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# Private equity in spotlight

**Investors pour record amounts into buyout and startup funds**

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From the $18.7 billion buyout of Clear Chan nel Communications proposed this week to the $530 million buyout of Cleveland's Penton Media, companies near and far have been acquired this year with money from private investors.

The firms doing the buying are using bank debt to stretch, or leverage, investments by institutions, such as pension funds or university endowments. Many of the biggest buyouts are taking public companies private. Investors have fueled the buyouts by pouring a record amount of money into private equity funds this year.

Northeast Ohio buyout firms have been busy this year, too, buying, combining and selling mostly mid-sized companies.

In addition, local venture capital firms, which invest equity in fast-growing companies, have had a solid year, though most have been less busy than in the late 1990s when the technology bubble kept investors jumping.

New fund and firm creations, several of which have started up in Northeast Ohio in the last two years, also can measure private equity activity. A few venture capital firms also have opened satellite offices here in that time.

Meanwhile, angel investors - wealthy people who privately invest in young companies - are forming networks. Cleveland nonprofit organization JumpStart Inc. is investing in business ideas that promise substantial growth.

**'Private equity' umbrella**

All of this investment activity falls under the umbrella of "private equity." Simply put, private equity is money from private investors that is invested in companies - often private, as well - usually in the form of stock or other ownership shares.

Private equity firms generally are organized as limited partnerships. Their investors - the limited partners - promise to invest a certain amount when a fund is raising money. Fund managers call in these commitments as they make investments.

The local private equity industry is made up of mostly mid-sized buyout and venture capital firms.

Leveraged buyout firms have the hot ticket for a second straight year. Household names such as retailers Toys "R" Us and Linens 'N Things were bought by LBO firms earlier this year.

"This is a busy time for a lot of the buyout world," said John Lutsi, who manages a $400 million portfolio of

companies at the buyout practice of Morgenthaler, Cleveland's largest private equity firm. "Our deal flow is probably at an all-time high."

Deal flow is high partly because investors are putting a lot of money in buyout funds.

Private equity funds that invest in both buyouts and start-ups had raised $177.89 billion by Nov. 2, according to Private Equity Analyst, a trade magazine published by Dow Jones & Co. With two months left in the year, that's already more than the 2000 record of $177.75 billion.

Some mega-buyout firms on the coasts - those that manage funds as large as $20 billion - are being criticized for chasing large deals and driving up acquisition prices, sometimes beyond the values of the companies being bought.

"Our problem is not chasing deals but prioritizing deals, making sure we're working on the right ones," Lutsi said.

Local buyout firms, which manage more modest funds of between $50 million and $200 million, also are paying more for companies they buy and earning more for companies they sell.

"In the LBO markets, we speak about multiples of EBITDA" as a measurement of company price, said Mark Mansour, managing partner for buyout firm MCM Capital in Beachwood. EBITDA stands for Earnings Before Interest, Taxes, Depreciation and Amortization, which essentially is operating profit.

"A sustainable level is probably 6 or 6.5 times EBITDA," Mansour said. "We've sold a couple of companies out of our portfolio for between 7 and 7.5 times EBITDA."

John Nestor, senior managing partner and chief executive of Kirtland Capital Partners in Beachwood, said earnings multiples for companies being sold range from 6.5 times to 8.5 times EBITDA. "It's good if you're a seller but difficult if you're a buyer," said Nestor, whose firm has acquired three companies this year.

Cleveland leveraged buyout firm Riverside Co., like most of its Northeast Ohio peers, does deals in the middle market - companies worth $100 million to $1 billion. Riverside focuses on the smaller end of that market, as well as on the micro-market - that is, companies that have annual revenues of $5 million to $25 million, said Stewart Kohl, co-CEO of the firm, which is co-based in New York City.

Successful buyout firms have little trouble raising money, in good times or bad.

"As a class, we think that outperforming the Standard & Poor's 500 index by 500 or more basis points (5 percentage points) is a good return," Kohl said. "If we can do that, institutions will keep investing."

Although banks and other financial institutions that lend money for buyout deals still have their wallets open - closed wallets quickly dry up deals - some local buyout managers see indications that the buyout industry is cooling.

Growth of the economy appears to be slowing. As a result, corporate profits, especially for housing- and consumer-related companies, are expected to soften in the fourth quarter, Mansour said.

Also, a number of investment banks and private equity firms have started adding to their turnaround practices and raising money for distressed debt funds, he said.

Although Eric Bacon sees no evidence of falling company price tags, the senior managing director for Linsalata Capital Partners said his and other local firms tend to be cautious about paying too much.

"Our view is, you can't pay 7.5 to 8.5 times earnings if you're going to have an economic decline in the

second year of your investment," said Bacon, whose firm is based in Mayfield Heights.

**LBO firms use leverage**

Unlike buyout firms that use money from investors and lenders to buy mature companies, venture capital firms invest equity in young, sometimes unproven companies.

