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Adam Blumenthal: In the Rough

The Blue Wolf Capital Partners co-founder explains why an improving market is ideal for turnaround investors

By Ken MacFadyen

Adam Blumenthal, co-founder and managing partner of Blue Wolf Capital Partners, loves a challenge. It's not just the turnaround that Blumenthal and Blue Wolf are after; the firm is basically looking for assets that nobody else wants — at least at the point at which the firm seeks entry. Blue Wolf's recent exit of Northern Resources Nova Scotia Corp. represents a perfect example. It wasn't that long ago that the firm and co-investor Atlas Holdings — in the midst of the credit crisis — acquired a paper mill that over its lifetime, under a string of different owners, fell into disrepair and accumulated a host of issues ranging from labor to environmental. Most PE firms would probably be turned off just by the mill's location, more than 100 miles north of Halifax, Nova Scotia — not exactly the easiest trip for most New York sponsors. Three years later, the assets went to a strategic buyer.

Blumenthal has spent more than two decades in private equity. He was at American Capital as far back as 1989, where he held roles such as president and vice chairman, and was a founding member of the business development company's investment committee. He left in 2002, and subsequently spent three years as the first deputy comptroller and chief financial officer for New York City Comptroller William C. Thompson, Jr. In this role, he oversaw the investment activities of

the New York City Retirement Systems. In 2005, he paired off with KPS Capital vet Josh Wolf-Powers — hence the name Blue Wolf— to launch the firm.



Adam Blumenthal

Blue Wolf, as of the end of May, had already put together a busy 2011. In addition to its Northern Resources exit, the firm also exited Healthcare Laundry Systems; gained majority control of Gloucester Engineering, a deal that was nearly a year in the making; acquired the assets of American Builders Supply; and named two new additions to the team, bringing on Charles Miller and Bob Sharp. The firm is currently investing out of the 2009-vintage Blue Wolf Capital Fund II, a \$118 million vehicle.

Mergers & Acquisitions talked to Adam Blumenthal in late May in a conversation exploring the market for distressed assets and evolution of the opportunity set for turnaround players. Blumenthal, perhaps against conventional wisdom, believes it's a great time to be a turnaround investor. The following is an edited version of the conversation.

Mergers & Acquisitions: Your recent sale of Northern Resources Nova Scotia Corp. seems like a perfect case study for the types of deals Blue Wolf pursues. As a jumping off point, do you want to provide a quick rundown of the investment and how it reflects the Blue Wolf story?

Blumenthal: We acquired the pulp mill less than three years ago. At the time there

were a number of complicated issues associated with it, so there were no other buyers. The issues ranged from market related, given the shaky economy and volatility around pricing at the time, to problems that were specific to the particular mill. The cost of operations were relatively high, and there were some unresolved issues between the mill and the First Nations community in Canada, largely related to environmental concerns. All of those factors served to scare off other buyers.

Mergers & Acquisitions: A three-year holding period seems like a relatively quick exit for an asset with so much hair.

Blumenthal: We were able to systematically and constructively resolve each of those issues, and a lot of it was upfront work that went into closing the deal. We were able to restructure the labor agreements to lower costs and create more flexibility; we worked very closely with the First Nations community and the government to improve the environmental features of the mill; and once those areas were addressed, we were able to focus on the operations and help drive economic development for the community. We later acquired a chunk of timberlands in partnership with the province, which was an enormous opportunity. The company went from a single mill to a full-fledged timber and pulp operator. It was a much more stable and rational business, which ultimately attracted the strategic buyer.

Mergers & Acquisitions: It seems like we're seeing more of these types of deals, actually, in which companies that either went bankrupt during the credit crisis or

were sold on the cheap, have since stabilized and are now looking for a longer term owner. What does that mean for the true turnaround opportunities? Are those going to be in short supply?

