Lead Left Interview – Michael Babiarz (Part 2)

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This week we conclude our conversation with Michael Babiarz of Clayton, Dubilier and Rice. Michael is a partner of the firm and been with CD&R since 1990. ***Second of two parts – View part one***

The Lead Left: How do you view what's going on with banks from a regulatory perspective?

Michael Babiarz: If you look back six months or so the traditional investment banks were reluctant to commit underwriting dollars. That's changed dramatically. They're even back to underwriting second lien debt, much to my surprise.

TLL: What's the financing outlook from what you're seeing?

MB: From an absolute cost of capital perspective, financing costs are still extremely low from a historical standpoint, and the markets are liquid. We'll certainly look at refinancings and accelerate timetables to take advantage of market conditions. We used to go to eight banks to get four proposals. Now we get eight proposals.

TLL: What's your minimum equity check?

MB: In general, we're writing $250-500 million equity checks, but we'll go lower for the right deal and risk-reward. On the smaller end, we've written small checks for growth businesses, but we also can go much larger given the amount of interest there is in co-investing by our LPs. That trend has gained momentum over the past five years. A short list of LPs actually has the ability to write $200-300 million checks by themselves. The result is much fewer club deals. On the larger deals, it's not unusual to see M&A bankers pairing off large LPs with certain GPs.

TLL: Do you think we're at the end of a business cycle?

MB: Most businesses have some degree of cyclicality. That's why we like RC capacity. Beyond twelve months it's anyone's guess as to what the outlook is. We spend a lot of time looking at downside. All businesses have some operating risk. We won't compound that with financial risk by overleveraging a business, even if the leverage is available.

TLL: How cyclical will you go? How about building products?

MB: We went through the down cycle with HD Supply and came out the back-end with our investment fully intact and realized at a profit, but it was a lot of hard work. Overall, the recovery in building products has not been as rapid as everyone anticipated, but we still think there's growth that can be achieved. As a result, it's a good time to sell. We sold our roofing distribution business, Roofing Supply Group, to a strategic buyer in 2015 and took Atkore public in June.

TLL: You mentioned retail. Where's your sweet spot in that sector?

MB: In both the U.S. and Europe, we've spent a lot of time pursuing value retail. In particular, we've focused on discount retailers like B&M, which is based in the UK and is similar to what the Dollar Stores is here in the U.S. B&M have some counter-cyclical elements, and has been among our greatest successes.

TLL: How do you think about US vs. Europe in terms of investing in platforms?

MB: We've been active in Europe the last 5 years, and our European portfolio has performed in line with our North American investments. Overall, the firm is agnostic to geography, but the bar is higher in Europe because of the lower growth profile on the continent at the moment and the political risk.

TLL: What's the financing picture there?

MB: It's equally robust in Europe. All the lenders are looking for assets. And cov-lite is there to stay.

TLL: What was the proportion of properties bought vs. sold last year?

MB: We sold a lot more in 2015 than we invested. In fact, we returned ten times the amount of capital that we committed to new investments in 2015. That statistic is a bit skewed because there were several assets we pursued but got outbid – most often by strategic buyers and in some cases, other private equity sponsors. The balance between new investments and realizations is more balanced this year, although we do expect to be a net distributor of capital to investors again in 2016.

TLL: What's been your biggest surprise this year?

MB: The turnaround in the capital markets. We live in cyclical markets; I've seen so many in my twenty-six years at the firm. It's amazing to see how quickly it went to the depths in late Q4 2015/early 2016 and quickly returned.

TLL: Michael, is there a question I didn't ask, but should have?

MB: The importance of relationships. That's why I was bullish in the beginning of the year. We weren't looking for the last dollar of leverage. We work with our relationships on financings – including our LPs and affiliates. Not every deal is in everyone's strike zone, but being there and being consistent is critical.

Contact: Michael Babiarz
mbabiarz@cdr-inc.com