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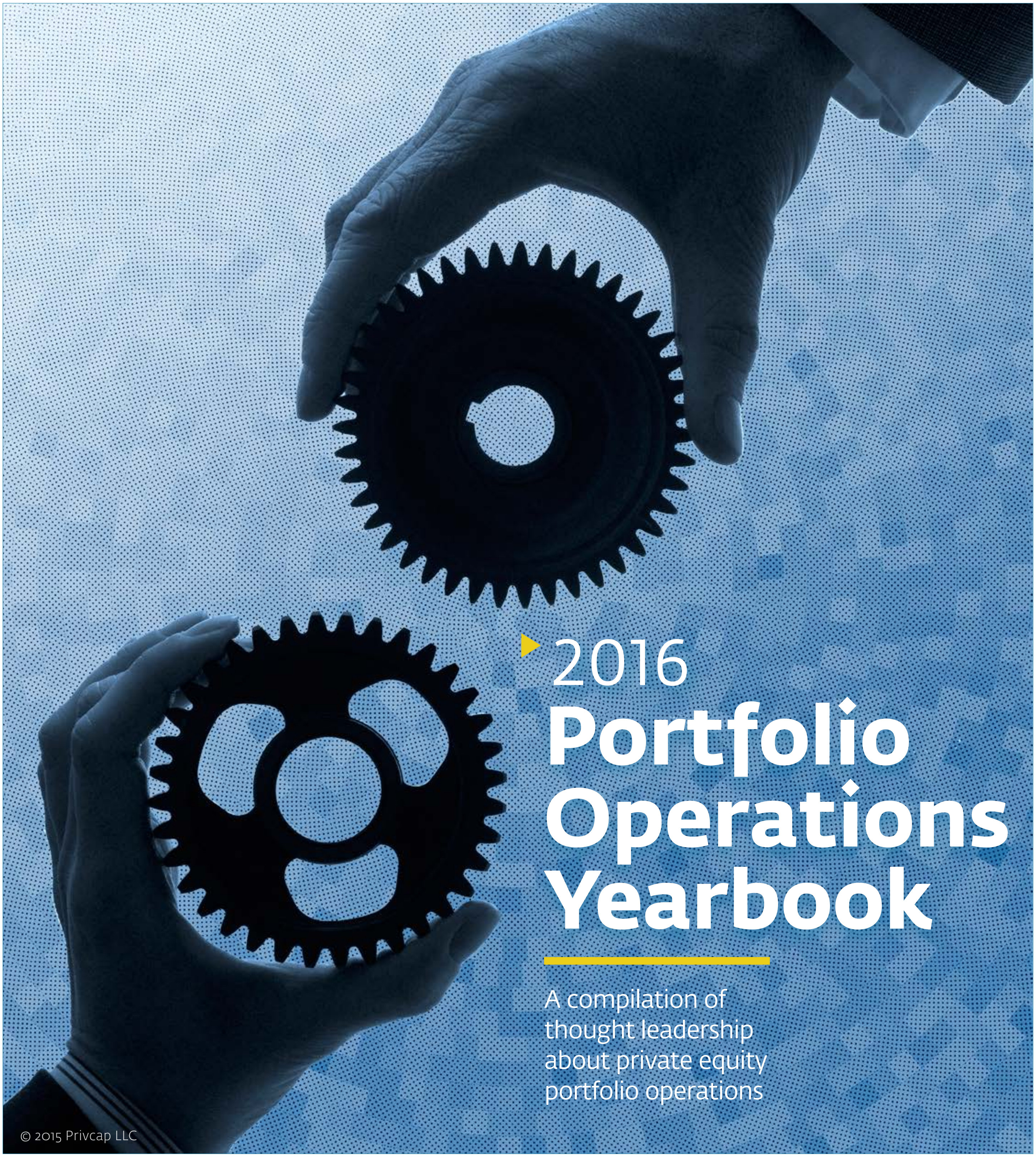

2016

Portfolio Operations Yearbook

A compilation of thought leadership about private equity portfolio operations

Don Lipari
National Private Equity Leader,
RSM

The Evolution of Portfolio Operations

Dave Noonan
National Director,
Private Equity Consulting,
RSM

At many private equity firms today, differentiating yourself in an increasingly crowded field is important. And creating value through a focus on portfolio operations continues to be paramount.

Digging deeper, the role of operating partners has continued to evolve and take center stage in terms of driving value. There is a continued focus on how you can extract value and drive performance in both the top and bottom line, and operating partners are a focal point.

Outside of operating partners, many RSM clients are creating value by adding additional assets to a platform in their portfolio. And those operating partners are spending a lot of time looking for synergies to drive value within portfolio companies. We see them looking at functional areas—whether that's the supply chain, sales optimization, making better decisions, or looking at infrastructure.

A common concern these days—one we hear from our clients all the time—is finding not only good leadership at the portfolio company level but good operating executives at the fund level. There's a lot of competition. Our advice is to never stop recruiting; keep looking for the next potential operative executive, whether you need one right now or not. Also, leverage your service providers and their networks because they're invested in their relationship with your firm and will go the extra mile to help create value.

An Unwavering Focus on Operations

Andrea Heisinger
Editor,
Privcap Media

In the past year, the Securities and Exchange Commission has increased its scrutiny of how private equity firms' operating partners are compensated. But the more intense gaze has not stopped firms from utilizing these seasoned professionals to improve the operations and bottom line of their portfolio companies.

In this *2016 Portfolio Operations Yearbook*, produced in partnership with RSM, we have compiled the best Privcap content from the past year that pertains to portfolio company operations and operating partners.

You will read about Arsenal Capital partnering with Chromaflo to create value, and about issues that can pop up when executing a carve-out. You'll find out why an operating partner joined Baird Capital after a 28-year career in industrial products, how two firms handle pooled purchasing, and why KKR partners with the Environmental Defense Fund to provide savings to some of its portfolio companies.

In addition, you'll find a roundup of professional news involving operating professionals, and some data about just how many portfolio companies U.S. PE firms own.

While there may be more regulatory eyes on the compensation of PE operating professionals, firms continue to utilize their expertise to improve their portfolio companies and ensure a solid return upon exiting.

This yearbook contains a wide range of content and insight into how PE firms are adding value to portfolio companies. I hope you enjoy it.

Andrea Heisinger

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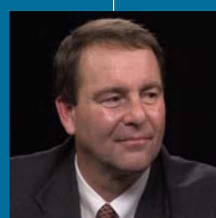

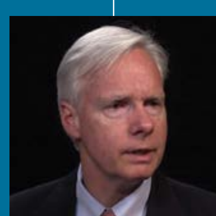

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A collection of thoughts from the Privcap interviews featured in this report

1 "I always considered it an interesting industry, to work with multiple companies to drive value."

2 "I like to keep score, and will create value within strategic areas I will help develop. And I like the entrepreneurial focus in the private equity world and gravitated towards it."

3 "We had a vision that we could pull this product set out—the biopsy system and a couple of other related products that they sold with the system—and create a stand-alone company out of it."

4 "Nothing prepares you for ESG at KKR until you're managing ESG at KKR."

5 "Our goal is to try to provide savings and service levels that our companies couldn't attain on their own… so they feel the benefit of being in our portfolio and programs right away."

6 "The most difficult situation for IT is when there's a carve-out or a merger, because you're standing up a completely new company. So you've got a new IT system."

7 "You have permanent executives who are not on staff—otherwise known as operating partners—who are brought in to add value to portfolio companies….
In many cases, since these operating partners aren't actual employees, sponsors have traditionally not offset these fees."

1 Scott Glickman, Graham Partners
2 Scott Hoffman, Baird Capital
3 Dean Mihas, GTCR
4 Ali Hartman, KKR
5 Jonathan Kinney, The Riverside Company
6 Blaine Clark, RSM
7 Robert Blaustein, Kirkland & Ellis LLP

Arsenal's 90-Day Plan for Chromaflo

Arsenal Capital acquired Chromaflo Technologies and formulated a plan to create value. The firm's Tim Zappala talks through how that plan played out with the company's Scott Becker.

Privcap: There is a term used quite a bit in private equity: the "100-day plan." There are variations on this term, but it's basically the plan to create value at the portfolio level. How does the plan for value creation work at Arsenal?

Tim Zappala, Arsenal Capital Partners: Prior to closing, once we have a fix on exactly what our overall strategy's going to be and we've dialogued enough with the portfolio company, we normally put together a 90-day plan, which has all the commercial aspects and technical aspects that the company will be focusing on from an imitative standpoint, as well as a variety of integration-related activities. And those vary.

Then, once the close occurs, the company moves forward with the execution, with our support. Then, roughly six months after the company is up and going, we get to know everybody better. We normally go back and we refresh the strategy to make sure we've got the right alignment for the next couple of years.

Scott, from your perspective, what was that process like? How intense was it?

Scott Becker, Chromaflo Technologies: Our 90-day or 100-day plan—as you described it—was developed well in advance of the close. We were probably done with our 90-day plan three months before the close occurred.

The first week after we became Chromaflo, we exhibited at a trade show—the whole show was around our new name. Our goal was established well in advance. We intended to double our earnings over a five-year period. I'm happy to say we've actually done that twice now. We're not only double, but we're four times our original earnings, and we've done that in less than three years. So, it's been a good run. We had to initiate a pretty extensive 90-day plan. It covered every single discipline—finance, operations, sales and marketing, and communications—and the template on how to implement it was provided by the Arsenal group.

Scott, what were the most important facets you identified in constructing this plan that you knew would really drive growth at your company?

Becker: Number one was transferring the technology we had in the U.S. onto the global platform that we developed through the acquisitions. The second thing was to make sure we had alignment. We actually put together quite a diverse set of cultures through these various acquisitions, and we needed to make sure we were all aligned and focused on the most important things, which in our case happened to be customers or potential customers.

Was there a toolkit or a set of resources you were able to reach into within Arsenal to accomplish some of these things?

Becker: I often reached out to Arsenal. I continue to reach out to Arsenal. There isn't a template that exists, but more or less experience and advice that's critical to making things happen.

Zappala: We tend to be a bit more specific in the functional areas. In the growth and strategy and technology areas, it varies by company. As Scott has indicated, if you looked at his plan, there were key initiatives that were team-oriented because we find we need to get the team in place first and make sure the organization has the right skills in order to move forward. Then it gets a bit more functional. What are you going to do on IT? What are you going to do on accounting? There are a handful of activities that you have to make sure you're covering both in a typical integration and, in this case, in a carve-out situation. ■

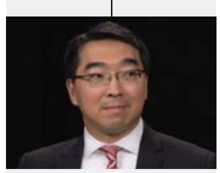
Why Sharing **Portfolio Company Data** Is So **Difficult**

Experts from Siguler Guff, CD&R, and AlpInvest share insights into why sharing portfolio company data between GPs and LPs can run into snags, and how firms are trying to overcome them

Privcap: Let's talk about the pain that has been experienced in private equity in sharing portfolio company data—getting it from the portfolio companies through the GP and to the LP. How is that improving, and can it be made better?

Tom Franco, CD&R: I would say it's a challenge and that we're evolving our capabilities to be more efficient. One area where there has been more investment in terms of managing the GP is in the area of fulfilling these kinds of disclosure requests. You have to have people who are able to find the data within the system, and then put it into a format particular to the LP that's requesting that information, so that takes time. The long-term efficiency will come from more standardization and from platforms that are providing services—or at least technology-related platforms—to deliver this in a much more effective way.

Jay, as an investment advisor, you are requesting information both from your own GPs and from their portfolio companies, and you are responding to requests from your own investors. What resources and people are necessary to make that happen?



