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One-on-One / With

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New Fund Looks to Government Contractors, Union Shops For Deals



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JOSH WOLF-POWERS IS A FOUNDING PARTNER OF BLUE WOLF CAPITAL MANAGEMENT, A PRIVATE EQUITY FIRM SPECIALIZING IN COMPANIES THAT RELY ON GOVERNMENT POLICY OR SUBSIDY, ARE UNIONIZED OR FINANCIALLY DISTRESSED. PRIOR TO FOUNDING BLUE WOLF, JOSH WAS MANAGING DIRECTOR - PRIVATE MARKETS FOR THE NEW YORK CITY COMPTROLLER'S OFFICE. PRIOR TO HOLDING THIS POSITION, JOSH WAS A VICE PRESIDENT AT THE KPS SPECIAL SITUATIONS FUNDS, PRIVATE EQUITY FUNDS.

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Q: Why is **Blue Wolf** targeting businesses dependent to some extent on government regulation or policy? Wouldn't most private equity firms avoid such situations?

A: Well, you answered the question with your question. We think that there is, in general, opportunity in those areas because there is less competition. For example, in the case of industries which are dependent on or in which value is driven by government regulation, policy or subsidy, we think that at the lower end of the middlemarket, financial investors, like private equity funds, typically shy away from those industries and companies.

At the larger end of the market, firms like **Carlyle** are very good at underwriting, managing and preserving value in companies where that value is a function of government decisions, whether in regards to procurement, policy or regulatory decisions. At the lower end of the market for companies with anywhere from \$25 million to \$200 million in revenue, financial buyers see government involvement, at best, as a

significant negative and, at worst, as a bar to prospective investment.

Our view is that government involvement in the value chain is a risk just like any business risk. The key to investing in any situation is the ability to understand and value the risks at the front end of an acquisition and to manage those risks subsequent to investment and, to the extent that it's possible, reduce the risks through either the structure of the investment or implementation of your investment plan over time.

Q: But the government is a good customer so there can't be that much risk, right?

A: In some ways, the government is the perfect customer. If the government is your customer, there is really no credit risk. That's one advantage of the government as a customer.

The disadvantage is that typically you have a good sense of when your customers are going to pay you and they are relatively timely. One of the challenges you have with the government as a customer is that they take a lot longer than the slowest commercial customer to pay. Whether it's a state, municipality, or a federal government agency, they are usually quite slow. There's little risk of not getting paid, but there's risk of not being paid quickly.

One of the things we conclude is that it is something you have to manage around, both with the capital structure you put in place and from a relationship perspective. The things that cause government customers to be timely payers are different than the things that cause commercial businesses to be timely payers. We are very sensitive to the importance of managing relationships at every level with everyone who has the ability to influence the value of the investments we make.

Q: How do you manage the risks of uncertain payment schedules?

A: You need to have a conservative capital structure. You can't lever up a business in which your working capital needs are substantial and volatile and predictable cash flows aren't adequate to meet the debt schedule of the business. Your capital structure needs to be appropriate to the potential volatility in collections and working capital.

An example of an industry in which we have not yet invested, but in which we hope to invest in some day, is energy services. Energy services companies provide energy efficient construction services to governmental or quasigovernmental entities. For example, they replace ancient windows in municipal buildings with double-pane windows. They finance that project for the agency; they pay the capital costs of putting in windows and then the way they get paid is out of the energy savings they produce over time. That is a business that has huge working capital needs because they make expenditures up front and collect from their customer over a period that can be measured over a double-digit period of years.

There are two different approaches to a business like that. One is to say, 'I am not prepared, as a construction services firm, to be a long-term source of financing for my customers.' The other approach is to look at the business as having multiple elements to it, one of which is a finance business. And the capital structure of a finance business is different from the capital structure of a construction services business.

Q: Why the interest in unionized companies?

A: That investment philosophy cuts across both government involvement in a company and labor union involvement. Just as many private equity funds see government involvement as an obstacle to investment, they also see labor union involvement as a bar to investment. Our view is that labor is another constituency whose relationship has to be managed.

