

This brings us quite naturally to stealing. When public company A tries to buy public company B, there is usually but not always (we will imply this term throughout this piece, even though we won't always say it) a semblance of fair play in that the Board of company B has a reasonable and logical sense of duty to try to secure the highest price for B shareholders. Senior management might not be entirely happy with the state of affairs, since they are often kicked out post-deal, but there is usually enough parachute-laden sweeteners for a consolation prize to go along with it. It may or may not be a great deal for shareholders as far as timing and business cycle issues (we will neatly skip over dozens of instances where shareholders have been painfully disadvantaged), but a reasonable auction process would have been conducted by somewhat arms length players which from a shareholder perspective constitutes reasonable fair play.

In contrast, when a private equity firm teams up with existing management to take a publicly traded company private, there is only one certainty - public shareholders are very likely being ripped off. There is one reason and one reason only that corporate insiders possessing all the inside information known to man would agree to participate in a management led buy-out with private equity – **THE PRICE AT WHICH THEY PROPOSE IS BELOW THE VALUE OF THE COMPANY IN WHICH THEY ARE IN A BETTER POSITION TO KNOW THAN ANYONE ELSE.**

The popularity of this game is due to the fact that it is rigged greatly in favor of private equity at the expense of the public shareholders. Here's how it works. Like the dotcom era before it, investment bankers and private equity funds are running around like crazy pitching any management team who will allot them eight minutes on the virtues of being private, the main one being the **ENORMOUS** sum of money management will make if the deal gets done. The crucial trick is to come up with a price that represents the lowest possible premium to the company's current stock price that will produce torrents of words like these, but a minimal amount of lawsuits. This is the great talent for which investment bankers are paid staggering amounts of money. The price is conceptually buttressed by pages of detailed analysis in the proxy statement under the heading of the "fairness opinion," a document which has been duly scorned for generations as hopelessly compromised and self-serving and one of the best examples of investment banking practices at their worst. (And currently a warm topic for SEC investigators.)

We know what management is thinking - they get to run a private company without the somewhat real annoyances of Sarbanes Oxley, pesky shareholders and a compensation plan that is exposed to all their neighbors and any number of now Democrat committee chairs in Congress. If they can execute, they will make multiples of their current compensation scheme with far less hassle. We know what the investment bankers and private equity players are thinking as well –

enormous fees that would make a run-of-the-mill hedge fund manager blush. These people are the best and brightest and greediest of our generation, and you can be sure that the only reason a private equity player is doing a deal at a price is because he thinks he can make money by buying an asset for less than its worth, either outright, or using a more efficient capital structure with which to extract value. I have a drawer full of airsickness bags pilfered from numerous airlines to assist me in reading Op-Ed pieces by private equity luminaries about the social services they offer the world by taking poor, suffering, public companies private to enable management to finally implement its truly visionary strategic plans that were previously blocked by the petty needs of shareholders. Today's private equity and investment bankers have been reared in the new world of transactional corporate finance and to suggest that this activity is related in anyway to the antiquity of the JP Morgan and Sidney Weinberg relational finance world is too embarrassing to consider.

So what should shareholders think when they wake up to a 23% premium on their favorite stock? One thought might be "lucky me," since the average premium for the past five years as calculated by Thomson Financial has been in the mid-teens. But the real issue should be: has the Board of Directors conducted a fair and open auction so that there is some reasonable assessment that this is the best offer for the shareholders at this juncture in time? For the time being, the United States remains a free market with basic capitalistic tendencies, so if in a fair auction, a financed group with money says it will pony up X price for company B, and there is no better offer, then in some ways it is entitled to it. The main caveat here is as noted above: if management is making the offer to shareholders, how can we not be suspicious? One of the worst mechanisms in determining an acquisition price in our opinion is looking at the "average premium paid" of other deals. In such cases, the verbiage in the proxy statement should read: "we are offering an 18% premium to the average price for the last thirty days which is the average premium for the twelve previous deals in which Directors did not stand up for shareholders." Since the market is "semi-efficient" at best, and there are thousands of varieties of apples and oranges to compare, what someone under or over-paid for company C means nothing to me as an investor in company B. What's it reasonably worth is the **ONLY** consideration.

