OPALESQUE PRIVATE EQUITY STRATEGIES

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In This Issue

Welcome to the March Issue of Private Equity Strategies. In this issue we're going to look at the potential symbolic and real effects when large institutions like pensions and endowments divest.

In our Dealmakers Q&A we will speak with Jim Butterfield of the Riverside Company to learn more how they shrink their funnel from 4000 opportunities to the 20-30 deals they make each year. Butterfield will also take us through their recent Baby Jogger transaction to learn about what set that portfolio company apart in the deal making process.

In Regs Watch, Jay Gould of the law firm Pillsbury has contributed a piece about the recent enforcement action the SEC took against Oppenheimer's private equity group and what it may mean for private equity firms now that they are coming under closer scrutiny from the regulator. We will also highlight other recent regulatory changes to put on the radar.

In our Data Snapshot, we discuss the growing institutional appetite for the IPO market with Maria Pinelli, Global Vice Chair of Strategic Growth Markets at Ernst & Young, which recently surveyed a number of institutions to find out why IPOs may heat up this year.

In our Movers and Shakers section, law firm Nixon Peabody contributes an update on a potential new investment area for private equity firms in New York State.

As always, Quick Hits will have a round up of fund news and events.

I welcome your feedback and hope you will continue to reach out to me about our coverage and where we might go next.

Sincerely,
Bailey McCann
Editor
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Does Institutional Divestment Really Matter?

Bailey McCann
Private Equity Strategies

Since the beginning of the year, there have been two fairly significant movements to drive institutions to divest from certain portfolio holdings. Specifically, the push after the Newtown, Connecticut shootings to get pensions and other institutional investors to divest from gun manufacturers, and a second movement across more than 200 college campuses nationwide to get endowments to drop their investments in fossil fuel companies. Both movements have had mixed success so far, and divestment skeptics say that the efforts are misdirected. Either way, any time an institution makes a significant shift in its allocations, the impact for GPs can often outlive the movement itself.

Consider what happened for investments in tobacco companies after whistleblowers shed light on how these companies were actively trying to hide the adverse effects of cigarette smoking. Consider also, the effects of student movements in the US against apartheid. While both cigarette smoking and bigotry still exist, you won't see many glowing announcements of recent tobacco company acquisitions by GPs – at least not GPs angling for favor with some of the market's most public investors.

When the push for divestment in both guns and fossil fuels started to gain traction, articles started making the rounds questioning the financial responsibility of these moves. A report surfaced in the Associated Press that when the trustees of the $46.6 billion New York City Teachers' Retirement System, took up the idea of dropping their gun investments - with the support of outspoken gun control advocate Mayor Michael Bloomberg - one of his own administration officials cast the lone vote against the measure. According to the report, he said that he thought these decisions should look at what is best for beneficiaries.

On financial grounds, it might be hard to argue for pulling out of gun investments. Gun manufacturers saw a dramatic rise in product sales following the re-election of President Obama, on fears of his goals for gun control. This rise was bolstered by the Newtown shootings, when many pro-gun rights citizens headed to their local gun shop ahead of what they feared would be a spate of new gun control laws. Looking at the numbers, these factors might be considered reasons to hold on to gun makers in a portfolio, as better returns go hand-in-hand with a buying spree.

A variation on this theme is also true for fossil fuels. Energy prices and US supply are hitting new highs. Not only are university endowments invested in these companies through their portfolios, they're also deeply invested as some of the larger consumers of these fuels Cornell University's president David Skorton noted these points in an interview with the Cornell Daily Sun, as part of his reasoning behind why, despite broad student support for the idea, Cornell wouldn't be dropping fossil fuel investments. "One, it has to be robust on returns we're counting on in the short-term," he told the student paper. He urged students to push for government action on curbing climate change, saying divestment wouldn't achieve the goals they were working for.

While the skeptics make some plausible points, they're only half right. Sure, individual companies make the bulk of their profit on actual sales, not in the stock market, and yes government action on climate change would be more definitive, but these movements have a bigger impact – even if unsuccessful – than merely denting stock price once you dig in.

