MERGERS& ACQUISITIONS

Roundtable

Different Investment Strategies

Family offices and fundless sponsors look to gain traction

Traditional private equity firms continue to dominate the dealmaking environment, but an increasing number of firms that act as limited partners in private equity funds are looking to source deals directly. These players have been around forever, but their efforts are making more of an impression on the business than ever before. Mergers & Acquisitions convened a special roundtable to discuss the benefits and challenges associated with different investment strategies. Benesch, Friedlander, Coplan & Aronoff LLP sponsored the event, and the excerpted discussion that follows provides a range of perspectives from key players who are investing into companies using different strategies. Participants included a traditional private equity investor, a placement agent, a fundless sponsor, a pension plan investor with a direct investment and co-investment program, a family office investor who invests in companies directly and an attorney.

Fugazy (moderator): How has private equity changed over the years?

Hill (Benesch): I started practicing law in 1978 in Chicago and immediately jumped into a middle market M&A practice involving private equity firms. In those days it was very different. The capital markets were very inefficient, and not every company was auctioned. In private equity there were more fees—transaction fees, portfolio company management fees, disposition fees, and these were not offset against the 2 percent management fee on committed capital.

There was also less buyer competition in general. There were fewer private equity firms, and many middle market private equity firms were still under the radar.

Today, the capital markets are much more efficient. We've all seen companies that are being auctioned off with a $3 million Ebitda,

"One of the most challenging things for family offices is the ability to have enough resources that you can find deals."

James Hill

Roundtable Participants

Kelly DePonte, Managing Director, Probitas Partners

Danielle Fugazy, Contributing Editor, M&A

James Hill, Executive Chairman, Chairman of Private Equity Practice, Benesch, Friedlander, Coplan & Aronoff LLP

Dan Lipson, Partner, Rotunda Capital Partners

Howard Morgan, Co-President, Castle Harlan Inc.

Nicole Musicco, Vice-President, Funds & Co-investments, Ontario Teachers' Pension Plan

Howard Romanow, COO, CFO, Island Management which you would not have seen in the '80s or '90s. There is more fee pressure on smaller funds because the limited partners are now limiting what you can actually charge as fees offsetting the 2 percent fee. Compliance has become a big issue. It's expensive, but funds are required to do it. It's another expense with which middle market private equity firms have to contend. Lastly, there's much more scrutiny on funds by limited partners looking, not just for cash-on-cash returns, but the continuity of the team, the industry focus and its operational capabilities And some limited partners are saying "maybe I don't want to pay these fees, maybe I should direct invest."

DePonte (Probitas): If we go back in history, this business used to be called leveraged buyouts. For the most part people were buying companies on credit, and a lot of the returns that were being made were coming off the leverage. Now LPs are looking for fund managers with a competitive advantage. LPs want GPs on the boards of portfolio companies, making strategic changes, improving operations and replacing weak management. To build a successful company and generate profitability today very often requires a lot of activity from the GP at the company level.

Fugazy: Everyone present has a different investment strategy. Please tell us why your investment strategy is successful.

Morgan: (Castle Harlan): It's important for us to stick to our discipline. At Castle Harlan our general approach hasn't changed radically in 25 years. We're quite disciplined buyers of businesses. We like to think we don't overpay, at least on purpose, and we try to add a lot of value to our companies. We can demonstrate that most of our returns come from growing Ebitda. Having been in a business a long time the Castle Harlan brand alone generates a lot of deal flow. We are also global, so that adds a dimension for growth as well. We do two or three deals a year and hopefully one or two of those are proprietary.

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Roundtable Photographs by JohnCalabresePhotography.com

Lipson (Rotunda): We focus on the lower middle market, and investment banks have no time for us. We're in proprietary deal flow market more than anywhere else. We network and use partners' networks to further advance our business development.

In 2008 Rotunda sourced a deal that we were all excited about and wanted to do. We had some personal capital, but not enough to fund the full amount. So we decided to raise one-off funds to bridge the gap. We had done a bunch of diligence and approached a family office to see if they would be interested and they were. We also raised money from some friends of the firm including CEOs of companies we had formerly been involved with and other deal professionals we knew. That company was doing $3.5 million of Ebitda when we bought in and is now projected to do $16.5 million by the end of the year.

