

M&A Monitor

Piper Jaffray Middle Market Mergers & Acquisitions

M&A Monitor: Analyzing M&A Activity—February 22, 2006

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Feature Article**Hedge Funds & Private Equity Firms—Will They Co-exist as Friend, Foe or Sibling?**by Adam Kroll, adam.b.kroll@pic.com, 312 920-2149

It is no secret that hedge funds have started peeking behind the curtain into the private equity community at increasing rates over the last few years. With 9,000 hedge funds now managing more than \$1 trillion this year, the pressure and difficulty to generate alpha is increasing, making it especially difficult to stand out from the crowd when attempting to attract investor dollars. As that happens, buyouts become more interesting. Notwithstanding that hedge funds seek low beta portfolios, their managers are compensated on absolute return, and buyout shops have more of it today. Simple capitalism suggests that hedge fund managers see private equity returns as an opportunity to boost their own fund performance, attract more capital and, yes, earn bigger paychecks.

There are three key similarities that exist today. Hedge funds and private equity funds both consist of a general partner charged with managing the capital of limited partners under partnership agreements that can be negotiated any way the parties choose. Second, there is substantial overlap among the limited partners (pensions, endowments, and high net-worth individuals). And third, general partner compensation structures are almost identical for hedge funds and private equity.

There are four notable structural differences between the money managers. First, private equity funds obtain capital commitments and issue capital calls when funds are needed for a particular investment. Once that money is invested, there is no second bite at the apple; hedge funds get the money upfront and recycle it until redeemed. Second, private equity partnerships have definite lives with relatively tight investment mandates; other than temporal lock-ups, hedge funds typically do not. Third, hedge funds are notorious for using leverage to generate returns, while buyout funds typically cannot. Fourth, private equity funds predominantly take active management roles and control positions, while hedge funds historically do not seek active involvement.

A review of recent history, however, indicates that hedge funds are capable of successfully entering the world of the illiquid. Hedge funds entered the middle market lending arena as an extension of their high yield and distressed lending activities. The last recession and credit tightening created perceived market inefficiencies. Enter hedge funds.

The onset of hedge funds taking control positions in distressed names led to restructured equity ownership (commonly referred to as the “loan-to-own” program). With a foot in the door, hedge funds became more active in commercial lending and facilitated the incredible boom of CLOs, CDOs, and CBOs. What is most impressive is that middle market leveraged lending activities effectively created liquidity in a previously illiquid market. Hedge funds also boosted, if not created, the corporate credit derivatives market, adding even more liquidity. Business Development Companies then started raising large amounts of capital, giving closed-end mutual fund status to middle market lending and buyout firms.

While few will argue with the mantra of “past performance does not guarantee future results,” investors (institutional or otherwise) often put their money behind managers with strong *historical* results. A brief review of state pension funds will tell you three important things: (i) allocations to hedge funds are increasing, (ii) expected hedge fund absolute returns are far lower than expected private equity returns and (iii) pension funds are consolidating investments into fewer managers, and hedge funds are taking greater share. In the aforementioned interview, Mark Anson stated CalPERS will ultimately pick 30 to 40 key partnerships (versus 450 funds managing \$25 billion of CalPERS alternative investment allocation). According to the Russell Investment Group’s annual survey on alternative investments, “Between 2003 and 2005, the percentage of institutional investors using hedge funds grew from 23% to 27% in North America ...” This puts additional pressure on both hedge fund and private equity managers to generate stand out returns to attract additional money and keep what they have.

The ironic implication, however, is that long-run profits will fall for everyone (the investing world’s Wal-Mart effect). According to Marketwatch, Thomas H. Lee commented, “... the expectations of investors have diminished since [I] began working in the private equity business in the 1970s. His firm has generally promised investors a 40% return in exchange for locking up their investments for 10 to 15 years. The entrance of hedge funds and institutional investors has diminished those expectations.”

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Feature Article, Cont.

Hedge Funds & Private Equity Firms—Will They Co-exist as Friend, Foe or Sibling?

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Nonetheless, if hedge fund managers are going to enter the buyout market, the question becomes, how? Illiquidity and concern over mark-to-market valuation are always considered the obstacles. There is one certainty: hedge funds do not lack creative financial engineering skills. The market conditions alone benefit hedge funds. As we reported in the last issue of M&A Monitor, 2005 transaction volume was up 4.5% to just under 7,000 transactions, while total values were up 10.5% to \$812 billion. For right now, this leads to the appearance of better liquidity. Consider the real estate analogy that our homes were once thought of as illiquid and during recent history buyers were showing up within days of listing. Hedge funds are increasingly turning to side-pocket allocations incorporated into LP agreements.

Side-pockets are reaching 30% of assets and do not require frequent valuations; carried interest is typically only taken when profits are realized. Furthermore, low beta total return typically involves arbitrage or hedging strategies. Private equity investments, certainly not as efficient, can open the door to pure play long position in a pair trade to a public equity or debt short position. Managers are generally increasing the lock-up period; many new large hedge funds have lock-ups that go out four years, and even five years in the case of Eddie Lampert's ESL Investments. This, of course, is far short of a typical private equity fund, so the problem is not entirely solved.

In M&A we talk a lot about synergies. Think about cost-saving opportunities between private equity and hedge funds. Hedge fund managers may raise their own private equity funds. Both are highly scalable businesses raising capital from the same institutions; the human capital is of course readily fungible. Such sibling relationships are already popping up, causing the line between buyout managers and hedge fund managers to begin to blur. Consider Cerberus, the \$18 billion hedge fund that has been very active in private equity. Recall they competed with a number of buyout shops for Toys "R" Us, including KKR. More recently, Cerberus partnered with investors to acquire its share (665 stores) of the carved up Albertson's sale. Going the opposite way, it has been publicized that Carlyle, Bain and Blackstone have each launched their own hedge funds or fund of funds to peek behind opposite curtain. It's also worth noting that the PIPE market was essentially created by private equity firms. Thus hedge funds and private equity funds may likely end up as "siblings."

