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Chasing LBOs

GOLDNER HAWN'S MIKE SWEENEY ON THE EVOLVING WORLD OF PRIVATE EQUITY.

If you want to understand financial markets, you should know who stands atop the heap. Today, two types of firms dominate: hedge funds and private-equity firms, the latter sometimes called leveraged-buyout (LBO) firms for their aggressive use of financial leverage in deals.

The leading lights of the private-equity business in the Twin Cities are Norwest Equity Partners—profiled in this column in October 2004—and Goldner Hawn Johnson & Morrison. Founded in 1989, Goldner Hawn is perhaps best known in the Twin Cities for its successful buyout of Byerly's, the upscale grocery chain that was sold to competitor Lunds Food Holdings in the mid-1990s.

Today, Goldner Hawn's nine partners are gearing up to invest their fifth fund, $255 million, which closed in November 2005. "What we do is acquire significant equity stakes in businesses that typically fall into one or two categories," says Mike Sweeney, the firm's managing partner since late 2001. "We have a real bias for companies in the Upper Midwest, and second, those in what we call 'spotlight' industries," which include building products, financial services, food, retail, and, increasingly, health care and medical products. Like almost all private-equity firms, Goldner does not invest in early-stage deals, because they don't have predictable cash flow. Its archetypal deal would be with a business that has at least $200 million in revenue.

Critics of the private-equity industry say that its best days are behind it; there is simply too much money waiting to be invested—well over $100 billion, by most accounts—and competition will drive down returns. Sweeney doesn't buy the argument.

He draws an analogy to the oil and gas business. "In the early, entrepreneurial days, there were wildcatters, but eventually the oil business was institutionalized, and now we have Exxon," he says. Similarly, in the LBO business, there were early "wildcat drillers in a target-rich environment with lots of good companies and not many buyers. Eventually, more and more people rushed in because the returns were so good.

"So, sure, some newer firms will lose their shirts," Sweeney acknowledges. "But the firms that are really good have gained more

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and more credibility, and thus more and more capital" to invest. He won't disclose his firm's rates of return, but says returns in his industry, over a meaningful cycle in the economy, still comfortably exceed returns in the public-equity markets. Industry sources indicate that a 20 percent annual rate of return or better is a typical target when structuring deals.

Returns begin, of course, with the initial price of a deal. Since hitting a low point in 2001, valuations of target companies are, on average, up 30 percent, according to Sweeney: "This is a high-water mark for valuations."

Much of that increase—largely an increase in the multiple of earnings that buyers are willing to pay—is due to what he calls the "free" availability of debt capital. For example, he says, "there's never been a better time to borrow against the real estate assets of target companies." In other words, private-equity firms are able to pay up for businesses because banks and other senior lenders have aggressively provided capital. Is there any tightening in that equation as the Federal Reserve raises interest rates? Not yet, Sweeney says.

In today's buyout market, many companies are auctioned off by investment banks. Sweeney doesn't like that process, though he says the problem isn't the upward pressure on pricing that presumably results from multiple bidders, it's the compressed time frame. "We much prefer to invest with people we know and get to know over time," he says.

Given the competitive market, private-equity firms must differentiate themselves. For Goldner Hawn, that has meant a focus on public companies that are perhaps better served by going private. For example, in October 2005, the firm announced that it was taking private Transport Corporation of America (Nasdaq: TCAM), a trucking company based in Eagan. The $120 million deal was scheduled to close in the first quarter of 2006.

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One such company was ShopKo, the retailer based in Green Bay, Wisconsin. In April 2005, Goldner announced a deal to take ShopKo private. "We thought highly of the management team, and the company was an orphan stock compared to its bigger competitors, Wal-Mart and Target," Sweeney says. "It was the quintessential public company that should be private." Interestingly, Goldner planned to put up only $30 million of equity to support the $1 billion deal (including assumed debt.)

Almost immediately, the deal ran into trouble when the stock rose above Goldner's $24 offer price. It meant that investors, in particular hedge funds, were betting that a higher bid would emerge. In fact it did, and after a series of bids and rebids, ShopKo was sold in December 2005 to another buyout firm at $29 a share. Sweeney points to the increased impact of hedge funds as one of the most significant changes in his industry.

"We did a great job of uncovering value in the ShopKo deal, but you can't control everything in a deal," he says. "In this case, what we couldn't control was the advent of activist hedge funds."

It's a reminder, Sweeney says, that some deals get completed and others don't: "If you can't stomach that thought, you can't be in this industry." ■

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