Then we had a second deal that came up in 2009. It was a $45 million purchase. We tried the same thing. We did 40 family office presentations and met with LPs and some smaller funds. We really got fortunate to find another financial partner, but in this case, it was a private equity firm. The point is it's a deal-by-deal basis. That company recently announced they were selling to a bank, and our investors are willing to roll their money back in to our "kitty." We've done three more deals since then. We now have a track record.

Raising a fund—a first-time fund—has become a lot tougher. It takes more than 18 months and it's very expensive and you're niched in. We are able to be really opportunistic.

Kelly DePonte

"LPs want GPs on the boards of portfolio companies, making strategic changes, improving operations and replacing weak management."

Fugazy: Would you like to build a track record so you can raise a fund at some point?

Lipson: The real drawback of not having a fund is that it's very hard for us to have investing options. Investment bankers and brokers are not going to send us deals because we don't have capital. It would be nice to have that pool of capital, but it's increasingly getting to the point where LPs are willing to invest with fundless sponsors. For a new firm with a fund the carried waterfall has all changed to European style, which makes it very difficult to make money. With our model, once you get paid, we get paid.

Romanow: (Island Management): For hundreds of years private families have been in and out of a broad cross-section of businesses and they realized a number of years ago that private businesses were more diversified, and provided a better return than public equity. If you're invested in privately held businesses through a bunch of funds you're likely getting frustrated by some of the issues around investing through funds including fees, incentives and holding periods. For private equity even if you like a company and it's doing well, you have to sell it because of shorter hold periods. And take a company that does poorly and you still have to hold on to that until the end.

More and more over the past few years you see private equity guys looking for alternatives to fundraising and regulatory demands. There are a lot more folks who look at direct investing as a real viable option and it's a lot more flexible. You don't have to worry about being put in a box that LPs put firms in when they are fundraising. Lastly, business owners are actually beginning to now turn to us as alternatives. It's the guy who wants to recoup and take 78 percent out. He doesn't want to sell and get out of the business in three or five years. He's going to hold on to it. Going to a family office or a fundless sponsor is a much more accepted path now.

The challenge for us is deal flow. We're not going to participate in an auction and get a book, put a bid in, meet management, put a final bid in. We're looking to hold something for 5, 10, 15, 40, 50 years and it doesn't have to be a majority so we are different.

Hill: It works better for family offices if management has significant ownership because management doesn't want to get flipped three times in 12 years, but if management has a significant say when ultimately somebody else buys the company, those are the best situations.

Romanow: The family shareholders have some sort of incentive; right? Whether it is the family name it wants to protect in becoming part of the big entity, or whatever the other reason may be, it matters.

DePonte: Over the past 10 years there has been more focus on growth capital, where the guy who owns the business needs growth capital, but doesn't want to sell it. He thinks he has a great idea that he wants to see play out for the next few years. So you now have more growth capital funds that are not looking for majority stakes. When you take a look at the number of strategies pursued in what was the LBO market 30 to 35 years ago—the number of different kinds of strategies today, be it growth capital, be it sector focused funds—it is extremely different.

Morgan: I feel compelled to defend traditional private equity funds. We have generally five years to invest the fund and hold years of three to five years on average. One of the advantages to having a dedicated fund, in addition to having capital for both overhead and structure, is it does create a sense of urgency, which I think is healthy. We say to our management teams, "As soon as you achieve your plan we're probably going to be looking for a liquidity event," and they get rewarded with hard cash, and oftentimes they can roll that into a bigger piece of the company the next go-around. There are some companies I would have loved to have owned forever; it's like parting with a child when we have to sell, but you have to be disciplined enough to say I've had my time with you, I've done what I can, I taught you what I can and now it's somebody else's turn to have the imprint on the business.

