

Bottleneck; Private equity firms race to the exits to secure realizations before the end of the year

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As of early October, Berkshire Partners had secured six realizations so far this year. The bookend deals for the Boston firm were the sales of United BioSource, which occurred less than a year after Berkshire invested in the company, and the sale of its stake in Advanced Drainage Systems (ADS), coming some 22 years after Berkshire first backed the business. Sales of American Tire Distributors, Electro-Motive Diesel and publicly held Bare Escentuals, as well as secondary stock sales of Crown Castle International made up the balance of Berkshire's 2010 exit activity in the first 10 months of the year.

In the case of ADS, Berkshire managing director Michael Ascione attests that the firm had never considered a sale of its holding until recently. It may not seem like it to some, but the second half of 2010 is indeed shaping up to be a once every quarter century type of market.

To be sure, nobody will confuse 2010 with 2007 when it comes to total deal volume. But for the past two years, sponsors have been in a state of suspended animation, holding off on both new deal activity and exits until clarity returned in terms of leverage and business prospects. With the improvements in the economy, portfolio company performance and the credit markets, sponsors have viewed the second half of the year the same way retailers view Black Friday. And in terms of volume, some bankers have never been busier.

"The salmon are running. You just have an enormous amount of middle-market dealflow," says Justin Abelow, a managing director with Houlihan Lokey who has been in M&A for the past 20 years. "You have [the Bush era] tax cuts that may expire at the end of the year, a pent up supply and uncertainty over regulatory issues going forward. It's a confluence of factors."

The sunseting break on capital gains taxes has been a theme dealmakers have discussed for years. It wasn't until this summer, however, that anyone actually showed any urgency. In one week in August, M&A volume soared to \$89.8 billion. The third quarter, meanwhile, saw global deal volume ring in at \$676.9 billion, representing the highest sum since Lehman Brothers collapsed.

"Private equity monetization activity has picked up considerably," adds Moelis & Co. managing director Roger Hoit. "A stronger economy, robust financing markets and the prospects of tax increases in 2011 has driven deals forward at an accelerated pace. Almost all the deals that were announced this past summer originated in the beginning of the year. The process takes at least that long."

Hoit, for instance, spent more than a year advising VMG Partners on its sale of Waggin Train to Nestle. The deal was announced in September.

Assuming there is no extension of the capital gains tax cuts, deals completed after Dec. 31, 2010, will see increase of 500 basis points in tax rates.

"It's real cash that makes a difference to the seller, but absolutely no difference to the buyer. It's true arbitrage," says Stewart Kohl, co-CEO of TheRiverside Company, which had exited six companies as of the first of October. It's most recent realization was the sale of Stoffel Seals, which generated a healthy 2.7x return on investment and respectable 18% gross IRR.

"If you owned something when the world was going nuts and it was worth \$100 and then the world crashed and it was suddenly worth \$70, than you might become a seller when that asset is now worth \$85," Kohl says, describing the mindset of sellers. "It's not as good as it was, but it's still pretty darn good."

Among Riverside's better exits was its disposition of Commonwealth Laminating & Coating, which generated a 10x cash-on-cash return.

"We have done our job with these companies. We have doubled and sometimes tripled the Ebitda through organic growth and add-on acquisitions. These companies have more upside, but now was the right time to sell," Kohl notes, alluding to the fact that limited partners are hungry for distributions.

While a number of factors have colluded to spur exits, the improved financing market deserves the credit for bridging buyer and seller expectations. Quality middle market companies can expect to get 2.5x to 3.25x of senior debt and another turn to turn and half of mezzanine debt.

"We have seen robust activity for 2010. We're not at the 2006, 2007 levels, but it's certainly been as good as any point over the last 24 months," attests Christopher Williams, a senior managing director with Madison Capital Funding. "The commercial banks and specialty finance companies have been active and I don't foresee that stopping unless there's a total meltdown. BDCs are more active again as well. The only thing we are not seeing is the second lien players returning to the market."

