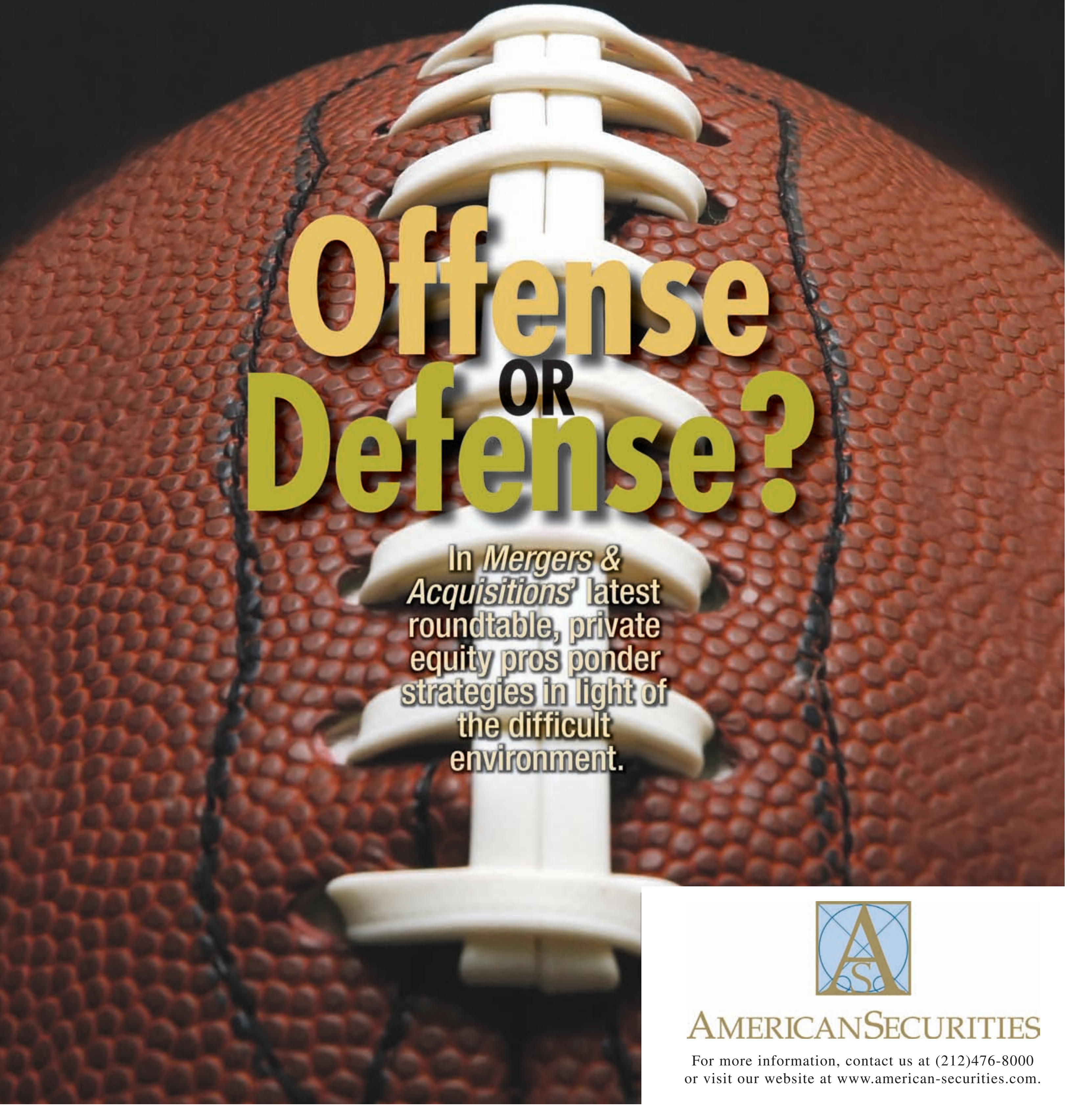
MERGERS & ACQUISITIONS

Roundtable



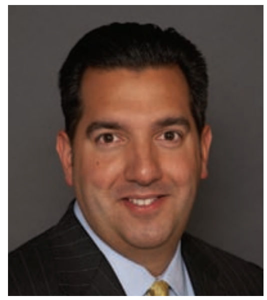
Offense or Defense?

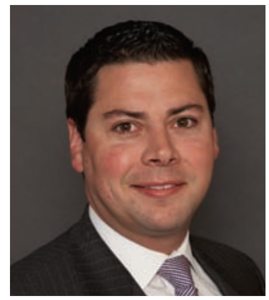
In *Mergers & Acquisitions'* latest roundtable, private equity pros ponder strategies in light of the difficult environment.