Musicco (OTPP): Since day one, we've had a two-prong approach to private equity investing — funding private equity firms as well as direct investing. In the early days at Teachers', there were 15 of us around the table and we were at $2 billion invested, and we thought we should really try to get the private equity portfolio to $10 billion, in 10 years.

That's when we started getting aggressive on the direct side of the business. That was in the 2004 time frame. But our fund program has always been a very important piece of our strategy because it gives us


Dan Lipson

diversification through sectors and geography. We would never stop investing in private equity firms. These are the teams that we co-invest with and now co-underwrite alongside of. We do a couple of deals in a certain sector with a group, and the next thing you know, through our networks and contacts we are

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in the fifth deal in that sector and suddenly we have in-house capabilities, and that's really how we ended up evolving to do direct investing.

We want to make sure our fund program stays true to being a strategic partner, while not forgetting to continue to build and feed the talent and the resources on the direct side of the business. With the two programs we have flexibility. We can be long-term investors, but we can also be short-term investors if the opportunity arises. We can be minority or we can be majority. The point is we have flexibility.

Romanow: We also invest in funds, especially if there is a particular niche or strategic area where we think there's some different strategy or skill set that we don't have. That's an important part of the strategy, but it's a much more limited focus now. For example, we have no skill set around gas and energy and we are not going to acquire it, and it's clearly a market where you want to be. That's a spot where we would look to other firms. The other place we've actually done this is real estate. We're not real estate guys, and I want to be in the pool with someone who has invested in the sector and has the skill set to invest wisely.

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Howard Romanow

Fugazy: What skill set and operational expertise do you need to be successful direct investors?

Musicco: We established sector teams on the direct side of the business and we introduced a portfolio management team that in the early days played more of an administrative role. They were really helpful with monitoring and finding outside resources to help us find expert help with our deals. For example, they could bring in strategy consultants or help us fill board roles from the outside. Over the last two or three years, we started to ramp up that role to make it more of a value creation team since as we discussed, the value being created in deals today isn't just from financial engineering. I'm spending a great deal of time from a fund program perspective making sure we have smart friends within our fund network and are leveraging that knowledge. So building operational expertise has been a huge focus for us.

Morgan: We don't believe in outsourcing the operating role. We're pretty heavy hands-on, so we have five professionals on every deal. We have a senior partner and a backup partner, which is a little unusual. We try to meet with our teams face to face once a month. Once a quarter we'll call that meeting a board meeting. The outside directors are usually welcomed monthly, but they're expected quarterly. We speak to our management teams once a week. Once a year we try to go offsite and do a two-day planning session for every company. So those are some of the tools we try to bring to really engage the companies and add value.

Hill: One of the most challenging things for family offices is the ability to have enough resources that you can find deals, be they off the auction path, and actually be involved in operations, and also do add-ons. We represent certain family offices that hire away some pretty significant management directors from fairly large middle-market PE firms. In my experience there aren't enough resources for those people to really do all that is done in a private equity firm because there's so much to do. I found with some family companies that there's nothing but the best of intentions, but that they are having trouble pulling the trigger very often because they are overwhelmed by the required multitasking.

Romanow: What is your objective? For us, over the next five or six years if we buy four or five businesses, we'll be very happy. We're looking to buy and build businesses over time, so it's a very different objective than trying to build a portfolio of 10 businesses. Maybe every year or two we sell one and buy one company. The needs are different.

DePonte: There is no model for a family office. I'm in the San Francisco area and there are a number of these firms there with tremendous wealth generated from the tech markets in the '90s. And they have an independent staff of five people doing nothing but private equity, and then they've got their bond guy, and they've got their public equity guys. On the other side, you got the really small family offices invested in mutual funds and PE fund of funds. There are some family offices whose wealth came from one industry and want to keep focused on that industry because they know it well. There are others that have said I'm so exposed to this industry, I want everything but. So you have family offices literally all over the map.

Lipson: A quote I've heard from a number of people is "if you've seen one family office, you've seen one family office." They are all over the place. We've met with a lot of family offices. That's where a lot of our capital comes from and the size and sophistication varies.