Guns, climate change v. butter

The move to divest of gun makers provided some interesting insights to what GPs may be looking at when these movements happen. Even before any pension or other institution announced plans to pull out of these companies Cerberus said it wanted to sell Freedom Group its investment in gun makers. Suggesting that some private equity firms may be less keen on short-term profits in the wake of broader issues around long-term investor interests, and press scrutiny around holding on to hot button companies.

This may also be happening at universities, as a movement to get university endowments to divest from fossil fuel companies swept across nearly 250 universities nationwide, led by climate change activist, Bill McKibben and his organization 350.org. So far, the bulk of that action has resulted in student led campus resolutions against investment in fossil fuels, but some of the student groups have also been successful in pushing endowments to divest, despite the criticisms outlined earlier.

While divestment may not immediately impact stock prices, pushing institutions to divest can have a wider impact. First, institutional portfolios like pensions or endowments are some of the last vestiges of long-term investment in the marketplace. In that vein, companies like Exxon, which are profitable now, at the height of the fossil fuel economy, may not be that way forever. Joe Romm suggests that these companies are headed for a stock price collapse in the future, as the reality of climate change sets in, unless they too stake out positions in more sustainable sources of energy.

Given the long term nature of a pension or endowment portfolio, they may also be uniquely well suited to act ahead of government intervention or short term profit cycles, and start picking winners in tomorrow's energy economy. This is also around investments in gun makers, as the groundswell of public opinion and new state laws, builds around issues like background checks and greater gun control. Those companies could face the same level of public stigma as big tobacco, making them less palatable long-term investments, no matter what the current profit picture looks like.

Indeed, CalPERs, one of the nation's largest institutional investors said as much in their proposed divestment resolution – "The Board further finds that the growing national controversy over gun violence, and the state and national legislative and regulatory efforts which now accompany the debate, will generate administrative and opportunity costs to address the system's continued ownership of the stocks of these two companies and that these ongoing costs will likely exceed any possible risk-diversification and portfolio return benefits from these investments."

Divestment could potentially impact government intervention too. Would state supported public pensions or endowments that are no longer directly tied to the overall well being of gun manufacturers and fossil fuel companies feel freer to pursue legislation that controls both of their relative outputs? Perhaps. The New York Teachers have divested out of their gun exposures, and Governor Cuomo recently signed some of the toughest gun laws in the country. Compare this to the US Congress, which is still heavily controlled by the NRA, and dropped its effort to ban assault weapons this week. While not directly causal, it may be easier for other Governors to make those decisions knowing their state pension liabilities are unlikely to take a hit.

So too for endowments, the move toward long-term sustainable investments would signal not only actions in the interest of the portfolio, but in the interests of the students universities support. They could take an active role in finding GPs and portfolio companies in industries their graduates will be working in when they become contributors to their alma maters.

Dealmakers Q&A: Riverside Company

By: Bailey McCann
Private Equity Strategies

In April of 2012, the Riverside Company, one of the largest and oldest global private equity firms focused on the small end of the middle-market, with more than $3bn in assets under management, announced that it was partnering with management to recapitalize Baby Jogger. Baby Jogger markets and develops baby strollers, bicycle trailers and related accessories. With that deal, Riverside will help Baby Jogger to build out product ideas already in the pipeline, and expand sales internationally. Private Equity Strategies spoke with Jim Butterfield, of Riverside's Origination group, about how he found Baby Jogger, and how Riverside sorts through thousands of opportunities per year to find hidden gems.

Butterfield has been a part of Riverside's origination team for 11 years. In this role he searches through thousands of deals, reducing that number to between 20-30 that then make it to the Letter of Intent Stage. In order to be one of those 20 or 30 companies, businesses have to present a variety of factors both quantitative and qualitative that add up to a good investment.

"Several things are going to make us enthusiastic about a deal," he explains. "We want to see a big moat around the business – if that company went away, would people miss it? Are there broad based growth opportunities? Are the objectives of the management team aligned with our interests? Can we build the business, together with management, to three times its size? We also want to see how realistic the company is about its valuation. If any of those factors are too far outside of what we think is fair, we're probably going to mutually decide to part ways."

