


Institutional Investor

TA Associates did well in financial and technology niches that other private equity firms neglected. But now the field is crowded, returns are pinched, and TA is pressed to keep its edge.



CEO Landry:
"People are willing to pay much higher prices than we've ever seen"

By Steven Brull

Financing finance

TA Associates made its mark going where few investment firms had gone before.

When it opened its doors in 1968, TA became one of the first venture capital firms not affiliated with a family fortune. Two decades later, propelled by the success of such IPOs as Biogen, Continental Cablevision and Federal Express Co., it pioneered an almost exclusive focus on larger, later-stage investments in profitable, fast-growing businesses. To accelerate its deal flow, it broke ground by systematically cold-calling prospects.

While funneling the bulk of its money into such venture capital staples as consumer, health care and technology companies, TA led the way into novel investment sectors. In 1989, the firm identified financial services — chiefly, asset management companies — as a lucrative niche, and it subsequently poured hundreds of millions of dollars into financial technology businesses. Its latest wrinkle: hedge funds.

"Investing in financial services, especially money managers, was a pretty radical concept before TA came into the game," says Donald Putnam, CEO of Putnam Lovell NBF

Group, a San Francisco-based investment banking subsidiary of National Bank Financial of Montreal. "Now it's quite an accepted notion that the cash flows of these firms have real enduring value."

Overall, TA has raised \$5.1 billion and invested \$3.5 billion, of which 20 percent has gone into financial services and financial technology. In the past five years, about 35 percent of its investments, totaling some \$700 million, have been in these categories. Since 1989, TA has invested close to \$400 million in eight money managers, including AIM Management Group and Keystone Corp., and has realized returns of \$1.4 billion. A 2002 investment of \$110 million in New York hedge fund manager Clinton Group, which went into a tailspin last year, was a clunker, and TA exited in February. But a \$215 million investment in pioneering e-brokerage Datek Online Holdings Corp. has returned some \$680 million in cash and stock.

TA boasts one of the industry's most impressive and consistent track records. None of its 21 funds — 11 of them still active — has lost money, and all but its first fund have outperformed the median rate of return of all private equity, including venture capital, buyouts and mezzanine funds, according to year-end 2003 data from Thomson Venture Economics.

Even TA's most recent major fund, the \$2 billion TA IX, has been a big success. Launched in 2000 in the middle of the technology stock meltdown, it is more than 50 percent invested and boasted a net internal rate of return of 20 percent at the end of last year, compared with the -12 percent median IRR for all private equity in the same period. TA VIII, which began investing \$800 million in 1997 and is 97 percent drawn, had a net IRR of 21 percent as of year-end, compared with the 4.3 percent industry median. Advent VII (TA's funds until 1996 bore the Advent name), a 1993 fund that is fully drawn, showed a net IRR of 57 percent, versus the 13 percent median.

"We would be ecstatic to have their results and longevity," says Robert Huret, co-founder of FT Ventures, a San Francisco-based venture capital firm that competes with TA in financial technology.

With 75 employees (including 12 managing directors and a total of 11 principals and vice presidents) in Boston, London, Pittsburgh and Menlo Park, California, TA makes deals in the \$75 million to \$200 million range. That places it somewhere between venture capital and buyouts. It's comfortable taking minority, noncontrolling positions that most buyout firms eschew, yet it can write bigger checks than most venture-stage investors. That unique positioning and its sterling track record have made the firm's institutional investors — including the likes of the Ford Foundation, Harvard University and the Industrial Bank of Japan — steady customers.

"They've invested in established, profitable companies with lower risk than most but achieved high returns consistent with the top quartile of the private equity world," notes D. Brooks Zug, a managing director of HarbourVest Partners, a private equity fund of funds in Boston with more than \$10 billion under management. HarbourVest has invested in TA since 1978.

But TA's winning formula faces unprecedented challenges. Competition in the private equity world is pushing up prices and lowering expected rates of return. A decade ago TA could

source original deals and then negotiate to buy parts of companies without having to bid against other investors or deal with intermediaries. Today that so-called proprietary deal flow is all but impossible to generate. Competitors such as Advent International Corp. and Summit Partners — both founded by former TA employees and the first of many to copy its systematic cold-calling practice — are crowding the field. TA encounters a growing list of rivals, including Bain Capital, General Atlantic Partners, Hellman & Friedman, Thomas H. Lee Partners and Warburg Pincus.