Romanow: Traditionally some of the offices used their relationships and networks to help with operational issues. But a lot of people realized that didn't work. More and more they started using recruiters to hire traditional private equity folks to come in house. It has been becoming a bit more professional in the past 18 months to a year.

In the smaller part of the market, call it sub $150 million, there's so much basic blocking and tackling going on consistently. Regardless of the sectors the owners don't have skill sets; they don't know how to create their reporting and take care of all basic stuff that needs to get done. Industry expertise is helpful, but there's so much more that needs to get done and you need to get all the basics in place first.

Hill: As an independent sponsor, your own firm uses alliances with family offices more than with private equity firms; why? And how difficult is it to raise the money in time to get the deal completed?

Lipson: Our objective is to raise money and put it to work, and when you work with a private equity

Howard Morgan

firm, there's no doubt the economics are not going to be the same. Private equity firms are not sourcing money from their LPs to then have somebody outsource the deal and sit on the board and run the deal.

GPs like to partner with people like us because they want the flexibility to have a say on each deal, but it's tricky. If you get the right management team who believes in your story, they want to do what they want to with you. If it's an auction process, you have to convince the banker you want to compete and you have 60 or 90 days to make it happen.

Fugazy: How have limited partners changed over time? Have you seen their demands and needs change?

Hill: They have changed pretty dramatically. If

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you're a firm that's highly successful and return two-and-half-plus times capital, you may be able to maintain the parameters and fees you get that aren't offsetting the 2 percent. But there is a backlash because they were annoyed by the large firms that raised $13 billion funds and had a 2 percent fee every year. That was a lot of money, so people started saying wait a minute that seems like way too much money to spend in a year to run their operation. It translated down to middle market funds where firms actually do need 2 percent to run their shops. One of the reasons you actually see people leave private equity today is because limited partners are now saying you can't have all these fees but it's hard to keep operations up. LPs also want more communication. Not just once a year, but quarterly.

Nicole Musicco

"I think a trend that we're going to continue to see is institutions like ours going direct."

DePonte: There are some LPs who have been in the business a long time who realize this, and they're willing to go 50/50 on deal fees for small funds. Some of the large organizations I know, the board has set up the policy "100 percent of fees to the fund, no exceptions." So the staff looks at that and knows that's not the greatest thing for this GP but they can't do anything else.

Fugazy: How big of an issue is fee pressure and how strong are the LPs' demands?

Romanow: We see the fees and we think we can save money and do this ourselves. We have to look at what we pay and what we get in return today. If you're returning 25 percent, 2 percent may be still a significant fee, but it's not bringing your returns down meaningfully. If you're getting mid-teen returns, people look at that 2 percent fee differently. They say with these dollars I can actually have a team doing this and generate the returns in-house and have the ability to be more discretionary in what we do, on what we hold, what strategies we implement. For us, the combination of all the different factors coming together, the returns, equity and the liquidity come together make sense to do this in-house.

DePonte: LPs are focusing more on fees, pushing for lower fees at times beyond reason. If you're getting a firm to give you a big discount on fees, it's very often because they can't get the capital otherwise, and you're paying money for what is likely a substandard GP. This business is about returns; it's not about the fees. There are still GPs out there that have made a lot of money for their LPs. And guess what? For them it's a three-month fundraise at the old fee level. I think you need to focus on alignment of interest as opposed to an absolute level of fees. Basically, if this fund doesn't work, is that GP going to be hit in their pocket and hurt because they put in a lot of money alongside you?

Lipson: We get a lot of calls from mid-market private equity firms to partner on deals that we source. But I think much of the time they're thinking of us as brokers more than investors simply because we don't have a dedicated pool of capital. That's far from our business. Our goal is to invest our own capital and that of our LPs. There are definitely deals that are just too large for us to raise the money necessary to complete and we need a partner. But we're going to be as involved, if not more, than any other partner.

Morgan: Control is the issue. We need 51 percent to do what we want. Otherwise, we love working with groups that have maybe a larger deal than they can do on their own.

