

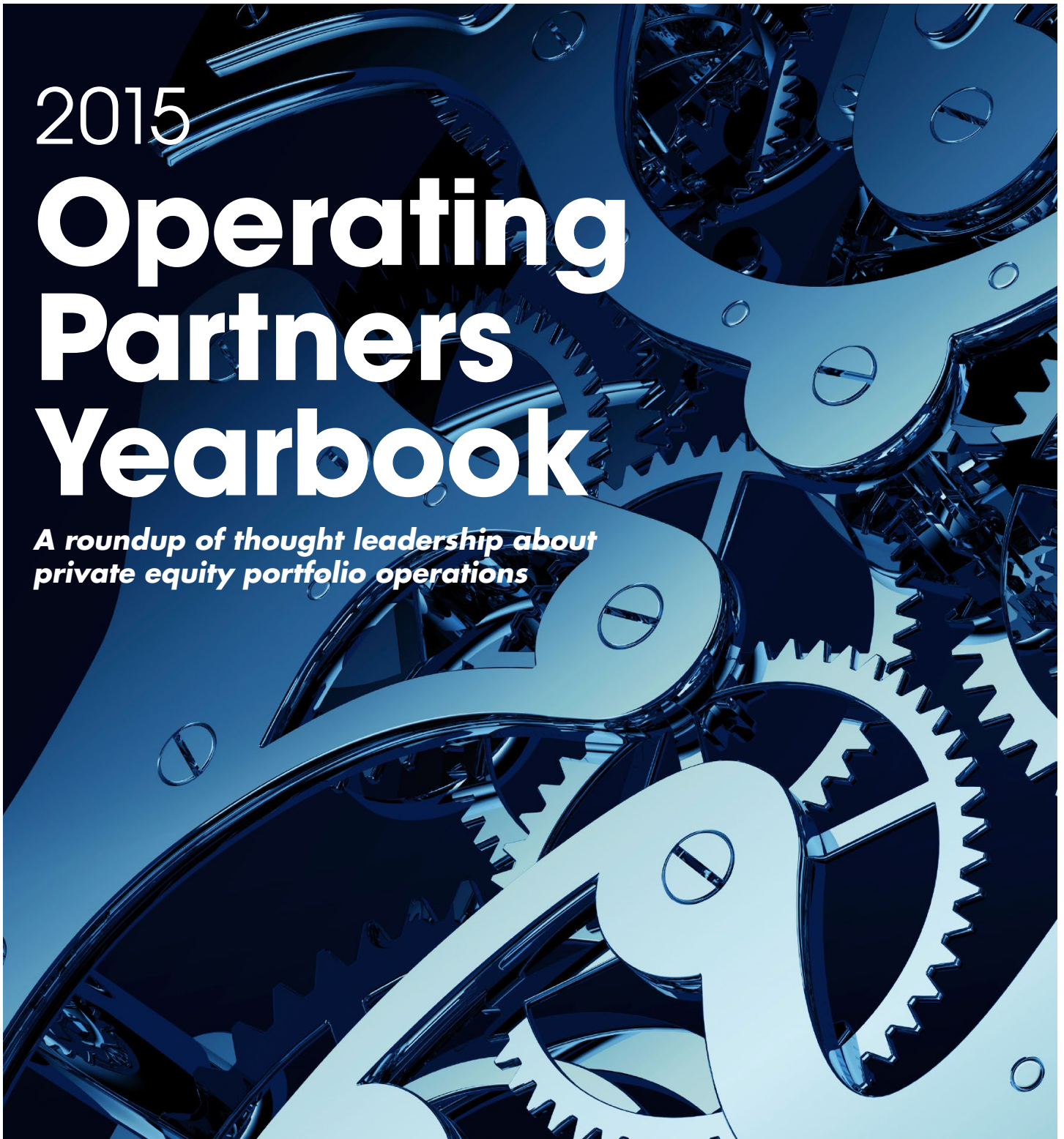
PRIVCAP REPORTS/

In Partnership with



2015 Operating Partners Yearbook

*A roundup of thought leadership about
private equity portfolio operations*



“In difficult times, the operating expertise that we have really comes into play... We get to make investments that perhaps we would not have been able to make in a more robust time.”

–Don Gogel, CEO, Clayton, Dubilier & Rice

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Don Lipari
National Private Equity Leader
RSM

Why Operating Partners Matter

The role of the operating partner has evolved greatly in the past decade. As private equity firm leaders have realized that financial engineering is no longer sufficient to produce attractive returns, particularly in the wake of the financial crisis, operating professionals have become an essential part of the private equity investment process.

Today, operational professionals are responsible for a greater component of private equity fund performance than ever before. Operations teams must scrutinize portfolio companies' workings for more efficient ways to run the businesses. They also must look externally for growth, whether that be entering new markets from a geographic or a product category perspective, bolt-on acquisitions, or new applications for an existing product or service. Increasingly, operating partners drive these strategies.

At RSM, we know just how important operating professionals are to the private equity sector. Our private equity practice works shoulder to shoulder with private equity firms and their operating partners at every stage of the portfolio company improvement, starting with pre-investment due diligence work, where we help firms assess risks and opportunities.

From there, our program is designed to positively impact fund-level value by enhancing enterprise value of individual portfolio companies. With our depth of solutions, global capabilities, and experience, we are able to strategically apply our services to provide maximum value at any point in a fund's life cycle.

As operating platforms continue to evolve, and as the role of operating partner continues to evolve with them, RSM will be there to act as a partner in improving portfolio company performance. We hope you enjoy the inaugural *Operating Partners Yearbook*, which offers a wealth of insightful views on the successful integration of operating partners into private equity firms. ■



Ainslie Chandler
Managing Editor
Privcap

Introducing the 2015 Operating Partners Yearbook

Welcome to the *2015 Operating Partners Yearbook*. Of the vast range of global private equity–related topics covered by Privcap since our launch, the rise of the operating partner is among the most popular with our global audience of private equity professionals.

This isn't surprising—the operating function within private equity firms has become the driver of portfolio company performance and, by extension, of returns. Without strong returns, private equity recedes as an asset class.

Proudly produced by Privcap in partnership with RSM, this report taps into Privcap's extensive network of experts who provide comprehensive intelligence on issues relating to the role of the private equity firm operating partner.

The yearbook features fascinating insights from key private equity professionals and consultancies—including experts at Bain Capital, Siguler Guff, Baird Capital, Clayton, Dubilier & Rice, The Riverside Company, Sun Capital, Korn Ferry, and RSM—who explore topics such as how operating professionals add value at portfolio companies, what a career as an operating partner looks like, and how limited partners conduct due diligence on a PE firm's operating team.

For more insights into the world of the private equity operating partner, be sure to watch out for Privcap's ongoing coverage of the rapidly evolving field throughout the year.

Enjoy the report. ■

Privcap: You were in charge of the recent exit of Emerald Performance Materials. How did you originally source the opportunity, and why were you attracted to that deal?

Mezzanotte: Emerald Performance Materials was assembled from five business units that we acquired from Lubrizol in 2006. They were fundamentally good businesses, just under-invested and, we felt, under-managed.

How did you and your team execute on a plan to improve the business? And is that indicative of the way Sun Capital typically forms a team to execute a deal?

Mezzanotte: Our approach at Sun with Emerald was pretty standard from our playbook. Our deal team sources these acquisitions. Once they're in the fold, we have an operations team—which comprises, in total, about 20 percent of the population of Sun Capital—that begins to engage with the acquired business.

How was it structured?

Mezzanotte: I'm the operating managing director on the account, but in the beginning there's a managing director from our transaction team that leads the actual acquisition. That same person will be around at the end when it's time to do the divesture. I am the air traffic controller for that interim period while we're trying to grow value at the company.

How much communication do you have with the transaction partner before the deal is closed?

Mezzanotte: It depends on the particular deal. Sometimes we interact



David Mezzanotte, Sun Capital

Operations in Action

Sun Capital managing director **David Mezzanotte** tells Privcap about the firm's most profitable exit to date, the 2014 sale of Ohio-based chemicals group Emerald Performance Materials, and how the firm's operational expertise contributed to the deal's success.

"I am the air traffic controller for that interim period while we're trying to grow value at the company."

—David Mezzanotte, Sun Capital

Mezzanotte joined Sun from logistics services giant CHEP International, where he served as COO for three years. He previously spent six years with AlliedSignal/Honeywell in a variety of executive roles and spent 15 years with E.I. DuPont. He holds a Bachelor of Science, a Master of Science, and a Ph.D. from the University of Notre Dame.

with them in the due-diligence phase, sometimes not. We're so busy on the operations team, working with our more than 60 portfolio companies, that we don't have a lot of time to be involved in due diligence.

You have mentioned that one of the most important things you did was to restructure these various divisions. What does that mean, and how was that executed?

Mezzanotte: With the five business units that we acquired, we realigned those into four strategic business units, made sure we had solid management teams responsible for each of those four, and then we immediately started to look at what they produced, where and how. For each of those, we either exited them or we increased prices to the point where it made sense to keep them in the portfolio.

You mentioned the drivers of success, but how was it that all of the stars aligned for this deal?

Mezzanotte: It really is attributed to the hard work that we put in with the company around restructuring and investing at the appropriate time, and in the appropriate locations for growth. There probably was some good fortune involved. The product that we chose to invest most aggressively in is called K-Flex, a non-phthalate-based plasticizer. Phthalates have some environmental issues, so slowly but surely, the world is shifting from phthalate-based plasticizers to non-phthalate-based plasticizers. In 2011 and '12, we authorized two major capital projects that came online in '12 and '13, at a total cost of about \$25M. These investments doubled our K-Flex capacity, and they have subsequently been sold out. ■

Smooth Operators

Three private equity operating partners open up about their role in the world of private equity, how compensation is structured, and their relationship with deal partners.



Don Charlton
Operating Partner
Argosy Private Equity



Fredrik Henzler
Co-head of Industry Value Creation
Partners Group



Ron Sansom
Managing Partner
Global Executive Operating Partner
The Riverside Company

Privcap: Fredrik, how is the operating team at Partners Group structured?

Fredrik Henzler, Partners Group: We are a team of 21 operating professionals organized in six industry verticals, and we spend about a third of our time in the investment process, alongside the investment team looking for companies, doing due diligence on the companies, developing an investment thesis and aligning it with the management, then winning management over to sell their company. Two-thirds of our time is spent implementing the investment thesis alongside the management team, given the holding period.

Don, does that sound similar to Argosy?

Don Charlton, Argosy Private Equity:

I think it depends on the size of the private equity firm. We are a lower-middle-market firm, so we are typically buying from founders and sellers who started the business. Our operating partners are allowed to source and work deals. In most traditional private equity firms, there's segmentation: There's a deal partner, there's an operating partner, and they play at different segments along the deal process.

Ron, how is the operating function structured at The Riverside Company?

Ron Sansom, The Riverside Company: We're involved from the beginning of the investment through the exit process. We help determine what investments to make;

we're involved in the whole period—the diligence period and then in the exit period—then we back off a little bit, and the deal partner takes over. On the other hand, we do work to get the SIM right, and we work with the management team to get them prepared for the presentation.

How has the role of operating partner evolved? Are you actively out sourcing deals?