Jay Koh, Siguler Guff: In the small-buyouts universe, we have close to $2B invested across more than 50 different managers, and 30 percent of that capital invested in co-investment transactions, direct transactions. The data interface is managed by the same team that manages that particular set of portfolio relationships and direct investments. And we've found that's the best way to do it, because the data is completely integrated into the decision-making process. How we extract performance information from that and then report it is much less duplicative than it might be if you had a completely separate reporting function that would provide it.

What we have had to do, though, is add more resourcing at the individual investment team level to make sure we continue to maintain these increasingly large and complicated databases, and to standardize where we're actually getting that reporting. We do get some customized data requests, and we also provide very specialized and tailored information, particularly in separately managed accounts.

Eduard, what team and resources have you built to process all of AlpInvest's requests for information?

Eduard Lemle, AlpInvest Partners: We've certainly invested or are continuously investing in systems and technology, in addition to processes, human resources, and growing teams. The result is that much of this is fairly automated. But there is always room for continuous improvement.

The deal team sends out a very tailored request. It's important to not inundate the GP with a laundry list of 500 items, but to have an initial analysis of that fund opportunity and then ask for those items that are value-added for analysis.

I would say there are three remaining challenges that cannot be covered by automation. One is reviewing and checking the data; the second would be disclosure; the last point is really making sure that we add value in how we design the reporting to our investors and show relevant analysis rather than just a table with 10,000 rows and 200 columns.

Is there a risk that many LPs are getting reams of information, but they don't have the team in place to do anything useful with it?

Koh: If you look at the structuring and resourcing and governance of different long-term pools of capital, they all have different fundamental human resources available. They have different decision-making processes, different data available to them, and different restrictions on how they can operate. Some of the role we play for our separately managed accounts in particular is this customized interpretation of what's happening in these different markets. The easy example is something like the emerging markets, where you've had election cycles in South Africa, Indonesia, India, and Brazil. So, how do you think about the performance of your portfolio and the currency effects of it in the face of these potentially major political changes? ■

Inside Graham's Operations Team

The firm's Scott Glickman discusses what's kept him interested in being an operating partner for almost a decade

After almost a decade working as a private equity operating partner, Scott Glickman of Graham Partners says it's the variety of the role that keeps him interested.

"I always considered it an interesting industry," he says, "to work with multiple companies to drive value."

Glickman, a senior operating partner at Graham, was in operations at TPG Capital for a few years. He came to private equity straight from working at Pratt & Whitney as director of quality globally, where he had started thinking about becoming an operating partner.

For Glickman, the appeal of leading the operations team at Graham is that he has the opportunity to work in several areas: looking at portfolio-wide programs and opportunities, working on value-creation initiatives at specific portfolio companies, and participating in due diligence.

"The most important thing is selecting what to work on with each portfolio company," he says. "We always start with a strategic planning process. After we acquire a business, we sit down with the management team, fine-tune things, and identify key value-creation initiatives. We then ask, 'Where does the management team need to be supplemented?' [Our] companies are often on the small side, so we look for where our team can add value."

During due diligence, prior to the acquisition of a vinyl siding manufacturer, that meant identifying that the company's resin procurement processes weren't very robust and had room for improvement that could boost the company's existing $6M of EBITDA by $1M. Glickman's team identified resin procurement cost savings, which ultimately saved the company $3M and improved EBITDA by 50 percent, he says.

But there is one thing that Glickman includes in all strategic plans: revenue growth. "You can cost-cut your way to an adequate return, but you need to grow [revenue] to have an excellent return," he says.

In addition to bringing in outside advisors—usually industry experts—during the diligence period, Glickman says advisory boards have also proven to be an effective tool for Graham's portfolio companies.

"One thing we've found very useful is the creation of advisory boards for our businesses…with increasing regularity in the past few years," he says. He and others on the operations team at Graham identify two to four industry experts, such as retired executives, and hire them for an advisory board, which then meets with the management team of a portfolio company a few times a year to help identify new customers and turbo-charge the growth plan, Glickman says.

This advisory board strategy has served the firm well in its investment in a remanufacturing business. An advisor recommended a customer that the portfolio company should be working with, and eventually they signed a contract with them. "Through an introduction from an advisory board member, we won the business's largest customer," he says.

In addition to being a hands-on "activist investor," Graham Partners' approach is looking equally at value creation and risk mitigation. "Adding value is an exciting topic that everyone wants to discuss. However, you can destroy value if you haven't properly assessed and prepared for the inherent risks that come with running a business," Glickman says. ■

Carve-out FUNDAMENTALS

There are intricacies to separating a piece of a company from its parent, as well as roadblocks that can occur, say experts from Vestar Capital, J.F. Lehman, and RSM

A diverse set of qualities attract firms to carve-out opportunities. There are different circumstances leading to a private equity firm finding a carve-out opportunity. Sometimes it happens when a portfolio company acquires another business. Rob Rosner, founder and co-president of Vestar Capital Partners, says that his firm has found carve-outs a number of ways. Within the acquisition, there may be lines of the business that are no longer core to the acquiring company and ripe for divestiture.

"Today, there's a lot more focus on activism and on increasing shareholder value," Rosner says. "In some cases, there are businesses held within a portfolio company that don't necessarily have the growth or core position in the market compared to some of the positions the parent company has."

Lou Mintz, a partner at J.F. Lehman & Co., says that in the space his firm operates in, there is constant aggregation and disaggregation of companies, although a shift is taking place. "Pressure is [now] on corporates to rationalize their portfolios…." says Mintz. "So we believe we're at a tipping point in terms of that particular space, where the disaggregation part of the equation is going to start coming about with increasing speed."

> "If you look at the services that you're buying from corporate and the money that you're spending on that, that's a focus drain and a cash drain. And the sooner you can unplug those, the more prepared you are to focus on the value-creation strategy going forward."
>
> — Blaine Clark, RSM

CONTINUES ON NEXT PAGE

Familiarity with doing a carve-out is key in price negotiations. Not having a track record of carve-outs can be a hindrance when an opportunity to sit down with a seller arises. Familiarity with any potential issues and the ability to deliver on the transaction are key discriminators in getting a seller comfortable or to even start considering a transaction with a PE firm, says Mintz.

Rosner agrees that they'll care about a price within a fair value, and "they're going to care about working with a partner who can help them do it in the least disruptive way. Sometimes these are businesses that are a little harder to package, because they're not free-standing with fully stand-alone, audited financials."

Sometimes after the carve-out deal is closed, the relationship will continue, says Mintz. "We've been involved in some situations where, for instance, the manufacturing plant that was being conveyed with the unit was actually doing some work for the parent. So we entered into reciprocal supply agreements over the medium and long term where each company was, in fact, dependent on the other to continue to deliver that particular good or service."

Businesses that are carved out start in different variations. A carve-out transaction may come to the process in a range of states. It could be a robust, nearly independent business or simply a product ready to break away from its parent company.

An organization such as Procter & Gamble may have decided to divest several divisions, and internal work may have been done to prepare them for sale, says Blaine Clark, director, private equity consulting at RSM. "But there are cases where it's really up to you as the buyer to rip it out and stand it up again."

A controller was at the center of an extensive tug-of-war when the parent company was reluctant to part with him, Mintz says. Ultimately, J.F. Lehman prevailed, but the incident highlighted the fact that the basic allocation of talent inside the organization is not readily packaged and needs to be worked through with the counterparty.

In many cases, it might be a first-time buyout as opposed to a business that's been stand-alone and already owned by PE investment firms, says Rosner. "That lends some of the interesting upside and opportunity, because in many cases the management team is, for the first time, experiencing the entrepreneurial enthusiasm and culture that comes with being owners of their business."

Rob Rosner, Vestar Capital Partners

Blaine Clark, RSM

Lou Mintz, J.F. Lehman

Performing a carve-out transaction can be complex. The complexity of a carve-out transaction can have many levels. Mintz points out that the process starts with how prepared the seller is to execute the transaction. It could be a relatively independent enterprise that has some connections to the parent company and is back-office-oriented, or there could be a product or part where the people, machines, and facilities aren't bound to the seller.

Other scenarios involve a recently acquired company, with the buyer planning to divest some businesses, and also a business that has grown up with the parent company and has history involved. "All of the back-office or support functions might have to be re-created from scratch. Those are, in many cases, the most interesting, because from a roll-up-the-sleeves-and-create-value point of view, there's so much to work on."

Another unique situation could involve a business distributed across multiple geographies and no central human resources, IT, or sales and marketing. "In some ways, you're doing multiple transactions to get the single transaction done, because there really is no unified seller," Mintz says.

RSM's Clark says that it's difficult to arrive at the value of a carve-out deal like this, because EBITDA could be different for a stand-alone company, due to the many variations. Many times there's not an EBITDA established for what's being carved out, he says, and it needs to be figured out. "It's essentially a project to model what the new company's going to look like after you pull it out of the corporate," he adds.

Each PE firm may have a different "checklist" for the carve-out process. There may not be a standard checklist involved when a private equity firm performs a carve-out, just as there is no standard carve-out transaction. Clark of RSM says that while a checklist isn't discussed, the "big rocks" that can be run into—human resources, supply chain, IT, finances in a shared service organization—are talked about.

Rosner's firm, Vestar, uses something resembling a 100-day plan for a carve-out, which he says management appreciates. He's also noticed that when developing a separation agreement, it's simplest to say there will be a year-long cooperation agreement that can specifically narrow down the areas of interaction with human resources, legal, tax, and so on.

In a transition services agreement, unnecessary money is sometimes spent. "If you look at the services that you're buying from corporate and the money that you're spending, that's a focus drain and a cash drain," Clark says. "And the sooner you can unplug those, the more prepared you are to focus on the value-creation strategy going forward." ■

Fredrik Henzler, Partners Group

Jonathan Kinney, The Riverside Company

How Two Global PE Firms Do Pooled Purchasing

PE firms use group purchasing programs to cut some common costs in portfolio companies. But there are differences among firms' programs, say experts from **Partners Group** and **The Riverside Company.**

As chains like Costco and Sam's Club have shown, buying in bulk can save money. The same concept is used for cutting costs in private equity portfolio companies.

Jonathan Kinney, managing director, Strategic Analysis & Sourcing at The Riverside Company, has been working on the global firm's pooled purchasing since 2004. He says that Riverside has anywhere from seven to 10 programs at a time involving pooled purchasing. Most of the time, a company will be made aware of this benefit before becoming part of the Riverside portfolio.

"Our goal is to try to provide savings and service levels that our companies couldn't attain on their own outside of Riverside, so they feel the benefit of being in our portfolio and programs right away," he says.

Riverside buys small companies but has a large portfolio, which leads to leverage. "After they're acquired, we get into the specific benefits of each program, measuring savings and the service level impact of switching [to the pooled purchasing]," Kinney says.

There is also a pooled purchasing program at Partners Group, the Switzerland-based global private markets investment manager. Fredrik Henzler is co-head, Industry Value Creation, and was previously founder and partner of a consulting company for procurement and supply chain optimization, building up the private equity portion of his practice over six years working with GPs in Europe.

"What is interesting is, the overriding reason most people start looking into pooled purchasing is to gain benefit of scale," Henzler says. For example, instead of one company buying 5,000 units of printer toner a year, portfolio companies together could buy 100,000 for a better price per unit.

Henzler says that at Partners, one of the common starting points is information technology. "Everyone needs laptops, printers, displays—these are very comparable across companies," he says. Aside from IT and related expenses, the second-most-common categories that Henzler sees pooled are miscellaneous office spend like materials and consumables.

Kinney says most of Riverside's pooled purchasing programs involve indirect spend such as insurance, shipping, office supplies, and IT supplies. Manufacturing and distribution companies usually have the most spend—and the most savings, he says.

"We had three enrollments in our insurance program, and each saved more than $100,000 per year," Kinney says.

The total savings percentage on all pooled purchasing programs is a little more than 14 percent at Riverside, he adds. If health insurance, which has the most dollars spent but a lower savings percentage, is excluded, that jumps to about 25 percent.

