CHIEF EXECUTIVE

FINANCE

Gearing Up to Go Private

For companies seeking the safe haven of private life, both promises and peril await.

BY ERIK SHERMAN

In 2001, Key3 Media Group was tumbling. With annual revenues of roughly $325 million and a work force of 800, the trade show producer owned such major brands as Comdex and NetWorld+Interop. But years of acquisitions left it mired in debt. Then the chill of business travel after 9/11, a shift in high-tech business models and a soft economy left cash trailing behind expenses. This past February, the company went into voluntary bankruptcy, emerging five months later with a new name, MediaLive International, a new home, San Francisco, and a new lease on life—as a private company. Out of the public spotlight, the company was free to concentrate on strategies and tactics to fortify business. "We needed the freedom to rethink our model when we were responding to a fundamental change of the market as a whole," says MediaLive International CEO Robert Priest-Heck.

It's the kind of shelter more and more public company CEOs have been seeking, as a result of the steep accounting expenses forced by Sarbanes-Oxley, the beating most stocks have yet to recover from, and the time being a publicly held company increasingly takes away from strategizing for the long-term. According to Factset Mergerstat, a mergers and acquisitions market research firm based in Los Angeles and New York, going-private transactions jumped from just 197 in 2000 to 316 in 2002, and 2003 has been keeping an equally busy pace.

But the process is demanding. Financing routes run the gamut from equity investment and subordinated debt combinations to asset lease-back plans, employee-funded stock buy-backs and even junk bonds. And if money is slow to come, competitors may attack the business, while other bidders appear, ready to steal the company out from under management. And then there are the shareholder lawsuits that can be set off by even the whiff of a conflict of interest.

But first, there is the challenge of finding the cash. If going public is an expensive proposition, retiring from the limelight isn't actually cheap, either. Some large companies have spent over $1 billion to go private, and even small to midsized companies can require hundreds of millions.

Show me the money

For Chan Suh, CEO of interactive marketing company Agency.com, searching for capital was a bewildering process. His New York-based firm, which boasts such clients as 3M and British Airways, went public in 1999 at $91 a share. But even as the company reached $200 million in revenues and 1,500 employees, the stock tanked. “There was a bit of a divorce between the performance of the stock and the performance of the company,” says Suh.

Then came the 2001 slump, and demand began to slow to a crawl. Being public was costing Agency.com millions in filings, outside board members, attorneys, auditors and PR. The $60 million in cash on hand wouldn’t fight both the stock market and the shrinking economy.

Going private was the clear answer, but shopping for money was insulting. “We were running around justifying the company’s existence,” Suh says of the many meetings he attended before pairing with New York-based Seneca Investments for a deal.

Learning to distinguish talkers from dealers—and doing the due diligence required to weed out the time wasters—can take time. And unfortunately, being slow in going private can leave a company in limbo, resulting in a lower valuation and lost ground to competitors. Hiring corporate finance professionals with expertise in this area, although an added expense, can help cut down the time the process takes, so it makes sense to get them on board early in the dealing.

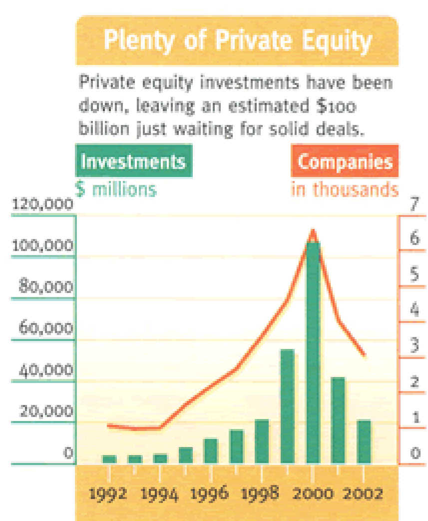
As far as finding cash, there are many money trees to shake: sale and leaseback deals of assets, private equity investments and even employee stock ownership programs. The latter has a great advantage, says Duff Meyercord, a partner with Carl Marks Consulting Group, a management and financial consulting firm in New York. Employees can repay, with pretax earnings, money borrowed to buy shares, and banks often provide preferential loan rates as they have incentives under the Community Reinvestment Act to aid such transactions. “Hell, in the ’80s, [ESOPs] used to be all over the place,” says Meyercord. “I see them coming back.”

Sometimes the money comes from close to the vest— or the once vested. In 1985, Rock Financial was a startup in the retail home mortgage business. By 1998, it had 30 branches nationwide, a thriving phone and Internet business and $100 million in revenues. The next year, Intuit bought the company and changed the brand to Quicken Loans.