OFFENSE OR DEFENSE?


John Almeida, Jr.
Welsh Carson


Thomas Arenz
Harvest Partners

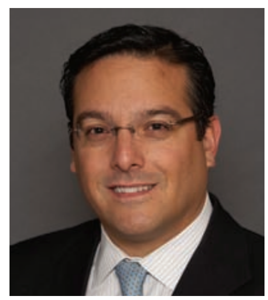

Paul Aversano
Alvarez & Marsal


Alexander Carles
Wellspring Capital Mgmt.


Howard Morgan
Castle Harlan


Paul Rossetti
American Securities


Louis Samson
Platinum Equity Partners


Aron Schwartz
Fenway Partners


Lawrence Sorrel
Tailwind Capital


Wray Thorn
Marathon Asset Mgmt.


Aleksandrs Rozens
Mergers & Acquisitions

In *Mergers & Acquisitions'* latest roundtable, private equity pros ponder strategies in light of the difficult environment.

Photographs by Alanfil

The private equity market is facing unprecedented change, creating uncertainty throughout the deal business. Deteriorating portfolios, a frozen debt market, and uncertain forecasts are just a few of the issues pros are dealing with, which raises the question of how to proceed in the months ahead. Some dealmakers will endorse an aggressive approach, thinking that the best time to buy is at a trough; others believe the current conditions call for more prudence, as there remains to be little clarity as to when and to what extent business conditions will improve.

The consensus among the pros present at the roundtable was that a defensive posture is important to avoid the proverbial falling knife, but that shouldn't preclude investors from taking advantage of opportunity.

Taking part in the discussion were Welsh Carson's John Almeida, Jr.; Harvest Partners' Thomas Arenz, Alvarez & Marsal's Paul Aversano; Alexander Carles, of Wellspring Capital Management; Castle Harlan's Howard Morgan, Paul Rossetti, of American Securities; Platinum Equity Partners' Louis Samson; Fenway Partners' Aron Schwartz; Tailwind Capital's Lawrence Sorrel; and Wray Thorn, of Marathon Asset Management.

Mergers & Acquisitions: *As a jumping off point, I'd like to go around the table and have each person describe the impact of the financial crisis on your business. Does it mean less deal-related work? For the private equity firms here, has the answer been to take more of a defensive posture or is this a time to become more aggressive as it relates to portfolio companies and new investments?*

Aversano: I would say about 12 to 18 months ago, we started to see the tide of private equity-focused deals start to recede in connection with financing becoming more difficult. As time went on, the leverage markets largely shut down and financing went from being difficult to impossible. The flow of new deals that we were seeing has certainly decreased from what we were seeing in the past.

More recently, in the last six months, we went from performing pre-acquisition work on new deals to more operational performance improvement work. We started to see cracks in portfolio companies. We were being asked to come in and help with interim management, cash-flow analysis and forecasting, working capital rationalization, supply-chain sourcing, and

leveraging costs across a group of portfolio companies. That's really where we have been spending our time.

From what we have seen, things are going to get worse before they get better. People are just now

> "Everyone in our industry is playing a certain amount of defense right now."
>
> John Almeida, Jr.
> General Partner
> Welsh, Carson, Anderson & Stowe

looking at their year-end results, so the reaction to that will come in the first quarter. Also, you will have covenant issues pop up in March. And with many of these companies that are in trouble and announcing layoffs, that still needs to work its way through the system. You're going to see those situations continue to happen in greater numbers throughout the quarter.

A lot of folks are still in wait-and-see mode, at least during the first 100 days of [President Barack Obama's] transition into office. They want to see what programs he will put in place and then they will figure out which direction they want to go.

Rossetti: We largely focus on value investing, so in this climate we are paying attention to our portfolio. There is both risk and opportunity. We are working hard to deal with both. It just depends on the situation of the individual company.

Consumer-oriented portfolio companies are affected by the downturn, so we are managing costs there. The non-consumer businesses — defense, media, and infrastructure — are all doing very well. Energy and power are also doing well and taking advantage of opportunities.

In this new investing arena, there is an unprecedented opportunity to buy performing, senior bank loans at very attractive yields. If our investors are getting zero percent on their Treasuries, 15% on the first tranche of senior bank debt probably isn't a bad investment for them.

We are also looking at other structures that make sense, such as minority investments where you don't trigger a change of control for the capital structure, and we're also looking at all-equity deals in which you don't need the debt markets. As far as industries go, we are sticking with what we know.

