

“The Role of Private Equity in the Development of U.S. Companies”

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Introduction

Good morning,

My name is Mark Vidergauz and I am the CEO of The Sage Group, a boutique merchant banking firm based in Los Angeles and New York. I would first like to thank the AIFI for inviting me here this morning. I am delighted for the opportunity to share my thoughts with this esteemed group regarding “The role of Private Equity in the Development of U.S. Companies.”

There is little doubt that over the past few decades, private equity funds have been prominent driving forces behind the economic growth and innovation in a broad cross-section of industries throughout the American economy - from basic manufacturing to business services and even to luxury products.

In fact, over the last 20 years, private equity funds have delivered average annual returns of roughly 13.2%, as compared to the Standard and Poor's 500 Index, which averaged a more modest 9.7% over the same period.¹ Private equity investors have provided critical growth capital, fueled a boom in the merger and acquisition market, and enabled public and private stakeholders alike to achieve unprecedented liquidity. Without question, the private equity investment model has become a foundation of American capitalism, to the advantage of companies, entrepreneurs, investors and the economy at large.

Notwithstanding these successes, a degree of skepticism remains regarding the nature of such success, both in the U.S. and abroad. The question is, are private equity-backed companies truly improving their operations over the medium and long term, or are the gains merely short-term, resulting from financial engineering, cheap and plentiful debt capital, or other more superficial means?

In truth, the social benefits of private equity depend to a large degree on whether better management and strategic planning trump financial

¹ Thomson Financial, NVCA "Private Equity Performance Remains Steady in Q3, 2006."

engineering. I believe that a strong case can be made that, on balance, private equity-backed companies are genuinely better managed. Nevertheless, good management in concert with financial engineering can also prove to be a very powerful alliance.

My overall message to you today is relatively straightforward: private equity investments can provide the opportunity for significant enhancement of a company's performance to the benefit of all of its stakeholders and the community at large. However, like other good ideas, one needs to be vigilant against excess – and excess does exist.

The fundamental benefits inherent in private equity investments transcend borders and cultures. As evidenced by the growing transaction volume across the globe, the very same elements that propelled the development of the industry in the U.S., are increasingly fueling similar private equity development in other markets, including here in Italy. I believe that as private equity investing continues to take shape and evolve in Italy and elsewhere in the world, such economies can and will enjoy the fruits of stronger economic development, product and service innovation, and shareholder wealth creation.

Additionally, I am confident that much of the action, in deal volume, if not in actual dollars, will take place in what we call the “middle market”, where companies are valued between \$50 million and \$1 billion. The mega-deals that we have seen over the past few years will continue to grab headlines and move global stock markets; however, the true economic development happens within this middle market, where private equity can make a relatively larger and more meaningful impact. Specifically, private equity capital can drive investments in human capital, technological innovation, and cutting-edge strategic planning, as well as providing expertise in accessing capital markets, all of which serve as the lifeblood for companies and economies to grow and flourish. I will further address the middle-market later in this discussion.

State of the US Private Equity Industry

Perhaps it would be useful to highlight some relevant statistics related to private equity in the U.S. After remaining at around \$40-60 billion in annual deal volume during much of the 90’s through 2003, private equity activity expanded rapidly between 2004 and today.² Last year, U.S. private equity funds accounted for roughly \$415 billion of domestic M&A volume. This

² The Blackstone Group

activity represented roughly 27% of U.S. M&A activity, versus less than 5% only five years ago.³ These figures are truly astonishing, and however large they may be, the trend is expected to continue. Why, you may ask?

- First, private equity fundraising has grown in a dramatic fashion. In 2006, firms raised over \$200 billion of fresh capital, a nearly ten-fold increase from the \$23 billion raised in 1996⁴, and
- Second, despite economic and political volatility across the globe, there remains an abundance of relatively cheap and industry-agnostic debt. Traditional banks are being joined by non-bank financial companies, hedge funds and other lending sources to provide an unprecedented level of leverage for private equity transactions.

The net result is that the capital base of private equity firms in the U.S. alone exceeds \$1 trillion, based on current leverage statistics and capital availability.⁵ Over time, I am concerned that this leverage environment is both a blessing and a curse. The temptation to over-lever business is great in this environment, and it will be incumbent on management teams and private equity sponsors to remain disciplined and avoid a crisis of defaults.

