

Venture capital investments favor alternative energy as opposed to fossil fuels because clean technology is more in line with the venture capital risk/reward profile than conventional energy. That is not to say, however, that venture capital is not eyeing the more traditional oil and gas industry for opportunities as it increasingly develops improved technologies to access domestic oil and gas.

"Certainly, fossil fuel extraction and oil refining are both areas of interest for us. We're interested in the trend of making those processes more efficient," says Twitmyer. "Fuel additives [such as ethanol] are another area we will keep a close eye on," he adds. Prominent VC investor Vinod Koshla, who is a colleague of John Doerr, has also made strong comments about the future of ethanol and other sources of alternative energy.

Even with the proven and projected returns on clean technology, some investors remain skeptical. With the exception of perhaps KPCB, many of the traditional top-tier venture firms are notably absent in the sector. The industry is considered to be beyond its infancy, but it still remains in adolescence and does not have the track record to boast the confident returns that VC investors seek. But many experts believe that the price of oil is going to remain high and has potentially reached a new equilibrium. This would result in a more sustained effort to develop alternative sources of energy, as opposed to the 1990s when the low cost of oil killed off such efforts.

"Keeping people on the sidelines now is the fact that historical returns in clean tech have not been comparable to those in information technology and some of the other high-tech investment markets.

Many VC investors are holding back, waiting to see whether these markets are mature enough to deliver the types of returns they expect for venture capital," explains David Lincoln, managing director with DFJ Element in Philadelphia. (Early-stage VC firm Draper Fisher Jurvetson is a co-sponsor of the fund.)

Many VC shops are confident in the growing clean tech field and have so far been successful in attracting investment dollars. "We fully expect to finish fund raising by the end of the second quarter. We are actively pursuing investments and expect to announce some in the next quarter," says Lincoln, who predicts that energy and power will ultimately represent 40% of the Element asset portfolio.

VC Energy Players

EnerTech Capital, whose investment strategy revolves around power and energy consumption, has an aggressive and defining role in the emergence of clean technology. It manages $290 million, 80% of which is in clean energy. Areas of focus extend from solar in companies like Advent Solar, which makes cells designed to reduce the cost of solar energy, to biofuels. Clean Air Power, which makes alternative fuel systems for diesel engines, is another of its investments.

Much of the assets that EnerTech invests in are in North America, although there are several deals that occur overseas. EnerTech searches for opportunities that will ideally post top quartile returns within three to six years. "We're playing further out on the risk/reward profile because we believe this is where our skills are most suited," said Twitmyer. EnerTech's expertise lies in the commercialization of technology within the energy markets, which gives its managers the confidence to take more risks. Twitmyer says he expects returns in the double digits. He adds that the EnerTech team invests with several exit scenarios in mind. "One is to go public. Another is to be acquired in a trade sale by a large industrial player. Third is to be acquired by a private equity firm."

DFJ Element, with offices in California and Philadelphia, is interested in power generation using wind and solar technologies that will help catapult those industries to a more commercial level. Draper Fisher Jurvetson is co-sponsor of the fund, and Element was born because DFJ managers recognized opportunity in the clean technology niche. Unlike DFJ where six of 40 deals are in clean tech, Element is involved exclusively in clean tech investments.

By December 2005, DFJ Element's Clean Energy Fund had raised $120 million. DFJ expects to finish raising capital commitments for that fund by the end of the second quarter, and the investment pool is likely to exceed target expectations. In the meantime, DFJ Element is actively pursuing investment opportunities.

The wind and solar industries "are maturing quickly, and we are looking at the enabling technologies that will help those industries scale commercially," says Lincoln. For example, DFJ is looking at software companies that manage wind and solar assets. "When it comes to renewable energy credits, nearly half of U.S. states have implemented a renewable portfolio standard, and in order to qualify for the credits, producers must be able to monitor and document their energy production. We're looking closely at software and networking controls in those markets," he says. DFJ Element is also interested in water technologies, such as filtration and monitoring.

"This is a rapidly growing area. A lot of the clean tech applications that come to market in the next 10-15 years will outperform or at least be comparable to the best investments in venture capital," says Lincoln.

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Private Equity Plays Both Sides

Private equity is actively involved in both the traditional and the alternative energy playing field. Still, many buyout shops are less likely than venture capital to invest in the first generation of anything simply because it does not fit into their strategy: buyout shops acquire controlling stakes in companies using high levels of debt, so they look for companies with strong cash flow, while venture capital financing uses minimal debt and generally provides equity investments to grow companies until they are large enough to take public or sell to a strategic buyer.

Still, private equity shops are opportunistic and recognize the potential in alternative energy investing. As such, firms like New Hampshire-based New Energy Capital (NEC) have set their sights on financing renewable and efficient energy projects, from wind power to geothermal energy, as well as biofuels like ethanol.

NEC is among the private equity shops that prefer to invest in commercially proven energy projects as opposed to first-generation technologies. It recently closed a project financing of $6.9 million for its own

16 mega-watt biomass-fired power generation plant in Greenville, Maine, a facility it acquired in 2005. The plant is designed to supply renewable energy to the Northeast market. The shop also intends to invest in a 55 million gallon per year ethanol facility in Albion, Mich. The total equity investment for the plant is $86 million and includes other equity investors, such as CoBank of Omaha and a consortium of farm credit banks in Nebraska. Ethanol, part of the alternative energy landscape imagined by Bush in his State of the Union address, will be blended with gasoline for use in the transportation system. (The president said he expects to replace 75% of oil imported to the U.S. from the Middle East by 2025 with ethanol and other energy sources.)

More recently, The Carlyle Group and energy private equity firm Riverstone closed on a new renewable energy fund to focus on investments "globally in the wind, solar, geothermal, biomass and biofuels (ethanol and biodiesel) sectors," according to a company press release in early April. "We are extremely pleased with the high level of interest expressed in our first renewable energy fund," Riverstone co-founders David M. Leuschen and Pierre F. Lapeyre stated in the release. "We believe that interest in this sector is set for rapid growth as maturing technology, increased focus on energy security, mandated renewable standards, and public sentiment have significantly expanded the return potential for renewable energy."

Private equity has not retreated from the traditional power industry, either, with its expected triple-digit returns. Among the most coveted natural gas power assets on the block in 2005 were facilities owned by Duke Energy, whose North American division divested the bulk of its power assets (due to its merger with Cinergy) to private equity fund LS Power in a $1.5 billion deal. The bidding was competitive and included dozens of private equity shops that will continue to target power assets.

In another conventional power deal, a consortium of private equity firms led by the Blackstone Group, Hellman & Friedman, Kohlberg Kravis Roberts and Texas Pacific Group recently turned over power company Texas Genco to the once bankrupt NRG Energy in an $8.3 billion deal. The price tag was over double what the consortium paid for the asset about a year before, and generated about a 6x return for the private equity investors. While those returns might not be exceeded, some private equity shops expect industry returns in power to be sustained at those levels.

An Exit on Wall Street

Wall Street's commitment to clean technology is on the rise as the sector matures, and its role in VC and private equity exit strategies, such as initial public offerings, is growing. Some firms, like Goldman Sachs, have also taken a leadership position in acquiring alternative energy assets. Goldman owns wind farm projects via its recent acquisition of Horizon Wind Energy, an aggressive developer of wind farm plants in California, Washington and Illinois, among other states.

In addition to Goldman Sachs' interest in wind power, there are a host of other investment banks that are involved in taking these companies public. "Credit Suisse Group and Lehman Brothers are [also] geared up right now. Canaccord Adams has taken many clean technology companies public on the AIM market," says Cleantech's Parker.

London's Alternative Investment Market (AIM) has become a prime listing candidate for clean technology because it offers looser regulation than the U.S. market, especially in the wake of Sarbanes-Oxley. "There is a more informed and sophisticated capital market in the UK surrounding clean technology," says Parker. Smaller clean technology companies are mostly listed on the AIM market, while larger cap companies ready for prime time often seek to be listed on the Nasdaq.

