

Investing Environment for the Period Ended December 31, 2006



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"The publicly held corporation, the main engine of economic progress in the United States for a century, has outlived its usefulness in many sectors in the economy and is being eclipsed."

— Michael Jensen
Professor, Harvard Business School
"Eclipse of the Public Corporation"
Harvard Business Review

*"This is the way the world ends.
Not with a bang but a whimper."*

— T. S. Elliott
The Hollow Men
1925

Thomas Kuhn's 1962 book *The Structure of Scientific Revolutions*, has been a staple on college reading lists for several decades. In this book Kuhn, a noted epistemologist and historian of science, coined the phrase "paradigm shift" to describe a change in basic assumptions within the fields of science. Subsequently, the term has been widely applied to multiple fields beyond science. In the private equity field, a paradigm shift occurred in 1982 when former Treasury Secretary William Simon led an investment group in the purchase of Cincinnati based Gibson Greetings. Gibson was taken private in an \$80 MM transaction using just \$1 MM of equity. Eighteen months later, the group took Gibson public in an IPO valued at \$290 MM reaping an estimated 200x return. The gold rush was on!

Every day it seems you pick up the morning paper (or perhaps more likely dial up your favorite Internet news service) and read about a new multibillion dollar buyout of a public company. While there have been prior waves of buyout activity, we have never experienced a boom in buyouts like we are today. Why now? This paper will attempt to explain the causal factors of the buyout boom and will discuss whether the boom is likely to end, since all booms ultimately must, in a whimper or a bang.

First, a few facts from our friends at Citigroup to put the buyout boom in context. Buyouts as a percentage of global merger and acquisition volume have risen from less than 5% in 2001 to nearly 15% in 2006. Moreover, the deals are getting bigger; the average deal size in 2006 has risen sevenfold in the U. S. and fivefold in Europe since 2001. Of the ten largest LBO transactions, nine have occurred in 2005 or 2006 with only the famous, or infamous depending on your point of view, RJR Nabisco deal in 1989 cracking the top ten from the earlier era. Of those nine largest LBOs, four have been in Europe. The buyout boom is a global phenomenon. Something big is happening. But that simple observation raises the question of "why now?"

The standard explanation from Wall Street observers is that financial conditions are perfect for LBOs. Among those conditions are the following recently cited by the

Leuthold Group:

- Low interest rates
- Easy credit
- Massive liquidity from current account surpluses in Asia and the Middle East
- Large pools of private equity capital raised
- Robust global economy
- Strong corporate cash flows
- Cash build up on corporate balance sheets
- Ample capacity for more debt on corporate balance sheets.

This list provides a fine summation of the financial factors driving the buyout boom. Clearly buyouts flourish in an era of cheap money. Bill Gross, famed fixed income manager of PIMCO, has observed that there has never been a better time to borrow money for a legitimate project because credit spreads are so tight. See last quarter's Investing Environment letter for a discussion of that phenomenon.

As good as the above list is in capturing the drivers of the buyout boom, I think it misses a more fundamental point. Public and private equity are competing paradigms of corporate ownership, each with its own advantages and disadvantages. There are several dimensions of this paradigm war, to coin a phrase, that are worth exploring:

Corporate Governance

Public equity ownership has always suffered from what academics refer to as the agency cost problem, which is the separation of ownership and control. The people who run America's large corporations typically own relatively small stakes in the company with the bulk of the shares widely dispensed. Hence, the owners are not generally the people who make the decisions that decide the fate of the firm. In the Private Equity model, there is no such separation of ownership and control.

Advantage: Private Equity

Feedback Mechanism

Management of any company needs feedback on company direction. In the private model, feedback is provided by the Board of Directors comprised of the investors who own the company and occasionally an outsider or two. In a public company, the share price provides the feedback mechanism. This feedback is one of the great strengths of the public model. A share price provides the smartest investors across the globe the opportunity to cast their votes on management's performance and company prospects. Such feedback is a form of competitive intelligence as it signals the effectiveness of management's strategies and the emergence of competitive threats of which management may not be aware.

