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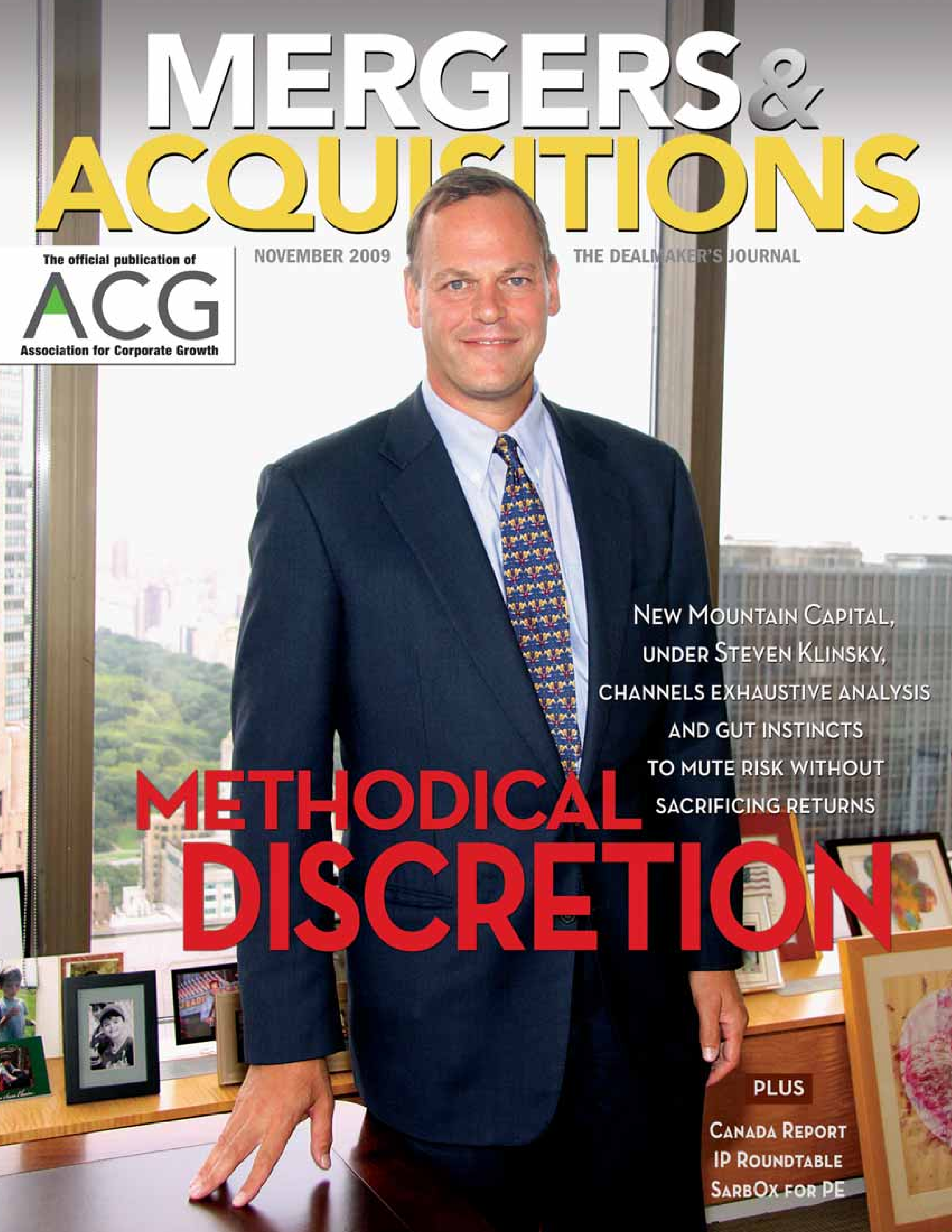

