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ACG

OC Private Equity: Small Firms, Big Impact

As an investment bank specializing in mergers, acquisitions and capital raising, RSM EquiCo Capital Markets works closely with private equity firms throughout the nation; slightly more than 40 percent of our 2007 M&A transactions involved a PE firm. So we were intrigued when ACG's Orange County chapter asked us to conduct an informal study of the county's PE firms for this special issue of the Orange County Business Journal. Our private equity focus team developed this overview by examining transaction data (primary sources: Mergerstat and Capital IQ), reviewing the PE firms' own communications and conducting interviews with several firm principals. It is not meant to be comprehensive.

Private equity firms rank among the nation's (and the world's) most powerful investors, and they have played a huge role in the nation's mergers and acquisitions market over the past several years. Orange County's private equity community is comprised of fewer than two dozen elite firms whose relatively low profile belies their considerable economic and financial influence. While each firm has its own unique qualities and attributes, as a group they evince a variety of common characteristics.

The firms themselves are quite small, with none employing more than a dozen people. Yet they control hundreds of millions of dollars of investor funds.

Their target investment opportunities in a dizzying array of industry sectors. Yet the financial criteria they use to evaluate acquisition opportunities are remarkably similar.

They avoid financing their transactions with excessive debt loads. As a result, they have largely escaped any negative impact from the sub-prime meltdown and ensuing credit crunch.

Several saw acquisition candidates priced uncomfortably high, and so they remained on the sidelines for much of 2007. But most are optimistic about the 2008 outlook and expect to be actively pursuing transactions during the coming year.

Between January 1 and November 30, 2007, 7,399 M&A transactions were completed in the United States, with 1,484 (20 percent) involving a PE firm as either buyer or seller. Of that total, 123 transactions involved an Orange County-based seller, the largest being Acer's \$1.012 billion acquisition of Gateway, followed by the sale of Intralase Corp. to Advanced Medical Optics for \$817 million. While deal values often are not publicly disclosed, there were at least 15 Orange County transactions in which the purchase price exceeded \$100 million (see Fig. 1). The overwhelming majority of deals involved domestic buyers; Parques Reunidos SA's purchase of Palace Entertainment Holdings and DCC's acquisition of Bio-Warm Corporation were the year's only cross-border transactions involving Orange County sellers.

While local deals were completed in seemingly every sector, a handful of industries proved particularly popular among acquirers. Technology was the most active sector, accounting for three of every 10 deals involving an Orange County seller. The financial services (14 percent), healthcare (13 percent), consumer products (11 percent) and business services (9 percent) industries were also busy – though dealmaking activity in the financial sector was heavily influenced by the sale of struggling mortgage lenders such as ResMAE Mortgage, ACC Capital Holdings and New Century Financial.

During this same 11-month period, there were 138 completed transactions involving Orange County-based buyers. The most prominent of these was Western Digital's purchase of WD Media for \$1.315 billion, followed by Sun Healthcare's acquisition of Haborside Healthcare for \$624 million. Among those transactions in which deal value was disclosed, nine involved selling companies with enterprise values exceeding \$100 million (see Fig. 2).

In Orange County, strategic buyers (i.e., corporations) played a dominant role in 2007. They were involved in approximately 85 percent of completed acquisitions of locally-based businesses and 93 percent of those involving sellers outside the county. While PE firms were buyers in 18 deals involving a local seller, only three – VMG Equity, which acquired Colorescience; Marwit Capital, which bought Boot Barn; and Riordan Lewis & Haden, which provided equity for a recapitalization of CyberCoders – have offices in Orange County.

Marwit acquired another Orange County company in 2007 – American Barricade – as one of four businesses acquired under its Traffic Control and Safety Corporation platform company. Marwit is currently locating TCSC's corporate headquarters in the county.

This outward focus is not surprising. Private equity is rarely a local business, and most of the firms we examined pursue deals on a regional or national basis. (Parallax Capital Partners is the only local firm to report completing transactions outside North America.) While 75 percent of Orange County-based PE firms have offices within 10 minutes of John Wayne Airport, most of those contacted acknowledged that their decision to open shop here had more to do with personal preferences than with local dealmaking opportunities. Several identified "lifestyle" as a dominant factor in their decision to locate here; business considerations appeared to be largely inconsequential. James Hale of Parallax Capital Partners noted that his firm has never purchased an Orange County-based company, and Richard Torre of Dauntless Capital Partners went so far as to say there is "no business reason to be here. Orange County offers nothing extra for the compa-

ny."

