Privcap/

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2016 DEALMAKER COMPENDIUM

Thought leadership from top private equity investors

Including:

Angelo Gordon
Audax
Bain Capital
First Reserve
J.C. Flowers
Lightyear Capital
New Mountain

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Privcap/Report

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Privcap is a digital media company that produces events and thought-leadership content for the global private capital markets. Privcap offers communications services to market participants.

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Privcap

Meet the Dealmakers

For all the industry chatter about management fees, alignment of interest, reporting standards, and the like, the success and viability of private equity will always rest on a single skill: the ability to find and capitalize on good deals.

Yet that straightforward proposition—source, buy, improve, sell—has grown increasingly challenging as the industry matures. There's simply more competition for the most attractive assets, and, at least for now, high valuations leave little room for error.

This Dealmaker Compendium report highlights the firms and people who've managed to get it right. Some succeeded through operational improvement, financial engineering, or identifying a strong tailwind when others did not. Others have formed partnerships or established new platform companies to tap big opportunities. Their success in these deals highlights private equity's enduring power to generate alpha.

Take First Reserve's recent $1B partnership with Pemex, Mexico's state oil company (p.23). A joint pipeline deal between the two entities was the first major investment since the country opened its vast energy market to foreign investment.

Then there's Lightyear Capital's joint purchase of AIG Advisor Group (p.36), the insurance giant's broker-dealer arm. Lightyear's Don Marron made an unsuccessful run at the business in 2009, and persistence paid off. The firm is now poised to capitalize on proposed regulatory changes that could redefine the broker-dealer industry.

These stories and others should provide insight and inspiration for those on the front lines of private equity value creation. As this report makes clear, in private equity it's ultimately not the small details but the deals that really matter.

Enjoy the report,

Hollie Moore Haynes
Founder, Managing Partner,
Luminate Capital Partners

How a Silver Lake Vet Launched Her Own Firm

Hollie Moore Haynes had built a PE career at Silver Lake Capital but then decided to start her own firm. She's using her experience gained in large-cap technology deals involving software to look for underappreciated established businesses outside of the normal hunting grounds.

When it came time to launch her own private equity firm, Hollie Moore Haynes was confident she could use the experience she had learned over 15 years at Silver Lake Partners to build a PE shop, and a brand, that spoke to what she wanted to do.

Silver Lake's focus is on private equity buyout and recapitalization investments in technology businesses—it's a leader in large-cap tech deals—and Haynes focused on software within that. Luminate is a continuation of her efforts at that firm, and her industry relationships and deal flow have followed.

"Most of what we're doing is what I've been doing already—the deal flow sourcing and working with companies," says Haynes. It's taken some effort to make sure people know that the deal flow sourcing and working with companies that she did at Silver Lake is the same as what they're doing at Luminate, but that the firm is different from Silver Lake.

The firm focuses on midsized companies in the software and software-enabled services areas that are located across the U.S., a market that's appealing because there are thousands of companies focused on enterprise software with less than $100M of revenue, Haynes says—most of which are not in Silicon Valley. "These companies are not on the screen of the venture firms in the Valley," she adds. Luminate's first portfolio company, Professional Datasolutions, Inc., is based in Texas.

Luminate focuses on making control investments in companies. The firm gets involved with a portfolio company, providing liquidity for founders or shareholders and adding operating capabilities that are not already present. They bring their expertise and an active engagement from running other businesses.

The work can be about managing costs, says Haynes, but also about helping them grow the revenue and position those businesses well in the market. "The easy part of the private equity playbook is to cut costs, but the tough part of the playbook—which matters in software—is revenue and product," she says.

"The deep, dark secret in enterprise software is it takes a long time to build a product. We can get involved when early investors might get tired and they want some liquidity."

> "The deep, dark secret in enterprise software is it takes a long time to build a product. We can get involved when early investors might get tired and they want some liquidity."
>
> Hollie Moore Haynes, Luminate Capital Partners

The firm's first portfolio company, PDI, is a provider of back-office retail software systems to the convenience stores and food service industries, used for things like tracking inventory—a crucial component for the operations of these companies, says Haynes. The PE firm partnered with the management team at PDI—which stayed intact—and bought out the parent company. The firm put in place a 100-day plan and is working with management on detailed ways to map out revenue goals and product strategy.

Luminate Capital operates a bit differently from Silver Lake and Bay Area or Silicon Valley venture capital or PE shops, Haynes says, starting with a nationwide eye for investment opportunities. "It's a frothy time in venture, and what we're doing is anti-venture," she says. "We buy established companies generally not in the Bay Area that have these incredible businesses and are underappreciated by so many investors in tech." ■

NAVIGATING THE GLOBAL FINANCIAL SERVICES INDUSTRY

Privcap CEO David Snow interviews J.C. Flowers & Co. founder and managing director J. Christopher Flowers about the firm's history, how the 2008 financial crisis affected the firm, and how to invest in financial services in these low-interest times

J. Christopher Flowers
Founder and Managing Director, J.C. Flowers & Co.

Privcap: When did you start investing in the financial services industry?

J. Christopher Flowers: I went straight from college to Goldman Sachs and spent 19 years there, then started my own company in 1998. All we do is investments in financial services. We're one of the largest—maybe the largest—private equity investors in financial services. And until 2008, we had a lot of fun and made a lot of money. In 2008, we did not have a lot of fun and we did not make a lot of money. But the last few years have been better.

