

# CFO

## deals

## WHAT LIES BENEATH

Private-equity firms know how to make companies look good. But this buyer knows how to look more closely. BY ROY HARRIS

topline

**L**IKE LOTS OF ACTIVE ACQUIRERS, Leggett & Platt Inc. often deals with private-equity sellers as it seeks targets in its “sweet spot” between \$20 million and \$40 million in revenues. But despite an abundance of candidates in private-equity (PE) portfolios, finding a good opportunity is far from easy for this manufacturer of components for bedding, furniture, and consumer products.

“By the time the PE firms are ready to sell a portfolio company, they’ve deleveraged the balance sheet somewhat by milking cash flow, and often neglected the necessary long-term investments to keep it competitive,” says Leggett CFO Matt Flanigan. Not only that, but the private owners are adept at hiding the weaknesses of the outfits they offer for sale. “We work hard to be sensitive to the fact that some PE sellers are putting lipstick on a pig,” he says.

Based in Carthage, Missouri, Leggett displays a decided “show me” mentality when it comes to picking and choosing among available deals—especially with financial sellers. When studying PE-owned candidates, the company, which has become a \$6 billion powerhouse on the heels of 160 acquisitions over the past decade, focuses on the implications of higher leverage. Specifically, it examines to what degree managers are geared to short-term results, thereby alienating the company’s customer base. Only if Leggett is confident that the private owners have done well by customers will it consider making an offer.



MATT FLANIGAN, CFO OF LEGGETT & PLATT: “LEVERAGE IS A TICKING TIME BOMB THAT YOU NEED TO MAKE SURE DOESN’T GO OFF.”

### CHECKING THE PLUMBING

With private equity such a huge factor in mergers and acquisitions—it now accounts for about a quarter of overall U.S. deal values as they approach 1998’s record \$1.63 trillion, according to Thomson Financial and Robert W. Baird & Co.—questions about the quality of the companies being shopped are more relevant than ever. On one hand, executives like Flanigan often find operational flaws beneath the surface. Yet PE firms and the academics who study them tend to view the assets being sold as relatively healthy, especially as measured by cash flow and other financial measures.

In a recent study of one particular type of private-equity exit strategy—initial public offerings—Harvard Business School professor Josh Lerner and Jerry Cao of Boston College found that such IPOs outperform the market generally in “economically and statistically mean-

ingful” ways. Higher leverage among IPO companies coming out of private equity, the study found, did not lead to poorer performance but, rather, just the opposite.

“That was the big surprise,” says Lerner, who acknowledges that “there are a lot of reverse LBO companies that have gone public over the years, and some people fixate on certain cases.” In actuality, however, he believes buyers often prepare themselves for hefty debt and related shortcomings stemming from a target’s PE roots, and somehow overcome the disadvantages.

“It’s like buying an older house,” Lerner says. “You see it’s got all these problems with plumbing and wiring, and presumably you’ll be more careful when you buy.”

*Careful* has been Leggett’s watchword in dealing with PE sellers. So far, such deals account for fewer than 10 percent of Leggett’s acquisitions. The company prefers to buy from entrepreneurs who know their companies inside-out and often accept performance-based earnouts as part of the price.

Few entrepreneurial companies are highly leveraged, but the entities being sold by private-equity owners often are. “Leverage is a ticking time bomb that you need to make sure doesn’t go off,” says Flanigan, noting that extracting cash from a business to make interest payments can hurt long-term growth.

Management teams installed by PE owners can also pose a challenge. Rarely will a firm’s founders wittingly alienate customers. But Flanigan often sees managers choosing cash production over customer needs. “One way to get cash out of the sys-

tem is to reduce days outstanding on receivables, or to stretch their vendor base,” he notes. “An entrepreneur may be willing to keep cash tied up in inventory in order to serve customers. If long-standing customers take longer to pay, he may say, ‘That’s fine.’ But if you put that same issue before managers dealing in a leveraged environment, they’ll say, ‘No, we want to get that payment as soon as we can.’”

Managers of PE-owned assets may make them look good on paper—part of the porcine “lipstick,” in Flanigan’s view. After all, the combination of low working capital and high leverage instantly improves returns on equity. But numbers ginned up by managers this way can be deceiving. “They have been well schooled in generating that absolute maximum amount of cash flow, which is certainly a shareholder value-creating priority,” he says. “Over time, though, they may be prevented from making good growth bets.” Sometimes he finds disgruntled employees, equipment worn out for lack of investment, and a flagging reputation.

### ABSORBING SPONGE CUSHION

A Leggett acquisition earlier this year, Morris, Illinois-based Sponge Cushion Inc., a maker of rubber carpet padding, illustrates the cautious approach described by Flanigan and CEO David Haffner when considering PE-owned targets. Sponge Cushion, with \$50 million in annual sales, had been starved for growth capital by its UK-based owner, which Leggett declines to identify. Being “basically cash-gener-

## HIDE & SEEK

Some Leggett & Platt concerns about private-equity targets

- ➔ The company starves facility upgrades and R&D.
- ➔ Steep cash interest payments hamstring company finances.
- ➔ Managers favor short-term strategies and don’t understand operations well.
- ➔ Morale is low because of managers’ attitudes and lack of investment.
- ➔ Customers are antagonized by low inventories and stingy policies.

Source: Leggett & Platt CFO Matt Flanigan

tion-optimized,” as Flanigan puts it, the target needed a capital infusion to remodel and expand operations to correct the previous owner’s approach.

Debt was originally 80 percent of capitalization, about six times operating cash flow. But Leggett’s due diligence revealed an unusually strong management that seemed comfortable with Leggett’s longer-term horizons. While no original entrepreneurs were on the team, many managers had worked for two previous owners and ran the business well. “We don’t typically buy turnaround situations; it’s not our forte,” Flanigan says.

Leggett was so enthused that it entered an auction for Sponge Cushion, eventually paying a “market-based price” that likely exceeded what a negotiated deal would have arrived at, concedes Flanigan. But the target’s rubber-cushion carpet padding “was our final piece of the puzzle,” he says. Because the deal extends Leggett’s carpet-related product line, the company expects it to yield a competitive advantage.

The Sponge Cushion purchase presents another potential advantage: giving Leggett more experience dealing with private-equity sellers. “As they sell smaller properties, and as we buy bigger companies, we’ll be seeing many more of these kinds of deals,” the CFO says. **CFO**

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## Blame It on the Froth?

**Some private-equity firms recoil at accusations** that they dress up ailing entities before selling them. Others tend to agree.

“There’s validity there; it’s a reflection of the markets,” says Mitchell Hollin, a partner with Philadelphia-based LLR Partners, which has \$620 million under management. PE players are “pretty savvy about how to maximize value, and in frothy markets they can get away with it because IPO investors and buyers let them do it.”

LLR is different, he says, in part because there’s low leverage in its portfolio. Also, LLR retains hefty interests in companies it takes public. “We’re not smart enough to bet on a new industry or new platform, as well as a new management team,” he says, chuckling. “And we’re not willing to double down on that strategy.” LLR also tends to keep legacy management teams in place. “It’s a huge red flag if a PE investor is going to sell most of its interest,” according to Hollin. — R.H.