Sorrel: We raised a fund two years ago and had a final closing of $800 million, so we had the good fortune to be out of the market during 2006 and 2007. Because of that, we have a relatively clean portfolio today. Admittedly, some of this might be good timing.

But our focus is quite similar to what Paul was saying. We are making sure these young companies are being thoughtful about the capital they have. Many of these businesses, in general, are sub-$250 million enterprise-value companies. They are good at what they do, but they haven't navigated this type of environment for the most part, and CEOs of young companies are often very optimistic. We are working with them to be thoughtful and pre-meditated.

We also made a couple of tuck-in acquisitions recently. In December, we bought a pipeline of generic drugs and also a research-and-development operation for one of our businesses. We were able to execute the latter transaction at a fraction of what it would have cost us a couple of years earlier.

On the new deal front, we are being patient; that's the watch word today. We expect this to be a long, tough run. A lot of what's going to happen in the real economy is still ahead of us. Obviously, those of us who live on Wall Street have endured a very dramatic twelve months, but we're still at the beginning in terms of what we are going to see in our portfolios.

We focus mostly on business-to-business. But even there we haven't seen it so much in the financial results yet, although we are starting to see it in the backlogs of some of these companies. You tend to see a lot of big customers delaying their decisions.

Thorn: As a firm, we are a little different because we have a number of investment activities. We actively trade credit, so we will invest in fundamental credit positions, both long and short, some of which is distressed. We also have a private lending business where we will originate financings and lend to companies that are either in or around restructuring situations. And we also have a control-private equity business that will make equity investments in restructuring situations.

Because of that, we have a lot of flexibility in how we look at different situations. Our approach today has been largely focused on the massive dislocation in the credit sector. There is an unprecedented level of distress in high yield, where roughly 80% of the high-yield index is trading at traditional distressed levels.

> "A lot of the situations today and going forward are not going to be about buying businesses in their entirety with debt and equity."
>
> Wray Thorn
> Managing Director
> Marathon Asset Management

You're also seeing approximately 15% of the investment-grade corporate index trade at distressed levels. There are a number of good companies with strong business prospects and solid capital structures that don't have default risk but are still trading at distressed levels. Those are some of the areas that we are intensely focused on today.

As we move forward in the credit cycle, there will be a lot of restructuring opportunities to buy the credit of companies that are either cyclical in nature, so their earnings are being impacted, or they are over-levered and need a cushion. We are starting to build total positions in companies that fit that description, where we can invest new capital and equitize our debt positions as a part of that to ultimately end up with an equity investment in the business. Those are going to be some of the best opportunities for returns that we will see.

“Across the capital structure, because of what everybody is facing in the financial industry, there is a willingness to address problems today.”
Thomas Arenz
Senior Managing Director
Harvest Partners

Mergers & Acquisitions: *It's interesting that you mentioned the high-yield spreads. They are trading at levels that imply losses akin to those of the Great Depression. Whether the defaults will come to fruition or not is a different story, but it's interesting that they are so excessive.*

Thorn: It is very much a name-by-name market, so the credit work is extremely important. Doing intense credit work around those companies, and identifying where in the capital structure to play is what will create the opportunities for outsized returns. A number of those companies are going to default and will need to go through restructurings. Recoveries are going to be a lot lower this time around because of the leverage, the complexity of the capital structures, the depth of the downturn, and because companies have a lot more financial flexibility before they have to enter default. So companies that are entering into a default or a bankruptcy situation are much further along in their credit deterioration than they would have been in previous cycles.

Schwartz: At Fenway, we're seeing a pretty slow and methodical pace of investment, which is a reflection of our strategy to target profitable but under-performing businesses in niche markets such as transportation, consumer distribution and building products. Our philosophy has always been that the best way to make returns, at least the most consistent way to make returns, is by leveraging the operations of the business, not by leveraging the balance sheet.

We started this discussion with the question about whether to take an offensive or defensive posture. I guess I would argue that that may be the wrong way to characterize whether or not you are doing deals versus focusing on internal opportunities. What I would say is that each of our jobs is to chase the best risk-adjusted returns for our investors. I would argue that, oftentimes, this can be accomplished entirely inside the four walls of an organization and sometimes acquisitions can assist.

I agree that we are in a very different type of environment. I don't think it's the Great Depression but I'm pretty certain it is, at a minimum, a “great” recession. It is a different type of recession than any of us, or probably any of our parents, ever experienced in their professional lives. It is a credit-induced recession rather than a demand-driven recession. My sense, and I think our firm's perspective, is that those sorts of shocks to the system take a lot longer to heal and they are generally a lot deeper.

