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PRIVATE BRIEFING: LEVINE LEICHTMAN STICKS TO DEBT-EQUITY FORMULA

The Los Angeles private equity shop's formula of combining debt and equity has been used in model deals such as Nothing Bundt Cakes and Luminator Technology Group.

BY STEVE GELSI

When Arthur Levine and Lauren Leichtman launched Levine Leichtman Capital Partners in Los Angeles in 1984, they tapped their own resources.

Levine had some capital from his time as president of radio network Westwood One, which he helped take public in 1984. Leichtman brought her legal expertise to bear as a former lawyer for the Securities and Exchange Commission.

Wanting to conserve their principal capital, the married couple (still together now) decided to invest a portion of their money in target companies as a debt security with a monthly coupon, along with a minority equity position.

They reached out to successful entrepreneurs at the helm of companies with $30 million or $40 million in revenue and up to $6 million in Ebitda.

"This structure allowed us to make a less dilutive investment than traditional buyout equity," Leichtman told The Deal. "We'd usually get 30% of equity versus 80% of equity in traditional buyouts. About 60% of our returns came from the coupon [payments] on the debt."

Fast forward to 2020, and Levine Leichtman Capital Partners (LLCP) has invested about $11 billion in institutional capital since it raised its first fund with outside capital in 1994 and launched four fund families, with offices Los Angeles, New York, Miami, Dallas, Chicago, Charlotte, London, Stockholm and The Hague.

The firm remains true to its core "structured equity" approach it pioneered back in the 1980s, although it has tweaked it a bit. Trading up from its early focus on companies with up to $40 million in revenue, LLCP now

looks at companies with up to $500 million in revenue and a sweet spot of $75 million to $200 million in revenue for its flagship fund, Levine Leichtman Capital Partners VI LP, which closed in January 2019 at its hard cap, with $2.5 billion in commitments.

In a return to its roots in smaller deals, LLCP Lower Middle Market Fund LP deploys its structured equity strategy in businesses with up to $50 million in revenue. It's investing in Europe from Levine Leichtman Capital Partners Europe II SCSp. The firm also manages a long-duration strategy with a retail investor base through Levine Leichtman Strategic Capital LLC.

A Unique Approach to Structured Equity

While some firms take to loading portfolios up with sometimes unsustainable leverage to extract fees and giving management little skin in the game, LLCP has has taken to its own form of structured equity.

First, the firm puts very little external leverage on portfolio companies -- generally about three times Ebitda. All other capital in deals comes from LLCP and management. Managers and owners get more operational control than they would from outside lenders, with LLCP working to help them accelerate growth while providing support and expertise. While LLCP started out as minority equity holders, it now typically holds a majority, but management may own as much as 45%.

To be sure, lots of firms claim to be unique in their approach. It's also much less rare nowadays for other firms to use both their own debt and equity in deals.

But even with these developments by other firms, LLCP maintains it's unique because it always invests debt and equity together from the same fund in every deal. Its debt and equity securities come in at the initial investment and are realized together upon exit.

Because it uses low-third party senior leverage and does not refinance its subordinated debt, LLCP's management teams and investors get the benefit of the current yield. They also get downside protection since the firm will hold the fulcrum security if a company hits a speed bump. Investors start getting a return 30 days after close from coupon payments on debt that LLCP issues to companies. LLCP's subordinated debt is generally priced at 15% and is paid in cash on a monthly basis.

LLCP also sets itself apart by allowing business owners to retain more equity than a traditional LBO structure -- as much as 45% equity, but typically 5% to 30% of equity.

The firm prides itself in getting results by growing companies, not through financial engineering.

LLCP aims its approach at owners and management looking to avoid the typical deal offered by traditional PE buyers: external debt as high as six times to seven times Ebitda, with management holding less than 10% of the equity. Other PE firms often want full control, or at the very least, they'll put an operating partner on the board to oversee management.

If managers at a prospective target want to cash out of a company in a deal and sell it entirely, LLCP sees that as a warning sign to stay away.

"I don't want to be a buyer if they're a seller," Leichtman said. "They know the company better than I do. They know their customers better. These men and women are the engine of growth. If they want to take all their money off the table, I don't want to buy it."

Model Deals

Leichtman and Matt Frankel, head of U.S. fund investments and permanent capital vehicles, said current portfolio company, Nothing Bundt Cakes, and a past portfolio company, Luminator Technology Group LLC, stand out as strong examples of the firm's structured equity approach. It's one of more than 20 franchise brands that LLCP has handled.

Addison, Texas-based Nothing Bundt Cakes was founded more than 20 years ago by two women who brought in a chairman to help grow the company. By 2015, the business had grown substantially. The chairman and one co-founder wanted to sell and monetize value, but the other co-founder, Dena Tripp, saw more growth ahead.

Frankel said LLCP was the only prospective buyer that could check off the four major boxes that Tripp wanted: experience with franchising, no big changes at the company, allow her to roll "significant" value into the business, and an owner that would avoid excessive leverage.

The firm acquired the franchiser of gourmet cakes and accessories in September 2016 and partnered with Tripp and CEO Kyle Smith. Since then, LLCP and management upgraded the team, almost doubled the store base, drove same-store sales increases, implemented new marketing strategies, added a new distribution facility, and upgraded IT systems. Ebitda is up by three times.

"It's a great validation," Frankel said.

Meanwhile, LLCP acquired Luminator Technology Group LLC, in 2010 as a carve-out from Mark IV Industries Inc., a truck parts maker. It was a non-core division that made lighting, signage and passenger communication systems for bus, rail and aerospace.

"They weren't given any cash flow to grow the business," Frankel said. "The team had great growth plans and a fire in the belly but were lacking an owner that was willing to invest in the company."

After less than four years. LLCP and management tripled the Ebitda by investing in the business to expand globally, launching new products and making accretive acquisitions.

"We took a race horse and we let it out of its stable," Frankel said.

LLCP continues to sift for prospective deals with a full-time roster of eight origination pros with relationships in their local geographic markets.

"These are not people in their 20s who smile and dial," Frankel said. "They have 20 to 25 years of experience in their local markets with strong relationships."

Leichtman said her strengths as a dealmaker and lawyer shape her craft to this day.

"My strength has been evaluating managers and partners and trying to match our strategy with the needs of those business," she said. "One thing law school gives you is the ability to organize tremendous amounts of material in an efficient way. When we crafted the firm, we were looking to provide something different. That's where those skills have helped the most."

Looking ahead, Leichtman said the firm plans to stick to its structured equity play book.

"We're just excited about continuing what we're doing," she said. "We're building on the platform we have now."

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