Capital Bridge
OnTarget

CapitalBridge's monthly newsletter focusing on institutional targeting and investor relations

OnTarget – Trends

How to Become a Private Equity Buyout Target

Tired of serving your public equity masters? Fed up with quarterly SEC filings and having to follow pesky rules like Reg FD?

Try these strategies to get yourself in the sights of private equity managers out there. After all, private equity managers *always* have the long-term interests of your employees, customers, and management in mind, right? Yes, generally IRO's don't have much of a place in private companies, but hey, you might get an opportunity to take a hard-earned vacation…

1. Generate consistent cash flow but minimize your earnings by high costs further down the income statement. Make sure these expenses recur period after period while your cash flows are steady, and make sure your investors are uncertain of their future.

Private equity buyers are looking for opportunities to make deep cuts in companies and "flip" them back into the public market. According to data from CapitalIQ, the median net income multiple for a company targeted by private equity in 2006 (total consideration paid for company over last twelve months' net income) was 16.5x (a small discount to the market as a whole), while median EBITDA multiple was 6.9x (a significant discount to the market). This shows companies that face headwinds on the cost side may pull in more private equity suitors looking to make these cuts.

Even if you're in the middle of changes to your cost structure, make sure to emphasize your targets for your costs to investors to the best of your ability, and do your best to communicate cost savings plans period-by-period instead of just lofty top-line figures.

2. Build up excess cash on your balance sheet, but make sure to tell investors you have no plans for what to do with it, either internally or externally.

Despite the recent drastic increases in share buybacks and the improved tax treatment of dividend income, plenty of companies, especially large caps, see large amounts of cash on their balance sheets (about 6.5% of the total reported assets of the S&P 500 fall under the cash & equivalents line, along with 4.9% of the mid-cap S&P 400 and 5.3% of the small-cap S&P 600). Communicating your long-term strategy on cash management can help alleviate investor concerns.

As an example, Four Seasons Hotels (FS) had built up a cash position of over $250 mm on assets of $950 mm, while foundering operationally during 2005 and 2006. Its special voting share class was one of the few impediments to private equity investors knocking on the door. Despite the cash available on the balance sheet, it maintained just a 0.1%-0.3% annual dividend yield throughout the two-year period, while spurning buybacks, acquisitions, and other effective uses of cash. Eventually private equity buyers decided to include management in the $2.7 billion buyout offer in November 2006 (to get out from under the voting issue).

3. Maintain a pristine balance sheet and express to investors zero interest in issuing debt, no matter how great the return or how low the costs.

Obviously any company's debt rating is important to management in its plans for the company, but Wall Street often has different plans for companies that face a high cost of capital alongside a historically low interest rate environment. Even with your company sitting at low leverage, make sure to drive home the point in presentations and conference calls that your company has a target debt ratio and is constantly reviewing its options; generally, minimizing talk of acquisitions and maximizing the discussion of internal opportunities is the way to best impress wary investors.

Interestingly, *The Wall Street Journal* reported on January 18 on Health Management Associates' (HMA) approach to recapitalize and conduct a "do it yourself LBO." While receiving bids from private equity firms after the purchase of its peer HCA Inc., the firm announced a $2.4 billion new debt issue and announced a one-time dividend of $10 per share to shareholders. The company was able to cut its cost of capital to the 7.5% to 8.0% range, down from the low teens, while pleasing shareholders and still maintaining a lower debt ratio than HCA faced. Though this is certainly an extreme case, it should express the point; for nearly any size company nowadays, even the possibility of private equity firms bidding for a company can affect capital structure decisions. Make sure your management is aware of the Street's most likely viewpoint on any incremental changes to your capital structure by looking at the effects on companies of similar size and leverage.

4. Work for a company in a changing industry, and make sure not to acknowledge the coming changes.

Four of the largest "going private" deals in 2006 came out of the media space, which is facing the transition of its advertising model over to new media – Clear Channel, Cablevision, Univision, and Emmis were all targets during the year (including a management buyout attempt by the Dolan family at Cablevision). Real estate also faces a changing interest rate environment and falling prices over much of the globe –a no less than 15 REITs and real estate management firms were targeted globally, including what may become the largest "going private" transaction ever (for Equity Office Properties Trust, valued at over $35 billion in a bidding war between Blackstone Group and Vornado).

If you face a changing industry, make sure your message includes particular focus on your company's approach to these changes; often IRO's can insert this kind of discussion by introducing a key "change agent" executive in the company to the investor base – this is a great chance to show not just forward thinking, but depth of management as well.

