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Private Equity Deals? Join the Club

PRIVATE equity firms have been teaming up in leveraged buyouts of larger publicly traded companies. Justin B. Wender, president of **Castle Harlan**, a private equity firm in New York that specializes in retailing and restaurants, analyzed the trend in a recent conversation. Here are excerpts:

Q. *Will the wave of private equity deals increase, or is it nearing the end of the cycle?*

A. Given the dollars raised in private equity, it's likely we're going to continue to see significant-size leveraged buyouts. But it's important to remember that this represents a relatively small percentage of all the securities traded in the United States. I don't believe this is a huge cycle that's cresting. It's just a function of the money that's been raised.

Q. *What exactly is a club deal, in the context of private equity?*

A. It is a transaction typically shared among several private equity firms. It could be as many as six or seven. To approach companies on a larger scale than historically might have been possible, they've teamed up to go after larger businesses. That means you have multiple owners as opposed to one private equity firm. At the peak of the deals of the 1980s, the one involving RJR Nabisco, you had one LBO firm doing a transaction worth more than $10 billion. Now you've got the equity being shared. It's partly a function of more equity going into LBOs today than we saw in the 1980s.

In the new wave of buyouts, more buyers, more equity and bigger targets.

Q. *Is what we're seeing now in leveraged buyouts bigger than the 1980s?*

A. There are more equity dollars and the companies are bigger. The average size of a Standard & Poor's 500 company is probably five or six times bigger than it was in 1987. In the '80s, you might have put up 10 percent equity. Today you might put up 35 percent.

Q. *Will some deals come unstuck when there's a change in the economic cycle?*

A. It's true in all companies that an economic cycle can have an impact. It's going to very much depend on the structure of the debt that was taken on and the ability of these private equity players to improve the underlying businesses that they're buying.

Q. *Have we ever seen how a club deal performs in an economic downturn? Will the different players cooperate, or will they stab one another in the back?*

A. This is a phenomenon of the past three or four years, when we've had a generally improving economy. We haven't been through a down cycle. It's relatively untested.

The good news is that all these owners have shared interests. Their interests are aligned. They would come together and agree on a plan to get the business back to where it needs to be. They all have very significant upside profits riding on the answers. At least they have a shared incentive structure.

Q. *Why are public companies going private to fix themselves, instead of restructuring while they are still publicly traded?*

A. As to why some companies are going private, there is increasing scrutiny and regulation, namely the Sarbanes-Oxley Act, and that has had an impact. Chief executive officers are spending much more of their time on compliance issues and dealing with shareholders and analysts and the outside world. They have less time for their business than they might like. And when they're private, they can dedicate time to the business itself.

Q. *Are you suggesting that a climate has been created in which public companies can't really take tough steps to correct their business model?*

A. I don't think that's true. But there are challenges in making changes in

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public companies. There is constant scrutiny. The research analysts and others are constantly digging into the business and putting out research. You have a lot of public documentation that has to be filed. You can't spend 100 percent of your time fixing the business.

Q. *Who are some of the C.E.O.'s who've been lured into the private sector?*

A. One good example is David Calhoun, leaving **General Electric** for an opportunity to join an LBO of the Dutch firm **VNU**. The public speculation was that he got a $100 million package to lure him. So here's a guy who was a vice chairman at G.E., where he ran $60 billion in revenues, and he left.

Q. *Isn't it bad for the average investor that people are taking companies private and reaping big gains that public shareholders might otherwise have shared in?*

A. The only way that a private equity firm is going to buy a business is as a result of a process in which the board looks for other buyers. Nobody is buying a business without paying a market-clearing price. Now, are private equity guys taking upside profit that shareholders would have gotten? The complication with that analysis is that doing a buyout creates a different risk profile. If you take a business and double its debt, you're taking different kinds of risks than when public shareholders were involved. The other point to add is that most of these buyouts probably will end up being taken public as an exit vehicle for these private equity firms.

Q. *Isn't it bad for the average shareholder, at least in the short term?*

A. Isn't that an apples-to-oranges analysis? Return and risk are correlated. When these buyouts happen and more debt is put on the company, it's a different level of risk. It's not exactly comparable to say that the same amount of equity value would have been created. There may be situations where the public market doesn't appreciate aspects of a business that a thoughtful private equity investor might see.