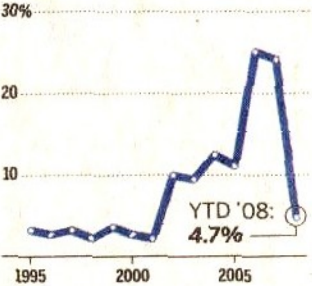
Buyout firms limit debt as credit ebbs

Financing squeeze forces strategy shift

By Becky Yerak
TRIBUNE REPORTER

Private-equity financing

As a percentage of funding for all U.S. mergers, acquisitions



SOURCE: Dealogic TRIBUNE GRAPHIC

Madison Dearborn Partners LLC has a long record of investing in wireless businesses. Nextel Communications, Omnipoint Communications, Clearnet Communications and Metro PCS, to name a few, have all been portfolio companies at one time or another.

But a deal this month for Weather Investments SpA, a mobile-communications-services provider, marked a recent departure for the Chicago-based buyout firm in one way: As the first deal in its sixth fund, it wasn't financed with any debt.

"If you look at our last fund, our fifth fund, which was invested mostly in 2006 and 2007, most of those dollars were in traditional leveraged buyouts because debt was cheap, terms were easy, and you could buy great companies with that leverage," said James Perry, Madison Dearborn managing director. "But we're shifting our focus a bit now that credit is tight."

With credit markets stressed and lenders tightening terms, debt-heavy deals have become less common. As a result, some private-equity firms are rethinking their business models, perhaps sitting on the sidelines until credit markets recover, creating more value by improving portfolio businesses, or putting more money into transactions to get them done and planning

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to refinance later when credit markets improve.

Year to date, the value of U.S. mergers and acquisitions is $645.2 billion, of which nearly 5 percent has been by buyout firms, according to deal-tracker Dealogic. For the same period in 2007, M&A activity was $887 billion, of which 30 percent was from private-equity firms.

When it comes to maximizing deal returns, private-equity firms generally have three strategies in their tool kit: improve profits at businesses they buy, sell those businesses at a higher multiple of profits than they bought them for, and use leverage to enhance returns.

"Private-equity firms using high leverage to supercharge returns will have a tough time in this type of market," said Thomas Bagley, senior managing director for Pfingsten Partners LLC, a Deerfield-based lower-middle-market private-equity firm.

Applying leverage

Why do private-equity firms use leverage? Leverage can work magic in deals, Kirkland & Ellis lawyer Jack Levin said at a recent private-equity conference.

For example, let's say a private-equity firm buys a company for $100 million, using $70 million in debt and $30 million in equity. Later, the private-equity firm sells the company for $130 million, a 30 percent rise in value.

It repays the $70 million in debt, leaving $60 million in proceeds for the private-equity firm. The private-equity firm, therefore, made two times its $30 million equity investment, or a 100 percent profit, Levin explained. That assumes that the portfolio company has broken even each year after covering interest charges on the leverage.

Or, let's say the private-equity firm was able to borrow even more, financing the deal with $90 million in debt and $10 million in equity. It later sold the company for $130 million, again a 30 percent rise in value.

The private-equity firm's proceeds, after paying the $90 million in debt, would then be $40 million, or four times its original $10 million investment.

But Levin said leverage also can be a nightmare when a private-equity firm sells a company at a lower value because the leverage magnifies the private-equity firm's loss.

And several Chicago-area private-equity firms, including Baird Capital Partners and Wynnchurch Capital, say leverage isn't even the biggest driver in the returns they make on deals.

"There are firms that build better businesses without the use of high leverage, and they'll not be affected by current market conditions," Pfingsten's Bagley said.

His firm typically finances its deals with at least 50 percent equity. Peer firms typically invest 25 percent to 30 percent, he said.

Wary underwriters

Chicago-based Water Street Healthcare Partners' returns are mostly derived from improving the sales, profits and competitive positions of portfolio companies, "as opposed to leverage and financial engineering," said managing partner Tim Dugan. "That's not to say we don't use leverage, because we do, but it's not our principal driver of returns."

Water's bigger headache is that debt financing is harder to find and more expensive.

"A year ago, we might prescreen five lenders and select one who'd underwrite the transaction and syndicate the loan to the remaining group," Dugan said.

In early June, Water bought a stake in two medical-products suppliers and is merging them. To do the deal, it initially talked to a dozen lenders.

"We assembled a club of five lenders who individually spoke for their piece of the transaction, but nobody underwrote the entire transaction, and that's typical today" because lenders are more jittery, Dugan said.

"They'll do a 'best efforts' syndication in underwriting, but it's not a true underwriting, meaning they'll speak for and stand behind that commitment. Instead it's, 'Here are terms we think we can get done, and we'll use our best efforts to get it done, but we're not standing behind those terms.'"

Its recent deals for California-based Tri-anim Health Services Inc. and Ohio-based Bound Tree Medical Products exemplify Water's strategy for driving returns.

"In merging these two companies, we're creating a clear market leader with better scale, stronger infrastructure and better access to customers," he said.

Similarly, leverage enhances returns for Thoma Cressey Bravo, but it's not the chief way that the private-equity firm makes money, said Lee Mitchell, managing partner in Chicago.

On average, 77 percent of Thoma's returns are derived from growth in portfolio companies' earnings before interest, taxes, depreciation and amortization. Profits are boosted through operational improvements, such as cutting personnel and facility and marketing costs, and later through add-on acquisitions.

About 3 percent of Thoma's returns come from "multiple expansion," or when a private-equity firm buys a company for, say, six times earnings and sells it for eight times earnings. The rest, about 20 percent, comes from leverage, Mitchell said.

"Leverage helps, and the more you can get, the better because it enhances returns," he said. "But if, before all these credit market problems, we could finance an acquisition with 60 percent debt, and now we can finance with 50 percent debt, that's not going to make an enormous difference" to overall returns.

"With our strategy, what makes the difference is operational improvements and add-on acquisitions," he said. With less debt available to boost returns through leverage, "you've got to work a little harder on operational improvements and on getting acquisitions done."

Disciplined approach

What do private-equity fund investors think?

"When leverage becomes scarce, [private-equity] firms are forced to be more disciplined, paying lower multiples and creating value in portfolio companies through operational improvements," said Scott Malpass, University of Notre Dame chief investment officer.

"Although the recent credit crisis is more severe than we've ever seen, we've been through cycles before where leverage is more or less available, and we prefer to partner with [private-equity] firms that create value through operational improvements and strong management."

Madison has regularly made low-leverage deals in growth companies since its 1992 founding. Those deals occur when a target company can't go public or doesn't want to or can't add leverage, yet it wants to grow or make acquisitions, or it wants to refinance debt.

In fact, many of its earlier wireless deals were similar to Weather. Madison invested in equity securities not linked to debt financing.

The deal by Madison and two other private-equity firms for Weather will help the company's majority shareholder refinance debt from an earlier acquisition.

"He had financing from the seller coming due, and so we financed that with an equity security," Perry said. Madison invested $427 million in a convertible preferred stock.

There is an upside to tighter credit: more affordable targets.

"If you look back at periods where credit was difficult to get or the economy was on the ropes, those were the best times to invest because you could buy a business at better values than when credit was readily available and prices for companies rose," he said.

Then, when the economy improved, they refinanced, raised debt to pay a dividend, or sold the company at a higher price.

"As dire as things look now, five years from now, we'll probably say that it was a pretty good time" to make money on deals, Perry said. "Boards and owners are more reluctant to sell when prices are lower, but the deals you can do often offer a better risk-reward than in highflying times."

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