5. Ignore buyout-friendly changes to your shareholder base.

As a rule of thumb, higher-turnover players such as hedge funds and aggressive investors are more likely to go along with lower-premium buyouts in order to "cash in" their positions, and they're less likely to vote with management or ISS on a potentially hostile buyout offer. A close watch on your shareholder base can help give warning of a potentially "buyout-friendly" holder base. Overall level of institutional ownership seems to have little effect on decisions made by private-equity firms (according to Bloomberg, median institutional ownership for a targeted company is 66.5% of outstanding shares, not far from the overall market's average), but the "quality" of ownership can differ company to company.

If you're not working with a professional market intelligence firm, US IRO's can nonetheless try to get advance warnings of a potential buildup of shares in a private equity transaction by looking at DTC reports. Private equity investors often hold their accounts in broker name (instead of at global custodian banks like most "traditional" investors); watching your DTC reports for any outsized increases in holdings at brokerages such as Bear Stearns, Goldman Sachs, and Morgan Stanley may help you "sound the alarm" that an investor may be accumulating an equity stake at a cheaper price prior to the subsequent announcement of a higher tender price.

Now, Back to Reality…

In all seriousness, a good communications effort can have a strong positive effect in situations where your company's cheap valuation, good cash flows, and conservative balance sheet situation might attract private equity suitors. Private equity firms have had their busiest year ever in 2006, and are likely to continue to snap up companies as their strong returns attract more assets in 2007. And, they've been easily able to build up the high leverage necessary to buy out even the largest public companies due to the ease of obtaining financing (largely through high-yield issues). Though it may seem counter-intuitive, transparency is one of the best ways to ward off the private equity investor, and transparency within the shareholder base falls squarely in the domain of the IRO.

For more on private equity investors, contact us at targeting@cap-bridge.com.

Top 10 New IR Questions for 2007

1. What are your company's plans to fully fund your defined-benefit pension plan?

In addition to the changes to reporting taking effect this year (putting the funded status of your pension plan on the balance sheet), the Pension Protection Act legislation signed last year will begin to put pressure on companies to either fully fund their pension plans or convert them to cash-balance equivalents. "At risk" plans that are less than 70% funded may be forced to increase their contributions to the Pension Benefit Guaranty Corporation (PBGC), and all plans are expected to be 100% funded within seven years. Given the tough decisions necessary to meet these requirements, you'll get this question early from your longer-term investors.

2. Can you certify that your company hasn't engaged in options backdating, spring-loading, bullet-dodging, or any other kind of options engineering?

As much as we'd all like to see the issue go away, every few days another headline hits the wires about a company restating earnings, firing executives, or changing compensation policies. At some point this year it may become clearer as to whether "spring-loading" (granting options before a positive piece of news) or "bullet-dodging" (granting options after a piece of negative news) is legal and/or a symptom of poor governance. Keep in mind that the SEC still has over 100 outstanding investigations ongoing into companies that are related to options – even if the issue isn't a problem for your company, you'll still get the question.

3. Do your compensation committee procedures meet best practices?

With high-profile cases on executive compensation (such as underperforming former Home Depot CEO Bob Nardelli's severance package) coming up against the new CD&A disclosures, expect new queries from the analyst community that sees potential liabilities that can result from legal or proxy action.

4. Is your company prepared for the onset of fair value accounting for any of your financial instruments (and have you prepared your disclosures)?

While the FASB has long looked at moving towards fair value accounting for most assets to bring US standards more in line with international standards, shades of Enron still hang over the process – with any step towards fair value accounting choices, a new set of disclosures will be required. SFAS 159, the so-called "fair value option," will likely allow companies to choose fair value measurement for some assets and liabilities, but only allow them to select the option at inception and only after measurement disclosures are made. This has the potential to change decision-making within your finance team down the road.

5. Are you expecting any changes to your uncertain tax position accounting based on new rules?

FIN 48 has already taken effect for statements filed as of the end of 2006, so analysts are preparing their first round of questioning on changes to your uncertain tax position disclosures. While these details and assumptions are often arcane, make sure you're familiar with how they affect your financial statements and, in particular, the background behind any "potential change to reserves" disclosures your company may make.

6. When are you planning to issue financial statements in XBRL format?

With the SEC now starting a pilot program for mutual fund companies to issue XBRL data on their return & risk (announced January 31st), we've now received another indication that the SEC's drive to implement XBRL is not going away. The SEC certainly has some reluctance to start mandating XBRL any time soon, since many companies are still struggling with implementing Sarbanes-Oxley regulations and setting up their internal-control reporting. With the assault on SarbOx currently underway in Congress, however, ironically companies might face the prospect of winning the battle on 404, but then facing a faster timetable for XBRL rollout. Stay tuned...