DePonte: We've talked about strategy a couple of times. The biggest strategy drift is firms that grow too quickly. A number of times I've seen a first fund at $300 million, the second fund is $600 million, the next fund is $1.8 billion, and then the next fund is never because the $1.8 billion blew up. GPs very often get more caught up in generating a larger size and more fees, and they end up being in a market size which is totally unlike the market where they generated their returns. You know, at $300 million you're probably doing lot of proprietary deals. At $1.8 billion, everything you look at is being shopped and if you get too caught up in an auction, I mean, what's the guy that bids the highest price? He's called the winner of the auction.

Hill: The most interesting is $500 million and the next fund is a billion dollars, and you say "are you guys going off-stream on Ebitda," they say no, we're going to stay exactly where we were before. You think about deal velocity and you realize there aren't enough people on the team.

Morgan: One of the ways we've approached that is co-investing. Even though we are on the larger end of the market, when we have a slightly larger deal there's an opportunity to bring in and reward existing relationships. We can also bring in new relationships and invest in companies that may be a little bit bigger than we would do on our own.

Musicco: As an LP, we focus on strong alignment and transparency. We believe the Institutional Limited Partners Association Principles have gone a long way in getting GPs and LPs closer together on these issues.

Fugazy: What are some of the biggest challenges that you think the industry faces over the next couple of years?

Hill: I would look at the maturity of portfolio companies today. The median hold period is 5.4 years. In the last year it was reported that a little less than 70 percent of the portfolio companies owned by North American private equity firms have been held for over seven and a half years, so there's a lot of portfolio companies within private equity firms. One of the biggest challenges in private equity is what is going to happen to all the companies and how is that going to affect private equity firms. There could be a bubble in 2015 and 2016 where a lot of smaller middle-market funds will not raise enough funds and ultimately the limited partners would need to sell off those portfolio companies. They weren't misperforming, but they weren't performing. We've all seen those companies because the firm is not going to put any more money in them. They're not going to make any more acquisitions. You are tapped out. Management has, frankly, gotten demoralized because now there are no resources to really build the company. So, that's a really interesting issue in private equity that will be resolved in the next two or three years.

Lipson: I agree that there will be a lot of companies to sell in 2015 and 2016. A lot of firms spun out of larger firms a few years back because the founding partners had all the carry and the junior people couldn't get the economics. These people went out on their own and raised funds in 2004 and 2005. They bought when the market was hot. It's going to be tough for them to get their returns.

DePonte: I looked at Zombie Funds recently, those which had not raised a follow-on in the last seven years. Roughly 20 percent of all the funds raised in vintage years like 2000 through 2005 are Zombies, but the percentage didn't fluctuate much annually. What did fluctuate was the amount of money at risk, so that if you took a look at the 2005 vintage (2005 was a boom year) the amount of money in potential Zombies went up a lot. The other interesting thing is that 70 percent of Zombies were first-time funds, and another 20 percent are second-time funds.

Morgan: I hear the prediction of an apocalypse in 2015 and 2016, part of me gets really hungry because that's going to be the time where we feast on some great deals and we can afford to wait a year or two to get really good investments. The other thing that I think has to be in the front of people's minds is debt capital markets that may impact the lower middle market in different ways. The yield curve is a one-way ticket. You can't go much further than zero. I think that has saved a lot of these portfolio companies.

DePonte: The weird thing about it is if you take a look at the stats, most of the loan volume now is refis. If you're a middle market GP and you're trying to get bank debt for a new investment, it's very difficult. You can keep your Zombie companies alive but you can't go after a new home run deal because you can't get the financing.

Musicco: A trend that we're going to continue to see is institutions like ours going direct. But direct programs are not born overnight. You need to start with a board that gives you the autonomy to hire and pay the right people. You need to be able to attract and retain deal people. The Canadian pension plans were among the first to execute a direct model, but I think even our peers in Canada are seeing that it's a tough thing to do. Even with a good decade of talent and experience at Teachers' doing direct deals, we would never get rid of the fund program. We could not have returned 19 percent IRR over 20 years if we didn't have a fund program alongside our direct program. M&A