³ Thomson Financial, *Mergers & Acquisitions Review 2006*

⁴ The Blackstone Group

⁵ Sage Group Estimate

This robust capital environment is driving the following key trends in the M&A market:

- The upward trajectory of acquisition multiples over the past several years.
 - o 7-8x EBITDA is the norm now, vs 5-6x just a few years ago
- Stable or rising leverage multiples, particularly in middle market deals.
- Mega-deals becoming increasingly commonplace.
 - o The landmark \$25 billion RJR Nabisco deal in 1989 has been eclipsed several times over the past 24-months
 - Hospital chain, HCA – was acquired by KKR and Bain Capital for \$34 billion
 - REIT giant, Equity Office – was acquired by Blackstone Group for \$39 billion
 - Texas utility, TXU – is presently being acquired by KKR and TPG for over \$40 billion

Industry critics and skeptics argue about the negatives associated with all of this private equity activity, harkening back to a day when so-called corporate raiders bought and dismantled companies for handsome profits. Though, one does not need to sort through the facts very closely to see that, in fact, the days of corporate raiding are largely over.

Today's private equity deals are noted for the positive impacts they have on companies, their stakeholders and communities. Among the most telling data suggests that private equity accelerates growth, stimulates employment and generates long-term value.

- With respect to employment, in the past four years private equity backed companies have created an estimated 600,000 jobs in the U.S. (and one million in Europe)⁶.
- With respect to top-line growth, companies backed by equity funds were able to increase sales at a much higher rate than their non-private equity backed peers; on average the improved growth rate ranged between 4% and 26% annually⁶.
- With respect to profitability, in the majority of cases, following a private equity investment, companies saw noticeable improvements in profitability⁶.
- Other reported benefits include more resources for recruiting top management talent, making acquisitions or major capital investments, and increased research and development, as well as increased tax income for local communities and investment in good corporate citizenship.

⁶ AT Kearney Study, including data from 30,900 portfolio firms

As such, the term the Economist coined for today's private equity firms – “The Kings of Capitalism” - seems quite apropos.

The Middle Market

As I mentioned earlier, I would like to address for a moment private equity activity in the middle market. Despite the fact that big deals capture the most sensational media coverage, the majority of private equity deals in the U.S. involve companies with less than \$500 million in annual sales.

My firm, The Sage Group, specifically focuses on middle market companies in the branded consumer goods and retail spaces – a particularly strong industry sector for private equity activity, and a very relevant marketplace around the world, particularly here on the streets of Milan and in my home town of Los Angeles.

Our core acquisition targets tend to be family owned or otherwise closely held businesses, with revenues in the \$50 million to \$500 million range. As an interesting observation, the California market, Sage's backyard and the self-proclaimed “Capitol of the Middle Market,” happens to have the 8th

largest GDP in the world, right behind Italy's.⁷ Not dissimilar to the Italian economy, its backbone is built on an extremely high number of small and medium sized, closely-held and family-owned businesses.

Private Equity and the Luxury Sector

The luxury sector, an industry near and dear to me and my firm, provides a compelling case study about the power and benefits of private equity investment. I'm sure you will find this study particularly interesting, as we are today in Milan, the "home" of the luxury brand.

For years, the luxury sector has been largely dominated by a small group of familiar faces. Firms such as LVMH, PPR, Gucci and Bulgari, to name a few of the true heavyweights, boasted unrivaled brand cachet, vast financial resources and broad international distribution. Smaller branded companies either competed vigorously for market share, or became acquisition targets themselves.

Private equity players have historically been cautious of the luxury market, given the fashion nature of the business, which has been a risk too great to

⁷ Center for Continuing Study of the California Economy (CCSCE), *January 2007*

swallow for most institutional investors. Notwithstanding this, the luxury goods industry has been growing at an incredible rate – now at over \$150 billion globally, with double and triple digit growth rates across the major world economies.⁸ Given these dynamics, and the revenue and profit margin success stories routinely told by well-run luxury businesses, it is not hard to imagine why private equity has been increasingly entering the fray.