Buyout and venture capital firms make money in "distinctly different ways," said Steve Haynes, founder and a managing director for Glengary LLC, the specialized venture capital firm that has an office at Baldwin-Wallace College in Berea.

LBO firms use leverage to make money. They also tend to buy "platform" companies, to which more acquired companies are added. This saves money by cutting operating costs and boosting revenues of the combined company.

On the other hand, venture capital firms depend on high growth rates of the companies in which they invest, Haynes said. Venture capitalists tend to look for companies that need tens of millions of dollars to grow, said Bob Pavey, a general partner in Morgenthaler Ventures' information technology practice. Morgenthaler Ventures also has a life sciences practice.

Firms like Glengary see regional economic development as a market opportunity. Other local VC firms see economic development as a distant goal.

"A disadvantage of venture capital, from a regional economic development point of view, is that we're not good candidates for the 15-to-20-year projects," Pavey said.

For instance, it might take 15 years for a biotechnology or an advanced materials startup to develop a prototype. "Our goal is to be in a company for five years," Pavey said.

How does a typical VC cash out of an investment? During the height of the tech boom in the late 1990s, the preferred "liquidity event" was an initial public offering - selling shares in a private company to the public at a spectacular price.

The IPO market has been stale since the stock market crash of 2000. More venture-backed companies are sold to larger companies or investment firms these days than are sold to the public.

That trend may be changing. "I think there have been maybe 10 venture-backed IPOs this year," Pavey said, "and two of them have been ours."

**Recapitalizations**

Some local firms straddle lines between private equity types. For instance, while Primus Venture Partners invests mostly in later-stage equity of business services, health care, education and communications companies, the Mayfield Heights firm also invests in some recapitalizations and management buyouts.

During recapitalizations, Primus buys out some existing shareholders of a company, making an additional equity investment, said Bill Mulligan, Primus managing director. Buyout funds join managers in buying companies during management buyouts.

"We might use some debt in completing those transactions," unlike pure venture firms that invest only in equity, Mulligan said. "We are a hybrid fund, in many respects."

CID Equity Partners straddles a different private equity line. The Indianapolis firm does both venture capital and mezzanine investing, which often involves debt and equity. Mezzanine financing often tides a company

over until an initial offering or sale can raise more money.

Key Principal Partners in Cleveland makes minority investments in companies, using both debt and equity.

**Bridging the gap**

Venture capital firms that invest in early stage companies have begun bridging the gap between an entrepreneur's own money and millions of venture capital dollars.

Jamie Ireland and his colleagues started Early Stage Partners in 2001 with the belief that Northeast Ohio and similar Midwest regions had economic development incentives to produce a significant number of technology startups.

"We were starting fund-raising at the bottom of the market with the bubble still the order of the day, in terms of market psychology," said Ireland, a native Clevelander, experienced private equity investor and community leader whose firm is based in Cleveland.

Early Stage Partners and Primus, as well as other VC firms, provide money that is the "life's blood" for AxioMed Spine Corp. in Garfield Heights, said the company's chief executive, Patrick McBrayer.

Venture capital "has enabled us to complete all of the development and get beyond the prototype stage and into the clinical stage" with the company's replacement lumbar discs, McBrayer said.

Other early stage venture firms in Northeast Ohio have raised money and begun investing in the last two years, including Bridge Fund and Mutual Capital.

In that time, several early stage firms, including Reserve Venture Partners of Columbus, Draper Triangle Ventures of Pittsburgh, Oakwood Medical of St. Louis, and last month, Chrysalis Ventures of Louisville, Ky., also have opened offices in Cleveland.

**Seed-stage companies**

JumpStart, formed by Case Western Reserve University and NorTech in January 2004, invests in "pre-seed" and "seed-stage" companies - those whose ideas haven't emerged as businesses yet.

This early money, which comes from the state, private foundations and the Greater Cleveland Partnership, helps entrepreneurs get started. JumpStart also advises entrepreneurs about financing and operating their businesses.

By organizing the earliest-stage companies, JumpStart helps get them ready for later stage venture capital. "JumpStart functioning as a sophisticated investor at that stage is very helpful," Morgenthaler's Pavey said.

Angels also invest in seed-stage companies. These wealthy individuals are beginning to organize into groups, pooling their money and expertise to make investments.

The North Coast Angel Fund was formed in August, raising about $1 million from 40 members during its first funding round, said Clay Rankin, managing member. Fund members already are evaluating three companies for investment, said Rankin, who also helped start the Ohio Tech Angels Fund in Columbus three years ago.

North Coast Angels expect to invest in bioscience, advanced materials, electronics, information technology and software companies. Fund members also could invest alongside the fund, Rankin said.

"In five years, the region has gotten its technology act together, it's developed a concerted strategy for multiple industry verticals," Ireland said. "The financing strategy in the region has grown in parallel with that."

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