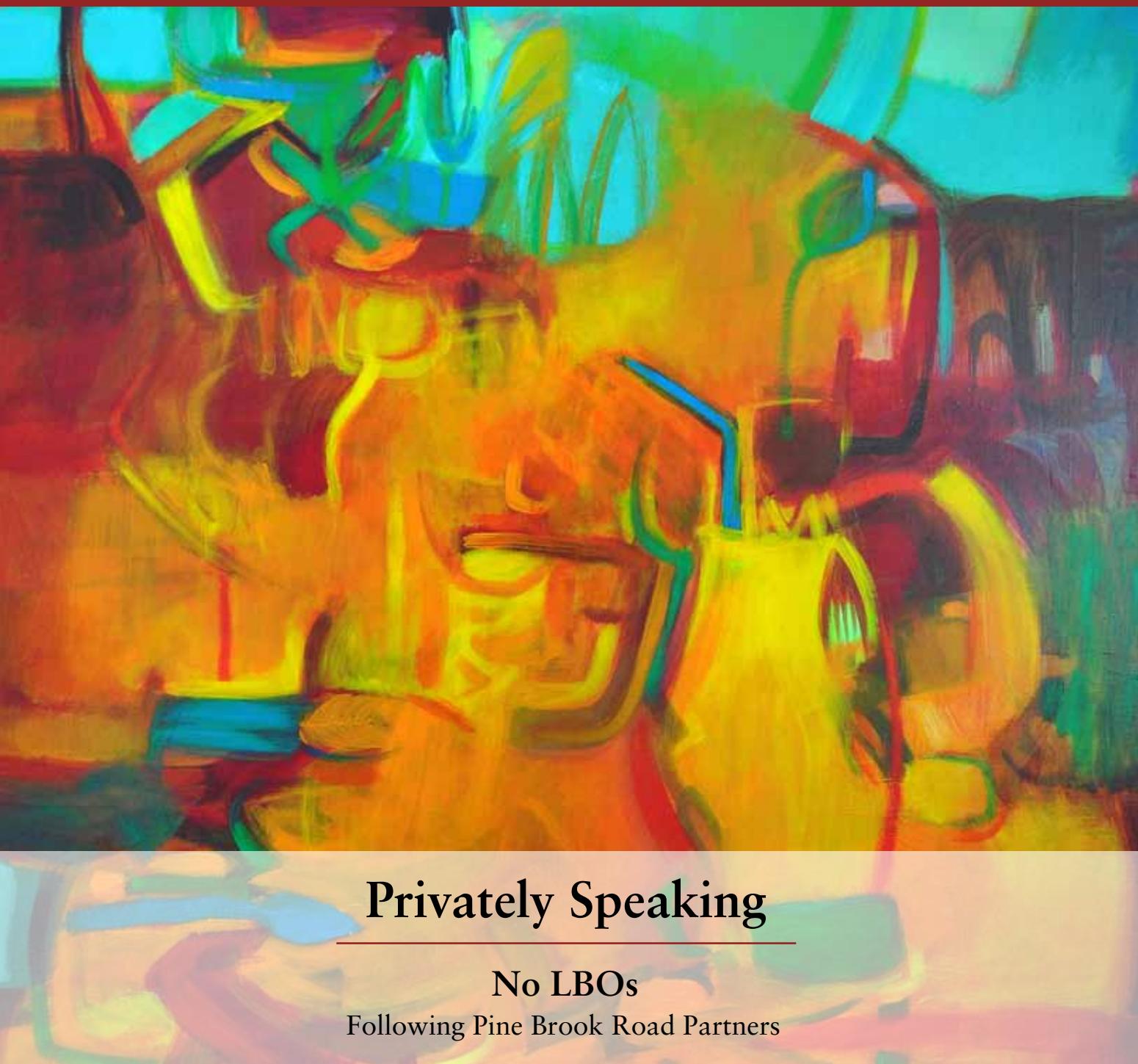


PRIVATE EQUITY INTERNATIONAL

WWW.PRIVATEEQUITYONLINE.COM / MARCH 2010 / ISSUE 83

THE GLOBAL MAGAZINE FOR PRIVATE EQUITY



Privately Speaking

No LBOs

Following Pine Brook Road Partners

PEI

London | New York | Singapore

www.peimedia.com





PRIVATELY SPEAKING

Scale from scratch

Pine Brook Road closed a \$1.4 billion fund last year in one of the toughest fundraising markets in memory. Clearly LPs liked what they saw. Christopher Witkowsky meets the team that says no to LBOs and yes to a business-building 'line of equity'

PHOTOGRAPHY BY JONATHAN SMITH

Joe Gantz, the chief operating officer of New York-based private equity firm Pine Brook Road Partners, calls out above the bustle of bodies crowding in and out of the conference room: "Who wants pizza? No one? Chinese food?"

The firm's 10 partners have been at it all day, huddled in an undersized meeting room cluttered with half-empty boxes of stationary and paper and containers of partially eaten food. Windows along one wall provide views of Park Avenue, where evening traffic has ground to a halt amid blaring horns.