As TA's average deal size has nearly quintupled — from an average of \$16.7 million in the late 1990s to about \$80 million this year — potential target companies have become better advised than before. Often they hire investment bankers who set up auctions that boost prices.

"Competition for the kind of deals [TA] wants to do is clearly going up," says Clint Harris, founder and managing partner at Grove Street Advisors, a Boston-based firm that has more than \$3 billion under management, including about \$100 million in TA on behalf of the California Public Employees' Retirement System, the nation's biggest pension fund. "In that environment it becomes harder to get there first, and the value of getting there first goes down."

TA chief executive officer Kevin Landry says, "There's so much private equity money around, so much overhang, that people are competing for deals, and they're willing to pay much higher prices than we've ever seen in this business."

Landry sees a rising tide of private equity money being raised this year, including buyouts, venture capital and proceeds from IPOs of business development companies being launched by Blackstone Group, Kohlberg Kravis Roberts & Co. and others. According to Thomson Venture Economics, money raised for venture capital and buyouts will increase from \$41 billion last year to \$55 billion in 2004 and \$95 billion in 2005.

All that money sloshing around has forced TA to lower its expected range of annual gross returns on investments to 30 to 35 percent, compared with 30 to 45 percent in the late 1990s. That's still higher than industry averages, which have fallen from 27 to 32 percent in the late 1990s to 20 to 25 percent last year and 17 to 23 percent today, notes Landry.

To maintain its discipline, TA has slowed its investment pace, postponing its next planned \$2 billion fund from 2004 to 2006. But the firm's portfolio also will take on slightly greater volatility as it pursues larger deals — companies growing at least 20 percent a year — and angles more often for majority positions. TA's average deal size will increase this year to about \$80 million, from \$70 million last year, and its average ownership stake is likely to rise from 35 percent today to 40 to 45 percent over the next three years, Landry says.

"We're paying up and hoping to get companies that are growing fast enough so that a year from now we'll feel comfortable with the investment," he asserts.

Some limited partners, mindful of TA's historical results, don't mind the slowdown. "They lose deals against people who overbid," says Thomas Schwartz, managing director of VCM Venture Capital Management, a Munich-based investment advisory firm that has invested a total of about \$250 million in TA since 1979. "But I prefer people who invest slowly and carefully."

TA GOT ITS START — AND ITS NAME — IN 1968 AS A venture capital fund within Boston brokerage Tucker Anthony & R.L. Day. The brainchild of Peter Brooke, then head of Tucker Anthony's corporate finance operation, TA was ahead of its time. In those days venture capital remained an immature cot-

Brooke left in 1984, had codified its pioneering strategy: a focus on later-stage, fast-growing, profit-making companies, preferably those with recurring revenues and low capital requirements. "We wanted to manage more money, and we couldn't spend 75 percent of our time working with early-stage portfolio companies," Landry explains.

It's a fine, if not completely unique, strategy, but one that is devilishly hard to execute. The trickiest part is finding companies that fit TA's investment profile. The answer was systematic deal-prospecting. In the firm's early days, Landry and his partners pounded the pavement, literally. When visiting a company in an industrial park, they would go around and write down the names of all the tenants for future reference. Gradually, the process became more systematic — and was copied throughout the industry.

Today 18 TA associates scour tens of thousands of Dun & Bradstreet reports on private companies, comb through trade magazines and search want ads in more than 250 newspapers to see who is hiring and in possible need of a capital injection. They maintain a database on more than 277,000 enterprises. The associates, and to a lesser degree TA's investment professionals, contact as many as 8,000 companies in the U.S. and Europe each year. TA pays in-person visits to about one in ten, and most turn out to be dogs. "You get on airplanes and visit companies, and it's like the *Gong Show*," says Landry. "The good ones are few and far between, and then they don't want to do a deal."

Getting acquainted early with an attractive company, though, can start a relationship that will give TA an edge against other suitors. "You've got to find 'em first, love 'em and close 'em," says Landry.

