

The Private Equity Economy **By KATE BERRY - 10/31/2005** **Los Angeles Business Journal Staff**

The giants of finance these days are no longer found just on Wall Street.

In small offices all over Los Angeles, firms that specialize in corporate buyouts and distressed debt – which fall under the broad umbrella known as private equity – are operating like stealth fighter pilots capable of taking over nearly any company in America.

Though their buyout targets tend to be private companies run by entrepreneurs, or the orphan units of large conglomerates, the goal is the same: to throw off returns of 20 percent or more by heaping on debt and improving cash flow through aggressive management.

Through the first three quarters of this year, 100 U.S. firms collected \$70.1 billion for private equity buyout funds, according to Private Equity Analyst, which is published by Dow Jones & Co. That puts 2005 on target to top \$100 billion in fundraising, besting the record set in 2000 when 151 buyout firms raised \$75 billion.

Private equity has flourished because low interest rates make borrowing cheap. Debt financing allows companies to borrow as much as eight times cash flow while still paying out handsome dividends to institutional sponsors.

“Despite all the competition, private equity is a lot better than the public markets, with returns far in excess of 20 percent or more,” said William Barnum, general partner of Brentwood Associates, one of the oldest private equity firms in Los Angeles with \$770 million under management. “Most people who are managing money are grappling with it because there don’t seem to be many good places left to invest.”

That’s the accepted view, anyway. In fact, data show that private equity returns aren’t so different from the broader market.

In the past decade, leveraged buyouts posted average annual returns of 8.5 percent, roughly 1.4 percent below the Standard & Poor’s 500 Index for the 10 years ended June 20, 2004, according to Thomson Financial.

Calpers, the California Public Employees’ Retirement System, launched an Alternative Investment Management Program in 2001 that has generated a net internal rate of return of 11.4 percent from its inception through March 31, 2005. That compares with a 10.5 percent average annual return for Calpers’ Customer Wilshire 2500 Index.

Despite its aura of invincibility, private equity investing is still fraught with risk.

Private equity frenzies have led to fiascos in the past, dating back to the much-publicized 1989 leverage

buyout of RJR Nabisco Corp. by Kohlberg Kravis Roberts & Co.

High interest rates can cause debt levels to topple a company. An expected turnaround can be crippled by a slowdown in the economy. Management teams can falter. Still, industry players say the good times will continue as long as interest rates stay low.

“Most of the funds are either running out of money or their investment period has expired, so new groups are coming out to raise money in full force,” said Scott Klein, a partner at Latham & Watkins who chairs the firm’s private equity group, “It’s a very healthy market.”

There is some fear of faltering returns because of too much capital. With roughly \$100 billion of uninvested cash searching for high-quality companies, executives say it’s becoming harder to find investments.

“Are there too many private equity dollars for the number of opportunities out there?” asked Murray Rudin, a partner at Riordan Lewis & Haden. “If there are, then the rates of return should decline in the industry. People show a lot of angst about too much money chasing too few deals.”

An example of how hard private equity firms are searching for deals is the proposed plan to buy El Segundo-based Computer Sciences Corp., which has a market capitalization of \$9 billion. As of last week, talks were in the early stage with the proposed buyers including Blackstone Group, Texas Pacific Group and Warburg Pincus – three of the largest private equity firms in the U.S. – teaming with Lockheed Martin Corp. in a plan that would split up CSC.

“In the past, these cycles of private equity shops paying more for businesses have tended to end badly,” said Rudin. “The pendulum tends to swing a little too far in one direction.”

Beating the averages

Many L.A.-based funds look to beat the overall market primarily because they tend to buy and sell mid-size companies that are too small for larger private equity firms to bother with.

“We’re not looking at those kind of mega-deals,” said James Upchurch, president and chief executive of Caltius Capital, which operates both equity and mezzanine debt funds. “We take a much more long-term approach on our deals.”

There is no strict formula for financing a private equity deal.

Companies invest anywhere from 10 percent to 50 percent of equity, and borrow the remainder through various levels of senior and subordinated debt. For highly leveraged companies, debt often is used as a prod. Faced with steep payments, executives will make radical changes, laying off workers and cutting costs to improve a company’s operating performance.

“If you can accommodate your business plan through debt, then you should do it because debt is a lot cheaper than equity,” said Luis Nogales, founder and managing partner at Nogales Investors. “By virtue of bringing in equity, you can borrow more, it increases the company’s cash flow and you have a stronger balance sheet. We see ourselves as the step in-between a company growing and the time it decides to go public.”

When Nogales started his own private equity firm four years ago, he already had a track record going back 20 years at United Press International and Univision Communications Inc. While working as an adviser to Deutsche Bank's private equity group in Latin America, he met frequently with investors and public pension funds that were eyeing emerging markets.

The first large investment in Nogales Investors Fund I came from Calpers, which was targeting low income and minority owned businesses with a \$475 million fund. He then went on a fundraising trip, getting commitments from Calstrs, the California State Teachers' Retirement System, and municipal pension funds in Chicago, Philadelphia and Contra Costa County.

Nogales even hit up the private equity arms of Wells Fargo & Co., Citigroup Inc. and Washington Mutual Corp., three big banks that were getting their own chunk of investment money to place with minority-owned firms.

The \$100 million fund has invested in G.I. Joe's, a sporting goods retailer in Wilsonville, Ore.; Chick's Sporting Goods in Covina and Video King in San Bernardino. Nogales now plans to raise \$200 million to \$250 million for a second fund.

"The most important thing in starting a private equity firm is to build something that attracts investors," he said. "Everybody wants you to have a track record, and rightfully so, because you're investing retirees' money."

In a typical private equity deal, the strategy is to repay debt within five to seven years. By that time, significant gains in operating performance are supposed to yield high enough returns to compensate investors for the higher risk.

It's a game of patience and ironclad discipline. Most firms take several years before their portfolio of companies starts to produce strong returns. And like any business, private equity is highly cyclical, dependent on the credit markets and the willingness of banks to lend.

Brentwood, for example, invests \$20 million to \$75 million in small, fast-growing consumer products companies, most of them based on the West Coast. It usually installs a new chief executive who can wring out inefficiencies in the business and drive up value over three to five years. Then the company is sold off and the cycle of raising money to fund new investments starts all over again.

The biggest investors are large public pension plans like Calpers, which funds the retirements of state and local government employees, from teachers to cops. Public and private pension funds have been looking for ways to get higher returns than the stock market will deliver because many plans are under-funded.

For years, politicians have refused to adequately fund pensions or have handed out too-generous retirement packages. Other funds have simply made bad investments.

A recent study of 64 state pension plans by investment advisory firm Wilshire Associates found that 54 of them were under-funded by \$175.4 billion. Municipal plans are in even worse shape, evidenced by San Diego, which is on the brink of bankruptcy because of a \$1.4 billion deficit in its local pension plan.

Since the stock market is expected to provide returns of between 6 percent and 8 percent for the next few years, pension plans and wealthy individuals are rolling the dice on alternative investments. And some funds have delivered.

“Almost all the companies in our portfolio are up significantly and this year has been phenomenal,” said Jay Ferguson, a partner at Kline Hawkes & Co., a venture capital firm that also is doing private equity deals. “Investors realize that it takes time for these companies to mature.”

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