Charlton: I would say the operating partner sourcing is not typical. But it makes a lot of sense. Most of the operating partners sitting here at the table have operating experience; we run companies, we've started companies. That's a big asset when you're up front trying to get a deal, or sitting across the table from an owner

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“Every investment is different, but you live off processes; there are always processes you can put in place to make your investments better over time. I’m a huge believer in getting these processes set up within your firms so that you have some consistency.”

—Ron Sansom, The Riverside Company

who started something from their garage and you can identify with some of the things that he or she went through.

Sansom: If you went back 20 years, most operating partners came in when a company’s in bad shape and needs help. In that timeframe to the present, it’s evolved to where operating partners are now involved from the beginning of the investment all the way through the exit. Our operating partners don’t originate either, but we have an entirely separate deal-origination organization. We do go along on first visits, which adds credibility.

Charlton: One of the ways it’s evolved is from the LP perspective. I attended an operating partner conference with an LP panel, and they spoke about the need for firms and GPs to talk about their operating resources. It didn’t used to be that way, but LPs looking to invest in funds are asking about methodology.

Fredrik, is your team helping to shape the macro view of the firm, even before certain companies are looked for?

Henzler: As a global company, it’s important we know which region we like, which industry we like, and where we want to be overweight. We also want to find out which segments and subsegments of the industry we’ll want to work with.

When your team is brought in to meet with potential sellers, what questions do they ask? Do they

take comfort from the fact that you are on the team, post-acquisition?

Henzler: We like finding a regional champion and then helping them expand globally. They often know their niche markets well, but they feel they need assistance stepping into a new region.

Having somebody begin to talk through what challenges we will face, and the success stories we can create together, makes it more tangible. This can be critical in getting the buy-in from founders and managers.

It’s important for operating partners to feel they’re part of the team, but then there’s an actual alignment of interest with the rest of the firm. How are operating partners economically brought into the deal?

Charlton: Some firms treat the function separately, but I think the majority [of operating partners] are going to be included in the equity carry of the fund. That’s the way it is at our department.

Henzler: The first operating partners often weren’t part of the company; they were external freelancers or kept as consultants outside of the GP. Then they started getting hired and put onto the cash and bonus, and later they got carry in their deals.

Most operating partners come from corporate backgrounds and are plugging into private equity firms

full of people with a banking or financial background. Are there clashes?

Charlton: As it relates to deal partners—whether they’re accepting of operating partners—I’d say they’re receptive. I respect their involvement in the banking field, although I didn’t come from banking. I was in startups for 12 years before I joined this firm. These operating partners respect that we’ve run companies, and they leverage that experience.

Sansom: The deal team and operating partners really have to work together. If you don’t, then you have a serious issue within your firm. We’ve never had much of an issue within Riverside.

Henzler: It’s important for the long-term success of an operating partner that you’re seen as peers and integrated into the private equity team.

Sansom: There will always be some tension now and then between a deal partner and an operating partner. The key is to work through those issues like any professional deal team would, whether it be in corporate America or private equity.

Henzler: The tensions can be valuable, because they flush out the problem you didn’t think about. They can make you focus on an issue and find a solution that wasn’t there. ■

Finding Strength During Economic Weakness

Don Gogel, CEO of Clayton, Dubilier & Rice describes how operating partners helped the firm's portfolio companies prosper in an economic slump



Don Gogel, Clayton, Dubilier & Rice

Privcap: What were some recurring themes your operating professionals encountered, in an exceptionally weak economy, as you attempted to improve your portfolio's performance?

Gogel: In difficult times, the operating expertise we have really comes into play. As a result, we see different opportunities. We get to make investments that perhaps we would not have been able to make in a more robust time. I say that because in a period like this, even some of the best-positioned companies are going to suffer reversals in performance. As a result, the valuation of those companies is going to be diminished—and, of course, not only on a multiple basis, but also the base of earnings on which you're able to buy the company is depressed.

Now, seeing through that and believing that there will be a recovery, both in the broader economy and in the fortunes of the indi-

vidual companies, is what makes private equity exciting.

We have invested pretty steadily through this last cycle, about \$1B a year each year for five years. That's what we had hoped to do in our 2009 fund. But even in these difficult times, we're able to put money to work if we have an operating executive who can help us recognize what we will do if we own a business. That's not an idle question. There's a lot of scrutiny on that assessment. The operating partner has the responsibility, and takes it very seriously, to deliver the results that he and the management team are committing to us.

During the downturn, your firm did a large number of deals of a certain type, and the selling corporation retained a significant stake in the business and turned over the keys to your firm. Why was that format appropriate at the time?

Gogel: In a difficult period, a number of businesses that might have been put out to market in a more typical auction could not really withstand the scrutiny, because they didn't have the results. It's very hard to sell a business when it has declined in both revenue and profitability over a year or two-year period. The deal flow just slowed down. The corporate seller was struggling with valuation concerns.

It was a time that required some innovative deal structures. Fortunately, we had the reputation of being corporate-friendly, of being

operating executives that could work closely with good-selling corporations.

We proposed transactions in which the selling corporation would retain anywhere from 41 to 49 percent of the total equity. We'd pay what we thought was a fair price on the earnings of the company that day. But both we and the selling company recognized that if we fixed this business and really ride a bigger steep curve up to profitability, there'd be a total valuation return several years down the road that would meet the seller's expectations.

The key to it is we needed an operating partner who could convince the selling company and its CEO and its board that we could do better with this business than they would be able to do alone. How could that be possible? Well, it's simply a matter of focus. That's the magic of private equity. We bought some of these businesses from parent corporations that have 100 strategic business units. We put all of our intention into making three investments a year, and we have very talented people to do that. ■

Gogel is Clayton, Dubilier & Rice's Chairman and Chief Executive Officer. He has been with the firm for more than 25 years and previously served as a partner at McKinsey & Co and a managing director at Kidder, Peabody & Company. He holds degrees from Harvard College; Balliol College, Oxford University; and Harvard Law School.

Notable Quotes About Operations

PLATINUM'S EIGHT-YEAR INDUSTRIAL ODYSSEY

Following an eight-year holding period, Los Angeles private equity firm Platinum Equity announced the exit of Acument Global Technologies, a company which provides mechanical fastening products to the transportation market. The company was sold to Italian manufacturer Fontana Gruppo.

Platinum acquired the company in 2006 from Textron Inc., but the investment did not go as planned. According to the firm, beginning in 2008, Acument “faced rapidly falling revenue caused by economic dislocation and steep declines in global automotive production. Platinum Equity worked with Acument management to develop and execute a global restructuring initiative.”

A number of Platinum executives weighed in on the operating plan and execution that allowed Acument to survive and thrive through a very difficult economic period.

“Acument is a healthy, thriving business today and will be a great fit within Fontana’s portfolio. Like many automotive suppliers, the company faced a lot of ups and downs over the past eight years. This successful outcome reflects the hard work done by the people at Acument and is a testament to Platinum Equity’s ability to steer its portfolio companies through good times and bad.”

–Platinum Equity partner Bob Wymbs

“At a time when a lot of suppliers were going out of business, we buckled down and made some difficult but necessary decisions in order to survive and ensure continuity of supply. Acument aggressively scaled its cost structure while working closely with customers, lenders, and other key stakeholders to stabilize the business.”

–Platinum Equity partner and president of portfolio operations Bryan Kelln

“Acument emerged from the crisis a much stronger competitor in the fastener industry, with a healthy balance sheet and an even greater focus on operational performance and customer service. As a result, we were well positioned to invest in and grow our transportation businesses going forward.”

–Acument CEO Patrick Paige

Andy Kerner found his way to private equity firm SunTx Capital Partners by chance, after working for a series of companies as chief financial officer.

He had retired from his work in financial positions and was working in the nonprofit sector of affordable housing when he went to a golf tournament in Oklahoma and met SunTx founder and managing partner Ned Fleming.

"We started talking, and in December of 2009, I took an office at SunTx without knowing exactly what I was doing," Kerner says. He had a wealth of experience from working in the PepsiCo organization and subsidiary Frito Lay, along with Texas-based Centex Homes, as CFO.

"I was a very hands-on operational CFO," he says. "I'm not an accountant by trade. I've run very large financial organizations for many companies with a strategy and operational element."

His first task for SunTx was looking at Carolina Beverage Group, a potential investment. It eventually became a portfolio company in the summer of 2010, and Kerner stepped into the operations side of the business as a director, working side by side with management. "That was a great deal, very traditional equity and bank debt on that one," he says. Working at Carolina Beverage was "right in my wheelhouse," he adds, because of his work experience at PepsiCo.

The SunTx partners then asked Kerner to take on an expanded role within the firm, with a new title of

Translating Financial Operations to PE

When **Andy Kerner** was invited to join **SunTx** as an operating partner, he wasn't sure what the position entailed. He soon found that his experience as a veteran CFO had prepared him for the job.

"We pay the managers to do their job and don't want to creep in to tell them how to do their job. What I've found is, that requires a heavy dose of relational skill sets."

—Andy Kerner, SunTx

Kerner previously held senior executive and financial management positions at Centex Homes, and CFO roles with the vialink Company and Cameron Ashley Building Products. He also had senior financial executive roles at PepsiCo and unit Frito Lay in the U.S. and Europe. He has an M.B.A. and B.A. from the University of Texas in Austin.

operating partner. Kerner became chairman of Houston-based Ranger Offshore, a subsea construction and diving company that works in the offshore oil and gas business, helping build new pipelines and facilities and maintaining and repairing existing ones, performing inspections, and doing decommissioning work.

SunTx acquired Ranger in early 2010. "It was a small shallow-water diving business," he says. "It's now one of the most highly certified diving businesses in the world, and we've expanded our operations to deeper waters and to international markets."

Kerner says being "a financial guy by trade" has been helpful in his transition to operating partner. "It's a great role," he says. "I don't think it's for everybody. You need to be a jack-of-all-trades."

The position also requires understanding the fine balance of dealing with the existing managers at portfolio companies. "We pay the managers to do their job and don't want to creep in to tell them how to do their job," he says. "What I've found is that requires a heavy dose of relational skill sets."

The founders of SunTx had operations backgrounds, Kerner says, and that is a focus for the firm. The current CFO at Ranger Offshore was previously an associate at SunTx, and Kerner mentored him to take on the position. He says that having operations knowledge is valuable in the world of private equity deals.

"If you're going to be a deal person, an understanding of how to run a company is critical," Kerner says. ■

SEC: Careful How You Pay for Operations



Andrew Bowden, SEC

One of the most closely watched trends in private equity operations in 2014 was the SEC's stated scrutiny of how private equity firms pay for the operating talent and resources they deploy at the portfolio level. The issue was highlighted in a speech given by SEC director Andrew Bowden at an industry conference in May. Below are excerpts from that speech.

// Within OCIE [Office of Compliance Inspections and Examinations], we have been sharpening our understanding of the private equity industry and our strategies to engage with you to fulfill our important mission to protect investors and the integrity of our markets....

"We believe that most people in the industry are trying to do the right thing—to help their clients to grow their business and to provide for their owners and employees. We therefore believe that we can most effectively fulfill our mission to promote compliance by sharing as much information as we can with the industry, knowing that people will use it to measure their firms and to self-correct where necessary. Put another way, we are not engaged in a game of 'gotcha.' ...