Among the hottest IPOs of 2005 was SunPower, a unit of Cypress Semiconductor, that was taken public by underwriters Credit Suisse Group and Lehman Brothers. It raised $139 million in the IPO. Lead underwriters for Chinese solar company Suntech Power Holdings, which listed on the New York Stock Exchange, were Credit Suisse Group and Morgan Stanley. It raised nearly $400 million in its public market debut.

In Germany, solar power company Q-Cells raised $288.5 million in its IPO. It was taken public by Citigroup and Dresdner Kleinwort Wasserstein, which is the securities unit of Europe's leading insurer Allianz.

Wall Street's role in alternative energy will likely intensify as concerns about peak oil supply, extreme oil and natural gas prices, and national security issues continue to push alternative energy to the forefront. Still, it will likely be years before there are solar panels on every roof and wind turbines across the country, or even nuclear power facilities in backyards across the U.S. In the meantime, the investment community is positioning itself for blockbuster returns. ❖

'Early Matters': Creating Value through Operations at Portfolio Companies

As increasingly large funds bid up the price of private equity transactions, firms are becoming actively focused on creating value through operations at portfolio companies to generate the kind of returns partners have come to expect. According to speakers at the 2006 Wharton Private Equity Conference titled, "Driving Returns: Value Added Investing," the most important element of operational performance is getting the right management team, which requires private equity owners to make a swift decision about whether to keep or let go of existing senior executives. After that, speakers on two operations panels said, private equity firms need to drive returns through management incentives, tight monitoring and forward-focused strategies.

"The only way to get value is by helping portfolio companies grow at some rate faster than their competitors," said Dan Haas, leader of Bain & Co.'s Private Equity Group and moderator of a conference panel titled "Operational Value Add." Over time, Bain has discovered several keys to adding value to a portfolio company. First, he said, funds must take an active role and structure deals that suit their own strategy. "What's most important is you get the [deal] right for the size of the fund, the style of investing of the fund and the culture of the fund," he said.

Finally, Haas said, Bain has learned that "early matters." Citing Bain's experience with "hundreds of companies," he noted that "returns on deals where the private equity fund got involved in the first year of ownership performed two times better than when the fund gets involved at a later time."

Sunil Mishra, managing director of JP Morgan Partners, said that in a typical deal he puts 30% of his time into the transaction and 70% into operations, beginning with a diagnostic look at the company to detect weakness and develop strategic priorities. He said he tries to build a sense of trust with portfolio company managers and introduces solid metrics including weekly and monthly reporting. Reports on portfolio companies are also circulated among partners to double-check those involved directly in the deal. Sometimes, Mishra said, partners become too close to their companies and don't see problems brewing. "We use this tool in a structured way to decide if there is an intervention needed."

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>
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James A. Quella, senior managing director at The Blackstone Group, said his firm has run into the same problem. "Often the guy who did the deal is not always the most forthright. There's usually a deeply personal relationship between the partner and the CEO, and when there is air turbulence it is not automatic that the deal partner will come in and say, 'I need help.'"

'A Meaningful Stake'

The early days following a transaction are critical, and most private equity firms devise strategic plans and reporting metrics to track the plan's progress even during the due diligence phase. The plans can address everything from whether to sell off divisions, how to invest capital, compensation, and governance. Some private equity firms install their own managers with operational experience to run companies and others hire third-party consulting firms, like Bain, to help devise a strategy.

John Abraham, partner at Kodiak Venture Partners, which funds technology start-ups, said future operational excellence is rooted in the initial equity structure of the deal. Entrepreneurs and top management should be allowed to retain a substantial equity stake in order to guarantee they will continue to work hard to develop their companies. “We want to make sure intellectual capital has a meaningful stake in the company,” he said. Other incentives are less tangible: Beyond financial compensation, venture backers need to provide some emotional support as well. “We empathize with entrepreneurs. We’ve been there. I’ve been a CEO and I understand it’s a lonely job.”

Once the company’s management and incentive structure is in place, fund managers step up monitoring and reporting at the companies to make sure goals are being met within set time frames, the panelists said. The first months are critical and many funds require managers to have 100-day plans.

“We focus on trying to make things happen very early on,” said Oliver C. Ewald, managing director at Audax. “Post-transaction change is accepted. You are in an environment where change is expected.”

In a turnaround situation, speed and decisiveness are even more important, said Dick W. Boyce, a partner at Texas Pacific Group. In this kind of deal, fund executives are not looking out three to five years, but one year at most. To give managers the data they need to make quick decisions, TPG requires portfolio companies to file weekly flash reports on results and to pay close attention to cash management. Many companies that have not had to cope with the kind of leverage behind private equity investment pay little attention to cash management, Boyce noted.

Boyce has been deeply involved in portfolio companies, using experience he gained from a career in operations and consulting work with Bain. From 1997 through 1999, he was president of CAF, Inc., a consulting firm that provided operating oversight and support to various companies owned by TPG, and he served as the CEO of clothing retailer J.Crew Group, Inc. Boyce was senior vice president of operations for Pepsi-Cola, North America, before joining TPG.

Boyce noted that TPG also tries to install reporting that focuses on the future. For example, when he was working on a turnaround at J. Crew, he learned that putting a catalog out in front of consumer panels before inventory was ordered allowed managers to predict top sellers 90% of the time. That prevented the company from running short on hot items and getting stuck with excess stock eight or nine months later when the clothes were in stores. “It’s crucial to get managers to think about what’s the better predictor, rather than being a person looking in the rear-view mirror,” he said.

Fund managers often have the experience and resources to introduce tools to help measure important trends that a portfolio company would not have developed on its own. “One thing we pride ourselves on is getting a fundamental data-driven understanding of the market,” said Mani A. Sadeghi, managing partner at Equifin Capital Partners, which specializes in private equity deals in the financial industry. “In many cases, we find conventional wisdom, or what people believe, is just wrong. When you [analyze the data], what seems crazy is really smart.”

Under New Management

When shaping the governance structure of a portfolio company, the nature and goals of the controlling private equity fund is an important consideration. For example, Ewald’s company, Audax, only takes on companies in which it can have complete control of the firm’s equity and, as a result, does not devote a lot of time to portfolio company boards. “We find that formal board meetings and a board structure makes [more] work. We don’t need it,” he said.

Instead, Audax focuses on monthly review meetings during which financial metrics and other measures of performance and service make up half the agenda. The other half of the review meeting is devoted to discussing key initiatives going forward.

On the other hand, Boyce noted that when the time comes to exit an investment through the public markets, there is a downside for fund managers who do not develop a portfolio company’s board structure. “It’s easy to be lazy about the board when you have control,” he said. “But you’re not really preparing the company to be a public company.”

As private equity firms raise increasingly large funds topping $10 billion, many are forming consortiums to buy and manage huge portfolio companies. In August, a team of private equity firms, including Bain Capital, The Blackstone Group, and Goldman Sachs Capital Partners, acquired SunGard for $11.4 billion. Then, in December, Ford Motor Co. sold its Hertz division to another group of private equity investors including Clayton, Dubilier & Rice, The Carlyle Group and Merrill Lynch Global Private Equity for $15 billion.

When it comes to managing consortium deals with more than three partners, Boyce said the participants must agree up front that one group will control certain aspects of managing the acquisition. "You can't have multiple hands solving the same problem." Quella added that involving two or three partners in a deal is workable, but when it gets up to around seven, the number of egos and competing goals present serious challenges to making a transaction work.

For large firms, like Blackstone, Bain and Texas Pacific, there can be opportunities to build value by managing across portfolio companies, the panelists said.

Quella said Blackstone has an automated web-based reporting system that is used by all its portfolio companies to feed information back to the firm. That information is then analyzed centrally, allowing Blackstone to detect trends and leading indicators for other companies in its portfolio. A natural resource company, for example, could provide Blackstone signals about the direction of material prices for industrial firms in its portfolio.