You had a front-row seat to the 2008 financial services crisis. Can you describe what that time was like for you and your firm?

Flowers: I did have the most amazing weekend of my life when Lehman Brothers went bankrupt. I was in Japan on the Wednesday before all this happened and got a call from Bank of America saying, "What we'd like to do is buy Lehman Brothers and split it with you. You take part of it, we take part of it." So we started looking at Lehman Brothers on Thursday morning. And then on Thursday afternoon I got a call

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from AIG that said, “We need to see you right away.” I met with the CEO of AIG on Friday, and he had this piece of paper he gave me which across the top said, “Monday, Tuesday, Wednesday,” and down the side it had the parent company cash position. By 10 days out, it was negative $5B, and by three weeks out, it was negative $30B. That sounded like a problem. So I knew this was going to be a busy weekend. We called our friends at Aviance [Capital Partners] and started making working investments in AIG on Friday. And then on Saturday, as if there wasn’t enough going on, the CEO of Bank of America said, “Forget Lehman, we want to buy Merrill [Lynch]. Can you help us?”

What did you learn from all of that?

Flowers: We usually make investments where we have control, but sometimes we don’t. In this kind of crisis, we did better where we had control, because we changed things faster. We put more capital in or changed the CEO. But where we didn’t, oftentimes the companies were slower to react, and that led to a lot more trouble. Secondly, the issue of liquidity is always important, but there were stresses on the liquidity of companies in the Lehman Brothers weekend aftermath that were of a different nature than we’d ever seen before. We’ve not forgotten what that experience was like.

What are the opportunities for private equity in financial services, and what do sellers need from your firm besides simply capital?

Flowers: We’re the most active we’ve been in many, many years. That’s from a lot of different areas. Here in the United States—one of the most active places where we do business—[there are] a lot of entrepreneurial-driven new ideas, ideas resulting from regulatory change, ideas from technological change. And people are looking for capital, but they’re also looking for experienced connectivity, regulatory connections, global connections, and we like to think we offer that. The other big area is Europe, which has been sluggish. But most sluggish are the markets where we operate, and that in its own way is interesting, because companies need capital, they need to restructure, they need to change.

What are the key drivers of disruption in the industry, and how do you position yourself to be on the winning side of that process?

Flowers: One driver is regulatory change. A lot of what’s going to happen has happened, and things are starting to settle down, but it provides opportunities. One opportunity is with businesses that are no longer permitted to be regulated financial institutions. Another is increasing capital requirements. And then oftentimes financial institutions are selling good businesses to raise capital for the rest of their business. Another factor of disruption has been low interest rates. We have an industry that has normally prospered more in a higher-interest-rate environment.

How have low interest rates affected your businesses?

Flowers: We have low interest rates in the United States. We have low interest rates in Europe. We have low interest rates in Japan. When we make investments, we price them in today’s interest-rate environment. We’ve been doing business in the world champion of low interest rates, Japan, for 17 years. So you can make plenty of money in low-interest-rate environments, but counting on [rates] going up is not something we want to do.

Can you tell us about how you came to invest in Xinxiang Bank?

Flowers: Xinxiang was a fantastic deal. And there’s an unexpected lesson I would offer from that: It is the best deal maybe ever done on a financial institution. Was it a secret? Was it done through some network of who you knew? No. I knew about this deal because I read about it in *The Wall Street Journal*. So what is the lesson? It is looking in places where other people aren’t looking. At that time, private equity people weren’t thinking about financial institutions. They weren’t thinking about Japan. Part of the way we’re going to find good deals today is looking in places where other people aren’t looking, geographically. It’s also going to be having advantages over other people to get through the regulators. ■

Trinity Hunt's Theater Remake Pays Off With Big-Name Exit

The Dallas-based private equity firm sold Starplex Cinemas to theater giant AMC after a merger with another small chain touting big amenities

A little-known fact is that the movie theater industry is resilient in tough times. And Trinity Hunt Partners had an idea.

In 2010 the firm bought ShowPlex Cinemas, then in 2012 acquired Starplex Cinemas, then merged the two in an effort to facilitate growth. That hunch by Trinity paid off with the roughly $175M sale of Starplex—a chain of movie theaters with 33 locations in 12 states—to AMC Entertainment Holdings.

Dan Dross, a managing partner at the firm, says that it was looking for industries that exhibited vitality and even growth during slower economic periods.

"We liked Starplex because it had a lot of differentiated strategies," says Dross. The company operated in a lot of secondary markets where it benefited from limited to no competition, he says, and had "first-class amenities" that were offered to patrons. That, combined with certain value-pricing strategies, allowed Starplex to enjoy above-average attendance growth compared with the rest of the industry during the entire time period that Trinity Hunt was an investor in the company.

"If you go back and look at the history of the performance of the [movie theater] industry throughout recessionary times, it's actually shown not only stability but growth," he says. "For instance, in 2009, box office revenues were up over 10 percent, and there were probably very few industries that you could see that had double-digit top-line growth during that year."

During Trinity's investment timeline, the firm continued to expand Starplex by opening five new locations and remodeling select existing locations. It installed luxury reclining seats in a number of Starplex's auditoriums, added large-screen formats such as IMAX in some locations, installed digital projection throughout all locations, and expanded concession menus; some locations even began to serve alcoholic beverages.

