

Private Equity Today - Growing a Different Kind of Investment

by Simon Francis and Dan Kaplan



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If "misery acquaints a man with strange bedfellows" as Shakespeare wrote in *The Tempest*, tucking hedge funds in with the adult-entertainment business shouldn't seem all that shocking in these times of economic doom and gloom.

Conventional wisdom used to be that depressed financial markets signaled a buying opportunity. But with so little capital flowing these

days, those with the cash seem to be holding out until the bottom is clearly in sight. The savviest investors, however, are making their move in more ways than just ferreting out distressed companies. They are pursuing fundamentally different opportunities altogether, like Francis Koenig, founder and CEO of AdultVest.

Good taste and moral judgments aside, Koenig is tapping into the virgin territory, if you will, of large-scale investment in the multi-billion-dollar adult entertainment industry.

For the best and the brightest in private equity, there are still fortunes to be made as the world economy staggers toward stabilization.

The Salad Days

When Fed Chairman Alan Greenspan cut interest rates to historical lows, borrowing money to snap up inefficient businesses could be had on the cheap. From late 2000 through 2005, the get-rich mantra was: get in, drive down costs and get out quickly. Four years was considered ideal.

Spending of all types went in to high gear. But banks have shut off the faucets and many now find themselves late to the party. And just as modest income people over-extended themselves with huge mortgages for

overpriced properties now face foreclosure, so, too, are PE funds saddled with overvalued portfolio companies that can't be unloaded because the IPO market has all but screeched to a halt. An alarming number are missing their debt covenants. Even the stalwart Harvard University endowment fund experienced a steep 22-percent drop from July to October of last year.

Putting predictions in print is courting trouble, but by the end of 2009, as many as one in four PE firms in business in 2007 may no longer exist. This winnowing will mean more financial experts looking for fewer and fewer jobs, but the cream will still rise to the top. When Lehman Bros. went out of business in September, for example, investment banks and PE firms lost no time in wooing the top performers. We're now seeing players move between PE firms and working alongside previous competitors. That's never happened before.

So while there may be fewer PE firms in the future, the fittest will survive and continue to generate returns in spite of the hostile economic climate. Only they'll be doing it in a different, edgier way.

Reinventing the Wheel. Literally.

Most products and services are not new, no matter how flashy their launch by PR flacks. Is Google truly revolutionary? Not really. At its core, the online search engine is just a better, faster, cheaper form of Yellow Pages. It is a proven commodity repackaged and re-branded to keep pace with the technological changes that are transforming a global economy.

Once thought recession-proof, healthcare companies are hurting, too. But they're running on a business model that hasn't changed much in 100 years. Entrepreneurs who find ways to make the delivery more efficient, there is still plenty of money to be made.

Hailed as the first mandate of the 21st century, cleantech is really just the next iteration of the combustion engine; albeit one that uses more environmentally friendly, reusable energy sources. Wind farms. Biofuels. Solar

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power. There is plenty of growth potential in these emerging technologies, but financing is another matter. Forward-thinkers are already looking to Purchase Power Agreements (PPA) to play a key role in the financing of electricity generating assets. Peer-to-peer lending has been around since 2005 and is slowly gaining traction in areas such as student loans and home mortgages. PE funds may take this form of bypassing traditional lenders to the nth degree.

And as institutional investors are increasingly expected to liquidate interests in private equity funds to rebalance assets and reduce unfunded liabilities, the secondary market for private equity interests will surge. In 2009, it is anticipated that financial institutions, endowments, pension funds and others will look to sell private equity interests to a growing set of dedicated buyers

Deals can be made, as can profits for PE shops that brought in the right CEO and management team for today's economy.

The Backable CEO Ignites Growth

Yesterday's CEO superstars who could strip away fat from under-performing companies simply don't cut it anymore. Today's leaders must be able to grow struggling portfolio companies and generate revenue—not merely tread water until a bull market rears again.

Much of this talent will still be sought by blue chip companies, but at a rung lower than the C-suite. It's the 40-year-old (give or take) brains behind the operation—the one working 100 hours a week—who knows in which direction to head. The CEO, still steeped in the traditional way of doing business, is merely the front man.

For that mid-level executive, the time is ripe to be recruited to take the helm of a struggling portfolio company. Much can be gleaned as PE firms interview these movers and shakers and hear their proposed strategies to expand in new geographic markets, for example, or shed a non-core retail business, or partner with an international supplier. The signing of the new CEO will signal to employees and investors alike that a new course is already underway because these executives will not take on the job unless they've been assured by the powers that be, that all are on board for this new course.

The new CEO superstars will and cherry-pick the necessary talent to turn around languishing assets. Will it be easy? Not like it was in early 2000. But just as no sector has been immune from the current economic fallout, specialization, expertise and relationships will continue to trump despite these tough times. Or, in the words of Sir John Templeton, "Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria."

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