



Private Label Investing: One-on-One Interview with Managing Director Douglas Meltzer of PCG Capital Partners

Q: Can you give us some background on PCG?

A: PCG Corporate Partners Fund is a US\$500 million private equity fund that partners with leading companies by providing structured, senior-equity capital to help finance strategic initiatives. Half of the fund has been invested. Recent investments have been in healthcare, energy, financial services, business process outsourcing, and media. We have made successful investments alongside Comcast, Mediacom, Radian, and Aegon. We are also looking at sectors that control costs for businesses and consumers, such as business process outsourcing and private label.

Our capital is typically used by our corporate partner to finance an add-on acquisition, fund organic growth, or reduce debt. We are not an LBO firm as we do not acquire control of companies. We are not a VC fund as we do not finance technology start-ups. We are not a hedge fund as we neither short stocks nor have a short-term investment horizon.

Q: Let's talk about your most recent investment.

A: Lincoln Paper and Tissue LLC is a private-label pulp-to-paper and tissue mill in Maine. Lincoln makes very short-run "niche" products in an industry that is typically described as having only commodity products. Within the tissue



Douglas Meltzer, Managing Director, is involved in the origination, screening, analysis, due diligence, negotiating and monitoring of private market investments. Mr. Meltzer is focused on the firm's direct investment activities and has over 15 years of experience as a principal investor. Prior to joining PCG, Mr. Meltzer was a Principal at The Blackstone Group where he was involved in sourcing, executing and monitoring private equity investments in a broad range of industries. Before that Mr. Meltzer had similar responsibilities as a Vice President at DLJ Merchant Banking Partners. Mr. Meltzer currently serves on the Board of Directors of Lincoln Paper and Tissue.

segments, Lincoln currently holds significant market share in the party napkin markets, typically found in party supply stores. Lincoln also has a leading share in business-reply cards, the postcards found in magazines.

The company was in Chapter 7 last year. The mill was purchased out of Chapter 7 by an existing manager and two industry veterans who were very familiar with the plant. The new management immediately embarked on a variety of cost-savings initiatives, such as elimination of the corporate jet. Keith Van Scotter, the CEO and John Wissman, the CFO, also did a great job bringing back the previous employees and working with long-standing customers who were facing a supply shortage when Lincoln was closed. As part of our due diligence, we spent a great deal of time talking to customers, making certain that the shut-down did not cause irreparable damage to the relationships.

Q: What first attracted you to Lincoln?

A: We identified private label as an area not fully recognized by other investors. The US private-label market generates sales over US\$70 billion, and has exhibited strong sales growth of between four and nine percent every year since the mid 1980s. This growth did not slow

during the last three recessions. Further growth is available. Private-label market share in the US is 16%, almost half the share in Great Britain and significantly below several other markets.

Private label has migrated up the value chain and is now taking market share in premium-price categories. For example, in frozen foods, private labels have moved up the value chain from commodity categories such as vegetables to more sophisticated specialty products such as pizzas and ice cream.

Retailers and consumers now accept that the old view that private label products are low cost, low quality is no longer true. Many retailers now have multiple ranges of private labels: a value line which competes against deep discount plays and a premium range which competes against gourmet products. Retailers not only drive profitability through higher-gross margins, but high-quality private label brands promote loyalty to a particular retailer.

Q: Describe the structure of the investment.

A: Lincoln raised capital to refinance its existing credit facilities and buy and install a new tissue machine, which will cost over US\$30 million to build. As a part of this transaction, Lincoln raised US\$69 million, of which US\$32 million was provided by LaSalle Business Credit in the form of bank debt.

PCG purchased US\$28.5 million of subordinated notes with a face value of US\$34 million and a 13% interest rate (10% cash pay, 3% PIK). PCG also invested US\$5.5 million in LLC interests for 35% of the fully diluted ownership of the company. PCG has also committed to invest an additional US\$2.5 million in subordinated notes. The management team is also investing US\$1 million in equity.

Q: Given your large equity ownership, this does not look like a typical debt with warrant structure that mezzanine funds use.

A: Correct, we are definitely not a mezzanine fund. We are taking equity risk on this and every transaction. The fact that we have two seats on the five-person board of directors is further indication that we are equity investors, not mezzanine investors. And we are typically the only financial investor.

Q: So why the complicated structure?

A: We often mitigate our risk by moving up the capital structure. This is one way to manage risk as a non-control investor. Although we are usually common or preferred, in this case management wanted to reduce some of our upside and offered us more downside protections - debt with a cash-pay component. We are flexible in our approach, and as long as we still have significant participation in the upside, we can meet our objectives.

Q: You did a PIPE in 2003. How do you compete with hedge funds?

A: For smaller, less-mature businesses, typically in technology or bio-tech, hedge funds have proven to be a viable funding option. We offer long-term capital, typically five-to-seven years, something most hedge funds are not able to do. Also, many hedge funds are unwilling to sign non-disclosure agreements and do not often have the expertise to gather and analyze the information. Further, many CFOs seek to avoid hedge funds as financing sources because they often short the stock, placing significant downward pressure on the stock price. Our investment in **WebMD**, which has recently changed its name to **Emdeon**, was a redeemable, convertible, exchangeable preferred security. It's a mouthful but it demonstrates our ability

to work with management to structure a security that's not plain vanilla – that actually addresses management's issues.

Q: Why Emdeon?

A: As I mentioned earlier, we focus on top-down research to identify sectors with positive long-term trends. Of course we are all aware of the rising cost of health-care, but most of the focus is on pharmaceutical costs, excessive litigation, etc. Less attention has been focused on administrative costs, which, as a percentage of healthcare costs, are two-to-three times higher in the US than most other Western nations. We believe Emdeon is extremely well-positioned to reduce administrative costs.

Q: You mentioned that you take less risk than LBO shops.

How?

A: First, since we are not taking control, we can avoid the take-over premium, which is typically 30%. In other words, we invest at a lower price. Second, the companies we invest in tend to be less levered, thus reducing risk. Third, we can customize transaction structures. A LBO firm can only buy a company. We have several options. For example, we can structure our investment as a joint venture, invest in a subsidiary, structure our equity or create an equity line of credit so our money goes in over time, not all at once. We also believe that providing primary capital to a company to grow its business is inherently less risky than putting money into the pocket of a seller

Q: What do you do when an investment is not doing well?

Our approach to “fixing” companies is significantly different than buyout funds. Since buyout funds have control of a company - a right for which they have paid

a significant premium - buyout funds have the option of changing management. Experience has shown us that these rights are exercised infrequently. In cases where management is changed, it is typically after a few quarters of poor performance, followed by an extensive search for new management.

Of course, the new management then typically requires at least a few months to familiarize themselves with the company, employees, products, customers, etc. before implementing significant change. By this point, the investment has likely lost significant value and the buyout fund is simply seeking a return of capital at cost.

In contrast, we are not under an illusion that we have the right to change management or implement significant change. As a result, we believe we are more focused than buyout funds on making certain that we are investing alongside the best management team in an industry. We must be right at the time of the investment. In those cases when the company is not performing within expected parameters, we usually have the option to exercise some type of exit right. That is, rather than being forced to implement dramatic and risky changes in the hopes of getting a return of capital, we have the right to demand our capital back from our corporate partner.

Q: How large is the Corporate Partnering Market?

A: There are no statistics on the amount of capital committed to the corporate partnering market (providing growth capital to established businesses). Our estimate is that US\$8 billion of private equity capital has been committed, mostly indirectly, to corporate partner investing. This is a small fraction of the LBO fund market.