Privcap/ Briefing: Solutions Capital in the Middle Market

Context for Private Capital Investment

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Solutions Are Hard Work

Private equity professionals are often referred to off-handedly as "deal guys." If doing a deal was the totality of the private equity strategy, this would be a much easier business. But today, especially in the US middle market, closing the deal is just the beginning of an arduous journey called "adding value."

A little understood fact of the US private equity middle market is that most of the investments target not "broken companies," but companies that are growing nicely and as a result encountering challenges that their founders and/or managers are often underequipped to face alone. In these circumstances, the right private equity firm can be a true partner for growth.

As you will learn from the expert contributors to this Privcap Briefing, the best private equity firms can provide sophisticated tools and techniques to management teams that have been so focused on the particulars of their legacy operations. A company that has never scaled before can benefit from a team that scales businesses for a living.

I hope this report is of interest both to private equity market insiders as well as ambitious business owners who have thought about pursuing a partnership with a private equity firm and want to make sure they do this to maximum advantage. I think you will agree with me that the expertise and candor offered here by Richard Leonard, Bela Szigethy and Anthony Zecca makes for enjoyable reading/viewing as well as a valuable guide to the highest standards of private equity investing.

Enjoy the Briefing,
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Webinar Playback

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Listen in to a fascinating conversation between Irving Place Capital Senior Managing Director David Knoch and Managing Partner, Cohn Consulting Group, a division of J.H. Cohn LLP Anthony Zecca in a Privcap Webinar called "Life After A Private Equity Deal." In it, Knoch and Zecca detail what exactly is expected of a management team during the due diligence stage of an investment and during the critical early stages of a partnership with a private equity sponsor.

Access the webinar at **www.privcap.com** or **click here.**

More Than Just Capital

An executive summary of the Privcap thought-leadership video series featuring three veterans of the US private equity middle market

Key Findings

1. Capital isn't everything
2. Operating partners are a rising force in private equity
3. 'Chemistry' between GP and management is key
4. Replacing underperforming management is a powerful, but gut-wrenching solution

The US middle market has changed significantly in the past decade and this has brought a host of new challenges for private equity firms. In order to compete, private equity firms today need to transform their cultures by bringing on board more operating talent. They will need to shower their portfolio companies with ideas and resources. Meet three experts who are leading the charge toward an operationally focused private equity middle market: Richard Leonard, managing director of Angelo Gordon & Co., Bela Szigethy, co-CEO of the Riverside Company and Anthony Zecca, managing partner at J.H. Cohn. Below are four key takeaways from their conversation that was captured in the Privcap video series, "Solutions Capital in the Middle Market."

1 Capital isn't everything

Success in middle market private equity has evolved to a point where portfolio companies need resources and guidance to compete. In the past, a private equity firm's ability to offer financing was often enough to generate a desired rate of return. But now firms need to bring other capabilities to the table.

"Prices for deals have gone up and it's become much more competitive—and as a result the basic strategy

Technology Traps

Richard Leonard

Upgrading your company's technology platform can usually bring real benefits. But a company and its private equity backers can get burned if they don't anticipate the risks that come with an upgrade. Richard Leonard, managing director of Angelo Gordon & Co, learned that firsthand a decade ago (at a different firm) when one of his portfolio companies implemented a new ERP system.

Two retail businesses merged and switched one system over to the other and "when the store manager ordered a dozen pairs of gardening gloves—because it was August—they got a dozen snow blowers," he said. Since then, Leonard has advised management teams to take a step back and think about the consequences of switching to a new system, because it can cause havoc to a company if it's not done properly.

Béla Szigethy

Culture Shocks

Private equity firms have always focused on helping their portfolio companies transform themselves and improve. But many now must transform themselves as they evolve from deal shops to solutions providers. This has caused a shift in culture at many firms—and some are finding it difficult to shift from smaller partnerships with financial capabilities to the new, larger operating-partner model.

Béla Szigethy, co-CEO of the Riverside Company, said that an influx of operating talent at a firm can lead to jockeying with the transaction side for influence over the portfolio companies. But as long as the value of everyone's carried interest is increasing, the industry should accept that this cultural shift will be permanent.

"Without the operating expertise, it's almost impossible to compete," he says. "By the way, these folks are sharing in our carried interest as well. So they have a strong interest in increasing the value of our portfolio companies and working directly for our investors as a result."

of how we add value has changed," Leonard said. Adding value can come in many forms—helping a company with its pricing strategy, helping it better understand its own data (see "Restaurant Science, p. 7), helping the company access new sales channels, and helping it build the right management team for its new stage of growth.

Private equity firms can also provide important contacts through their supply chain and help companies access channels previously untapped. "With most middle-market companies, their biggest struggle right now is growth," Zecca said. "Lots of companies can benefit from not just the capital but the advice and access that a private equity firm can give them."

