

# ANATOMY

## Public titan

Nasdaq-listed American Capital's expansion has encompassed taking on LP capital, establishing an overseas presence and building new verticals. By Judy Kuan

Public listings of buyout firms and their funds initially drew unprecedented press and attention earlier this year with high-profile listings on Euronext Amsterdam. The fervor fizzled and spluttered as investors' interest waned in such vehicles, in part because of long ramp-up periods. However, Kohlberg Kravis Roberts and Apollo Management were by no means the first wave of buyout firms listing their private equity funds - and indeed, even their management companies - public.

Celebrating its twentieth anniversary early this year, American Capital Strategies (ACAS) has spent nearly half of its life - since its IPO on Nasdaq in 1997 - as a public company. Since then, the firm has grown to manage around \$10.7 billion (€8.5 billion) in total commitments, delivering its investors 22 percent compounded annual returns since going public. In the last year, ACAS has invested over \$6 billion in debt and equity in buyout transactions.

ACAS has achieved these "private equity-level" returns as one of only two publicly-traded buyout firms in the US, notes Malon Wilkus, ACAS's chairman, CEO and president. The firm is now supported by a staff of 452 and enjoys the distinction of being ranked second only to The Carlyle Group in terms of number of employees at a buyout shop. ACAS' shareholder base is a considerable 200,000, of which 70 percent are retail shareholders.

As a public venture within the private world of private equity, ACAS has at times been termed an "interloper," says Wilkus. Only recently have publicly listed private equity funds become a more palatable concept to many in the industry. As for the concept of taking the private equity management company public, only two firms - ACAS and Allied Capital - can lay claim to the feat within the US. The average US retail investor is prohibited by securities laws from investing in the three recently listed European private equity funds.

Since ACAS has - until recently - solely invested permanent capital, it would perhaps be unfair - and inaccurate - to compare it with its non-publicly-traded counterparts on a "committed capital under management" basis. According to Wilkus, in the past year ACAS did the equivalent of "raising" another \$6 billion of capital for making investments: \$2 billion of which was capital returned via exits from investments,

another \$2 billion from raising debt, and \$2 billion from issuing stock - at a premium to book value - in the public markets. "As a publicly-listed company, we have tremendous access to capital," says Wilkus.

ACAS now touts itself as a "one stop buyout shop." According to Wilkus, the firm is not confined to investing in only one strip or tranche of capital. Rather, it can "go up and down the balance sheet" to invest in the senior debt, subordinated debt and equity of its target companies. "That gives us a tremendous advantage," says Wilkus. "We can write one check and get the transaction done - that's different than what our competition can do."

Because it can provide the entire capital structure of a portfolio company, ACAS does not engage in "big" deals - the cap on any investment is \$500 million. To achieve what Wilkus describes as a "granular, diversified" portfolio, ACAS now executes between 60 and 70 deals each year, and the average size of ACAS' 159 portfolio companies is \$44 million - or 0.6 percent of the firm's total portfolio. This granularity and diversification reduces risk, contributing to ACAS' access to lower cost capital, says Wilkus.

## Accessible private equity

Last month, ACAS announced that it had raised a \$1 billion private equity fund for investment in the US. In creating the new fund, the Bethesda, Maryland-headquartered firm sold \$670 million of equity to the new fund, in addition to raising \$330 million of undrawn commitments for future equity investments to be made by American Capital. The \$670 million will be directed toward reducing American Capital's existing obligations under its revolving credit facilities. The new fund will acquire roughly 30 percent of American Capital's equity stakes in 96 portfolio companies, with the combined cash purchase price of \$670 million. The remaining \$330 million of American Capital Equity I will be used to invest in 30 percent of each private equity investment made by American Capital in the US.

With American Capital Equity I, "we raised capital in a way that's never been done before - no GP has ever gone to a fund of funds and raised capital by selling them the assets that they've generated on their balance sheet," says Wilkus. "We have syndicated a whole new asset class by syndicating equity investments in midmarket companies for the first time in history, and in doing so, raised a billion dollars."