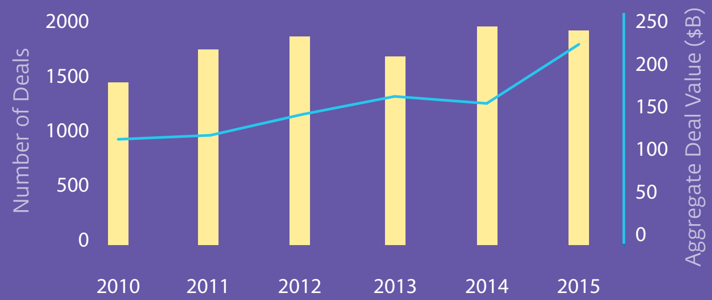
Starplex was at the forefront of some of the changes that the industry has witnessed over the last several years, says Dross. "The luxury reclining seats have become popular in a lot of markets, and Starplex saw that trend and got ahead of it." He adds that AMC—which has similarly been at the forefront of that trend—recognized that Starplex had made those investments.

After making the investment, Trinity supported the Starplex management team with some of the initiatives it undertook, including identifying new markets that were underserved and helping to arrange acquisitions of one-off theaters being sold by other circuits.

Trinity is no newcomer to the entertainment industry. Using the same fund from which it invested in Starplex, the firm made another investment—since exited—in DMX Music, a provider of pre-programmed music to retailers, restaurants, and hospitality establishments. ■

Private Equity Asserts Itself in U.S. Deals

The overall number of PE deals and exits has risen and fallen in the past five years, with a sharp increase in aggregate value between 2014 and 2015



PE-Backed Buyouts Remain Steady

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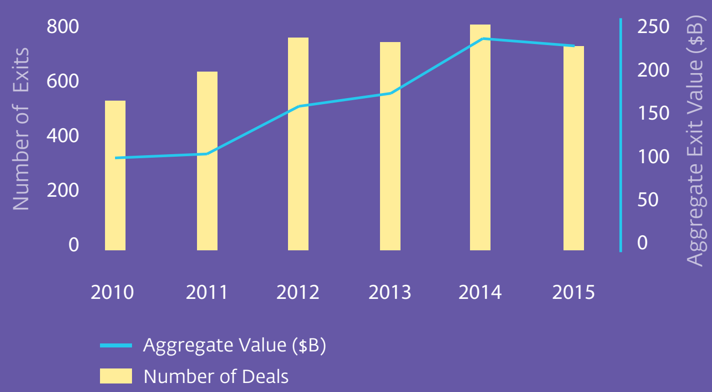
From 2010 to 2015, the number of PE-backed deals in the U.S. went up and down slightly from year to year, but the overall aggregate value of them hit a high of $246B last year.



PE Exits Peak, Then Drop

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The number of overall deal exits in the U.S. hit 798 in 2014 with a five-year-high aggregate exit value of $212.1B. The numbers are in striking contrast to 2010, where the number of exits was roughly 200 fewer than in 2015.

Top 10 PE Dealmakers in 2015

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Unsurprisingly, the big guns—Carlyle, KKR, Blackstone, Warburg—are represented on the list, but it's a close race.

Fund Manager	Number of Deals	Aggregate Value ($B)
Carlyle Group	68	15.6
KKR	49	11.4
Hellman & Friedman	41	3.0
ABRY Partners	40	1.9
Ardian	40	2.5
Warburg Pincus	39	12.0
Blackstone Group	38	8.1
Riverside Company	37	0.2
H.I.G. Capital	33	0.0
Vista Equity Partners	30	9.5

Top 10 PE Dealmakers by Aggregate Value

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Tech-focused Silver Lake was at the head of the list, with the aggregate value of its deals at $75.6B, while Carlyle had the most deals, but with a much smaller value.

Fund Manager	Number of Deals	Aggregate Value ($B)
Silver Lake	16	75.6
MSD Capital	1	67.0
3G Capital	1	40.0
Carlyle Group	68	15.6
CVC Capital Partners	24	14.7
TPG	27	14.1
Warburg Pincus	39	12.0
KKR	49	11.4
Sequoia Capital	3	10.5
Permira	18	9.9

Source: preqin

Dissecting the DISTRIBUTIONS BOOM

The period through January 2015 showed the highest-ever level of distributions to limited partners. Experts from Cambridge Associates, Coller Capital, and Guardian Life discuss what's behind the increase.

Privcap: What's going on right now by way of distributions coming back to LPs?

Andrea Auerbach, Cambridge Associates: Looking at distributions to LPs from 2006 to 2015, it's definitely not lost on anyone that distributions through January of 2015 are the highest they've ever been, at about $147B. That is the fourth year in a row of year-over-year increases. A lot of that money is getting plowed right back into the space, because fundraising is also on the rise year-over-year as well, across the exact same time frame.

If you go back to the previous boom time in private equity, 2007, the distributions now are essentially double. Maurice, as someone overseeing a major private equity program, are you benefiting from this gusher of distributions?

Maurice Gordon, Guardian Life: Absolutely. I would like to thank all of the GPs and sponsors for doing the hard work and learning from the mistakes in the past. So many people held on all the way up and then rode it all the way down and never sold. A lot of people have learned that lesson. And when you're getting paid very well to exit, you should really do that. Being in a mutual insurance company, we need a distribution to actually generate income to pay a dividend. So it's very much appreciated that people are taking advantage of this good market.