METHODICAL DISCRETION

NEW MOUNTAIN CAPITAL, UNDER STEVEN KLINSKY, CHANNELS EXHAUSTIVE ANALYSIS AND GUT INSTINCTS TO MUTE RISK WITHOUT SACRIFICING RETURNS

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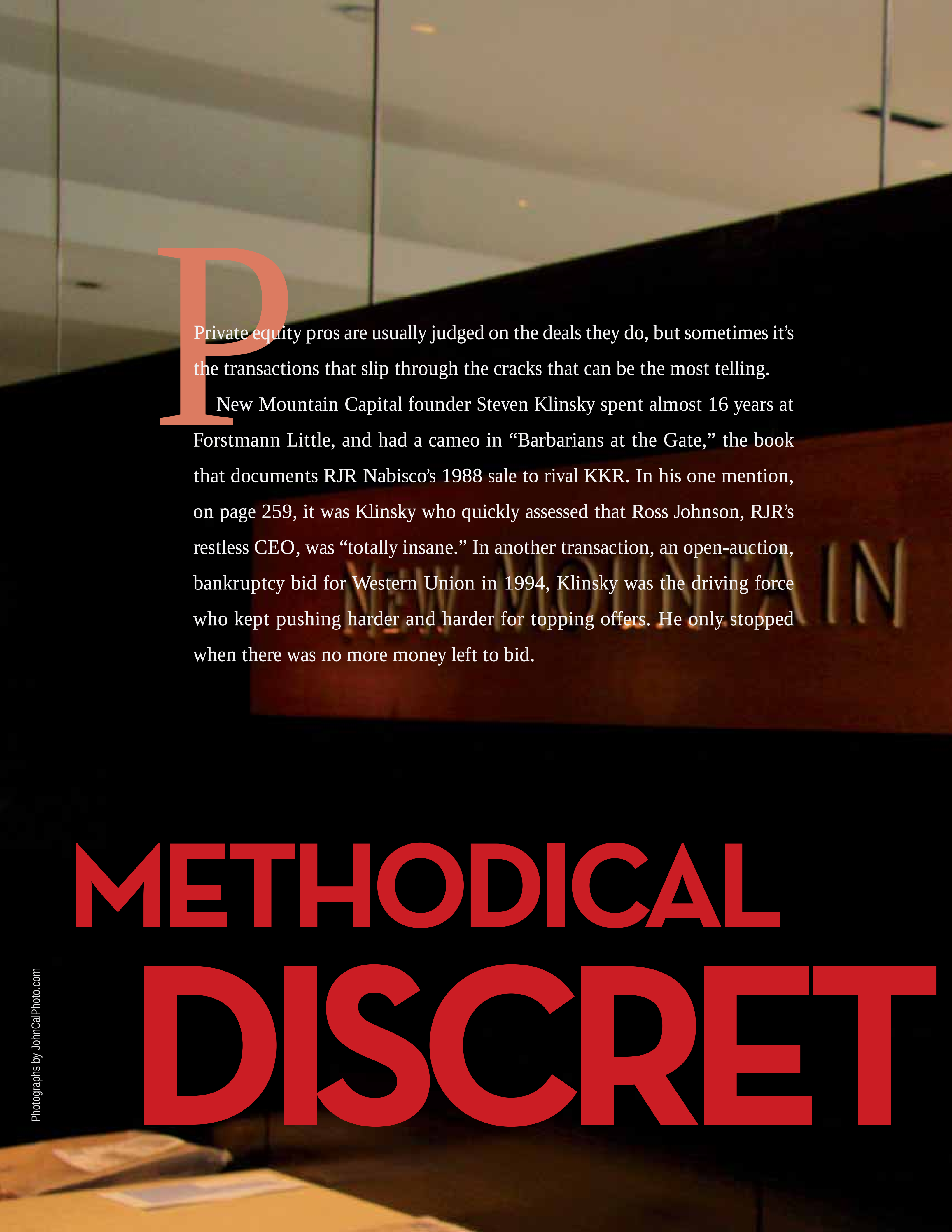

Private equity pros are usually judged on the deals they do, but sometimes it's the transactions that slip through the cracks that can be the most telling.

