

Q&A: KEEPING PACE ON THE SIDELINES: WILLIE WOODS DISCUSSES THE EVOLUTION OF ICV AND THE FIRM'S STRATEGY FOR WORKING IN AN OVERHEATED MARKET

By *Ken MacFadyen* ken.macfadyen@sourcemedia.com **Investment Dealers Digest**

April 23, 2007 (c) 2007 Investment Dealers Digest and SourceMedia, Inc. All rights reserved.

Willie Woods, Jr., left his investment banking role at Deutsche Bank in 1998 to help found ICV Capital Partners with Tarrus Richardson, a veteran of private equity firm Joseph Littlejohn & Levy. The pair built a firm, which raised its second fund last summer, dedicated to investing in small-market companies, ideally businesses with revenues of \$25 million to \$100 million and Ebitda ranging from \$5 million to \$15 million. While the rest of the market is tripping over itself to win the next auction, ICV has taken a deliberate approach, mimicking a strategy that worked well for the firm's last fund. Woods sat down with IDD earlier this month to discuss ICV's strategy.

ICV was founded in 1998. What was the genesis of the firm?

Woods: What sparked us getting started was a previous relationship I had with Michael Porter, [a professor] at Harvard Business School. He had a mutual friend at American Securities Capital Partners, and they were thinking of launching a fund dedicated to the smaller end of the middle market that would look at deals with companies located in inner cities or run by minorities. Porter and Michael Fish, of American Securities, contacted Tarrus Richardson [an ICV co-founder] and myself and asked if we would consider it. While I was at Deutsche Bank, I had worked with Tarrus before [while he was at JLL], so it was something that really got us excited.

Tell me about fund raising? I know each fund generated a lot of enthusiasm.

Woods: We started with a \$100 million target and ultimately raised \$130 million. We've already invested the first fund and we're now in the process of exiting. We've sold all of the portfolio companies from Fund I, except for two. With that track record, last August, we raised our second fund. That had a \$200 million target, with a \$300 million cap, and our LPs were kind enough to let us exceed that. We ended up raising \$313 million.

Could you describe the inner-city focus of ICV? It seems like this is something that attracted a lot of institutional investors.

Woods: When we started, there was a lot of excitement about it and the thinking was that it would be a good area in which to source deals. As it turned out, the targets we were finding were too early-stage and too much like venture capital deals.

Also, I think everyone in this business is just looking for a good investment, so it's hard to box inner-city companies into a particular niche. If a generalist private equity fund sees

a good business in downtown Detroit, just because it's downtown Detroit, it won't stop them from investing there. So there wasn't much of an angle.

The minority market is a little different. We are better able to differentiate ourselves. But the issue is that there aren't a lot of business owners who are minorities and are looking for change-of-control capital. Oftentimes, they've started these businesses from scratch and it's very difficult to part with them. It goes beyond economics. Because of that, it's more of a mezzanine market.

How has the ICV business model developed in light of this?

Woods: We evolved our strategy to focus on the broader market but concentrate on all of the things that those businesses have in common. We'll look at the smaller end of the middle market and try to partner with a strong leader who may not have all of the resources to take the company to the next level. In addition to capital, we'll try to bring in fresh ideas. They may be focused on just one channel, or maybe they haven't considered new products. We'll help open the door to get them to see what other opportunities are out there.

All these things are common to a small business, whether it's located in the inner city or it's minority owned, but the trick is understanding the nuances of working with a strong CEO.

There are a few firms out there that do invest in inner cities and specifically target the emerging domestic market. Woods: Two years ago, it was a really hot area. I still think it's a good area, but we couldn't build our investment thesis around it. It really lends itself to venture capital and earlier-stage investing. But there are a lot of opportunities; they're just not as mature, typically.

Let's face it. Minorities did not get a head start in this country, so a lot of these companies may be a bit behind. They're not going to be the same size as a Procter & Gamble. There'll be deals that get done in this area, but it has to be with an investment strategy that fits the opportunity. And the people who are doing that have that focus.