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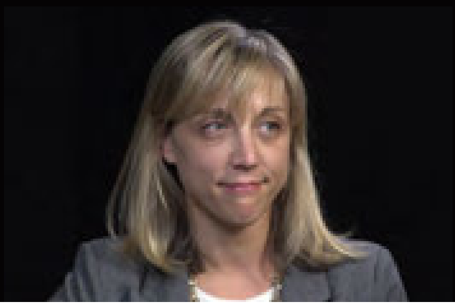


Andrea Auerbach
Managing Director and Head of U.S. Private Equity Research, Cambridge Associates

Maurice Gordon
Managing Director, Guardian Life

Luca Salvato
Partner, Coller Capital

And what are you observing, Luca?

Luca Salvato, Coller Capital: From our portfolio, it's probably the healthiest distribution that we've seen in a long time. But there is an interesting dynamic when you look at the market, certainly if you go back over the last 10 years and compare invested capital against distributions. What you're seeing currently is a flip in terms of that trend, where you're having distributions outpace invested capital.

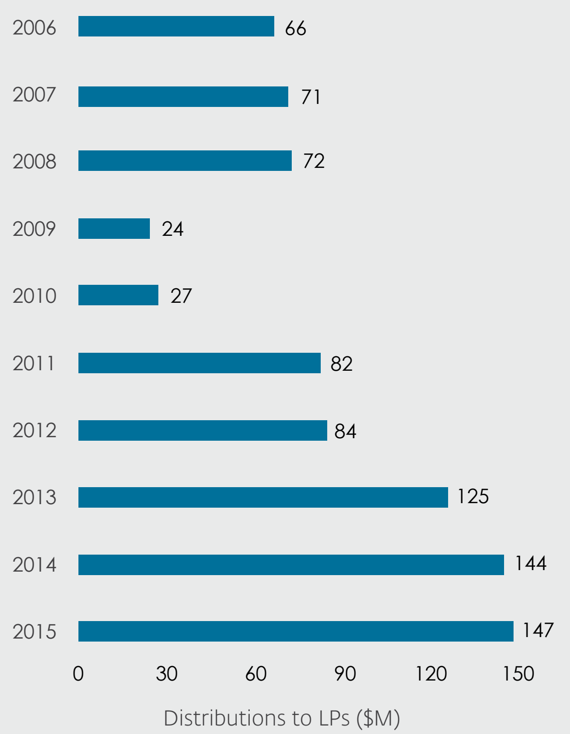
Prior to that, in the buildup to the previous peak in '07-'08, it was the inverse. So what that ultimately meant is that a constant amount of capital was building that was invested in the ground that was increasing rather than decreasing.

But there's still a long way to go. If you look at the vintage years of '05 to '08, and you look at the net asset value that is still captured within those funds, it's enormous—probably $800B or thereabouts. Now those funds are reaching, or coming towards, the end of their natural lives. And it's hard to see that they're going to be able to release all of that through just natural distributions and selling of companies.

So what does it mean that LPs aren't plowing money into the market at a fast enough rate to match the distributions they're getting? Are they being cautious?

Auerbach: A lot of managers are simply unable to raise the capital that they want to raise in a formal, traditional fund. And so they may be seeking it through co-investment in other ways.

Do I think LP commitments are on the rise? Yes, for several reasons. A significant one is simply that private equity, as a return-generating strategy, is one of the best ever of all investment strategies. And it continues to attract capital. So I do think LP commitments are going to start to go up. ■



U.S. Private Equity Distributions

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The amount of distributions to LPs as of March 31, 2015

Source: Cambridge Associates

Are You Making This Huge Due Diligence Mistake?

Failing to conduct IT due diligence can make or break your investment strategy

Don't fall into the "simplicity trap."

That's the warning from Dave Noonan, national leader of RSM US LLP's Private Equity Consulting Group. Too often, Noonan says, investment teams analyzing a carve-out or M&A deal think that only complex businesses with complex technological infrastructure require extensive due diligence of IT systems and processes.

"If you look in the marketplace today, only half of the transactions include IT diligence," Noonan says.

And too often that leads to costly mistakes.

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What's at risk?

Without a pre-close understanding of the systems upgrades that need to be made, a 100-day improvement plan could instead take a year. And without the right systems in place, management won't be able to generate meaningful data and metrics to make informed business decisions to grow revenue—making an efficient and effective IT improvement plan a critical element of success.

It's a Strategy 'Breaker'

"A flexible IT platform can make or break an aggressive M&A strategy," explains Jonathan Caforio, principal in Technology and Management Consulting at RSM US LLP. "In some cases, 50 percent of the post-acquisition synergies are IT-dependent."

The reality is that even the most "simple" business relies on a range of hardware and software that requires integration with a platform company or, in the case of a carve-out, needs to be untethered from its corporate parent and either dispositioned or re-established.

Caforio says that extensive IT due diligence answers obvious questions, such as whether an existing phone system needs to be replaced and whether an enterprise resource planning system, customer relationship management system, or payroll system will require extensive integration work. But that due diligence also answers more fundamental questions.

"For the companies we do diligence on, you get a good leading indicator on how the business is run and the discipline in the organization," he says.

Diligence Done Wrong and Done Right

In one recent carve-out, an RSM client neglected to perform IT due diligence on a $40M deal and estimated its integration costs at approximately $125,000. Noonan says that after it began running into trouble, the company asked RSM to review its plan. The review quickly revealed about $1M worth of work.

"For every deal that they now do, they do IT diligence," Noonan says. "It could have negated the investment thesis. Luckily, it still fit in the model."