Blackstone has also set up a central buying cooperative to purchase office equipment, paper and other non-core supplies for the firm's portfolio companies. The system has created savings of 15% to 40% for some of Blackstone's companies, said Quella. The purchasing group is independent of Blackstone, so companies can continue to use it after they go public, he pointed out.

Decisions about management structure and systems are likely to become more complex as the rise of huge megafunds allow private equity firms to take on increasingly large public companies and subsidiaries. Quella said he expects to see $3 billion to $4 billion companies going private. He said his firm is fielding calls from managers of public companies who are under pressure to deliver short-term earnings growth every quarter and increasing scrutiny through the Sarbanes-Oxley legislation and state attorneys general. "Their hands are tied," he said. "A lot of really good senior managers are coming to the conclusion that private equity ownership is a superior way to create value, and these large public companies are increasingly becoming the target market."

Still, the ultimate goal of private equity firms is to sell refurbished companies to the public markets at a premium. To achieve that, fund managers ultimately need to remain focused on their exit plan, according to panelists.

Sadeghi said the exit plan is a living document for his firm's portfolio companies and is reviewed constantly with the management team. "We are always asking, 'Are we making progress, and what has changed?'"

Abraham said general partners in private equity deals must constantly monitor the investment thesis that justified doing the deal in the first place. If results deviate from the thesis, private equity investors must reevaluate the strategic plan. If new capital is needed, investors should think about the transaction as if it were a new deal and only invest based on the merits at that time. If the additional investment cannot stand alone on its own merits, the company should either be folded or sold. "Then of course you need the discipline and intestinal fortitude to close the company when it's not working — just shut them down."

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Shake-up vs. Partnership

The best way to avoid that fate, and build healthy returns from improvements in operations, is to choose the right managers and devise strategies to help them run portfolio companies successfully, according to speakers on another panel titled, "Selecting and Working with Management Teams."

Kevin Prokop, a director at Questor Partners Funds, said that about 80% of the deals he is involved with focus on distressed companies in need of a turnaround. Usually that means a major management shake-up. "We've found that turnaround management skills are a unique and different skill set than managing a company in a growth mode or status quo mode," he said. "The makeup of the DNA of the managers we bring in will tend to be different than the makeup of the team that created the situation. That creates the opportunity for us. We don't object to leaving management in place, but those deals tend to be few and far between."

Greg Mondre, managing director at Silver Lake Partners, specializes in technology and growth industries and tries to partner with management when possible, mainly because the high-tech industry is so specialized and it is difficult to find new managers. "There are a lot of private equity firms buying bad companies and making them o.k.," he said. "We choose to make investments in good companies and make them better."

Praveen Jeyarajah, a managing director at The Carlyle Group focusing on leveraged buyouts in the U.S. industrial sector, said his firm generally prefers to partner with existing management, but he said senior partners are spending an increasing amount of time working on systems to improve management of portfolio companies. "We've found that in the first year of operations it is really good if someone from the firm, the lead deal partner and the deal team in general, gets to know the CEO and the CEO's direct reports and can really assess if they have the human capital to meet the plan," he said. Carlyle, as one of the nation's largest private equity firms, can also help firms by bringing in senior advisors, including Louis Gerstner, who turned around IBM, and George Sherman, former chairman of Danaher Corp., the tools and equipment manufacturer.

A '360-degree View'

When a change in management is needed, many of the panelists agreed that speed is critical. "Often the private equity partner does not make the change quickly enough," said George T. Corrigan Jr., senior client partner at search firm Korn/Ferry International. "Then they come to a search firm. Meanwhile, time is ticking."

Corrigan outlined some initial screens to find good managers for private equity investments. First, Korn/Ferry looks for other managers in the same industry or for candidates within a company considered to be a management academy, such as General Electric or Danaher. He also looks for managers who are experienced in managing cash. Finally, Corrigan added, he likes to find managers who are "a magnet for talent" who will be able to draw more quality managers into the portfolio company.

William Woo, managing director of Ironwood Equity Fund, a small firm that specializes in buying from founders through referrals, relies on standard reference checks to screen for talent, but also interviews people who have worked with the candidate to develop a 360-degree view of the potential hire. Woo also encourages companies to check his own references before doing a deal to establish credibility and trust.

Questor Partners Funds' Prokop has learned early on to listen to how existing managers explain their company's problems as a clue to who needs to be replaced. "If the manager says, 'The market went against us,' or starts talking about general economic conditions, then they generally don't have their arms around what specifically went wrong," he said. "On the other hand, if they tell you crisply, 'Here's five things that happened and three things to address each of these five points,' then you know you've got a management team that has its act together."

Peter Cornetta, principal in H.I.G. Capital, which specializes in transactions involving family-owned businesses, said his firm has to screen carefully because founders often install a son or daughter to take over management of the company. When it comes time to sell, the founders represent that it is the next generation running the company, but Cornetta said he often finds the parents are still critical to keeping the business on track. "But it is the son or daughter that our partnership is with going forward, so we spend a lot of time understanding the capabilities of that individual," he said.

Once a team is selected, employment contracts can be used as a tool to improve results by forcing incoming management and private equity owners to discuss the touchy subject of what will happen if the partnership does not work out. "Employment agreements are key tools to force you to deal with the situation in advance," said Woo. "It's like a prenup."

As the Operational Value Add panelists noted, incentives are key. In the technology sector, competition for top executives is intense, said Mondre, who added his firm uses incentive packages to hire the best. "The one nice thing about private equity is you can create incentive packages that you are not able to achieve in public companies" by granting hirees additional equity options.

Corrigan also echoed those on the Operational Value Add panel who said that, in the face of Sarbanes-Oxley and other pressures, private equity ownership is becoming an increasingly appealing opportunity for managers at public companies. Recently, an officer of a public company told Corrigan he would never be able to make a difference in the stock price of his public company, but at a smaller, private firm that would be possible. "It's not that much fun being in a public company anymore," said Corrigan. "Private equity is becoming a lot more interesting."

Bad News Is Good News: Distressed for Control Investing

Michael Psaros, co-founder of the $600 million KPS Special Situations Funds, expects good times to get even better for his investment firm. So does David Matlin, co-founder of MatlinPatterson Global Advisers LLC, a private equity firm that manages nearly $4 billion. Both operate in the still relatively fledgling arena of 'distressed for control' investing, a growing industry that combines elements of both private equity and hedge funds.

Simply put, their line of work is to make a profit from companies that have failed to do so and are on the brink of bankruptcy. Unlike traditional hedge funds, however, their investment doesn't stop at buying significant portions of these companies' debt for pennies on the dollar, tidying up the balance sheet and then selling at a higher price. Instead, KPS and MatlinPatterson get in and stay in — bringing in new managers, installing a new strategy, renegotiating labor and supplier contracts, and so on. (That's the 'control' part.) It's not an easy task, especially given the state of these companies when they step in.

But bad news for others is the lifeblood of KPS and MatlinPatterson, and both Psaros and Matlin expect a growing wave of it. The reason is an upswing in second-lien loans, which hedge funds — flush with cash to invest — have made their specialty in recent years. Essentially, hedge funds are providing financing to prop up troubled companies that nobody else is willing to provide. Traditionally, hedge fund money is not patient money, and Psaros and Matlin are betting that, soon, these funds will lose their patience.

Hulya Eraslan, professor of finance at Wharton, agrees with that assessment. "After the 2000 bubble burst, there were a large number of bankruptcies that opened up room for investing opportunities, and more players came in. Now, there is a rise in second-lien loans.... A second wave of bankruptcies is coming, because the debt out there is beyond the capacity of companies to pay back," she says, adding that 2006-2007 could be the "critical" time frame for a shakeout.

Excessive Leverage

Psaros says he and his partners are excited about the prospects. "A confluence of trends will lead to an extraordinary market for firms like us over the next 12 to 36 months." He lists the factors: "[Buyout]

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> —Hulya Eraslan, Professor of Finance, Wharton

firms are paying exorbitant prices for companies today. Pedestrian manufacturing companies are getting bought for 6 to 8 times EBITDA, or cash flow, when the normal level is 5 times. Also, firms are levering against that cash flow for buyouts.