Blumenthal: I would observe that the overall number of transactions is increasing, and I think that is significant. For us, we're not going to be pursuing your conventional, down-the-fairway, types of deals. But the increased level of activity will also shake loose the niche opportunities and deep value plays, because nobody wants to take the time to clean up discontinued operations. Also, as the balance sheets have improved, owners of these assets are strong enough to recognize some losses as they shuttle orphan assets.

Mergers & Acquisitions: When will this start to play out in the form of increased activity?

Blumenthal: We've actually observed our own dealflow picking up significantly. We're looking at a number of opportunities under letter of intent right now. In one case, we're looking at assets that are owned by a major private equity fund. They already sold a larger part of the business to a strategic acquirer, but still had these other assets left over that weren't a strategic fit. Usually those types of deals would happen ahead of time.

In another case, we're in negotiations with an over-levered and distressed public company. Its lenders are effectively forcing it to sell off its cash flow positive businesses, which creates an opportunity for us. As deal volume increases, I think we'll have more chances to come in and help fix lingering problems.

Mergers & Acquisitions: So there is effectively a lag time in the distress markets. I think a lot of people were curious about why the distress and special situation investors seemed to be sitting on their hands at the depths of the crisis.

Blumenthal: Absolutely there is a lag. At the time, the assets we were seeing looked very, very cheap, but nobody wanted to sell them at that price. So you really saw very few transactions. At the same time, healthy assets were still able to fetch healthy multiples. That only served to contrast the dropoff in valuations of distressed properties. There were very few people who were willing to face up to reality on troubled assets.

Mergers & Acquisitions: I imagine that's why you saw so many lenders assume control of problem companies? Many of those creditors, based on the processes launched for Buffets and other former bankruptcies, or the recent IPO filing for Aleris, now seem to be looking for exits. Do you anticipate seeing a rush in the second half of this year in which these so-called 'unnatural' owners — the lenders, hedge funds, et cetera — cut loose the assets subsumed amid the downturn?

Blumenthal: Definitely. In the most recent addition to our portfolio — American Builders Supply — we were able to acquire the underlying business from a lender. In that case, the initial lender had sold its entire portfolio of distressed assets to a trading desk. The trading desk happened to control the fulcrum security, so it found itself as the owner of what we considered to be a solid operating business that has real potential.

Mergers & Acquisitions: Generally speaking, what is the state of assets controlled by these 'unnatural' owners?

Blumenthal: What we're seeing are companies that are just drifting. If there's no growth or no strategic initiative, businesses tend to just drift along whether they're doing well or not doing well. It's really important to align the management team. If you can align interests, it can get people motivated again and it will go a long way toward stimulating growth.

Mergers & Acquisitions: In terms of assets that you're seeing, are there still 'balance sheet' plays available, in which the underlying business is healthy, or are you seeing a lot of true turnaround situations, in need of both capital and a strategic fix?

Blumenthal: There has to be a turnaround element. The debt markets are liquid enough today that the credit is available for those other assets. In fact, I'd say that that's where a lot of traditional firms are focused and that market is thriving.

Mergers & Acquisitions: Where else are you finding deal flow? Everyone talks about the impending expiration of private equity fund lives as a driver, but there hasn't really been an extraordinary rush of exits from what I can tell.

Blumenthal: I think people are looking to take advantage of this market to show realizations. Last year was a good year, and you had a lot of firms sell off their healthiest and most pristine holdings. 2011 is the year in which they're looking around at their portfolio trying to figure out what else they can move. Both strategics and private equity funds have plenty of cash available, and the credit is there. So I do think the market will support higher deal volumes as sponsors look to unload their problems or even just put some points up on the board ahead of a fundraising.

Mergers & Acquisitions: Let's end with a prediction. How do you see the deal market shaping up for the balance of the year? Is there any chance there will be an end of year rush similar to the tax-driven flurry we saw in 2010?

Blumenthal: I don't think we'll see anything similar to last year. The tax issue is off the table, at least until the end of 2012. With that said, I do think we're in a stable environment so volumes should pick up. **MA**



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