Another client engaged RSM to evaluate the acquisition of a $600M company by a $1B platform company. The diligence revealed about $10M in IT integration costs. The deal went forward.

"We were able to both do the diligence and validate the implementation timeline, helping save the company quite a bit of money because we were able to get off some IT platforms earlier," Noonan says.

Avoid the Trap

Failing to perform diligence up front can compound subsequent costs—not only in overlooked upgrade and integration expenses, but also in disrupting an ongoing business. Yet this happens again and again.

"They fall into a simplicity trap," Noonan says. "Simple IT systems often lead to expensive surprises." ■

For more information visit www.rsmus.com

Dave Noonan
National Director,
Private Equity Consulting,
RSM US LLP

Jonathan Caforio
Principal in Technology and
Management Consulting,
RSM US LLP

The Red Flags

Companies with less than $100M in sales and fewer than 300 employees are typically most susceptible to the simplicity trap. Their systems generally consist of:

- Small-business accounting software (QuickBooks, Peachtree), which often needs to be replaced with an enterprise-wide system to accommodate an increase in transaction volume or the ability to support business process and workflow improvements.
- A couple of in-house servers that are often aging and have limited capacity.
- Standard business software (Microsoft Office, etc.) where licenses may not be current and will need to be purchased.
- Outdated software and networks (e.g., Lotus Office Suite, Novell) that will need to be replaced with industry-standard systems.
- Under-resourced or underqualified IT support departments.

Bringing the Customer Experience to the Forefront

Brentwood Associates partner Steve Moore explains how the firm is looking to expand premium apparel retailer J. McLaughlin

Steve Moore
Partner,
Brentwood Associates

Consumer-focused private equity firm Brentwood Associates has discerning taste when it comes to its apparel and retail acquisitions. In late 2015 the firm added Brooklyn-based J. McLaughlin to its portfolio of high-end apparel companies.

Brentwood has a lot of experience in the apparel and retail industries, says partner Steve Moore. "We play across channels, and we are focused on helping companies enhance their direct-to-consumer marketing efforts." The firm's goal is to help J. McLaughlin expand its footprint nationally, both online and offline, he adds.

The clothing company is known for its nostalgic and classic style of American fashion, and Moore says there are two main attractions to the brand—its ability to offer unique in-store customer experiences and the fierce brand loyalty customers have demonstrated.

With more than 100 stores sprinkled around the U.S., J. McLaughlin is not quite a household name, but that's about to change, says Moore.

"We see a clear path to at least doubling the number of stores, and we can also add value with our experience in direct marketing," he says. "There's still a ton of white space and a lot of area to grow, and we have significant expertise in these areas."

Brentwood likes to play in the lower middle market, with the majority of its investments going to companies with between \$50M and \$300M in annual sales. And while many investors have the tendency to acquire iconic brands in order to license intellectual property for cash flow, Moore says a major part of the firm's strategy is to find brands they can help to grow.

The firm prefers to buy a brand that's already doing well with consumers, and then build upon that loyalty and increase awareness, Moore explains. "We also like businesses that own and control their brands, from manufacturing or sourcing through retail. We like to control our own destiny."

To that end, J. McLaughlin designs its own products and maintains quick-turn manufacturing capabilities, then sells the products in its own stores, thereby owning the distribution channel.

Moore says J. McLaughlin is a typical business, but he also has seen new spending trends heading into 2016.

"There's no question the way consumers interact with brands is evolving, and the pace at which it's evolving is accelerating," he says. "The biggest change we've seen over the last five or 10 years is consumers demanding a far better and more integrated online experience." ■

Examining the 'Blocker'

A blocker corporation is sometimes used by a PE or VC fund to invest in an LLC or partnership. Goodwin Procter's John LeClaire and Jamie Hutchinson explain why this is used.

John LeClaire
Partner, Co-chair,
Private Equity,
Goodwin Procter LLP
LeClaire's practice focuses on private equity transactions and relationships with growth companies. He joined Goodwin Procter in 1982 and has been a partner since 1989. His PE work includes leveraged recapitalizations, buyouts, and minority investments in the U.S. and abroad, both in later-stage situations and earlier-stage ventures, for leading PE firms.

Jamie Hutchinson
Partner,
Goodwin Procter LLP
Hutchinson is a partner in the firm's Private Equity Group, as well as a member of its Technology and Emerging Companies Practice. He has extensive experience advising private equity, growth equity, and venture capital funds and their portfolio companies in a wide variety of transactions including leveraged buyouts, recapitalizations, M&A, and growth-equity financings.

For more information visit www.goodwinprocter.com

Q: What are blockers?

A: A "blocker" is a corporation that an investor (e.g., a private equity fund) sets up to invest in a company that is a pass-through for tax purposes, such as an LLC. The investor puts money into a blocker corporation, which, in turn, invests in the company.

Why put a blocker between the investor and the target company?

Taxes. Many PE/VC funds have limited partners that are pension funds or non-U.S. investors such as sovereign wealth funds. If a PE/VC fund with pension fund LPs invests directly in a pass-through, the pension fund realizes "unrelated business taxable income." If the LP is a non-U.S. investor, making an investment in a pass-through subjects the foreign LP to effectively connected income in the U.S. Such investors typically abhor these outcomes. When you interpose a blocker between the PE/VC fund and the target company, you "block" these bad tax results.

Does the "blocker" situation come up often?