In fact, the first quarter of 2006 has already seen "U.S.-based private equity firms complete at least 225 control-stake transactions for a disclosed total of approximately $42 billion," according to the April 3 issue of Buyout. At that pace, the newsletter notes, 2006 is shaping up exactly like 2005, which was a record-breaking year for these transactions.

"The high-yield market has been on fire for the last three years," Psaros adds. "If you look at a regression analysis, three years after a good high-yield market there is an echo boom in bankruptcies."

Matlin is more circumspect, but reaches the same conclusion. "It's hard to predict the end of the world, but I think there is a lot of leverage building up in the system again." The positions hedge funds have taken in distressed companies through second liens probably have delayed bankruptcies, but not averted them, he believes. By the end of 2007, he expects a repeat of the 2002 flight of hedge funds from the distressed sector.

Psaros explains how the second lien works. "If someone needs to borrow $100 million to buy a company that has $20 million in cash flow, they would lever to five times cash flow. A traditional bank like JP Morgan would give you $60 million. The rest comes from a second lien, usually from a hedge fund. Previously it came from mezzanine lenders or the high-yield market. Now the hedge funds are filling this void for what I believe are excessive levels of leverage," he says.

Psaros expects private equity firms such as KPS to be in good position to catch the falling deals when the hedge funds let go of them. "The guys providing this capital are traders. When these companies get into trouble — and they will, because the economy will slow down, or buyers will have paid too much — they don't have a mindset to work out the problems of the company. They are traders by nature and will seek to trade out of the problem. And when they do, there will be few buyers."

That's when firms like KPS and MatlinPatterson enter the picture. For example, in September 2005, in a prearranged bankruptcy transaction, KPS purchased the assets of Jernberg Industries Inc., a maker of automotive power-train parts. In 57 days, Psaros recalls, KPS "negotiated 37 contracts, including 12 with large customers such as Visteon, General Motors and Harley-Davidson; we negotiated new bank agreements, 15 capital leases, and three collective bargaining agreements." During that time, KPS also negotiated five new contracts with key vendors and recruited a new chief executive officer, a new chief operating officer and a new chief financial officer.

KPS accomplished this through a newly created holding company, and — as it always tries to do — purchased assets free of all liabilities. The company's operations have been profitable from the first month of KPS' ownership, Psaros says, though he will not reveal financial data for the closely held company.

Wanted: Bad Management

Unlike hedge funds and some other private equity firms that operate in the same area, Psaros says that KPS doesn't try to create value "by playing with capital structures. We believe true value is created by recreating businesses."

Most private equity funds "look for a great company with a great management team" with its own business plan, he notes. The private equity fund then tries to decide how much to invest in and leverage that company.

"We are completely different. We are looking for a great set of assets or a great company that has ended up in extremis through bad management, or terrible cost structure, poor strategy, bad collective bargaining agreements and usually excessive leverage," he says. Then his firm goes in with a business plan it has developed and brings in a management team to execute its own vision. Unlike the typical middle-market leveraged buyout firm, "we de-leverage the company," he adds.

Along the way, KPS has acquired the reputation of being a fund that is unusually sensitive to labor unions. Psaros credits unions for providing KPS with a significant part of its deal flow, and he calls them "a critical constituency in turning around a company."

A Tangled Thicket

Matlin says distressed for control investing "can be a dangerous game if you don't know what you are doing." He notes that practitioners have to juggle three balls — "a bankruptcy ball, a process ball and a company in free fall." The rescuers must have the ability not only to bring in new capital and management, but also a new strategy for growing the business, he adds.

Those who are successful have a thorough knowledge of the legal rules, Wharton's Eraslan says. "They can maneuver well within the bankruptcy law." Their names are well known to the other players, though competition has grown. "If a bank wants to sell its claim against a firm, they will call Oaktree, for example," she says, referring to Oaktree Capital Management, a high-profile name in the distressed-investing industry whose $30 billion in assets under management include $2.5 billion in controlling positions.

David K. Musto, professor of finance at the Wharton School, agrees that a distressed investor must negotiate a tangled legal and financial thicket to make money.

"You get bargaining power over a distressed firm by purchasing its debt," Musto says. Typically, a bankruptcy plan groups classes of creditors by similarity of claims. For instance, all banks would belong to one class, and all senior secured bonds in another, and all senior unsecured bonds in yet another, and all trade creditors would be a separate group. Because Chapter 11 reorganization proceedings hinge on their approval by each "class" of creditor, investors in distressed debt aim to buy enough of a class of credit to influence the outcome.

"If you own more than a third of a class of debt then you can make it difficult for debtors to confirm the bankruptcy plan they want because they need two-thirds approval of each class of debt," Musto says. "If [the debtor] doesn't get two-thirds approval then he can potentially get the judge to cram it down the throats of the class that refused. That is much harder to do than just to get the class to approve it." The debtor can also try to shape classes in ways that would dilute the creditors' clout, he adds.

The bottom line, Musto says, is that investors in distressed debt who acquire blocking positions gain negotiating power and get more favorable settlements as companies emerge from bankruptcy. It's also a key path to control for such investors as the debt they have acquired often is exchanged for equity in the company.

The process has been so fine-tuned since the 1990s, says Musto's colleague Eraslan, that very often distressed companies now come up with "prepackaged bankruptcy plans" that have the prior blessing of all participants. This practice has grown essentially as a way to get over a huge hurdle presented by the U.S. Trust Indenture Act, Eraslan notes. According to that law, "if a company wants to change the maturity, principal and interest on a bond, each and every bondholder must agree, so it is essentially impossible," she says.

The law was passed in the late 1970s; it took the players a decade or so to learn the game, Eraslan adds. Now in many cases, most negotiations are held outside bankruptcy proceedings and prior to a Chapter 11 bankruptcy reorganization filing. This process gives comfort to investors such as KPS which seek to minimize their risk of acquiring the distressed company's liabilities along with their acquisition of its assets. Existing labor contracts and loans and vendor deals often are revised long before such investment firms commit themselves to acquiring the company's distressed debt.

No Guarantee

Speaking at a Wharton Private Equity Partners conference in New York last year, Matlin noted that there has been "a sea change" in the distressed-investment climate in recent years as larger pools of money have come into the space.

"The whole community has grown up and become a lot more sophisticated, not just investors but also the body of professionals who surround them, like turnaround management teams, specialized bankruptcy counsel, auditors — the whole professional swath that follow distressed investing. That has made it a lot easier for people who maybe did not have as much experience in the business to get involved, investors as well as sellers of these securities, such as mutual funds and bank workout departments," he said.

> Those who are successful have a thorough knowledge of the legal rules, Wharton's Eraslan says.

But smarter as all the players may have gotten, that does not guarantee success for a distressed deal.

A few years ago KPS created Republic Engineered Products L.L.C., a company that took over from bankrupt Republic Steel. The turnaround was going well, Psaros says. The predecessor company had 15 plants and 4,000 employees manufacturing about one million tons of steel. About six months into the transaction, the company was down to six plants and 2,200 employees but was making about 20 percent more steel, he says. "Things were going great. We had a superb CEO and model collective bargaining agreements and built a new finishing plant. The restructuring had gone very well," he says.

Then the lights went out — literally. And it was a disaster. A multi-state blackout on August 14, 2003, caused a blast furnace to blow up at one of Republic's facilities, in Lorain, Ohio. No one was hurt, but the company urgently needed $5 million to $10 million to bring the critically essential blast furnace back on line. The bank refused a loan, Psaros says. Six weeks later, the company filed for bankruptcy. Investors lost $42 million.