"A private equity advisor typically uses client funds to obtain a controlling interest in a non-publicly-traded company. With this control and the relative paucity of disclosure required of privately held companies, a private equity advisor is faced with temptations and conflicts with which most other advisors do not contend. For example, the private equity advisor can

instruct a portfolio company it controls to hire the advisor, or an affiliate or a preferred third party, to provide certain services and to set the terms of the engagement, including the price to be paid for the services...or to instruct the company to pay certain of the advisor's bills or to reimburse the advisor for certain expenses incurred in managing its investment in the company...or to instruct the company to add to its payroll all of the advisor's employees who manage the investment.

"We have seen that these temptations and conflicts are real and significant....

"Many limited partnership agreements are broad in their characterization of the types of fees and expenses that can be charged to portfolio companies (as opposed to being borne by the advisor). This has created an enormous gray area, allowing advisors to charge fees and pass along expenses that are not reasonably contemplated by investors....

"By far, the most common observation our examiners have made when examining private equity firms has to do with the

advisor's collection of fees and allocation of expenses. When we have examined how fees and expenses are handled by advisors to private equity funds, we have identified what we believe are violations of law or material weaknesses in controls over 50 percent of the time.

"This is a remarkable statistic.... Some of the most common deficiencies we see in private equity in the area of fees and expenses occur in the firm's use of consultants, also known as 'Operating Partners,' whom advisors promote as providing their portfolio companies with consulting services or other assistance that the portfolio companies could not independently afford. The Operating Partner model is a fairly new construct in private equity and has arisen out of the need for private equity advisors to generate value through operational improvements. Many limited partners view the existence of Operating Partners as a crucial part of their investment thesis when they allocate to private equity funds, largely because the Operating Partner model has proven to be effective." ■

Franchise Fast-Forward: How Riverside Grew AIA

The Riverside Company's Ron Sansom tells Privcap about his firm's investment in promotions and marketing group AIA Corporation



Ron Sansom, The Riverside Company

What first attracted Riverside to the opportunity to invest in AIA?

Franchising is one of our specialties; we're always looking for businesses in various sectors, and our origination team contacted a parent company in the U.K. about selling one of their units. The chairman was thinking the same thing and asked David Woods, the CEO he brought in to turn the unit around, if he wanted to sell the company. He said he needed a partner and financing, and a deal was formed after meeting with them.

The company hadn't sold any franchises for several years because of internal issues, and it was unprofitable, so they brought in a CEO to turn it around. Then it began making money, and we thought it would be a good investment.

These are small companies, so we're not sitting back from 100,000 feet. We

established our operating rhythm, with monthly reviews, quarterly board meetings, annual strategic plan updates and talent review, and a budgeting process.

David was looking for some marketing people on the board, so we added one, along with someone who knows the franchising market exceptionally well. After fixing a technical issue, we were able to start selling franchises again.

The owners or franchisees were struggling with our enterprise system, and providing a portal for them to work with our providers and to ship and input orders is really the key to what AIA does. We spent about \$2M, but it's now one of the best proprietary systems in the industry.

Then we got the sales machine going. In the beginning, it was an inbound situation where we would generate leads, but we started doing an outbound calling effort. We grew system-wide sales at a double-digit clip through our ownership, other than a dip during the recession. We exited this company in the third quarter of 2013, and it was wonderful.

We got lucky with strong management and leadership. It's one of the few cases where we didn't change anyone out: David Woods was CEO, Tom Lehr was CFO, and they stayed. We upgraded a bit along the way, but there was good leadership, good strategy, and it worked out well for everybody. ■

“The owners or franchisees were struggling with our enterprise system, and providing a portal for them to work with our providers and to ship and input orders is really the key to what AIA does. We spent about \$2M, but it's now one of the best proprietary systems in the industry.”

—Ron Sansom,
The Riverside Company

Creating Carve-out Success

How companies can use a phased approach to help get off a transition services agreement faster and to optimize their growth. By **Dave Noonan, Tom Byrne,** and **Bob Jacobson** of RSM

How did a private equity firm save nearly \$5M executing a carve-out of a \$100M retail operation?

It didn't look promising at the outset. When discussing potential strategies with an IT services provider, the provider proposed a nine-month implementation cycle to develop an industry-specific customized IT platform for the new stand-alone company. Meanwhile, the firm would be paying \$800,000 per month on the transition services agreement (TSA), or \$7.2M for the nine-month plan.

Instead, the firm decided to take a phased approach. It implemented baseline operational functionality such as order entry, receiving,



shipping, and financial reporting in 12 weeks, ended the TSA, and later added custom functionality. The cost of the 12-week implementation was \$1.8M, but it saved \$4.8M by shaving six months off the TSA.

Private equity firms executing carve-outs in the middle market have the same primary objective as with all their portfolio companies: optimize exit price within a limited timeframe. For carve-outs, that means removing dependency on the TSA as quickly as possible. All too often, however, firms take an "all or nothing" approach, with a flurry of activity starting midway through the exclusivity period to develop customized systems and infrastructure—a risky and expensive process.

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Achieving Balance

To balance risk and practical considerations, private equity firms should instead take a three-phase approach to carve-out execution

PHASE ONE:

Negotiate the Right Terms, Pre-Letter of Intent

Firms are hesitant to invest resources in assessing a carve-out when faced with the risk of not winning the bid. This perspective ignores the risk of winning the bid but severely underestimating the cost of the carve-out execution.

That's what happened to one private equity firm that did a carve-out of a \$40M division of a \$20B company. The firm planned to outsource the division's IT needs and assumed a cost of \$150,000. But the complexity of the business meant that it ultimately paid nearly \$1M for the work. Had the buyer invested in a quick assessment pre-letter of intent, the firm could have negotiated a purchase price adjustment or better terms.

A pre-letter of intent assessment is particularly valuable for firms that have never or only rarely been involved in a carve-out situation.

These firms can fall into a "simplicity trap," where they assume that transitioning off the parent company's infrastructure is a simple matter of setting up a new server or two. Implementing even basic functionality can be difficult when the previously developed processes of the parent

company are no longer in place. When combined with more complex tasks like addressing compliance and privacy issues, a project estimated at \$100,000 can easily cost 10 times as much.

Even more experienced buyers will benefit from starting the process as early as possible. If the likelihood of winning the bid is high, firms can use the assessment as a foundation to begin some light planning and start lining up contracts, which will ensure less time on the TSA and can help buyers negotiate a more favorable TSA with regard to personnel and other factors.

To set the right course for the carve-out, use the time before the LOI to start negotiating the TSA, as well as to articulate strategy changes for the new company. Once the LOI is signed and the TSA finalized, planning for the first 100 days can commence.

PHASE TWO:

Remove Dependency on TSA Post-Close

This phase requires establishing a project management office and executing the 100-day plan, all while focusing on items to get off the TSA—fast.

A management steering committee should provide strategic direction, define targets, align resources, help champion change, resolve issues, and guide results. However, ineffective management teams can be an issue.

In McGladrey's 2013 Private Equity Survey, an ineffective management team was ranked as the most common reason for portfolio companies underperforming, with ineffective strategy or execution a close second. Similarly, management capabilities

and effective strategy and execution were given as the primary drivers of success.

With carve-outs, there are two main concerns: First, the head of a \$100M division of a multibillion-dollar organization may not make an effective leader of a stand-alone or platform company. Second, management may have difficulty changing its mindset about what the "right" systems and processes are. Managers at a \$130M manufacturing division argued that forms and processes needed to be set up in a certain way—one that made sense when they were part of a huge global organization but was needlessly expensive and complex for the division alone.

A smaller internal workforce can also lead to internal control issues, including improper segregation of duties and inappropriate user/data access.

Removing dependency on the TSA quickly often means investing in an outside provider that can provide experienced project leadership and work with management and the private equity firm to establish short- and long-term plans, facilitate and coordinate implementation, guide analytical priorities, allocate resources, monitor progress, and ensure quality. This arrangement also allows management to focus on its core competencies and running the company.

Structured incentives for meeting deadlines will share the benefits of getting off the TSA faster across the entire organization and can have a tremendous return on investment.

While more complex situations will require a longer timeframe, Phase 2 should typically be concluded in less than six months. The money saved by ending the TSA quickly can then be put to use in realizing the value of the investment.

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At the same time, it's important to make plans for the future state of the business. There are numerous software packages and platforms aimed at middle-market companies that can be implemented efficiently at a relatively low cost and then customized as needed.

PHASE THREE: Optimize for Growth Post-TSA

Once the company is up and running on its own, it's time to execute the future-state plan developed in Phase 2. Implement, track, and monitor master plan initiatives to achieve the strategic vision for the carve-out.

A 12-to-36-month performance-improvement plan provides the necessary guidance and benchmarks for optimizing value, but implementing the plan often proves difficult. Respondents to McGladrey's 2013 Private Equity Survey report that management pushback is an issue, as is a lack of internal resources.

When implementing information technology systems to optimize growth, consider cloud-based computing to avoid costly upfront infrastructure investments and to allow for scalability. Software-as-a-service will help keep software applications up to date, potentially increasing exit price. Regardless of the approach, the company should have the necessary internal systems to measure results, avoiding another common roadblock to performance-plan implementation.

Private equity firms must assess management capabilities and determine if outside help is required to ensure the right benchmarks are established, monitored, and checked off in a timely fashion. One approach is to push accountability to managers but still offer suggestions and guidance, either through an operating

partner or outside team, on how to increase efficiency and effectiveness.

Carve-out Project Components

The earlier that private equity firms start the clock, the faster they can achieve success.

Regardless of the timeline, carve-out execution projects have five core components:

- Project mobilization
- Synergy and integration planning analysis
- Development of solutions and business-case preparation
- Detailed design of implementation plan
- Implementation

Throughout the process, effective project, communication, and change management are a must. The critical elements of project management—managing risk, budget and time control, as well as scope and expectations—may overly burden internal team leaders who have other responsibilities. A project management office should be in place to provide overall transition structure and management, bring decisions and roadblocks to the steering committee, and oversee various project teams.

Education, communication, and empowerment are important transition agents for defusing pushback and often require an outside resource that can serve as part of the transition team and as advisors to management, as well as assisting with implementation.

To save time and effort, integrate project management as much as possible. Beyond

technology, the carve-out may need some level of CFO advisory, process-improvement support, financial transaction accounting, risk advisory services, and other assistance.

Investing in the Right Outside Resources

A holistic approach to carve-out execution requires a depth of capability and capacity that private equity firms may not have on staff. Operating partners with brilliant strategic insights and process-improvement experience may need help sorting through the details and providing the necessary level of support to the internal management team, including the CFO.

Too many suppliers can lead to things falling through the cracks, whereas a single provider can think through the interdependencies of different items. A provider focused on handling all of the carve-out needs, in contrast, will be proactive towards streamlining wherever possible, addressing potential issues, and communicating to all the relevant teams.