Yes, with increasing frequency. Since the introduction of the LLC in the 1990s, entrepreneurs are increasingly choosing the LLC over the C corporation, which is the other main structural alternative for U.S. businesses. Entrepreneurs' election of the LLC form collides with prohibitions on making direct investments in pass-throughs on behalf of UBTI /ECI sensitive investors.

Why do the entrepreneurs want to organize as LLCs?

For various reasons, but the main ones relate to tax economics for the entrepreneur and other owners. Notably, an LLC can generate tax benefits at sale or IPO. Also, LLCs can provide current tax advantages, but there are countervailing considerations. Historically, institutional investors—especially VCs—have tended to look with disfavor on LLCs.

Are there any detriments?

There can be. The main detriment occurs at exit. A PE/VC fund that invests in an LLC through a blocker generally must exit by selling the blocker stock. If the blocker sells the underlying LLC equity, there would be a tax inside the blocker and another tax when proceeds are distributed to the PE/VC fund. But if the fund sells the blocker stock, the ultimate acquirer generally has reduced tax advantages going forward, since selling blocker stock doesn't create the tax benefits that selling LLC units does.

Does the blocker owner get a lower price in that situation, or must it sell in a tax-disadvantageous way?

Usually a PE/VC fund that invests through a blocker pre-negotiates a right to exit without creating additional tax and with no price discount, i.e., all investors benefit from tax attributes of the sale, even if only some of the owners create the benefits. Failure to pre-negotiate, especially by a minority investor, could result in the investor being forced into a tax-disadvantageous exit.

Are there PE investors who don't need to use blockers? Do they have advantages?

Sometimes. A family office, for example, typically doesn't need to use blockers. All else being equal, that can be an advantage when bidding.

Are these rules you're telling us about written down anywhere?

Not really. They are a collection of practices and knowledge that has evolved among those active in the middle market and growth equity. ■

Viewing Consumer and Retail Through the PE Lens

E-commerce, social media, and the Internet have fundamentally changed consumer buying behavior. Richard Leonard of Angelo, Gordon & Co. and Tricia Patrick of Bain Capital compare notes on how they've changed their investment and operational strategies in consumer and retail businesses.

Privcap: Tricia, can you paint a picture of the pace of change that is happening right now in the consumer and retail market?

Tricia Patrick, Bain Capital: E-commerce and Internet-enabled commerce has seen a massive shift in the last 10 years. So you have big players in the U.S. retail landscape—Amazon, Wal-Mart, Macy's—with a lot of boxes and lots of footprint and reach to customers.

But Macy's was 100 years old before it hit $1B in sales. Wal-Mart was 35 years old. And once they hit that billion in sales, they took off from there. But Amazon was able to build a business that's $1B in sales in just five years. And if that's the opportunity for a new entrant to hit the market, you just need to be really cognizant as you're investing in this space of what can happen.

Richard Leonard, Angelo Gordon: I completely agree that the pace of change is at a faster tempo than it has been historically.

And as investors, we've looked at a lot of the traditional hard-line and soft-line retailers as a very challenging space—mostly because of the disintermediation from the Internet. And as a result, we've focused more on food. Our restaurant and supermarket investments are really a defensive position, because those are experiences that are harder to get on the Internet.

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Patrick: I don't disagree that there are still really interesting places to invest. Being cognizant of what is out there and then picking your spots is what we need to do every day in this market. E-commerce is not just a channel shift. It changes price transparency. It enables a longer tail of retailers to get to market, which makes for interesting investments. If you can use the Internet as a tool to engage new customers, you might have that ability to grow a brand, for instance.

We've invested in two brands in the last year: Canada Goose, a luxury outerwear business, and Tom's Shoes, the pioneer of the one-for-one model. In both of those cases, we think there's opportunity to use the Internet to reach more customers more quickly.

Is there a sector or a type of business that has shown vulnerability to disruption, even though it was recently viewed as being relatively safe or stable?

Leonard: I don't know if anyone would say that mall-based specialty retail was historically viewed as safe and stable, but it's become a lot more challenging. Malls will continue to be important and powerful retail centers. But there won't be a lot more of them built, and those in marginal markets will have increased vacancy rates. So what does that mean if you're investing in a business where you're counting on unit growth? It's more challenging to say that you're going to do that if it's going to require opening hundreds of small-footprint specialty retail [locations].

What's your macro overview of the U.S. consumer market?

Patrick: Consumers are not created equal in the U.S. Not everybody has the same spending power.

Sixty percent of Americans are still worse off today than they were before the recession in 2007. On the other end of the spectrum, luxury consumers—more driven by the state of the financial markets rather than the state of gas prices or employment levels—have been really strong. So when we look at any given business, we're spending a lot of time figuring out whom we're selling to.

Leonard: At the moment, our two grocery store brands—Kings Food Markets and Balducci's—are focused on the high-end prepared foods. That really appeals to the consumer who has disposable income to spend, either entertaining their friends, or they want to have a family dinner but they don't have the time to sit down and prepare.

On the other side of the spectrum, we have an investment in Benihana, a well-known Japanese restaurant chain. And in that demographic, we actually skew a little bit lower in terms of income, and it's more of a special-occasion restaurant. And you really have to recognize who you're targeting and where you're trying to grow, because the most important decisions that we make are where are we going to build the next 10 restaurants? And we have a tremendous amount of data that we try to use to make those bets properly.

People are not out there spending the way they were before the recession. They're being a little bit more conservative, deleveraging. They're not accessing home equity lines to go out and buy expensive toys the way that they were.