Kohl alluded to it, but in the back of every GP's mind these days are their limited partners. During sponsors' two years in hibernation, the clock ticking on their funds' investment period didn't stop. That means GPs are facing a tightening window within which to put their remaining capital to work. It also means they have to start thinking about their next funds, especially as the time it takes to raise a new vehicle today has stretched out to more than 19 months on average. While there are a host things LPs say they want, the only thing that really matters are the distributions.

"Fundraising is definitely on peoples' minds. It's been a general theme all year," says Madison Capital's Williams. "We have been seeing exits and recaps; basically any structure that will return money to the LPs so the GPs will be in a better position."

Indeed, exits have taken on many forms. In some cases, it's about clearing out older properties, taking whatever profit they can. Oak Hill's sale of Duane Reade for instance produced a small return for the firm, but represented an unexpected victory for an investment plagued by bad luck. Some firms have even resorted to the piecemeal exit to clear out dead wood. DLJ Merchant Banking, for instance, walked away from its investment in DeCrane after 12 years through separate sales of two divisions and a restructuring of its remaining assets.

Others, meanwhile, have used partial sales to infuse portfolio companies with new equity, while maintaining a stake for future upside. Guggenheim Investment Management did this when it sold off control in BPO provider iQor to Huntsman Gay Capital Partners. The return of the credit markets has also allowed sponsors to revisit dividend recaps. KPS Capital Partners has been among the more active players in this segment, tallying at least five recaps resulting in combined dividends nearing \$500 million.

The IPO market has probably been one of the few disappointments for GPs, as many of the high profile buyouts from the bubble, such as HCA, Toys R Us, and Nielsen, have filed S-1s, but have been yet to list shares. The growing backlog - which exceeds 150 companies - hasn't dampened spirits, as PE-backed names such as Restoration Hardware, GNC, and Spirit Airlines all filed for IPOs in September and

October. Even special purpose acquisition companies have re-appeared on the scene, providing perhaps another outlet, with Tom Hicks, LLM Partners and others fashioning new SPACs.

But for GPs, the best bets have been the straight sales, whether it's to strategic buyers or sales to their peers. And considering both groups have sat on the sidelines for the past two years, buyers often appear as anxious as sellers. And for those with new funds on the horizon, the timing couldn't be better.

"It's a really good time to sell," Williams adds. "Many private equity firms are reaching their typical hold period; some have even had to hold longer than they wanted too. They now need to show returns to their LPs."

And many have; some in a huge way. Huron Capital secured a venture-like 18.7x return on its original investment in post-secondary education provider Ross Education. The sale came after a five year holding period and cemented a 76% IRR for the firm. Other notable exits include Arsenal Capital's sale of IDQ to Castle Harlan, which resulted in an 8x return on equity after an eight-year stay in the firm's portfolio.

"Overall now is a good time to sell. I wouldn't call today robust, but things are stable," says Harvest Partners senior managing director Ira Kleinman. "In general private equity portfolios are getting a little long in the tooth and it's time to move. As business continues to improve you will see a lot more companies come up for sale."

Harvest Partners, alongside co-investor Investcorp, recently agreed to exit Associated Materials through a secondary sale to Hellman & Friedman for \$1.3 billion. Harvest had originally invested in the vinyl window and siding maker in 2002.

According to participants in the market, both strategic buyers and sponsors are proving themselves to be aggressive in the market.

"The cost of capital for sponsors is very low and it allows them to be competitive," says Moelis' Hoit.

"However, the strategics are still in the mix, which shows that they are comfortable with their businesses and moving forward with growth initiatives."

To be sure, the experience of some in the market may be wildly different from others. The properties that are generating buy-side interest are assets that are battle-tested. Berkshire's Ascione qualifies that it's a "good exit environment if your companies are performing well."

For those that aren't, Hoit says, "those processes aren't as well attended."

Dealmakers aren't quite sure what to expect when the clock strikes midnight on December 31.

Uncertainty remains in the form economic questions, potential legislation and the sustainability of the credit markets. Assuming the status quo, however, observers anticipate sponsors will continue to demonstrate urgency in their efforts to find the door.

"Some deals just couldn't get done before the end of the year because they weren't the highest quality and firms were focusing on their best assets," says one banker. "These companies will still be in the market and they will find homes."