Advantage: Public Equity

Shareholder Base

While public corporation liquidity can be a great advantage, frequently this liquidity transforms into a great disadvantage in the form of an unstable shareholder base. Warren Buffet has observed that his ideal holding period for a stock is forever. Most investors do not share his view. The average holding period for a stock is less than one year. This instability in the shareholder base is frequently associated with dramatic swings in the share price which may provide distorted signals to management and encourage managing the business for short term results. Shareholder base volatility is simply not present in the private equity model.

Advantage: Private Equity

Regulatory Burden

The regulatory burden on public companies is high and rising. Add to that burden shareholder lawsuits, the need to pander to various public interest groups and the public company regulatory burden and private equity has a significant advantage. Small companies exaggerate this phenomenon as there is a large fixed component to these costs, magnifying the impact on smaller companies. Is it any wonder that IPO activity continues to be sluggish in U.S. markets?

Advantage: Private Equity

While there are other aspects of the differences between a public and private model of ownership, the above discussion touches on some of the key ones. How long will this buyout boom last and how will it end? The first part of the question is easier to answer than the second. There is good reason to believe that as long as the precipitating factors cited earlier by the Leuthold Group remain in place, buyouts are likely to continue apace. As long as the lending spigots remain wide open and the global economy remains relatively prosperous, there is little reason to believe that the buyout boom cannot continue as management teams and Boards of Directors around the globe come to realize the many advantages of the private model of corporate ownership.

"How will it end?" is the more interesting question. Here is where T.S. Elliott's famous quote about whimper or bang comes into play. Here are two scenarios:

Bang Scenario

In the Bang Scenario, a large deal or two collapses spooking lenders and regulators leading to a credit crunch which grinds the boom to a halt. Sic Transit Gloria. Such a collapsed deal could be caused by a downturn in the economy that damages a company's prospects or it could be caused by too much leverage coupled with a relatively modest turndown in the company's cash flow.

Whimper Scenario

Under the Whimper Scenario, the other constituency of the public company, its mass of shareholders, wakes up to what is happening. Much of the float of public companies is held by mutual fund managers who operate in a competitive fishbowl where performance relative to their benchmark is the difference between wealth and prosperity and the unemployment line. Heretofore, such managers have been delighted when a buyout firm comes along and offers a 15% premium for XYZ company in their portfolio. A 15% premium on a 3% position provides 45 basis points of outperformance relative to the benchmark, a powerful incentive for portfolio managers to happily turn over their holdings to the private equity sponsor. But what if the 15% premium still grossly undervalues the company? The private equity sponsor is presumably not foolish; clearly the sponsor believes that the public company can be taken private and, through a series of actions, produce a high level of return for its investors. The Whimper Scenario is that public company shareholders begin to look at the long term value of their companies and demand that management undertake the same actions as the private equity but under continued public ownership.

Will the "pop" in performance when a company is taken private continue to mollify the public shareholders? It is not clear yet, but there are straws in the wind. Fidelity, the largest shareholder of Clear Channel, signaled its intention to oppose the take private transaction of the company. Additionally, Anheuser Busch announced on December 20, 2006 that the Board of Directors had approved a new, more leveraged capital structure to enhance shareholder value, much as a private equity sponsor would do.

Whimper or bang? Or both? I believe it depends on the economy. If financial conditions remain robust, buyouts will likely continue and the occasional pushback from public company shareholders is unlikely to derail the buyout boom. In my view, greed and performance pressures on mutual fund managers will override theoretical discussions about the long term value of a company. We'll see.



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*The opinions expressed herein are those of John J. O'Connor and do not necessarily reflect the thoughts, opinions and conclusions of Fort Washington Investment Advisors, Inc. or its subsidiaries, affiliates and or employees.



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