"All it took was that one aberrational explosion to negate all the good steps," Psaros says. "When you own any business, sometimes your success or failure is truly beyond your control." ❖

Limited Partner Roundtable: Outlook for Private Equity

To take the pulse of the private equity industry, members of the Wharton Private Equity Club (WPEC) coordinated a roundtable discussion between four leading limited partners representing, in total, well over $30 billion of alternative asset buying power:

Kristin Gilbertson is chief investment officer of the University of Pennsylvania, a role she assumed in 2004. Previously, she was managing director of public equities at Stanford Management Company.

Sandra Pajarola is a partner and private equity investment committee member at Partners Group in Zug, Switzerland. She leads primary private equity partnership investments for the firm.

Cory Pulfrey is managing director and co-head of Morgan Stanley Alternative Investment Partners. He previously served as managing director of the Weyerhaeuser Pension Fund Investment Group where he managed the global private markets investment program. He is a Wharton alumnus and a member of the Wharton Private Equity Partnership Advisory Board.

Michael Taylor is a managing director at HarbourVest Partners, currently focusing his activities on primary and secondary partnership investments in venture capital funds. In earlier roles at HarbourVest, he also managed direct co-investments. He is a Wharton alumnus.

WPEC: From your perspective, what's the outlook for general partners? What are some of the main issues you expect them to face in the next few years?

KG: One of the things I would worry about is that there is a change in the alignment of incentives. In the old days when you raised a small private equity fund, you really made your money on the carry (the percentage of profits that the fund partners get to keep). If you only [managed] a billion dollars, you weren't going to get rich on the management fees. As these businesses have grown, the management fees have grown substantially. So the alignment — where traditionally 'you only get rich if you make me rich'— has changed. On the other hand, you have to pay up for talent, and many of these people have made tons of money for Penn and their other investors, so I would say, don't begrudge fabulous investors the fees and the carry.

SP: Hopefully most [fund partners] are motivated just by the business, so it's not the money; they will just keep going and they just love it, it doesn't matter if its $20 or $200 million. What we might start to see are some that say, this is enough; I don't need more, so now I can retire. And I don't think we've seen that happen already to any great extent in Europe yet. I think we might see more of that.

CP: There is also a very strong market these days for talent. Hedge funds are taking private equity guys and private equity guys are leaving to start their own funds. Keeping talent is a bigger issue today in private equity than it was three to four years ago. It can be at any [job] level, and is often times driven by how the rewards are distributed.

SP: I think it will sort itself out. I think private equity and hedge fund people are very different by nature. And I think people will find their balance where they belong. Yes, on the hedge fund side there is higher compensation, but there is also higher risk of hedge funds falling apart. And when you look at the life of the hedge funds and how long they last and how many last, [versus] private equity, they are very different numbers. I don't see this as a problem. Yes many people are driven by money, but also they are driven by what they want to do.

KG: Managing growth is [also] a very challenging thing, and it's one of the things we look at with all of our [external] investors, be they private equity, hedge funds, real estate, or public equity fund managers. The founders need to bring in the next generation and coach, mentor and promote them, but how do you manage that process of growth so that you don't have too many people itching to do deals and lose discipline?

WPEC: You've all just talked about internal issues, questions that GPs face with respect to their organizations. What about external issues? What's important in the investment environment these days?

KG: Buyouts have benefited from easy credit. Spreads are low, interest rates are low, and covenants on loans are absent. It's a wonderful environment to leverage up. We've seen a lot of private equity shops execute some very good deals and subsequently dividend recap those deals for a very nice IRR (internal rate of return). *[**Editor's note:** a dividend recap occurs when a company raises debt and uses the proceeds to pay dividends to private equity investors.]* But that environment is not going to persist forever. I am concerned that some of those same companies where we've seen spectacular returns may suffer if they're in cyclical industries. Some of these companies are going to experience some earnings volatility. What happens if they're perhaps over-leveraged? How do the private equity shops deal with that? What happens if the markets somehow seize up and you can no longer refinance? Private equity shops have certainly benefited from credit market conditions but that easy credit can go away and I think that will make it more challenging for private equity shops in the future. It's been a perfect storm in a positive way. You've had easy credit in a rebounding economy and greater consumer confidence with better exit options in the public markets, and those conditions may not persist. That's very important because right now everyone is raising a lot of money and funds are getting bigger by multiples. There's a lot of money chasing deals, and if the environment tightens up, there might be more competition for deals and we may see some investors lose discipline. I think one of the issues they will face is that having raised larger funds, and there now being much more capital out there, and having grown their teams substantially, they're going to have to exercise considerable discipline — which is hard to do when you have a lot of money burning a hole in your pocket.

WPEC: That's a vivid picture of the buyout market. What about venture capital?

MT: In venture, if you are not a well known GP, it's really tough to get a fund raised. First time funds or less well known GPs are having a tough time in the market. If you are a brand name, particularly [on the] West Coast, it's a different story. There's a widening gap between the rich and the poor or the experienced and the inexperienced.

KG: Not all investors are created equal!

Hedge Fund Convergence

WPEC: One of the most talked-about issues facing GPs, which we haven't yet talked about, is whether the private equity industry is colliding with the hedge fund world. Have you seen any evidence of this?

CP: You always had some overlap on the GP side in the distressed area between hedge funds and private equity, but it is becoming more material these days. In the past, a fund would be either hedge funds dabbling in private equity or private equity funds dabbling in more liquid, distressed investments. Nowadays, the trend is that hedge funds focused on distressed in the past are now doing more illiquid, private equity-like strategies.

SP: Private equity GPs look to the compensation structure of the hedge funds. They are envious and would love to build in yearly compensation as opposed to having to wait five to ten years for carry. Hedge fund GPs are allocating twenty percent [of their funds] to non-liquid assets so they can really start dabbling in private equity. You see them tremendously in the debt markets, and on the mezzanine side. They are also dabbling on the equity side to see if this is a place they really want to be.

CP: Another new trend is hedge funds doing buyout transactions — plain vanilla ones. That convergence model is probably not as robust compared to the distressed side, because hedge funds are not generally as experienced working with companies to effect change compared to private equity funds, and when hiccups happen, there is a greater chance that they would have issues as opposed to the guys with long-term private equity experience. We are seeing a clear trend by some funds, for example Carlyle and Blackstone, in becoming broader alternative asset platforms. Those two in particular are doing private equity, hedge funds, hedge funds of funds, and real estate. That trend will continue because investors who are familiar with the brand are just comfortable with the group and are going to take a look at other types of products.

MT: There's a lot of synergy on the fundraising side given that at most institutions, the decision maker in charge of alternative assets invests in both private equity and hedge fund managers. If you like the hedge fund manager and believe in their ability to grow the management company, why not ask them to raise a private equity fund or vice versa? But I would be somewhat suspicious of groups that try to do too much under one management company. It makes sense logically; it's like Marketing 101 in that you want to extend your brand. The rub is, can you find the right people who will fit into the organization and not create cultural issues? Do you want your brand associated with another asset class? The view here is, let's stick to our knitting.

KG: The way we're structured [at Penn], is that we have a managing director of private equity and a managing director of absolute return, so [they are] two separate things. As in all organizations, you need to have people who are specialists in what they do, but there will invariably be overlap. We're a small enough team that we're all in the same office and we can all talk about what makes the most sense.

Distressed Debt

WPEC: It seems as though one of the mains points of convergence is in distressed debt. Do you think this will ever be large enough to be considered a sub-asset class in private equity, along with venture and buyouts?

SP: I think there would have to be a fundamental change in the amount of debt for it to be really its own area, to come out of its niche. By definition, distressed debt should be a small percentage of the total amount of debt; there could be times it is higher, but by definition it should be a small amount. There might be short shifts, and equity levels have come down in the recent years. But it hasn't been that significant; on average it has gone from 35% to 32%. That is not a big shift. So despite all this talk about debt markets, people have been very prudent about the amount of leverage they are using on deals. You have to put in longer term perspective. It's not going back to the 1980s. Yes, I think there will be one or two deals that struggle and they will miss their covenants and have to renegotiate. But it's not absolutely crazy. I don't see a fundamental shift of distressed debt stacking up to buyouts, venture and mezzanine in the long term. Rather it will always be a niche area.