What are some of the most important items of due diligence that you have to get right before you invest in a consumer-facing or retail company?

Leonard: I would separate that into two broad categories. One is a company where things are really humming, and you're presumably going to pay a high multiple for a high-performing company, and the growth is going to come. The other is a fixer-upper.

With a fixer-upper, you have to focus on the core bedrock, and as we try to change this thing and fix it up, let's make sure we don't throw the baby out with the bathwater. In high-growth businesses, you're trying to improve and build infrastructure, but you're probably not going to monkey with the basic nuts and bolts of the business too much. In the fixer-upper, you know that you have to change something fundamental. And when you do that, you're making a pretty big bet, and you just want to make sure that you're not pulling the wrong lever. So you do a lot of work up front, talking to consumers to make sure that you don't make changes that are going to scare away the only thing that's keeping the company afloat.

Patrick: Consumer research is important no matter what type of bet we're making. And in the world of retail, just walking the stores, seeing what consumers do in their real environment, seeing how engaged they are, is massively important. And we do that on every deal we get serious about.

We also spend a lot of time trying to get to know management, because for all of the changes you need to make, having a management team who knows their business, believes in their brand, and is out there able to out-execute every day is incredibly important. We don't run businesses; we partner with management teams.

In the Canada Goose research, we went in thinking this brand should stand for something differentiated. It is the warmest jacket. People wear it on Arctic expedition trips. The consumer research really held it up. ■

Why It Pays to Think Through Outsourcing Administration Functions

Fund managers considering shifting accounting and IR processes to a third-party provider should consider the pros and cons before making the move

Greg Myers
Managing Director,
Cortland Capital Market Services LLC

Myers oversees product management for Cortland's fund administration group and has nearly 20 years of broad-based financial services expertise. Prior to joining Cortland, he managed the Specialty Bank Loans team within LaSalle Bank's Global Securities and Trust Services Group.

For more information visit www.cortlandglobal.com

Outsourcing functions from a private equity firm to a third party can seem like a great idea: The firm frees up some of its human capital resources for other tasks or can eliminate a position or two and seemingly save money.

But it's important to weigh the pros and cons of making such a move, says Greg Myers, a managing director at Cortland Capital Market Services. He explains that outsourcing internal accounting and investor relations processes can make sense, as a fund administrator can have more robust software and more capacity at peak times to handle accounting functions, allowing the staff at the fund manager to focus on the investment and asset management side of things.

"The inverse is a lot of managers feel they don't have as much control over the day-to-day accounting functions because they've outsourced it," Myers says. "It's more of a perception than a reality. The administrator may have more flexibility on reporting timelines and forms of reports from their systems than the manager may have previously enjoyed or had the capacity to produce. They may not have direct access to information via an internally supported system, but through a cooperatively produced set of periodic reports and the administrators' reporting portal they can get all of their historically produced financial reports and additional management and investor reports not previously available through internal processes."

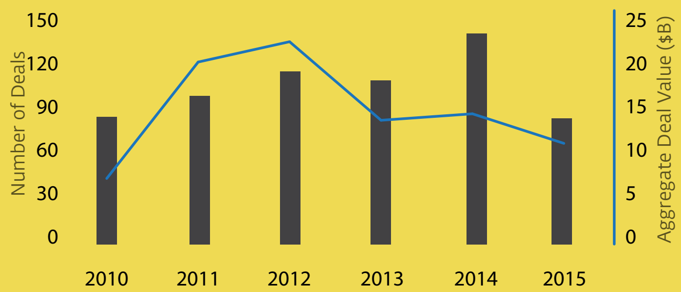
Aside from the perceived inconvenience of a GP outsourcing some functions, there are other advantages that need to be considered. "You're dependent on a third-party provider," Myers says. "The other risk is that they don't report directly to the manager; it's more of a service-level agreement." However, if you take a step back and look at keeping these functions in-house, there's the risk that as a fund winds down and there's a delay in raising the next fund, "you're going to need to terminate employees and deal with those overhead expenses and HR issues," he says, referring to people who were doing the accounting or other IR tasks.

One of the things that's key for a third-party provider is to have a dialogue with fund managers to see what kind of information they are looking for, Myers says. If they want a lot of reporting, that incorporates more accounting and financial work relating to assets or leverage reporting relating to investors. Reporting stood out to Myers in a trend he's seeing. "The emerging trend, for better or worse, is this idea that crowdfunding or Internet marketing will be a large portion of capital for a lot of funds," he says. "With that, there's the requirement for functionality and transparency that these platforms have that would be difficult for a lot of managers to provide. The difference in reporting information and the corresponding expectations of a $10,000 investor versus a $10M investor is vast, as is the method of delivery and granularity of data."

