7. VDA Medium-Sized Business Day

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- Prof. Dr. Dieter H. Vogel -

The Advance of Private Equity Companies: Is the structure of our industry changing?

Ladies and Gentlemen,

Thank you for the invitation and the nice introduction. What wasn’t said was that my professional roots are in the medium-sized automobile supply industry.

From 1975 on, starting with a sales volume of 30 million DM with garden hoses and plastic watering cans with Peguform in Bötzingen, I built up an automobile industry supply company that 10 years later, when I switched to Thyssen, had grown 50 fold, with a sales volume of 1.5 billion DM.

As typically happens, after I switched to Thyssen, Peguform was bought by a large German concern, which more or less ruined it. It was in fact Cerberus, the PE fund that took Chrysler off of Daimler’s hands, that revived Peguform in the past few years. And there is also a good possibility that Cerberus will also revive Chrysler.

With that we move to our main theme.

Some basic things have already been said about private equity. I therefore want to concentrate on giving you a realistic, practical picture on the basis of my past eight years of experience in the private equity world. As a result, perhaps some of you may leave with a less biased view of private equity than you now have.

Scenario 1: Private equity, ladies and gentlemen, is first and foremost nothing more than a financial product. It is neither good nor bad, but rather an offer, an option, which one may or may not use as a non-stock market oriented, in other words private, company for acquiring capital resources. Usefulness goes far beyond suitability as a potential buyer.

The differences between private equity and public equity can be established on the basis of some key points:

- For private corporations and partnerships, private equity often offers the only access to capital resources from outside without giving up entrepreneurial independence. Particularly when large sums are requested quickly and without red tape and furthermore when a certain amount of know-how transfer in value appreciation management is desired.

  And for anyone who would like to sell his business completely, the private equity fund gives rise to a circle of bidders with many advantages. It makes high sales profits possible and avoids selling to a competitor, something that medium-sized business owners in particular frequently do not wish to do. Aside from this emotional component, as a rule a private equity buyer opens up better opportunities for management and employees than a strategic buyer, who immediately questions the structures and implements cost synergies that are usually tied to major job losses. Whether or not private equity in an individual case is in fact an advantageous solution obviously depends in large part on the seriousness and the business qualifications of the respective private equity company. It goes without saying that the differences here are the same as those that are found from one traditional company to another.

- As a further comparison: During the hold time of the engagement, which as a rule may be several years, private equity investments have a stable shareholder structure, as opposed to the typical stock-exchange listed corporation:

  The shares usually change hands in a semiannual cycle. The common interests of shareholders, which in publicly listed companies range from the investment fund, the hedge fund, to the day trader and the private small shareholder, are not an issue. In my opinion, ladies and gentlemen, the absence of the principal in stock exchange-listed companies is one of the reasons why scandals, mass dismissals, and bankruptcies are much more common in well-known concerns than in the environment of private business and private equity. Bribery of customers and staff representatives, illegal price fixing with hundreds of millions in fines: anyone of us can easily think of a dozen DAX [German stock index] concerns that we've recently read about in the morning paper at breakfast, plus a whole bunch of public corporations.

  Is private equity the same way? No way! Mass firings, shutdowns, major relocations to foreign countries. These things are much more likely to happen in concerns than in companies that are in the hands of private equity investors.

  Why is this so? It is because concerns are slower, more sluggish, and less innovative than private companies, whether they are in the hands of private equity firms or a family, and consequently reaction to changes occurs much too late in concerns and when that happens, it is necessary to resort to the heavy artillery such as mass firings. Out of the many thousands of bankruptcies annually, the number in companies owned by private equity funds is negligible.

- And now for the painful subject of returns! For the investor, private equity investments are not fungible and in some cases illiquid for many years. For this reason alone they qualify for higher returns than what the stock market offers. And they usually also measure up. As we shall soon see, there are a number of reasons for this.

- Along with rigid cost management, private equity firms place particular emphasis on the growth of their portfolio companies. M&A activities are thus a solid component of value appreciation management. Traditional concerns and private medium-sized businessmen alike frequently act more passively in this regard. No wonder that the private equity fraction in the M&A market is skyrocketing. Already 50% in the last half of 2006.

- Did you know that hostile takeovers, a torture instrument of the ugly side of capitalism, are a regular attack technique employed by traditional concerns, but not by private equity funds? Popular opinion thinks otherwise, but as is generally known, nothing is more enduring than prejudice.