But the synergy was short-lived, as Intuit decided to refocus on tax and small business-accounting software. In February 2002, executives reached a $150 million deal to buy it from Intuit. The firm's original founder, Dan Gilbert, was still in touch with Quicken Loans’ management and knew “about five people right off” who could help raise the down payment, recalls Bill Emerson, who became CEO of Quicken Loans in July 2002 when the company eventually went private. Notes to Intuit for the balance were paid within about half a year.

Hampered by public life

Stamford, Conn.-based Esselte also made good connections pay off, finding a partner quickly and relying on that source of expertise to move the deal along. Esselte, which owned such office supply product brands as Dymo, Leitz and Pendaflex, had been around almost 100 years by the time its managers began thinking about going private. Esselte’s then head of marketing, Magnus Nicolin, recognized that the company needed shaking up to be more competitive.



Source: Greenberg Traurig, 2003

“The company needed to do a lot of difficult things, like reorganize itself, manage the European operation in a totally different way, make some acquisitions,” says Nicolin, now president and CEO, who believed at the time that with drive and focus, the company could be a great acquisitions platform in a fragmented industry. But public companies have a hard time making sweeping changes—including getting rid of some members of top management—without telegraphing their moves.

Nicolin met and clicked with J.W. Childs Associates, a Boston private equity firm that specialized in going manufacturing concerns it identified as having potential to greatly increase efficiency with the right lean manufacturing processes in place. Esselte was a perfect fit. “The Childs team took responsibility for the totality of the transaction, and obviously used their banking contacts to get a number of interested banking consortiums to bid on the deal,” says Nicolin. Esselte’s price was about $560 million, of which $220 million had to be debt equity.

It’s that split between equity and debt that makes a return on investment possible. For example, the equity firm buys a company for $300 million and it doubles in value over time. In an all-equity deal, the firm would see a 100-percent return. However, invest $100 million and take the rest in fixed debt, and the growth goes to the equity portion, providing a 300-percent increase. “We have more return opportunity because of the leverage, but we also have more risk,” says Childs partner Adam Suttin. “We don’t think we stress the companies to a point that is imprudent, but that’s how we generate the greater rates of return.”

Childs prefers to invest 35 to 45 percent of the total capital as equity with the remainder coming from some combination of debt financing, including senior secured debt and subordinated debt offered privately to institutional investors or publicly through junk bonds. Each firm has its own formula, and the company seeking funds must be able to show investors the potential improvements that will bear debt service while continuing growth.

A management team that cannot identify the necessary changes, with or without expert help, cannot steer the new private firm. Striking a deal in which increased efficiencies and improvements can more than make up for the debt service can reduce that potential burden so operations avoid crippling overheads. If majority stockholders are pushing for the upper end of a valuation range, a counter offer—providing less cash up front and increasing payments only if projections hold true—might be in order.

Avoiding the sting of lawsuits

Price and other terms also offer potential danger to investors. When an existing management team is interested in raising the money to take the business private, there is an inherent conflict of interest. On the one hand, as buyers, they’re looking for the best price and conditions to increase their own chance of success going forward. On the other, until the company changes hands, the senior managers are still officers of the public corporation, with a legal fiduciary responsibility to maximize shareholder value, which includes working to find a better price than they themselves can offer.

As Joe Sullivan, president of Dallas-based Joseph Sullivan and Associates, a financial advisor for large company purchase and sales transactions, puts it: “If management thinks this is such a bargain, why hasn’t management actively worked to see to it that the shareholders get this value” through a higher purchase price? Sullivan uses an analogy of an elderly woman who owns some land near the site of a new interstate highway. If the woman is unaware of the situation, she might be willing to sell the property at a cheap price to a developer. “But management is on the inside and they’re fiduciaries,” says Sullivan. “It’s as if the woman’s lawyer or trust officer, knowing full well the value and knowing about the interstate highway, went to her and offered the farm land value.”

Investment bankers retained to offer a fairness opinion to the board and stockholders can fuel the problem because they have their own potential conflict of interest: If they support a deal that serves the interests of management, they may stand a better chance of getting the financing work, and the sizable fees that go with it.

Shareholders who get the idea that managers are focused on their own interests tend to file class-action lawsuits first and ask questions later. The results? Damage to the business, an emotional grind and the real possibility of having to pay a substantial judgment or see a deal struck down by a court. “Don’t think that because you dot the I’s and cross the T’s you are being a fiduciary,” Sullivan says. “People can get angry, and some of them have a lot of money” for lawyers, he adds. Even in the absence of legal complications, going private can take months. It can also take a whole lot of patience and careful judgment. But, done right, it can set a business free.