KG: I think distressed funds already are a viable third pillar of the private equity world. The issue with distressed is that it is a cyclical business. There are better times to invest than others, and sometimes, there's just nothing to do. But I think that sophisticated investors have always looked at distressed and it's one of the things that I'm excited about going forward. I don't know where we're going to have an opportunity to invest in distressed — it may come in CDOs (collateralized debt obligation funds), or it may come in private equity deals with lots of leverage… there may be another Enron. We don't know where it's going to come, but we do know that it's likely to happen — if not this year, maybe in two years, maybe in three years.

CP: I think it is cyclical. I think there is always a level of secular distressed opportunity that is present globally, but the opportunity is much richer at certain parts of the macro cycle. During the whole time we were investing in distressed, in general we found opportunities throughout the cycle, but the opportunities really differ in different years. I first started investing in distressed in the early nineties and it was pretty clear at that time, given the slowdown of the economy, that there was an opportunity there. That is really when the industry started. We believe there is a good probability there are going to be a lot of distressed opportunities in the next year or so.

New Horizons in Venture Capital

WPEC: What changes are you seeing in the venture capital industry? Are there new sectors that the top tier firms seem to be pursuing?

MT: What is new may just be old. IT and healthcare have been the bread and butter for the venture sub asset class. But there is a return to older, recently out-of-favor, sectors. Several venture funds are now doing consumer deals again, which is what they were doing twenty years ago. That could mean restaurants or retail or internet services, but the emphasis is definitely on the consumer. It's a new spin on the old, in the search for high growth opportunities. Three to four years ago people were talking about nanotechnology, but that is still twenty years out, which is still too far out for a ten-year fund.

WPEC: How about alternative energy? Is that a viable sector specialty for professional venture capital?

MT: Alternative energy has been very good to us over the last two years. We were acquiring alternative energy assets in Europe at very cheap prices prior to the run up in oil pricing. It appears that there is no easy or short term fix for our fossil fuel woes so alternatives will probably continue to be an appreciating asset class. Not to say that a lot of these funds can't do well, but everyone raising a clean tech fund is getting traction from the backlash of high oil prices, Bush's energy initiatives and recent alternative energy subsidy announcements in California. I don't know how big it is going to be but alternatives are a small amount of the overall energy market. Even a ten-times increase in Solar, for example, would still be immaterial to the overall size of the global energy market.

KG: I'm intrigued by renewable energy and clean tech, certainly because oil prices are so high today, it has brought heightened awareness to our dependence on oil, and that has implications for the economy, for national security.... I think some of these areas are truly exciting in the same way that IT was exciting and new and different and revolutionized our world over the last two decades. So I think that it's only natural that the venture community reaches out to the next 'new new' thing. We'll see which of these areas it ends up being.

WPEC: Kleiner Perkins just hired Colin Powell. What do you think are the prospects of homeland security as another potential new sector in venture capital?

MT: I think after the initial shock of 9/11 wore off, managers [focused on homeland security] are finding it hard to get funding out of the government for projects that once seemed interesting and a security necessity. The focus really shifted to the war in Iraq, so that's where the spending has occurred with the military contractors. Homeland defense has actually been quite disciplined in how they go about allocating capital, so there hasn't been a lot of success on a large scale in the security area.

WPEC: Any developments in the way that venture capital firms are investing?

KG: I think one of the other interesting trends to emerge out of Silicon Valley is an increase in stealth investments. You're not seeing all the [venture firm's] investments on its website. They're trying to incubate those deals for longer, and that's a sign of competition for deals — not so much competition to get into a particular deal, but the company that's being incubated also has to worry about competition from other startups. So stealth is becoming increasingly a tactical tool in the venture capital business.

International Markets

WPEC: There's a lot of talk about international private equity lately. What's new?

CP: A real venture community is emerging in Europe, and that's going to be an opportunity. Israel has a material and growing venture industry, including a number of world class venture firms.

WPEC: Many observers are focused on private equity in emerging markets. Is this hype, or is it real?

KG: There's a lot of discussion of India and China, and certainly India and China are very exciting growth stories with hundreds of millions of people who have lifted out of poverty into the middle class, creating whole new markets and also some fabulous world-class companies.

SP: I think everyone likes the macro story. But what is different [from developed markets] is you can't tell who the true winners are. You can't look back on a long history and say they have proven it over three cycles. And so everyone is using their due diligence to make guesses about who is going to be the winner. And it's not so clear.

KG: There are going to be more of those world class companies created in India and China and other countries going forward. But one of the challenges that we face is there is a real lack of institutional quality investors. I think it's also instructive to think of the story of Infosys. Infosys was founded with the savings of these men's wives and there was no venture capital involved in this company and it's a huge multi-billion dollar success story.

> "One of the other interesting trends to emerge out of Silicon Valley is an increase in stealth investments."
> —Kristin Gilbertson, CIO, UPenn

MT: We are skeptical about what's going on in China, particularly with venture. It seems that everyone is focused on it, but that just may be the press blowing it out of proportion. This is the third or fourth time that we've seen this story and we still believe that the fundamentals are not in place. As a firm evaluating Asia-Pacific opportunities, we find comfort in Asian buyouts, which are still relatively new in the overall scheme of things. We have had good, consistent returns there for the past ten to twelve years. There are now teams with track records of two or three funds, with little investor turnover, staffed by local talent instead of a bunch of ex-pats.

CP: Our experience in Asia in the last few years has been quite good. But you run into issues that you are not running into in developed markets, like legal and regulatory issues, integrity issues, huge macro swing issues that in illiquid situations can take you to zero, with Russia and Argentina being examples of funds losing a lot of money in the mid-nineties.

WPEC: What if you had to choose between India and China today? Which provides the better opportunity for long-term private equity investment?

CP: We are invested in both India and China. India has a better developed legal and regulatory system. India has a stronger need for external capital than China given their relative internal and affiliated resource bases. But I don't know which country is better positioned for private equity successes in the next ten to fifteen years. We have high hopes for both countries but we approach both cautiously based on our historical experiences.

KG: There is certainly money to be made there and value to be created there but I think many of these venture investments won't return capital. I think the foundation and endowment community is very active in investigating the market and planting a few seeds to gain information so that as the market matures, we are there. It's tough to be institutional quality when you're in an emerging market.

Words of Wisdom

WPEC: So, in closing, what advice would you give to the present and future private equity GPs reading this article?

KG: Well, particularly for newly minted MBAs, training is vital. This is an apprenticeship business. I would not be quick to take the highest offer or the flashiest title. I would research where you're going, who you're going to be working with, and the quality of the organization. View your career as a long term investment, and go to a place where you'll spend five or six years getting trained with someone who is a top quality investor.

SP: No matter what kind of fund you go into, small cap in the U.S. or venture in Asia, whatever it may be, it's global no matter what you do. For example a small cap fund in Italy, very small cap, has an office in China because they have a lot of manufacturing companies in their portfolio outsourcing to China. So wherever you are, it's global. And you always have to have the global perspective. ❖

Case Study in Operations: Eldorado Stone

Suppose you receive an investment memorandum proposing the rollup of a franchisor and two of its franchises in the building products industry. The combined company will not have a management team, infrastructure or information systems, and you have no previous experience in the niche. Upon further research, you learn that analysts are forecasting a near-term peak in the housing cycle and interest rates are expected to rise further. Sound like a good deal? While it's not for the faint of heart, this is just the kind of situation in which operationally-oriented private equity firms thrive. One such firm, Graham Partners, received a memorandum in the fall of 2000 that described this very scenario, and it jumped at the opportunity.

Founded in 1988, Graham Partners originated as the corporate development arm of The Graham Group, a York, Pa.-based manufacturing conglomerate and investment concern. It has operated as a separate entity managing third party capital since 1998 and seeks to invest in industrial companies that participate in manufacturing niches benefiting from product substitution or raw materials conversion trends in their industries. When the firm received an investment memorandum for Eldorado Stone, a maker of molded artificial stone products, it recognized a potential buyout opportunity. Graham viewed Eldorado as a chance to invest in a high-margin, high-growth firm that could significantly benefit from the additional operational and transactional expertise it could bring to the table.