2 Operating partners are a rising force in private equity

Szigethy can remember a time not too long ago when his firm employed zero operating partners. That number rose to six about five years ago and now has jumped to 25 full-time former CEOs, CFOs and other C-suite executives. The shift at Riverside is representative of the changes in the middle market overall in the last decade. Operating partners are now vital because the competition for deals has increased. "You have to do something differently and without operating expertise it's almost impossible to compete," Szigethy said.

Firms hope that by bringing on additional management talent they can greatly increase the value of their portfolio companies. "With most middle-market companies, one of the areas they need help on is, 'How do I grow my business?'" Zecca said. "Because it's not about money anymore. It's about how to grow the business and get a share of a bigger pie. The fact that private equity companies can now have operating partners

Doing Your Homework

A middle-market company looking for a private equity partner will hear a lot of good presentations. A mistake many of these companies make is to underestimate the effort necessary in vetting these GPs. Getting the real story on potential partners means more than looking at some financials and taking a few meetings. It may require sit-downs with many, many portfolio-company CEOs.

"References are the best way of doing it—talk to people who've worked with them," said Anthony Zecca, managing partner at J.H. Cohn. "Do Google research on them and find out what people are saying about them. So many middle-market owners get so caught up in getting the money that that's all they focus on, so they don't really do the homework to make sure that's the right partner for them."

Anthony Zecca

who can come in and help that company is to me a big indicator of change."

3 'Chemistry' between GP and management is key

As in any relationship, chemistry is key to making a partnership work in private equity. When a company takes on private equity partners, the company owner, who's likely been there for years and has established a work pattern with his management team, has to embrace significant changes. And if a conflict should arise, how will it be resolved?

"If there isn't a meeting of the minds on the strategy of the business going forward and how that business can realize the best value, then you've got a big problem from the beginning," Leonard said. "We obviously have to make sure we get along and see eye to eye with the managers and owners." And since it's rare for any deal to go perfectly, when there's a rough patch good personal relationships and rapport will make it easier to overcome.

4 Replacing underperforming management is a powerful, but gut-wrenching, solution

All private equity firms are looking for talented, motivated managers to take portfolio companies to the next level. At the same time, removing an underperforming manager can be a difficult decision for any firm, no matter how necessary it may be. Szigethy said that knowing when to address the issue of replacing management has proven to be a consistent challenge over many of the deals he's been involved in.

But waiting too long to pull the trigger can have disastrous consequences. "If anything, the mistake that private equity firms typically make is staying with a manager too long despite underperformance," he said. Leonard agreed that in the cases when his firm has had to make a change in the chief executive, it's usually waited a year longer than it should have. ◆

Expert Q&A

with Anthony Zecca
Managing Partner
Cohn Consulting Group, a
division of J.H. Cohn LLP

What challenges do middle-market companies face as they grow?

> For most of them the biggest issue they have is, "How do I grow?" For some it is simply the fact that the ability to grow has outstripped the talents of the team. A lot of middle market companies started from scratch, the owner/operator grew to a certain level and they get to a point where they hit a wall and they really don't know how to get beyond that wall in terms of growth. In that case, a private equity firm can bring more professional management and more professional talent to help the management team assess where the growth opportunity is and to move beyond that.

Lots of times the management team is a homegrown team and they're not necessarily professional managers. Many of them have only worked in that one company. So, they've never really been challenged to grow and if the CEO is not of the type to really drive growth, everything stagnates.

What can J.H. Cohn do to help private equity firms connect with middle-market companies in need of capital and ideas?

> We at J.H. Cohn have thousands of clients and most of our clients are middle market companies. So, we have many companies who are potential candidates for private equity investment. We have a private equity group within the firm that focuses on the relationship with private equity firms in terms of understanding what they're looking for from an investment perspective. We can then marry that up with the clients that we have that are looking for some form of exit or capital to see if we can bring the PE firm deals that make sense for our clients and make sense for them as well.

What is QlikView?

> It's a business intelligence platform. Through the QlikView platform, management can access the thousands of data points that exist on their IT systems, Excel spreadsheets, desktop applications or anywhere the data resides and pull that data together and make meaningful information out of it. Most financial departments spend man weeks developing spreadsheets to try to get to the right information. QlikView removes all of that because it takes all of the data and puts it into a format that's actionable. It removes the noise from all the numbers and really focuses on the managing of the business. It easily reports anomalies in the data and most importantly, provides a much clearer picture of what the issues are and their root causes. Most importantly, it provides insight into the future, it shows trends that are developing in many cases before problems are created allowing management to "manage" as opposed to react.