Henzler says that he's seen up to 40 percent savings in certain spend categories, but the minimum they expect at Partners is 15 percent. "If the cost savings are lower, we wouldn't initiate the program," he says. "We would wait for the next opportunity rather than save 6 percent."

Partners Group is a global mid-cap investor, with the portfolio scattered among emerging markets, Europe, and the U.S., making it impossible to have a portfolio-wide pooled purchasing program. "It's just too large a geographic dispersion," Henzler says.

Riverside has more than 70 portfolio companies across four continents, and Kinney's team is always looking for pockets of leverage to create savings.

"We're monitoring the implementation process, staying on top of contract renewals and the bid process," Kinney says. "There's someone at Riverside to call to deal with these things. We try to make it very easy for companies to participate and see the benefit." ■

Baird's Products Operating Partner

Privcap speaks to Scott Hoffman about why he joined the private equity firm after a 28-year career in industrial products

After spending nearly three decades at an industrial products company, including running four global businesses, Scott Hoffman made the leap to private equity operating partner.

It was an easy decision for him to move to Baird Capital as part of the firm's products team. Hoffman spoke with Privcap during his first week on the job, about why he wanted to become an operating partner and why Baird stood out from other firms he spoke to.

He came from 28 years at Brady Corp., the Milwaukee-based international manufacturer and marketer of safety-related products.

"I met with a number of PE firms in the Midwest and a few in the New York area," Hoffman says, "looking for the right strategic fit, an operating culture and philosophy that was positioned well for future growth, along with a proven track record of results and a high-caliber team."

He settled on Baird, which will make use of his time working in different capacities at Brady, and he'll be adding his expertise in value creation to their global portfolio. "They're looking to rely on my years of experience to assist the team with strategy development and execution," Hoffman says.

Although it's early in his new career as an operating partner, Hoffman says he will have several responsibilities at Baird, including working with the investment team to develop strategies in mutually agreed-upon industry sectors, assisting in sourcing potential transactions, and working with the team to drive value within existing global portfolio companies.

So why make the switch to private equity operations, working with portfolio companies? "It's the most efficient model in the business," Hoffman says. "You know the end game, and the exit comes in four, five, six years. I like to keep score, and will create value within strategic areas I will help develop. And I like the entrepreneurial focus in the private equity world and gravitated towards it."

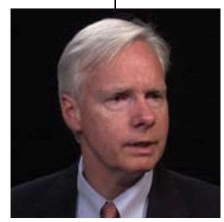
Hoffman adds that his experience in industrial products cuts across many different industries, channels, geographies, and value-creation drivers. "I was looking for an opportunity that would capitalize on this."

"I like to keep score, and will create value within strategic areas I will help develop. And I like the entrepreneurial focus in the private equity world and gravitated towards it."

–Scott Hoffman, Baird Capital

Lincolnshire's Focus on Portfolio Operations

The firm prides itself on its operational expertise, with many of its professionals coming from operations backgrounds, says president Michael Lyons



Michael Lyons,
Linconshire
Management

"Before we brought on dedicated operating people, I've spent time living out of a portfolio company for many months at a time, working at the company, as have other folks, even on our investment committee."

–Michael Lyons, Lincolnshire

Privcap: What is the operating philosophy at Lincolnshire, and how has it evolved over the past two decades?

Michael Lyons, Lincolnshire: The genesis of our operating philosophy goes back to the 1990s, long before it was fashionable for private funds to have operating talent. We infused much of the deal teams with operating partners who have run companies. Many of the businesses that we were looking to acquire were smaller and didn't have a lot of depth, and so we wanted to go in and do a couple things. We wanted to assess what we can do with the business, and we wanted to connect with the managers. In many cases they were entrepreneurs, and you don't want to come off as a suit out of New York. If you can sit across the table from some CEO who's been running this business for all his life and he can have a conversation with you and say, "Wait a minute, this guy really understands what it's like to make a payroll," that opens up the doors and opens up his eyes to say, "This guy can be helpful, and this firm can be helpful to me beyond just providing capital." And that's critical, and it's been a key to our success over the years.

How do you put your operating partners to work within the firm?

Lyons: They're employees of Lincolnshire. They work in diligence before we do an acquisition, and they also help assess what we would want to do post-acquisition, and that includes going in and running that portfolio company. I've done that myself, actually. Before we brought on dedicated operating people, I've spent time living out of a portfolio company for many months at a time, working at the company, as have other folks, even on our investment committee. As we've evolved over time, we brought operations people in to be able to serve that role. It's very helpful to have someone who can be a resident at that company.

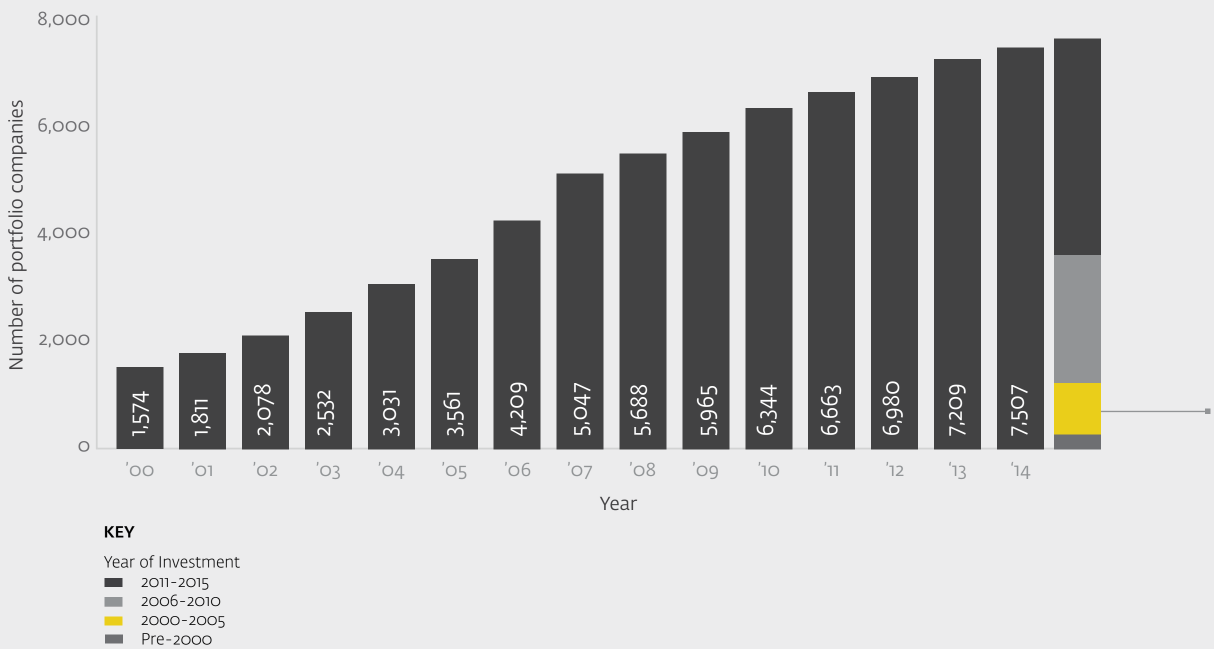
What kind of a background would one of your operating partners have? Are they an ex-CEO? Are they industry-specific?

Lyons: We're a generalist firm, so we look at a lot of different industries across many different manufacturing service environments. And so we do bring in somebody who has that CEO experience. A lot of it is manufacturing-service-driven, to the extent that you need specialized help, whether it's in consumer products or direct marketing. We can go out and get that experience in the form of consultants—and therefore, as the need subsides, they can easily move on to the next thing. ■

If you want to see how much private equity has grown as an asset class since 2000, look at the number of portfolio companies held by firms then versus now. And while M&A remains the top way PE exits companies, buyouts have taken a significant piece of the pie.

Portfolio Companies Add Up

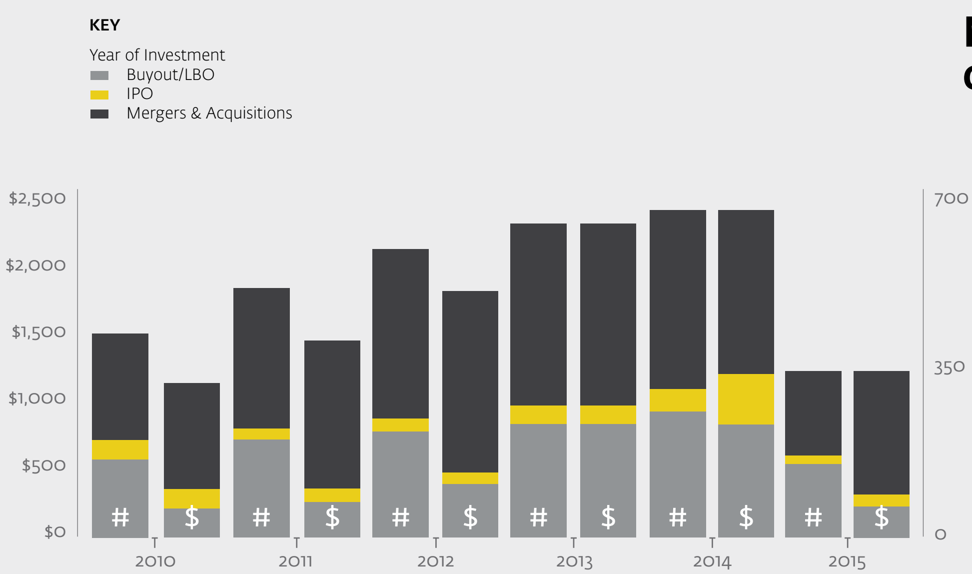
The Slow Rise of Companies Held by U.S. PE Firms



In a show of how much private equity firms have expanded their reach, portfolio company inventory has been on a steady rise since 2000. There were 445 investments in companies in 2000, and at the midpoint of 2015 there were already 426.

There are less than 1,000 portfolio companies still being held that were invested in between 2000 and 2005.

M&A Remains King of Exit Strategies



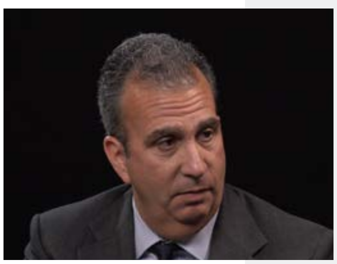
Since 2010, mergers and acquisitions have remained the most popular way to exit a portfolio company, besting both IPOs and buyouts or leveraged buyouts in number and dollar amount. The number of buyouts and LBOs began edging closer to the number of M&As as of June 30, 2015, but by dollar amount, M&A was on top by a long shot. Time will tell if the number and dollar amount of overall exits in 2015 can beat the high-water mark in 2014.

Data as of June 30, 2015 | Source: PitchBook

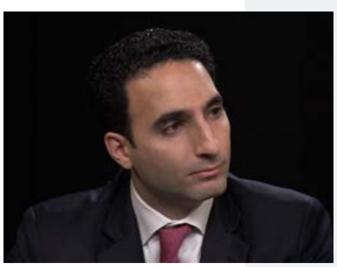
Fees Outside the "Offset Paradigm"

Experts from Kirkland & Ellis, Gen II, and Credit Suisse dive into a controversial fund-formation topic: fees charged to portfolio companies that fall outside of the traditional deal fee arrangements

Robert Blaustein,
Partner,
Kirkland & Ellis LLP



Steven Millner,
Managing Principal,
Gen II Fund Services



Raed Elkhatib,
Managing Director,
Head of Due Diligence,
Credit Suisse Private Fund Group

Privcap: Can you tell us what the offset paradigm is?

Robert Blaustein, Kirkland & Ellis: When we're talking about the offset paradigm, we're talking about fees that sponsors are receiving from prospective portfolio companies that will reduce the management fee that's actually paid from LPs. And so there is a question about what fees are going to the sponsors that aren't reducing LP fees. And there are a couple baskets of them.