As a private equity firm, Riverside has a reputation for being generalists within a certain market-cap. Unlike some firms focused solely on health care, or consumer product companies, Riverside will look at opportunities across many industries. This makes their initial funnel considerably larger, but it has also given executives like Butterfield, the opportunity to develop specialties in certain industries without getting siloed into one area forever. The generalist approach also allows Butterfield and others on the origination team, to find opportunities through personal relationships, or even the odd cold call.

"A company we got involved with recently, was the result of an introduction from a trusted advisor and friend. 18 months later we bought the company, that happens more than you might expect," Butterfield says.

Baby Jogger was the result of one of these relationships. The opportunity came through an investment banking contact, with whom Riverside & Butterfield enjoy a strong relationship, shortly after Riverside failed to win a competitive sell-side process for another infant-mobility branded consumer product company. "We had an industry-knowledgeable internal transacting team assembled and pursuing a branded consumer products deal, but we failed to prevail. However, when the Baby Jogger investment opportunity surfaced, we still had all of those resources in place," Butterfield says.

"What appealed to us with this company was that baby strollers are not cyclical, not seasonal, and are quite price inelastic."

He says when Riverside first met the company, there was the usual "get-to-know you" apprehension on both sides, but their approach helped them stand out. "When we visited the company, we brought pictures of our employees, worldwide, using the Baby Jogger products. We wanted to show that, not only were we investors looking to own the business, but we were actual enthusiastic consumers of their products."

Riverside also has boots on the ground worldwide, which they use to provide support to their portfolio companies through more than just capital injections. With offices on four continents, and natives on the ground around the world, Riverside helps facilitate and accelerate globalization for its portfolio companies. From opening Asian markets and introducing new suppliers through their Hong Kong office to tapping regulatory or industry expertise on one continent and applying it to another, Riverside's international team takes smaller companies to places they might not have even imagined.

Ultimately these factors, and a positive relationship with the management team, helped Riverside prevail and Baby Jogger to align itself with a like-minded investor. "So far we have been involved with Baby Jogger for one year, and we see significant opportunity. There are new product launches under development; and new international distribution relationships. We have also added new systems and reporting technology," Butterfield says.

Typically, Riverside invests for an average of 4.5 years in a given company. However, Butterfield notes that the relationship can sometimes be longer if there is significant positive value being generated. They are currently considering selective acquisitions to expand Baby Jogger even more.

Deals like Baby Jogger represent the ideal scenario for an origination team, but what about the deals they pass on? Butterfield explains that one of the key issues is valuation. "Everyone thinks their company is worth more than it is," he says.

"When you're looking at 3000-4000 opportunities you see all kinds of stuff. We've seen valuations all over the place, depending on company specific and industry dynamics. That's why it's important for businesses to have a strong advisory team. Companies with a good advisory team come into these discussions with more realistic expectations."

He notes that more entrepreneurial owners who choose to go without advisors often fail to advance in the deal making process, because they are unrealistic about their business. "Entrepreneurs are more informed than they were 10-15 years ago, but we still see folks who overestimate their value."

Chemistry between the management team and a prospective private equity firm is paramount. "We've gotten far with deals we liked on paper, but you can be sitting at a table and just feel the chemistry is off and interests don't seem to be aligned, and you have to walk away," he says.

For his part, Butterfield also relies on chemistry at the early part of a deal - literally knocking on doors, or cold calling to find opportunities. "Sometimes if I see a company while I'm out driving I'll cold call them. It doesn't always work, but sometimes it does, you have to take a shot. Just this morning I was dropping my son. AJ, off at school and I passed by a service truck with the name of the company painted on its door. I was intrigued because it listed all of its locations and its services and it triggered an idea. After some research, I called the CEO of the company, we chatted and turns out the business is quite large, profitable and is looking for an equity partner to help accelerate its growth. Who knows, it might lead somewhere for us…I'll let you know in a year!"

