THE M&A ADVISOR SYMPOSIUM REPORT

Featuring

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THE YEAR M&A RETURNED: GLOBAL BUSINESS IN A NEW ERA

At The M&A Advisor New York Summit, Marshall Sonenshine, Chairman of New York investment banking firm Sonenshine Partners, moderated a discussion between two prominent private equity dealmakers, Steven Klinsky and James Attwood, whose firms, New Mountain Capital and The Carlyle Group, respectively, are at the forefront of the dramatic M&A revival six years after the onset of the global financial crisis.

The illuminating session addressed:

- The bifurcated M&A recovery in which corporate buyers currently have the upper hand
- The ways to unearth value in legacy businesses
- The role of shareholder activists in M&A transactions
- The role of the U.S. in leading a global recovery
- The outlook for Europe
- The current state of U.S. private equity

With 2014 M&A volume at a record-setting level, private equity, a global multi-trillion dollar force, is playing a crucial role in driving M&A dealmaking worldwide. From the leveraged buyout funds of the 1980s to today's multi-strategy private capital firms, private equity and M&A have been intertwined disciplines for three decades. In the new post-financial crisis era ushered in by the M&A revival, M&A is a catalyst for steady, if unspectacular, economic growth around the world.

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Contents

Executive summary	1
Introduction	1
The Year M&A Returned: Global Business In A New Era	1
Symposium session video	8
Contributors' profiles	9
Report sponsor profile	10
Publisher	11

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Executive summary

Six years ago the U.S. and world economies were in free fall as the financial contagion that gobbled the U.S. economy spread across the globe. Reflecting the economy, M&A slid into a trough. Since 2008, the U.S. and other major economies have awakened slowly. Growth, though it has sputtered, has improved slowly but steadily, as has M&A volume. In 2014, however, M&A volume rocketed to unprecedented levels and appeared to have finally shed the shackles of the Great Recession. Though M&A on the whole has returned to the spotlight, it has done so paced by the big corporate buyers. Armed with cash troves accumulated over the past few years, corporates, in many instances, have largely pushed private equity toward the sidelines in deals in which buyers are determined by the sealed auction process. In other non-auction deals, however, private equity firms like The Carlyle Group and New Mountain Capital can offer middle market sellers the opportunity to grow for several years as PE portfolio companies before returning to market. As a result, private equity continues to play a leading role in the M&A revival and in the ongoing reawakening of global business.

Introduction

At the 2014 M&A Advisor Summit, Marshall Sonenshine, Chairman of New York investment banking firm Sonenshine Partners, moderated a conversation between himself and two leading private equity dealmakers. The subject of their conversation: the revival of M&A and the slow but steady resuscitation of the global economy as both embark on a new era of growth.

Marshall Sonenshine | Chairman, Sonenshine Partners
James Attwood | Managing Director, Head of Global Telecommunications and Media, The Carlyle Group
Steve Klinsky | CEO, New Mountain Capital

Sonenshine led the conversation in an exploration of the current M&A revival, the role of corporate buyers and private equity firms in that revival as well as an overview of the state of private equity in the U.S. and Europe.

The Year M&A Returned: Global Business In A New Era

Marshall Sonenshine opened the conversation by describing the leadership roles played by James Attwood and Steve Klinsky at their respective firms, The Carlyle Group and New Mountain Capital. Klinsky, a former partner of the legendary 1980s buyout firm, Forstmann Little, is the founder of New Mountain Capital (NMC), a privately held $11.5 billion multi-strategy private capital fund. The average NMC portfolio company commands an average purchase price of $500 million. James Attwood, on the other hand, heads the telecommunications, media and technology (TMT) activities at the Carlyle Group, a global alternative asset manager with $203 billion of assets under management across 129 funds and 141 fund of fund vehicles, and with 1,700 investors from 78 countries. NMC's first private equity fund began its investment period in 2000. Founded in 1987, Carlyle quickly achieved icon status. Atwood recalled that when he joined Carlyle in 2000, the firm had $13 billion in capital under management.

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While Klinsky oversees all of NMC's businesses from his CEO's perch, which include, in addition to the $11.5 billion private equity fund, a $2.5 billion hedge fund and a $1.3 billion debt fund. Attwood focuses mainly on the telecommunications and media sectors, which he describes as dynamic "but is not for the faint of heart." He has also assumed responsibility for Carlyle's increasing involvement in technology. During the past decade, Atwood said, Carlyle has invested close to $20 billion in the technology and media sectors worldwide.