The first is where firms have a value-creation-services provider group. That could be an operations group, or bundling services, or anything that the portfolio company could be going outside of the sponsor to provide. Second, you have permanent executives who are not on staff—otherwise known as operating partners—who are brought in to add value to portfolio companies in the same way that a public company might hire an independent director to come in and consult or serve as the director. In many cases, since these operating partners aren't actual employees, sponsors have traditionally not offset these fees. And then the last basket is negotiated. If you look at a venture fund compared to a buyout fund, there are a number of directors' fees and things that wouldn't serve as an offset, like real estate groups that have affiliated lending or leasing offices.

Steve, are LPs driving these offset paradigm fees?

Steven Millner, Gen II: LPs want to know what you're bringing to the table to create value. How do you create value beyond financial engineering? And that's a whole new set of costs that goes into the mix. Ultimately, someone is going to have to pay for it—there is no free ride by the LP. The GPs' budgets are getting constrained as a result of all of these things. Plus, every GP now has to have a compliance officer. And the manifestation of the dialogue between LPs and GPs is really a negotiation.

What we increasingly see in the LP documents is more specificity regarding this fee paradigm about what is included and what is excluded—so, where there's an offset as opposed to where there's not an offset. There is much more transparency around what that right line is today than there has been in the past.

Raed, do most LPs understand and accept that a lot of the management fee is getting eaten up by these back-office, compliance, and regulatory costs of the private equity firm? And do they recognize that there needs to be a source of revenue to support portfolio operation endeavors?

Raed Elkhatib, Credit Suisse: They do value some of these services and recognize the cost is rising. But a more direct link that fund managers can identify is the cost, and here is the associated value that's critical going forward. There is a cost to all these services to generate outsized returns. And in what's becoming a more mature, more competitive market, there needs to be a more direct link. You're going to see a lot more disclosure and a lot more transparency in limited partner agreements. And even before it's negotiated as to what's actually included in the fee offset paradigm, [you have to] define what those are. If it's a monitoring fee, does it go to the waterfall, or is it a separate monitoring fee? Does it go through the outside of that paradigm? That's going to happen—more disclosure and transparency.

Bain's Nine-Year Journey With Burlington Coat Factory

After buying Burlington Stores Inc. for $2.1B in 2006, Bain Capital took the company public in 2013. During its ownership period, Bain was able to grow Burlington's revenue substantially by making operational changes and adding new stores. In 2015, Bain sold its remaining shares in Burlington. What follows is an excerpted conversation with Josh Bekenstein, a managing director with Bain Capital, about the firm's involvement with Burlington Coat Factory and what made the deal a success.

Josh Bekenstein,
Bain Capital

Privcap: Why were you originally interested in owning Burlington Coat Factory?

Josh Bekenstein, Bain: Burlington was a great fit for what Bain Capital brings to investing. The company competes in the off-price channel, which we felt offered them lots of opportunities for growth. And we felt that we could help improve the business operationally as well. This was a family-run business that had done very well, but with accelerated growth plans, we felt professionalizing management offered a large opportunity to improve the business.

How did you initially plan to grow the company?

Bekenstein: When we bought Burlington, the company operated approximately 300 stores, and we figured we could grow the store base to 500 to 1,000 stores. We also felt we could bring efficiencies to help them do a better job for their customers and grow the business at a faster pace.

Did you replace the management team?

Bekenstein: The family owners wanted to leave when the sale was done, so we brought in a new CEO in 2008 and helped him build a mostly new senior executive team, including a CFO, head of stores, head of merchandising, head of planning and allocation, head of HR, and a head of marketing.

And how did you grow sales?

Bekenstein: We did a number of things to grow sales. Most importantly, we improved the customer experience by improving the company's discipline in merchandising. With better planning and allocation, and a better merchandising organization, the company doubled inventory turns, allowing for more freshness in stores and less inventory. The stores became more shoppable for customers.

We also worked with the company to do a better job of localizing the selection in the stores. Today there is different merchandise in stores depending on the customer base, and this has significantly improved the customer experience.

We helped make the central distribution center more efficient so Burlington could get merchandise to stores more quickly and [make the clothes] more floor-ready. That process used to be done at the store. Now it's done in the central distribution center so store employees can focus on customers and the merchandise can get on the floor quicker, giving customers more to choose from more frequently. This improved sales and gross margins.

We also worked with the management team to do a better job of scheduling. With the data we were able to collect on when customers were shopping, our management team could schedule more people to work when the stores were busiest and fewer during slower traffic times. As a result, the company was able to reduce costs while offering better service to the customer. The company also made investments in hiring and training associates to help them be more effective and successful.

What was the real estate strategy?

Bekenstein: When we bought the company, it was clear they needed a better real estate selection process. We worked with the management team to better identify what locations would do well for new Burlington stores based on what made sense for the brand and was an overall fit with our customer base. The company had grown to 525 stores by the time we took it public.

Why did you decide to sell your remaining shares now?

Bekenstein: The company went public in 2013 and has performed really well. It went public at $17 per share, and now the stock is trading in the mid-$50s. We were able to sell our shares over time without having any negative effect on the company's stock price, which is always our goal as we exit. ■

Whipping Distressed Assets Into Shape

Newly formed SOLIC Capital brings a deep bench of familiar faces to turn around portfolio companies in need of help

Whereas typical private equity investments have a five-to-seven-year time frame from acquisition to exit, distressed assets, already on life support, have to work faster to get healthy before investors pull the plug. At SOLIC Capital, a portfolio company has three years, at the most, to get back on its feet. That includes a full operational turnaround within 24 months and then position for exit in 12 months or less.

"We are not pushing a can," explains Robert Annas, a senior managing director at SOLIC. "[We have the] ability to make things happen."

For SOLIC, whose management considers the firm a one-stop shop offering advisory, principal investing, and distressed management, initiating change begins with its 3P3M strategy, comprised of people, plan, process and measurement, monitoring, motivation.

"We are not pushing a can. [We have the] ability to make things happen."

–Robert Annas, SOLIC

SOLIC was formed in January 2014, but its leadership has been working together for more than 15 years. The team started out as Caremark International in the early 1990s, went on to build Casas Benjamin White, and was acquired by Navigant after seven years. Ten years later, they created SOLIC with the blessing of Navigant in a friendly transition.

Annas says the key to rehabilitating distressed assets' operations is immediately identifying a handful of levers that need to be reworked in order to "drive the ability to grow enterprise value." The next step for SOLIC is to install measuring tools. A main aspect of doing this is keeping it simple and not overcomplicating the issues, Annas says.

SOLIC recently exited a private home-healthcare company where one of the biggest operational levers in need of adjustment was its people. The firm reconstituted the company's senior management, decentralized sales efforts to allow local teams to react to individual markets in a customized fashion, and reviewed metrics on a daily basis. All of this worked to create a culture of accountability, Annas says.

After a short time, SOLIC exited the investment to a strategic buyer. Interestingly, the acquiring company had its sights on the portfolio company when SOLIC bought it, but waited until the turnaround was complete. Annas says this is typical of a SOLIC investment, because strategic buyers are not interested in doing the heavy lifting of turning around distressed companies; they prefer to have "clean" assets at the onset of acquisition.

Getting those distressed assets to a position of growth that acquirers find attractive is a fast-paced business not for the faint of heart. In addition to daily measurements, SOLIC takes 30-, 60-, and 90-day evaluations of operations. If, by the three-month mark, conditions are not moving in the right direction, decisive action is taken.

"You can't get enamored with your own b.s.," Annas says. "We get [investments] into positions of growth to sell."

Cybersecurity: **The New Due Diligence**

RSM's Daimon Geopfert and the founder of a security firm discuss how private equity firms include cybersecurity as part of their overall risk assessment

For private equity investors, cybersecurity is not only becoming a significant part of the portfolio company acquisition process, but also an important part of fund operations.

"What we try to coax a lot of our clients into understanding is, there's the security at the fund level itself, at the portfolio level, and then the interaction between the two," says Daimon Geopfert, national leader, security and privacy consulting, at RSM. "A lot of funds will come back and say, 'We don't contain a lot of sensitive data.' Usually, on review, they have more than they think, and they always seem to forget that they are also an entrée into some of the portfolio companies."

"Most breaches are actually targets of opportunity. They didn't come looking for you specifically; you just happened to be vulnerable."

–Daimon Geopfert, RSM

Geopfert says most cyberattacks are crimes of opportunity, and private equity firms that think they're not targets should think again.

"Most breaches are actually targets of opportunity," he says. "They didn't come looking for you specifically; you just happened to be vulnerable. They took a shot at you and then realized later who you were."

One of the most common misunderstandings about cyberattacks is that organizations assume they will know very quickly that they've been breached. But Geopfert says the number of days it takes to discover a breach is between 200 and 300 days. By then, a lot of the damage is already done.

According to Scott Larson, a former FBI special agent and founder of Larson Security, private equity firms are trending toward making cybersecurity part of the early stages of due diligence. In fact, he predicts it will become the norm in the next two to three years industry-wide.

Larson, who led the FBI's computer investigations and infrastructure protection program as a supervisory special agent before founding his security firm, has seemingly seen it all. An immediate red flag includes IT groups that are hostile when questioned about processes.

"There are weaknesses they do not want exposed," Larson explains. "There is something they are hiding."

For private equity, the potential damage a cybersecurity event can have for firms is exponential. For instance, a disgruntled employee could provide sensitive data in order to torpedo a deal, Larson points out. And if a hacker breaks into the firm's network, that person would gain access to LP information.

Working with private equity clients often means the stakes are higher than in other industries, because the goal is to provide a full assessment of the IT security without negatively impacting a deal for a target portfolio company. And while a full assessment of a company's cybersecurity is quite expensive, the alternative could cost considerably more.

"With the multiples being so high right now, there's a lot of money at risk," says RSM's Geopfert. "If they're breached when they buy a company or right afterwards, they can lose that entire investment." ■

Operational Expertise Makes the Difference

Dealmaking has been going like gangbusters for private equity firms throughout 2014 and 2015. However, many experts believe that PE firms will have a hard time producing outsized returns from the deals they completed in today's market, where valuations are very high and leverage is abundant. To help portfolio companies achieve growth in all situations, but especially in today's environment, Advent International and Welsh, Carson, Anderson & Stowe have both developed extensive operating partner programs over many years.

What follows is an excerpt of a conversation with **Conor Boden**, head of portfolio board development at Advent International, and **Tony Ecock**, a general partner at Welsh Carson, who is responsible for helping portfolio companies identify and implement initiatives focused on growth and operational improvement. They share insights into how operations professionals can add value and why they are important to investment strategies.

Conor Boden,
Advent International

Tony Ecock,
Welsh Carson

Privcap: Why do you think having operating partners is important?

Conor Boden, Advent International: There are many different definitions of what makes an operating partner. Advent defines them as senior ex-CEOs who act as independent advisors to Advent and the companies we invest in to support the development of the businesses. These people are not employees of Advent but work very closely with us on pre-close activity as well as post-close. They are experts in their sector. Our approach to creating value is to work with management teams to grow the portfolio company's earnings by increasing the top line or investing in operational efficiencies. We recognize the value the operating partner brings in helping us do that. It's a proven program we have had in place for 10-plus years. We have more than 60 operating partners around the globe and believe they are important to what we do.

Do private equity firms with operational expertise excel?

Tony Ecock, Welsh Carson: It's hard to tell with so many other contributing factors, but all else equal, firms with operational expertise will excel going forward. Market multiples are at all-time highs, and

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you need to add value to your investments to earn competitive returns. We actually measure the contribution of our operating team, and we are satisfied that they have significantly improved our returns. But admittedly there is so much variety in private equity and so many other factors that influence returns, it is hard to prove that [contribution] at a general level across the industry.