In the last four to five months, we have seen a morphing from what was just a financial crisis into both a financial and economic crisis occurring simultaneously. How those play out and how they feed back to one another is probably going to be one of the defining challenges for all of us in our professional lives over the next 10 years.

Almeida: We are currently putting the finishing touches on a $3.5 billion equity fund. We also have a $1.3 billion captive subordinated debt fund, which we use to support our equity investments and we recently raised a new roughly $4 billion equity fund. Fortunately, we are fairly well capitalized to participate in what we expect to be an attractive market as it relates to opportunities in the next handful of years.

We focus on two industries. One is healthcare, which, fortunately, isn't as cyclical. It has its own challenges on the regulatory front but it's not as impacted by the economy as some of the other spaces. Our other focus is what we call information and business services, which, depending on the company, tends to have second or third derivative exposure to the economy. It's not directly touching the consumers, per se, but it's certainly more cyclical than healthcare.

In terms of whether we are playing offense or defense, my simple answer is that everyone in our industry is playing a certain amount of defense right now. Anyone who is not focusing on cost cutting and keeping their companies well capitalized and positioned to weather what we expect to be a multi-year economic storm probably isn't paying attention. Fortunately, we started doing this in early '08 as opposed to waiting for the problems to fester until later in the year.

As far as Welsh Carson is concerned, we were fortunate, and I think it was intentional, that we didn't participate in the credit-fueled buyout binge in '06 and 2007. Our overall portfolio is reasonably well capitalized. Also, over the past three or four years, we have built up an 18-person senior executive group. These are operators; folks who work on the ground with our companies. They're looking not only at defensive issues around cost cutting, but more importantly, they're thinking about growth initiatives in terms of taking advantage of the environment to strengthen market positions.

On the deal front, as it relates to our portfolio, we are selectively looking at acquisitions to grow our less cyclical companies. We are also looking very hard at buying back debt for portfolio companies and taking advantage of the dislocation in the credit markets. Buying the debt of companies that we know well, looking at the risk-adjusted returns, is probably a once-in-a-generation type of opportunity.

On the new deal front, I would say our overall view is fairly cautious. We are industry specialists, so we try to always approach things from a fundamental-value point of view. However, when you are looking at opportunities and you can't forecast earnings that are six months out, let alone 12 months or two years, it makes it very hard to come to a fundamental value today. This is an economy that none of us have ever seen before.

Our view is that we will give up some of the upside that would be there if we got in early and we'll wait for a little more clarity before we get overly aggressive. That having been said, we believe the next handful of years, is going to be a once-in-a-generation opportunity. It's just a matter of not being too early and catching the proverbial falling knife.

Carles: We are more than halfway through our fourth fund, which is a $1 billion fund. Our firm is interesting, because basically half of our partners come from a restructuring background and the other half are more traditional LBO guys. The restructuring folks have focused a lot on healthy companies over the last few years given the limited number of prospects in the restructuring space. Obviously, that market is coming back for those guys in a big way and the flow has certainly picked up. Despite all the press, though, the actual restructuring of many of these companies has yet to hit.

Right now is not a time to jump the gun. But it's important to be ready to move quickly with some of the changes in the bankruptcy law and the changes in capital markets. The readiness of firms to move quickly through controlled debt investments will be critical. A lot of these bankruptcies are going to happen pretty quickly and the courts are going to be overwhelmed. When that wave does crest, hopefully our firm will be positioned well.

Surprisingly, we have been pretty active. We closed three deals last year. We are primarily looking at businesses in which the multiples are at a level that compensates for a high degree of economic risk or we're buying into industries that are either counter-cyclical or non cyclical. We made a major investment in a food distributor; another investment in a capital goods company that had a very long backlog; and we just closed an investment, in December, in a company that makes hunting products, which, surprisingly, is a non-cyclical area.

> **"As time went on, the leverage markets largely shut down and financing went from being difficult to impossible."**
>
> Paul Aversano
> Managing Director
> National Practice Leader
> (Transaction Advisory Group)
> Alvarez & Marsal

Financing the deals was tough. Someone made the comment about credit moving from difficult to impossible, and that's correct for some big parts of the capital structure. We raised about $380 million of private high-yield debt last year through alternative providers. Unfortunately, many of those opportunities are now gone.

"For the rescue-equity investments to be compelling, though, the buyers are going to take their pound of flesh from somebody."

Alexander Carles
Partner
Wellspring Capital Management

Most capital structures we see now have a very heavy ABL [asset-based loan] component with a small tranche of private debt or seller paper. There needs to be something to balance out that private debt, which right now is at exceedingly high price levels. Beyond the cost of the debt, we struggle with new deals on call protections and things like that, because after things do change, you are going to have this thorny piece of paper that's killing you when the tide turns.