Private equity sponsors that are unable to dedicate their own resources throughout the carve-out should invest in an outside provider that offers a full suite of services and can coordinate internally, resulting in one point of contact for the entire process. Choose a provider that understands the nuances of carve-outs as well as the private equity business model and general partners' priorities. ■

How FFL Uses Operating Partners

In-house operations teams are increasingly common at private equity firms. **John Roach** and **Aaron Money** of **FFL Partners** tell Privcap how the firm's integration of operating partners is unique.



John Roach
Operating Partner
FFL



Aaron Money
Managing Director
FFL

As do many private equity firms featuring operating talent, FFL Partners brings in people from a variety of backgrounds: chairmen and CEOs, consultants, small business managers, executive search professionals.

A managing director at FFL, Aaron Money, says that the firm focuses on alignment among these operating professionals, portfolio companies, the fund, and the rest of the firm. "Our operating partners do well when our investments do well," he says. "That's the only way to incentivize the behavior, which is creating value in the portfolio."

While operating partners do well if the portfolio companies they work on do well for FFL, Money says they will also participate in the range of investments the firm makes.

FFL operating partner John Roach found his way to the firm through a connection to Money after time spent as a chairman and

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“The role of an operating partner means you’re available to step in during an emergency for 90 days or so, if need be. Your job is to coach and help the management do their job and produce sufficiently good results so that the financial partners can spend their time looking at new things.”

—John Roach, FFL Partners

CEO of several companies. He says that FFL’s approach to operating partners is different because it doesn’t merely bring people into companies as CEOs, advisors, or board members; it involves them from the start of a possible investment through due diligence and sometimes through to the investment itself.

“Being involved from the start, getting acquainted with the management and the nuances of the company, gives you a head start in how to deal with the company, the people, and the issues,” Roach says.

There is a world of difference between being a CEO of an ongoing company and being brought in for a finite period of time as an operating partner, Roach says. A regular CEO has a 24-hour responsibility to deal with issues that come up, and it’s an acquired skill. “The role of an operating partner means you’re available to step in during an emergency for 90 days or so, if need be. Your job is to coach and help the management do their job and produce sufficiently good results so that the financial partners can spend their time looking at new things.” ■

How FFL Boosted C.H.I.’s Performance

In a tight-knit industry of only four or five major players, C.H.I. Overhead Doors stood out to FFL Partners as a potential portfolio company because of its unique strategy of having a single facility to distribute directly to customers.

The overhead garage door company only has about a 10 percent market share, says John Roach, operating partner at FFL, but it was interesting to look at as a potential investment. In August of 2011, C.H.I. became an actual investment for FFL, and it was also where the firm was introduced to Roach.

The firm had been looking for an investment in the building products space since 2008, when the recession began,

and C.H.I. stood out when FFL looked at it three years later, during a rough time in the economy. “C.H.I. was taking a lot of market share through the downturn, and we expected that to continue because of its unique business model,” says managing director Aaron Money.

C.H.I.’s sales, profit margins, and outstanding EBITDA are the first level of metrics that FFL looked at. Among the changes to C.H.I. that FFL oversaw was improving material scrap performance: The operations crew managed to save \$1M to \$2M per year on steel scrap costs. ■



Rolling returns: FFL took garage-door market share with its C.H.I. investment.

Image Source: C.H.I.

Operating Partners, the Bain Way

Bain Capital's Steven Barnes discusses the firm's Portfolio Group, which is committed to helping build its portfolio companies



Steven Barnes, Bain Capital

Steven Barnes knows Bain Capital as well as anyone. He joined the firm in 1998, four years after its founding, and now runs its private equity group in North America. He is also intimately familiar with Bain's founding concept of value-added support, having led the development of its Portfolio Group, which works with management teams to outline and execute strategies to help portfolio companies deliver on their potential.

"Working with portfolio companies was something that Bain Capital pioneered," Barnes tells Privcap. "We started with a bunch of consultants and operating executives who came together into the private equity business. As the firm grew, the size of our deals grew, and the complexity of what we did grew, we decided in 1999 to form a dedicated portfolio group."

Today, the team collaborates with deal teams from due diligence to exit. When a deal closes, members of the Portfolio Group

typically serve as consultants to management, rather than fill specific management roles. That usually happens only when one of the firm leaders departs or has a health problem, and then it's only a temporary arrangement.

"Our job is not to run these companies," Barnes says. "Our job is to help these companies realize their full potential more quickly and more successfully."

It requires a particular skill set. "You need the IQ—the strategic understanding and operating experience to understand where a company is, where you want it to be in five years, and the road to get there. But you also need a special sauce called EQ [emotional intelligence]. You need the partnership skills and the ability to develop trust-based relationships with management teams so you can partner with them and help them get their companies to their full potential."

As the Portfolio Group has grown—it's now at 70 executives worldwide—it has recruited a number of specialists in areas such as talent management and sales growth.

Success is not always the case, of course. But the Portfolio Group has done a good job of minimizing the failures.

"They happen in every situation," Barnes says. "There are macro changes and microdynamics of an industry. That's why we have the operating team partnered with the deal team—to make sure we're doing everything we possibly can, reacting in a

thoughtful, strategic way. Look at the massive macro-impact of the crisis of '08 and '09. Our ability to work with our companies and get them doing unbelievably well has been a cornerstone of this operating group." ■

Barnes has been associated with Bain since 1988 and has been a managing director since 2000. He has held senior operating roles at several Bain Capital portfolio companies and previously held senior management positions in the Mergers & Acquisitions Support Group at PriceWaterhouseCoopers. He holds a B.S. from Syracuse University and is a Certified Public Accountant.

"Our job is not to run these companies. Our job is to help these companies realize their full potential more quickly and more successfully."

—Steven Barnes, Bain Capital

When Hilary Goshier started with venture capital and private equity firm Insight Venture Partners in 2000, the role of operating partner barely existed. “I took a risk at that point,” she says. “The title was ‘project manager.’ It was a whole new position.”

Goshier, who manages Insight Onsite, the firm’s 14-person operations and growth team, was recruited after working in management consulting. Her previous positions were at The Monitor Group, where she worked with healthcare, technology, and infrastructure companies, and Marketspace, an e-commerce firm focused on startups and online retail businesses.

“I was excited about applying what I had learned in a big context to smaller companies,” Goshier says. The idea of testing strategies in real time and gaining immediate feedback and results was also appealing, she says, as was the prospect of working with “optimistic” entrepreneurs.

Insight Ventures introduced the role and the broader operations team to help bring an “empirical rubric” to help management make decisions, according to Goshier.

Private equity professionals had previously gotten by more on, “gut feel” but companies had grown to a point where they needed to supplement that with data.

Almost 14 years in, Goshier says the role of operations professionals continues to evolve.

“The term ‘operating partner’—and



Hilary Goshier, Insight Venture Partners

Carving Out a Career in Operations

Insight Venture Partners’ Hilary Goshier explains how the role of operating partner has evolved

“The term ‘operating partner’ and the notion is still being invented. It’s in its infancy.”

—Hilary Goshier, Insight Venture Partners

Goshier is an adjunct professor at NYU’s Stern School of Business and holds an MBA from INSEAD, as well as law and economic history degrees from South Africa’s University of Natal.

the notion—is still being invented,” she says. “But we are going to start to see innovation in the services [offered] and a more diverse range of people joining the industry.”

Goshier says more private equity firms are starting to use operations teams as a strategic weapon, pre- and post-acquisition. During the bid process, operating partners can be used to determine how to win deals by becoming the target company’s management’s first choice or having a point of view on the business that changes the bidding strategy. After the deal, operating partners are being used to execute an investment thesis and change the risk curve.

“I don’t think people thought about that five years ago,” she says. Goshier advises on strategy, sales, marketing, and M&A, and she sees the role of the operating partner as focusing on both the “minutiae and big picture,” striking a balance between finding and implementing incremental changes that create cash efficiency or achieve a better use of resources, and taking a big-picture view of the competitive landscape, including customers and macro changes in the market. Or, as she says, “making sure the business doesn’t miss market opportunities, in addition to maximizing existing opportunities.”

Since joining Insight, Goshier has worked with more than 90 software and Internet companies. She currently works with Datasift, Drillinginfo, Mimecast, and OverDrive. She has previously worked with Primavera, which was bought by Oracle; Argus Software, which was purchased by Altus Group; and Scriptlogic, which was bought by Quest Software. ■

Paying Operating Partners

Privcap spoke with **Korn Ferry's Joseph Healey** and **Ben Sanders** about the thorny issue of the operating partner's role and compensation



Joseph Healey and Ben Sanders of Korn Ferry

“During the recession in 2008-2009, a lot of private equity firms realized they needed to get involved with companies, and it was better to hire an expert to do that rather than try to do it themselves.”

—Ben Sanders, Korn Ferry

Privcap: Have private equity firms reached a point where they have conceded that they need to lift their operating game and bring more operating talent in-house?

Sanders: It's something that can be afforded by large-cap firms. Most large-cap firms have some version of operating partners, with many different functions within the firm. If you look at a lot of the middle-market firms, they might have one. Not every firm follows the same model.

It's hard to find firms that don't say they add operating value, yet not every firm out there has a deep bench of people with a background in running corporations.

Sanders: One reason why you see more and more operating partners is that LPs look for that when they evaluate whether to invest in a fund. So being able to speak to that is important. During the recession in 2008-2009, a lot of private equity firms realized they needed to get involved with

companies, and it was better to hire an expert to do that rather than try to do it themselves. That created demand for operating partners, too.

Healey: Even firms that don't have an operating partner bench and don't have a roster of people listed on their website as operating partners, they seek to draw in those capabilities on a project-by-project basis. They'll have senior advisors or former CEOs of their own portfolio companies they've come to know, and they seek to draw in that expertise on an as-needed basis, as opposed to making them a part of the infrastructure. Even if the operating partner team isn't deep, the need to have a greater degree of sensitivity to operating issues is at play across the industry.

To what degree do operating executives have their pay tied to the deal they have been assigned, compared with the health of the whole fund? Is there a perception among limited partners that you're a real operating partner if you are incentivized by the whole fund, versus a hired gun with just the deal that you hunted?

Healey: Limited partners care about the outcome, and the individual firms leave it to themselves to determine what's optimal. If you want to think about it in a theoretical sense, the idea is that you have a group of very smart people—some of whom have an investment background, some an operating background—whose interests are aligned to a common outcome across a portfolio.

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“This is an idiosyncratic industry, and every firm has their own approach. What you find is a range as to whether they’re full-time, permanent members of the team or they’re brought in on an ad hoc basis.”

—Joseph Healey, Korn Ferry

There are some firms that think they’re backing great CEOs, and they don’t feel they need an operating partner on their bench to oversee their activities. Their objective is to let the CEO do what he or she does well.

Sanders: The one distinction that comes to mind is that for the large-cap firms, they probably would have an operating partner for a specific industry sector rather than going across five or six, whereas for a midmarket firm, the operating partner would focus more firm-wide, especially if it’s someone with a finance background, and they’re really there to help the CFOs.

Healey: Some feel the need to build the operating partner and make it an in-house capability. In some models, there’s one senior operating partner who’s effectively a general contractor or the architect of the operating-partner kind of thinking within the firm. They create this network of operating partners that can be drawn in on a one-off basis.

What are some models that firms use to integrate their operating talent into their investment teams?

