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Roundtable predicts '06 equity flow

ROUNDTABLE PARTICIPANTS

Jay Jester, managing director, Boston-based Audax Group. Audax Private Equity invests in middle market companies with annual EBITDA of $8 million to $60 million; Audax Mezzanine invests in subordinated debt and other junior capital securities of middle-market companies. Jester has a BA degree from the University of North Carolina.

Aaron Richmond, principal, Seattle based Endeavour Capital, a private equity fund that invests in Western lower-middle-market companies with annual EBITDA of $5 million to $30 million. Richmond has an M.B.A. from Stanford Business School.

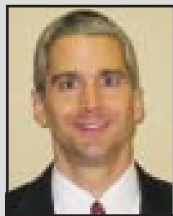
J. Mark Jones, partner, Chattanooga's River Associates, a private equity fund that invests in lower-middle-market companies with annual EBITDA of $2 million to $10 million. Jones has an M B.A. from Samford University in Birmingham.

ROUNDTABLE MODERATOR

Alan Mayer, managing director, Denver-based Green Manning & Bunch, an investment bank specializing in M&A, private placement of equity and debt, and strategic financial advisory services for middle-market and lower-middle-market companies, with annual EBITDA of more than $10 million. He has a J.D. from the University of San Francisco.

Jester

Richmond


Jones

Mayer

BY RENEE MCGAW
DENVER BUSINESS JOURNAL

U.S. private equity deal flow surged in 2005, dwarfing the record-breaking growth seen in 2003 and 2004. What's the outlook for 2006?

To answer that question, the Denver Business Journal discussed the state of the private equity market with moderator Alan Mayer, managing director of Denver-based investment bank Green Manning & Bunch, and managers of three private equity funds: Jay Jester of Audax Group, Boston; Aaron Richmond, Endeavour Capital, Seattle; and J. Mark Jones, River Associates, Chattanooga, Tenn.

The funds, which range from large to small, East Coast to West, were to participate March 15-16 in the fourth annual Rocky Mountain Corporate Growth Conference, hosted by the Association for Corporate Growth Denver.

Here's what they had to say:

By all accounts, 2005 was a record year for private equity. Some 845 private equity-sponsored transactions were disclosed, accounting for almost $200 billion in aggregate value. Private equity firms raised almost $175 billion of capital, roughly four times the amount raised in 2004. What do you see in 2006? Can this level of activity be sustained?

RICHMOND: There may be some fundamental changes that are going to make private equity, for the longer term, a larger industry than it has been in the past. One of those is that Sarbanes-Oxley has made being public ... that much more of an unpleasant experience and less of an alternative for a quality midsize company. Secondly, you are seeing the transition of a whole generation of business owners to a new generation, and that new generation is using private equity almost as a gray market ... between a traditional family private company and a traditional public company.

JONES: Obviously the early 2000s were not the best time for the stock market ... If you're not in energy or emerging markets, you're probably not seeing a whole lot of gains in the public market. As a result, there has been an increasing flight to alternative assets. Institutional investors, endowments and pension funds seeking a way to bolster returns and diversify their allocation model increasingly are turning to private equity, and there has been a substantial amount of capital coming in. Will that change in the near term? There is certainly nothing to say that it will.

JESTER: Lenders are back in the market. If you flash back to 2001, it felt like there were only four lenders you could consider for a transaction, but in the current market there are hundreds that you could partner with. Also, the sellers are back in the market. People have seen us climb out of the depth of the burst bubble and are saying 'deal prices still aren't back to where they were in the late '90s but they're getting pretty close. This feels like a pretty good time to sell.'

EBITDA multiples are at record levels, surpassing even the pre-bubble levels seen in the late 1990s. For deals up to $250 million, the average middle-market EBITDA multiple was approximately seven and one-half times in 2005, a significant increase over 2004 levels. For larger deals, we've heard that 10 times is not uncommon. What are the factors behind this, and do you see it as a window that is going to close in the near future?

JONES: One of the big drivers over the past couple of years has been the emergence of second-lien money, which is being driven by alternative lenders and hedge funds. Senior debt multiples have been relatively constant, in the three-and-a-half-to-four-times-EBITDA range. But second-lien money from some of the alternative lenders has exploded onto the scene. That's really driven the larger deals, those with $10 million EBITDA and up.

While multiples for the lower middle market sector are also at historically attractive levels, they are often less than the bigger deals. What drives valuations for smaller companies, and why is there that differential?