New Mountain Capital founder Steven Klinsky spent almost 16 years at Forstmann Little, and had a cameo in "Barbarians at the Gate," the book that documents RJR Nabisco's 1988 sale to rival KKR. In his one mention, on page 259, it was Klinsky who quickly assessed that Ross Johnson, RJR's restless CEO, was "totally insane." In another transaction, an open-auction, bankruptcy bid for Western Union in 1994, Klinsky was the driving force who kept pushing harder and harder for topping offers. He only stopped when there was no more money left to bid.

METHODICAL DISCRET

Photographs by JohnCalPhoto.com

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New Mountain Capital, under Steven Klinsky, channels exhaustive analysis and gut instincts to mute risk without sacrificing returns

By Ken MacFadyen

Tom Lister, who spent eight years investing alongside him at Forstmann Little, including one very long day at the bankruptcy court, says that the pair knew Western Union was a gold mine. "If Steve likes something, he'll push very hard for it," says Lister, currently a co-managing partner of Permira. "If he doesn't, he won't waste any time on it at all."

Bert Notini, the chief executive of New Mountain portfolio company Apptis and a senior adviser at the firm, puts it another way. "Steve has a unique ability to be very analytical, but at the same time he has exceptionally good instincts," he says. "Usually you find someone who fits one category or the other, but rarely you'll come across someone who brings both of those traits to the table."

> "Good ideas speak for themselves and are age-independent."

The bridge between those two traits for Klinsky is his appreciation for risk. Unknowns can be resolved with exhaustive research and analytics. And instincts can be sharpened with clarity. Taken together, it is Klinsky's judgment and trust of gut that have kept him from allowing outside motivations — be it cheap debt or the draw of a trophy asset — to influence his strategy. As a result, in the nine years of New Mountain's existence, the firm has never experienced a business failure in its portfolio.

Of course, other factors are also at play. Klinsky's appreciation for risk likely goes back to his childhood. Growing up, he says the mall was the center of his universe. His grandparents launched the department store Albert's during the Great Depression, and his father and uncle expanded the business, creating a chain across Detroit. Klinsky says he spent much his youth reading comic books, but put in many more hours at the stores. "You learn very quickly that people's lives are connected to the business," he says. "Companies aren't like poker chips where it doesn't matter if you lose some and win others."

For someone who chose LBOs as a profession, Klinsky's take on risk is decidedly tame. Swashbuckling, a favorite adjective in the business press for deal pros and rainmakers, would not apply to Klinsky.

His New York office overlooks the stretch of the Hudson River where US Airways captain Chesley Sullenberger executed the emergency landing in January. (Klinsky was among those to dial 911 that afternoon.) Pictures of his four kids are scattered throughout the office, resting on nearly every flat surface. The framed art work is a mix of early 20th century Americana and late elementary-school arts and crafts.

Klinsky doesn't give off an impression that he is in the buyout business for a gambler's rush. Rather, it's an intellectual curiosity that seems to drive him, balanced by an aversion of the unknowable. These motivations have guided New Mountain into low risk industries — niches and sub-sectors that have often yet to intrigue other rivals in the LBO space. In nine years, and 16 investments, New Mountain has yet to make an acquisition through a sealed-bid auction process. The firm also rarely relies on leverage, as 12 of its 16 investments eschewed any third-party debt at their closing. Klinsky and company are confident that the sectors and businesses they back will provide enough growth to drive returns.

It sounds old fashioned but it's actually more complex. Rarely will New Mountain invest through just common equity. The firm structures many of its investments using a combination of subordinated debt and convertible preferred equity, providing a current yield and taking a senior position to other equity holders. Again, it goes back to risk.