The real proof is that limited partners are smart enough to know what to look for, and they are demanding more operational involvement at the portfolio level. As a result, most every PE firm has developed some in-house operational capability by now.

Has the role of the operating partner changed over the years?

Boden: It has changed in two respects: In the early phases of our program, operating partners were largely focused on working with specific companies post-close. These days, we work with them at least as much pre-deal. They are helping us think about the subsectors we should be looking at and where we can deploy capital. They also help inform our thinking about certain sectors while offering sound advice, so it's more than just working with portfolio companies.

Ecock: It's changed significantly, because the sheer number of operating partners has grown. You have a mature industry built around the operational partner. They have significant experience and well-developed job specifications now. Some firms are on their second or third iteration of how to deploy these resources. You can now find operating partners with track records. It's really a well-established profession, and the growth is obvious. Consider our PEOPEN [Private Equity Operating Partner Executive Network] organization, which is made up exclusively of full-time on-staff operating partners; we had six people in 2008, and now we have 500. The field should continue to grow.

How has using an operating partner helped you achieve your goals with your portfolio companies?

Ecock: The clearest examples are in growth and cost efficiency, particularly in procurement. It's hard to quantify the precise impact on growth, but we can point to companies where we have helped them build sales forces or provided ideas and input to their new products and services, which have worked well. The company has to do the work, but the operating partner is supporting them. On procurement, we aggregate our purchases across 25 to 30 portfolio companies, which allows us to buy at much lower prices than the companies could buy for on their own. We have saved over $100M in procurement costs on an annual run-rate basis. This is a huge win, and this money can be reinvested in growth initiatives.

Before we even consider buying a company, we ask, "How can we improve its value?" We begin with a formulated value-maximization plan. Then we look to the management team, with support from the operating partner as necessary, to move the business in the right direction.

Boden: It's been tremendously helpful. For example, in one situation, we worked with an operating partner and it helped us win the deal. We were coming in second during the process, and then the firm we were competing against started chipping away at the price and indicating that they wanted to remove some of the employees. The seller was pretty upset. Turns out he knew our operating partner—they were part of the same network—and he asked our operating partner, "What's Advent like?" Our operating partner told him that he had worked with us before and knew we invested in people and the business. That gave us credibility, and we won the deal.

Are there any sectors that lend themselves more to using operational partners?

Boden: We invest across five sectors and have operating partner relationships in all five of these areas. There is no sector where the model isn't viable, though it is less viable in some, such as real estate, where it's more about the asset play than about what a strong team can do operationally.

Ecock: All sectors in which PE invests have an operating component to them, so they all lend themselves to the input of qualified operating partners. The operating intensity is more dependent on the type of investment than on the industry sector. If you are doing turnarounds, you need more operating input and resources than you would, for example, need in a high-growth company that is tracking well to plan.

Operating performance is fundamental to all businesses. I can't think of a situation where a qualified operating partner could not add some value.

Are there any common strategies for improving operations?

Ecock: The key process we go through is to collaborate with management to develop the value-maximization plan. First and foremost, we are trying to nail growth to drive returns. There's only so much cost you can take out of the company. Whether it's improving the products and services or pricing products correctly or improving the go-to market approach, we have to find the growth, year in and year out. And sometimes that will come in the form of an add-on company that will support our vision for growth.

It's important to apply pattern recognition—to look for problems you have solved before—when pursuing companies. For example, if we can't point to work we have done for a company in a certain channel or geography, then we shouldn't enter into a deal with knowledge that channel or geography is important. There are a lot of things you can do operationally for a company, but you don't want to try new things with other people's money. You want to take risks you can overcome.

Boden: Ultimately, it's the management team that has to improve the business, and a strong team can make a huge difference. Still, you want to understand the market potential and the risk and give the team the support it needs to be successful. The core of everything we do is to ensure we have been backing a strong management team to create value in the business.

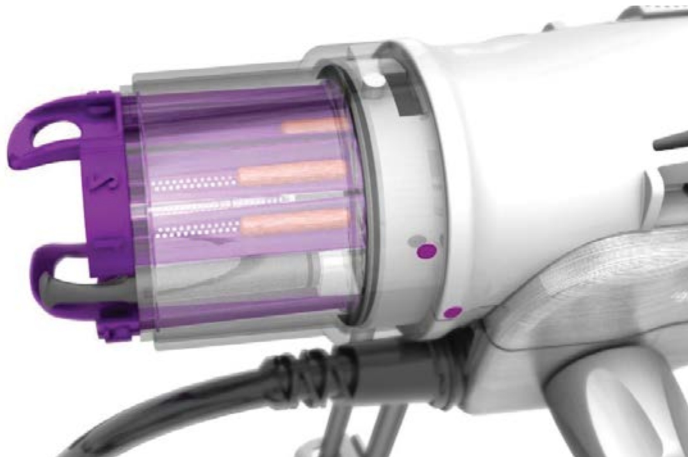
What are the characteristics of a strong operating partner?

Boden: We are looking for someone who is credible. That would imply that they have had success in their sector. We are looking for a rounded skill set and someone who is able to follow a clear strategy. We have to make sure we are getting things right. Our operating partners need to have an appetite to engage in the more detailed operations of the business to drive transformation. It's not just about putting together a strategy and handing it over to management. They need to engage on a weekly basis to help management with the challenges they will face.

Ecock: There are a lot of smart businesspeople; what differentiates a good operating partner is the ability to read the situation and partner with management and the investment team. You need to work with both of them well. A good operating partner needs to build trust and deliver results. A good operating partner prioritizes initiatives and helps management achieve positive change. ■

How GTCR Built Up Devicor

Managing director Dean Mihas discusses how the medical-devices business was improved and ultimately exited



Mammotome components and tools

Privcap: You invest in healthcare companies on behalf of GTCR, and you recently exited a big platform company that GTCR built up called Devicor Medical Products. How did that deal come about, and what did you do to improve its fortunes?

Dean Mihas, GTCR: Devicor is a medical-products company based in Cincinnati. Its main product is a system that performs a breast biopsy. The situation is, a woman has a mammogram, and there's some abnormality that the physician wants to extract and test for cancer. We have a system where the woman would go in for an outpatient procedure and get that lesion removed via biopsy. The company sells directly into 10 countries and distributes to another 40 countries.

What do you think were the drivers of success in the Devicor deal? Of all the strategic or tactical moves, what made the biggest difference in helping this to be a successful company?

Mihas: First, we proactively approached a number of companies. Johnson & Johnson was one of the companies we approached. They had a product line we were familiar with and that fit our thesis. We were able to negotiate a deal with J&J, which took about 12 months to complete.

It was a business that didn't really fit inside J&J. We had a vision that we could pull this product set out—the biopsy system and a couple of other related products that they sold with the system—and create a stand-alone company out of it.

The carve-out process from J&J required us to set up an entire back-office infrastructure. We had to move our manufacturing out of the J&J facility. We set up new manufacturing facilities within 18 months after closing the transaction. Then we had to get regulatory approval in each of the countries that we distributed or sold the product to directly. That took anywhere from a year to three years.

In addition to that, we completed four small acquisitions of products related to the products we were selling, and two licensing deals, also of products that were related. All those things in totality effectively created a very different business from the one we started with and created a stand-alone company that became an attractive strategic asset for a number of larger med-tech companies. Ultimately, Danaher has a business called Leica [Biosystems] that acquired Devicor. ■

Keys to Seamless Merger Integration

When a private equity firm's portfolio company makes an acquisition, the goal is quick integration. But sometimes things don't go as planned. Experts from RSM offer tips on avoiding common pitfalls that trip up integration.

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An excerpt from the RSM paper "Strategic Growth and the Impact of an Effective Integration Infrastructure," prepared by Jim Cashin, Partner; Greg Maddux, Principal; and Daniel Wheadon, Partner

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Here's a nightmare scenario—a portfolio company made an acquisition and told the private equity firm that integration would be completed in 90 days. The management team identified the synergies, calculated the financial impact and estimated the expected returns. Then they actually started to consolidate the plants.

Ninety days went by; integration stalled. Delivery times slowed. Their biggest customer—a major reason for doing the deal—walked away. This is a true story.

There are multiple consequences to an unsuccessful merger integration. The biggest risk, however, is that the management team will be so distracted trying to manage the process that critical items get overlooked, the day-to-day business suffers and customers leave.

The risk of unsuccessful merger integration is especially high for private equity firms investing in the middle market. Many firms lack robust operational capabilities to provide dedicated support to portfolio companies undergoing this process. At the same time, portfolio companies that grew organically prior to investment are now facing their first merger or add-on acquisition. The management team may underestimate the amount of time and resources needed to execute the merger and meet growth targets and reporting requirements stipulated by the private equity firm.

While every situation is different, there are four general components to a successful integration: *speed, prioritization, focus, and accountability*.

Merger Integration: Establishing an integration infrastructure

A $250M company that had grown organically before being acquired by a private equity firm went on to complete more than 140 successful acquisitions, becoming the $3B world leader in its industry.

What made this rapid growth possible? A cohesive integration strategy and approach, as well as organizational, process and technology changes that established an integration infrastructure at the company, made it possible. The changes included a detailed integration plan for multiple acquisitions on an Oracle e-business suite platform, a shared service center structure designed to support the entire North American business, and accounting operations divided into three core departments by business unit.

Private equity firms investing in the middle market commonly take a buy-and-build approach to optimize value, and when executed successfully, a merger can have a significant positive effect on EBITDA. However, more than half of all acquisitions fail to deliver the expected returns—particularly when platform companies lack the experience and expertise to handle add-on acquisitions on their own, and private equity firms do not have the operational resources to provide them with additional counsel and support.

For platform companies whose growth strategy is heavily focused on making multiple add-on acquisitions, it's critically important to develop an integration infrastructure—back-office systems and processes—and invest in the necessary operational resources to successfully complete the first two or three acquisitions. At that point, the capability can be transferred to the management team, and subsequent acquisitions can be handled internally in an efficient and effective way.

The integration infrastructure should include a playbook for integration and an operating model for the new company, focusing on the components to be integrated but also looking at systems and processes in the field and at the business unit level to allow for a cost and benefit analysis of a potential roll-up in these areas as well.

Beyond dealing with the integration process itself, the management team may not have adequate resources to ensure that communications to various stakeholders—employees, vendors, customers—are handled effectively from day one to minimize confusion and pushback. A detailed communications plan should also be incorporated into the integration infrastructure.

An efficient integration leads to short- and long-term EBITDA growth

A $100M international manufacturer of industrial coatings was able to successfully integrate a $40M acquisition in just three months. As a result, 2,000 hours of coatings capacity was transferred to the newly acquired site—freeing up existing capacity to produce additional films in a dedicated specialty film site and leading to

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higher sales overall. In addition, a redesigned organizational structure created a lean, well-defined operating model that cut costs in the long term.

Structured integration management, a strong steering committee and a defined scope allowed the company to move quickly—without overburdening the management team.

The faster integration is completed, the faster synergies add to EBITDA, and management can turn their attention to other growth initiatives. When outside resources mean the difference between a successful integration in six months and one that's still incomplete after two years, the return on investment is clear.

If outside resources are necessary, it's best to enlist them early, during the due-diligence phase, to prevent time and money from being wasted. Operational due diligence provides an upfront assessment of post-close synergies—including consolidation of headcount, purchasing power and facilities—to preclude unreasonable assumptions. Operational due diligence can also determine potential revenue enhancement activities, such as cross selling product lines.

Pre-close, a general back-office and IT assessment is required to gauge the existing systems and processes of the company being bought as well as at the platform company, to get an idea of what investments will need to be made post-close to complete the integration. By reviewing technology capabilities and developing a road map based on the findings, the management team can decide at an early stage whether it makes more sense to reinvest in the existing systems, continue with planned implementation and capital spend, or select another application.

