The Journal of
PRIVATE EQUITY
Strategies and Techniques for Venture Investing

VOLUME 6, NUMBER 3 SUMMER 2003

Even though the markets took a much-needed tick upwards in mid-March, those of us in private equity with an eye on the IPO window know not only that it remains substantially closed, but that its reopening will trail a broad turnaround in stocks by many months, or even years. So we are forced today to build for a better tomorrow. For those of us involved in equity buyouts in this sideways economy, the prospect of purchasing a turnaround situation is more likely than ever. Herewith we present some ideas on managing your companies through the turnaround process, and some ideas on the vital difference in value between private and public company values. For those of you patiently waiting for the IPO scene to take off, we present views on how the process may be able to be improved. For those having difficulties inside their current VC partnership, some tips; for those thinking of getting involved with a franchise business, a study of returns; and for those wondering where the entire segment of "private equity" belongs, a comment on what private equity represents amongst and against other investment classes.

William Fetterman leads off our issue with a look at the general concept of a professionally managed turnaround. Just what is there that is different when bringing in outsiders to either review or lead your company's turnaround? What are the key issues they concentrate on? William takes us through the five stages of a turnaround with specific financial and operational actions to be taken at each stage. Anyone looking at a turnaround situation, either in your portfolio or as an acquisition, will find this outline a useful way to organize your plan.

Earnings before interest, taxes, depreciation, and amortization: how meaningful is EBITDA to your business? Is it the best way to look at earning power? I have long been of the opinion that this measure, while useful in some cases, can also hide from view critical components of the financial and operational progress of a business. Calabrese and Rafferty take us through a Cook's tour of how EBITDA can be used and abused as you look at your troubled businesses and think about a turnaround plan.

David Kupetz takes us through one of the less well known but very powerful techniques of moving assets from a troubled company into a better one: an ABC. The assignment for the benefit of creditors gives both owners and creditors a useful way to wind up operations or transfer assets without the lengthy, expensive, intrusive, public, and often capricious court process of a bankruptcy. Understand the way an ABC works and you may be surprised at how much better it is in many situations than a bankruptcy.

Things get messy inside a private equity partnership when the companies are going through "down rounds," that difficult time when new money enters at a value less than previous valuations. Just what obligations do directors owe to the stockholders in this special situation? Hill and Gambaccini take us through the general and special duties owed, and how best to discharge them.

And what to do if you are having problems in general with the general partners of your firm? Ah, yes, as so many firms struggle over smaller sets of limited partner funds and reduced levels of returns, hidden problems often surface. Allen Weingarten covers such topics as non-competes for departing partners, limited partner revolts when general partners depart, partners that are construed also as employees … and many other vital issues. These are the times that try men's (and women's) souls, and when that happens, can the legal community be far behind? Read this piece to stay just a bit ahead.

The IPO market is like the weather: very hard to predict and constantly changing. When times are good, the sun shines and seems that it will never end. Yet when the clouds roll in, we wonder if the sun will ever come back. Giant waves of good IPO weather are driven by industry upheaval, yet some academic studies show those who sell on the first day do better than everyone else. What in the heck can we do about this situation that seems almost too wild even for Wall Street? Bartlett and Shulman offer a thought-provoking look at what is being discussed throughout financial and government circles on how to tame this wild beast. Forewarned is forearmed; you will find this interesting reading.

What does the idealized rational and diversified investor have to look forward with when investing in private equities as a class? Varun Sood takes a broad look at this question and posits a number of ways to think about the issues. Should general partners be positioned to take risks or to insure the longevity of their partnership? How many of us have watched the fantastically successful VC firm morph with later- and later-stage investments into a conservative source of pre-IPO capital, far away from the seed-stage investments that were the source of their success? Why does this happen?

Thinking more about the line dividing private and public companies, Kooli, Kortas, and L'Her present their findings about the differences in value between private and public companies. Each of us forming a private company with the expectation of taking it public someday is counting on erasing this discount the day we hit the public market. Just how big has the discount been? Has it changed over time? What has caused it to change? What will it look like next year? All fascinating questions.

Our final piece takes us into an area that has had more attention since the implosion of the tech sector: franchising. There was a day when franchising was the growth engine for small businesses. How have these companies done in the decade of the roaring 1990s? Are they more or less risky than the market as a whole? Do certain characteristics of the franchisor predict success or failure? Spinelli, Birley, and Leleux tackle this interesting topic and develop a good overview of the area.

James E. Schrager
Chicago, Illinois