The opportunity is huge and it's going to get bigger. We believe we're going to see a lot of these companies grow into the market we cover. There will be opportunities, and we don't miss any of those. And the demographics are moving that way. Switching gears a little bit, how are you finding the overall market?

Woods: I wish we could find it. It's a rough market out there. We've done three deals in the last 12 months, so we've been on the sidelines, but not completely. We've looked at a lot of new platform deals, so we've been very busy on that front, but frankly, the debt markets are overheated right now, so the valuations are pretty high.

Is buying right more important in the small to midmarket?

Woods: On the smaller end, you really need to be more disciplined on valuations, because these companies get hurt disproportionately more than the larger businesses. And financial engineering is a very small part of it for us. When you invest in this area of the market, you have to believe that you can grow the cash flow and make the necessary changes to take the business to the next level. So you have to do that with operational improvement. You can't get returns by piling sub debt and senior debt onto the company. That model won't work because the companies are too fragile.

As soon as the economy turns, if you've got an overlevered balance sheet, you can easily trip into bankruptcy, and the truth is the banks don't care about these companies. If you've got a company that generates \$100 million in Ebitda, the banks will hang in there with you. But for the smaller companies, people will just flush those and keep moving.

What's a typical equity-to-debt ratio for an ICV deal?

Woods: Generally, we'll fund our transactions with around 40% to 50% equity.

Does that fluctuate depending on the environment or how flush the debt markets are?

Woods: No, which is why we prefer the bad markets. In those markets, prices come back down and our capital structure stays the same. What hurts is when lenders are willing to put out all this money that goes against our philosophy. Once someone says they'll lend you five times Ebitda, by definition you have to pay seven or eight times just to make the math work. That's not to say we won't get deals done in this market, but we just have to look a little harder.

With a new fund, and an investor base that is obviously aware of all the M&A activity going on today, do your LPs apply any pressure to put money to work?

Woods: Our investors understand our strategy. They know it's a value-oriented strategy that requires us to be patient and disciplined. Ultimately, if we do it right, we'll make everyone a lot of money. These markets don't last forever. Invariably, they'll cool off. And, of course, we only raised our fund last August, so we have plenty of time to wait it out.

Why aren't more firms sitting on the sidelines today? A lot of "smart" money is putting capital to work at a record pace.

Woods: Well, once you reach a certain size, it becomes more of an asset management business. They'll say, "We won't lose money on this deal, so as long as we get a 12% return, we can pay eight times for it." It didn't use to be like that. The market has matured. More people are coming in and that makes it harder. But again, there'll be another downturn. Something will blow up, and it will lead to a fallout in the credit market. That's when you'll see valuations come down again.

Considering that ICV was launched in 1998, I'm sure you've seen this before.

Woods: We raised our first fund in 2000. Then the bubble popped, and it turned out that 2001, 2002 and 2003 was the right time to be buying. Firms that had been buying companies the three previous years had a portfolio full of problems, so they sat on the sidelines during that stretch. But we've seen this movie before, and we can see all those signs today.

What are some of the worst things you've seen?

Woods: Well, the valuations some of these small companies are getting are unbelievable - eight or nine times, or sometimes as high as 10. This is for businesses with less than \$10 million in Ebitda. It's scary, and I can't figure it out. The other thing that amazes me is that banks are doing deals with virtually no covenants. It's basically like a bond deal.

Are you seeing this in your market?

Woods: It's not in our market yet, but we're seeing it in American Securities' space, and it won't be long before it finds its way down here.

As an investor, is that something you want to see?

Woods: Not really. That scares us to death. At the end of the day, it's good to have your own red alerts in place. The covenants help the management team know their boundaries.

(c) 2007 Investment Dealers' Digest Magazine and SourceMedia, Inc. All Rights Reserved.

<http://www.iddmagazine.com> <http://www.sourcemedia.com>