Klinsky's take on debt isn't necessarily black and white either. He describes that in the early '80s, when interest rates were hovering around 16% and inflation was over 10%, leverage made analytical sense. "You could take a business with no unit growth at all, put in 95% debt versus 5% equity, and with the inflation alone you could triple your money in a year," he says. For the rest of the decade, as interest rates sank and P/Es climbed, leverage was an easy way to lock in a risk-adjusted return — again without even factoring in unit growth. In the 1990s, while the dynamics changed, leverage as a strategy still worked. "You had the greatest bull market of all time, so almost anything you bought with debt looked smart," Klinsky adds.

The message is that debt works as long as the risks are managed. After 2000, though, the obvious trend lines started to blur. This was the year Klinsky launched New Mountain, and he concedes that he had no idea where the economy was going. "The smartest way to play it under those circumstances is to find a great industry that will grow in a good or bad economy; then find a safe defensive business in that industry and build on it."

Klinsky's first job out of school was at Goldman Sachs. Without any concern about dating himself, he notes that the firm didn't even have an LBO arm when he arrived in September, 1981. He joined a small M&A group that was comprised of 12 people, and included other peers such as Gary Gensler, currently the chairman of the Commodity Futures Trading Commission, and Christopher Flowers, who runs JC Flowers & Co. Goldman Sachs entered the buyouts business in 1983, assigning Alfred Eckert III, a vice president at the time, and Klinsky, still an associate, to the new division.

The goal of the group initially was to provide an alternative for clients who wanted to maintain control of their business, and weren't keen on selling out to one of the independent LBO shops. Taft Theme Park was one of the first deals Klinsky worked on, and he remembers the difficulty he had trying to convince a vice president to sign off on the capital structure. He had to sell them on the idea that a roller coaster could serve as collateral.

When the team started backing the deals as a principal investor, it brought a whole new level of scrutiny on the upstarts. The first time Eckert and Klinsky put partnership money into a transaction was for a buyout of Trinity Bag and Paper Co. Goldman invested $2 million of equity in the $12 million deal, carving the company out of Rockefeller Center Inc.

"It seemed to me that every senior partner at Goldman — up to the CEO — was either on the deal team or watching it closely," Klinsky describes.

An exit for Trinity came in 1988, through a sale to Stone Container Corp. By that time Klinsky, at 31, was already in his fourth year with Forstmann Little, entering his second year as a general partner at the firm. It was at Forstmann Little where Klinsky built his name. He oversaw the firm's investments in General Instrument Corp., Ziff Davis Publishing, The Thompson-Minwax Co., and The Yankee Candle Co. Thompson-Minwax, which generated a 24% internal rate of return, was the dog of the group, while The Yankee Candle Co. represented the best return, at least on paper. It took a short 15 months to turn a $176 million equity investment into $874 million, translating into an IRR of 260 percent.

General Instrument (GI), however, is the transaction that always seems to follow Klinsky. The details of the investment, completed against the backdrop of Drexel Burnham Lambert's implosion, have already been well documented in both the mainstream and the trade press. A key takeaway that often gets overlooked is that GI actually ramped up its R&D spending under Forstmann Little. The roughly 10x return came only after the firm transformed the conglomerate, remodeling it around its growth and creating a leader in cable tv technology in the process.

When Klinsky formed New Mountain in 2000, he came with a track record of unrivaled consistency. From 1989 to 1999, Klinsky's investments at Forstmann Little cumulatively generated roughly $2 billion of equity gains, without a single loss of principal during that time.

John Robertshaw, a managing director in Credit Suisse's placement agent group who marketed New Mountain's fund, notes that the consistency was important to limited partners, but perhaps a bigger draw was the process that delivered the steady returns. He notes that all three equity vehicles were oversubscribed. "The firm is focused on defensive growth in a very unique way," Robertshaw says. "They don't use a lot of leverage; they're operationally oriented, and that resonates with limited partners."

