Lions in Winter: Private Equity Goes Back to Basics

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Financial Post – January 2010

It was an unusual move in the private-equity playbook. Shortly after carving out Allison Transmission Inc. from General Motors, Seth Mersky, managing director of Onex Corp., took a garbage truck powered by one of his new company's automatic transmissions for a ride on an outdoor test track.

Living out the dream of many six-year-old boys, he took the 15-ton-plus truck up steep inclines and down again and even tore into the deep gravel portion of the all-terrain track. Even though he got stuck, for Mr. Mersky the truck's versatile performance was a real eye-opener.

"Once you do it, you understand why the heavy-duty automatic transmissions are so sought after," he said.

The anecdote underscores how Onex's managing partners take a hands-on approach to the companies they buy. But Mr. Mersky's ride also highlights how good companies can get bogged down in a bad economy.

One year after Onex and its partner, Carlyle Group, bought Allison, sales for commercial trucks and buses plunged. Last March, U.S. credit ratings firm Moody's Investors Service put Allison in its "bottom rung" list as one of 283 firms most likely to default on its debt.

It hasn't. Allison has paid down $380-million of debt and its bonds are no longer discounted. Mr. Mersky is helping pull Allison out of the gravel pit.

Welcome to the new world of private equity. Tales of hostile takeovers and big acquisitions have faded. Gone, too, is the focus on the larger-than-life private-equity personalities. The credit crunch has rubbed off the sheen, and now the funds and their portfolios are in the spotlight.

Globally, 2009 was the annus horribilis for the buyout community. The average rate of return for the year ending June 2009 was -31.4%, reports U.K. research firm Preqin. Fundraising was also dismal: 84 funds raised US$102.2-billion in 2009 compared with US$233-billion raised by 233 funds in 2008. The Boston Consulting Group and the IESE Business School have predicted at least 20% of the 100 largest private-equity firms - possibly as many as 40% - could disappear.

As a result, a new conservative tone has crept into the buyout lexicon. It's back to basics.

Expect "leaner and meaner" private-equity funds, says Paris-based Daniel Dupont, partner at Coller Capital. Mr. Dupont, whose firm buys out distressed private-equity funds, said those most at risk are the generalists who relied on financial engineering and credit to achieve returns. The survivors, he says, will be those with the best operational expertise or specialized knowledge in certain industries or sectors.

Anthony Munk, managing director at Onex, says staying focused has been Onex's theme for some time. "The few times [in the past] that we ventured out beyond our areas of expertise, we found the outcome wasn't that great. ... That reinforced itself during this downturn."

For the most part, Onex, under the continued direction of Gerry Schwartz as chairman and chief executive, has indeed played a conservative game. With the exception of its Allison purchase, Onex has used leverage at low levels. The team also managed to steer clear of duds during the frothy acquisition years.

"We spend a tremendous amount of time deciding not to put money to work, and that isn't sexy at all," Mr. Mersky says. He added that Onex looked at roughly 300 deals between 2006 and 2007.

That's not to say the company predicted the credit crisis or was immune to it. "One year ago, we were making sure hatches were battened down, and doing everything we could to make sure we weren't wasting time and money on anything, anywhere in the system," Mr. Mersky says.

Onex bought made three significant investments during the height of the bull market, and paid a premium for them, but claims the purchases are holding their own. The three are: Allison Transmission, Husky Injection Molding Systems Inc., which makes machines for plastic mold products such as water bottles, and Carestream Health, carved out of Eastman Kodak's old health-care division.

"We look for companies that give us a cushion on our returns," says Bobby Le Blanc, Onex managing director.

Key to Onex's formula is that all of its portfolio companies "enjoy extraordinary positions in their market," Mr. Mersky says. This ensures some pricing protection in bad times. Allison has 80% of the global market for automatic transmissions in commercial trucks, Husky commands more than 66% market share in its core market, while Carestream Health dominates the medical and dental film imaging market.

Onex hedged well with Carestream, a firm that is transitioning from film x-ray imaging and radiology to digital imaging technology. Although the economy has slowed hospital spending for new technologies, a slower-than-anticipated rate of decline in its film x-ray business helped Carestream maintain its margins. The goal is to have sales of new digital imaging technology overtake the shrinking film business, and grow the company further as the economy strengthens.

At both Husky and Allison, the strategy has been finding cheap and more efficient ways to procure parts, trim labour costs and enter new markets.

Despite a dismal truck market in 2009, Onex was able to transform Allison's cost structure and keep margins stable.

"I think the Moody's list demonstrates that not all private equity-sponsored companies deserve the negative views that many had at the height of the crisis," says Onex's Chris Goven.

Husky's margins have also been boosted, from 10% to 14%. Mr. Munk, who oversees the operation, is hoping to see the payoff in earnings jump substantially this year.

"Our portfolio is not immune to economic downturn, but the profitability in large part held up quite well and that's reflected in the fact that we focused on improving productivity, initiated lean manufacturing practices and optimized processes to reduce our cost structures," Mr. Munk said.

It takes a special set of skills to manage both complex buyouts and operation overhauls. Onex's secret is its ability to offer 29 in-house professionals to support the build up of its fledgling firms.

"You need not be afraid to own a business that isn't quite a business yet, not afraid to own a business that doesn't have an accounting department, legal department, tax department or a fully fledged IT department, when they start," Mr. Munk says. "It takes plenty of patience to help departments blossom into fully fledged firms, he adds.

Onex has been rewarded for its patient capital. A host of limited partners - private investors - upped their commitment to the Onex III fund. Last year, in one of the toughest climates ever for raising capital, Onex raised US$3.5-billion from these investors. This at a time when 28% of limited partners in North America and 50% in Europe reported dissatisfaction with the funds in which they were invested, says a report by Coller Capital.

On Jan. 4, Onex's managers announced they would boost their capital in the fund, from US$500-million to US$800-million. The move was a way of demonstrating the amount of skin they had in the game.

But while limited partners have shown their commitment to Onex's team, the public markets are withholding the love. When Onex met with a group of shareholders last fall, their frustration was evident. Over the past two decades, Onex has delivered a 29% gross internal rate of return (IRR) to investors in its funds, easily placing it in the top quartile of private-equity firms. But shares of its publicly traded entity sell well below its net asset value.

"So, why does our stock trade at a discount?" Andrew Sheiner, Onex managing director, asked at that meeting. The discount remains a "pet peeve" of Onex, he told the audience. Research analysts are torn. UBS analyst Fadi Chamoun can't understand why the stock trades at discount after the "mind-boggling" returns of the past.

One institutional investor at the meeting gave his own assessment: He wasn't prepared to pay a premium for "past performance" given the current economic climate. And he wanted a juicy tidbit or two, an IPO or sexy takeover to create some buzz. Onex had already announced its purchase of the Tropicana Resort & Casino in early 2009, but investors were hungry for more.

To appease the audience, Onex's managing directors offered up a few tidbits: two possible IPOs, for Husky and the Warranty Group Inc.

Then the directors went back to message, hammering home the progress they've made with their portfolio companies. Even if 2010 remains soft, Onex has plenty of "room on covenants, no maturities of any magnitude until 2012 and 2013, and is paying debt down on some companies," Mr. Munk says.

The company is confident that the economic shake-up will drive a flight to quality, with Onex a winning recipient.

"As long as you have a capital structure that allows you to withstand the downturn, then you end up with an investment that generates a good return," Mr. Munk says.