If we push these prejudices aside, ladies and gentlemen, it then becomes evident: Private equity has something to offer medium-sized businesses. Private equity can – and if I may add, I am thoroughly convinced that it will – change the medium-sized industry structure even more. Above all, as I already implied, their success speaks to the suitability of private equity investors as partners for medium-sized businesses. Private equity funds are usually much more successful than – let us call them – strategic investors. It seems, ladies and gentlemen, that there are structural, methodical elements of the private equity approach that promote this success. I would like to outline them briefly.

Concerns that sell the subsidiaries that they do not count among their key businesses to private equity investors regularly rub their eyes when they see that their former daughters are resold a few years later for 3 to 4 times as much.

Why is this so? Because private equity investors exploit companies and leave behind scorched earth, according to popular parlance? Nonsense! No one can seriously believe that anyone who pays a private equity fund 3 to 4 times the purchase price when something is resold would do so for a company that has been bled dry and that has no future. Of course not! The opposite is true. After the years of ownership by the private equity investor, the company has simply become worth more.

Scenario 2: Here are just a few of the key basics in the admittedly cut and dry comparison of private equity management and concern management. From the listing of criteria for success and the comparison with traditional concerns, you can see that there are many similarities between the private equity approach and the thinking and actions of a private businessman, many more than between private businesses and concerns.

- While the typical concern is run by a cooperative board with a chairman that has very little ranking authority, the CEO in private equity structures is clearly Number 1.

- Strategic questions as well as important operative questions are worked out between the board of directors and the owner immediately and solutions are implemented without delay. The energy-devouring detour via the supervisory board is dispensed with.

- The transparency of all important procedures is complete, timely, and furthermore, informal. Long-winded elaborations are done away with. As for transparency in concerns, one can learn by watching, say, Siemens.

- Financing is related to, or tailored to, the project. This leads to ironclad discipline in handling capital, which often cannot be said for traditional companies.

- The main goal of a private equity investor is the systematic increase of company value. Value appreciation management thus addresses every aspect of profit and loss calculation and every aspect of accounting. Slogans are: Greater profits through growth, stringent management of costs and capital, assurance of a high cash flow. Concerns work differently; much more politics is involved. Reconciling the stakeholders clearly outranks the goal of increasing the company value.

And finally, ladies and gentlemen, one of the most important reasons for the success of the private equity asset class: The company management has a direct stake in the equity. Fund investors and company management: They are all owners and are by principle involved in the same opportunities, the same risks, and the same hold time of the investment. Share options, like those that boards of publicly listed corporations receive, are not the same thing. They have no downside and everyone can sell when he wants to. Principle of shared interest: No way.

Scenario 3: You see, ladies and gentlemen, private equity is much closer in thought and actions to medium-sized business than many people think. Three current examples from the Lindsay Goldberg & Bessemer Fund (LGB), the European branch that I manage, should illustrate that what I've already said is put in practice in a well-managed fund. LGB is a medium-size fund with $5 billion in available capital over the last 5 years, a large part of which was raised by one family. To give you an idea of the order of magnitude: the portfolio managed by the fund had a business volume of ca. $18 billion in 2006. The fund invests heavily in family businesses, also as a minority, and primarily in order to finance growth. Scenario 3 corroborates the substantial dynamization of two concern companies that we acquired as well as an investment in a family business after the takeover.
The yearly growth rates two years before and two years after our entry are compared.

As you can see, the annual growth rate for Mapress, a former Mannesmann subsidiary that was successful before the purchase and which had a turnover of €160 billion and 600 employees, clearly increased from 4% to 14% per year. The operative profit expanded at an above average rate of 16% annually after our entry. The number of employees rose 15% in the first two years following the takeover, whereas it had grown by 8% annually before the takeover.

The Wacker Construction Equipment AG, a family-owned company that is a world niche market leader, and in which we acquired a minority share, has flourished splendidly with our help. The company is going on the stock market. As you can see, Wacker acted on the defensive side before our time, but afterwards showed impressive growth figures. An annual increase in business volume of 18% and an annual profit increase of 29%, based on a €360 million turnover.
11% new jobs each year round out the picture of the first two years after our share acquisition.

A third example, Klöckner & Co, shows similar characteristics. After the takeover, things started going uphill for this company, a company with a €5 billion turnover and which is also the largest steel dealer in the world that is not part of a concern. The strongly negative sales trend reversed itself and turned into a clear growth. The growth offensive led to an annual increase of 21% in profits. Another piece of good news is that in spite of the need for considerable streamlining measures, these growth dynamics made it possible to keep the number of employees stable.

Scenario 4:

Similarly enlightening and in my opinion even more impressive is the reflection on the changes between our entry and exit. We sold all three example companies within a 4 year period after we invested in them: Mapress to a strategic investor, Wacker back to the family.
In the middle of last year, Klöckner & Co was placed on the stock exchange and developed into the most successful IPO of 2006, and has maintained its sharp upward growth in 2007 as well.