7. Are you on target for the faster 10-K reporting deadlines for large accelerated filers?

The faster 60-day deadline for the 10-K release is already causing headaches across the corporate world – while the timing of the move to the faster deadline has been known for quite some time, auditors have needed to add resources and to meet the demands as well, and "crunch time" may take place not just internally, but externally as well. Companies can request automatic 15-day extensions for filing deadlines with the SEC, and it's likely many companies struggling through 404 may use this option.

8. Are you aware of activity in your credit default swap market?

For companies with widely held public debt, keeping at least some eye on movements in your company's CDS market can give a view into how investors see your company – by some measures, the CDS market is the largest asset market in the world (the International Swaps and Derivatives Association measured the notional principal of all outstanding contracts at over $26.0 trillion in 2006).

9. Do you have a sustainability plan that is in place across your operations?

The SRI and sustainability trend may have finally reached critical mass in 2006, and not just because of Al Gore receiving an Oscar nomination – reinsurance companies such as Lloyds of London are now beginning to model the potential effects of climate change and include them in their actuarial models, putting an actual cost on the financial statements of other insurance companies across the globe. No matter what your stance on the issue, prepare your answer for the question, as you'll be hearing more of it soon.

10. Are you prepared for round-the-clock liquidity in your stock?

Despite the London Stock Exchange's constant refusals of bids from NASDAQ, and the slow movement of the NYSE/Euronext merger, the long-term trend seems clear: fewer humans directly involved in trading, faster trading, higher liquidity, and "ubiquitous trading." The recently announced alliance between the NYSE and the Tokyo Stock Exchange only covers sharing of investment technologies, but taken to another step it could move to allow sharing of liquidity platforms (for example, porting NYSE's Arca structure over to Japanese investors). Despite all the regulatory hurdles, you may someday see your stock begin trading at 3 AM New York time in London, then continue trading on the NYSE at 9:30 AM, then trade in San Francisco or Sydney during the inter-exchange session, then Tokyo again at 7 PM New York time, all on an interoperable platform.

For more details on any of the above questions, contact us at targeting@cap-bridge.com.

OnTarget – Weightings

A Roller Coaster North of the Border

Spirits appear to be high in the Canadian asset management industry, which has experienced something of a renaissance over the last couple years. Equity assets managed by Canadian institutional investors have jumped by more than 50% over the last 18 months, with the vast majority of these new assets coming into institutions based in Toronto (such as AGF Management and AIM Trimark Investments).

Moves by the Canadian government with respect to its traditionally high tax base may have contributed to the increase in asset size. First, only 50% of overall capital gains are taxed by Canadian authorities, with the current government looking at additional proposals to help lower capital gains rates; this option can attract cross-border companies with significant investment holdings to domicile their investments in Canada. Also, one of the chief campaign promises of the newly elected Conservative government was to exempt all capital gains that are reinvested within six months. While this may prove difficult to enact in total, it certainly shows the trend toward lower taxes that can attract more private investment.

Second, the Canadian government has fostered the growth of the income trust structure with its tax policy. Similar to a REIT in structure, Canadian income trusts are allowed to distribute large gains to shareholders with favorable tax treatment, allowing their equities to yield extremely high payouts (many yielding 10% or more). S&P added income trusts to the benchmark S&P/TSX Composite Index in early 2006, further attracting index managers and global institutional investors, including many major US active investors seeking higher yields. By October 2006, 57 non-REIT income trusts were represented in the Index, accounting for over 9.1% of its overall market cap.

In late October, however, the Canadian government announced it would begin taxing income trust distributions at 34%. The asset class took a beating in subsequent trading (with many issues losing 10-20% over the following two weeks). Canadian and US investors alike faced serious losses, many of which have yet to be reported to their mutual fund clients. The aforementioned S&P/TSX Composite's income trust weighting fell to 7.8% by the end of January 2007.

Top 5 US Owners – Canadian Income Trusts (non-REIT)		Top 5 Canadian Owners – Canadian Income Trusts (non-REIT)	
Firm Name	Holdings ($mm)	Firm Name	Holdings ($mm)
Fidelity Investments	1,341.73	Goodman & Company, Invst Counsel	2,015.60
Franklin Templeton Investments (CA)	800.83	CIBC Asset Management	1,676.11
Barclays Global Investors (US)	613.48	Acuity Investment Management, Inc.	1,477.04
Pyramis Global Advisors, LLC (Fidelity)	577.34	Guardian Capital, Inc.	1,470.14
Wellington Management Company, LLP	285.78	TD Asset Management, Inc.	1,399.54

With the extremely tax-efficient high yields of income trusts threatened, Canadian investors appear to be replacing some of their income trust holdings with similar high-yielding equities. Of particular note, Altria (MO), which typically yields near 4%, has been the most popular stock entering the portfolios of Canadian institutions, with overall Canadian holdings of Altria jumping more than 36%.