Diamond in the Rough

Founded in 1969, Eldorado was a pioneer in its field. The company's initial focus was to develop a national base of stone-making franchises that would buy the molds that it made. Many of its franchises grew rapidly during the latter half of the 1990s because they were able to produce an increasingly realistic cement-based stone veneer product using Eldorado's proprietary molds at one-third the installed cost of natural stone. Eldorado's flagship franchise in Southern California, StoneCraft Industries, grew at a rate of more than 50% a year for several years, far surpassing the revenue Eldorado generated from its mold manufacturing business.

> When the firm received an investment memorandum for Eldorado Stone, it recognized a potential buyout opportunity.

In 2000, the founders of StoneCraft and Eldorado, under the leadership of StoneCraft founder Mike Lewis, proposed a new strategy for the Eldorado Stone brand that would require a dramatic change in each of its businesses. "Based on the tremendous success we experienced with the StoneCraft franchise, I understood the potential opportunities for the product on a much larger scale," Lewis says. However, he adds, "it was apparent that we needed not only additional capital, but a partner with operational expertise to help in the growth and development of our business."

The proposed transaction entailed merging StoneCraft with Eldorado to form a platform business with enough critical mass, influence and capital to consolidate up to 27 remaining independent Eldorado franchises. Ultimately, this plan would enable Eldorado to improve its market position by launching StoneCraft's product line with consolidated marketing materials, consistent pricing, a national advertising campaign and customer service on a nationwide basis under the Eldorado Stone brand. To effect this plan, the founders of StoneCraft and Eldorado, along with the founders of Northwest Stone and Brick (another Eldorado franchise), worked with the investment banking firm Houlihan Lokey Howard & Zurkin to structure a three-way merger between the stone-making operations of the two franchises and the mold operations of the Eldorado franchisor. The founders recognized that the success of this strategy would require more capital, a disciplined integration effort and a team of investment professionals with strong operations and transaction skills. As a result, they were seeking an operations-oriented financial partner to help with the consolidation plan. After a thorough search, Graham Partners emerged as the leading candidate and was selected by the founders based on those criteria.

The Devil Is in the Details

Once they were granted exclusivity, Graham Partners turned to confirming its belief about the growth prospects for artificial stone, which was the key underlying component of its investment thesis. The firm hired consultants to research the market, and initial reports indicated a market growth rate of 17% per year for the artificial stone market as compared to the 3% annual growth expected for the overall $7 billion U.S. siding market. Companies within the niche were able to achieve this rapid market share expansion due to both advances in product aesthetics that made artificial stone nearly indistinguishable from natural stone, and reductions in price that made artificial stone competitive with brick and stucco siding. These advantages allowed Eldorado to convert consumers from more expensive natural stone, as well as from the larger stucco and brick siding markets.

During its due diligence, Graham also focused on a review of Eldorado's franchise agreements. Many of these agreements contained a strict right of first refusal clause, which gave Eldorado the right to buy the franchises out from under a potential acquirer's nose, even just before closing. This clause gave Eldorado a significant amount of leverage in negotiating with its franchisee acquisition targets, as other potential buyers would shy away upon learning of this risk. In fact, the clause helped Graham Partners in significantly advancing discussion and delivering a letter of intent to another franchisee before the initial deal had even closed.

Filling out the management team was a critical aspect of closing the deal. After working with Mike Lewis for several months, Graham Partners realized that he seemed capable of running a much larger company than the Southern California Eldorado franchise he had co-founded. In addition, the firm began to actively recruit other management candidates and was able to find a CFO who started within two weeks of closing, as well as a VP of Operations who started soon thereafter.

The deal, however, also had its share of risks. One of the company's biggest shortcomings was a lack of infrastructure and management team experience that would be necessary to implement its growth strategy. However, the broader Graham organization had experience in succession planning and in growing industrial middle-market, family-held companies through a combination of organic growth and acquisitions. In addition, the firm had already identified an operating partner who attended the management presentation and worked with Graham to assess the management team throughout the due diligence period. "Our goal was to support the Eldorado management team . . . by expanding their business into new geographic areas where demand for manufactured stone was on the rise," says Joe May, managing principal at Graham Partners and a member of the Eldorado team.

Challenges while Closing the Deal

Eldorado's complex ownership structure and lenders' misgivings about the prospects of the housing market made completing the deal a challenge. The three-way merger resulted in a complex corporate structure whereby the shareholders of the company, who collectively represented the six founders of the three different predecessor companies, owned stakes in the company through dissimilar interests in complicated stock ownership and partnership arrangements. Consequently, Graham Partners had to devise a complex, creative transaction structure that would lead to roughly equivalent after-tax treatment for the various shareholders. Otherwise, the firm's offer would have run the risk of alienating one or more shareholders, who in turn could have foiled the entire deal.

In addition, the shareholders had disparate views on valuation and ownership retention. Shareholders who intended to roll over a portion of their equity and participate in the future earnings potential of the business were more interested in selecting the right partner and less interested in accepting the highest nominal offer for the company. In contrast, those who did not want to remain active with the business preferred to maximize the cash delivered at closing.

The initial stages of raising debt for the transaction were difficult because of concerns about the state of the housing market, the execution risk in acquiring and integrating the franchise network and the lack of infrastructure within Eldorado. Graham Partners went out to almost a dozen financing sources in order to find a partner who could see the potential in the deal and would be willing to take on the risk. In the end, CIBC World Markets, a firm with which Graham Partners had a long-standing relationship, signed on as lead underwriter and was able to syndicate the financing.

Summing up the major risks that Eldorado presented, Rob Newbold, managing principal at Graham Partners, notes: "The level of housing starts was an issue on everyone's mind. We were creating a new company but it did not have any management. The CEO was the founder of the Southern California franchise, but there wasn't a CFO or vice president of operations. In addition, the company lacked an integrated MIS system. One of the companies ran its business on QuickBooks." Adds May: "To further complicate matters, the strategy was dependent on our consolidation of a number of independent franchisees who had the right to use the Eldorado name and to sell into our territory. This was perhaps the most important area to clean up with the greatest execution risk. Multiple operators competing with one another in the same territory can create damaging brand confusion, and it was impossible to tell if a franchisee would be willing to sell to us at this early stage."

Despite these difficulties of structuring, financing and closing the deal, Graham Partners and Eldorado management won shareholder approval for the recapitalization and obtained ample leverage for the transaction. The transaction was structured as a hybrid asset/stock purchase, involving the purchase of a portion of the shares of StoneCraft Industries, a portion of the Class A units of Northwest Stone and Brick Co., 100% of the common stock of Eldorado Stone, and 100% of the Class B units held by Northwest Stone and Brick Co. CIBC led the senior financing, which was eventually oversubscribed at a multiple of 2.9x trailing 12-month EBITDA. Indosuez, National City Equity Partners and Argosy Capital provided the subordinated debt financing for the transaction, pushing total leverage to 3.7x trailing 12-month EBITDA. The equity component of the deal included a 27% rollover interest from certain of the company's founders who planned to remain active in the business, in addition to the cash paid by Graham Partners for a controlling stake.

Enhancing the Organization

"Immediately after closing the deal, we worked to focus company management and our investment team on the development of a strategic plan, the creation of financial and operational reporting templates, and the assessment and identification of executive management capabilities and needs," Newbold says. "This plan set accountability for all efforts and ensured that new management hires had a clear vision of responsibilities."

Generally speaking, small, entrepreneurial businesses tend to be run a bit more loosely than larger organizations. When Graham first asked about indicators used to gauge productivity, management replied (a bit facetiously) that the "smudge test" was crucial. "We just go over to that window, wipe a smudge off the pane, and count how many trucks are leaving the plant." In fact, prior to the rollup, each of the businesses had been run more or less by the gut instinct of management, which may have been adequate for an entrepreneurial concern, but needed to be supplemented and professionalized as the company grew into a larger, fast-growing organization. This was certainly an area where Graham intended to focus.