From a defensive standpoint, we are really beating on our [portfolio companies] to say, 'You have got to take the costs out now in advance of what is going to be a worse environment than you think.' Also, we have looked at our supply chain in virtually every company.

When the economy was going well, those are the types of situations where we would get a lot of pushback. What's happening now, as the economy softens, is we are forcing people to go back and re-examine their supply chain. New business opportunities may be limited, but companies can revisit a number of assumptions that were made about everyday business. They can re-contact those vendors and begin negotiating. And if you don't have the expertise in house, go out and get it. We have actually had a lot of quick wins with the simple stuff.

Arenz: We are investing an $850 million fund right now. We held the final closing in 2007 and haven't deployed much, so we have a lot of capital that's available to be invested at this point; nearly $700 million. Over the last couple of years, we felt conditions were extraordinary for sellers, so we found ourselves exiting a number of portfolio companies that we had bought in the early part of the decade. Right now we don't have as many portfolio companies, frankly, as we would normally have. We have a handful instead of eight to 10 at the moment.

All of us are really looking at entirely new playbooks because of the lack of credit that's available and the overall economic weakness that all of our companies are experiencing. It really is causing us to look hard at how we deploy capital. The traditional method of getting a dozen books a week from a variety of sources is over for the near term. We have undertaken some deep dives in various industries that are potentially interesting. This is a market in which all of us have to be active in generating our own ideas. It's really more of a custom deal market than it's ever been.

We are also looking at senior debt; not only in middle-market companies that we may be familiar with, but also in some of the larger names. Senior debt in some of the large LBOs is very attractive, with returns of 15% to 20% without leverage, which is unprecedented. We are looking hard at those.

All of us, I think, are also looking at non-controlled ways to invest capital. It could be an investment in a public company through a PIPE, or we've also had conversations with other middle-market firms about companies in their portfolios. They may have a position in an older fund; they know that it's not the time to bring a company through a normal auction process, so they will consider bringing in an investor. It allows for some liquidity. Maybe they make a couple of turns on the equity they invested, so they can show a return, and that might help facilitate a fundraising.

We are also looking at corporate spinoffs. We have been meeting with a number of banks to explore those, but the problem there is that some of the better companies trade at multiples that exceed the prices we would pay for a business. Those transactions are dilutive to a corporate seller so we are not seeing a lot of that yet.

Rescue financing, I think, is another interesting area to look at. Companies are facing debt maturities. They can't refinance at current levels of leverage. So you will find a sponsor who says that they're willing to take on a new equity investor as a way of facilitating a refinancing.

All of these things are somewhat new. I don't think any of us had to employ this level of creativity over the last several years. Some did to a degree, but things have changed, and all of us have to rewrite the playbook.

Samson: At Platinum, we are investing right now out of a capital pool of just under $3.5 billion. Our latest fund held its final close in September of last year, so our timing is impeccable, although we had been chipping away at fundraising for about eight or nine months. We are very much playing defense and offense, but this market is perfect for us. We are set up to do value investing. We have historically been value investors, so we have a big component of the firm that is operationally focused, which means we have a lot of resources to attack turnaround situations and restructurings.

We had the wisdom, I guess, to build a distressed debt capability about a year ago and I can tell you that this is a busy place right now. We are very much looking at that strategy, which is kind of a new thing for us. The firm has really been built around buying non-core divisions, or orphans, out of large corporations. We have mastered that particular discipline in terms of throwing our operational people at complex carveouts and partnering with large corporations to execute deals that just aren't that easy to get done. The appeal to these deals is that they're not conducive to heavy auctions because of their complexity. I see that market being vibrant in the future and we are going to be aggressively hitting the road on that initiative since it's always been at the core of what we do.

The firm has branched out over the years and we have done public to privates; we have bought businesses from entrepreneurs; and this latest focus on distressed debt is, perhaps, a new way of addressing the market that we are focused on, but the values are the same.

We are a culture of hands-on, detail-oriented people. We are ultimately control investors, so we like to affect change or get involved operationally without necessarily running the businesses. But I think that in a market like this, understanding the operation of a business and where the fixed cost line may be is critical.

We have 22 companies. We have people at Platinum on the ground knee-deep in these companies. Their responsibilities may range from helping to complete a turnaround that might have been initiated six months ago to taking advantage of an attractive market position because we expect a lot of competitors to be very weak in the next 12 months. There is a sense of urgency at Platinum that is renewed. Not that we have ever not had a sense of urgency, but we are expecting a tough 2009. There is a big focus on the portfolio and doing what's right, and being decisive about it.