As the situation with Canadian income trusts shakes out, be aware of not only the extra funds invested by Canadian investors, but also the current relative lack of growth-and-income investments currently available in the Canadian market. Not only may it be worth your while to approach more Canadian investors, but you may find your growth-and-income story and clearly stated dividend policy receive a warm welcome in the cold North.

If you're looking to target Canadian investors for your investment story, contact us at targeting@cap-bridge.com for a breakout of Canadian ownership (no charge of course).

OnTarget – Firms

Target Firm: Pzena Investment Management

Targeting Profile

Pzena's built a good reputation in the world of value investing, and most importantly for IRO's, it's also built up a large asset base (over $23 billion invested in equity, versus just over $13 billion at the end of 2005). Its small- and mid-cap value accounts appear to be the top performing portfolios, but it's willing to invest in value securities of nearly any size. With just enough portfolio turnover to force it to continuously look for new investments, but not enough to make it a "fly-by-night" investor; you'll want to take your attractive valuation story here.

How to Approach

If you've been watching your valuation stay static or decline based on short-term weakness in a part of your business, you might be exactly what Pzena is looking for – while not a true "Graham and Dodd" value investor, the company will take a significant stake in investments it sees as "temporarily" broken. The list of the firm's investments reads like a rogue's gallery of yesterday's "busted" stories – firms like Bristol Myers (facing a tough drug pipeline), Lucent (which languished for years before Alcatel finally purchased the company at a fraction of its former value), and CA (the former Computer Associates, whose prior CEO resides in federal prison for misleading accounting) have all seen notable turnarounds since Pzena's purchase. Essentially, tying your valuation weakness to a particular issue, describing your company's solution to the issue, and showing the strength of the rest of your company can lead to an investment of easily 3-5% or more of your outstanding shares.

Average equity holding period: 3.8 years

How Not to Approach

While companies sitting at the top of the valuation bell curve may not look attractive compared with the rest of the firm's investments, if Pzena is interested in communicating with you, it may make sense to build up their research folder on your company in case a specific issue does hit at some point down the road. Don't waste much of your time on descriptions of your competition; this investor is looking to profit from your company overcoming a particular challenge, and if it's not a challenge involving a specific competitor, it won't add to your attractiveness.

Largest Portfolios Managed

John Hancock Classic Value Fund ($6.5 billion equity) – John Goetz et. al. (212-583-1293, goetz@pzena.com)

Investment Potential

Average holdings for the firm at each market cap range:
Giant-cap: ~$280 mm
Large-cap: ~$245 mm
Mid-cap: ~$95 mm
Small-cap: ~$35 mm
Micro-cap: ~$1 mm

OnTarget – Funds

Target Fund: Fidelity Fifty Fund

Managing Firm:

Fidelity Investments – Peter Saperstone (617-563-7897, peter.saperstone@fmr.com)

Targeting Profile

Fidelity's been willing to revisit the lead manager decisions on many of its portfolios over the last two years, as it seeks to regain momentum in the mutual fund space. Peter Saperstone replaced Jason Weiner in November 2006 at the controls, while continuing to manage Fidelity Advisor Mid Cap Fund and Fidelity Global Opportunities Fund. Fidelity's traditionally allowed rapid portfolio changes in these cases to make sure a new manager is judged only on his/her own portfolio selection, so the fund is likely to be looking for new investments right now.

How to Approach

Given the tight and undiversified portfolio, it's impossible to keep any kind of sector balance in place, and investment decisions have to be made on individual company merits, not relative merits versus a peer group. While Google's been the top holding in the fund for several quarters, don't be surprised if it becomes a cash casualty. If the fund does indeed move towards Saperstone's discipline in other portfolios, it's likely it will be willing to pay higher valuations for more growth than in the past. Even given the different profile of his mid-cap focused fund, the portfolio-wide PEG ratio was one of the highest of any mid-cap fund around. So, lean your story towards your short- to mid-term growth prospects and show your built-in advantages.