Sanders: There are four used regularly. One is for business development, where they call them a senior advisor or operating partner, and they have advisor contacts, evaluate the investment opportunity, and then win the deal. The second is for functional expertise, like an investment sector within a private equity firm. Another is more of a generalist, perhaps a former CEO or a business president who is going to work with the management team once they’re in

place. The fourth is a former portfolio company CEO of the private equity firms, or someone they’ve brought in from the outside to look for and run deals.

Healey: This is an idiosyncratic industry, and every firm has their own approach. What you find is a range as to whether they’re full-time, permanent members of the team or they’re brought in on an ad-hoc basis. You could have senior advisors who are less than full-time and standard operating partners, oftentimes deeply embedded in the investment team, and the pay structure is identical to the investment team members.

Are you sensing reluctance or a hesitation on the part of some firms to open up their partner economics and bring in these new people who may or may not have an impact on profits?

Healey: I don’t think there’s much of a choice, to be honest. There’s an expense to be incurred. Sometimes these expenses can be billed back to the portfolio companies directly, and some firms underwrite the cost of a very large group and then, throughout the course of a year, they bill back the costs of that group on a project-by-project basis as the functional expertise is brought to bear on individual companies.

Sanders: It’s always a challenge to get the investment side of the firm to share their economics, but they look at it as an investment decision. Is this operating partner that we’re going to bring in going to create more value than he’s going to cost over the life of the fund?

What percentage of the operating partners have a direct interest in the incentive, whether it’s portfolio-wide or with specific companies?

Healey: The answer to that is probably very high. Some have specific economics and a specific deal, and some have carry in the broader pool. That might be more. Of those who have direct participation, that might be 50-50.

Sanders: If you go back, six, eight, 10 years ago, it was probably a much lower percentage, and it was more people being paid on a project-by-project basis and being paid cash rather than carry, much to their chagrin. But now it’s become a more highly valued function, and the best people are going to want carry, whether that’s firm-wide or deal-specific.

Healey: And it shouldn’t be overlooked that some operating partners are not pursuing these types of roles purely for kind of W2 cash income or even carry participation. They may be in a position to seek highly attractive co-investment opportunities with the private equity firms. They might find that to be much more valuable, so they can make their own kind of direct investment in these companies with the benefit of having done their own due diligence on these deals, because they are working side by side with the private equity firm. It is very idiosyncratic, depending on the firm and the circumstance and even the individuals who are in an operating-partner capacity. ■



Adam Weinstein, New Mountain Capital, and Rick Bailine, RSM

Are Monitoring Fees Actually Dividends?

Two tax experts discuss the IRS' focus on a common method for funding services provided to portfolio companies

When a private equity sponsor charges a “monitoring fee” to a portfolio company, should this be treated as income or dividends? Rick Bailine of RSM says the U.S.

Congress is looking into whether the policy should be switched from the former to the latter, a change that would have broad implications for how private equity partnerships fund the services they provide to portfolio companies. At issue, according to our two experts, is the common practice of splitting fees with limited partners—a proportional arrangement that some argue makes these fees more like dividend payments and less like income.

The debate is another example of accepted private equity practices being increasingly scrutinized by the government.

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“It's interesting that Congress is choosing to look at this at a time when changing the characteristic might benefit the shareholder and the management company by giving them a lower tax rate.”

—Rick Bailine, RSM

Privcap: I'd like to dive deeply into some important trends in the world of tax and private equity. Let's start with one where people predict there may be some movement. It has to do with the treatment of the advisory fees GPs charge to their portfolios, often called “monitoring fees,” and how they get treated at the portfolio level and at the GP level.

Adam, can you set the stage and talk about what the practice is now by way of taxes and these monitoring fees?

Adam Weinstein, New Mountain Capital: Today, the way it works is often, during a negotiation, you're buying a company—there are minority shareholders sometimes coming in; sometimes it's going to be 100 percent owned by the private equity fund. You negotiate to have some type of advisory or monitoring fee that's paid on a quarterly or annual basis to the private equity firm. This is intended to help mitigate some of the costs that go into just overseeing a portfolio company. Some private equity firms don't charge any travel back to their funds, so this would help offset travel. Others are viewing it as, effectively, a fee for helping to oversee the company.

In the grand scheme of transaction fees and

the dollar amounts you're talking about, these are usually relatively small fees, from as low as \$100,000 for a \$100M-sized company to \$1M a year. There are outliers in both directions.

From a GP perspective, it's getting captured. It's coming in as ordinary income, as fee income, and then flows to the partners if it's a partnership. Usually it comes into the management company itself. The GP is then offsetting this and reducing their LP's management fees in the next drawdown that they do customarily with transaction fees and other things. Whenever the fee offset we've talked about a lot in the industry, 50 percent, 65 percent, or 100 percent—it actually just gets credited back to the LPs effectively through that.

LPs are less focused on it these days, because many firms have gone to 80 percent or 100 percent fee offset. From their perspective, it's helpful to get advisory fees from the company, because it reduces their management fee burden. That's the practice today.

From a tax perspective at the portfolio level, how are these fees treated?

Rick Bailine, RSM: That's what's

truly causing the controversy. If a portfolio company—typically a C corporation—pays a fee to someone for providing management services, that's simply an ordinary and necessary business expense to the portfolio company, which is fully deducted. The rumblings we have heard coming from Capitol Hill—that's what has started the focus.

There has been a great deal of focus by the IRS and Congress for many years on any flow of cash from a C corporation to a shareholder. Probably the most litigated issue in the history of our internal revenue code is called “debt equity.” It is a corporation making a payment of interest, which would be deductible to the corporation and income to the recipient. Or they are paying a dividend, which would be nondeductible to the corporation and taxable to the recipient.

The difference is, the way our code stands today, it's not an even balance in the sense that if the portfolio company is paying a fee, the portfolio company gets a deduction, but then, as Adam said, the recipient has income. If it were to be reclassified as a dividend, in fact, the portfolio company would not have a deduction, but the recipient would also have a 20 percent or a 23.8 percent tax rate, not the typical 39.6 percent.

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It's interesting that Congress is choosing to look at this at a time when changing the characteristic might benefit the shareholder and the management company by giving them a lower tax rate.

Weinstein: The specific area they focused on is where monitoring or advisory fees are going to the private equity firm and/or others in proportion to their ownership, as Rick said. When you have a private equity firm that owns 80 percent of a business and a minority shareholder that owns 20 percent and there's a \$100 fee getting paid annually, with \$80 going to the private equity firm and \$20 going to this minority shareholder, they believe it's simply a dividend.

Ironically, there is a different argument if you are an 80 percent owner and you're getting the monitoring fee all to you and none is going to the minority shareholder. Actually, in this case, that is helpful to the argument and fact pattern.

They're focused on it, and you said it exactly right, that on the face of it today, it would cause a rate reduction for private equity. But obviously, in the long term, if you are the majority owner of a business, less tax deductibility is ultimately going to hurt your outcome to the business. If you do it in a way that is proportional, that is the thing most susceptible to be changed.

Bailine: That's exactly right. The cash flows from a C corporation to a shareholder always have been scrutinized closely and typically, for anything that was distributed to a shareholder on a pro-rata basis in proportion to their shareholdings, the government's initial reaction almost uniformly will be, "If you're paying this to your shareholders based on their ownership of the stock, why is that not a dividend? It appears to us that you're simply making distributions to shareholders with regard to the stock that they own, not with regard to the services that someone is providing."

"...in the long term, if you are the majority owner of a business, less tax deductibility is ultimately going to hurt your outcome to the business."

—Adam Weinstein, New Mountain Capital

Importantly, and Adam said it exactly correctly, if you are providing services, why would management fees be going to others if you are the provider of the services? That's exactly the type of thing the government has looked at almost since the inception of the code.

Typically, distributions to shareholders on a pro-rata basis are viewed, at least by the government, as dividends. They will look closely at whether or not the payments are, in fact, for services. Are you actually rendering, the services? Are the payments commensurate with the services you are rendering or is something extraordinary going on here?

Weinstein: If you're at 100 percent offset and you get \$1 from this type of monitoring fee and you reduce your management fees by \$1 in the next year, to the point Rick made, you now have a tax rate of 23.8 percent on income, and you are reducing management fee income, which is always at the 39.6 percent rate, presumably, if you're in the highest tax bracket on the management fee. So there's a windfall for the firm if this type of thing happens.

There could be an interesting scenario where, in an effort to go after a private equity and these unusual fees they pay themselves, the government could have an unintended consequence of possibly creating a windfall by

changing what was income and more into something of a dividend.

Bailine: Which brings us to the next question. I don't think Capitol Hill is that foolish. It's one thing for us to say, "If they were to change the rule and say, 'This should be a dividend, because it's being paid pro rata with regard to your shareholders. Therefore, it's nondeductible to your portfolio company.'" It's not going to take them long to realize the point that Adam illustrated, that you're now having a benefit to the private equity group. Maybe it would surprise no one if their solution were that it's nondeductible to the portfolio company and we still believe it should be taxed at 39.6 percent to the recipient.

Weinstein: That is the entire argument on carried interest, which is why legislative action is needed for it—because it is a conversation. The three of us are in the partnership; the two of us are LPs, and you're the GP. I would only pay capital gains rate on the income that comes to me from that partnership. Nobody's disputing that. It's the piece of the capital gains that now goes to you, which today is taxed at the same rate, and an argument is being made that it should be taxed at a higher rate. Does that make those you look at important in making the contextual argument of what tax rate to charge them? ■

After years in leadership positions at healthcare companies, Michael Bernstein retired, shifted course, and became a private equity investment partner.

His role at Baird Capital is an “investment partner with a twist,” he says. “I perceive the world like an operating partner, but my role is classic investment partner.”

Bernstein spent years as what he calls a “serial CEO,” running a series of healthcare businesses, although his career began as a lawyer at Blue Cross Blue Shield in Milwaukee. Eventually he would become president of that plan and work there for a total of 14 years, with a stint as an executive at the University of Wisconsin’s medical services plan in the middle. Of that job in healthcare delivery, he recalls, “I’m a bit of a change agent, and that was a business where my constituents didn’t want any change.”

He was later rehired by Blue Cross to be a senior vice president of strategy and planning. He became head of the company and helped take it public—the second-to-last Blue Cross in the country to transition to a for-profit. The company was sold to WellPoint in 2003, and Bernstein retired at the age of 43, marking the beginning of his transition into private equity.

Bernstein says he began by “trying my hand at small business.” He took over running a small healthcare business from a former colleague, and four years later it was sold for \$81M. “From that, I learned how much wealth was generated from small businesses,” he says.



Michael Bernstein, Baird Capital

Baird's Healthcare Company Revivalist

Michael Bernstein spent much of his career as a “serial CEO” of healthcare companies but recently moved into the operating-partner-like role of investment partner at **Baird Capital**. He explains how he got there, and why this career change was a good one.

Prior to joining Baird Capital, Bernstein held executive positions at Leprechaun Inc., Innovative Health Strategies, Cobalt Corporation, the University of Wisconsin Medical Foundation, and University Health Care. He received degrees from the University of California and the McGeorge School of Law.