Pine Brook is in the process of moving to a new office across the street, but the upheaval of the move has not halted the frenetic pace of the investment team. Throughout the day the partners have been locked in intense discussions that will resume after a short pause to catch up with *PEI*. It is early evening, and while Grand Central Station just down the street is filling up with commuters heading home, the team plans to keep their meeting rolling well into the evening.

To those who know Howard Newman, the firm's leader, it must seem a safe bet that the energy and the enthusiasm pervading the room trickles straight down from this veteran of the private equity industry.

Newman spent 22 years at Warburg Pincus, where he invested in 47 companies, several using a strategy he calls "line of equity" that is the core strategy at Pine Brook.

When Pine Brook was founded in 2006, its strategy contrasted with that being pitched by many mega-funds in the market.

The executives in the room – Newman, Gantz and partners Mike McMahon and William Spiegel – have over the last three years helped create eight businesses from the bottom up.

"We wanted to build an investing practice which was unleveraged, focused on creating organisations of scale from scratch, and we wanted to do it in an organisation where that form of investing would be central rather than peripheral," Newman says. "It was fortunate that Mike was available at the time to help me start this, and Joe and William were equally committed to the organisation. It just seemed like the right thing to do."

Drawing on the expertise of its partners, the firm makes

control investments primarily in the energy and financial services sectors. Newman has experience investing in both; McMahon spent many years focusing on energy; and Spiegel came to the firm with financial services know-how.

NO BUYOUTS

Pine Brook, which held a final close on \$1.4 billion last year for its debut fund, does not follow the leveraged buyout model.

Its investment thesis revolves around partnering talented managers, usually executives the firm already knows, and building new businesses around them, typically investing between \$100 million to \$200 million and using little to no leverage. Pine Brook refers to it as providing a line of equity to entrepreneurs.

"We're in the private equity business; we think that's about putting equity into a business," Newman says. "We think about the potential that can be created by the business seeds we're planting, whereas in a buyout you tend to look at an existing business and figure out what the durability is of that business."

The line of equity approach could work like this: an energy industry veteran approaches Pine Brook with a business plan. The firm knows the executive,

listens to the pitch, evaluates the business plan and eventually, after extensive deliberation – including macro analysis of the industry, state of the economy and many other factors – the firm decides to fund the plan.

Pine Brook and management would agree on a total capital amount required to scale the business, which is typically no more than \$500 million. Pine Brook would usually commit about \$100 million to \$150 million of this amount, with the balance taken up in smaller pieces by co-investors and strategic investors. The firm then starts the executive with a small portion of the agreed investment, often \$5 million to \$10 million. The executive, with the initial money, starts to assemble the management team, putting together the "plumbing" of the business, as Spiegel describes it.



McMahon: outstanding managers are key

More funding becomes available as the company progresses and the business grows. The firm can also cease to fund the business if it determines management is not executing on the business plan, though it hasn't encountered this situation yet.

While allocating a certain amount to fund a business plan, the firm knows that not all investments will require the full line of equity due to outperformance. On average, Newman says, previous investments used only two-thirds of the line of equity.

"We try to match capital with the business plan, but business plans always take twists and turns you don't anticipate," Spiegel says. "So we're constantly monitoring our portfolio companies to determine how much of the line of equity that we've allocated toward them do we think they're going to use. It's a constant process looking at the business plan, looking at its development that helps us determine how much is going to be used."

The firm has no prescribed hold period for investments, but expects to exit portfolio companies after five to seven years.

Pine Brook has 10 investments in its debut fund, with about \$369 million actually invested from roughly \$1 billion in line of equity arrangements. In addition, the firm also has about \$843 million of LP

co-investments in the 10 investments. Gantz says: "We continue to reach out to our LPs when opportunities exist to invite them to join us. It's an important part of our strategy."

TRACK RECORDS

Raising \$1.4 billion for a debut fund is an extraordinary feat, but as LPs are quick to point out, there's a big difference between a first time fund and a first time manager. Pine Brook, while technically a first time fund, is led by partners with long private equity track records and experience working with one another.

McMahon has spent many years investing in the energy sector, working at Salomon Brothers and Lehman Brothers. He also founded RockPort Capital Partners, an energy and clean-tech venture firm, and worked at Harvard Management Company, where he was responsible for the university endowment's energy-related private equity investments.

Spiegel worked with The Cypress Group from 1994 through 2006, where he helped manage financial services and healthcare investing. Gantz is a founding partner of Walnut Investment Partners, an SBIC fund focusing on retail,

"We try to match capital with the business plan, but business plans always take twists and turns you don't anticipate"

Pine Brook Road Partners, LLC

**Proud to be Voted 2009 North American
Mid-Market Private Equity Firm of the Year
by the readers of *Private Equity International***

Pine Brook makes "business building" and growth equity investments in new and growing companies, primarily in the energy and financial services sectors.