Sonenshine then moved directly to address the current position of private equity firms vis-à-vis large cash-rich corporate buyers. While calling 2014 a year of resurgence for M&A, he attributed most of that surge in volume to corporates, thanks to their full investment coffers, which afford them price domination. Sonenshine, as examples, cited two recent deals in which very expensive targets were bought mainly with stock. Current valuations, he said, have put private equity at a disadvantage.

"Today, the big corporations dominate M&A, which represents a major shift from earlier decades."
– Steven Klinsky

James Attwood conceded that the current dynamic holds true in traditional telecommunications and media sectors, citing other very expensive 2014 transactions: AT&T's $48.5 billion acquisition of DIRECTV, Verizon's $130 billion acquisition of Vodafone (of which $65 billion was in cash), and Comcast's proposed acquisition of Time Warner Cable. "All those deals were strategic," Atwood noted. He pointed out that a decade ago there was similar activity in the sector. "What eventually happened was a rationalizing of the portfolios when these big companies were assembled. In the past decade, the rationalization has been initiated by the companies themselves." As a result, he does not expect to see many follow-on, smaller private equity deals in the telecommunications and media sector.

Steven Klinsky agreed. "Today, the big corporations dominate M&A, which represents a major shift from earlier decades." He recalled that he was a partner at Forstmann Little during the controversial 1980s sale of RJR Nabisco made famous by the book and movie, Barbarians at the Gate. Back then, he said, private equity firms like Forstmann and KKR were major drivers of M&A. Now, however, the pendulum has swung in the opposite direction: Corporates, Klinsky asserts, "can pay the best because their cost of cash is such a low yield." It's just a question, he added, of when corporates are ready to strike, as they "can effectively pay very high prices and still be accretive to their own incomes."

Sonenshine asked Klinsky if inexpensive capital benefits all private equity participants, thus neutralizing any potential competitive advantage. Klinsky agreed that it did. "Carlyle has its own approach," he acknowledged, "but we try very hard not to buy in competitive auctions." NMC, Klinsky explained, has never bought a company in a sealed-bid auction: "When we have become involved in those processes, the price ultimately becomes so high that we choose not to pay it." The NMC strategist, Klinsky said, "has emphasized, as a selling point, our ability to grow a portfolio company. In fact, we have been especially successful in appealing to entrepreneurs who want to retain a minority stake and have a control partner." NMC's objective, he added, "is to distinguish ourselves in ways that do not involve waving a checkbook."

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Sonenshine acknowledged the challenge facing NMC by citing a remark once made by KKR co-founder Henry Kravis. "Please don't congratulate me when I buy," Kravis said, "only when I sell." Sonenshine than observed that NMC and Carlyle usually prefer not to use debt to finance acquisitions. "You both are less dependent on debt for making your investment decisions, but more focused than most private equity firms on how you will change [a portfolio company's] business because, from inception onward, you believe in your investment thesis."

This is so, Klinsky explained, "because we believe that private equity is a form of business, not a form of finance." NMC, he said, has elected not to use debt in half of its acquisitions adding that, when NMC has used debt, "we have always used less debt than was available because our focus is on buying a company, formulating a strategy for it and building the enterprise." Debt, he concluded, "is used as a sweetener, but only as a corporate finance tool."

"We prefer to build companies in which we've made investments."
– James Attwood

Carlyle, however, is a different species from NMC, said Sonenshine, "in that it has tentacles in many countries and operates at several levels of play." He asked Attwood, "Is there any way, in the robust Carlyle portfolio platform, to somehow synthesize perspectives about debt?" Referring only to Carlyle's private equity activities, Attwood replied that Carlyle's style is consistent across all funds and platforms. He acknowledged that Carlyle takes leverage, but only rarely as much leverage as banks offer. "In this environment, leveraging our returns is often the only way for us to achieve our 20% objective." Nevertheless, Attwood added, "We are always seeking angles because we never win plain vanilla auctions." Carlyle occasionally participates in auctions, but only in sectors in which the firm possess deep knowledge. "Unless, you have an angle with the target management team, a view that's contrarian, or a specific strategy that would be effective in the target's sector, there is no way to differentiate yourself."

In addition, Attwood explained, "we prefer to build companies in which we've made investments." As an example, he cited the Nielsen Company, a leading information and audience measurement enterprise. In 2013, Nielsen bought Arbitron, a consumer research company that collects listener data on radio broadcasting audiences. Arbitron was then folded into Nielsen. Explained Attwood, "We bought Arbitron because it was a terrific add-on, and because this is an area in which we can compete." Most of the time, however, Carlyle finds itself unable to compete with the big strategics, because Carlyle lacks the synergies offered by strategics. Attwood then pointed out that Carlyle can compete successfully "when we have portfolio companies that enable us to build an existing position." Carlyle, he added, was able to do this with a portfolio company, Syniverse Technologies, which develops mission-critical technology services to manage and interconnect voice and data systems: "We bought two of the company's competitors, one in Europe and the other in Asia, which enables us to create synergy value as well as to broaden the platform and grow it organically." Ideally, he continued, "we do that with the debt capacity that's been created in the company, so we don't have to put more equity into it."

