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CRAIG HARTLEY/HBJ

Frank Hevrdejs of The Sterling Group: 'We made a commitment to keep the business going for two years, regardless of what happened.'

Trouble-shooter

Private equity and investment firm The Sterling Group has made a mint by providing struggling companies with financial and managerial boosts

BY DEBRA BEACHY
SPECIAL TO HOUSTON BUSINESS JOURNAL

When Frank Hevrdejs launched The Sterling Group nearly 25 years ago, he knew he had his work cut out for him.

Even though he and the firm's co-founder, the late Gordon Cain, had solid business credentials, they were newcomers to the private equity industry.

"We made a commitment to keep the business going for two years, regardless of what happened," recalls Hevrdejs.

It's a good thing the partners were willing to stick it out, because it took almost that long — 18 months — to make any money at all.

"The toughest challenge was getting through that period," Hevrdejs says. "We had very little capital and no credibility because we were new. After the third year, things changed.

THE STERLING GROUP

Business: Private Equity investments

Founded: 1981

Co-Founder: Frank Hevrdejs

Employees: 25

2004 revenue: \$20 million

2005 revenue: \$25 million

Web Site: www.sterling-group.com

STERLING: Private equity pioneer stays ahead of competition by working smarter

We became a known commodity.”

Before starting The Sterling Group, Hevrdejs, then 36, had been working for an investment bank where Cain, a retired Conoco Chemical Co. CEO who was then 69, was a client. The two decided to team up and open their own business using their savings and income from consulting while they pursued potential investors.

Although Cain died three years ago, Hevrdejs has continued with The Sterling Group, which now boasts six partners and 14 employees.

Since opening its doors in 1981, The Sterling Group has acquired and sold 29 businesses worth \$7 billion.

In 2005, the company posted revenue of \$25 million, up from \$20 million in 2004.

The Sterling Group makes money by acquiring troubled firms, improving them and reselling them. Sterling also raises money for investment through private equity funds that it manages. These include a \$120 million fund and a \$470 million fund.

CROWDED FIELD

Just a few months shy of Sterling’s 25th anniversary, Hevrdejs is savoring success even though his company is competing with a soaring number of private equity firms.

Competitors range from companies as large as Washington, D.C.-based The Carlyle Group to smaller firms such as Houston-based The CapStreet Group LLC.

Hevrdejs says that when The Sterling Group started in 1981, there were less than 100 firms in the private equity business. Now there are more than 2,000 firms in this space.

The rapid increase in the number of private equity and venture capital firms is largely being driven by an influx of money from institutional investors. Faced with a relatively stagnant stock market and low interest rates, investors are eager for the higher returns they can get from private equity funds.

For example, Hevrdejs says, pension funds seek out returns of at least 15 percent to 20 percent.

One institutional investor, Texas Tech University, chose to invest in the Sterling funds because of the high rate of return, as well as the company’s staff, says Charles Wall, assistant vice chancellor for investments for Texas Tech.

Wall says the university’s endowment has an asset allocation for investing in leveraged buyout firms, which led Texas Tech to The Sterling Group.

“We looked at the quality of personnel, the methodology, the expertise, and the rate of return,” he says.

An initial \$2.5 million investment in a Sterling fund netted a 40 percent return for the university, so the endowment chose to invest \$6 million in a second Sterling private equity fund.

Despite these successes, Hevrdejs says companies like The Sterling Group must “work smarter” in the face of tough competition.

He says there is more money chasing after fewer deals, as well as a trend toward auctioned deals. And multiple bids from potential buyers are putting downward pressure on returns.

In addition, hedge funds and investment banks have entered the picture and are now competing for these same investment deals.

Indeed, according to a survey by Thomson Financial and the Houston Association for Corporate Growth, 87 percent, vs. 78 percent nationally, of Houston private equity professionals say there is more private equity capital available for investment than there should be.

Respondents also said the greatest opportunity was in buyouts of midsized firms (39 percent in Houston vs. 30 percent nationally) and small private investments (29 percent in Houston vs. 36 percent nationally).

Midsized firms are the type of company most often acquired by The Sterling Group. And these companies now have more investors pursuing them, eager to make purchases. As a result, many of the firms are asking for a larger percent of equity from investors.

“In the ‘80s, we could buy businesses with a smaller percent of equity,” Hevrdejs says.

Meanwhile, dealmakers are using the same type of criteria to select companies to acquire. Houston dealmakers said on the survey that they put the most emphasis on sales and revenue growth (38 percent vs. 30 percent nationally), an attractive business sector (16 percent vs. 23 percent nationally), management strength (14 percent vs. 18 percent nationally), proprietary technology (14 percent vs. 9 percent nationally), and profitability (13 percent vs. 18 percent nationally), when deciding whether to acquire a company.

These are the types of aspects that Sterling examines. But the company also searches for something else that’s a little more on the unusual side.

“We’re looking for companies that aren’t living up to their potential,” Hevrdejs says. “We can add value to through business strategy, operational efforts.”

The companies that The Sterling Group tends to acquire are typically divisions of a larger firm or are medium-sized privately held firms.

Before purchasing a company, The Sterling

Group performs “a tremendous amount of due diligence,” Hevrdejs says.

Once acquired, The Sterling Group assesses managerial talent, cash flow and the industry outlook, and makes changes accordingly.

“While those changes can be as severe as replacing the CEO or management team,” Hevrdejs says, “there are typically more specific problems that need to be addressed.”

For example, one company The Sterling Group acquired was not getting paid for all of the services it performed because of inadequate bookkeeping.

To fix the problem, all crews were given computer tablets outfitted with work orders and an approval box for each task performed.

Hevrdejs says The Sterling Group found that 50 percent of that company’s work wasn’t getting billed because when the crews went onsite and were asked to do additional work, it wasn’t tallied.

“We are teaching people how to operate smarter,” he says.

At another company acquired by Sterling, excess costs were cut when the number of unnecessary vehicles owned by the company was reduced.

Besides cutting costs and reviewing management practices, Hevrdejs says his firm listens to “the good ideas held by people who are not necessarily at the top of the company.”

The Sterling Group also evaluates why a company might not be meeting the same goals as its competitors.

All of these specific factors were taken into account even with The Sterling Group’s first-ever acquisition. Seven years after acquiring Balco International, a Wichita, Kan.-based firm that makes specialty architectural items for hospitals, The Sterling Group sold the company for \$2.5 million, netting \$1.8 million in the process.

Hevrdejs says Balco was discovered as a potential buyout candidate through talking with only a handful of contacts, and the deal required tough negotiations lasting for months. A fee for doing the deal paid by investors became the first revenue ever collected by Sterling.

Now, says Hevrdejs, the company has more than 1,000 contacts to draw upon in order to find companies to acquire, improve and eventually resell in about three to seven years.

DEBRA BEACHY is a Houston-based freelance writer.