From there, he became an executive-in-residence at Baird Capital under a new platform that sponsored executives to pursue investments. But it was 2008, the beginning of the recession, and Bernstein says it was evident that sourcing deals was going to be very slow. After less than a year, he took a turnaround gig for a hedge fund, dealing with distressed businesses.

Baird acquired METI, a maker of robots used by medical and nursing students, and Bernstein served as the co-investor. The business went into distress after the close, and Bernstein was swapped into the CEO role. METI was sold two-and-a-half years later for 2.5x the initial investment. He continued in the role as divisional president of healthcare at that successor company until April of this year.

That was when the conversation started with Baird about becoming an operating partner specializing in the healthcare sector, but it evolved into Bernstein becoming an investment partner. “This is the first time in the PE firm’s long history that it has a partner dedicated to only healthcare investing,” he says.

He’s adjusting to the role from his serial CEO status and calls it “more kinetic but less purposeful,” compared with running a business, where little energy is wasted. “In PE, there’s a lot of energy spent learning about and sourcing deals that may never happen. The partnership model is also different from being a CEO, as there’s a lot of decision-making done by consensus,” he says.

“I’m liking that. Running a business is very lonely, and being in private equity isn’t nearly as lonely,” he says. ■

The New Era of PE Operations

In an increasingly competitive deal market, private equity firms need to differentiate themselves with their operations teams. Having the right professionals on hand to improve the performance of portfolio companies is key. Here are five key takeaways from an illuminating expert conversation.



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 background and rely completely on management teams to provide the execution, which can work in certain industries 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

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“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.”

—Dave Noonan, RSM

these days, there is tremendous pressure on firms to put capital to work. They 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,” Stubitiz 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 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 a 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,” Stubitiz 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,” Stubitiz 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. “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.” ■



How LPs Vet Operators

Two major investors discuss their approach to vetting the operating platforms of GPs large and small

Just as it's hard to find a general partner who doesn't claim to be in the top quartile, it's difficult to find a private equity team that doesn't claim to "add operating value" by pairing operating partners—often former CEOs and senior executives with relevant industry experience—with their portfolio companies.

"There's a lot of emphasis on [operating platforms], especially at the larger end of the market," Maarten Vervoort of Alpinvest Partners told Privcap. "Including plain-vanilla actions like leveraging is something people already know, and it's so clearly already priced into the deal."

Within the portfolio company, the operating partner's role is typically straightforward: They serve as an advisor to existing management or as a replacement until a new leader is found. Within the private equity firm itself, the structure is far less defined. In some cases, operating partners are members of the firm, get a piece of the carry, and return to the mother ship once their work is done; in others, they are hired guns who helicopter in and out of portfolio companies on a deal-by-deal basis.

Each arrangement has its pros and cons, and limited partners need to understand them clearly before committing capital. To help guide the way, Privcap spoke with Vervoort and Helen Steers of Pantheon, two deep-pocketed LPs with extensive experience conducting due diligence on a GP's capabilities.

In-House vs. Hired Gun

The most significant differentiator among operation platforms is where the operating talent calls home. In other words, are they partners within the private equity firm, or are they brought in on a deal-by-deal basis as consultants and board members?

Neither Steers nor Vervoort expressed a preference for one model, but they did stress that each private equity firm needs to assess what's appropriate, given its size and investing style. If a firm considers a certain industry silo a "core capability," then it makes sense to employ operating partners within the firm, says Vervoort, but only if it has the proper scale. "If you only have one or two people on the operating team, the skills can get stale over time," he says.

Steers adds, "Some of these skill sets can get obsolete if the industry experts remain within a private equity firm. Certain skills, like supply chain management, can get used and replicated again and again within portfolio companies. But if you're talking about a sector skill, people outside the firm might be more up to date on technologies and practices."

Deal Sourcing

Another area the pair investigates is the role the operating partner plays in deal sourcing and, if they source a deal, the way they're compensated for doing so. "What you quite often see is the operating

partners don't get any carry to the extent that the investment partners would receive," Steers explains. "So, who is ultimately responsible for the deal and how is it aligned with the investors?"

"The easier model is, the guy who sources the deal is responsible for managing it. Tensions can arise if an operating partner says, 'You sourced the deal with a strategy that is not working.' The better model is where you have people on the operating side involved pre-deal, helping to assess the opportunity. Then there is a pre-agreed 100-day plan that's put into practice."

Vervoort also prefers to see the industry experts involved in sourcing, even if it's just assessing the opportunities found by others. "It sounds like a cliché, but the sourcer needs to be able to ask the right questions. For example, if you look at the reporting that a GP will get from a potential portfolio company, it can be very financially driven, looking at sales, etc. But the best GPs are operating driven, and they'll want to know different sets of KPIs [key performance indicators]."

The Question of Carry

The only "wrong" compensation structure for operating partners is one that does not properly align the partner to the success or failure of the portfolio companies. The many GPs that Alpinvest and Pantheon invest with pay their operating partners in different ways.

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Peeling Back the Onion

For **Kevin Kester** of **Siguler Guff**, due diligence into the operating function means separating fact from fiction

Private equity firms are like great sports teams: Sometimes one or two star players carry the load; other times a well-defined playbook and collective grit leads to success.

“Look at Bill Belichick and the Patriots,” Kevin Kester, managing director at Siguler Guff, told Privcap. “They have a great system, and they can plug people in and out.”

Kester has spent a lot of time thinking about the impact of operating talent on the performance of private equity funds, specifically funds that target small and midmarket buyout opportunities.

Before placing a single dollar with a private equity firm, Siguler Guff does extensive scouting and recruiting. The process begins with interviews of fund managers and specific questions about the types of operational value they bring to their portfolio companies.

“We’re looking for managers to be explicit about such things as cost-structure improvement, sales and marketing improvement, gross-margin improvement,

R&D improvement and lean-manufacturing improvement,” Kester says. “Whatever they’re doing at a particular company to add operating value, we want to understand their take on it.”

Siguler Guff also wants to see the hard data backing up those claims.

Then he’ll follow up that conversation by speaking directly with the CEOs of portfolio companies, because they will often give an unvarnished account of what’s really going on. It’s Kester’s job to determine what’s true and what’s wishful thinking.

“These CEOs are often not scripted,” he says. “If you specifically ask them where they received help or how often they interact with the private equity fund, you’re really going to uncover what’s truly happening on a day-to-day basis. You may determine that this is really a part-time operating partner who spends 85 percent of his time doing other things. So you can quickly differentiate between what’s real value-add and what’s window dressing.” ■

“Clearly, success has many fathers. You can analyze it and talk to the management and look at board minutes, etc. But really pinpointing it to a causal relationship—that’s the hardest part.”

—Maarten Vervoort, Alpinvest Partners

Those with the scale to afford a large operating staff typically offer carry to operating partners, Vervoort says. “But typically the amount of carry is lower than the deal partners usually receive.”

That’s not necessarily a problem, he adds, as it may allow the GP to have a more dynamic operating function. “In order to make sure that the operating gene pool is fresh and healthy, you want to over time refresh the pool of people,” he explains. “Carry is so long-term it might not be appropriate.”

Attribution

A focus among sophisticated LPs today is to look beyond the top-level performance history of a private equity team and actually determine where that performance came from. For firms that claim to significantly improve the operations of their portfolio companies, a potential LP must try to determine whether operating improvements were the result of GP skills rather than market momentum, the existing management team, or just plain luck.

“It’s very difficult and gets to the heart of private equity due diligence,” Steers says. “How do we determine that a private equity team turned a so-so company into a much better company? We look at realized deals, look at profit attribution. We look at how much value was created through financial leverage and how much came through profit improvement.”

Vervoort adds: “When we look at a realized deal, we look at leverage, multiple appreciation, and talk to management to get their perspective for what the GP has done. Clearly, success has many fathers. You can analyze it and talk to the management and look at board minutes, etc. But really pinpointing it to a causal relationship—that’s the hardest part.”

Ultimately, Pantheon and Alpinvest share a distinct advantage in vetting GP performance. As active co-investors, they get direct insight into how a GP approaches the operating-improvement process. “Being a co-investor brings you really close to the war stories,” says Steers. “It is an interesting window into what’s really going on.” ■

Operating Platforms Compared

Privcap looks at the operating platforms of ten private equity firms

KKR

The Captive Consultant Model

Private equity behemoth KKR makes its operating improvements through KKR Capstone, its internal operating consulting team.

A firm with \$90.2B in assets under management (AUM), best known for its majority equity investments in large-cap companies, focuses on retail, healthcare, industrials, media and communications, financial services, and tech investments.

The firm employs more than 60 people in its KKR Capstone team, with more than 20 in its senior advisor group, who often play operational roles in its portfolio companies.

KKR Capstone was created in 2000 and has professionals in North America, Europe, and Asia. The team is organized according to operational expertise, not industry acumen.

Capstone typically works with companies for a 12-to-24-month period.

Silver Lake

The Tech Exec Model

Silver Lake utilizes a handful of former tech

executives of high-profile firms in its Value Creation unit.

The firm has \$20B invested across multiple platforms and focuses on technology and tech-enabled industries and invests in companies of varying sizes, including large-cap and middle-market companies.

Silver Lake focuses on companies with leading market positions, strong management teams, and proprietary core technologies.

The firm has 10 members in its Value Creation unit, which also has 16 advisors. The operating unit consists primarily of former tech executives of brand-name firms.

The firm's operating professionals are often involved in creation and introduction of new products and services. They also assist in deal sourcing and due diligence.

Arsenal

The Flexible Operating Model

Arsenal Capital Partners deploys its industry-savvy operating unit in different forms for different managers. The \$1.675B firm specializes in healthcare and industrials investments.

The firm typically invests in companies

valued between \$50M and \$250M. Its investments are usually sector-specific, in cash-flow-positive companies where it has identified opportunities to enhance productivity.

Arsenal has a six-person operating committee, nine operating partners, and eight senior advisors.

The firm leverages operating resources in varying roles depending on management needs. The operating team has both general management and functional skill sets and offers assistance in IT, human capital, supply chain, six sigma, and international expansion.