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Referring to the 2013 privatization of Dell, Inc., Sonenshine then addressed the issue of legacy technologies, where sometimes buyout opportunities are available due to the market's tendency to under-appreciate such technologies. Dell, he remarked, possessed a declining computing

franchise and had spent $13 billion on amalgam of enterprise software, services and other acquisitions. "The public markets say 'Bad idea!' when it comes to acquiring a Dell," Sonenshine remarked, "but there's almost always a contrarian private equity firm that bucks the tide and proclaims, 'Good idea!'"

Attwood pointed out that there are legacy technology companies that are large and rich in cash flow. Such companies, he added, are intriguing to consider. "I'd put HP at the top of that list," he said, "but an HP transaction would be too large for a private equity buyout." HP, he commented, "is an example of a company that traditionally maintained strong positions – and continues to maintain some strong positions – but has lost its way and is not favored by the public markets." Companies in the HP class, he said, are attractive due to their size, scale and cash flow, "but private equity firms, even Carlyle, should not delude themselves by believing that private equity can fix a company of that size and scope when other individuals and management teams have spent years trying to do exactly that."

"The public markets say 'Bad idea!' when it comes to acquiring a Dell, but there's almost always a contrarian private equity firm that bucks the tide and proclaims, 'Good idea!'"
– Marshall Sonenshine

Legacy technology, Attwood added, has become fertile ground for shareholder activists, who, in recent months, have been generating considerable deal flow with legacy technology companies that include Tibco Software, Inc., a leading infrastructure and business intelligence software company, and Riverbed Technology, a venerable application performance enterprise. Tibco, for instance, agreed in late September 2014 to be acquired and taken private by Vista Equity Partners in a $4 billion deal after pressure was exerted on Tibco management by activist investment firm Praesidium Investment Management Company, LLC. In mid-December 2014, Riverbed agreed to be acquired by private equity firm Thomas Bravo and a Canadian teachers' pension fund in a $3.6 billion deal. Riverbed had been under pressure from activist investor Elliott Management headed by Paul Singer. "There are legacy technology companies that are not trading at crazy multiples, that have cash flow and that occupy entrenched market positions," Atwood said, but added that when activists become involved, those companies, especially in the western U.S., often seek out safe haven under the protection of private equity firms. He expects to see this scenario played out often in 2015.

Sonenshine asked Attwood if activists have a point when it comes to their disapproval of the 2013 privatization of Dell, Inc. Atwood allowed as how activists may indeed have been correct about Dell, "although Michael Dell disagreed." Carlyle, Attwood added, decided not to take a hard look at Dell and conceded that Dell is off to a "decent start" as a private company. The challenge in gauging a low-multiple enterprise and betting on a cash flow decline curve, Attwood remarked, is that the cash flow embedded in that declining business "can pay off a lot of debt."

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Responding to a Sonenshine question about the activism's role, Klinsky replied that New Mountain Capital's $2.5 billion in public equity, much of it under the governance mandate of large state institutions, has earned NMC a classification as an activist investor. Nevertheless, he added, "we conduct our business in a low-key, behind-the-scenes manner, building value." As an example of the quiet activism practiced by NMC, Klinsky recalled his experience with a Buffalo, NY gas utility that owned one million acres of land in Pennsylvania, but had never compiled a reserve report and had only drilled about 10 shallow wells annually, saying: "We added value by working the land, turning it

into one of the most productive landholdings in the Marcellus Shale [a formation of shale found in the eastern U.S. that contains largely untapped natural gas reserves]."

According to Klinsky, the concept realized by his Marcellus Shale achievement (that a public shareholder/investor adds value to an enterprise) is an example of the alpha generating idea. Employing such innovative strategies requires buy-in from company managements. Without sufficient credibility with management, he notes, alpha generating ideas are not possible. Management has to believe that an investor's ideas are actionable and will bear fruit, he emphasized. He calls management acceptance of investor alpha generating ideas a form of private equity minus a control premium. "It gets you from efficient market theory and a casino mindset," he explained. "It's like picking up a roulette ball and carefully placing it in the winning slot." Quiet activism, he noted, is far more likely to succeed than activism hallmarked by angry letters to management and dramatic confrontation. The ability to succeed at quiet activism, Klinsky said, "is based on how effectively an investor presents to management."