JONES: There aren't as many dollars or as many funds chasing smaller companies. Also, there are fewer debt sources. Cash-flow financing, unsecured financing, is not as readily

ROUNDTABLE: Media, medical devices among the hot properties

available. When you're below, say, $5 million in EBITDA, it's pretty tough to get super-aggressive cash-flow financing. There are more players than there used to be, but until you get in the $8 million to $10 million of EBITDA range, you're not getting the real cash-flow players.

JESTER: The cost of doing a small deal is not that different from the cost of doing a medium-size or a large deal. When you have a hot market like this, with a lot of capital being raised, groups are going to migrate up to larger transactions. The middle market is where it's really competitive ... When you go smaller than that, you begin to see ... companies that need more hand-holding, more help, more additions to the management team. You see lower multiples there because they need more work.

RICHMOND: For two companies with similar prospects and momentum, bigger is going to tend to be better, but a smaller company that really has thought about management succession planning, developing bench strength and projecting a brand or some other competitive advantage, probably can do more to edge up their valuation and defeat what is normally a smaller company discount.

Can you speculate on which industry sectors will see a lot of activity in the coming year?

JESTER: It's such a high-velocity market, the stuff that doesn't require a big story is the stuff that's hot. Health care, medical devices — people understand the trends driving them. They aren't tied to interest rates or the housing cycle. Media properties are very hot. Transforming technology companies, information delivery, information aggregators — those seem to be hot right now.

RICHMOND: The private equity industry, in contrast with the venture capital industry, is not as focused on hot industries as much as great companies, because we're not as focused on selling at a premium valuation two years later in an IPO. But we're always focused on great companies within their respective industries, and certain industries have always traded at higher multiples. Media, as Jay mentioned, and other services businesses, like information services, with relatively low capital expenditure requirements and potentially wonderful margins and growth opportunities, those certainly trade at premium multiples today. But companies in more prosaic industries that are just extremely well-run and dominate their industries can rival any other industry for the amount of attention they'll get and the sort of multiples they can command.

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>
> **Aaron Richmond**
> investor

JONES: People are a little nervous about something tied directly to housing or energy. You're seeing some companies that, two or three years ago they had $2 million in EBITDA and they've got $8 million to $10 million this year. That's a tough deal to get comfortable with. But in general, unless you're at risk of foreign competition or a cyclical downturn, most businesses right now are commanding pretty strong multiples.

What are some of the characteristics that private equity groups seek in determining whether to invest in a particular company, specifically relative to the ongoing role of management after closing?

RICHMOND: People thinking of the Gordon Gekko [from the 1987 movie "Wall Street"] model of what a private equity firm and its partners looks like can be nervous about what it would be like to have a financial partner in the business. There are all different models for what level of participation the financial partner will take — that is to say, what role they'll play ongoing, either in management or as an active board member — and with the number of new funds that have been raised, there are all different models out there. A management team or business owner ... should spend time trying to figure out which model makes the most sense for them, and try to find an equity fund that offers that appropriate matching of participation.

JONES: Ultimately we are looking for a company with a sustainable and defensible niche in its given market. You create those niches in a variety of ways, one of which is the strength and the depth of the management team. Can that business continue to be successful in doing what it's doing? If, for example, a key owner leaves the business, will that business lose key customers or suppliers? A lot of times it's a subjective investment decision.

What are some of the factors that a potential business owner, as a seller, should consider in selecting the right private equity partner? And what do you do to differentiate yourselves from your competition?

JONES: There are two important things. One is the track record of the private equity group. What have been their successes and failures, and how do they react to tough situations? Ultimately you find that out by talking to the private equity groups' portfolio companies ... The other thing is the investment thesis. Why does River Associates, for instance, get interested in XYZ Widget Co., and what does it want to do with the business? Do those plans match with what the management team wants to do? If there's a disconnect, there are probably going to be problems down the road.

RICHMOND: Do your homework. The private equity fund will do a ton of homework on the company. Private equity funds can, at first glance, look awfully similar.

JESTER: In a market like this, there are a lot of brand new entrants. There are even whole asset classes of people who did not used to be in private equity that are now jumping into it. This is not a trader's business. This is a farming business, where you are planting seeds to be harvested many years down the road.

Any closing remarks?

JESTER: I'd like to mention that as I look at our deal flow by MSAs, Denver is a top 20 MSA for us. That's surprising for me, coming from Boston and looking at how much of our deal flow comes from the Northeast. On a state basis, Colorado is 16th for us. ... It's indicative of what's going on in your economy, the young businesses there. It seems like a place that is very business-friendly, and the capital is responding.

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