On the new deal front, we are being cautious and realistic, but we are aggressive. This is a market for us to find ways to put capital to work. My personal view is that there will probably be very few deals completed in the next 18 months that we regret. Assets, in general, are re-pricing, whether it is consumer goods or real estate. It is difficult for anybody who is in the business of valuing assets to really figure out what they are worth right now, so caution is a big theme.

Morgan: At Castle Harlan, we have about $4 billion of assets under management, of which about $1.5 billion is liquid. That includes our fifth US fund, which has yet to deploy any capital. We are also in the process of raising our third fund in Australia.

We are doing a lot of the things that have been mentioned around the table. One thing that might be a little different is that we spend a lot of time looking at complex international transactions, targeting companies that may have $20 million to $100 million of Ebitda and

may operate in as many as 12 different jurisdictions. It can make the legal complexity and financing complexity even more challenging. I think you need to have an aptitude and a desire to wade out there and approach these businesses. There are going to be some very, very compelling opportunities globally.

In addition, there is a defensive aspect. Having a global perspective has been critically important in terms of sourcing for companies and understanding the dynamics of low-cost countries. In terms of offense versus defense, though, I think we have 22 portfolio companies in the US and Australia and $1.5 billion of fresh cash, so like everyone else, we're trying to keep a good balance.

"Having a global perspective has been critically important in terms of sourcing for companies and understanding the dynamics of low-cost countries."

Howard Morgan
Senior Managing Director
Castle Harlan

Offensively, one of the things that hasn't been mentioned is the prospect of potentially over-equitizing, if not pursuing all-equity type deals. Of course, the price needs to be fairly compelling.

Historically, we have invested most of our capital at an average of around six times Ebitda. So an all-cash deal probably has to be materially south of that. There are structures to give additional upside to sellers, such as seller paper and earnouts, which are now doable. These things were largely banished for the better part of five years. But we closed an add on in November in which a significant amount of the financing ultimately came from the seller. That was a recognition of feedback from the capital markets.

From a diligence standpoint, people have talked about patience. Our view is that it's going to take even longer to do deals in this environment. I have always thought it took at least nine months to get a deal done, start to finish. It's just about as long as it takes to have a baby. Now I'm expecting it will take at least that long or maybe longer.

Mergers & Acquisitions: *Since you are all effectively owners of businesses, I wondered if you could share some anecdotes about how you tried to save costs at the portfolio level.*

Rossetti: I can provide one approach we took. While each company is doing their own thing and their own circumstances vary, we got everybody together last year — all of the CEOs and CFOs — and had each of them come up with a contingency plan for how they would deal with their own cost structure.

We got them all together to share ideas. It turns out that one of the CEOs had been a turnaround specialist, so he probably contributed the most ideas, but it was a way for them to cross fertilize their best practices among the group. Everybody had their own story of accomplishment of what they could get done in a certain area. Other management teams, for instance, could see that it was actually possible to take lease costs down by 30 percent.

At the end of the day, it was people in the same positions who were able to share ideas, as opposed to some outsider telling them to go do something. They walked away energized with a whole list of ways to attack costs.

> "If our investors are getting zero percent on their Treasuries, 15% on the first tranche of senior bank debt probably isn't a bad investment for them."
>
> Paul Rossetti
> Managing Director
> American Securities

Sorrel: For the most part, our portfolio has smaller companies than a lot of the people here. So really, the history of our practice has been to help companies build out their resources and help professionalize the business. Those kinds of challenges are the same more or less in any environment.

We are also oriented toward growth. And in this kind of environment, cutting costs and growth investing are somewhat at odds with each other. What we have been doing in a number of cases is going to our portfolio companies' largest customers and most important relationships and trying to retool how we work together to broaden and deepen what we are doing and establish longer term commitments.

It's offensive and defensive at the same time. It results in spending money more efficiently, taking some cash and investment out of the process, but ultimately, it should reduce costs as well.

We are assuming we will be with these companies five, six, seven years. We take the view that these aren't two- or three-year builds.

Thorn: One of the key elements for us is having the right management team. And in almost all cases, we will attempt to work with the management team that we initially supported when we made the investment, although we will always try to augment that group.

We have an operating bench of professionals that are former industry executives, CEOs and CFOs who have experience in turnaround situations. We will initially supplement the existing management team with these professionals.

In some cases, though, we will find that the existing management isn't experienced in this kind of environment. So we will be in a position in which we need to change management in order to drive profitability improvements.