On the other hand, if hedge funds don't help themselves, they might as well help out their private equity cousins. Hedge fund activism is at least likely to create a symbiotic relationship with private equity firms by agitating more assets into play for M&A/buyouts. First, private equity can serve as a white knight alternative to hedge fund activism. This was most recently seen when Carl Icahn threatened a hostile bid for Fairmont Hotels & Resorts. The company turned to buyout fund Colony Capital as its white knight. Second, the push for public firms to divest non-core or undervalued assets will put more assets in play for buyout funds.

This was recently evidenced by McDonald's and Wendy's being pushed to spin-off Chipotle and Tim Horton's, respectively; they chose the IPO route. Similarly, Eddie Lampert's decision to divest Orchard Supply from Sears Holdings, opened the door for Ares Management to take a \$58.7 million stake in the \$463.7 million recapitalization of the company. The chatter in the market also supports this conclusion. George Roberts, co-founder of buyout fund KKR, in a January 19, 2006 article in The Oregonian, stated they would have no trouble investing capital raised in their new fund in part because they "... increasingly have been fed deals as hedge fund managers have agitated for higher returns ..." Mark Anson (former CalPERS CIO) echoed Roberts in a January 27, 2006 interview with The Deal, stating he also believed that restructurings at public companies would create opportunities for buyout funds.

The substantial debate is likely to continue over whether hedge funds belong in the private equity world. Ultimately, the decisions will be made by selling shareholders and their respective management teams with the advice of M&A advisors. Sellers will consider both price and the long-run best interests of the firm. The reputation of hedge funds as fast traders will continue to precede them as they enter private equity. The transition, if successful, will need to prove itself over a number of years for hedge fund managers to exhibit themselves as good shareholders who are willing to wait the possible four to eight years before realizing returns.

Private equity investing is not for everyone. For the near-term at least, it is likely that most hedge funds will stick with what they know best: public equities, credit, commodities and derivatives. But as these hedge funds moved into the unlikely worlds of reinsurance, mezzanine lending and market making, before long, many are likely to stop peeking behind the private equity curtain and jump all the way in. Many will make friendly entrances, as co-investors with buyout funds, some will be the siblings to existing hedge funds and others will be foes competing for attractive buyouts directly. Some may be a combination of all three.

Feature Transaction

Piper Jaffray Advises Oasis Outsourcing, Inc. and H.I.G. Capital

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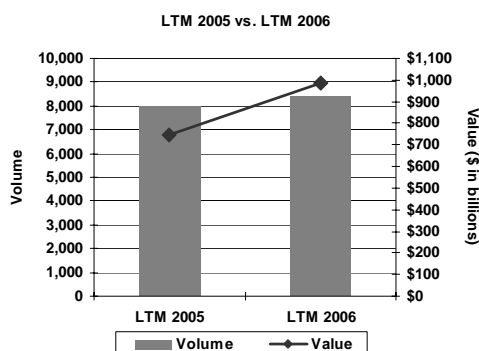
On February 17, 2006, Oasis Outsourcing, Inc. ("Oasis" or the "Company"), a portfolio company of H.I.G. Partners, was acquired by Nautic Partners. Oasis, headquartered in West Palm Beach, Florida, is the fourth largest Professional Employer Organization in the United States and the largest private company in the industry. Founded in 1996, the Company provides outsourced human resource ("HR") services and benefits administration, including full-service payroll processing, employee benefit plan management and a full suite of additional HR-related functions for more than 1,700 clients and 51,000 work site employees.

Piper Jaffray served as exclusive financial advisor to Oasis Outsourcing, Inc. and H.I.G. Capital. Terms of the transaction were not disclosed.

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Domestic Transactions

(\$ in billions)	Value*	Volume
LTM: 2005	\$745.6	7,986
LTM: 2006	\$988.0	8,378



*Total value based on deals with reported values

Source: Thomson Financial Securities Data Corporation

LTM median deal value for 2006 is \$30.5 million compared to \$27.1 million for 2005.

LTM Transaction Multiples

By Size (\$ in millions)	EBIT	EBITDA
Less than \$25	7.4x	4.1x
\$25 to \$100	10.1x	8.4x
\$100 to \$250	12.7x	7.1x
\$250 to \$1,000	16.2x	8.9x
Over \$1,000	14.7x	10.1x

Current data as of February 21, 2006

Source: Thomson Financial Securities Data Corporation

Based on multiples between 0x and 25x; excluding media and telecom.

Public Company Premiums

1 week prior to announcement	23.8%
4 weeks prior to announcement	25.2%

Current data as of February 21, 2006

Source: Thomson Financial Securities Data Corporation

Deal Financing

	Current	1 Year Ago
Leveraged Bank Loan	7.39%	5.36%
High Yield Bond Rate	8.06%	6.85%
Senior Debt/EBITDA*	4.4x	3.4x
Total Debt/EBITDA*	5.2x	4.6x

Current data as of February 21, 2006

Source: Portfolio Management Data, The Wall Street Journal and LCD Comps

*Represents leverage statistics for middle market LBOs (less than \$50 million of EBITDA)

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Buyout Fund Market

(\$ in billions)	2005	2004	2003
Funds Raised	\$173.5	\$42.2	\$24.0
Deals Completed	\$198.0	\$136.5	\$94.8

Data as of February 21, 2006
Source: Buyouts

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