SEC Hammers Private Equity Fund Manager

By: Jay Gould, Partner, Pillsbury Law

Last month, the Securities and Exchange Commission (the "SEC"), published its examination priorities for 2013. As we suggested in our Blog posting at that time, the SEC is fixated on examining and bringing enforcement against its newest class of investment adviser – managers of private equity funds. Fast forward four weeks, and we should not be surprised to see that the SEC is doing what they said they would do. Last week, the SEC charged two investment advisers at Oppenheimer & Co. with misleading investors about the valuation policies and performance of a private equity fund of funds they manage.

The SEC investigation alleged that Oppenheimer Asset Management and Oppenheimer Alternative Investment Management disseminated misleading quarterly reports and marketing materials, which stated that the Oppenheimer Global Resource Private Equity Fund I L.P.'s holdings of other private equity funds were valued "based on the underlying managers' estimated values." The SEC, however, claimed that the portfolio manager of the Oppenheimer fund actually valued the Oppenheimer fund's largest investment at a significant markup to the underlying fund manager's estimated value, a change that made the performance of the Oppenheimer fund appear significantly better as measured by its internal rate of return. As part of the Order entered by the SEC, and without admitting or denying the regulator's allegations, Oppenheimer agreed to pay more than $2.8 million to settle the SEC's charges and an additional $132,421 to the Massachusetts Attorney General's office.

In its press release, the SEC reiterated its focus on the valuation process, the use of valuations to calculate fees and communicating such valuations to investors and to potential investors for purposes of raising capital. The SEC's order also claimed that Oppenheimer Asset Management's written policies and procedures were not reasonably designed to ensure that valuations provided to prospective and existing investors were presented in a manner consistent with written representations to investors and prospective investors. This claim gave rise to an alleged violation of Rule 206(4)-8 (among other rules and statutes) under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), the rule that the SEC passed after the Goldstein case permitted many funds to de-register as investment advisers from the SEC.

This case illustrates the new regulatory landscape for private equity fund managers. Many private equity fund managers have not dedicated the time and resources to bringing their organizations in line with the fiduciary driven rules under the Advisers Act. Many of these managers have not implemented the compliance policies and procedures required by the Advisers Act, nor have their Chief Compliance Officers been empowered to enforce such compliance policies and procedures when adopted. Much of this oversight goes to the fact that many private equity fund managers do not have a history of being a regulated entity nor have they actively sought out regulatory counsel in their typical business dealings. Private equity fund managers generally use outside counsel to advise them on their transactional or "deal" work and they often do not receive the advice that a regulated firm needs in order to meet its regulatory obligations. Oppenheimer serves notice that failing to meet these regulatory obligations can have dire consequences.

This article is also part of the Investment Fund Law Blog, authored by Pillsbury Law Attorneys.

Regs Watch: Brief Updates on Changes in Regulation for Private Equity

As journalists like me and lawyers have written ad nauseum, new and ever more regulations are in the pipeline for private equity and alternatives as a whole. Here we will hit on some of the cases of note and provide links to new guidance over the past month.

Wagstaff & Cartmell takes on private equity firms

Kansas City law firm Wagstaff & Cartmell LLP has a hand in a class action lawsuit targeting marquee private equity firms that is headed for trial.

SEC Spotlight on Private Equity Fund Managers – Compliance, Examination and Enforcement Issues

The SEC's Office of Compliance Inspections and Examinations (OCIE) and the Asset Management Unit of the SEC's Division of Enforcement (AMU) have recently spoken about the focus of both Divisions on private equity fund managers.

U.S. GOP tax lawmaker urges tighter U.S. partnership rules

The top Republican tax writer in the U.S. House of Representatives on Tuesday proposed shaking up taxation of privately held businesses in ways that would tighten rules on partnerships, such as private equity and hedge funds.

SEC Charges Private Equity Firm, Former Executive, and Consultant for Improperly Soliciting Investments

The Securities and Exchange Commission today announced charges against New York-based private equity firm Ranieri Partners, a former senior executive, and an unregistered broker who violated securities laws when soliciting more than $500 million in capital commitments for private funds managed by the firm.

