

Private Equity

CONNECTION

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Northwest Edition

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Connecting Businesses In The Pacific Northwest With Private Equity Investors

Interviews

KCB Management

Bob Blair & Lorin Knell

Focus: Generalist
Western U.S.

Criteria: EBITDA \$1 - \$5 Million
Revenue \$3 - \$50 Million
EBITDA % Revenue 10%+



Q: *What is the most defining characteristic of KCB?*

A: **Bob Blair:** The important differentiation for KCB is our long-term investment prospective. We have a traditional fund with limited partners and committed capital, but our fund is structured to allow us to hold investments indefinitely. We are able to be patient long-term investors. Our core philosophy is to back the management teams in our transactions. Our long-term perspective puts the power to manage the investment in the hands of the management team. The management team is the key in determining when and how we should exit given that they know the industry and they know their markets. Since 1986, we have employed this strategy to obtain superior returns over very long holding periods.

Q: *It seems to me I recall you held one entity for some seventeen years or more, is that correct?*

A: **Bob Blair:** Yes, for 18 years, Ulta Salon (NASDAQ Symbol ULTA), which is a leading chain of specialty retail stores focusing on salons, cosmetics and fragrances. They are a 10,000 sq. ft. footprint retailer, generally located in neighborhood or big box shopping centers. We were one of the initial investors and we continue to be an investor in the public stock of ULTA. ULTA

is a story of patience. We were very active initially as ULTA grew from a very small company to a mid-market company. After a period of significant growth, management and our other partners determined that it was necessary to bring in some larger financial partners to help continue to grow the business beyond our capabilities. So we stuck in there, seeing the opportunity to grow the business well beyond where KCB had brought it. Management was committed to continue to grow the business rather than looking for an exit. By waiting, the business reached a level of over \$80 million in EBITDA and it was a great return for us. Our hold periods over the past 23 years have been in the 7 to 10 years range, but we have held businesses as short as 3 years and as long as 18 years. Our model is to work with the management team to determine the appropriate holding period versus exit timing driven by a fund structure.

Q: *In looking at your industry focus, we note that you list retail as the first category on your list, which is a bit unusual compared to your peers across the country.*

A: **Bob Blair:** Our principals have a very deep background in retail and operations, so we are comfortable in the retail category. However, we take the operating experience we have gained through

retail and apply it to other industries. We invest well beyond the retail segment. Over the past 23 years, we've been in about 16 different industries including business services, light manufacturing, training services, distribution, consumer products, healthcare services and facility based healthcare. We currently have a portfolio of 48 skilled nursing facilities, which gives us a real depth and understanding of the healthcare market. Also, we own a chain of 12 collision repair shops and a government services business, so we truly are generalist investors.

Q: *Geographically, is your focus on the Western U.S.?*

A: **Bob Blair:** Yes, the Western States which includes Texas and everything west of Texas.

Q: *Let's say we presented you with two companies with somewhat similar growth characteristics; one that required additional investment, say retail, for each new unit that was put in, and another that was a business services company requiring only an additional PC computer and a cubicle for each person added to support growth. Of the two, do you like the capital intensive business because there's a bigger barrier to entry or the low capital business because you can grow it with internal cash flow?*

A: **Lorin Knell:** Generally speaking, even retail companies can often be grown with internal cash flow, but if you are talking about basically identical companies, we would probably gravitate toward the lower CapEx (Capital Expenditures) requirements as it would provide better cash flow to our investors and the company would have additional cash to explore some interesting growth alternatives. The additional cash flow could be used for acquisition growth or you could accelerate organic growth

more easily than you can in a more capital-intensive business.

Bob Blair: However, we would seriously consider a capital-intensive business by using a cash flow analysis to see what the appropriate purchase multiple might be. Or, alterna-

"We are starting to see a rebound in the availability of ABL"

tively an EBITDA minus CapEx analysis to look at the multiple that we're paying relative to the low CapEx business. In a cash flow analysis, you can determine what multiple provides an equivalent return for the private equity investor.

Q: *So neither one would be off your list, it's just a matter of running the cash flow analysis to arrive at an appropriate buy in price?*

A: **Bob Blair:** Exactly - and, an appropriate capital structure going forward. The one thing we didn't talk about as far as KCB's philosophy is that we use leverage prudently. In peak years we used less than 3 1/2 times (EBITDA) leverage. By comparison, the market was probably using 4 1/4 to 4 1/2 times leverage when multiples were at a peak. Our use of lower leverage is partially driven by the market we're in, as well as a level of conservatism. So whenever we would look at two deals per your example, the Cap X definitely comes into play because their CapEx limits the ability to service debt.

Q: *Speaking of the debt component, do you see the banks coming back with senior lending positions or does that still require some time to run its course?*

A: **Lorin Knell:** Senior lending seems to still need some time to run its course, especially for the size of businesses we are looking at; which tend to be asset light.

Continued On Reverse

We do have some good relationships with a couple of banks and they have indicated interest in financing quality deals even without that asset backing. In general, senior bank debt is still slow to come back for companies between \$1 to \$5 million EBITDA. **Bob Blair:** We are starting to see a rebound in the availability of ABL (Asset Based Lending) for businesses under \$3 million of EBITDA. During 2009 it was even tough to find an ABL lender that was willing to lend without a guarantee, and of course we don't do guarantees as a private equity fund. Recently, the ABL market has started to open up with more aggressive existing groups and new entrants, including Celtic Capital, First Community Financial, and Wells Fargo's Midmarket and Business Bank.