Blackstone

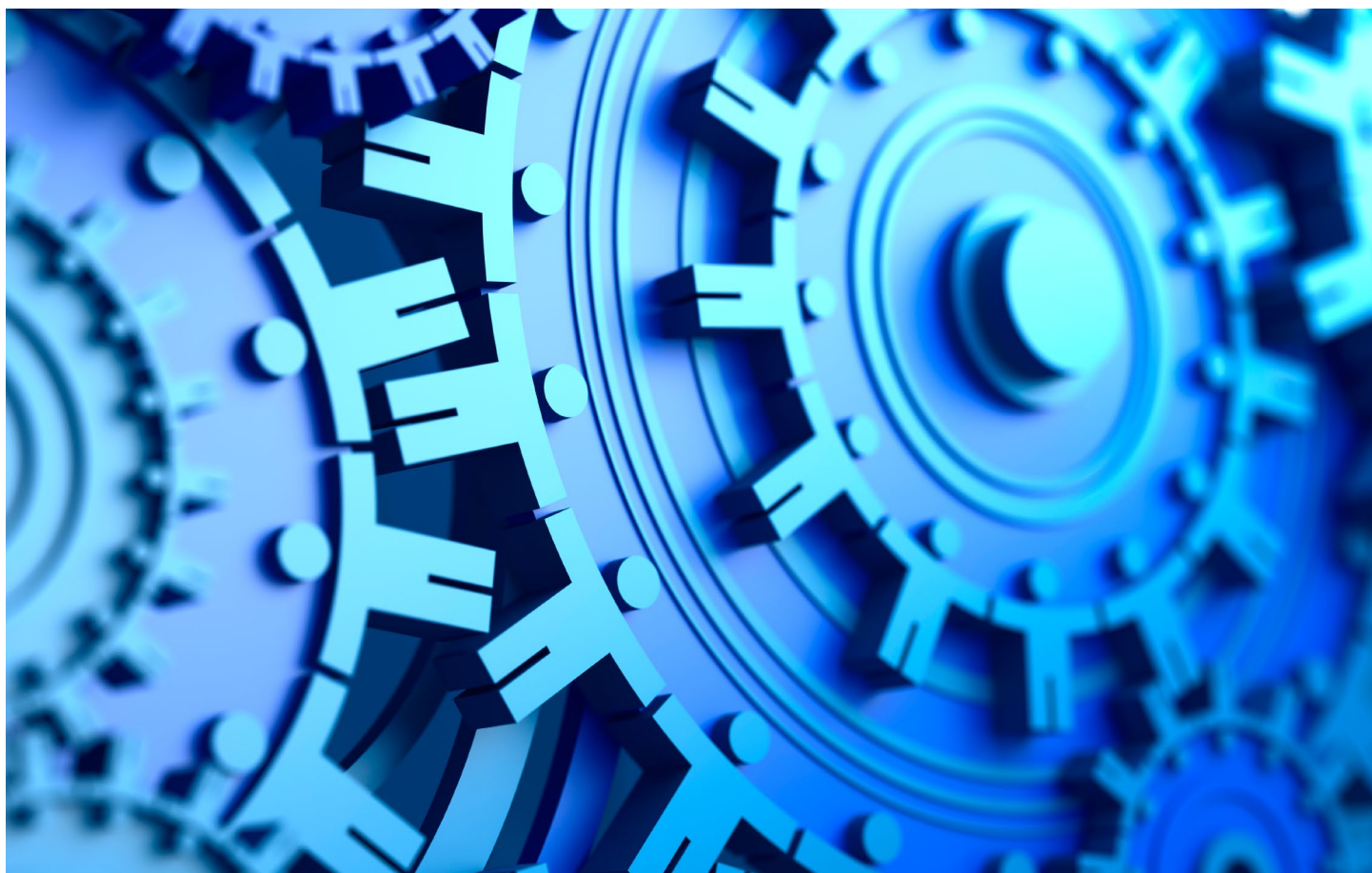
The Cross-Portfolio Efficiency Model

Blackstone maximizes operating efficiencies across its portfolio with the aid of its internal operating unit.

The group, which had \$63B in private equity platforms (as of Sep. 30, 2013), invests in a wide range of industries, depending on the fund and investment type.

The publicly listed asset management firm has four operating partners on its private equity team, 21 people in its portfolio

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operations group, two portfolio operating advisors, and 10 industry advisors.

The Portfolio Operations Group, Blackstone's in-house operational consulting unit, works across the entirety of Blackstone's portfolio. The CoreTrust Purchasing Group manages \$2B in annual spending across nearly 60 portfolio companies.

The operations staff focuses on revenue realization, operations, services and infrastructure, purchasing and cross-selling, leadership development, and healthcare.

Clayton, Dubilier & Rice

The Original "Operators as Partners" Model

CD&R's operating partners have been the heart of the \$17B firm since 1978.

The firm's investments span multiple industries, but it frequently invests in distribution or service-related industries, typically making large equity investments in companies with enterprise value between \$1B and \$15B.

CD&R invests in market-leading companies that are underperforming, targeting enterprises with large customer and supplier bases and diverse revenue streams.

The firm has more than 10 operating partners and seven operating advisors.

CD&R's operating partners are typically installed as chairmen of the board at portfolio companies. Operating partners are typically at the helm of one to three portfolio companies at a time.

More than one-third of company profits go to the operating team. The firm prides itself on making countercyclical operational

improvements and is responsible for some of the most widely publicized turnarounds in private equity history, including Kinko's, Hertz, and Lexmark.

Cerberus

The Operation-by-Affiliation Model

Cerberus keeps a fleet of more than 100 experts on hand at its affiliated operational unit. The firm, which has a total of \$25B (including non-private equity investment vehicles), invests in a wide variety of sectors, including manufacturing, government services, transportation, and financial services. The sizes of the ventures it invests in also vary, but are typically large-scale investments in large-cap companies.

In addition to its distressed, real estate, and

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commercial lending platforms, Cerberus makes control and minority investments in its private equity vehicle.

The Cerberus Operations and Advisory Company has more than 100 professionals. Roughly half of the operating team is currently employed by portfolio companies. The team also assists in sourcing deal opportunities.

TPG
The Turnaround
Consulting Model

TPG, which has \$54.5B in AUM across multiple platforms, invests in a broad range of sectors and company sizes, depending on the fund.

TPG executes global public and private investments through leveraged buyouts, recapitalizations, spinouts, growth investments, joint ventures, and restructurings.

It has more than 60 in-house operations professionals. At TPG, operation partners are full partners in all profits.

Operating team members typically have a blend of direct management and consulting experience.

The operations team is fully integrated with the investment team. Operating assets also include a field operations advisors group focused on cross-portfolio business functions.

Sun Capital Partners
The South Florida Blend

Sun Capital mixes former industry executives with business function specialists. The firm, which has \$10B in AUM, invests in a variety of industries, typically in companies ranging from \$50M to \$3B in revenue.

Sun Capital typically makes control equity investments and leveraged buyouts in middle-market companies. The firm often targets enterprises undergoing corporate divestitures or operational challenges.

It has more than 35 professionals in its operating team, 10 of whom are managing directors.

The firm's operating imperative for portfolio companies stresses liquidity and performance benchmarking.

Its team includes geography-specific functional specialists and former industry executives.

**Welsh, Carson,
Anderson & Stowe**
The Blended Industry/
Functional Model

Welsh, Carson, Anderson & Stowe utilizes both industry executives and functional specialists in its operational unit. Since its inception, the firm has organized 15 funds with total capital of \$20B, investing in information and business services as well as healthcare, with no standard deal size.

Welsh Carson typically focuses on operational improvements and partnering with talented management teams.

It has six generalist professionals, eight functional specialists, five senior industry executives, and four affiliated industry experts. The in-house operational team is called the Resources Group. It comprises both functional specialists with cross-portfolio expertise (such as procurement) and former industry chief executives. It maintains a group of affiliated former chief executives who also assist with deal sourcing and due diligence.

Since 2000, 90 percent of Welsh Carson's investment returns have been generated by operational growth. The firm develops value maximization plans for newly acquired companies.

The Riverside Company
The "Growing Small"
Operational Model

Riverside employs industry expertise to help small companies grow over the long term.

The firm, which has \$3.5B in AUM, invests in a wide range of sectors, in companies with enterprise value of less than \$250M.

Its operational team, which comprises four managing and senior operating partners, 10 operating partners, nine operating executives, and 10 senior advisors, focuses on organic growth and add-on strategies.

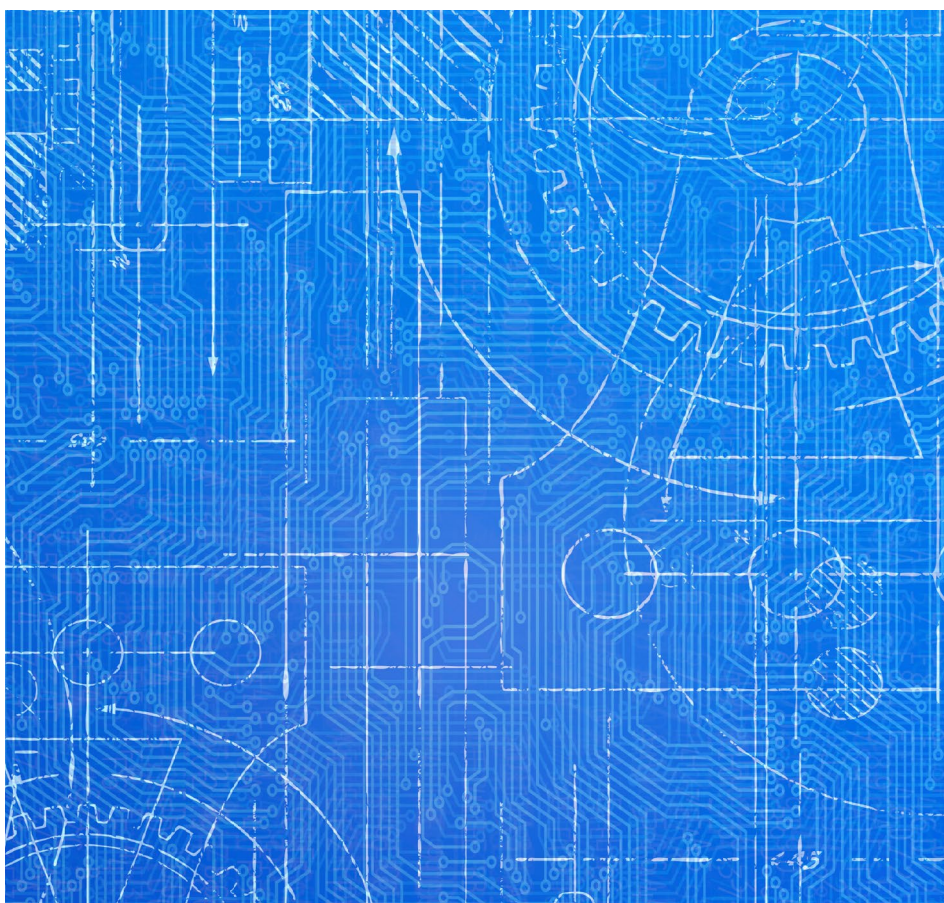
The operating team is instrumental in Riverside's focus on organic earnings growth as the most important factor in value creation.

Operating professionals range in background from Fortune 500 executives to small-company founders.

The firm created a "Riverside Toolkit" that helps small companies with marketing, pricing, and lean manufacturing. ■

Everyone Says They Have the Best Operating Model

But the only thing that really matters about a private equity firm's operating structure is that it delivers results, says **Privcap CEO and Co-founder David Snow**



It is far from clear which model for incorporating operating talent into private equity works best.

The logic behind the full-partner operating executive model is this: Only a partner who is fully integrated into an investment

program, whose economic incentives and personal pride of ownership penetrate the entire firm, will be willing and able to exert his or her full energies into optimizing a deal. An operating partner only assigned to particular deals, or brought in as a hired gun, will fail to give a damn about the fund

as a whole, the culture of the firm and its long-term relationships.

But there is an equally compelling argument for the operating advisor/hired-gun model. A former corporate executive embedded in a private equity firm for years, scanning deal flow and jumping into portfolio companies, may become stale, especially in fast-morphing industries such as technology. Better to catch a mid-career superstar for a value-add project and then release him or her into the field.

