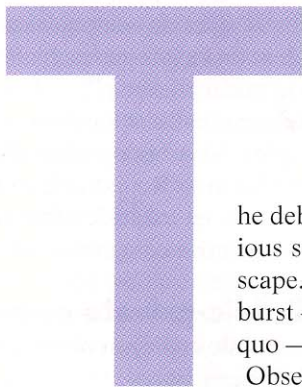


BRIDGING



As the surge in LBO action highlights the allure of going private, public companies are taking notice. Is the private-public divide narrowing?

THE GAP



he debate over private versus public equity has given rise to various scenarios of how LBOs might reshape the corporate landscape. While some view the buyout boom as a bubble ready to burst — to be followed by a return to some version of the status quo — others foresee a more profound change on Wall Street.

Observers believe many companies will continue to go private to avoid close scrutiny and meeting quarterly earnings to the penny. However, in recent months bankers and other deal makers have come to realize there may be a convergence rather than a polarization of these two forms of corporate ownership. **Blackstone Group LP**'s multi-billion dollar IPO last week may be the latest evidence of this mix of corporate styles.

Private and public companies likely will become more of a mixed breed, with public companies having more private-ownership components, and vice versa. Some of these structures are already in place as public companies, such as **Marshall & Isley**, spin off a subsidiary to a private equity firm and remain independent. In other cases, such as the \$8 billion buyout of **Harman International Industries**, private equity and public shareholders are coming to an agreement that allows shareholders to hold onto stakes in the new private company up to the ultimate exit.

“There is almost a convergence between public company activity and private equity,” says **Robert Profusek**, an attorney with **Jones Day**. “I don’t think all companies are going private, and I don’t think we are in a bubble. I do think because of the shift in the amount of investable capital, we now have a meaningful set of alternatives that will operate and continue to exist and make things better.”

This convergence is in many ways a response to the unprecedented buyout activity, which in the first quarter of this year alone was a record \$264

By Avital Louria

billion, according to **Standard & Poor's**. "Private equity has always challenged companies to compete harder, find efficiencies and deliver returns," says **Peter Taft**, a partner with the private equity firm **Morgenthaler Partners**. "Now, as private equity nears the \$1.5 trillion mark [in buying power], I see our industry issuing that same challenge to the public markets."

Change in the air

Taft sees private equity as ultimately redefining and raising the bar for corporate governance and performance, prodding public companies to improve their practices in a number of areas. Ultimately, such an influence can make US companies better competitors in a globalizing world, Morgenthaler's Taft says. "The fact that we're asking this question at all shows how fundamentally the course of capitalism is changing."

Change is beginning to take place in several ways. Public companies, seen as clumsy and ineffective compared with private equity companies, are increasingly deploying private equity-like thinking. They are shedding subsidiaries, loading up on debt, buying back stock and in some cases reforming executive pay. They also are chaffing against onerous quarterly estimates.

A broken public model?

The Sarbanes-Oxley Act of 2002 has been blamed for many a woe, from IPOs moving to London to public company executives' unabashed yearning for private owners. But some believe that the driving force behind many executives' desire to flee goes much deeper than that. "Public companies are increasingly choosing private equity because the public model is broken," says **Michael Goss**, chief financial officer of private equity firm **Bain Capital**.

The damage to the public model is on several levels, say private equity investors. One, they argue, is that the capital structure of many public companies is not levered enough, making capital less efficient. Corporate governance is a problem, too, as boards are often ineffective and fail to contribute actively to a company's business success. And executive talent is often wasted on managing quarterly guidance as opposed to long-term growth.

Indeed, the crux of the frustration lies in quarterly reports and GAAP valuation, along with a constant dance to appease one constituency or another — shareholders or analysts — plus frustration over always having to make timid rather than bold moves. "If you ever got stuck in O'Hare Airport in that bar there and ended up next to a CEO, he wouldn't be com-

plaining about SarbOx — he got over that. He wouldn't be complaining about executive compensation — he got used to that, too. What you would hear [is], 'I wish I could really build something here and wouldn't need to tiptoe around in managing the business,'" says Jones Day's Profusek.

A backlash is now in the making against quarterly targets. Last week, a coalition of large corporations, along with a number of pension funds and trade unions, came out with a set of principles aimed at scrapping quarterly earnings guidance. Led by Jeff Kindler, chief executive of **Pfizer Inc.** and **Xerox Corp.** CEO **Anne Mulcahy**, the group slammed the relentless pressure that short-term investors such as hedge funds place on companies and advocated a focus on long-term results. The group is acting under the auspices of the **Aspen Institute** and calls its initiatives the Aspen Principles. This high-profile alliance includes the Business Roundtable and the AFL-CIO, and it is set to tackle other sore spots, such as executive compensation.