Among the standout deals in the sector, the Jimmy Choo transaction is regarded by many as the beginning of the current increase in activity. Jimmy Choo, a footwear and accessory brand, was initially acquired by Phoenix Equity, a UK-based private equity fund, for \$30 million in 2001. Phoenix subsequently invested in the brand's development, helped to expand design and distribution, and enjoyed impressive top and bottom-line growth. In stunning fashion, Phoenix sold the business in a secondary buyout to Lion Capital⁹ for roughly five times its original investment. Just last month, the company was sold again – this time to another investment group, TowerBrook, for \$360 million, or 12 times the company's value six years earlier. This case is a true demonstration of the powerful combination of luxury brands and institutional capital. As the CEO of Jimmy Choo, once

⁸ WSJ: *In Style: Designer Buyouts*, March 18, 2007

⁹ Formerly Hicks Muse

said: “We had a Ferrari, but we had to put a bigger engine in.” Private equity provided the money to buy the engine, and helped to drive the brand from \$20 to \$140 million in sales in five years. Of course, Jimmy Choo is just one of many such examples. Other prominent luxury private equity investments have included Seven for All Mankind, Citizens for Humanity, Stuart Weitzman, Halston, Asprey, and Christian Lacroix, among other premier large and small enterprises.

The influx of private equity into the sector since 2001 is demonstrative of the opportunity to turn emerging, as well as underexposed, brands into global phenomenon. By injecting capital, as well as financial, tactical and managerial talent, private equity players are increasingly and successfully seeking to achieve brand expansion, increased product breadth and depth, and penetration of new distribution channels and markets, such as China, India and Russia – all of which has the promise of leading to Jimmy Choo-type returns.

This opportunity, however, is not without considerable risk. Luxury brands are very hard to predict, and require patience and fortitude to ride shifting trends and consumer appetites. Nevertheless, the evolving sophistication,

global scope and sheer size of the luxury market should make it a popular destination for private equity capital for years to come.

What About Italy?

Shifting gears to Italy for a moment, it appears that a number of studies are tracing the similarly positive impact of private equity investments on target companies in Italy, as well as on the Italian economy as a whole. Some of you might be familiar with this data, but I believe that the findings of a recently published study by PricewaterhouseCoopers¹⁰ are quite revealing.

- The annual revenues generated by private equity-backed companies in Italy on average increased 10.0% per year, three times more than the average growth rate achieved by other medium size firms.¹¹
- Operating profits (EBITDA) also experienced above par growth, with an average increase of 14.3%, compared to a decrease of 4.1% for other medium size firms.
- Finally, the headcount of Italian private equity-backed companies increased by an average of 10.7% per year vs. a benchmark of 0.3% for other medium size firms.

¹⁰ The economic impact of Private Equity and Venture Capital in Italy*

¹¹ From 1996 to 2004

Surely, these types of findings do not suggest a negative connotation from private equity, nor do they suggest that private equity investors are enriching themselves at the expense of their portfolio companies – rather, the opposite seems to be true. With the right mix of public policy support and continued development of the capital markets, the Italian private equity industry should continue on its compelling expansion path.

Implications and Conclusion

In conclusion, the development of the U.S. private equity industry over the past 30 years, and the countless number of success stories across many different sectors, demonstrates the benefits for companies, shareholders, employees and investors involved, as well as for the economy in general. The important point that I would like to repeat is that none of the key drivers I mentioned today are uniquely country-specific, and substantially all of those elements are as applicable to a California-based company, as to one based here in Italy.

That said, it is clear that private equity needs to be carefully adapted and tailored to other world economies, as U.S. companies may have differing concepts of aggressive growth, leverage, governance, due diligence and

other critical factors in private equity investing, as do their global peers. Furthermore, political, labor, taxation and regulatory environments vary greatly across the world, and the intricacies of such can have a dramatic impact on the pace and attractiveness of private equity investing. Perhaps the positive private equity trends in the U.K., France, and here in Italy are a bellwether of the future.

One thing is certain...there does not now seem to be any target, in any sector, in any corner of the globe, which is beyond the reach of the private equity community. While this statement may seem menacing or even ominous, we believe that this capital rich, risk-tolerant and highly-sophisticated element of the world economy will provide a springboard for growth, development and prosperity for decades to come.

I thank you very much for your time and attention, and wish you a pleasant rest of the conference.

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