Setting priorities: First, do no harm

A $2B financial services organization acquired several business units, and was able to quickly generate $25M in cost savings by implementing shared service centers for common functions across four major divisions.

When prioritizing what to integrate first, start with back-office functions and work towards the front office, minimizing disruptions to customers while cutting costs through consolidation. To differentiate between critical and noncritical back-office functions, determine during the diligence phase what needs to be ready on day one, and what can be considered phase two initiatives.

Customer-facing synergies, including distributing one company's products through the other's sales channels, can be accomplished relatively fast but require adequate planning and a structured approach to prevent unforeseen delays that could result in lost business.

IT integration is essential to a successful merger, but timing depends on the situation—some IT improvements may be necessary to execute and monitor integration progress and should be implemented as soon as possible, during the first 100 days. For systems and processes involved in day-to-day business, consider allowing the merged companies to run separately before deciding what works best for the overall company.

Outsourcing may be the most cost-effective and efficient way to obtain flexible resources to develop the IT infrastructure, complete data migration, build bridges (write code to interface systems) and manage the overall project without overburdening the internal IT department.

Focus: Flexible resources to quickly execute complex merger integrations

When a $40M manufacturing firm merged with a $40M division carved out of a $20B business, the management team was able to achieve synergies within five months' time. While the integration process was relatively quick, it was by no means simple — completing integration in 150 days with minimal disruption to the ongoing business required significant planning and support.

By enlisting flexible outside resources, the company was able to bring in experts as they were needed, saving time and money. In addition, outsourcing all payroll-related processes led to long-term cost savings.

For a company whose previous growth had been achieved organically, merger integration poses several challenges from an accounting, tax and operational standpoint. Private equity firms and outside providers handling the deal can assist with accounting and tax matters, but operational improvements often overburden management teams simultaneously dealing with cost-cutting initiatives, increased demands for reporting, and other issues.

Expected to deliver results in the short term while planning for future growth, the management team may not have the capacity to focus adequately on what needs to be accomplished, including pulling together the necessary teams, setting reasonable deadlines, monitoring progress and solving problems as they appear. For most midsize businesses, integration needs change on a weekly basis, and outsourcing parts of the process is often the most cost-effective way to bring in resources as they become necessary.

Focus is especially important when assessing methods and processes—often, the platform company will assume that these will remain the same following an acquisition, but the add-on may have systems that are better for the merged organization. The management team must be able to focus on what is best for the business and determine what accommodations need to be made in terms of culture and fit to gain buy-in for any changes among affected employees.

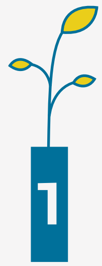
Accountability

Accountability is necessary to ensure people are focusing on the right things throughout the integration process. A transition management team, composed of certain key managers throughout the organization, as well as individual transition teams prioritized by key areas of the business, need to have a clear understanding of what needs to be accomplished overall and in their particular area. However, many companies do not have the internal resources to build and manage the teams needed, or to establish appropriate milestones without overlooking key elements.

A tracking program that measures how well critical functions are performing within the merged company and a process that identifies process improvements should be implemented within the first 100 days. This will allow companies to measure continuous improvement and the success of integration. ■

Buy and Builds Done Right

Experts from One Equity Partners, RSM, and Audax discuss how buy-and-build projects find success faster than organic growth strategies—if executed with the right skills



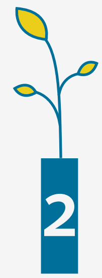
Buy and builds make sense—if executed correctly

More private equity firms are embracing the buy-and-build blueprint to speed up growth. The strategy is to obtain a platform company with good management and infrastructure, then build it out with add-on companies to achieve growth. A firm looking to increase revenues and get to exit can usually do it quicker via a buy-and-build approach than by organic growth, which means finding success with shorter holding periods.

Another advantage of a buy and build is the number and variety of opportunities the strategy opens up. "We're focused on platform companies as small as $5M of EBITDA and as large $35M of EBITDA," says Jay Jester, managing director at Audax Private Equity. "That's hundreds of thousands of companies in the United States. There's an opportunity to help those companies grow from the small-deal market into the really crowded, very competitive, and very expensive middle market."

Gregory Belinfanti, senior managing director at One Equity Partners, says a buy-and-build venture at his firm begins with a close look at selling, general, and administrative expenses (SG&A). If a firm can combine business A with business B and take out two to three percentage points of SG&A, this value accrues to shareholders.

If you do that, Belinfanti says, you're telling potential strategic acquirers that they'll be able to do what you've just done, and that you've laid out the road map for them by putting these businesses together. "Then they're going to pay you for the synergies they've gotten," he says.



A successful buy and build requires the right skill set

Firms that embark on buy-and-build strategies need certain skills. The first is vision. Many managers don't have a chance to step back and think about where they should be in five years and how they're going to get there. A firm that does buy and build must be able to help managers plan that future.

"The second thing we spend a lot of time with our folks on is, 'Who's going to be the buyer for this company?'" Belinfanti says. He adds that his firm calls on companies and actively brings targets back to the management teams, asking whether it's something they would be interested in.

"The leaders we interact with at the lower end of the middle market are small companies, often in small towns," Jester notes. "They're incredibly lean leadership teams. They say, 'I don't want a board member. I need help in the trenches.'"

If a firm is going to dig in and help out, it should have expertise in areas like capital markets and in deal sourcing, Jester says. "There are almost 4,000 different deal-sourcing firms just in the United States. Having a lot of transaction experience with that massive universe of deal sources is really important."

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Gregory Belinfanti,
One Equity Partners

Dennis Cail,
RSM

Jay Jester,
Audax Private Equity

3

Some industries lend themselves to a buy and build, and some don't

The goal of a buy and build is to assemble a business that is greater than the sum of its parts. That's doable in some industries; in others, not so much. "Real estate tends to be a place where the buy-and-build strategy doesn't make any sense," Belinfanti says, "because when you buy two office buildings, you haven't made anything better. You've not been able to drive revenue growth. You just own two office buildings."

Belinfanti says One Equity Partners focuses on companies that have a high gross margin—north of 30 percent—and a high cost of supporting that margin. The firm looks for companies with high selling expenses, high general administration expenses, and high R&D, then puts them together to rationalize the SG&A line. "We think the fundamental problem of our time is that the SG&A has continued to expand. The cost of supporting the gross margin has ballooned. What we're trying to do is bring companies together and rationalize that number."

4

There is a process to mapping out a buy-and-build strategy

Like most PE investments, a buy-and-build process starts with a thesis.

"Once we have a thesis, we start by calling a company that's the size we want to invest in," Belinfanti says. "'We think your company should merge with Company X.'" If you simply say you want to buy their company, he adds, you won't stand out. "We try to sell the fact that we're thinking strategically, long term, about where the business should go."

Often in a buy-and-build project, the process determines the final product. Thesis in hand, GPs approach an industry sector and try to meet as many companies as possible. Soon, a GP has met with 15 or 20 companies in the industry and is putting together a new thesis of who should merge with whom.

5

Firms use different sourcing techniques to find add-ons

The techniques run the gamut: cold-calling, using intermediaries, or firms establishing teams to find companies complementary to their current buy-and-build platform.

"Most of our PE firms focus on acquisitions between $50M and $500M, and what we're seeing now is that they're creating their own in-house business-development teams that go out and evangelize the firm and the investment thesis," says Dennis Cail, director, M&A Complex Delivery Lead at RSM.

Cail adds that firms must convince LPs that their sourcing techniques are sound. "GPs are lobbying for the same dollars as all the other PE firms. One of the things these LPs want to know is how you source your deals. What makes you unique versus the other firms that have asked us for these same asset dollars?"

Jester notes the distinction between hunting and farming. The hunters source big deals and target the companies they want to put together. The farmers, like Audax, must nurture many potential companies to maturity and then make their pick.

"At our end of the market, we're planting thousands of seeds across an enormous field, and they don't always grow up in the same year," he says. "It's important to have a dedicated sourcing team that has not only visibility across all the different plantings, if you will, but visibility across years, across different cycles and different industry groups." ■

Riverside Makes Its Mark on ECN

The Riverside Company intended to hold Emergency Communications Network for five years. Instead, the firm exited the company via a sale in three years, says partner Chris Jones.

"We were able to make good progress in a short period. We originally planned to hold the company for five years but achieved our goals in three years, so it was time to sell."

–Chris Jones, The Riverside Company

The Riverside Company recently sold its ownership position in Emergency Communications Network (ECN) to Veritas Capital for an undisclosed amount. The sale was completed in June, but not before Riverside did a complete overhaul of the emergency notification company—almost doubling its sales revenue and more than doubling its EBITDA.

Riverside bought the Ormond Beach, Fla.–based company in 2011. At the time, the company was a founder-owned business that sent notifications to residents on behalf of government clients like cities, states, and counties. "The system alerted residents about time-sensitive, geographically relevant events that could impact them, such as a missing child or when residents needed to boil their water prior to drinking it," says Chris Jones, a partner with Riverside. "There are hundreds of reasons why residents might need to be alerted.

"ECN was the clear market leader, and at the time we expected there to be more adoption of this technology as people came to expect this type of communication more frequently."

Riverside saw room for growth, as most of ECN's competition was from mom-and-pop shops that ultimately became acquisition targets. Additionally, Riverside realized that ECN's capabilities could be used in other industries such as healthcare and utilities, broadening the company's reach. Riverside completed six add-on acquisitions of competitive or attractive companies in industries that ECN had wanted to break into. All the add-on acquisitions were sourced by Riverside.

Additionally, Riverside professionalized the company, adding a financial reporting system, a board of directors, and a sales budget. The company also moved to new headquarters during Riverside's tenure. The firm added a few senior people to the company, including a head of sales, while keeping the original president and CEO on board. Riverside also brought in two outside directors who had experience with larger technology businesses. They helped ECN develop its sales and marketing program and team.

"The business we sold is a very different business than what we bought," says Jones. "We were able to make good progress in a short period. We originally planned to hold the company for five years but achieved our goals in three years, so it was time to sell."

During Riverside's holding period, ECN's sales grew by 93 percent while EBITDA grew by 112 percent.

Riverside went into the deal with growth in mind and worked with existing management to reach the goals set forth. "We gave management equity incentives to grow the company, which the prior owners never did," Jones says. "We agreed on the goals and laid out what needed to be accomplished. We disagreed from time to time, but we all had the same end goal in mind, which helped us be successful. Our approach was the difference between fishing for them and teaching them how to fish." ■

Juniper Capital's Focus on Operations

The new Dallas-based PE firm is looking for investments in manufacturing, infrastructure, and industrial products and services sectors

After deciding to strike out on their own late in 2014, founding members Bryan and Lou Grabowsky launched Juniper Capital Management in July 2015. The private equity firm, based in Dallas, will focus on investments in manufacturing, infrastructure, and industrial products and services. The fundless sponsor's strategy is to partner with management teams to help companies grow in specific sectors.

"One of our guiding principles is to work with management teams to create value," says Bryan Grabowsky. "We both have a long history of working with companies, and we felt our past experiences would help us achieve our goals. These are the sectors where we have the most experience."

Prior to co-founding Juniper Capital, Bryan Grabowsky was a vice president at Lone Star Investment Advisors, where he evaluated and executed equity and mezzanine investment opportunities on behalf of the firm. Bryan Grabowsky actively worked with management teams on strategic planning and operational initiatives.

Bryan Grabowksy says the goal of being a successful investor is to know when to be hands-on and when to back off. "The management teams need to lead the identification and execution of the strategy," he says. "We are an extension of that team, helping them accomplish their goals. It takes organization and the right collaboration to make the relationship work. If there isn't a solid relationship, then the financial returns will suffer."