There are exceptions to this generalization. Dave Baran of VMG Equity noted that his firm invests in "entrepreneurial-driven small and middle-market companies building great consumer brands – and there is no better place than Southern California generally, and Orange County in particular, to find such trend-setting companies." And while Clarey Capital has historically looked beyond the county for most of its investment opportunities, Managing Director John Clarey identified potential advantages of an Orange County address: "This area offers a good pool of employees, partners and advisory board members, and it's relatively easy to draw from Los Angeles and San Diego."

Local firms rarely concentrate their investments in particular industries. Rather, they deploy resources across a wide variety of categories. (Noteworthy exceptions include MedFocus Fund, LLC, which specializes in the medical and healthcare fields, and Parallax Capital Partners, which focuses on the software industry.) It sometimes seems easier to identify industries that particular PE firms tend to avoid than it is to highlight those they target for investment. Still, we found that technology, healthcare, branded consumer products, and business services were viewed as the most popular industry sectors among private equity investors. Other industries targeted include wholesaling and retailing, manufacturing, industrial technology, food and food service, basic industries, marketing and advertising, and aerospace and defense.

One way to segment the firms is to distinguish between those that prefer to buy underperforming companies and turn them around (Clarey Capital, Dauntless Capital Partners) and those that concentrate on well performing businesses boasting strong management teams (Windjammer Capital Investors, StoneCreek Capital, Riordan Lewis & Haden).

Although Orange County's PE firms pursue companies in an extraordinarily diverse array of industries, they demonstrate considerable homogeneity both in the financial criteria they use to evaluate acquisition candidates and the amount of equity they invest in each transaction (see Fig. 3). Orange County's PE firms are all middle-market specialists that focus their buying on companies with annual revenues up to \$500 million. Six of the firms profiled buy companies with revenues of \$100 million and above; two will consider buying companies with annual revenues as low as \$5 million.

Because they focus on relatively small deals, the county's PE firms rely much less on leverage to finance their transactions, unlike the firms pursuing multi-billion-dollar "mega deals" that attract most media attention. As a result, the sub-prime mortgage meltdown and ensuing credit crunch have only minimally affected them.

"Because we focus on transactions below \$50 million in total value, we have experienced very little or no impact from the credit crunch," said Drew Adams, president, StoneCreek Capital. Richard Torre of Dauntless Capital Partners added, "We are not dependent on debt, and we don't do highly leveraged transactions, so we really haven't been affected." Ken Hubbs of Riordan Lewis & Haden echoed their views. "We are not significant users of 'maxed-out' debt financing leverage," he said. "We seek to create value through growth, and we want our business owners to manage their business, not their debt levels."

According to Jeff Miehle of Windjammer Capital Investors, there are still plenty of lenders willing to provide the debt on middle-market deals. "We're seeing aggressive lending from some sources," he said. "So for us, at least, the credit crunch has had no big impact."

Principals at several local PE firms believe that problems in the credit markets and the resulting impact on company valuations could redound to their benefit. They say the difficult credit environment is creating fresh acquisition opportunities following a year in which lofty prices kept many on the dealmaking sidelines. As a result, they expressed considerable optimism about the coming year.

"We didn't complete an acquisition in 2007 because prices were too high," said Hale. "However, prices seem to be stabilizing, and even declining, as a result of the credit crunch, and growth and profitability expectations are coming down to earth. Our outlook for 2008 is very positive."

Chris Britt, Marwit Capital's managing partner, also has a favorable view of the coming year. "We're excited about 2008. The credit crunch has contributed to more stabilized valuation expectations, and despite the current uncertain state of the economy, the lower middle market remains healthy. We're continuing to see a steady flow of opportunities from a market filled with entrepreneurs and well managed family businesses offering growth potential. And we're uncovering more every day."