Mergers & Acquisitions: *To follow up on that point, it must be a difficult decision to bring in new management.*

How does that work? How do you go about that without disrupting the day-to-day operations of the business?

Thorn: It's one of the more difficult decisions you have to make as an owner. It is not only your responsibility, but it's also one of the ways that you can change the direction of a business. I would say in most cases that have required a change, we have looked back and said, "We really should have done this earlier."

Inaction can be the biggest mistake a manager can make. So we are looking at situations in which our management teams aren't aggressively reacting or planning ahead. Those are typically the situations where we feel like a change is necessary. And once we have made that decision, we try to move aggressively and quickly to find a better alternative.

One thing that we have the ability to do as private equity owners, particularly in the middle market, is attract higher caliber managers than the companies on their own would otherwise be able to attract.

Schwartz: Probably going back nine or 10 years ago, the firm, in hindsight, misjudged a particular executive. Shortly after we removed them, one of our junior analysts asked if we've ever regretted getting rid of someone. It was one of those ironic-but-profound moments; we concluded that if you thought about making such a move three times, then you probably thought about it one or two times too many.

Obviously, you have to stay dispassionate in terms of how you assess people and not act on a whim. But the flip side of it is that so much of this business and creating value is an art rather than a precise science. If you have a level of discomfort about someone's ability to execute, it's probably time to make a change.

A corollary is we also believe that you shouldn't have to tell a manager that they need to remove their subordinates. At that point, you need a new manager because they are not properly assessing the capabilities of the people that work for them.

Mergers & Acquisitions: *It must be tough to apply this level of scrutiny across borders. How do you pay closer attention to what the management is doing at a business overseas?*

Morgan: We always have local partners. We built our Australian business by acquiring half of a business that had already been doing private equity there for 10 years. In growing our Singapore office, we have hired some locals as well.

I think that the exciting thing about investing outside the US is that there is still probably more to be done. We can go back to the future and pull some tools out of our kit that we were employing maybe five or 10 years ago.

On the cost side, for instance, we have actually been a little more focused on full-cost allocation. Maybe

it sounds arcane, but historical standard costs might be the devil in the detail of a lot of businesses. They are selling things that they don't really understand what the true cost is or what the true margins are.

Rossetti: Similarly, we opened a Shanghai office a little over two years ago to focus on sourcing and also global strategy, and the early returns have been great. It really helps you think globally and figure out how to deal with low-cost labor areas. It teaches you about the cultural differences when dealing in China, which is important because those issues can be extremely sensitive. It also just gives you a perspective about how to cut your costs in a global environment.

We started out just doing sourcing for the portfolio companies in China and Asia. We then expanded it to be a global strategy group, which turned out to be the most valuable piece of it.

Mergers & Acquisitions: *Switching gears a bit, can we talk about how the financing market will impact how you invest in the future?*

Thorn: A lot of the situations today and going forward are not going to be about buying businesses in their entirety with debt and equity. It will be more

> **"In the absence of DIP financing, the conventional wisdom is that you better get your act together and restructure out of court."**
> Louis Samson
> Principal
> Platinum Equity Partners

about taking the existing capital structure of the company and figuring out how to make it work.

There is something like 175 companies, public companies, with a market cap greater than $500 million where the enterprise value is 75% or more comprised of debt. The point is that there are a lot of companies that have too much leverage, but as buyers, we need to figure out how a new investment can bring that leverage back in line with the company's current earnings prospects.

"There are some interesting opportunities for private equity firms to step into existing capital structures."
Aron Schwartz
Managing Director
Fenway Partners

And then, as a control-equity investor, we need to bring all the skills that we talked about earlier in terms of value creation to the company post close to help it improve its earnings.

Schwartz: There are some interesting opportunities for private equity firms to step into existing capital structures. Whether it's another sponsor or an equity holder who wants to preserve some of their current position but can't without new equity, we think these situations could be interesting.

The other thing that is very different is with respect to add-on acquisitions. If you have an existing capital structure that's compelling and you see a possible add on that is compelling, the irony is that you may need to refinance your primary capital structure to complete the deal. That's where we have been using what I would call seller and buyer paper. The goal is to keep the capital structure in place, and figure out which debt in the target's capital structure can be retained. Everything else has to come from either new equity, which means you have to pay a lower price to justify an acceptable rate of return, or from the seller, who may provide some of the leverage that you would normally seek from third parties.

Carles: It's sort of an expectation reset. You have a bunch of GPs who know they have a problem, but it has taken a while for it to sink in. For the rescue-equity investments to be compelling, though, the buyers are going to take their pound of flesh from somebody. The expectation reset occurs when the GPs concede that they can't do it alone and they decide that doubling down may not work either.

