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THINK LIKE PRIVATE EQUITY TO ENHANCE PUBLIC COMPANY VALUE

Private equity has helped bring shareholder value back to the boardroom agenda, but public company executives don't need to watch from the sidelines. Here are six lessons learned from PE philosophy that public companies can apply.

BY
JUSTIN PETTIT

The financial world was riveted earlier this year by the bidding war for Equity Office Properties, one of the largest publicly held office building owners. The Blackstone Group ultimately prevailed in the contest, but only after it raised its offer to $23 billion from $20 billion, outbidding strategic acquirer Vornado Realty Trust.

It was a huge win for shareholders of Equity Office, who got a premium of more than 25 percent compared with their share price before Blackstone made its initial offer. But, you can bet Blackstone expects to get an even bigger return when it sells Equity Office one day in the future.

After all, that is what private equity firms like Blackstone specialize in — enhancing shareholder value. Across many public companies, there's a lot of enhancing to do. Research suggests that companies' shares often trade at up to a 30 percent discount to what they would fetch if the pieces were on the market separately. That's a lot of unrealized value, and it helps explain why at 20 percent of all global M&A deals, leveraged buyouts surged last year to some $700 billion.

And, while there is much talk of a slowdown in deal volume, according to *The Wall Street Journal*, leveraged buyout (LBO) deal volume through August 10 of this year was $705.6 billion worldwide and $435 billion in the U.S. That is up almost 87 percent and 100 percent, respectively, from the same period last year.

While financial sponsors, including private equity firms and hedge funds, don't say much about their plans for improving the profitability of individual companies, their overarching strategies are no mystery. And, indeed, those strategies are available not just to the Blackstones of the world, but to financial executives at any public company. What follows is a look at six lessons to be learned for enhancing value.

Lesson No. 1: Objectively Value The Portfolio

Once they acquire a company, financial sponsors evaluate the company's individual business units, its portfolio, along two dimensions to figure out where to invest, hold or divest. The first dimension is each unit's strategic fit — how "core" the business is to the larger company's opera-

tions. A business unit that is core will support and benefit from the unique competitive advantages enjoyed by the larger company of which it is a part. Those units, like the star players around whom sports franchises are built, are generally not for sale.

The second dimension of portfolio evaluation is economic — whether a unit is worth more to someone else than it is to the financial sponsor. Financial sponsors make this sort of value gap assessment by comparing internal measures — such as a discounted cash-flow analysis — with external measures, such as the market values of comparable businesses. In the case of a core unit, selling isn't an option, but the value gap analysis can signal whether the unit requires further investment or needs to be fixed. In the case of a non-core business unit, the analysis can provide useful information on the timing of a sale (see diagram on next page).

The General Electric Co. is a company that has been particularly clear-eyed about valuing its portfolio. The company is focusing its investments on areas it considers core — such as selling energy products, like wind turbines, into emerging markets. For instance, GE has said it expects its infrastructure business in India to grow 30 percent this year.

On the divestiture front, GE recently sold its plastics business, which the company no longer considered core and where profit fell 23 percent in 2006. Chief Executive Officer Jeffrey Immelt said GE will use the $9 billion in after-tax proceeds from the plastics-division sale to increase GE's stock buyback program — another technique public companies can deploy to improve shareholder returns.

Lesson No. 2: Manage for Long-Term Value

To be effective, portfolio evaluation can't be a one-time event; it needs to be an ongoing process, determining where each business falls on the dimension of strategic fit and identifying exit strategies for non-core business. If they do these reviews as a matter of course, CFOs, like financial sponsors at their savviest, will always have a sense of whether they should be fixing or growing a business, selling it, abandoning it or simply sitting tight.

To have a plan is to be able to move with assurance and alacrity when a business ceases to be strategic, as GE's plastics-division sale demonstrates. It's a rigorous mode of operating that enhances long-term value.

There are two other actions financial executives can take to keep the focus on long-term value. First and most important is the de-emphasis of quarterly results in favor of the things that will drive value three to five years out.

