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GUEST ARTICLE

Small Remains Beautiful To The Riverside Company

By Stewart A. Kohl and Béla Szigethy, The Riverside Company

They drive the market for 20,000 square-foot starter mansions, and their founders host spectacular birthday parties, thereby filling the society pages on days when Paris Hilton is feeling under the weather. Of course, we are talking about mega-funds. They buy huge, high-profile public companies and find that large pension funds, who themselves need to find good homes for hundreds of millions or even billions of dollars, are all too eager to provide the necessary capital for the transactions.

But quietly, the subterranean world in which The Riverside Company lives and plays—the smaller end of the middle market (companies with enterprise values of less than a cool \$100 million)—continues to be an attractive area of investment for those private equity groups willing and able to make the investments in people, offices, resources and technology necessary to succeed in this brave world.

Today, private equity firms playing in the small deal space are often paying up for companies that are already improved, that are well represented by capable investment banks, and are a lot more sophisticated about corporate finance and working with private equity firms. So in order to generate net returns of 20 percent or better, you have to do much more to improve these companies. It's very heavy lifting.

How Do We Do It?

In order to succeed in today's small LBO market, we focus on making companies quantitatively bigger AND qualitatively better in a number of ways:

- Management, management, management. Increase the caliber of management and processes used.



Stewart A. Kohl

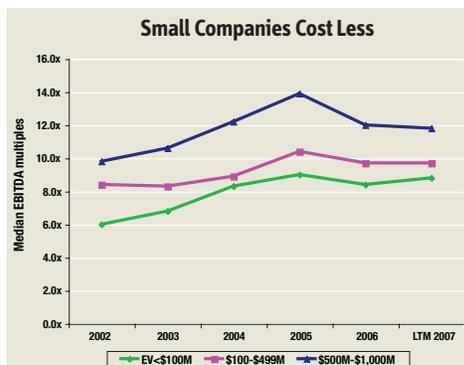
- Add value via access to operating expertise.
- Purchase add-ons and integrate them quickly and effectively.
- Establish a board of directors for oversight and input, recruiting industry veterans and retired CEOs.
- Innovate in areas like product development, customer and product pruning, pricing and geographical growth.
- Source, sell and operate in Asia.

While many of these concepts were considered fairly innovative just a few years ago, today they are viewed as routine when increasing the value of portfolio companies. At Riverside, we embrace this process of improvement as we focus on opportunities to evolve as better owners. Two distinguishable examples include the implementation of our

strategic sourcing program, and the conscious decision to grow globally. Harnessing the purchasing power of our entire portfolio in key areas such as benefits, shipping, telecom, travel and office supplies has resulted in meaningful savings for our respective companies, not to mention the collective increase in equity value. With respect to Riverside's global initiative, we believe strongly in the benefits of being the global leader at the smaller end of the middle market and the opportunities it provides. After all, what other buyout firm would purchase a small blood analyzer manufacturer in Hungary, hire a Scottish-born CEO to run it, help it establish Chinese manufacturing, and look at add-ons in Sweden, Italy, Israel and Germany, all the while expanding its relationship with its largest customer, a U.S. company located in California?

Why Are We Willing To Provide A Roadmap For Others?

The answer boils down to a concept well known to our brethren and "sistren" who do



Source: Thomson Financial and Robert W. Baird & Co. Incorporated M&A Market Analysis. LTM as of February 28, 2007.

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deals: high barriers to entry. While Riverside has a simple buy-and-build business model, the execution behind excellent buying and superior building is complex and labor intensive.

Indeed, working at the small end of the middle market isn't for the feint of heart. For example, we've had CEOs die in a plane crash, be arrested for child pornography, and suffer from debilitating medical conditions. In addition, we've been defrauded three times in our history (that we know of). Rather than bemoan these events, we've built a structure that enables us to deal with the inevitable, unplanned and unannounced developments that require quick action.

And, if you are able to do several successful small deals, it's very easy for buyouts firms at the smaller end of the middle market to follow the light and go up-market. Let's face it, small deals aren't as sexy, especially when they specialize in such things as adult incontinence products as offered by one of our portfolio companies—ActivStyle (you may be smirking now, but just wait 20 or 30 years).

Why Do We Remain Dedicated To Small Transactions?