"The U.S. is the best house in a bad neighborhood."
– Steven Klinsky

Attwood saw a beneficial role for activists. Activists, he declared, "shine lights into areas that need to be illuminated." However, Atwood evidenced concern about technology industry activism: "The playbook seems to be focused on cutting costs – which may be a good idea, but may also involve reductions in R&D budgets." Although he acknowledged that some R&D budgets are bloated, he had trepidation about this: "I worry that this approach amounts to taking a sledgehammer instead of a scalpel to a problem."

There was agreement among the session participants that a global recovery was in progress. Sonenshine, however, posed a two-part question to Klinsky and Attwood: Is the U.S. leading the global recovery, or is the recovery currently too fragmented to claim that anybody leads anything?

Klinsky replied that NMC seeks to invest in individual companies that are non-cyclical. He therefore had no opinion on how aggressively an overall global economic recovery was benefiting, or not benefiting, an individual company. Nevertheless, he stated, "My sense is that the U.S. recovery is not that robust; it appears fragile to me." In addition, he pointed out that Japan had slid back into recession, the Chinese economy is slowing and Europe is on the brink of a slump. Klinsky concluded that, compared to these trends, "The U.S. is the best house in a bad neighborhood."

Attwood then responded, saying that U.S. GDP growth ought to be in the 2.5%-3% range in 2015 (based on the assessment of data Carlyle routinely gathers from an array of companies, as well as data provided by Carlyle staff economists who track companies relative to public economic measures). Europe, Attwood added, is in the doldrums, yet it hasn't stopped Carlyle from investing: "The irony is that we have been very active investors there during the past 18 months because valuations are 30% below U.S. valuations and good companies in good industries are available in Europe." Similarly, he said, Carlyle has been very active in Japan during the past 12-18 months, even though the Japanese economy is moribund. Attwood claimed that he views the

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global economy from two vantage points: On the one hand, robust economic growth worldwide is always desirable; on the other, sputtering growth creates opportunities.

According to Sonenshine, as the U.S. and global economies have evolved in the past two decades, so, too, has private equity. Twenty years ago, he pointed out, private equity was finance-focused. Private equity firms became involved with management and operations only when one or both sprung a leak. Today, though, private equity firms are typically involved with portfolio company management from the outset and understand that they need operating partners and industry expertise. The reason for the change, according to Sonenshine: "Private equity now is about business; it's not about finance."

"Private equity now is about business; it's not about finance."
– Marshall Sonenshine

Back in the 80s, when Steven Klinsky began there as an associate, Sonenshine commented, Fortmann Little was the second largest private equity firm in the world. In addition to Klinsky, the Forstmann staff consisted of five professionals. When he departed Forstmann in 2000, the staff there had grown to eight professionals. Carlyle and KKR were much smaller then compared to now. Klinsky views the expansion of private equity professional staff as a healthy development. This expansion, he pointed out, reflects the realization "that we really do own companies and that in addition to infusing portfolio companies with money, private equity firms are responsible for also infusing them with the management and strategic capability required to support the entrepreneur CEO." This responsibility is especially acute at middle market portfolio companies where the entrepreneur founder had spent decades growing the company to the extent that his skills permitted. "It's our job now to help him take his company to the next level," Klinsky declared. "It's no longer about lending money with covenants; it's about buying companies and building them."

Sonenshine then noted that publicly traded private equity firms are coming into vogue, a trend nearly unheard of for 20 years. Today, Sonenshine said, The Carlyle Group is one of the most prominent publicly traded private equity firms. Attwood said that he is often asked how Carlyle's public status has changed his approach. His response was that estate planning at Carlyle was very intense before the firm went public, "and then everything reverted to what it had been." Carlyle, he said, "consists of individuals who are investing in a $13 billion fund. "It's the same team that did the previous fund and the fund before that, buying the same types of companies, employing the same strategies to create value." The difference, however, he added, "is that the firm has a much larger footprint and thus more things for publish shareholders to focus on." Regardless, Attwood stated, his job "hasn't changed at all."