We have looked at a number of deals in which we would have come in, but it's very difficult as a control investor to have both sides appeased.

You also have lenders out there who two years ago beat their chests saying, "I'm willing to own this asset, so I'm going to loan against the enterprise value." A lot of these guys have had significant redemptions or they have their own portfolio issues.

As you look at the landscape, the question that I have is whether the GPs — as they reset their expectations — are willing to take on significant pain when they let new capital in? They will also have to ask how that impacts their LP relationships, although maybe, with the new valuation rules, that changes things.

On the financing side, you have seen some debt exchange offers take place over the last four months. That has not happened as much in the middle market, partially because our capital structures are very clearly delineated as first lien, second lien or first lien and sub debt. But in the larger market, you're seeing certain debt holders say, "I'm not at 100 cents on the dollar, so do I go through a bankruptcy? Does new capital need to come in? Or do we just need to re-scramble the egg?" In these cases, everybody is forced to share what is an unfortunate situation.

There are going to be opportunities. But the question is: How quickly is that money going to go out and will people reach an agreement on some of those out-of-court restructurings?

Samson: It's very hard.

Carles: There are a lot of constituencies that have to be made happy.

Samson: In the absence of DIP financing, the conventional wisdom is that you better get your act together and restructure out of court because liquidation is the other option.

Almeida: A handful of these investment bankers who do restructuring work have actually tried to pitch us on providing the DIP financing. They'll say that if it's a business you like, you get a leg up. You get to see the business for a while, and in the meantime you collect a return in the mid teens.

Now, I don't know that that's our business, but it's an interesting approach when you know you like the asset. It gives you a perspective on it before the process starts and it puts you in a poll position.

Arenz: Across the capital structure, because of what everybody is facing in the financial industry, there is a willingness to address problems today. In the past, a sponsor would say, "I'm going to keep it alive, see if the economy gets better, and try to pull a rabbit out of a hat."

Samson: I think the debt providers might be more realistic than most sponsors because they have deadlines, so they have years in which it's smarter to restructure certain things. Broadly speaking, I'm always skeptical at the ability of GPs to crystallize a loss. There is a lot of politics involved with the LPs that might involve fundraising dynamics.

Arenz: If there has ever been a time where there is cover, when you can say, "It's not working out as well as it's supposed to," it may be now. You're not saying, "I failed," but rather that it's not working out the way it was supposed to, so you may see different attitudes.

Morgan: And we are living in a FAS 157 world with mark to market, so it's fundamentally different than any other time in private equity.

Carles: Actually, in situations in which you are negotiating with lenders, you have a reasonable basis for saying that each additional dollar of capital, given how few opportunities are out there in the market, has to have a very attractive return profile. And outside of our portfolio, I have seen a list of 50 bank deals that have been amended over the last six months, and it's shocking how little capital went into those companies.

If you are a creditor in a situation and new capital is out there, I would think that there has to be a newfound appreciation for new capital, and you are going to bend to bring it in.

Almeida: But you have to have a real point of view on the business. That's the only way we would ever look at something like that.

Mergers & Acquisitions: *In the last couple of months, we have been bombarded by media stories about fraud on a massive scale. When you engage in an investment, how do you make sure you protect yourself and your investors?*

Schwartz: Fenway, unfortunately, had a very public fraud in its first fund; a company called Aurora Foods. Actually, some might say it's unfortunate, but the conduct of our board upon the discovery of the fraud became the template for the Sarbanes Oxley requirements when fraud is discovered.

Coming out of that situation 10 years ago, part of the reason we are as operationally engaged goes back to our fraud avoidance strategies that we implemented. It's very easy or it is much easier for a C level executive to both have the incentive and the ability to mislead. It is much more difficult for a C level executive to do that if you are two or three layers deep into a business.

> **We are being patient; that's the watch word today.**
> Lawrence Sorrel
> Managing Partner
> Tailwind Capital

We will spend the first 100 days at our portfolio companies building a reservoir of knowledge and relationships. On top of the operational benefits, that is partly about making sure that the junior accountants or the junior person on the sales team is very aware of who I am and that I can be trusted.

The other thing I would say is that I personally believe that most frauds are created in times of excess, not in times of distress. Most become visible in times of distress, but it is jealousy more than fear that drives people to commit fraud.

The irony is that in times like this, I worry a little less about the fraud and due diligence right now. Three years ago, it was very easy for people to cheat and it was tougher to determine what was cheating and what was just the momentum of a very strong economy or business. M&A