The new firm is currently seeking platform investment opportunities in U.S.-based companies with approximately $10M to $75M in annual revenue, proven and sustainable business models, and management teams that want a strategic partner. Juniper will make investments in the form of equity and debt in amounts typically ranging from $5M to $20M per transaction, with a possibility of smaller or larger investments. Transaction structures will include full and partial recapitalizations, growth financings, generational transitions, and leveraged buyouts.

Co-founder Lou Grabowsky is ready to get to work. Most recently he served as Grant Thornton LLP's chief operating officer. During his career, he has led and advised management teams and boards of directors on a global basis.

"My experience gives me an appreciation for management teams and governance," says Lou Grabowsky. "We want to work with companies that can benefit from our support, network, and relationships that we bring to the table. We think having an operator's perspective will pay huge dividends. If you don't understand the business, you can't provide valuable insight."

Juniper plans to offer hands-on assistance and board involvement to assist its portfolio companies while letting the current management team retain control over day-to-day operations. The firm has already looked at about 20 investment opportunities, is actively meeting with management of one company, and is excited about another company. Juniper intends to make at least one acquisition this year and expects to make five acquisitions in the next three years. ■

Operating Executives on the Move

A roundup of operating partner hires and portfolio company leadership appointments by private equity firms

Joe Damico

Joe Damico Appointed Chairman of TIDI's Board

Joe Damico, founding partner and co-chairman at RoundTable, an operating-oriented private equity firm focused on the healthcare industry, was hired to serve as chairman of the board of TIDI after the firm acquired its products. The company was solely a manufacturer of paper-based barrier products, but has expanded its offerings to include a portfolio of differentiated, acute-care-focused medical products.

Paine & Partners Brings New Chairman to Spearhead

John Atkin, former chief operating officer of Syngenta, will work as the new Chairman of Spearhead International after its acquisition by England's Paine & Partners LLC. Spearhead International is one of the largest agricultural producers in the European Union, and Paine invests in global food and agribusiness. Atkin will help Spearhead's management team grow a new range of services to enhance the company's offerings across the value chain.

Francisco Partners Appoints Ilse as ClickSoftware CEO

The leading provider of automated mobile workforce management and optimization solutions for the service industry was acquired by global technology-focused private equity firm Francisco Partners. The firm's operating partner *Paul Ilse* was named CEO of this company, ClickSoftware, and intends to achieve its growth targets. Ilse has nearly 20 years of executive leadership experience in enterprise application software solutions, most recently with Aptean.

Proenza Schouler Acquires Former Saks President

Castanea Partners has acquired a minority stake of New York-based luxury fashion brand Proenza Schouler, and appointed one of its operating partners as interim CEO after the current leader stepped down. *Ron Frasch*, the operating partner and former president and chief merchandising officer of Saks Fifth Avenue, will be joining the brand's board of directors.

Carlyle Acquires Jill Wight

Jill Wight joined the global alternative asset manager The Carlyle Group as a principal in the U.S. middle-market team in a newly created portfolio operations role. Wight previously worked as director in the special situations group at Goldman Sachs. At Carlyle, she will seek to harness the firm's global resources to add value in the middle-market fund's portfolio.

Aviation Exec Joins Resilience Capital Partners

Rick Organ, a longtime aviation executive, has been hired by Resilience Capital Partners to serve as an aviation operating executive alongside longtime Resilience partner and aerospace operating executive Kenn Ricci, chairman and CEO of FlexJet. Before joining Resilience, Organ worked as CEO of two private equity-backed aviation-related businesses, Schneller and Align Aerospace.

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Todd Lachman

Former Johnson & Johnson VP Joins Avista Capital

Avista Capital Partners has hired *Robert P. O'Neil* as an operating executive. His focus will be on consumer-related healthcare investments. O'Neil has more than 35 years of strategic and operational business leadership experience and a proven track record of building healthcare businesses in the pharmaceutical and consumer sectors. Recently, he was worldwide vice president of Johnson & Johnson's Consumer Group of Companies.

Altamont Capital Hires Ex-Mars Exec

San Francisco-based private equity firm Altamont Capital Partners hired *Todd Lachman* as operating partner. He will focus on investment opportunities in the consumer sector, with a particular focus on consumer packaged goods, and bring 25 years of experience leading global businesses in the consumer sector. Most recently he worked as the global president of the Mars Petcare business, a leader in the pet food category.

Mainsail Hires BrightRoll CFO in Operating Role

Mainsail Partners, a growth equity firm that invests exclusively in bootstrapped companies, has hired *Ron Will* as CFO and operating partner. He is the third operating partner at the firm. Will plans to use his extensive experience scaling technology companies to help Mainsail's portfolio companies grow and profit. He previously was CFO of BrightRoll, a company that Yahoo acquired.

Former Apria Exec Joins Frazier Healthcare

Chris Karkenny has been appointed an operating partner with the growth buyout team at Frazier Healthcare. Frazier, a leading provider of growth capital to healthcare companies, will have Karkenny help identify investment opportunities in the healthcare services space and other related sectors. Karkenny joins Frazier from Apria Healthcare, a national healthcare services company, where he served as executive vice president and CFO.

Redbox Founder Hired By Pritzker

Mid-market investor Pritzker Group Private Capital appointed Redbox founder and former CEO and president of Coinstar *Gregg Kaplan* as operating partner for the services team. Kaplan will join investment partner David Rosen in Chicago, where they will lead the services investment and operations team and oversee a group of services companies owned by Pritzker Group.

Gregg Kaplan

Chris Karkenny

GOING GREEN

with KKR

KKR is one of two big-name PE firms to have partnered with the Environmental Defense Fund to allow its portfolio companies to "go green." The firm's Ali Hartman and Elizabeth Seeger explain the program, and why companies are jumping on board.

PRIVATE EQUITY MAY NOT BE THE FIRST sector to spring to mind when the phrase "going green" is uttered. But there are some firms that would like to change that.

Two big-name PE firms—KKR and The Carlyle Group—are among those to have partnered with the nonprofit advocacy group Environmental Defense Fund [EDF] to bring mutually beneficial changes (including millions of dollars in savings) to their portfolio companies. Privcap spoke to Elizabeth Seeger and Ali Hartman, who work on KKR's Green Portfolio Program, about the environment-related changes being made since 2008.

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"I actually was pleasantly surprised at how quickly we started expanding KKR's efforts beyond the Green Portfolio Program."

-Elizabeth Seeger, KKR Business Operations

Elizabeth Seeger,
KKR Business Operations

Ali Hartman,
KKR

The program at KKR began with three pilot companies, says Elizabeth Seeger, principal, KKR Business Operations, who joined the global public affairs team in 2009 to lead the Green Portfolio Program [GPP] and expand KKR's responsible investing efforts. Since 2008, 27 of KKR's portfolio companies, including retail chain Dollar General and data center First Data, have participated, with 19 companies reporting results to date.

The purpose of the Environmental Defense Fund's program is to "make environmental management and innovation a standard best practice across the private equity sector," according to their website. KKR's project focuses on the operations of existing private equity portfolio companies, using analytic tools and metrics to improve business and environmental performance in five key areas.

Seeger worked for EDF in 2008 when their partnership with KKR was launched. From EDF's perspective, the goal was to look at the core competencies of the private equity model, and then use those to improve the environmental aspects in portfolio companies.

"The model that EDF likes to follow is to prove a concept with one market leader and then spread it across the industry," she says. "For EDF it was a big win [partnering with KKR]."

Seeger calls her transition to a PE firm a positive one. "I actually was pleasantly surprised at how quickly we started expanding KKR's efforts beyond the Green Portfolio Program," she says. Those include a responsible sourcing initiative, focused on the management of labor issues and human rights in portfolio companies' supply chains.

Ali Hartman, vice president, ESG strategy and communications at KKR, came from a job in global sustainability at The Coca-Cola Company. She calls KKR's focus on energy management "its own world" and "very different from doing CSR at a singular company." "Nothing prepares you for ESG at KKR until you're managing ESG at KKR," she says.

Shortly after Hartman joined KKR in 2011, EDF also announced a partnership with The Carlyle Group, which uses a due-diligence tool called EcoValuScreen prior to an investment, to improve operations and create value through environmental innovation.

KKR's Green Portfolio Program is voluntary and based on value creation, Seeger says. "We're looking for companies where there are significant operations, where senior management is interested in support and being part of a larger community. It's certainly a dialogue with management teams to see if it's a good fit."

There are some shared areas of opportunity among portfolio companies for improving environmental footprints, Seeger adds. These include improving the efficiency of data centers, which are energy hogs; analyzing truck fleets, along with using more efficient vehicles and improving routing; and reducing the water usage in manufacturing facilities.

At KKR, a company enters the Green Portfolio Program either during or after an acquisition, Seeger says. "There are a couple of companies where the program was part of the 100-day plan. We do have fairly robust diligence processes that include environmental and social governance issues."

Regardless of when participation in the GPP is initiated, the portfolio companies drive their performance improvement. It's a collaborative approach, Seeger says.

Dollar General, the discount retail chain, saw massive improvements during its participation in the program. "Their results were quite significant in both fleet and waste management," Hartman says. "There was upwards of $220M in waste cost [reduction] and recycling revenue, and over $400M in fuel cost [savings] from 2008 to 2013."

She says Dollar General's focus on waste costs was particularly interesting, as most of the inventory was being delivered to the stores in cardboard boxes, after which the company had to pay for their disposal. "The company invested in compactors, rerouted their trucks to allow for backhauling," Hartman adds. The cardboard bails were then taken to a recycling facility, which produced revenue as Dollar General was paid for the waste. "It was a cost and became a value," Hartman says.

Chicago Growth Upgrades SchoolMessenger

The firm bought the education information specialist, despite seeing much room for improvement, and managed to successfully exit in four years

In 2010, Chicago Growth Partners bought SchoolMessenger on the basis of liking its offering, despite seeing lots of room for improvement. After implementing significant changes, in 2014 the firm was able to sell the education communication specialist to West Corporation—more than doubling SchoolMessenger's revenue and nearly tripling its EBITDA.

SchoolMessenger is in the K-through-12 school space and transmits messages to parents if school is closed or there is a PTA meeting. "This business can seem mundane, but it's very important, because it's also used in emergency situations," says James Milbery, now a partner at ParkerGale, a spinout of Chicago Growth Partners. "For example, SchoolMessenger was the system of record for Sandy Hook [Elementary School] in Newtown, Connecticut, during the shooting."

Chicago Growth bought the company from its founder, who had taken the business as far as he could. "The company was formidable, but it really needed operational guidance and improvement. We liked the market it was in, because it's a sticky market with recurring revenue and contracts that span multiple years, and the customer renewal rate is high," says Milbery.

However, SchoolMessenger had its challenges. Its hardware system was aging; it didn't have a backup data center, or an engineering team with the ability to grow. The company's finance department was also lacking. "SchoolMessenger is an emergency system," Milbery says. "It has to stay up and running no matter what happens. The team was also really too small. Put it this way: If someone won the lottery and decided not to work again, the company would have been in trouble."

"The company was formidable, but it really needed operational guidance and improvement. We liked the market it was in, because it's a sticky market with recurring revenue and contracts that span multiple years, and the customer renewal rate is high."

–James Milbery, ParkerGale

The private equity firm added a chief financial officer, a vice president of engineering, a number of engineers, and two outside board members. The firm also overhauled SchoolMessenger's infrastructure, adding a backup data center. While these moves were instrumental in upgrading SchoolMessenger, Chicago Growth Partners made additional changes to grow the business, such as the capability to have the calling system be usable with iOS and Android phones. The team also implemented least-cost routing, allowing the call systems to place calls from around the United States where the lowest prices are available.

"Everyone is mobile today, so adding that capability was very impactful," says Milbery. "It's made the system incredibly usable for the school administrators to get messages out using their smartphones."