Q: How would you deal with potential investments in unionized companies?

A: We have an advantage over many of our peers in private equity when it comes to companies at which unions represent all or a portion of the workforce. We don't start with the preconception that unions are bad or good. We think that unions are a constituency with which the relationship needs to be managed very sensitively. We have a lot of experience in working with unions.

We believe one of the sets of skills we possess that differentiates us from our peers is the ability to manage relationships with different constituencies, such as unions. We have experience in working in those situations and arriving at solutions that are acceptable to all parties. Between (managing partner) Adam Blumenthal and myself, we have probably negotiated or participated in the negotiations of 20 collective bargaining agreements, either as an adviser to labor early in our careers or, in other instances, negotiating as managers and owners. The experience of having been in those negotiations and being on both sides of the table makes us very effective. That's not to say we are capable of getting more from the people on the other side of the table because I think that's not necessarily the approach we would take; but rather to say that we're effective at solving the problems negotiations represent to people sitting around the table.

Q: What are some examples of companies or industries benefiting from policy or regulatory issues?

A: We made our first acquisition, **Montauk Energy Capital**. We think that landfill gas-to-energy represents, if not a unique, an unusual corner of the alternative energy market. Without regard to subsidy policy or regulation, the unit economics are favorable. There is a whole industry of people making money from landfill gas. It's a fragmented industry and it's a growing industry. Its development has been affected by subsidy, but not driven by subsidy. We think that alternative energy, in general, is quite promising for a variety of reasons: the global geopolitical situation as well as domestic energy policy. There will continue to be growing demand for alternative energy, which will outpace demand for conventional energy. What we think is exciting about landfill gas and energy services companies, which traffic in energy efficiency, is that they are profitable businesses today and are poised to reap the benefits of super-normal growth in the demand for some combination of alternative energy and energy efficiency.

There are some other examples of that. There are some forms of biodiesel where the unit economics are positive. The areas that are more often talked about as being promising, such as ethanol or solar or wind, are very different from the areas on which we have focused since they are not, to date, profitable except for subsidy. In the case of landfill gas, although there is some subsidy, the industry has developed on its own. It is always possible to convert landfill waste to gas profitably. It's not complicated. In the case of ethanol, the total government subsidies directed toward the industry and the total revenue generated by sales of ethanol to date are roughly offsetting. That's never been true with landfill gas. There's no initial investment in the industry to make it work. The process is technologically straight forward. It doesn't require specialized knowledge. At 75% of the landfills at which the gas is converted into energy, it's converted into electricity using turbines that are off-the-rack. The industry didn't need government subsidy to be built. But it stands poised to benefit from the impact of government regulation and policy.

Q: What kinds of opportunities does Blue Wolf see in distressed companies?

A: What we think characterizes our strategy is our ability to manage complex relationships with multiple constituencies, some of which may be ones other than those that typically represent a healthy company. We don't think of ourselves as primarily distressed investors. What we think is that, just like situations characterized by government involvement or union involvement, situations characterized by financial distress require sensitive management of relationships with a variety of different constituencies.

We have a lot of experience working in and around the bankruptcy process. We think the complexity that it presents represents an opportunity for us to create value by wading through that complexity. The kind of financial distress we find most compelling is not caused by liquidity or the economy, but created by some combination of mismanagement or bad luck, neither of which has a particularly cyclical element to it. The volume of distressed situations is dampened by the availability of credit. Like everyone else, we think we are standing on the precipice of a wave of distressed opportunities.

Q: How strong has been the supply of potential investments presented to your firm?

A: We have been overwhelmed, in a good way, by the high quality of deal flow since we started in 2005. We have seen a wide variety of companies ranging from pure government contractors to industrial companies with heavily unionized work forces to financing companies that are serving those categories to businesses. We have seen a consistent flow of opportunities, both shopped by investment bankers and more proprietary-type deals.

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