To be sure, taking the long-term view is easier for companies that have gone private and are no longer answering to public-market stockholders. But some public companies do operate this way, and some CFOs have even gone so far as to abandon the practice of providing quarterly earnings guidance. Two high-profile companies that fall into this category are Google Inc. and The Coca-Cola Co.

The second change that executives can make is to favor fundamental intrinsic value over generally accepted accounting principles (GAAP)-based financial results. While earnings releases are key indicators used by both buy- and sell-side analysts, when public companies pay too much attention to these metrics, their managements run the risk of making decisions and resorting to tactics that don't enhance long-term value.

Lesson No. 3: Buy High

If there is one myth about value-creation that needs to be shattered, it is this idea that low-priced acquisitions always make the most sense. In fact, history has shown that the best acquisitions are often those where the targets are fast-growing and close enough to the acquiring company's core that they can benefit from strengths the acquirer brings.

It certainly didn't look cheap when News Corp. bought the social networking Internet service MySpace in July 2005 for almost $800 million, but News Corp.'s stock has jumped 40 percent since that time. Recently, News Corp. Chief Executive Rupert Murdoch has closed another pricey acquisition — that of Dow Jones & Co., for over $5 billion. At $60 a share, his bid was 67 percent above the stock's price before the offer became public in May.

Similarly, the Danaher Corp. didn't let seemingly high prices discourage it when it decided to expand its presence in the healthcare market last year. At $2 billion, Danaher's purchase of Sybron Dental was Danaher's largest acquisition ever. A few months later, Danaher had to outbid other companies to get Vision Systems for $520 million. If reaching deeply into one's pocket was the first step to going broke, Danaher's stock would have been decimated. Instead, it's up more than 10 percent in the last year.

This counter-intuitive observation about the value of pricey acquisitions was borne out in a survey done by UBS a few years ago. The investment bank studied more than 1,500 deals over a 12-year period and compared the 500 that had ultimately driven the acquiring company's stock up the most to the 500 that had driven the acquiring company's stock down the most.

UBS found that of the 500 best deals, the top performers had enterprise value-to-capital ratios of 3.5-to-1, while the worst had enterprise value-to-capital ratios of only 2.8-to-1. Indeed, sometimes you get what you pay for.

Lesson No. 4: Relentlessly Manage Low Growth

Not every business can be a star. Financial executives need to understand this, and must make an unsentimental distinction between the high- and low-opportunity businesses in their portfolios. In particular, executives need to press low-opportunity businesses to be extremely disciplined and efficient, wringing operational savings that can be used to fund faster-growing product lines and to pay down debt.

Maximizing the value of low-opportunity businesses involves con-

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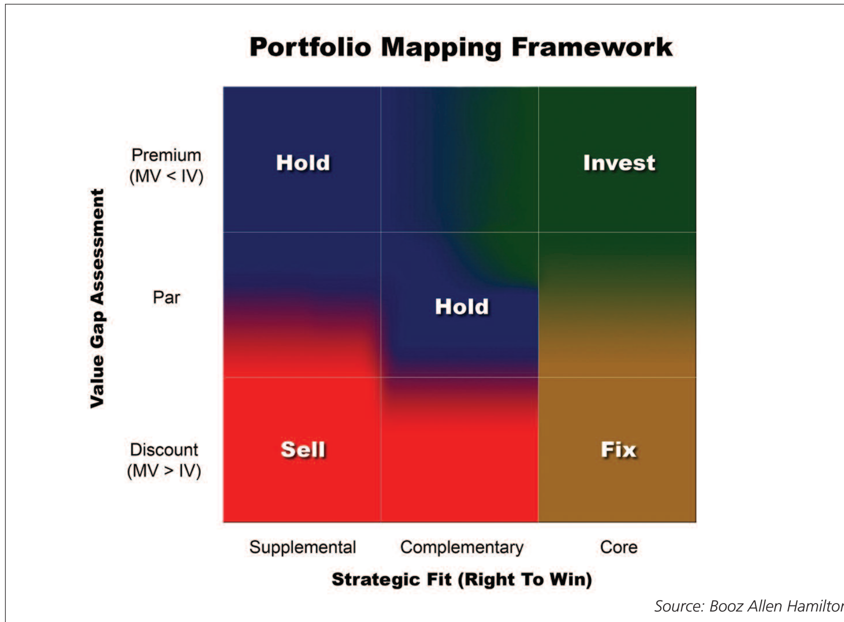