TA, based in Boston's financial district, has made lots of successful closes. From a bright 25th-floor perch on High Street, employees can see boats plying the harbor. Mahogany furniture and romanticized paintings of alma maters in partners' offices convey a sense of New England tradition.

TA partners have a hard-driving work ethic that stems in part from Landry, 60, who helped put himself through Harvard University and the Wharton School of the University of Pennsylvania by digging ditches and driving taxis. The work was less about making ends meet — his father was a neurosurgeon — than a compulsion to stay active. "You could not be idle in my family," Landry says.

He's still hustling. He pilots his own ten-seat Citation Encore jet to business meetings, often flying across the country and back in a 24-hour period. (He flies a single-engine propjet for fun on weekends.) Landry says he'll cut back his role in 2006, when TA plans to close the \$2 billion TA X fund.

Landry has seen the firm through its early struggles — he was part of the management that bought TA out from Tucker Anthony in 1978 — to the heady Internet era and beyond.

TA first became a financial services industry investor in 1989 when Landry heard from a friend who worked at Keystone that the company's parent, Travelers Insurance Corp., wanted to sell the money manager and that Keystone's management wanted to



Financial investments chief McLane (left, with partner Schiciano): "We'd like to tell you there was a grand strategy, but there wasn't"

tage industry, the province of a few family offices, such as the Phippses' Bessemer Securities Corp. and the Rockefellers' Venrock Associates, and rich individuals, classic "angels."

In its first decade TA raised a mere \$12 million. "We didn't have enough money to keep the group together, so I had to do some consulting, M&A work and everything else I could do," recalls Brooke, 75, now chairman of Advent International Corp., a global private equity shop he spun out of TA in 1984 to focus on international deals.

The passage in 1974 of ERISA, which allowed pension funds to invest in venture capital as limited partners, gave TA a huge boost. It launched the \$60 million Advent IV fund in 1980 and the \$167 million Advent V in 1983. With its growing sums TA moved up from the early-stage market and concentrated on bigger-ticket deals in larger companies. By the late 1980s Landry, who had worked at the firm since 1969 and became CEO when

find a financial partner to do a buyout. Landry concluded that the asset management business, with its recurring revenues, high margins, modest capital requirements and substantial free cash flow, fit his investment parameters perfectly. TA realized \$82 million on its \$15.5 million investment when Keystone was acquired by First Union Corp. (now Wachovia Corp.) in 1996.

"We'd like to tell you there was a grand strategy, but there wasn't," says P. Andrews McLane, the senior managing director who now oversees TA's investments in financial firms. McLane joined TA in 1979 after earning a bachelor's degree in psychology and an MBA from Dartmouth College and spending two years drilling wells in Chad as a Peace Corps volunteer.

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In 1990, TA followed up on its Keystone investment by plunking down \$3.3 million for 19.7 percent of Thomson Advisory Group, whose management wanted to split off from brokerage Thomson McKinnon. Four years later Thomson Advisory merged with Pacific Investment Management Co. (since 2000 part of Germany's Allianz), and TA cashed out more than \$70 million.

In 1993, TA incubated in its own office Affiliated Managers Group, a holding company led by William Nutt, a former president of Boston Co. Over the next two years, TA invested a total of \$21 million. AMG had acquired ten money managers by the time it went public in 1997. TA sold its shares between 1998 and 2000, realizing \$119 million.

TA's most lucrative investment was in AIM Management Group. In 1993, TA invested \$34 million in equity for a 28 percent stake and arranged a \$180 million bank loan from a syndicate. Houston-based AIM merged with Invesco to create Amvescap in 1999, and over the next two years, TA sold stock worth \$808 million.

FOR ALL THESE SUCCESSES, TA FLOPPED IN AREAS where it allowed its investment discipline to slip. In 1999, at the height of the Internet boom, the firm made a record 19 deals, compared with a historical average of ten to 12 a year. "There was a lot of pressure, especially from younger people in the firm, who didn't think we 'got it' — there was a lot of venture envy," says Landry.