Q: *I notice that value added distribution is on your target list and then, jumping up to your EBITDA line, that you're looking for EBITDA margins in excess of 10 percent. Do you apply that to value added distribution or do you look more at the gross margin being in excess of 25 or some such?*

A: We would apply this criteria to value-added distribution as well. We have seen several value-added distribution businesses with over 10 percent EBITDA margins. When a business has over 10% EBITDA margins, especially as a value added distributor, but really this applies to any company, it generally means that you've got some good trenches and moats (as Warren Buffet would say) around your business. There's a pretty good chance that the business has a competitive advantage or some special sauce to it that makes it a real viable business. When you get below 10% margin (EBITA as % of revenue), you're getting much more into the commodity type businesses where you just don't have a competitive advantage on a going forward business.

Bob Blair: Usually these types of distributors are providing some kind of specialty service whether that's special delivery service, some sort of maintenance or training or other kinds of activities, such as kitting processes – something that firmly establishes their value added to the product, versus, being as Lorin said, a pure commodity distributor.

Q: *The investment focus section of your website lists education and training services and products. Could*

you amplify a bit on the types of things you'd like to see in education and training?

A: Bob Blair: Sure. It's of course, for-profit, education and training services. Education could be in the adult professional education space such as, dental assistant schools, nursing schools; you might call it the med-tech space. Also, we are also interested in many other types of professional and trade schools. From a product standpoint, it would be products that facilitate providing those educational services. Another interesting sector is providing training services to government and other government agencies. We just invested in a business which provides training, curriculum development and actual instructor level services, in human intelligence for the U.S. Army. The company is defense oriented, but it's also a training services opportunity.

Q: *How about a word about your proximity to Washington, Oregon, Idaho? It seems to me that you guys are close and you haven't been reluctant to fly to these states whenever there's an opportunity that merits it.*

A: Lorin Knell: Absolutely. We consider the Northwest to be in our backyard and we own a portfolio company based in Portland, Oregon - Kadel's Auto Body. They have 12 shops in Portland, Oregon, Vancouver, Washington and Boise, Idaho. We visit the Pacific Northwest on a regular basis while working with the management team of Kadel's. We're happy to jump on an airplane and fly up there in a heartbeat. It's an easy flight with lots of choices, lots of options to get up there.

Q: *Have you done like many others have, kind of drawn a line on "no building products related firms at this point, thank you very much?"*

A: Bob Blair: I wouldn't say that. I think it's a tough business case right now to invest in building products because of the downturn in construction across the commercial as well as residential segments. There are still opportunities for innovative specialty building products businesses that we believe would be worthwhile investments. We think that we are uniquely positioned to be able to evaluate those products and how those products would fit into the retail and the commercial construction space given our roots of having owned one of the largest

home center chains in the U.S. From a commercial construction standpoint, in our commercial real estate investing we are a user of commercial construction. We have a very large real estate portfolio that buys existing properties and also does its own development projects. We understand the uses and attractiveness of these materials. We wouldn't turn our backs on that segment, but we need to be a little bit more careful as we assess the risks.

Lorin Knell: I think there are some very specific areas that have done well even through this downturn. The easiest one to pinpoint is plumbing services as it relates to repairs and maintenance. People's sinks are still getting clogged and pipes still need to be replaced. That's a subset of the building supply industry that has fared well during this environment.

Q: *Please tell our readers a bit more about your real estate focus.*

A: Bob Blair: In addition to operating companies, we have a large real estate presence and practice. We have four real estate funds and we are fundraising right now for a new \$100 million fund. We are buying commercial real estate - shopping centers, multi-family housing, medical offices and facility-based healthcare. More specifically, skilled nursing facilities are an area where we have a lot of depth with a current portfolio of 48 facilities. We also look at other commercial sectors such as student housing. We have about \$600 million in real estate currently in our portfolios. We are a multi-asset class investor and not just private equity. We definitely can take a different point of view than your typical private equity investor given that range of activities.

Q: *And so even if there's no operating company involved, a significantly sized real estate opportunity is a call you would like to get?*

A: Bob Blair: Yes, if it falls within the segments that we mentioned and within the United States. Real estate is a national strategy. However, we are very interested in looking at opportunities in the Pacific Northwest.

Lorin Knell: Additionally we look at larger deals in real estate as opposed to our private equity strategy. We've done packages of nursing homes with a deal value of approximately \$100 million.

Q: *What are your deal size parameters for your private equity fund?*

A: Bob Blair: Generally enterprise values for our private equity fund are between \$5 and \$50 million.

Q: *Any closing comments for our readers?*

A: Lorin Knell: The only other thing I would really add that wasn't covered relates to our style. We ask a lot of upfront questions. We want to take a good look at a business before we give an offer, so that when we give an offer it's really a qualified offer not just lobbing in an offer and then working it down during due diligence. Adjustments to an offer may happen, but it will be based on true diligence findings. We try to be very upfront. Our Letter of Intent is in excess of ten pages and goes through all the major terms that a seller doesn't usually see until the Purchase and Sale Agreement. We do that to be upfront with the business owner in exactly what we are looking at and what's going to be part of the deal. We do this because we realize that the seller, whether they are active in the business or not, has a stake in the business and its employees. We want to build a good partnership with that owner and the management team, and the last thing we want to do is have them feel like at the last minute we started eroding their position in the deal. Indemnities are often overlooked by sellers but something we make sure we are upfront about. In the 1 to 5 million EBITDA space, this is probably going to be the only transaction they ever do. They are not familiar with the level of diligence and level of documentation. We put our fees in upfront to avoid misunderstandings. We're very straightforward and direct and what we say and what we do are exactly the same.

Bob Blair: Putting in a qualified offer with a full summary of deal terms is critical for a long-term investor. We need to be good partners with our management teams as well as with the people that sold us the business. Even if they're not continually involved, they are still part of the community and important to the community where they built the business. We are going to be a long-term partner in our local community with those businesses. ■