How Not to Approach

Don't worry too much about focusing on your dividend policy or growth-and-income story – given the objectives and low yield profile of both this fund and Saperstone's other funds, you won't be doing yourself any favors. Also, as with any investment story pitch to Fidelity, your industry or sector analyst will be the first line of defense in gaining any successful investment. Even with a direct pitch to the fund manager, don't forget to include your sector focus info that will feed into the analyst's understanding of your company. Analysts within Fidelity's organization gain recognition and bonuses by providing funds like Fidelity Fifty with good research on their top picks – close work with your analyst can make both of you look good.

Investment Potential

Average holdings for the firm at each market cap range:
Giant-cap: ~$33 mm
Large-cap: ~$17 mm
Mid-cap: ~$21 mm
Small-cap: ~$8 mm

Average equity holding period: 1.1 years

OnTarget – Contacts

Recent notable contact moves:

Nick Barnes (Portfolio Manager and Analyst) joined Nevsky Capital, LLP in December 2006, covering the global oil and gas industries. He was formerly a portfolio manager and member of the emerging markets team at Thames River Capital Ltd.

Steve Bishop (Principal, Portfolio Manager and Analyst) at RS Investments became co-manager of the RS Emerging Growth Fund in January 2007. He was previously a principal, portfolio manager, and analyst primarily covering the technology sector at the firm.

Steve Buller (Vice President and Portfolio Manager) at Fidelity Investments began managing the Fidelity International Real Estate Fund in January 2007. He continues managing the Fidelity Real Estate Investment Fund at the firm.

Melissa Chadwick-Dunn (Vice President, Portfolio Manager and Analyst) at RS Investments became co-manager of the RS Emerging Growth Fund in January 2007. She was previously a vice president and analyst covering the healthcare sector at the firm.

Ryan Harkins (Portfolio Manager and Senior Analyst) joined Chartwell Investment Partners in January 2007. He was formerly a vice president, portfolio manager and an equity analyst at Credit Suisse Asset Management, LLC.

Joe Krocheski (Equity Analyst) joined Turner Investment Partners, Inc. in January 2007. He was formerly an associate portfolio manager at ING Investments, LLC.

Jeff Reich (Vice President and Senior Analyst) joined Cramer Rosenthal McGlynn, LLC in January 2007, covering the healthcare sector. He was formerly a portfolio manager and senior analyst at Merlin Bio Med Group.

To keep an eye on other major contact moves, subscribe to CapitalBridge's IRxtras monthly newsletter containing research updates on movements from contacts, firms, and funds. There is no charge for this newsletter. To subscribe, simply email IRxHelp@cap-bridge.com.

OnTarget – Conferences

The tail end of earnings season always brings about a rush of industry conferences (many in relatively warm locations…)

Conferences – February 2007

Mon	Tues	Wed	Thurs	Fri
			1 UBS Italian Financial Services Conference – Milan	2
5 Merrill Lynch 11th India Investor Conference – Goa Credit Suisse Energy Summit - Vail	6 Cowen and Company Aerospace/Defense Conference – NYC Merrill Lynch Pharmaceutical, Biotech & Med Device Conference – NYC	7 JPMorgan Hong Kong Tech Conference – Hong Kong Credit Suisse Financial Service Seminar – Naples, FL Credit Suisse Disruptive Technology Conference – San Francisco	8	9
12 Deutsche Bank Small Cap Growth Conference – Naples, FL Citigroup Retail Field Trip – Orlando	13 Bear Stearns 3rd Annual Issues in Securities Valuation Conference – NYC Merrill Lynch Internet, Software & Services Conference – NYC Merrill Lynch Insurance Investor Conference – NYC	14 Credit Suisse Digital Media, Memory & Storage Conference – Boston BB&T Capital Markets 22nd Annual Transportation Services Conference – Miami	15	16
19 Roth Capital Partners 19th Annual Growth Stock Conference – Laguna Niguel, CA Consumer Analysts Group NY CAGNY Annual Food, Beverage & Tobacco Conference – Scottsdale, AZ	20 Morgan Stanley Basic Materials Conference – NYC	21 Prudential Equity Group Washington Healthcare Conference – Washington, DC Bank of America Technology Conference – NYC	22	23
26	27 Bear Stearns London Health Care Conference – London Goldman Sachs Technology Investment Symposium – Las Vegas Bear Stearns 13th Annual Retail, Restaurants and Consumer Conference – NYC	28 Jefferies & Co. 3rd Annual Internet Conference – NYC Keefe, Bruyette & Woods Regional Bank Conference – Boston Wachovia Securities 2nd Annual Homebuilders Conference – Las Vegas		

This calendar shows a sampling of investment community events held around the world during the month.

 targeting@cap-bridge.com