Lastly, SchoolMessenger implemented a new compensation plan and a customer-retention-manager system, and it upgraded its branding and messaging. "This helped the sales staff to stay motivated and engaged in moving forward," Milbery says. "Overall, there was a lot of work, but we knew everything was doable and we could achieve a great outcome." ■

The Far-Flung Life of Operations Professionals

After The Presidio Group acquired Croatia-based Hattrick Sports Group, two veterans of its PE division, Karl Schade and Barry Rudolph, packed up their families so they could improve the company's operations

When The Presidio Group's Karl Schade and Barry Rudolph formed the small-buyouts private equity division in 2007, they were fully prepared to execute an investment strategy involving learning new languages and new cultures.

"When we start our investments, we back good management teams and watch them very closely, knowing that in about 25 percent to 50 percent of the cases there will need to be some management turn," says Schade, now CEO and managing director of Presidio. "If management change is needed, the teammate dedicated to that investment is responsible for making sure the business meets its milestones."

One such investment was the Hattrick Sports Group, an online betting outfit with offices in Croatia. After an appointed CEO missed a few milestones, both Schade and later Rudolph, a managing director with Presidio, became interim CEOs, which required each of them to relocate their families for more than a year.

"We need the support of family members to be able to do what we do for a living," says Schade. "And frankly, our entire team is invigorated by the opportunity to learn new things and took this on in stride."

For Rudolph, the move was equally welcome, and as the former CFO at Oslo, Norway-based company Chipcon, international living was already a household standard.

The move proved worth the sacrifice, because Hattrick Sports Group has proven to be a success story for Presidio. During their time operating the company, profits increased multiple-fold, says Schade, and investors have noticed.

"Our existing limited partners have been very appreciative of the fact that both Barry and I separately went and made sure that the investment performed the way that it was supposed to," Schade says.

Rudolph says operating partners are good for the entire PE industry.

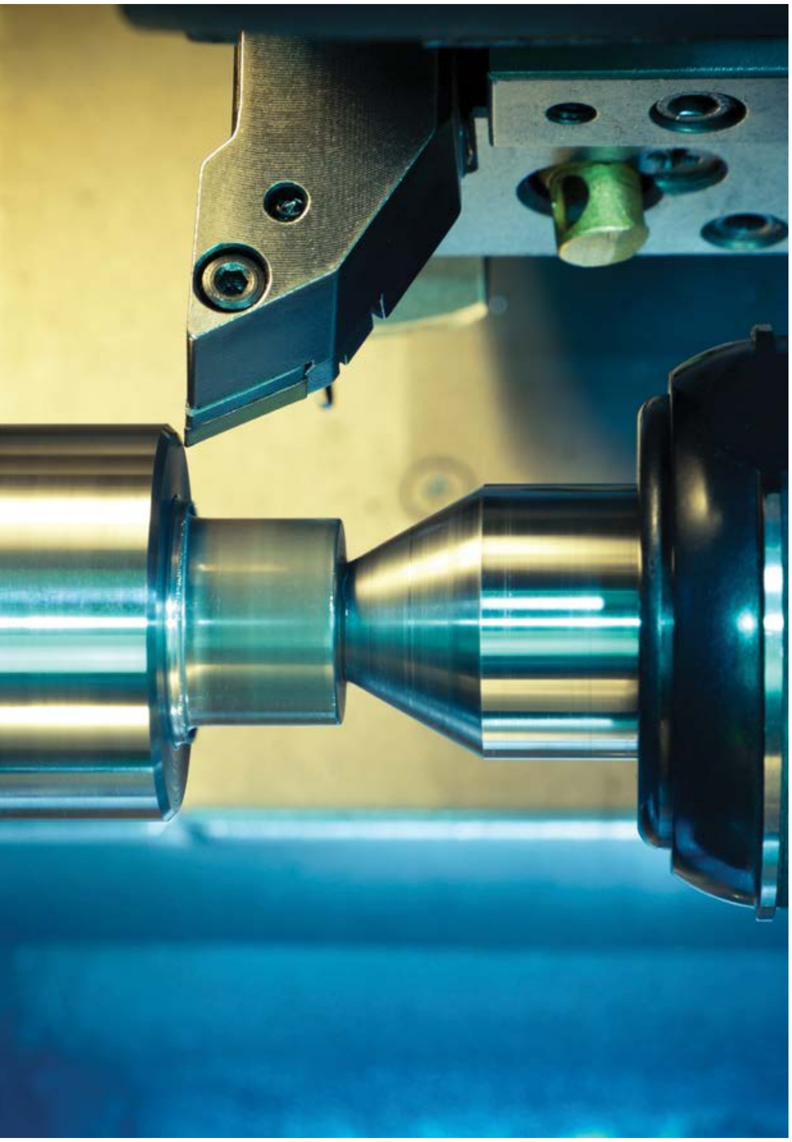
"The more people we have in private equity that have real operating experience, the better, because they'll have a good understanding of what it really takes to get accurate financials every month, to grow new product lines, and to manage an existing team," he says.

Schade says there's a caveat to taking families on location when working on a company's operations.

"These were very long hours, so while both of our families were looking forward to the variety and new cultural experiences, they were left to fend for themselves most of the time," he says. "It takes a very supportive family to do what we do for a living." ■

Main Line's Operations Team of One

The firm has its first operating partner in Doug Hart, who plans to make operational improvements through the life of its investment in a portfolio company



Main Line Equity Partners ran its private equity firm for years without operating partners. But the New Canaan, Connecticut–based firm has changed course, adding Doug Hart to its investment team as its first dedicated operating partner.

The fundless private equity firm focuses on investing in profitable next-stage growth companies with less than $10M in revenue. Main Line looks to be actively engaged with its portfolio companies throughout the investment life cycle, hence the need for a dedicated operating partner.

Hart expects to help Main Line by providing operational guidance from the due-diligence phase all the way through the life of an investment. "With portfolio companies, I often find they lack simple leadership experience, or they don't have the experience necessary to improve their operational practices and, as such, their bottom line," says Hart, who recently helped a Midwestern company improve its production output significantly. For every 100 yards of product the company was producing, on average 15 percent of it was scrap or yield loss. Hart created a production-yield tracking system that allowed the employees to focus on the value of what was wasted and its impact on the bottom line.

Given that the company was located near the Indianapolis Motor Speedway, where the Indianapolis 500 takes place, Hart put it in terms that the employees could relate to, explaining that the 15 percent waste the company was producing could fill the speedway's track 80 times.

"All of a sudden they understood the magnitude of the loss and wanted to make the changes," says Hart. "We were able to improve production yield by 8 percent, which is considered world-class for the industry. It took about a year to implement, and the savings directly impacted the bottom line and the value of the business."

Hart brings more than 25 years of experience to Main Line as an owner, operator, and advisor of small-to-midmarket businesses across a wide variety of manufacturing and consumer-product industries.

Hart says more private equity firms are starting to understand the value of the operating partner. "You will see some private equity firms that will rely on external consultants, but more frequently private equity firms are showing a solid respect for the operating partner, because good operating partners can dramatically improve a company's predictability and success. The objective is to have a broader impact on the portfolio company, and with my help, Main Line is committed to doing that."

Prior to joining Main Line, Hart served as director and chief operating officer at Uretek-Archer, a privately owned composite-materials manufacturer for the medical devices, aerospace, military, and outdoor recreation products industries. Additionally, he had established Hart Advisory Group, a small-to-midmarket business advisory firm focused on driving client sales, income, and enterprise growth through best-of-breed operating practices, and he also owned Reeves Brothers, Inc., an international manufacturer of engineered industrial consumable products.

A Twist on the Operating Partner Model

At EQT, industrial advisors play a significant role in portfolio company oversight. A partner in the firm's New York office discusses the program.

The role of operating partners in private equity continues to grow as firms look for ways to differentiate themselves and get a leg up on competition in sector expertise. At EQT, a firm based in Sweden with 19 offices worldwide, the position of industrial advisor is a little bit different than the typical operating partner.

For starters, EQT's industrial advisors are not employees; they are consultants offering expertise independently. According to Glen Matsumoto, a partner who heads the New York office, EQT's advisors "have real-life operating expertise" similar to other private equity firms' operating partners but are not on the EQT payroll. Rather, they are available to offer sector expertise and are paid a nominal daily advisory fee when assisting during the due-diligence process. Otherwise, EQT's industrial advisors are not financially compensated for their services until investments are exited.


Glen Matsumoto,
EQT

EQT advisors participate in the entire life cycle of transactions, from deal origination and execution through the realization of an exit.

EQT counts on a stable of roughly 400 individuals for its industrial advisors program, each of whom offers specific sector and subsector expertise at the ready to assist the firm. From that large group, approximately 80 are involved with EQT on "a regular basis in multiple situations," Matsumoto says. At any given time, there are between 12 and 18 "very active" industrial advisors, meaning they spend as much as 80 percent of their work time on EQT business. Still, these people are not employed by the firm.

Should EQT move forward with an acquisition, advisors are asked to join the board of directors, as well as put a significant amount of their own capital to work in the deal. With some skin in the game as equity investors, EQT advisors earn a better rate of return on their capital than do fund investors.

As board members of the newly acquired company, industrial advisors play an active role in determining overall strategy and direction, challenging management, and providing support with sector expertise and industry connections. However, they do not play a role in the day-to-day functions of the portfolio company. Whereas many private equity firms will hire an advisor to run the daily operations of the portfolio company as chief executive officer, at EQT they are there to provide oversight. To be sure, there is interaction with the CEO, but he or she runs the business. Period.

"We never want to confuse that [arrangement]," Matsumoto says.

Outside of the dealmaking process, EQT gathers its advisors once a year for a two-day confab in New York to talk, debate, and network. Topics typically include shared experiences and strategies on how to improve EQT portfolio company operations. The firm has held these meetings for the last seven years, with each gathering growing in size. Last year 50 advisors attended.

"Many are retired," says Matsumoto. "They are able to stay connected."

Challenges of Carve-outs and IT Integration

With expectations of a relatively quick return on investment looming, investing in a portfolio company's IT can be difficult. RSM's director of PE consulting, Blaine Clark, discusses what he looks for in IT due diligence and the difficulties of performing a carve-out.

Privcap: How can you optimize IT in a portfolio company?

Blaine Clark, RSM: Information technology [IT] is complex in any environment. And in the private equity environment, it's even more difficult, given the compressed time frame for the return on the investment. [With] the extreme focus on cash conservation, it's difficult to sometimes make the investment required for IT. Having said that, if a proper assessment is done prior to the investment, usually some low-hanging fruit is identified to really accelerate the value-creation model.

The most difficult situation for IT is when there's a carve-out or a merger, because you're standing up a completely new company. So you've got a new IT system. Or maybe you're trying to merge two different IT systems into one. And the complexities there are great.

In an IT due-diligence engagement that we work on, we're typically looking for several things. What is the application platform that the company is running on, and how does that look? Is it a platform for growth, or does it need to be replaced? In certain situations, we also look at how the new company is going to look after the investment by the private equity firm. And that allows us to identify investments that are going to be required in IT, and how they're going to help the growth pattern going forward.

What are some of the biggest challenges in making a carve-out successful?

Clark: When we talk about an engagement, many times we use the analogy of big rocks. And for us, a rock is one of those things that prevent us from getting down the path to success. In a carve-out, those are typically in four major areas: human resources, finance, supply chain, and IT.

Human resources is a big opportunity, or a downfall, in a carve-out. If you get the right people on the team at the beginning, then you're positioned for success. The other key there is culture and how you're going to take that forward. Is it a new culture? Do you want to maintain the corporate culture and the brand? Or do you want to do something new going forward? All of those things have to be considered in a carve-out.

Supply chain is particularly important in a carve-out. Many times you'll see a corporate entity that has an integrated supply chain, and so the business that's being carved out is going to end up without a supply chain, and so they have to rebuild it after the transaction takes place. ■

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