SEC Finding Some Hedge Funds and Private Equity Groups are Not Complying with Custody Rule

The SEC has issued a Risk Alert on compliance with its custody rule for investment. It notes that with respect to advisers to audited pooled investment vehicles, its examinations found some failed to meet requirements to engage an independent accountant and demonstrate that financial statements were distributed to all fund investors.

SEC Settles First-of-its-Kind Asset Valuation Case

The SEC has opted to settle with KCAP Financial, Inc., f/k/a/ Kohlberg Capital Corporation, over misstatements of exit prices and fair value. The number of these such cases are on the rise, two others closed this month.

NFL Teams With Private-Equity Firm to Seek Media, Tech Investments

The Wall Street Journal reports, The National Football League is teaming up with private-equity firm Providence Equity Partners in a search for ventures the two entities can jointly invest in.

While the NFL and Providence have yet to specify investments, they plan to have about $300 million available to invest in start-ups that work within sports, media and technology.

Dodd-Frank Progress:

Movers and Shakers: New York State contemplates laws to allow private equity and publicly traded investment in health care facilities

By: Michele Masucci & Barbara Asheld
Nixon Peabody, LLP

The need for increased private capital investment in New York's health care facilities is receiving serious attention during negotiation of the 2013–2014 New York State Budget. Governor Andrew M. Cuomo's budget proposal contains language that authorizes two pilot programs, one in Brooklyn, allowing the Public Health and Health Planning Council to approve business corporations to own or operate hospitals.

Participating entities must affiliate with academic medical centers. These entities would also be permitted to own certified home health care agencies, licensed home care services agencies, and hospices. Specific existing requirements of the approval process relating to stock ownership would be waived.

The governor's proposal would permit publicly traded companies to own and operate two hospitals in New York and permit for-profit investment in these entities. The New York State Senate proposal authorizes a maximum of ten entities to evaluate the establishment or restructuring of health care delivery systems through increased capital investment. The proposal requires one entity to be in Brooklyn. There would be two routes to approval under the Senate program. The first would build on the governor's budget proposal but permit only "benefit corporations" to own and operate hospitals. It would continue the ban on investment by publicly traded corporations. The Senate bill would also authorize a second route to approval to test more flexible approaches under which hospitals would be permitted to access private capital. These vehicles would be designed to promote development of new sources of capital and to evaluate the impact private equity investment would have on quality of and access to care and its benefits to the hospital, its patients, and the community. Broader waiver of NYS Public Health Law Article 28 provisions addressing ownership structures would be authorized for the latter type of projects.

Although the bills appear to use the term "hospital" in the broad Public Health Law Article 28 sense and to permit nursing and other health care facilities to participate in the pilot program, they are not entirely clear. Those interested in establishing nursing facilities or diagnostic and treatment facilities under the pilot program may wish to confirm their eligibility by submitting comments.

As of March 12, 2013, the NYS Assembly budget proposal contains no language addressing private investment.

Some observers are predicting early resolution of issues and "lock-down" of the budget before April 1, 2013, so time is of the essence for those wishing to submit comments to their legislators or to Governor Cuomo.

This article was contributed by Nixon Peabody, LLP. It does not constitute legal advice, and readers should not act upon the information in this publication without professional counsel. This may be considered advertising under some rules of professional conduct. The original brief can be found here.

Data Snapshot: Institutional Appetite for IPOs Up

Bailey McCann
Private Equity Strategies

According to a new Ernst & Young survey, investors cite brighter earnings, improved macro-economic conditions and more stable equity markets as the reasons for the improved market sentiment. Private Equity Strategies spoke with the author of the survey, Maria Pinelli, Global Vice Chair of Strategic Growth Markets at Ernst & Young, about the results and what that could mean for the IPO market this year.

Some 4 out of 5 institutional investors invested in an IPO last year, that's up from only 1 in 5 in the past two to three years. This data is especially notable in light of the high profile failure of the Facebook IPO last year. This trend is expected to continue throughout 2013, although Pinelli notes that companies are going to have to make a significant effort to stand out, as it is a buyers market.

"The price has to be right, the terms have to be exactly right and the management team has to be right, for a company to see investment in this buyers market," Pinelli tells Private Equity Strategies.