Which brings us to the other huge consideration in how we are likely getting ripped off in management led buy-outs. The "system" of public companies and those who invest in them has created a conceptual "time arbitrage" between those who report quarterly and those who don't. Most money managers will take the quick 18% in the hand versus the longer term 55% in the bush and that psychology is neatly being gamed today. This is assisted by the fact that so much institutional money is being managed passively (whether they know it or not) via indexing or quasi-indexing strategies that there is often precious little thought even given to this

math. As noted above, it is in some ways fair to suggest that “the best and current bid wins” in a free market. But it raises the question for the Board of Directors of whether it should be selling at all. How does the current “best bid” compare to the present value of the long run internal operating plan?

The current deal to take Jacuzzi Brands private illustrates these tricky issues perfectly. We owned 5% of the outstanding common at an average price in the eights, when it was announced that the company was going private in at \$12.50 in a deal sponsored by private equity firm Apollo Management. (Nice quarter, guys!) But Jacuzzi is in the midst of a turnaround in its bath operations and there is substantial operating leverage to be delivered to shareholders in a reasonable housing environment. Yes, it’s a decent premium (23% or so) to where it had been previously trading (so what!), but one can very effectively argue that Jacuzzi could be a high teens stock in two years if new CEO Alex Marini can deliver the goods, which he has a solid record of doing. But we also know for a fact that Jacuzzi has been “for sale” for two years with no takers. The proxy outlines some of this long process with many firms taking a sniff. Apollo looks like the highest current bidder. Should the Board of Directors recommend the bid? Is not the present value of the operating plan a bid in and of itself to be compared against that of a third party? Does the internal bid get fair play if management is about to be offered an enormous levered incentive plan to get rich quickly if the deal works?

While Jacuzzi has been shopped around like a ragged Mom on Black Friday in the toy aisle at Target, in many cases the deal has NOT been shopped at all or the process has been “arranged” to a degree that makes a mockery of the definition of “auction.” This again could be pure behavioral finance - people simply don’t like to upset apple carts and offend friends, investment bankers and deal-mates with whom they would like to work with in the future. Thus, hostile takeover bids and newspaper reports of angry Board members speaking out on inequities tend to be relatively rare. It is also prohibitively expensive for all but the largest investment firms to conduct legitimate corporate governance jihad. This led us to conclude that Jacuzzi is unlikely to attract a much higher bid and if the largest shareholder succeeds in blocking the bid, the stock will tank. We sold at \$12.50, succinctly highlighting the systemic bias of the system that allows private equity a reasonable license to take from shareholders for themselves.

When you have just earned \$100mm in fees or the prospect thereof is within reach, it appears unseemly in pleasant company to talk about money. So, the thought leaders of the private equity world have conjured dandy intellectual arguments about their noble ventures. The main tenets of this flowering intellectualism are as follows:

- 1) A private company can pursue the proper long term strategies that would be impossible considering the attention deficit disorders of public investors.

- 2) A private company can employ compensation strategies that are perfectly aligned to ensure that management and the owners are operating hand and glove. Talent “flourishes” and better decisions can be made by a small group whose purpose is aligned solely to achieve operating perfection.
- 3) Companies can be managed for cash and cash returns rather than earnings per share.
- 4) Private equity is a more stable shareholder base composed of big pension plans and endowments vs. CNBC watching stock jockeys which leads to out-performance.
- 5) A sense of urgency is created and expectations are reset higher to achieve success.
- 6) More efficient capital structures can be employed.

Most of the first five reasons can be shoved back into the airsickness bag under a very simple heading: why can’t you do that now? Why doesn’t management stop hiring consultants and polling shareholders as to what they may want and actually run their business the way it should be run? I have never heard worse blather in my life than when a CEO tells us he “can’t” do something because of the perception of quarterly issues or its short term effect on earnings or the opinions of Wall Street analysts. Study after study has shown that the “market” sees through short term nonsense and rewards good long term investments made by management, regardless of their short term effect on earnings. We have told dozens of management teams that having public shareholders is like being married, eventually you wind up with who you deserve. If a company courts Wall Street analysts and prides itself on its quarterly earnings per share guidance, it will attract owners whose time horizons are approximately that of a Taco Bell drive-through lane. If you think and talk long term with shareholders, tie compensation to cash-return based metrics and articulate and execute clearly delineated investment plans, you will attract long term shareholders. We would also question the “long term” nature of private equity given how many deals we have seen turned around in two years or even three months.

By definition, most funds are compelled to wind down at the five to seven year mark, so are they not the epitome of a strategy to buy and sell, as opposed to buy and build? All these groundbreaking ideas can neatly be had by purchasing The Quest for Value by Bennett Stewart and reading the last chapter, “Remaking the Public Corporation from Within.” (A great stocking stuffer for your hard-to-buy-for Board member.)