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Restaurant Science

by Kevin Ley

How Angelo Gordon uses proprietary data to help its restaurant portfolio companies win

Benihana: The Japanese restaurant chain was recently acquired by Angelo Gordon, which uses 'mind-blowing' data tools to help chains be more strategic with each location

EVERYONE KNOWS THE THREE MOST IMPORTANT factors in real estate are location, location, location. That's especially true when you're looking for a restaurant space. Whether Anthony Bourdain is consulting on your menu or you're carving slices off a slowly twirling hunk of mystery meat, your location will determine if you succeed or fail.

Traditionally, choosing a spot has involved equal parts shoe-leather research and luck. Private equity firm Angelo Gordon is working to turn the search into a science. The data it deploys in the service of its restaurant portfolio companies is a good example of private equity firms bringing solutions to middle-market companies.

The privately held firm manages $24 billion and the restaurant industry is an increasing area of focus. To improve its expertise in the field, in 2009 Angelo Gordon hired Richard Leonard as managing director of private equity and special situations. Leonard was previously at Bruckmann, Rosser, Sherrill & Co., where he built a reputation for helping grow a variety of restaurant concepts, including Corner Bakery and Bravo Brio.

Leonard said many management teams, asked why a particular restaurant or store in their fleet is underperforming, can offer only a general explanation, not analysis. Leonard's group has developed an algorithm that combines several off-the-shelf software programs in an effort to add a degree of predictability to a location search.

"You've got millions and millions of data points that are updated very frequently. And it's not just demographics. It's where the competition is, what the particular location characteristics are," he said. "Can you see the sign? How many parking spaces are there? Who's the nearest competitor and where is he? Is there a good school in the neighborhood? We look at the existing stores in the system and see what made one successful and one not successful. The range of data involved in this is mind-blowing."

‘The range of data involved in this is mind-blowing’

Dealing in Demographics

Among the multitude of data, Leonard places particular importance on demographic information. Do people live, work and shop in the area? Who are they? Where are the competing restaurants? “When you think about restaurants, one of the key things is you don’t want the customers to drive past a competitor to get to you,” he said. “If you’re in a commercial area on a fairly busy road and people are driving home and thinking about where they want to go for dinner, you’d rather they come across you first.”

Other critical data points include whether there are shopping centers nearby and, of course, parking. “Parking has for many years been very important,” Leonard said. “For example, a singles-oriented concept is going to need more parking spaces than a family-oriented concept. And if you’ve got a requirement for more parking spaces, you’re going to find fewer sites and pay more in rent to get them.”

Leonard’s information comes from a variety of sources, including publicly available demographic and traffic-flow information as well as third-party databases that report who lives where. The use of this location software was originally viewed as a novel concept at Angelo Gordon, but Leonard’s track record spoke for itself.

> **‘Whenever we go out for dinner I’m asking too many questions’**

One success there was Logan’s Roadhouse, which saw dramatic improvement in new-unit performance after Leonard applied his algorithm. Bruckmann purchased the chain’s 143 restaurants in 23 states for $486 million in 2006. It sold Logan’s Roadhouse to private equity firm Kelso and Co. in 2010. By then it had added 40 locations and reported sales of $535.5 million for the previous fiscal year.

Growing a Hot Chain

Leonard is now hoping for similar success with North Carolina-based Firebirds Wood Fired Grill, which was acquired by Angelo Gordon in April 2011. The chain has 21 units in eight states—typically in “lifestyle centers” and strip malls—and is looking to expand and become a national player.

It’s too early to say if Leonard’s program can find the locations necessary to make that happen. Benchmarks he’ll be watching include sales-to-investment ratio, which should be 1:1 or better, and ROI, which should be at least 30 percent. Logan’s Roadhouse was opening new units in the mid-20-percent range before implementing Leonard’s program. Afterward that number jumped to the mid-30s.

“Some companies, as they get more mature, are running out of places to build, so you’ll have cash-on-cash returns in the 20s or high teens. And that’s not good enough growth,” he said. Rapid growth in a restaurant portfolio can tax a firm’s resources, though, and Leonard’s program is designed to assist there as well. “If you were used to opening five stores a year and now are opening 30, unless you have a giant real estate department you’re probably not spending the time to think about where these stores are going. The algorithm can help with that.”

But Leonard knows his algorithm can’t do everything. “These systems aren’t foolproof. When you walk into a store of a competitor, ask the manager things like how do they like working there, do they get good volume and traffic, how does this store compare to the others in their system? By and large they will be forthcoming about that information—and though it’s anecdotal, it’s important.”

Sometimes Leonard takes it too seriously. “My wife is a good sport, because whenever we go out for dinner she finds I’m asking too many questions.”

Series / Solutions Capital in the Middle Market

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