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It is NOT the L Word

The pervasive success of small deals isn't driven by luck, or even leverage.

By Stewart Kohl and Béla Szigethy

Private equity is dead meat. Whether it's new regulations and tax treatment, a wave of bankruptcies by PE-owned companies, tightening credit, or a backlash against perceived greed and excess in our industry, some people may feel that private equity has outlived its usefulness. We're happy that some aspects of this are true; the industry needed to change and certainly couldn't keep up the pace of the heady days driven by easy credit. But we're happier that rumors of private equity's demise are exaggerated. In fact, our industry is providing guidance, know-how and capital that greatly benefits our investors, portfolio companies, and, by extension, the broader economy.

Béla Szigethy and Stewart Kohl

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A smaller private equity industry will emerge from this tumultuous period. Those firms that survive will truly be the fittest - correctly focused on value creation and able to raise capital when it is scarce. The middle market and the mega funds need new investment strategies and new routes for value creation. Given the intelligence of the leadership of these firms and the stakes involved, we're sure they will emerge, though we can't guess the specifics.

But at the small end of the middle market (deals under $200 million), where Riverside has remained maniacally focused for over two decades, there is no question as to raison d'être and strategy. We will thrive by becoming better and better at buying these little gems and making them bigger and more able. And the prospects in our market are bright: Small is getting more beautiful every day.

Given our positions, you might accuse us of bias, but we have the numbers to prove it. Since the start of the recession in January of 2008 until our latest set of data in June 2009, only one of our companies fell into bankruptcy (out of a current portfolio of 68), and we managed to close 31 transactions in 2008 despite the recession. Additionally, our exits since January 2008 have produced 3.0 gross cash-on-cash return and a 21% gross IRR after an average hold period of 5.5 years, helping clearly demonstrate that building great companies is rewarding even in the worst of times. It also demonstrates that we're not just flipping companies based on appreciating market multiples in the good times; we're building long-term value through hard operational, strategic and financial work.

The outperformance of smaller deals is not a recent phenomenon. Based on data from Cambridge Associates and Riverside analysis, you can see how smaller buyout funds have outperformed larger funds over five, 10 and 15-year timeframes.

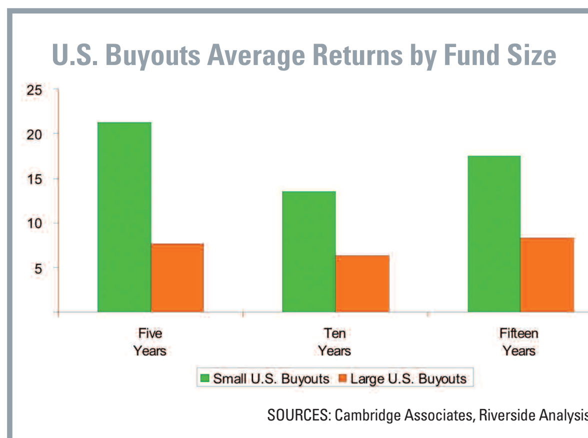
The pervasive success of small deals for multiple decades isn't driven by the "L" word — luck — though that certainly plays a role in most successful buyouts. And it's not that other L word either — leverage. At the peak of the market, cheap debt was not the "rocket fuel" that Carlyle's co-founder Bill Conway correctly labeled it for large deals. At the small end of the middle market it has never been about financial engineering but instead about building bigger and better companies.

Instead, it's about the "A" word: Alignment. It's about buying the right company in the right industry and employing the right CEO, CFO and management team. It's also about setting the correct strategy and then carefully and diligently executing it over a number of years. It's not drive-by investing. We get our hands, arms and torsos not just dirty but at times filthy as we work to polish these gems.

Readers are probably wondering how we can be shamelessly cheerleading during the downturn. Our enthusiasm is rooted in the knowledge that private equity is an ideal ownership model for thousands

of businesses around the world, especially for companies found at the smaller end of the middle market. How? Why?

We hold up our own experience at Riverside to answer these questions. While our companies have certainly been affected by the broad economic situation, they're going to make it through the tough times for many reasons. Among those, they are not highly leveraged (with an average debt to Ebitda of 3x), we intensively use operating expertise, and our companies have been carefully selected, with just one percent of the targets our origination team researches making the grade for an investment. It also doesn't hurt that we've avoided cyclical areas like retailing and nascent technologies.



SOURCES: Cambridge Associates, Riverside Analysis

> Critics tend to miss the fundamental strengths of private equity.

Some of our companies are growing not only despite the downturn, but in some cases because of it. Training and education is one such area, and none of our companies has benefited quite as much as post-secondary career training provider ATI Enterprises. Since we invested in the company in 2004, it has more than doubled in size and shows even greater promise.

Critics tend to miss the fundamental strengths of private equity. We would argue that private equity, especially at the smaller end of the market, largely avoided everything that was out of whack about the US economy from roughly 2003 until 2007. Properly done, private equity provides greater oversight, discipline, management accountability, and long-term thinking, among many other basic building blocks. In other words, it is aligned.

Infamous megadeals involving huge amounts of debt and risk, and massive paydays regardless of longer term success have turned popular opinion against private equity. With that said, the space in which Riverside operates — dinky deals of under $150 million in enterprise value - is reliably fertile ground for managers, the companies in which they invest, and, most importantly, investors.

Decade after decade, little deals just keep happening. For one, there are literally millions of buyout candidates in North America, Europe and Asia. Also, smaller, typically family-owned businesses tap PE to monetize investments following retirement, death or divorce, and private equity can help ensure legacies continue after the owner departs. Moreover, companies need capital to become bigger andbetter. Private equity provides liquidity for expansion, product development, adding key staff positions, and for many other strategic efforts.

Of course, capital isn't just about currency. The best firms provide both financial and intellectual capital. They add value and avoid many of the problems that are at the root of what when wrong in the recent bubble — be it out of whack compensation schemes, poor alignment of interests or a lack of long-term thinking.

The best private equity managers strive to avoid these problems. At Riverside we've been getting better and better at what we do, not just operationally, but also as we fill some gaps that we had as young whippersnappers. We've learned immeasurable amounts after 215 transactions. For example, we now have specialist resources for select industries like healthcare and franchising. We also have professionals and offices all around the world, spreading our risk, helping us pinpoint areas of potential and finding new ways to create value by internationalizing our portfolio companies.

Private equity firms are in the risk capital business, and sometimes we lose. (Over 21 years at Riverside our loss ratio is well under 10 percent.) But when this happens, it isn't because of misaligned incentives. The healthiest firms among us understand that when we get the alignment just right, the world is a better place. So maybe private equity is not dead meat after all. Maybe it's just started cooking.

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