Private equity is correct on two issues: running a company with a Hewlett Packard-like Board cannot compete with six people gathered to make money and most companies do not maximize their capitalization structure for the benefit of shareholders.

This neatly segues into a brief 2007 crystal ball reading. The biggest reason there is an explosion of private equity and management led buy-outs is simply the slatternly state of the global credit markets and the magnificent talents of corporate financiers to create products to enable nearly any transaction. The latter issue we expect to continue, but the former state of affairs is most certainly ephemeral. Most private equity deals are based upon the principle that in today's market, a private firm can employ multiples of more debt than can a publicly traded firm. Again, this is one of those situations which beg the question: why? Why is it these new Masters of the Universe can borrow up to nine times their cash flow in private radio deals and Clear Channel as a public company thinks it can't go above four times? Why can't the management of Clear Channel execute their announced going private plan to sell their television assets at 12-14x cash flow multiples, and pare down their radio assets at similar multiples (higher than what they are paying us for the whole company which includes the higher flying outdoor business) while they are public? And then pay us a \$20 plus dividend and lever themselves up, effectively becoming a public LBO? It is SO OBVIOUS that the younger members of the Mays family at Clear Channel are opportunistically trying to take advantage of Wall Street's trendy derision of radio and outdoor businesses and steal the company. After one bone-headed play of selling part of the outdoor company to the public (why you would sell ANY part of your best and fastest growing asset to anyone, we have no idea), they are ramming through a deal in a very quick process that makes it highly likely their low-ball offer will win. And in three years, we will see their smiling faces during the new issue road show pitching their fabulous collection of stable media assets...and it will work.

Since not much in radio is going to change over the next three years (flat growth, high margins, fat cash flow), the simple math of the private equity craze is supported by the singular pillar of leverage and its wonderful benefits should you get it right. In 2002, AA-rated companies were having problems getting their bank lines renewed. We are now about to close the fourth year of tightening credit spreads and credit complacency that is unprecedented in its size and breadth. This is being assisted by an explosion in credit derivatives, which like Portfolio Insurance in 1987, allows participants in credit to perceive themselves as hedged without actually having to sell any underlying assets or in many cases, do any credit work at all. Credit finance as an art form practiced today rivals any of the more humanistic fields as far as subtlety, deftness of the brush in brandishing a heretofore unimaginable wide palette of tranche and structure, and the ability to manipulate an already Byzantine tax code.

This environment has enabled higher prices to be paid with less and less equity which obviously has been good for the equity investor. But the history of mankind has shown that risk-taking is a mean reverting proposition. The ability to effortlessly raise and borrow money on increasingly questionable terms will eventually turn the corner and go the other way. The remonstrations and finger-pointing and write-

offs will cast ripples throughout global markets, leading to substantial financial hurt. We will let the reader fill in the gap as to what is the precipitating event: the Middle East, bone-headed Washington policy, a few hedge fund blow-ups, or the garden variety economic slowdown putting the screws on those least able to handle lowered projections.

The current happy environment has also had the effect of compressing valuation spreads, which in English means that what is cheap has tightened greatly in relationship to what historically has been expensive. What this means for the investor is there does not appear to be a lot of home-run type opportunities within the realm of reasonable risk. It also means to us that "big and high quality" is what's cheap, reasonably on an absolute basis and severely on a relative basis. You also get the bonus of relatively decent capital retention if there is some unpleasantness ahead, which of course is far from certain. Business seems "ok," but is clearly slowing. Most companies will face tough earnings comparisons when they report earnings in 2007, which often does not produce much joy for many investors. We think people are kidding themselves about the duration of a housing-related slowdown as this will remain a fat headwind for GDP in 2007 and possibly beyond. The "market" is fairly valued as a whole as best as we can tell, which provides some support for a year like 2005 – a lot of slogging to wind up with mid-single digit returns.

We are closing out the year at RCB in a sprightly manner performance-wise, as it seems five quarters of watching the paint dry on our portfolios was enough oblivion for our psyche to handle. Our oft-abused motto, "sometimes early, rarely wrong," has rung true as 2005's laggards turned into swans in the second half of this year. We are delighted to once again be able to back our words and conviction with performance and feel we are well-positioned for more of the same in 2007 and beyond.

Best wishes to you and your families.

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