Figure 1
Major Transactions Involving Orange County Sellers
(Jan. 1 through Nov. 30, 2007)

Date Closed	Target	Buyer	Transaction Value (\$MM)
10/16/2007	Gateway, Inc.	Acer Inc. (TSEC:2353)	1,012.44
04/02/2007	Intralase Corp.	Advanced Medical Optics Inc. (NYSE:EYE)	817.28
05/21/2007	L.A. Fitness International, LLC	Madison Dearborn Partners, LLC	600.0
10/03/2007	Palace Entertainment Holdings, Inc.	Parques Reunidos SA	348.76
02/23/2007	Cherry Aerospace LLC	Precision Castparts Corp. (NYSE:PCP)	300.0
02/20/2007	Jazz Semiconductor Inc.	Jazz Technology, Inc. (AMEX:JAZ)	280.11
02/20/2007	VitalStream Holdings Inc.	Interneat Network Services Corp. (Nasdaq:NMNAP)	226.47
05/07/2007	SRS Technologies Inc.	ManTech International Corp. (Nasdaq:NMANT)	195.0
11/01/2007	TUI University	Summit Partners	190.0
09/15/2007	ResMAE Mortgage Corp.	Cladwell Investment Group, L.L.C.	177.6
09/29/2007	New Century Financial Corporation	Carrington Capital Management, Llc	177.4
04/16/2007	Alliance Imaging Inc. (NYSE:AIQ)	Oaktree Capital Management, LLC, MTS Health Investors, LLC	153.13
03/19/2007	Bloomfield Bakers	Ralcorp Holdings Inc. (NYSE:RAH)	139.6
09/29/2007	Nationwide Health Properties Inc.	Complete Care Services, Inc.	128.0
09/20/2007	LPL Independent Advisor Services Group LLC	LPL Investment Holdings Inc.	103.26

Sources: Mergerstat and CapitalIQ

Figure 2
Major Transactions Involving Orange County Buyers
(Jan. 1 through Nov. 30, 2007)

Date Closed	Target	Buyer	Transaction Value (\$MM)
09/05/2007	WD Media, Inc.	Western Digital Corp. (NYSE:WDC)	1,315.78
04/19/2007	Haborside Healthcare Corporation	Sun Healthcare Group Inc. (Nasdaq:NMSUNH)	624.4
10/16/2007	Esprit Pharma, Inc.	Allergan Inc. (NYSE:AGN)	368.47
03/23/2007	Boston Marriott Long Wharf Hotel	Sunstone Hotel Investors Inc. (NYSE:SHO)	228.2
07/12/2007	Global Locate, Inc.	Broadcom Corp. (Nasdaq:NASDAQ:AVGO)	226.0
02/28/2007	Carespring Health Care Management	Nationwide Health Properties Inc. (NYSE:NHP)	170.0
01/10/2007	Quality Care Solutions, Inc.	TriZetto Group Inc. (Nasdaq:NASDAQ:TRZT)	146.2
05/01/2007	Marriott Boston Quincy Hotel	Sunstone Hotel Investors Inc. (NYSE:SHO)	116.6
02/02/2007	CoreLogic	First American CoreLogic, Inc.	100.0
02/21/2007	Endoart S.A.	Allergan Inc. (NYSE:AGN)	97.0

Sources: Mergerstat and CapitalIQ

Figure 3
PE Firm Investment Criteria
(all figures in \$ millions)

PE Firm	Investment	Enterprise Value	EBITDA	Revenue
Clarey Capital		10 - 50		10 - 250
ClearLight Partners, LLC			5 - 25	20 - 250
Crosse Partners	Up to 10			
Dauntless Capital Partners				20 - 200
Fairmont Capital, Inc.		2 - 60		10 +
Forrest Binkley & Brown	2 - 6			
Glenmount, LLC	3 - 10			10 and up
Marwit Capital		5 - 50		10 - 100
Parallax Capital Partners, LLC				5 - 500
Pinereck Capital	2 - 8			15 - 75
Riordan Lewis & Haden	10 - 50			20 - 250
Solis Capital Partners	2 - 25			10 - 75
StoneCreek Capital, Inc.		10	2 - 10	
TGV Partners	3 - 10	10 - 50	1 - 2	20 - 50
VMG Equity Partners				10 - 100
Westar Capital LLC	5 - 25			25 and up
Windjammer Capital Investors LLC	20 - 100		7 and up	

Sources: Listed firms

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