"This billion is just a tiny part of the story," emphasizes Wilkus. "This billion from LPs, along with the billions from the public markets and billions from the debt capital markets, indicates that there are multiple ways of raising capital, and together these represent the lowest cost of capital in the industry."

Last year, American Capital also launched European Cap-



**Erickson: building an infrastructure**



**Wilkus: pioneering public PE**

ital, a private fund structured as a SICAR, a type of regulated Luxembourg company that invests in private equity. According to Wilkus, the main difference - apart from geographic focus - between American Capital Equity I and European Capital is that the European fund has a greater ability to leverage capital and can borrow money without much limitation, whereas ACAS' newest US fund is unlikely to be able to borrow money.

"European Capital certainly is a candidate for taking public someday," adds Wilkus. "This US fund has a possibility of that as well."

## Superstructure support

Supporting the investing and fundraising aspects of its business, ACAS has an army of financial and administrative support staff under its employ. This is a drastic change from ACAS' early post-IPO days, when the entire firm was similar in size to a middle market private equity firm, with 25 to 30 people, says John Erickson, executive vice president and chief financial officer of ACAS.

"At that point, Malon and I were very involved in the fundraising function," recalls Erickson. As the firm has grown over time, so has its infrastructure for functions like investor relations and finance and accounting, providing Wilkus and Erickson with time and resources to take on a larger role on the deal and strategy aspects of the firm.

Now, as an investment-grade public company that funds itself through securitizations and raising debt and equity, ACAS requires "tremendous administrative capability that a typical private equity firm couldn't even imagine," says Wilkus.

Consequently, to provide these services, American Capital has about 40 on staff in its corporate finance group, plus over 30 for its accounting and reporting group and around 55 employees in its compliance group. Most of ACAS' finance and operations talent is housed at the firm's Bethesda headquarters, but the firm also has 10 people based in London who are dedicated toward the accounting, fundraising and loan serv-

icing functions for ACAS' activities in Europe.

With its sizable in-house investor relations capacity, the firm's managing directors and other executives on the investment side can focus on deals without being pulled away for fundraising every few years, as is the case for most buyout firms. "This time they had to participate a little more," says Wilkus of the fundraising process for American Capital Equity I, adding that the principals' participation could be measured in days of work rather than years.

"We have quite a capacity in that area..To be able to manage these very sophisticated, cutting edge capital-raising techniques, we've had to really staff up," says Wilkus. "We have 180 companies in our portfolio, and we can analyze them left and right - we know the IRR of the portfolio of every one of our principals, we generate an income statement and balance sheet for each office and each investment team, we know the cost associated with various pools of investments, we track investments on an annual static pool basis and value investments every quarter through an incredibly rigorous process."

According to Wilkus, the quality of these valuations is proven by the fact that the proceeds from \$3 billion of portfolio company exits have exceeded their fair value on the prior quarter's balance sheet by 2 percent. That ACAS, as a business development company with a public structure, is already required to base its quarterly reporting on fair value, the additional amount of work and reporting required for American Capital Equity I - which will purchase 30 percent of each equity investment made by American Capital - is negligible.

Despite its sizeable infrastructure, the firm has an expense ratio of 1.9 percent of assets - noticeably below the industry average of about 2.75 percent (2 percent management fee plus direct fund expenses totalling approximately 0.75 percent of total assets, explains Wilkus) - which ACAS attributes to its public structure and its scale.

## Forward strategy

ACAS' big-picture strategy is to build up its fee-based asset management business as the only US publicly traded manager of funds of private assets. For instance, ACAS will collect a 2 percent management fee and 30 percent carry (subject to a hurdle rate of 8 percent) for managing American Capital Equity I, which will make equity investments alongside ACAS. The European Capital fund has economics approximating 2/20. "This expands our asset management strategy, with more and more of income coming in the form of asset management fees and carried interest," says Wilkus. "The fees from American Capital Equity I should improve our return on equity, and be accretive to our net operating income by \$0.25

per share in 2007.”

In addition, ACAS' growth strategy has included the creation of a number of new verticals - such as mature technology companies, energy companies, logistics, medical products, the equity of commercial real estate, CDO equity, turn-around and special situations and financial institutions - have been added as strategic areas for ACAS. The firm has also recently opened a Palo Alto office to focus on early stage technology investments.