**KBW's
Roberts:
Spinoffs are
becoming more
innovative.**

Public-private ownership

Public criticism of private equity firms has been fierce, thanks to the fabulous wealth accumulated by such folks as Blackstone Group's president, **Steve Schwarzman**, now known as the \$7 billion man. The sense that many buyouts are unfair to the selling shareholders is mounting, and increasingly, a higher price per share is not enough of an incentive for shareholders, who demand to be included in the entire private equity investment cycle, all the way to a lucrative exit. More and more, rather than resisting, private equity buyers allow public shareholders to stay in the deal, giving rise to a deal structure called stub equity.

The first stub equity deal took place in April, when **Goldman Sachs** and **Kohlberg**

Kravis Roberts were in talks to buy Harman International Industries, which makes JBL-brand speakers and home theaters. The buyers met stiff resistance from public shareholders. Instead of fighting back, the acquirers allowed the Harman shareholders to retain up to 27% of the private company and share in the profits when the company is sold or goes public.

The technique also came to the rescue of the obstacle-filled buyout of **Clear Channel Communications**. After a long series of negotiations, the deal was restructured as a stub equity arrangement allowing existing shareholders to participate. Such structures will likely increase, say private equity insiders. "Shareholders who have the appetite to hold the stock for four to five years and not be so quarterly focused can choose to stay in, while investors with a shorter-

term orientation can sell," says Bain Capital's Goss.

Another form of partnership between public and private interests can take place when a public company needs to expand but wants to avoid a large financial burden that may have a negative impact on its share price. In such a case, a deep-pocketed private equity partner can fill the gap.

Such was the case with **Dominion Energy Services**, which set out this spring to build the largest ethanol plant in North America. Dominion joined forces with private equity firms **Riverstone Holdings** and the **Carlyle Group** to build a 300 million-gallon biofuel plant in Alberta, Canada. The plant came with a price tag of roughly \$600 million, too high for Dominion to bear alone, according to Jones Day's Profusek. The way the partnership works, Dominion will be able to increase its ownership in the plant over a number of years.

The coming spinoffs

At the same time, on the private equity side, the buyout boom has made whole-company acquisitions quite expensive. Consortiums may target larger companies, but most of the activity is shifting to acquisitions of or investments in subsidiaries, says **Melissa Roberts**, a quantitative analyst at **KBW**. Spinoffs are advantageous both to the private equity firm that can find value in a piece of the company and to the public parent shedding the subsidiary. "The parent company has the advantage of being able in large part to determine the terms of the spinoff and ultimately the leverage structure," she writes in a study of spinoffs entitled "Welcome to Spin City."

Roberts says that spinoffs are becoming more innovative, with such new structures as sponsored spins providing tax advantages (*IDD*, "Imagination at Work," 6/11/07). In fact, Roberts examined the performance of financial services divestitures through spinoffs or IPOs, comparing 500 companies with a market cap of \$250 million that completed a spinoff against the overall market. She found that returns of companies spun off exceeded the overall market by 20%.