Learn more at www.pinebrookpartners.com



Newman (left) and Spiegel: planting business 'seeds'

consumer products and financial services. He helped turn around two private equity-owned companies in the 1990s – Seymour Housewares, backed by Chase Capital Partners, and Fitz & Floyd, a company backed by ML-Lee Acquisition Funds II, a joint fund managed by Thomas H Lee Partners and Merrill Lynch.

In 1989, McMahon, who at the time was working as an investment banker, and Newman teamed up on a plan to create an oil and gas exploration company that would work in the shallow waters of the Gulf of Mexico. Backing an experienced management team, Newfield Exploration was financed in 1990. Warburg invested \$25 million in Newfield and held it for 10 years. Today the business has a market capitalisation of more than \$6 billion.

Newman and McMahon again collaborated on a company called Spinnaker Exploration, with Warburg making an initial \$60 million investment in 1996. The company was sold in 2005 for \$2.6 billion.

In the financial services sector, Newman led a team at Warburg creating a company called Renaissance Re in 1993 with

"The secret sauce of our business is to find outstanding managers. If you can back teams that made a lot of money for you before, and they come back to you, that's a good thing"

a \$140 million investment. The company today is worth between \$3 billion and \$4 billion.

FINDING AN EDGE

"The secret sauce of our business is to find outstanding managers. If you can back teams that made a lot of money for you before, and they come back to you, that's a good thing," McMahon says. The firm also looks for management teams "who have very focused ideas", he adds.

Invest early and "elsewhere" is the firm's approach to both energy and financial services deals, says Newman. One example was when Pine Brook backed one of the CEOs from Newman's Warburg days, former chief of Spinnaker, Roger Jarvis, to run Common Resources, a Houston-based oil and gas exploration and production company. Common Resources was formed around the idea of extracting natural gas from shale, a process known as "fracking". The company bought into two attractive shale formations before the process "was on the front page of the business press", McMahon says. In a sign that gas from



Gantz: keen on co-investment

shale since then has hit the mainstream, Exxon Mobil made a \$30 billion bid for XTO Energy late last year. XTO uses the fracking process.

When it comes to financial services, finding dislocation is key, says an animated Spiegel. When he uses the word "dislocation", it elicits groans and chuckles from the other partners, who've clearly heard Spiegel expound on the concept of dislocation before.

"A dislocation is the credit crisis, a hurricane or frankly it's excess demand for a product. That dislocation allows a higher return of equity to be achieved than in normal times," Spiegel says. "We look for those dislocations, we try to think ahead as to where those dislocations might be and then create businesses in the face of those dislocations," he says.

As an example, he points to the creation of Essent, a mortgage insurance company. In late 2007, as a financial storm ravaged the mortgage market, Pine Brook planned out ways to capitalise on market conditions. It recruited an executive it knew well, Mark Casale, to help figure out how to seize the most attractive opportunity and craft a business plan.

"After some macro research, we concluded there was a very big opportunity in the mortgage insurance market," Spiegel says. "The existing players were challenged and therefore there was a need for a new business to be formed." Historically, long-lasting high returns followed similar dislocations in the sector, Spiegel says.

"We're in the private equity business; we think that's about putting equity into a business"

A DIFFERENT MINDSET

That Pine Brook is not a buyout firm is one message that is constantly hit upon by the partners. In fact, the skills needed to be successful at Pine Brook's strategy differ from those needed for successful buyouts, according to Newman.

The firm's goal is to take risk out of an investment by using only a small amount of equity early on. The riskiest money is invested in the early days of a project, before the firm can really know how a management team will perform.

"Look at the oil and gas business. We start out with a management team, they go out and buy a lease, do a geological analysis, develop a prospect, then drill a well. They're just taking risk out of the system by learning more about it," he says. "Once they find oil and gas, then they have to develop it, that takes even more money, then at some point in time they begin to produce it, and that's when the serious cash flow follows."

It's a process that, at the very least, Pine Brook knows will play out over several years.

"We're building companies and creating jobs, and that's not all bad," McMahon says. The other partners agree, and as the interview draws to a close, the hustle of bodies darting around the office resumes. For the partners, it's time for more deal work – and probably a slice of pizza. ■

PINE BROOK ROAD'S PORTFOLIO AT A GLANCE

Sector	Company	Initial investment
Energy	Asia Pacific Exploration Consolidated Comet Ridge Resources Common Resources Global Oilfield Services Phoenix Exploration Company Stonegate Production Company	Sep 2007 June 2008 Aug 2007 Apr 2009 July 2006 Mar 2007
Financial Services	Aurigen Re Capital Limited Narragansett Bay Insurance Company Syndicate Holding Corp Essent Group	Sep 2007 Jan 2008 Mar 2007 Jan 2009

Source: Pine Brook Road

PRIVATE EQUITY ONLINE

RELATED STORIES INCLUDE:

Private equity group launches US mortgage insurer:

PrivateEquityOnline.com/Essent1

Pine Brook hires First Reserve pro:

PrivateEquityOnline.com/Jarchow

Pine Brook commits \$100m to energy venture:

PrivateEquityOnline.com/Comet