Attwood then said that, whether today as a public company since 2012, or in recent yesterdays pre-2012, Carlyle has subscribed to the necessity to make operational improvements to portfolio companies, "because today's pricing is almost to perfection and there is little wiggle room—you can't make money on the price at which you bought the company," adding that every Carlyle investment requires a 100-day plan and a value creation thesis. In an ideal world, Attwood stated, "We'd like to buy the company that has a perfect management that we don't have to change or coach, but that rarely happens, because companies become available for several reasons, which means that there are management, strategic or other issues that must be fixed." Like Klinsky and

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NMC, "[Carlyle has] always believed that deep industry knowledge is a necessity," Atwood said, adding that Carlyle's deep focus is directed at specific industry sectors in order to help Carlyle make good investment decisions. After that point, however, "it's all about operations, about a team that can react to changes, because invariably issues will emerge that had not been anticipated in a 4-5 year investment."

Since too many private equity firms are currently pursuing too few deals, Sonenshine concluded the session by asking Klinsky and Attwood if the private equity industry might be helped by attrition, specifically, the theoretical disappearance of the industry's bottom quartile of participants. Klinsky explained that NMC circumvents the competitor glut by seeking out the owner-decision-maker who cares about what happens to his company after its sale and by striving to be the better partner. "I've been in this profession for 33 years and there has always been competition," he remarked. "You drive in your own tracks. My guess is that if one-third or one-quarter of our industry evaporated tomorrow the competition for deals would be just as fierce as it is today." Nevertheless, he said, "Our thrust is about trying to find opportunities in areas that are relatively uncompetitive." As an example, he cited an NMC deal that was announced in early November: the acquisition of DealLogic, a performance platform used by global and regional investment banks. The deal was a proprietary transaction in which NMC approached the DealLogic owners and proposed an acquisition, to which the owners agreed. An exclusive was signed, and the deal closed in December 2014. "It still happens," Klinsky concluded.

Symposium session video

To watch The Year M&A Returned: Global Business In A New Era at M&A Advisor's Symposium in New York, click on the following image:

The Year M&A Returned: Global Business In A New Era

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Contributors' profiles

Marshall Sonenshine
Chairman
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Marshall Sonenshine is Chairman and Managing Partner of Sonenshine Partners. Mr. Sonenshine is also Professor of Finance and Economics at Columbia University and a frequent global finance commentator on CNBC and Bloomberg Television, and the author of numerous articles on financial, legal and public affairs that have appeared in the New York Times, Financial Times, Harvard Law Review, Harvard International Law Journal, and Institutional Investor. Mr. Sonenshine holds a B.A., magna cum laude, from Brown University where he was elected to Phi Beta Kappa, and a J.D. from Harvard Law School, where he served as an editor of the Harvard Law Review. He studied at L'Institut d'Etudes Politiques and the Sorbonne in Paris, and served as Teaching Fellow in International Relations at Harvard University's Government Department, an Instructor in Legal Writing and the International Tax Program at Harvard Law School, and was law clerk to Hon. Lawrence Pierce of the United States Court of Appeals for the Second Circuit in New York. He is a member of the New York State Bar Association.

James Attwood
Managing Director, Head of Global Telecommunications and Media
The Carlyle Group

James Attwood joined The Carlyle Group in November 2000 as Managing Director and head of their New York-based Global Telecommunications and Media group. Prior to joining Carlyle, Mr. Attwood served as Executive Vice President for Strategy, Development and Planning at Verizon Communications, Inc. At Verizon (and GTE prior to that), he was responsible for the oversight of all strategic planning, alliances, ventures, corporate strategy, development and M&A activities. He was a key player in several industry-shaping transactions including the merger of Bell Atlantic and GTE (creating Verizon) and the creation of Verizon Wireless. Prior to his four years at Verizon and GTE, Mr. Attwood served as an investment banker at Goldman, Sachs & Co. for 11 years, working in both the New York and Tokyo offices. Mr. Attwood graduated summa cum laude from Yale University in 1980 with a B.A. in applied mathematics and an M.A. in statistics. In 1985, he received both J.D. and M.B.A. degrees from Harvard University.

Steve Klinsky
CEO
New Mountain Capital

Steven Klinsky is founder and Chief Executive Officer of New Mountain Capital (NMC). He established NMC in 1999. Prior to founding New Mountain Capital, Mr. Klinsky was co-founder of the leverage buyout group at Goldman Sachs in 1981-84, where helping to execute over $3 billion of pioneering transactions for Goldman and its clients. He then joined Forstmann Little and Company, where he was an associate partner and a general partner, helping to oversee seven private equity and debt partnerships totaling over $10 billion in capital. Mr. Klinsky was the most senior partner of Forstmann Little outside of the Forstmann family for a majority of the 1990s. Mr. Klinsky received his B.A. in Economics and Political Philosophy, with high honors, from the University of Michigan in 1976. He received his M.B.A. from Harvard Business School and his J.D., with honors, from Harvard Law School. He is or has been chairman or a director of numerous corporations and philanthropies.

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