Source: Booz Allen Hamilton

siderable fiscal prudence and a focus on tactics and execution. This is something that financial sponsors excel at — often to the dismay of managers who see the tight controls as both unfair and a form of short-sighted stinginess. It isn't stinginess per se — it's prudent capital allocation.

Operating in a slow-growth business in 2006, food company ConAgra Foods Inc. set a goal of operating its businesses more efficiently. Although ConAgra's sales grew only 4.8 percent in the fiscal year that ended in May, net profit jumped 43 percent as the company did a better job of managing its expenses. The improvement has propelled ConAgra's stock up by 23 percent in the past year.

Lesson No. 5: Optimize Capital Structure

Once the province of financial sponsors, capital structure optimization is now a well-known route to value creation. The right amount of financial leverage can preserve a company's financial strength while reducing equity capital and thus boosting return on equity (ROE).

But how much leverage should a company have? There is no cut-and-dried answer to this; optimal debt levels differ between industries and even among companies in the same industry, and are a function of the economic and regulatory environment, the vendor's bargaining power, the opportunities it enjoys and the threats it faces. Still, sometimes a financial executive handles the equity vs. debt question so deftly that there is no doubt he or she has found the right answer.

A case in point is what financier Edward Lampert did after he took a big stake in bankrupt Kmart in 2003. Lampert engineered a financial restructuring of the company, replacing debt with equity and securing billions in operating funds. The rejuvenated company is now part of Sears Holding Corp., whose stock has about sextupled in the last four years in one of the greatest retail turnarounds in history.

Lesson No. 6: Send Money Home

Cash is the ultimate asset. It gives a company bargaining power, shows customers the company isn't going away and allows the company to react quickly to opportunities. It is also one of the most straightforward ways CFOs have of returning value to shareholders, either through dividends or by launching stock buybacks.

For the many years in which it was unmistakably a growth company, Microsoft Corp. husbanded its huge cash store, using it to weather a hostile regulatory climate, finance acquisitions, enter new markets and battle competitors (WordPerfect, circa 1990; Netscape, circa 1997; Google, now). As its growth has slowed in recent years, however, Microsoft has begun returning cash to shareholders through increased dividends and buybacks.

In 2004, at a time when it had $56 billion in the bank plus more than a billion per month in cash flow, Microsoft announced it would pay a special one-time dividend of $3 a share, double its already doubled quarterly dividend and initiate a $30 billion open-market share repurchase program. Its financial executives did something big, just as every CFO must do something big or risk having some financial sponsor come along and do it for him.

Private equity has helped bring shareholder value back to the boardroom agenda, but public company executives don't need to watch from the sidelines. By embracing similar tactics, corporate executives can become much more adept at positioning their companies for long-term success. In doing so, they'll raise the value of their companies' shares and create significant value for their shareholders.

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TAKEAWAYS

>> As of August 10, deal volume was up 87 percent worldwide and 100 percent in the U.S. over 2006 levels.

>> Companies shares often trade at up to a 30 percent discount to what they would fetch if the pieces were on the market separately — a lot of unrealized value.

>> One key for enhancing value at a public company is to objectively value the portfolio from two dimensions: which parts to invest in, hold or divest; and whether a part is worth more to someone else.

>> One myth about value creation is that low-priced acquisitions make the most sense. History has shown that the best acquisitions are often those where the targets are fast-growing and close enough to the acquiring company's core that they can benefit from strengths the acquirer brings.

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