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The New Era of PE Operations

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The New Era of PE Operations

Key Findings

1. Operating platforms differ from firm to firm—and differentiation is critical to winning deals
2. The days of pure financial engineering to generate returns are over—firms now need specialized skills
3. Operating partners are increasingly involved in deals from the outset
4. The operational approach should be suited to the portfolio company
5. Management teams must take ownership of the firm's plan if the plan is to succeed

The Panelists

Dave Noonan
National Director, Private Equity Consulting RSM

Frank Schiff
Managing Director MidOcean Partners

Steve Stubitz
Operating Partner The Riverside Company

1. Operating platforms differ from firm to firm—and differentiation is critical to winning deals.

The operating platform is now among the most vital assets at any private equity firm. It plays a crucial role from acquisition to exit. "It works with the deal teams to help out in due diligence to make sure we buy right," says Steve Stubitz, operating partner at The Riverside Company. "It participates in portfolio monitoring. And—you hope you don't get to this part—when companies get in a bit of trouble, it's usually the operating partner that's the quarterback in determining what mix of resources we need to fix the company."

Different firms structure their operating platforms differently. MidOcean Partners uses "management affiliates" to perform the functions outlined by Stubitz, an arrangement derived from the firm's origin as a spinout of Deutsche Bank. "It was difficult for us to compete with the bank's own sponsor clients," says Frank Schiff, a managing director at MidOcean. "So we had to figure out ways to differentiate ourselves in the marketplace. And one of the ways we did that was to surround ourselves with management affiliates to make us more attractive to management teams."

This sort of marketplace differentiation is now critical, Schiff adds, because deals are no longer all about dollars. They're about knowledge and a firm's strategy for the companies it targets. "All of that's important, and it's dictated largely by guys at the table who have been there before and can appeal to management teams," Schiff says.

Dave Noonan, a national director of private equity consulting at RSM, notes that his firm works with some private equity clients that have no operating back-ground and rely completely on management teams to provide the execution, which can work in certain in-dustries and types of funds. "And then there's a hybrid approach," he says. "We work with a lot of firms that outsource their operating team out of a very specific vertical with specialists who bring expertise to a very specific type of transaction."

2. The days of pure financial engineering to generate returns are over—firms now need specialized skills.

Most private equity firms have reached the conclusion that the days of generating returns via financial wizardry are done. "Now you have to buy smart, you have to run right, you have to sell right—and you need a certain type of professional for each phase," Stubitz says. "Depending on what the business needs, you may need some specialized skills to fix up a company. You may have some of those skills in-house. You may have to go outside to get those skills. And that's where a seasoned operating partner can really help drive returns."

With the amount of money in private equity these days, there is tremendous pressure on firms to put capital to work. They simply don't have the luxury of waiting for the perfect deal to come knocking on their door. "You have to chase a lot of companies to find a few needles in the haystack that'll generate outsize returns, and some of those require some fixing up," Stubitz says.

It's more important than ever to involve operating partners in that chase, Schiff adds, because they're the ones who truly know an industry inside and out. "Management affiliates or operating partners give us a lot of conviction around paying a price in a competitive market," he says. "They give us the confidence to go ahead

Steve Stubitz, The Riverside Company

Demoting the CEO

The second-hardest thing in private equity is replacing a company founder. The hardest is convincing that person to stay with the company in a lesser role. "Sometimes you have a brilliant founder who is no longer capable of running the business because the market has changed, the product has changed," Stubitz says. "You need a strategy to bring in somebody new to run the business yet retain the skill of the entrepreneur and keep him involved in the business." Stubitz recalls a portfolio company that made industrial boilers for educational institutions. The business had been founded by a savvy entrepreneur but, after the initial growth phase, had started to lose its way. "We had the hard discussion with the founder," Stubitz says. "The brilliant thing is, we convinced him to be the head of product developmenwt, which he was actually very good at. We brought in a seasoned CEO, and within a year the business turned around dramatically. It's now one of the top performers in our portfolio."

Inside Job

Every private equity firm relies on operating advisers for guidance. Some of the best advisers will actually go in and run a portfolio company. MidOcean called for insider help when it acquired a company called Pre-Paid Legal Services in 2011. Pre-Paid Legal sold its services via a direct-selling model, and MidOcean had access to advisers who specialize in the field. "We would not have done the deal without our management affiliates," Schiff says. "This company had been largely losing members over the past five years and was in an FTC investigation at the time. But our advisers gave us the confidence that everything was going to be fine, which indeed it was." The first order of business was replacing the Pre-Paid Legal founder and installing a new management team, which in this case consisted of MidOcean's operating advisers. "When you put in your own operating partners, it changes the dialogue," Schiff says. "They're not just regurgitating answers to me. Instead it becomes a conversation. Since that time, they've stabilized operations, and we're actually growing again."

and buy that company with a plan to take it toward execution."