New Mountain as a firm seems to embody Klinsky's mix of intellectual curiosity and cautious instinct. Klinsky has taken pains to build a flat, non-heirarchal firm, and in the process has created a team that exhibits the ingenuity and enterprise of youth, mixed with the judgment and business sense that comes with seasoning.

Each year, a memo is circulated calling on every member of the firm to submit their three or four best ideas for new areas of industry coverage. Before the partnership will look at the submissions, the writers' names are removed. "That way, we don't know if the idea is coming from a first-day associate or a 20-year veteran," Klinsky notes.

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The partnership will then vote on the best ideas to determine which industries to pursue in the coming year. It won't always translate into an investment, but the process allows New Mountain to continually build out its capabilities. It also gives everyone in the organization a sense of ownership.

"We want our people to give honest feedback, thoughtful analysis and ignore politics," Klinsky adds. "We want our younger people to have a full chance to participate, and we believe good ideas speak for themselves and are age-independent."

Klinsky cites that the decision about which industries to target underpins the firm's focus on defensive growth."If you pick the wrong industry, and it blows up, it usually doesn't much matter what you do. You've already sealed your fate." From there, New Mountain's approach seems simple. It installs a solid capital structure — "so you don't kill an otherwise healthy company" — and is incredibly attentive to the operations.

"In that sense, psychologically, you treat it like a family business," Klinsky describes.

> "Ted Forstmann thought you should buy one good company a year."

Apptis' Notini, who has spent time as an executive at the portfolio companies of other firms, notes that his experience with New Mountain has been markedly different. "I'm on the phone with them everyday talking about a whole range of issues. It's not about reporting back to the team or having New Mountain check up on the company; it's more of an unstructured, open collaboration so we can react to opportunities and overcome challenges."

Klinsky refuses to take any credit for individual deals at New Mountain. He is quick deflect attention back to the team, which upon inspection share many similar traits as Klinsky. Douglas Londal, who joined the firm in 2004 from Goldman Sachs, also has a family business background, as does Michael Ajouz, a KKR veteran who came on board in 2000. Over the past two years, New Mountain has staffed up considerably, adding around 30 new employees, many coming from places such as Goldman, McKinsey & Co., and Lazard. Operators have also gravitated to New Mountain, including Lawrence Jackson, the former CEO of procurement at WalMart, and Randy Thurman, Viasys Healthcare's ex chief. Not all of New Mountain's additions arrive from traditional investment backgrounds. David Vise is a Pulitzer Prize winning reporter, who joined the firm from the Washington Post. "He's with us full time, so he can do investigative due diligence for us on whatever we're looking at," Klinsky cites.

Ajouz, a managing director at the firm, notes that he didn't know Klinsky when he was first recruited out of KKR. What drew him to New Mountain, he says, was the shared belief that investing begins — not with the capital structure — but with the business model. "From the opening dialogue I really appreciated the way he invested. It felt different," Ajouz says.

Ajouz adds that the dialogue he shared with Klinsky at that first meeting has carried over to the firm's Monday meetings. The partnership, he says, all believes "in the four corners of New Mountain's investment thesis," but Ajouz adds there will often be considerable debate around the edges and whether or not a particular deal fits the bill. "Steve is very honest, and the process is completely transparent. It's the quality of the dialogue that usually determines the quality of the investments."

The meticulous nature of New Mountain's vetting process has translated into a very deliberate pace in terms of its investments. In 2007, at the height of the market, the firm completed three platform deals. Over the past 12 months, which could be considered the depth, New Mountain has cinched two new deals. "That's a Ted Forstmann trait," Lister notes, adding, "He thought you should buy one good company a year."

Of course, it also allows New Mountain to do some things that may require a little more time.