An authoritative study comparing the financial results of one operating model over another. More importantly, experience has shown investors that spectacular success and soul-crushing failure can result from all of these models.

What matters most is this: Whatever way you try to extract value from a portfolio company, are you good at it? Are the right people being deployed in the right way? It is possible to create what appears to be a winning marriage between operating and transactional talent with a flawed incentive structure?

On the flip side, a firm that relies on accomplished, super-incentivized hired guns may have a habit of buying hopeless companies for too much, at the wrong time. Such a portfolio company will fail to thrive, even in the hands of an operating superstar.

The head of a major endowment private equity program, well known for his outspokenness and cynicism, once told me that he scoffs at any GP who claims to "add operating value." Invariably, this LP says, he would find wipeouts and underperformers in these GPs' track records and ask, "The special things you did to the winning deals, why didn't you do them to these other deals?"

Perhaps an unfair challenge, but the dismissive attitude isn't far from the well-resourced limited partners' current state of mind. Showing them an operating platform that is supposed to work is very different from presenting an operating platform that works. ■

Operating People

A roundup of 2014 news about operating professionals in private equity

Altamont Hires Legg Mason Exec

San Francisco firm **Altamont Capital Partners** hired **Dave Odenath** as an operating partner to focus on investment opportunities in the financial services sector. Odenath was a senior executive vice president and head of Americas at Legg Mason, the asset management and mutual fund company. Keoni Schwarz, managing director at Altamont, said Odenath would help the firm pursue a “distribution-centered strategy” within financial services. Altamont has more than \$1B in assets under management.

Castanea Promotes E-Commerce Guru Chu

Boston-area firm **Castanea Partners** promoted **Julian Chu** to operating partner. Chu, who joined Castanea in 2012, is an e-commerce and digital marketing specialist. In a statement, Castanea partner Robert Smith said: “Julian’s industry and technological insights are vital to successfully supporting our investment portfolio, and to the process of evaluating new investment opportunities.” Before joining the firm, Chu was head of commerce for PUMA North America, the sport lifestyle brand. Castanea is currently investing from its third private equity fund, which raised

\$50M. The firm targets companies with enterprise values of up to \$250M.

CD&R Operating Partner Chairs Helicopter Co.

Clayton, Dubilier & Rice operating partner **John Krenicki** became the chairman of **CHC Group**, the largest operator of helicopters for the offshore oil and gas industry, following a major investment commitment from the New York private equity firm. Krenicki is the former CEO of GE Energy. The Clayton Dubilier commitment to invest as much as \$600M in CHC came after the helicopter company failed to raise as much as expected in a January IPO. The deal gave the private equity firm the right to appoint a chairman as well as three board members. Energy specialist private equity firm First Reserve Corp. continues to own a 29 percent stake in the company.

Advent Names Heinz Chairman as Operating Partner

Global private equity giant **Advent International** named **Bill Johnson** as operating partner. Johnson is the former chairman, CEO, and president of H.J. Heinz, the consumer foods company. Heinz was taken private last year by a group that

included Berkshire Hathaway and Brazilian private equity firm 3G Capital Partners. At Advent, Johnson will focus on consumer packaged goods and food businesses, the Boston-based firm said in a statement. Advent has some \$32B in assets under management and substantial investment practices in the emerging markets, including Eastern Europe and Latin America.

Advent Names PPG Exec as Operating Partner

Advent International appointed **J. Rich Alexander** as an operating partner. Alexander was previously a senior executive at PPG Industries, where he oversaw the company’s global architectural coatings, fiberglass, and flat glass businesses. At Advent, Alexander will work with the chemicals team to source investment opportunities in the chemicals and materials sector. In a statement, Advent managing director Ronald Ayles said that Alexander’s “formal addition to our operating partner program strengthens our robust international team.”

Industrials GP Names Operating Partner

Minneapolis-based **Spell Capital** appointed **Kip Colwell** as operating partner.

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Colwell was previously CEO of Advanced Web, a label and flexible packaging coverer for the medical device and consumer goods industries. At Spell, Colwell will focus on strategy and operational improvements at the portfolio company level. In a statement, Colwell said: "I've been involved for a number of years [with Spell] as both an investor and board of advisor member in all of the previous funds, and I think this team is second to none." Spell invests in industrial and manufacturing businesses and also has a mezzanine debt investment division.

GenNx360 Names Army Vet as Operating Partner

Otis Spencer was named operating partner at **GenNx360 Capital Partners**. Spencer was formerly manufacturing strategy and operations advisor at WBS Financial, where he advised on effectiveness of manufacturing, quality control, planning, and engineering. At GenNx360, Otis will focus on sourcing new platform investment opportunities, conducting strategic and operational analysis, and business model sustainability. In a statement, GenNx360 founding and managing partner Lloyd Trotter said: "Otis' experience in our core investment segments is highly complementary to our team." Spencer began his career in the U.S. Army. He was director of administration and operations in Iraq and Kuwait and was awarded the Bronze Star Medal for leadership during wartime.

Sterling Operator Becomes Interim President of RMG

Robert Michelson, an operating partner at **Sterling Partners**, was named interim president and CEO of RMG Networks Holding Corp., a publicly traded video advertising network. At Sterling, Michelson "served as lead director, helping companies enhance their operational effectiveness and realize their full potential," according to a press release. Michelson's appointment

followed the resignation of Garry McGuire from leadership of the company. Michelson was with Sterling from 2009 to 2012. The Baltimore-based firm has \$5B in assets under management.

Z Capital Hires "Operational Efficiencies" Expert

Turnaround specialist **Z Capital Partners** hired **Timothy Clayton** as managing director and operating partner. Prior to Z Capital, Clayton was CFO of Tile Shop Holdings, a specialty retailer and portfolio company of private equity firm J.W. Childs Associates. He was also founder and managing principal of Emerging Capital, a management consulting firm. Z Capital has \$1.7B of committed capital and offices in Lake Forest, Illinois, and New York City. The firm pursues an "opportunistic, value-oriented approach in private equity that includes making control investments in middle-market companies that may require growth capital, turnaround, restructuring or other special situations," according to a statement.

Venture Veteran Names Operating Partner

Draper Fisher Jurvetson, fresh from raising a \$325M Fund Xi, named **Heidi Roizen** as an operating partner. Roizen was formerly a managing director with Mobius Venture Capital.

LLR Partners Hires State Dept. Official

Middle-market private equity firm **LLR Partners** has hired former assistant secretary of state **John Hillen** as operating partner. Hillen was most recently president and CEO of Sotera Defense Solutions, which completed an IPO in 2009. At LLR, Hillen will pursue investment opportunities in

the security and defense industries. "John is a thought leader within the government contracting industry and a deeply experienced executive. He has executed the same growth strategies and led businesses through the same challenges that our companies face today," said Dave Stienes, partner at LLR, in a statement.

J.F. Lehman Appoints defense operator

New York private equity firm **J.F. Lehman**, led by a former secretary of the navy, announced the addition of **Thomas Dyer** to the firm's operating executive board. Dyer was co-chairman of law firm Blank Rome. He also served in the U.S. Navy. "Mike brings not only an exceptional reputation for business acumen and leadership to our firm, but also a deep knowledge of the maritime industry and government contracting—which are critical to our investment strategy," said Dr. John F. Lehman, the firm's chairman.

KKR Capstone Names China MD

KKR Capstone, a firm that works with private equity firm KKR on portfolio company operations, named **Matthew Chang** as managing director in China. Prior to joining KKR Capstone, Chang was an executive at Roland Berger Strategy Consultants, based in Shanghai. According to a statement, KKR Capstone "works in partnership with KKR's private equity investment professionals and portfolio company management teams to help maximize businesses' potential and create sustainable improvements to generate growth, increase efficiency, and enhance capital allocations." ■



Mauro Bonugli, RSM

How to Choose an Operations Consultant

Technology sector veteran **Mauro Bonugli**, who joined RSM in 2014 to head the firm's East Coast private equity consulting practice, tells Privcap about key trends in the private equity operations space and what firms should look for when hiring a third-party team to help execute their strategies

Privcap: Has there been an increased focus on operations in the private equity sector? And why?

Bonugli: Of course. There are significant opportunities for private equity funds to increase their returns through operational improvements. That has been an increasing focus for private equity funds for the past 10 to 15 years. In the '80s and '90s, returns were traditionally driven by financial engineering and leverage. With changes in capital markets, post-financial crisis, operational improvements have become a key component in the investment thesis.

What are the biggest trends you see in the area of private equity operations?

I continue to see more and more private equity firms building out their operating capabilities. With LPs becoming increasingly interested in understanding how private equity firms apply their operating resources to maximize fund performance, many operating partners are discovering new ways to improve returns through operational improvement. This includes building close relationships with third-party service providers to augment their teams. In many

cases, operating partners are driving the strategic discussion with management teams and developing the key value-added initiatives. They are then hiring third-party providers to execute their plan. Operating partners are looking for a third-party provider with service focus and depth, a strong team that focuses on a very specific area, and a depth of knowledge that will help execute their strategy. It's very different from hiring a management consulting company, because they are first doing the strategic decision-making process, then coming to a service provider.

What should private equity operating teams look for when they hire a third-party group to help execute their strategy?

Besides the depth of understanding and a proven track record on specific projects, the third component is an understanding and experience in working with private equity funds. There is a big difference between working with a private equity portfolio company and a non-private equity-owned company. The private equity life cycle is not long enough for a multi-year business transformation program. It has to be specific initiatives with a quick time-to-value program

that fits within the five-to-seven-year life cycle of investments.

What is McGladrey's area of focus when looking for operational improvements?

We execute many technology-driven initiatives. Most of those are coupled with a set of performance improvement metrics, driven by top-line or bottom-line improvements and a technology component that will enable that initiative to take place. For example, increasing the throughput of a distribution center by enabling a series of process automation through the deployment of a warehouse management system, rather than having to invest in a new warehouse.

RSM has about 1,500 consultants overall. Our private equity consulting team is structured in a way to most effectively leverage our diverse set of capabilities and deliver a product that optimizes the most value for our clients. We have dedicated senior complex delivery leaders that focus solely on private equity engagements, and we also have a dedicated pre-investment due diligence team. In addition, our practice leaders are constantly expanding our consulting capabilities to better serve private equity firms. ■

Mauro Bonugli is a director, private equity consulting, at RSM. He has more than 15 years of experience in developing and executing technology-driven growth and business improvement strategies. He was previously an advisor at Warburg Pincus and has worked at the Resources Group and Credit Suisse.



RSM meets the needs of private equity firms and their portfolio companies with integrated transaction advisory, tax, audit, and consulting services. Our clients benefit from our single-point-of-coordination service model and expert teams that operate as strategic partners at every point in the private equity life cycle.

Our expertise in privately held first-time-sold companies offers a unique perspective on how these companies operate and their common issues. Private equity firms investing in the middle market turn to us because of this deep expertise and an industry specialization that aligns with many firms' portfolios.

RSM LLP is the leading U.S. provider of assurance, tax, and consulting services focused on the middle market, with more than 7,000 people in 75 cities nationwide. **RSM** is a licensed CPA firm, and serves clients around the world through RSM International, a global network of independent accounting, tax, and consulting firms.

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