Earnings outlooks are critical, according to the survey, "Investors in almost every region rank a brighter earnings outlook as the key driver for improving IPO market sentiment. " In Asia, confidence is particularly strong as both private equity and venture capital are looking for opportunities in this market - and there are many deals to be had. Companies may find it difficult without strong numbers, and a core differentiator to break out ahead of what is a considerable opportunity set.

In North America, it may be slightly easier for companies as investors are looking more closely at stabilization of macroeconomic factors before investing. Companies may be able to benefit if Congress moves toward a budget agreement. Report data shows that as these decisions are made and the overall financial landscape in the US becomes clearer, investor sentiments are likely to fall in line with the rest of the world - meaning North American investors will too be in the market for deals.

Good quality companies have generally been able to be successful in the IPO market. However, the survey shows that now more than ever, even good companies will have to take careful consideration of factors including market timing, and picking the right point in the lifecycle. "We have seen companies that rush to go public, or fail to take into consideration all of the appropriate factors come away unsuccessful. Recovery from something like this can be considerable," Pinelli says.

She says that companies need to ensure that they have a solid infrastructure in place before going to market. Data in the survey shows that a number of companies that list too early also tend to have holes in infrastructure areas like reporting, corporate governance or compliance. Nearly one third of investors in the survey cited a strong corporate infrastructure as one of their core concerns.

"Investors want to see quarterly reporting, they also want to have transparency and know that a company is going to deliver on their promises," Pinelli says. "It's impossible to predict everything, but surprising investors can cause a significant drop in market value and it can take up to three years to regain that credibility with the public."

Factors most likely to improve IPO market sentiment

	North America	Central and South America	Middle East and Africa	Europe	Asia
Brighter corporate earnings outlook	57%	60%	50%	66%	69%
Stabilization in macroeconomic conditions	65%	43%	20%	60%	51%
Stabilization in equity markets	61%	45%	50%	47%	42%
Higher investor appetite	39%	49%	50%	41%	49%
Recovery in market valuations	29%	37%	40%	38%	35%

Note: % represents the number of respondents that chose the particular factor as one of their top three choices.

*Image Source: Right team, right story, right price - Survey - By Ernst & Young

Quick Hits

Wilbur Ross Jr. is seeking $500 million for a new private-equity fund that will buy distressed shipping and other transportation assets. WL Ross & Co., the New York-based private-equity firm founded by Ross that is now a unit of Invesco Ltd., is teaming up with Oslo-based Astrup Fearnley AS to make investments.

Newly created private equity firm Quadria Capital has acquired Milestone Religare, an equal joint venture PE firm between financial services major Religare Enterprises and Mumbai-based Milestone Capital Advisors. Milestone Religare currently manages India Build-out Fund I, an indian fund focused on health care.

The Bonadio Group LLP plans to grow its private equity team by partnering this spring with a national broker/dealer. The firm will become a registered representative of Decosimo Corporate Finance LLC starting May 1, 2013.

Cortland Chosen to Administer Procida's 100 Mile Fund, Cortland will provide enhanced investor servicing and other back office support and services for the Englewood Cliffs, NJ based Real Estate Fund.

DeNovo Health Partners, a newly formed consulting and private equity firm backed by three former health care executives -Jonathan Doctor, Glenn Golenberg and Sherwin Voss - is looking for new investments in the health care space. They will also provide consulting support to investors and firms in the health care industry.

Arlington Capital Partners has acquired Micron Technologies Inc., a Malvern, Penn.-based provider of particle size reduction and analytical services to the pharmaceutical industry.

Ted Laufik has joined Foundation Medical Partners as a partner and chief financial officer.

Mark Terbeek has joined venture capital firm Greycroft Partners as a Los Angeles-based partner.

Events

Private Equity Investing In Apparel & Footwear Companies -- Winning Ways to Profit From The Power of Branding

May 2, 2103

Hosted By: Capital Roundtable

As Cybersecurity Threats Get Bigger, So Do The Private Equity Opportunities -- P.E. Investing In Middle-Market Cybersecurity Companies

April 11, 2103- New York, NY

Hosted By: Capital Roundtable

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