3. Operating partners are increasingly involved in deals from the outset.

A successful exit depends more than ever on a smart entrance. That's why many firms now bring in operating partners during the bidding process. Their industry knowledge is invaluable.

"We get involved in transactions earlier and earlier," says Noonan, "sometimes before the letter of intent is even completed, to help identify those areas where economies can be driven and value can be created. On the other side, we try to come up with what the risk components are in that transaction and come up with a plan to help mitigate those risks to the point where it has an impact on the purchase price up front."

This gives firms the opportunity to buy smarter and with the understanding that they have a way to take advantage of the investment thesis as they have laid it out.

4. The operational approach should be suited to the portfolio company.

A lot of executives at companies acquired by a private equity firm have no idea what to expect. In these cases, the deal goes more smoothly if the operations team is involved at the outset, sitting in investment committee meetings, getting to know management, and developing rapport.

"That's a differentiator in how we view the company and the space and build up a basis of knowledge," Schiff says. "We have to be more than dollars-to-management. We have to be their true partners. To do that, we have to share knowledge, and that often comes from an operating partner or management affiliate. For all the deals we're able to complete, we feel the management affiliate is added value. And the management team has to feel that as well."

Companies new to the private equity process need to be assured that the acquiring firm will drive success, and involving operating partners early is important in doing that. At the other end of the continuum are those companies where the management team has been there and done that.

"There are firms that are very laissez-faire with regard to even having an operating partner interface with management." Noonan says. "And that can work out really well in cases where the management team is well-heeled, may have been through a private equity transaction in the past, and understands the pace and complexity and the endgame that private equity brings to the table."

But not every company runs perfectly to plan, where the GP can check in every quarter and then disappear again. "You'd love to have a whole portfolio of companies like that. But that's not reality," Stubitz says. "We have companies across the spectrum. We have some that execute very well and have a light touch from the operations group. We have ones that struggle a bit and need more intense focus from the operating group."

5. Management teams must take ownership of the firm's plan if the plan is to succeed.

Management buy-in is essential to the success of any deal. So how does a firm ensure that it happens? "Whatever you come up with, it has to be their plan," Stubitz says. "You never want to get into the situation where the management team feels, 'Well, that's Riverside's plan.' When you get to that point—whether you want to admit it or not—you're essentially running the company."

He says Riverside has a set of tools, templates, and techniques to help management teams develop a plan. But in terms of objectives, outcomes, and milestones, the firm leaves those up to management. "We may insist on a certain reporting structure, but at the end of the day, we want to make sure that it's their plan and they buy into it."

Buy-in is not always easy, though. Schiff says MidOcean Partners regularly encounters management teams that are skeptical. "Remember, this is a management team that's been left to execute without someone looking over them, so we have to prove our worth," he says. "We have to prove that we're value added to their process. If we don't do that, there's little incentive for them to ever come on board with us. We have to show why we're going to add value to the process, and they have to believe it." ◆


Dave Noonan, RSM

Balancing Act

As a private equity industry adviser, Noonan has seen it all. He's seen GPs who walk the factory floor every day to check on their investment. And he's seen GPs who phone it in because they have total faith in their management team. Noonan believes there is not necessarily a right or wrong approach. Every company must be handled according to its needs. But he agrees that the intensity of communication between a private equity firm and a portfolio company depends on how well the management team is executing. Obviously the worse the team is doing, the more closely the firm should be involved. "I've seen some command-and-control-type relationships in special or distressed situations that really require a stronger operating group to come in and provide deeper oversight to make sure that you can realize benefit from the transaction," he says.

Expert Q&A

with Dave Noonan
Managing Director
W. P. Carey

What is unique about the RSM offering to pri-vate equity firms?

Our private equity value-creation program was based on the fundamental issue that private equity firms are in the business of buying companies, creating value during a whole cycle, and selling those companies for a profit and a return to their limited partners. The services we've put together to address that market revolve around things we provide day-to-day in a commercial marketplace, whether it be expertise, functional expertise, vertical experience, technology, or methodology—those types of things we're well-versed in throughout our consulting organization.

We've simply applied those resources very strategically, either at a point in time in the investment cycle, or for specific types of transactions where we can extract the most value for our private equity clients through that service offering.

What are some services RSM leverages for private equity clients?

It starts with things that happen pre-LOI or pre-deal—everything from quality of earnings reporting to tax due diligence, IT and operational due diligence, and even rapid assessments on a market feasibility for a certain asset that a private equity firm is thinking about acquiring.

When you get into the deal side, the transaction side of it, we focus more on process innovation, performance improvement, solutions, technology solutions, and infrastructure solutions that can allow that asset to build a foundation for future growth.

As you go through the pre-divestiture cycle and get closer to the time when you're going to exit, the services revolve around how you apply those same assets at a different point to impact the enterprise value shortly before sale.

Series / Inside the PE Operating Function

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- What Makes a Solid Operating Platform
- Management Buy-In: The Key to Operating Value-Add
- Operations in an Underperforming Portfolio Company

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