With stories like that, and knowing that in the old days, small leveraged buyouts were a lot easier and a lot less competitive, we resist the temptation to move upstream for many reasons:

- The fundamental risk/reward proposition is attractive if you can properly mitigate the risks and optimize the rewards.
- While it's no longer like shooting fish in a barrel, you can still purchase small company gems for lower purchase price multiples—generally one to three turns of EBITDA less than their bigger peers, leading to a pot of gold at the end of the rainbow. Once you build them, you can sell these little gems at a higher multiple and enjoy the arbitrage.
- Whether it's optimizing pricing, reducing costs, internationalizing or driving down working capital, there generally are still opportunities to improve the operations of these businesses.
- Because the debt financing options are much more constrained, small deals have less financial risk. They are less levered and so are less likely to gasp during economic downturns.
- In our size deals, we don't have to hold hands with a larger group of investors to get the deal done and then make critical decisions in the future, particularly under adverse conditions when tempers are likely to flare and differences get exacerbated.
- We are excited about the diversified portfolio that we have created for our investors. We



Béla Szigethy

own 60 fascinating little companies spread across North America and Europe.

- There's a wide world of exit opportunities out there for small deals. We're not reliant on the status of the IPO window.

Deals Exist For Fundamental Reasons

Death (fatal cancer prognoses for owners have driven us two deals over the past eight months), succession planning (business owners who are ready to cash out, but are reluctant to turn over their businesses to dopey sons-in-law), divorce, and spin-offs that result from the endless desire of large corporations to refocus their core businesses all generate opportunities in this space. In fact, we're salivating as we expect the mega-deals to drive such subsequent divestitures.

Survival Of The Fittest

There's a lot of discussion right now about whether private equity is a better form of ownership than public stock in the post-Sarbanes Oxley era. We've seen less attention paid to the benefits of private equity ownership in the sub-public world. Here access to capital, management expertise, group buying programs, international intelligence and nepotism are all significant barriers or benefits that can be overcome or implemented, as the case may be, by the best buyout firms. We've been interested by the studies that indicate that private equity-backed IPOs outperform the general IPO market. Darwin seems to be at work, and based on this, we predict that the percentage of smaller enterprises that are private equity-owned will continue to grow.

Proof Is In The Taste Of The Pudding!

Over Riverside's 19-year history, we've bought 159 companies under 87 platforms, of which we've exited 30. Only three times have

we lost capital, and only one other time have we not sold the business for a multiple in excess of that which we paid. In each of the remaining 26 exits, we sold the platforms for a multiple in excess of that which we paid, on average realizing an arbitrage of about three turns. Just looking at last year alone, we exited four of our platform investments, generating a net IRR of 52% and a net value multiple of 5.5x. The average EBITDA for these four investments at acquisition was \$5.8 million. And in each we sold about \$10 million or more of EBITDA to a sophisticated buyer (American Securities Capital Partners, ABRY Partners, Atlas Copco, and Grief Brothers). Over our period of ownership, these four platform companies had collectively completed and integrated eight add-on investments.

Once upon a time, the small end of the middle market was very accommodating. Any small group—often two guys and a dog—could get a deal done. And we were one of them, operating without a fund (and sadly without a dog) until 1995. Just find a deal, buy it cheaply (sometimes even without an investment banker in the middle), lever it up, do a few things to make it better or cut costs, and sell it to a firm of three guys and a bigger dog.

While those days were too good to be true, the opportunity for outsized returns still exists today, but only if you can follow the admittedly difficult and expensive suggestions above. In fact, research shows that over a 20-year period, small buyouts outperform their larger siblings.

In fact, Riverside is so bullish on the small market that we've doubled down on it. In the summer of 2005, we started buying micro-sized companies with EBITDA of \$3 million and less. These are some of the fastest-growing companies in our entire portfolio, and we expect terrific things of these small but mighty heroes.

So don't kiss us small-deal folks goodbye. You won't see us splashed across the front page of *The Wall Street Journal* any time soon, but the curtains have not closed on private equity firms investing in small deals. At Riverside, we continue to believe that great things come in small packages. ❖

Stewart A. Kohl is one of two co-chief executive officers of The Riverside Company, a private equity firm that invests in premier companies at the smaller end of the middle market. He joined the firm in 1993. Béla Szigethy, the other co-chief executive officer, founded The Riverside Company in 1988. Under the guidance of Kohl and Szigethy Riverside has expanded to employ 130 people in offices in 15 cities: New York, Cleveland, Dallas, San Francisco, Atlanta, Chicago, Los Angeles, Munich, Prague, Budapest, Warsaw, Amsterdam, Madrid, Brussels and Tokyo.