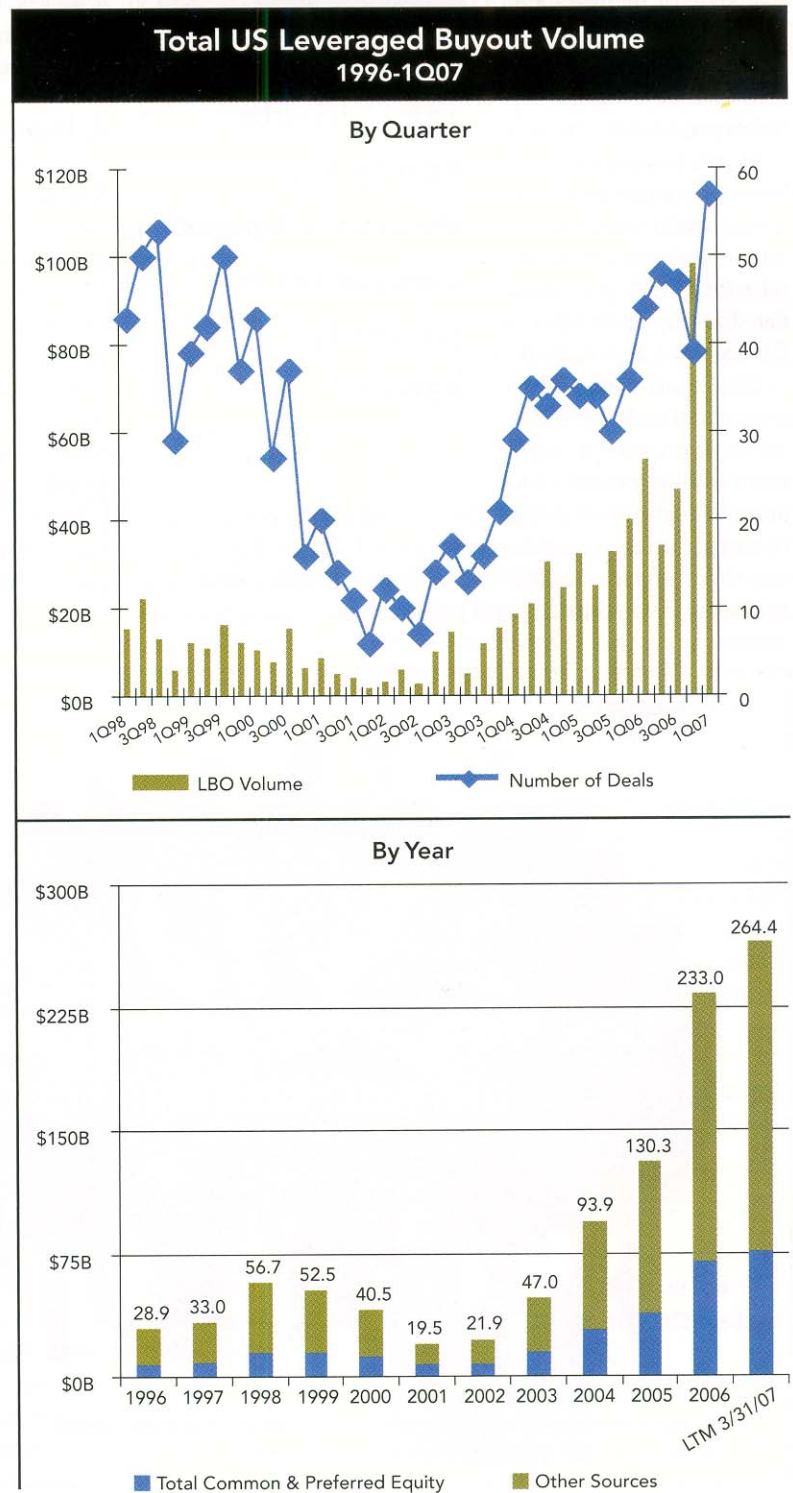
Buyback craze will feed M&A

Private equity firms will not be the only buyers seeking pieces of companies. Strategic acquirers are also expected to purchase subsidiaries and divisions from company executives under pressure to improve earnings by sharpening their focus on the right mix of businesses.

It's about time. While private equity firms have been on a tear since the market recovery, public companies have acted conservatively, shying away

from expansion and capital expenditure and instead using much of their excess cash to buy back stock, points out **Howard Silverblatt**, a senior index analyst at S&P's.

Stock buybacks have been at historic highs, with S&P 500 companies buying back \$117 billion in the first quarter of 2007, a record they will likely top in the second quarter, according to Silverblatt, who says the pace of first-quarter buy-



COVER STORY

backs represents a 17.5% increase from the same period in 2006. In the 12 months ended March, buy-back volume reached an unprecedented \$430 billion, which to Silverblatt is a passive style of management. "The public companies are gun-shy and lack a commitment to expansion and capital expenditures," he says.

On the positive side, buy-backs show companies are taking action to reduce cash on their balance sheets and raise their stock price, helping shore up their value in the ongoing LBO onslaught.

The good times of 18 consecutive quarters of double-digit growth in corporate earnings have put a lot of cash in corporate pockets and helped enrich private equity firms. An unprecedented amount of capital has flowed into their funds, a result of the trade deficit with China indirectly supplying liquidity and pension funds raising their al-



Morganthaler's Taft: 'Private equity has always challenged companies to compete harder.'

locations for alternative investments. Then, there is the low cost of borrowing that has encouraged deals.

But while private equity funds are richer than ever, they are also becoming more institutionalized. Blackstone's IPO, for instance, has become the poster child for the maturing of the private equity industry. And public concern about the concentration of wealth has led to proposed tax changes, which, if they go through, may deprive private equity firms of some of their profit, further narrowing the gap between public and private equity. Some call it the latest evolution of capitalism.

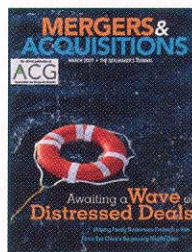
A looming tax bill

The recent proposal by Senators **Max Baucus** and **Charles Grassley** would tax private equity firms that go public at ordinary income rates rather than capital gains levels. That could have severe ramifications, as taxes could increase to 35% from 15%. Some have estimated that Blackstone's market valuation of \$40 billion could fall as much as 20% if the tax rate increases.

No one knows just how the tax treatment will change, but one thing is clear: More tax means less compensation, and less compensation means less risk taking, says one private equity insider who did not want to be named. So a tax hike, should it happen, might further blur the differences between private and public equity. "Like any evolutionary change, the process will be painful for some, but highly rewarding for others," says Morganthaler's Taft.

IDD

MERGERS & ACQUISITIONS



By placing your advertisement in the pages of *Mergers & Acquisitions*, your message will reach over 11,000 readers

and ACG members, 15% of which work in private equity firms. Every month, *Mergers & Acquisitions* provides professionals the most complete, authoritative picture of trends in the M&A market, with detailed coverage on private equity, corporate dealmaking, regulatory news and personalities.

How many private equity firms are you reaching?

For more information on advertising and integrated marketing solutions, contact:
Naz Bayazit • 212.803.8638 • naz.bayazit@sourceMedia.com

ACG

SourceMedia