INO Therapeutics, for instance, was a unit within German engineering giant The Linde Group that manufactures and markets inhalable drugs, including nitric oxide for the use of respiratory failure in newborns. Klinsky says that the research behind the product won the Nobel Prize for medicine in 1998. The problem, he says, is that that while the unit could produce steady cash flows, there was little in the way for potential growth. "The issue we were facing was where do you take it?" Klinsky asks.

The answer was to approach venture capital firms Venrock Associates and ARCH Venture Partners, which together backed an early stage company called Ikaria. Ikaria didn't have any marketable products, but did maintain a pipeline that could instantly provide a growth story. New Mountain, ARCH and Venrock agreed to acquire and merge both assets in a $670 million deal. The transaction required more than 11 months of due diligence, but Klinsky says that at this stage the company is performing well ahead of plan. He also notes that Ikaria's founding scientist was named a MacArthur "genius" Fellow for his work in biology. Observers may not immediately recognize the significance, but Klinsky's enthusiasm and pride affirm that it's important.

While New Mountain plays in the middle market, Klinsky doesn't think too long about deal sizes. In fact, Klinsky notes that the firm's hedge fund, New Mountain Vantage, is designed to give the group access to companies that are too large for its PE vehicle. The approach, however, is largely the same — incorporating a research-intensive model designed for long-term investments. Klinsky cites an investment in National Fuel Gas Co. as an example.

"It was a very sleepy company trading off of its dividend. But it had almost a million acres of land in the Marcellus Shale that two years ago nobody was paying attention to." New Mountain hired Slumberger to look into the potential of the $3 billion market-cap company. "A huge amount of work" ensued and an investment followed. Vantage eventually won the right to nominate a board member, and as of press time National Fuel was maintaining a $3.6 billion market cap.

Out of New Mountain's most recent fund, the firm is also selectively putting capital to work in secondary debt. The effort underscores that while New Mountain may lose out on some deals, no amount of research could ever be considered a wasted effort. "We went back to all of the most attractive companies we'd studied before, which somebody else may have bought for 12x or 14x Ebitda. A lot of these companies remained strong businesses and were still on plan even though their debt prices had collapsed after the fall of Lehman Brothers." As an example, New Mountain snatched up a position in the senior debt of EDMC.

He calls these types of debt investments "one of the safest things you could find in this market" that were providing returns in line with traditional private equity investments.

In the aftermath of the credit bubble, Klinsky won't discuss the ways in which others in private equity may have gone off course and refuses to be drawn into discussion about how leverage corrupted the asset class. For Klinsky, it all goes back to risk, and despite what the textbooks say, he believes that returns don't necessarily have to run parallel.

"If you're buying a bond, you're going to look at the yield and weigh that against its credit rating and risk. In private equity, there are different levels of risk as well," he says. "If you're just going to leverage a cyclical, no-growth business with 95% debt, and then hope that there isn't a recession, that is different than investing in a great,

"Psychologically, you treat it like a family business."

acyclical industry using a safe capital structure and then growing the business." The difference, Klinsky says, is not in the size of returns but rather that the latter approach leaves the fate in the hands of the investor. He equates it to physically stopping the roulette wheel, and placing the ball in the slot that matches the bet.

Klinsky's favorite part of the job is the meeting that takes place every Monday, gathering between 45 and 50 members of the firm for an hour or two each week. There, they'll discuss every portfolio company, every private equity deal being considered, every stock position, debt position, and general market trends. Klinsky will walk around the room as the agenda moves on.

Ajouz notes that everyone — from the top to the most junior person at the firm — plays an active role. "Everyone is on the same team; there are no clans or subcommittees, we're all incentivized in the same boat," he adds, noting that it creates a dialogue that is both transparent and honest, and challenges the people at the firm.

Klinsky, meanwhile, relishes the process of the deal; the little things that may seem trivial to those who don't have the endurance for 12 months of due diligence. "The combination of all of the different inputs and analysis, coming from all different directions; that is what I enjoy more than anything else," Klinsky says. M&A