With reference to the numbers, the effects of our value appreciation management during our hold time are clearly demonstrable. In lieu of the typical characteristics that the critics (including the Takeover Board (*Übernahmerat*) of the German federal government) typically impute to private equity: shrinkage, exsanguination, stripping of assets, excessive debt, extensive cutbacks in investment and research activity, a totally different picture emerges. Between entry and exit, enormous growth was achieved in all three companies, 37% in Mapress, 72% in Wacker, and 15% in KlöCo. The profits increased by 62%, 135%, and 46%, respectively.

The market capitalization of the companies increased by 161% in Mapress, 211% in Wacker, and in KlöCo, in just under 2 years, 723%.
As you can see, the debts, where there were any, were clearly eliminated. In Mapress as well as in Wacker, a large volume of jobs were created, some through acquisitions; the larger fraction through internal expansion. Klöckner & Co noted a minor loss in the number of employees, which was primarily due to the sale of a subsidiary outside the core business, but otherwise there was an increase here as well!

Ladies and gentlemen, the three examples prove that private equity funds are anything but bringers of horror scenarios. With the right partners from the private equity zone who possess business as well as social skills, and as you may guess, we count ourselves among this number, companies will not be bled dry and will not lose their sustainability. Instead, they will become more dynamic, more valuable, and more sustainable. Yes, there are also private equity companies that encumber companies with excessive debts when they acquire them and on top of that, generate massive debts for the purposes of paying out dividends. But that is not my private equity world; rather, it is the minority in a sector that has otherwise made great strides economically, in Germany as well.

After a slow learning process in the beginning, the federal government has meanwhile also come around to this point of view. After State Secretary Hendricks told the FTD on August 30, 2006: "The economic benefit of private equity is rather minor," the tune changed in a small federal government survey on November 11, 2006, i.e., a good two months later: “The private equity sector is assuming an important economic function.”

The EZB recently (April 19, 2007) said something along the same lines and added: "A stricter regulation of private equity is not necessary. The opposite is true for hedge funds, where greater transparency is advisable." I can only confirm this view.

Private equity, ladies and gentlemen, is a success model, and one that will continue to catch on. In my opinion, its suitability as a partner for medium-sized businesses is obvious. We are in the beginning stages of implementation in the automobile supply industry as well. We cannot anticipate where it will end, but it surely will not be an end with horrors, nor a horror without an end.

1. Characteristics of Private Equity

	PRIVATE EQUITY	PUBLIC EQUITY
Target companies	Corporation or partnership not listed on the stock exchange	Stock corporation listed on the stock exchange
Shareholder structure	stable during the hold time	frequently highly variable
Fungibility	low	high
M&A activity	high	depends on the case
Hostile takeovers	no	possible

2. Success Criteria of Companies Managed by Private Equity Compared to Traditional Concerns

	PRIVATE EQUITY	**PUBLIC EQUITY**
Type of management	CEO orientation	cooperative board
Governance partner	owner	supervisory board
Transparency for owner	complete	limited
Financing	transaction-related	flat rate concern financing
Company goal	increase of company value	optimization of stakeholder interests
Management incentives	direct stake in the equity	stock options

3. Changes during the Pre-ownership and Private Equity Affiliation with LGB Companies as Examples

CAGR %	MAPRESS GMBH		WACKER CONSTRUCTION EQUIPMENT AG		KLÖCKNER & CO AG	
Seller	Concern		Family		Concern	
	before	after	before	after	before	after
Business volume[1]	+4%	+14%	-2%	+18%	-4%	+1%
Operative profit[2]	+1%	+16%	-4%	+29%	+4%[3]	+21%
Employees	+8%	+15%	-2%	+11%	-1%	-1%

in each case 2 years prior to and 2 years after the change in ownership

[1] sales at KlöCo

[2] EBITDA

[3] without windfall profit in 2004

4. Changes from Entry to Exit with LGB Companies as Examples

	MAPRESS GMBH	**WACKER CONSTRUCTION EQUIPMENT AG**	**KLÖCKNER & CO AG**
Buyer	Strategic Investor	Family	IPO/Stock Exchange
	Change	Change	Change
Δ Business volume	+37%	+72%	+15%
Δ Operative profit[1]	+62%	+135%	+46%
Δ Company value[2]	+67%	+249%	+171%
Δ Market capitalization[3]	+161%	+211%	+723%
Δ Debt	-24%	-	-41%
Δ Employees	+53%	+30%	-3%
Acquisitions	+1	+3	+9

[1] EBITDA
[2] Enterprise Value
[3] Equity Value