VENATOR
CAPITAL MANAGEMENT LTD.

PRIVATE EQUITY: The Undisciplined Discipline

November was another solid month for the Founders Fund which posted a 7.5% gain, putting the fund up 25.5% since its March launch. All major North American markets were up over the month (including the Canadian market, the income-trust debacle not withstanding). Commodity prices were also strong with accelerating momentum partially (primarily?) attributable to weakness in the greenback (versus currencies *other than* the Loonie). Our success in the month can be attributed to the earnings reports of our investee companies. Finally, the generally strong markets had a negative impact on our short positions, where even the companies that missed earnings expectations rebounded smartly after initial sell-offs.

This month's commentary centers around the headaches that the private equity glut is giving us, on both the long and short side of the market. In case you haven't heard, private equity is raising a ton of money (plus 3x-5x for leverage). As is always the case when a certain group raises a ton of money (think venture capital in the 1990s and hedge funds recently) there is too much money chasing too few ideas, and likely too many people running money who aren't properly qualified to do it. In the case of venture capital, no one *really* cared because they were largely confined to the private market (private money investing in private companies); in the case of hedge funds, most were just "levered-up" mutual funds and had to play by the rules of the public market and deal with the "marked-to-market" consequences of bad decisions, which largely kept them in check. Private equity, on the other hand, is increasingly putting private money into public companies, and paying big premiums to do it (paying up for illiquidity).

Private equity, as its being played out today, seems to be offering the worst of both worlds to investors, while giving the best of both worlds to the managers. These "worlds" are "investment terms" and leverage. Like the venture capital market (which is just another form of private equity) the private equity market is characterized by long investment lock-ups (but with larger sums of money involved) that are not "marked-to-market"; like the hedge fund market, it is characterized by lots of leverage. Big leverage without near-term accountability or liquidity is great for the managers and risky for the investors.

However, the true beauty of the private equity model is that the firms/managers don't ultimately need to pick good investments in order to make money. By the time they are done taking management fees, consulting fees, debt spreads and the operating cashflow out of the investment, they need only sell the investment at a breakeven valuation in order to receive a satisfactory multi-year return (with the exception of the operating cashflows and ultimate divestiture, we are not sure how many of these fees find their way back to investors). However, the leverage, along with an inability to liquidate a "position" if things start to go wrong, could be suggestive of a disconnect between actual returns (objective and advertised) and "risk-adjusted" returns (subjective and rarely spoken of). From a PR perspective, all news is good news. We hear about companies being taken private (positive since investors make money on the takeover), and private equity investments going public (always a big win). What you will never hear about are the ones that don't do so well; short of a bankruptcy, you likely never will.

We are fascinated by the private equity phenomenon in part because we are shocked at the valuations we are seeing for public LBOs. More than a few low growth companies are going for well over 20x EPS or 10x EBITDA (even the capital intensive ones). Companies are getting valuations that would more likely put them on our "short lists" than buy lists; and many don't

have the “hidden assets”, depressed margins, or defensive/staple characteristics that are often the historical attractor to private equity. While not having to mark-to-market will delay our thesis from being proven, we believe that, like with VCs and hedge funds, private equity will eventually disclose their share of disasters when investor lock-ups expire, only the damage will be far worse as individual private equity funds are putting more funds at risk (including debt) than individual hedge funds (Amaranth’s $6BB will look like nothing by comparison).

You may ask: Why do we even care? It’s because the seeming price insensitivity of private equity has made us more fearful of shorting stocks. Currently, our primary thought with regard to a potential short is: “would a private equity guy buy this?”. Valuation appears to be no object with the larger funds desperately trying to put money to work. Too much liquidity (egged-on by easy debt) creates “bubbles”.

Another issue is on the long side. While the siphoning of public companies out of the market is causing a general lift in valuations through speculation of targets, comparative valuation inflation, and “freed” money trying to find its way back into a smaller market, we are finding that the private equity valuations are getting in the way of the business plans of acquisitive companies. Tellingly, our public companies have slowed down their acquisition programs on basis that valuations are too rich, while we don’t hear the same complaints from people we know in the private equity business; curious given that the “industry/strategic” players should be able to get more “synergies” out of a buyout than the “financial” buyers.

Before we take things too far, we should say that our concerns lie mainly with those private equity money that are taking out already efficiently run public companies, without hidden assets or impressive growth rates, at what we consider to be rich valuations (Four Seasons comes to mind). Those that are out there buying distressed companies, private companies, hard assets, or non-strategic divisions of public companies, and don’t need a 25x EPS exit to make money, are likely to continue to reap impressive gains for their investors. Here in Canada, we have one of the best in the business in Onex Corporation.

As we head into December, an unpredictable month due to lack of news, tax-loss selling and generally low volumes, we are satisfied with our positioning for the Q4 earnings season. We remain under-invested in commodities, as we have a difficult time finding companies trading at valuations below their net asset values based on our required rate of return (15%) and “safety cushion” target prices for the underlying commodities (think $40.00 oil). We have recently dipped our toe into income trusts, but are generally finding that valuations are still a little too high, or that the companies are a bit too mediocre. However, if the business is non-cyclical, can organically grow by over 40% in the next four years, offers us a good current yield on distributions (which they can afford as cash flow from operations; not “distributable cashflow”, a term we can’t wait to forget), and can give us a positive capital return in 4 years based on an exit of 15x taxed earnings, we will look at it (suggestions welcome). The fund is nearly 100% long (25 positions) and 25% short (10 positions); and 60% Canada vs. 40% international.

Happy Holidays,

Brandon Osten, CFA
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