Among the TA deals that went awry: Last year the firm wrote down a \$28 million early-stage investment it made in Questia Media America in 2000. Questia wanted to digitize and sell research materials for students writing term papers, but, in classic bubble-era fashion, the company spent about \$150 million to develop its product and then lacked the funds to promote it.

Nor was TA's money management record perfect: The firm lost \$18 million on its 1997 investment in Altamira Investment Services, a Canadian firm that was one-third owned by Manulife Financial of Toronto. TA stepped in as a white knight to Altami-

ra's management, which wanted to repel a Manulife bid and gain control for itself. But Altamira, which was on a tear in the late 1990s as it focused on aggressive growth and technology investments, suffered after the market collapsed in 2000. TA exited when the National Bank of Canada acquired Altamira in 2002.

Worse was to come. In 2002, TA put \$110 million into New York hedge fund manager Clinton Group, reflecting its optimism in the alternative investments market — and a desire to share in Clinton's 20 percent performance fee. With \$5.8 billion in assets at the time, Clinton was a major, and seemingly secure, player. TA planned to exit the way it had other money managers: a sale, merger, management buyout or even a public offering.

But last October, Anthony Barkan, manager of Clinton's asset-backed securities team, quit, citing a dispute over the valuations of asset-backed securities in hedge fund portfolios. The Securities and Exchange Commission and the Commodity Futures Trading Commission opened investigations, and investors ran for the exits. Clinton's hedge fund assets plunged to \$1.4 billion as of March, just

weeks before both regulatory agencies concluded their investigations without taking action.

In February, TA suffered a loss when it sold its investment — a combination of subordinated debt and equity meant in part to finance the hedge fund's capital expenditures — back to Clinton. Neither firm would comment on the terms of the transaction.

Dusting itself off, TA announced in May that it would pay an undisclosed sum for a 50 percent stake in Numeric Investors, a Cambridge, Massachusetts, hedge fund that manages some \$7.5 billion in traditional and market-neutral portfolios. As with Clinton, says Landry, TA will get a cut of Numeric's performance fees.

TA'S INVOLVEMENT IN FINANCIAL TECHNOLOGY started serendipitously in 1997. Jonathan Goldstein, a managing director specializing in health care deals, was an early customer of Datek, one of the first companies that enabled retail investors to trade like pros. "He was talking about trading stocks online, and everyone in the office thought he was a little crazy," recalls Kenneth Schiciano, a TA managing director and one of the architects of the financial technology strategy. "Then, in July 1998, an article in the *New York Times* brought the company more to our attention."

The article reported that Manhattan District Attorney Robert Morgenthau and the SEC were investigating whether Iselin, New Jersey-based Datek had participated in a money-laundering operation and illegally offered customers guaranteed returns. Datek denied the charges but nixed its plans for an IPO that year.

Datek's problems — and costs — would mount up. The SEC fined the company \$50,000 in May 1999 and \$6.3 million in 2002 for fraudulent financial reporting and illegal trading at its day-trading unit, Datek Securities. In 2003 the SEC finally closed the case by levying a massive \$70 million fine against Datek Securities and Heartland Securities Corp., which had acquired the operation in March 1998. However, it wasn't Datek Online that was liable, but rather past execu-

tives of Datek Securities, including former chief trader Sheldon Maschler and former CEO Jeffrey Citron.

In May 1999, just a week after the SEC levied its initial fine, TA announced a deal to invest \$60 million in the brokerage plus \$15 million in its spin-off, Island ECN. TA invested alongside LVMH Moët Hennessy Louis Vuitton, the French conglomerate headed by Internet finance enthusiast Bernard Arnault, which put in \$125 million. In 2000, TA put up an additional \$140 million as part of a \$700 million leveraged recapitalization with Bain Capital and Silver Lake Partners. At that point, Datek

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spun off Island, a leading electronic communications network for trading Nasdaq stocks, into a separate company. In September 2002, Datek merged with Ameritrade Holding Corp. and Island was acquired by Instinet Group, which is 63 percent owned by Reuters Group. TA has realized cash proceeds from both deals totaling \$362 million; it also retains about 21 million shares in Ameritrade valued at about \$231 million and 13.6 million shares in Instinet worth some \$86 million.