The international scene is also an attractive growth frontier for the firm. Prior to opening European Capital, ACAS spent 18 months researching whether it would make sense to engage in a European strategy. At the time, ACAS had been trying to decide between expanding into Europe or into Asia; it ultimately decided that Europe was a better way to go given that the firm's competitive advantages in the US were more applicable to Europe.

To establish its European business, ACAS brought aboard three managing directors, opening offices in Paris and London from which European Capital is managed. Starting as a €750 million fund, European Capital now has €1.6 billion in

capital commitments and has invested €1 billion in the past year. The firm is planning to expand into the German and Spanish markets and will open additional offices in Frankfurt and Madrid by the first quarter of 2007. Wilkus sees “fertile opportunities” in Europe and expects the firm will expand its activities there quite substantially.

ACAS has also spent a great deal of time in Asia, says Wilkus. The firm has several investments in China, as well as a number of portfolio companies that have substantial dealings in China in the form of plants and facilities, joint ventures and outsourcing. Of ACAS' 30-strong operations team, five are supply chain management specialists. Virtually every month, one of these supply chain experts is in Asia, helping ACAS' portfolio companies and evaluating the risk and reward of potential portfolio companies relative to Asia.

It is clear that Asia presents fewer opportunities to ACAS than do Europe or the US. However, it is still possible that ACAS will open an office in Asia to invest in the region or to provide support to portfolio companies, adds Wilkus. “While there are fewer opportunities, there are also fewer competitors,” he says. ■

## > American Capital Strategies

**Founded:** 1986 (went public in 1997)

**Capital under management:** \$10.7bn

**Offices:** Bethesda, Maryland (headquarters); Chicago; Dallas; London; Los Angeles; New York; Palo Alto; Paris; Philadelphia; San Francisco; Frankfurt (planned); Madrid (planned)

**Total employees:** 452

### Key operations personnel include:

Malon Wilkus	Chairman, CEO and president
Ira Wagner	Executive VP and COO
John Erickson	Executive VP and CFO
Samuel Flax	Executive VP and general counsel
Roland Cline	Senior VP and managing director
Brian Graff	Senior VP and managing director
Gordon O'Brien	Senior VP and managing director
Darin Winn	Senior VP and managing director
Mark Opel	Principal and senior VP, business development
David Ehrenfest Steinglass	Senior VP, corporate development
Jeffrey Schumacher	Senior VP, group head of syndications
Thomas McHale	Senior VP, finance
Rich Konzmann	Senior VP, accounting and reporting
Jay Beam	Senior VP, financial analysis and compliance team
Lionel Ferguson	Senior VP, human resources
Juan Carlos Morales Cortes	VP and finance director, European Capital
Attila Freska	Director, international business development
Brian Maney	Director, corporate communications
Amanda Ladd Cuthbertson	Investor relations manager
Miriam Tejada	Marketing coordinator

### Funds:

American Capital Strategies, Ltd (NASDAQ:ACAS) (\$8.5 bn enterprise value; 2006)

American Capital Equity I (\$1bn; 2006)

European Capital (€1.6 bn; 2006)

American Capital CDO (in development)

American Capital Energy (in development)

American Capital Financial (in development)

American Capital Real Estate (in development)

American Capital Special Situations (in development)

American Capital Technology (in development)

**Types of investments:** buyouts, recapitalizations, growth financing, add-on financing

**Sectors:** energy, logistics, special situations, early & later-stage tech, medical products, financial products, CMBS, CDOs

### Selected investors:

HarbourVest Partners, Lexington Partners, Partners Group, Fidelity, Vanguard Group, US Trust Co of New York, Goldman Sachs Asset Management, Barclays Global Investors, State Street Global Advisors, TIAA-CREF Asset Management, Ohio Public Employees Retirement System, Gardner Lewis

### Strategic relationships:

Accountants	Houlihan Lokey, Ernst & Young
Law firms	Arnold & Porter, Weil Gotshal & Manges, Patton Boggs, Kirkland & Ellis

Source: American Capital