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Buyout All-Stars Stumble

 By **PETER LATTMAN**
 March 10, 2008; Page C1

February was a rough month for Sun Capital Partners Inc.

Two of the buyout shop's companies, retailers Lillian Vernon Corp. and Wickes Furniture Co., filed for Chapter 11 bankruptcy protection. Through a struggling hedge-fund vehicle, Sun also was the largest shareholder of Sharper Image Corp., the gadget retailer that filed for Chapter 11 protection after an abysmal holiday-shopping season.



Left: Jason Nuttle/WpN; Inset Top: Digital Railroad; Inset Bottom: Associated Press

Marc J. Leder, left, and Roger R. Krouse, the founders of Sun Capital Partners, have forced changes at Friendly's Ice Cream (a New Jersey store, top right) but have stumbled with their investment in Sharper Image (bottom right).

The rapid-fire filings illustrate just how life has changed for the private-equity industry, where easy credit, a steady economy and willing sellers created a buying bonanza. And no firm was more voracious than Sun, whose well-oiled deal machine has purchased, on average, a business every 11 days for the past three years.

The Boca Raton, Fla., turnaround specialist seeks businesses that few others will touch. Its portfolio reads like a roster of the misbegotten: women's-clothing chain Limited, bought from **Limited Brands**; fast-food chain Boston Market Corp.; discount retailer ShopKo; and department-store chain Mervyns.


More than half of the revenue from Sun's 75 companies comes from retailers, restaurants or auto businesses -- all cyclical industries that depend on ever-fragile consumer-spending levels. Many of the buyout targets were already struggling in a robust economy. A weak economy won't help.

Marc Leder, the firm's 46-year-old co-founder, says that while the bankruptcies eat him up inside, they come with the territory. "It's inevitable that in any investment business you're going to have some failures," he says. "We're far from perfect, but we think our results speak for themselves."

Indeed, Sun's returns have been stellar -- its buyout funds have generated annual returns, before fees, of more than 40% a year since 1995. Sun attracted wider notice when it closed a \$6 billion fund last spring, four times the size of its previous one.

"They've done a masterful job of building the premier turnaround firm in the country," says Jeffrey Ennis of asset manager Wilshire Private Markets Group, a Sun investor.

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But Sun, like the rest of the buyout industry, will have to prove its mettle in the years ahead. It must quickly make tough decisions about fixing, selling or closing pieces of its companies and whether to pour money into their investments that are under water. And lenders have tightened their purse strings, making new deals scarce.

Mr. Leder and 46-year-old Rodger Krouse were classmates at the Wharton School at the University of Pennsylvania and then colleagues at Lehman Brothers in New York. They moved to Florida and started Sun in 1995, hoping to trawl the Southeast for deals.

They soon realized that investors everywhere were competing against them. "There was no advantage in being down here," Mr. Leder says. "But it turned out to be a nice place to live."

From 1995 through 1999, they "passed around a hat" and raised \$28 million for a series of one-off deals. Early investors included partners at Boston buyout firm Bain Capital who knew Messrs. Leder and Krouse from their Lehman days. Today, Sun's funds manage about \$10 billion. Its companies employ some 165,000.

Sun revels in dysfunction. More than 40% of its acquisitions have negative earnings before interest, taxes, depreciation and amortization, or ebidta. Many targets are nearing a bankruptcy filing; some are already there.

Once a deal closes, Sun moves swiftly. All Sun-owned companies must file identically formatted 18-page monthly reports -- "plus appendices," emphasizes Mr. Krouse -- that force financial rigor.

"We try to impart a sense of urgency," Mr. Krouse says. "People at these companies know there are problems, but these processes help bring them to the surface."

A case in point is Friendly's, acquired by Sun last summer. The lowdown on the East Coast restaurant chain: great ice cream, poor service. One reason for long waits was an extensive menu that slowed the kitchen. So it's testing a pruned-down menu, discarding certain "low-volume, high-complexity" items such as the flounder dinner while highlighting popular choices, such as the Fribble ice-cream shake.

To drive earnings growth, Sun obsesses over costs. One trick is pooling Sun-owned companies' purchasing power for everything from health-care benefits to food. Friendly's management has slashed about \$1.6 million in expenses, including \$50,000 for office supplies and \$40,000 for UPS freight costs. Now, it's looking to offset record commodity prices by gaining buying leverage on dairy and poultry. "One of the bigger opportunities could be in cheese," says a delighted George Condos, Friendly's CEO.

While private-equity firms protest they are not into "financial engineering," Sun embraces the concept. Consider the purchase earlier this year of Smokey Bones Barbeque & Grill. Sun paid \$84 million for the struggling **Darden Restaurants** Inc. unit. It then executed a "sale leaseback," selling the chain's real estate for \$78 million and then leasing it back from the new owner. It also received roughly \$5 million in mortgage financing on the deal.

"Now don't get me wrong, casual dining is in the dumps and we've got our hands full," Mr. Leder says of Smokey Bones. "But I'll take a \$220 million-revenue chain of restaurants for free all day long."

Because Sun often puts little money into its deals, a single successful investment can generate huge upside. In December 2003, Sun acquired Horsehead Corp., a Pennsylvania zinc producer, for \$19 million. Sun brought in new management, improved operations and benefited from a strong zinc market. It took the company public last year, pocketing about \$345 million.

Sometimes companies are cheap for a reason. In May 2006, Sun acquired Lillian Vernon, the Internet and catalog retailer for about \$12 million. The company hadn't made money for nearly a decade, but Sun hoped to revive the once-iconic brand. It invested an additional \$5 million, but after an increase in postage rates and a feeble holiday season, the company filed for bankruptcy-court protection on Feb. 20.

Like other buyout shops, Sun has departed from its core buyout strategy. It launched a stock-picking vehicle in 2004. Sun Capital Securities Fund applies its turnaround expertise to the stock market, buying stakes in ailing public companies. The \$1.3 billion fund lost 17.4% in 2007 and is roughly flat in 2008.

It is through this fund that Sun owned a nearly 20% stake in Sharper Image. Mr. Leder and a colleague joined the board, but resigned just before the bankruptcy filing. "We were on the board but were not operationally involved," Mr. Leder says. "It was just a bad stock pick."

Its performance raises the question of whether it overreached in straying from its core buyout strategy. Sun has also co-invested with Cerberus Capital Management in two of its highest-profile, and worst-performing, investments -- **GMAC LLC** and Chrysler Holdings. "The fund has given us access to far more underperformers," said Mr. Krouse, defending the strategy. "It is a natural extension of what we do."

Sun remains active in the deal market. Last month it made its biggest investment ever, paying \$542 million for apparel maker **Kellwood Co.**

The wilting economy hurts Sun's companies, but also offers more bargains on ailing businesses. "This is a phenomenal environment in which to invest," says Mr. Leder, but it "requires a strong stomach."

--Jeffrey McCracken contributed to this article.

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