> One of the company's biggest shortcomings was a lack of infrastructure and management team experience that would be necessary to implement its growth strategy.

Vinay B. Nair, a professor of finance at Wharton, points out that Graham Partners' approach to Eldorado differed considerably from that of private equity firms that make large cap investments. "Large cap firms don't usually get involved in operational issues," he says. "They make their money from leverage and financial engineering. If they want to bring about operational changes, they do that through hiring appropriate executives. Graham Partners was significantly more hands-on in its approach."

Moreover, Nair adds, "Buyout firms trying to add value in small entrepreneurial businesses often play some of the roles that VCs do. VCs are known to play an important role in the professionalization of start-ups through actions in information technology, human resource policies, adoption of performance-based compensation plans, and the hiring of senior managers. Buyout firms dealing with smaller firms have a similar role."

Although Eldorado's management had already identified several of the key metrics that were driving sales and productivity, "Our team and our operating partners worked with the company to institute additional measures to more formally and proactively monitor plant productivity and implement best practices across locations," Newbold explains. "While we initially experienced some resistance from management on this front, who perceived the measures as 'overkill,' these concerns were put to rest once the company began to realize productivity gains across plants."

In addition to adding more professional management practices and infrastructure, Graham set out to implement its strategy of acquiring additional franchises and unifying the company's product and marketing efforts under a single nationwide banner. Prior to the acquisition, each of the franchises maintained its own name brand, packaging and marketing plan. As franchises were acquired, names were changed to Eldorado Stone and consistent packaging was adopted throughout the system. "In keeping with our initial investment thesis, the franchise acquisition strategy was very effective. Over the course of our ownership, we completed five additional acquisitions, all at very attractive multiples," says May.

One of the major difficulties that arose while implementing the acquisition strategy hinged on the fact that current Eldorado management had formerly been a competitor of many of the other franchisees, who had to overcome their sense of competitiveness to work on the same team. Because of the company's outstanding growth and performance, these acquisitions were executed with no additional equity from Graham Partners. More importantly, most of the acquired franchisees also stayed on as general managers, making the transition much easier. Within three years from the original transaction, Eldorado represented approximately 90% of the total North American franchise network volume.

Moving to a consistent, nationwide product line also proved challenging as a result of the inefficiencies caused by changing the well-established production methodologies at various plants. One plant had developed a coloring and production system that was superior to systems at other plants, but rolling this out nationwide during a period of rapid growth proved to be difficult. While it resulted in significant non-recurring expenses, the company managed the issue by employing large numbers of temporary employees while permanent workers were trained in the new production methods.

Though certainly one of the more exciting aspects of the company, the 25% organic growth rate achieved in the first few years also resulted in capacity constraints much sooner than expected. After less than two years of ownership, the company needed to build a plant in Southern California to keep up with demand. As this was by far the largest plant ever built by Eldorado or its predecessors — adding roughly 33% to the production capacity of the company — inefficiencies were expected and did materialize. However, Graham and the company's focus on a key metric used in managing plant efficiency (square footage of stone produced per man hour) turned out to be critical. Once plant managers began consistently tracking and monitoring this metric, it became clear which plants were producing efficiently, and adjustments could be made to incorporate best practices across facilities. Another difficulty arose in recruiting plant employees. While the company had hoped to use some production managers from its existing plant nearby, these employees proved difficult to recruit. After a few months of working out the kinks, however, the company had all of its plants running efficiently and the capacity issue was resolved.

Commenting on Graham Partners' strategy, Wharton's Nair explains that it had pros as well as cons. "Any time a private equity firm gets involved with a small firm, franchise or family owned firm, it pushes through operational changes that make its finances more transparent and efficient," he says. "These changes are made — as Graham Partners did in the Eldorado case — among other reasons, to prepare the firm for future sale. The downside is that these changes can de-motivate managers who have been used to running the firm in a certain way. They now have to run the firm according to the new rules. You can compensate managers by giving them equity but they don't realize these rewards until the sale goes through. In the meanwhile, you can antagonize your managers."

Reaping the Rewards

Just a couple years after investing in Eldorado, Graham Partners found itself having completed its initial objectives and decided that the time was right to find a buyer to implement the next stage of the company's expansion. After interviewing a number of investment banks, Graham Partners settled on Citigroup Global Markets to run an auction.

However, the company's difficulties with its new Southern California plant persisted after the auction process began, and potential acquirers were unwilling to fully adjust for the one-time, non-recurring plant start-up charges. As a result, Graham Partners decided to suspend the auction until its new plant was running efficiently.

Soon after the auction was put on hold, another investment bank contacted Graham Partners regarding a client, Headwaters, that was interested in Eldorado. While Headwaters had not been on the original list of potential acquirers, the company was looking to expand into a higher growth, higher margin business segment that would also create synergies with its current business units. Headwaters was attracted to Eldorado as a result of its strong historical growth and high margins.

Nair believes that, "The timing of the exit was questionable. With problems in a major plant, an unsuccessful auction was a possibility and an important risk. If this happened, Graham would carry the stigma of a failed sale attempt and possibly lower exit multiples in the future. In a perfect world, Graham should have waited. Fundraising pressures, however, could have affected the timing. Private equity firms are keen to exit on good investments such as Eldorado when they are in the process of raising follow-on funds, making them more willing to take on such risks. In hindsight, Graham Partners could have received a higher valuation if it had waited."

"In our case, as it related to Eldorado Stone, there were a number of factors we had to consider in determining the timing of our exit," says Christina Morin, a managing principal from Graham Partners who also worked on the Eldorado Stone transaction. "In particular, the long overdue end of the housing boom continued to loom in front of us, we had achieved all of our initial objectives for Eldorado that comprised our investment thesis, and we had the opportunity to sell the company into a strong M&A market at a very full multiple, generating a return that exceeded our overall objectives for our investments. Had we held onto Eldorado, which was just one of several building products holdings in our portfolio, and if the housing market had softened, as was projected, our investors would have really questioned our decision, as fiduciaries of their capital, to leave all of our 'chips on the table,' rather than put some cash back into their pockets."

As such, the sale of Eldorado to Headwaters worked out well for Graham Partners and its investors, who had invested some $18 million out of a total $30 million of equity to complete the Eldorado transaction. (Most of the remaining equity was from management, with a portion from debt financing sources.) The sale closed in June 2004 and was an all-cash transaction representing an enterprise value of approximately $210 million (including a working capital adjustment of $8 million). As a result of the sale, Graham Partners distributed to its investors roughly half of the capital invested from its vintage 1999 fund. The sale yielded a 4.3x gross return on invested equity and a gross IRR of 57%. Who says you can't squeeze gold from stone — even if it's artificial stone? ❖

Upcoming Private Equity Events at Wharton

Fall 2006

- Finance Conference (7th Annual)*
- Recruiting Process Overview conducted by Denise Palmeri of the Pinnacle Group
- Recruiting Trends in VC / PE / Hedge Funds conducted by Glocap
- Workshop on Due Diligence by PriceWaterhouseCoopers
- Workshop on Tax Structuring of Private Equity Transactions

Spring 2007

- PE Conference (12th Annual)*
  http://www.wharton-pec.org/index.asp
- Restructuring Conference (3rd Annual)*
  http://www.whartonrestructuringconference.org/
- LBO Case Competition (2nd Annual)
- Workshop: "How to Win a PE Auction" by Harris Williams
- VC/PE Career Treks (New York, London, West Coast, Chicago and more)

Venture Capital & Private Equity Speaker Series (Past Guests)

Peter Bloom, Managing Director, General Atlantic

Dan Haas, Director, Bain & Co Private Equity Practice

Dean E. Miller, Partner, PA Early Stage Partners

Vivek Pandita, Principal, Eastward Capital Partners

Ted Schlein, Partner, Kleiner Perkins Caufield & Byers

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