“Because the penalty for a broker-dealer who engages in fraud is so severe — a de facto death penalty — there were people who were just not prepared to take on the risk of investing in us,” recalls Edward Nicoll, a former chairman and CEO of Datek who is now CEO of Instinet Group. “But TA saw that this was a problem confined to the prior management and business model and that the risk of the death penalty being imposed was extremely small.”

Through Datek and Island, TA came to understand how technology was fragmenting equities markets and frustrating traditional dealers. How to profit from that trend? The firm looked to one of Island’s biggest customers, New York-based Lava Trading, which had developed a highly automated system to help institutional traders aggregate data from, and route orders over, ECNs and alternative marketplaces.

Lava was on the cusp of profitability when American Airlines Flight 11 from Boston crashed 12 stories above its 83rd-floor offices in the north tower of the World Trade Center on September 11, 2001. The firm was reduced to its staff of about 50 employees (all of whom survived) and a set of backup tapes.

In December 2001, TA paid a call on Lava, and in March 2002 the firm invested \$28 million for just under a quarter of the company. Lava’s revenues climbed from \$1 million in 2001 to \$50 million in 2003, and TA says an IPO is possible next year.

“We were not actively looking to raise capital and didn’t think it was the best time because we were rebuilding,” says Lava CEO Richard Korhammer. “But TA was able to see where we were moving, so we got to terms that worked well.”

The alternative-asset space has been the primary focus of TA’s recent financial technology deals. In October, TA announced an \$82 million investment in GlobeOp Financial Services, a

London- and New York-based company that automates hedge funds’ middle- and back-office processes and risk management analytics. TA had to fight hard for GlobeOp. Jonathan Meeks, a 31-year-old principal at the firm, had been pursuing the \$80 million-in-revenues outsourcer for 18 months. But major fund administrators, including J.P. Morgan Chase & Co. and Mellon Financial Corp., had been wooing GlobeOp, and late last summer the company’s founding principals — a group that came out of the infamous Long-Term Capital Management hedge fund that nearly collapsed in 1998 — were leaning toward selling to one of those strategic buyers.

Meeks sought and got one last chance to persuade the GlobeOp executives, and he won them over. Although TA’s investment, for about 40 percent of the equity, implied a much lower valuation than GlobeOp would have otherwise attained, it offered the entrepreneurs a way to remain masters of their own destinies, with the potential to reap greater rewards in the

future. “After Jon’s presentation there was a great deal of enthusiasm and clarity that this was the right thing to do,” says GlobeOp chairman and CEO Hans Hufschmid.

DESPITE ITS TRACK RECORD AND THE RECENT spate of finance-related transactions, TA’s game is getting more challenging, and its returns are likely to diminish. The firm has always excelled by finding markets and niches that others overlook and by being the first to knock on prospects’ doors and lock them in. Today, grouches financial technology strategist Schiciano, “nobody has proprietary deal flow.” Indeed, over the past five years, TA made the initial outreach to 78 percent of the companies it ultimately invested in. But very few deals were consummated without rival suitors or intermediaries.

The average transaction size is rising, in part because that’s a way to put more money to work in fewer deals. TA plans to boost the proportion of deals in which it takes a majority interest to 50 percent from the current 40 percent, says Landry. “We’re going to spend less time on run-of-the-mill auctions where we can’t bring any value and others feel comfortable and bid up on it,” the CEO adds.

To maintain its high returns, the firm is also focusing on companies with annual growth rates in excess of 20 percent. It’s extending its reach, having opened a London office last year to scope out more European deals. It also will look into new industry segments, such as financial databases.

The overarching problem, however, is simply too much capital, which drives up prices for companies and lowers returns for investors. “I don’t see any slowdown of capital coming into the private equity industry, so we could see rates of return driven even lower,” observes Landry. “If the private equity industry is a bubble, then we could be at the very early stage.”

So far, he says, “we’ve been able to bob and weave and stay out of the competitive fray.” But if capital inflows continue to increase, TA will have to face the inevitable. “You can’t buck the market forever,” Landry notes. “TA will move that way, too.” For one of private equity’s old boys, agility will determine just how far. **i**

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