There's also a continued push to keep investors informed of capital positions, the performance of assets, the expense ratio, and the cash-flow metrics, Myers adds. "It's a fine line between keeping investors up to speed on the performance of their investment without giving them so much detail that the message is confused or lost." ■

Private Equity Energy Deals Become Embattled

Energy and utility deal volume and value fell along with oil prices between 2014 and 2015



U.S. Energy Deals Take a Nosedive

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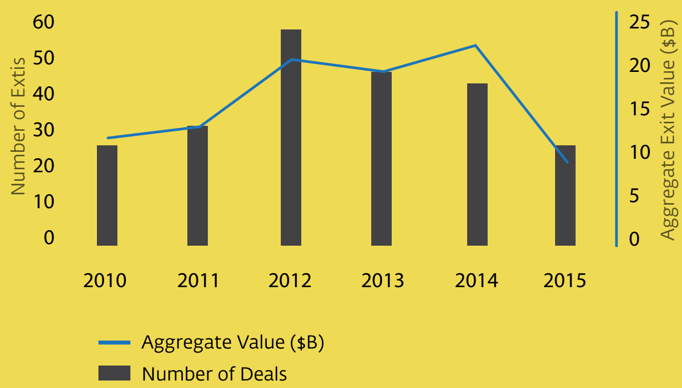
The number of PE-backed deals in energy and utilities hit 139 in 2014, but the aggregate deal value hit a high in 2012 at $21.7B.



Energy & Utility Exits Down Sharply

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Amid depressed oil prices, exits in the U.S. by energy-focused PE firms dropped from 42 in 2014 to 26 in 2015, with the aggregate value going from $20.3B to $7.8B.

Top 10 PE Fund Managers for 2015 by Deals

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NGP was the king, but only beat out Warburg Pincus by a couple of deals, with the same aggregate value.

Fund Manager	Number of Deals	Aggregate Value ($B)
NGP Energy Capital Management	9	1.4
Warburg Pincus	7	1.4
Riverstone Holdings	6	1.3
Kayne Anderson Capital Advisors	6	0.8
Carlyle Group	5	0.5
Encap Flatrock Midstream	5	1.1
Post Oak Energy Capital	3	0.3
LKCM Headwater Investments	3	0.0
Ardian	3	1.3
Azimuth Capital Management	3	0.4

Top 10 PE Fund Managers for 2015 by Value

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TPG and Goldman Sachs tied for the number of deals and their aggregate value in 2015.

Fund Manager	Number of Deals	Aggregate Value ($B)
TPG	2	2.3
Goldman Sachs Merchant Banking	2	2.3
Brookfield Asset Management	1	2.1
TDR Capital	1	2.0
Quantum Energy Partners	3	1.7
NGP Energy Capital Management	9	1.4
Warburg Pincus	7	1.4
Riverstone Holdings	6	1.3
Ardian	3	1.3
Encap Flatrock Midstream	5	1.1

Source: preqin

Andre Burba
Managing Director,
Energy Investment Team,
Pine Brook

Backing an E&P Team in a Challenging Environment

In the midst of a challenging oil price environment, Pine Brook put money behind the management team of Red Bluff Resources. Andre Burba, managing director of the firm's energy investment team, explains what compelled the firm to back Red Bluff.

"It's a very good time for a strategy that's centered on acquisitions and development of resources rather than exploration."

Andre Burba, Pine Brook

Privcap: Pine Brook recently invested $300M in the newly formed E&P company Red Bluff Resources. What qualities did you see in this company that made it look like a good investment?

Andre Burba, Pine Brook: Red Bluff is consistent with our core investment strategy, which is backing experienced management teams and starting new companies. And in this case, Tim Haddican, the CEO of Red Bluff, really fit that description. He has experience in the two geographic areas where the team is going to focus, and that's the Permian Basin and the Mid-Con region.

Tim desires to build a team that has all the relevant competencies represented: geo signs, land function, finance. And that philosophy is also consistent with our investment approach. Finally, what attracted us to Tim and his team is their desire to focus on exploitation plays rather than exploration plays. It's a very good time for a strategy that's centered on acquisitions and development of resources rather than exploration. So it was the combination of the team's experience, the team's breadth, combined with their strategy that attracted us to the investment.

You mentioned this company had a seasoned management team. Is that something that you look for in all of your investments?

Burba: It's a critical element of our investment practice. That's not to say that we always back experienced CEOs. We quite often back division leaders who are becoming CEOs. But above all, we're looking for people who are experienced in the types of strategies that they intend to pursue in their new businesses.

What other opportunities are you seeing in the E&P space?

Burba: Notwithstanding the negative headlines and the oil price collapse, we think it's actually a fantastic time to be investing in the E&P space for two reasons. One, the commodity price decline that we've seen is bound to create very attractive acquisition opportunities. The distress that's being created is going to generate very attractive investment opportunities for existing companies—and also for new entrants like Red Bluff.

Secondly, we're seeing a greater interest among entrepreneurial, experienced executives, [who are currently] sitting inside larger companies, in starting their own businesses. And whereas an executive like that might otherwise stay in his current role for an extended period of time, they're now more interested in starting their own businesses, being capitalized by private equity, and trying to take advantage of the environment, which is bound to create better investment opportunities for them. ■

Case Study: SolarEdge

In March 2015, NewWorld Capital Group exited solar technology company SolarEdge after it raised $150M in an IPO. NewWorld's Lou Schick explains the deal.

Lou Schick
Partner, CTO,
NewWorld Capital Group

Privcap: Your firm, NewWorld Capital Group—which invests in environmental opportunities—recently had an exit from a company called SolarEdge, which went public. What was your view on the solar opportunity before you got connected with SolarEdge?

Lou Schick, NewWorld Capital: I was approached by a banker who has a small boutique firm. And he started telling me about a company that makes inverters, which take the solar energy that is converted in the solar panel so that it comes out as direct current and which make it into alternating current so you can use it in the house. And so the inverter basically is an electronic switching device that can manufacture AC out of DC.

And when you think about the supply chain and the equipment necessary to do solar, inverters are a very important part that hadn't gotten as much attention; panels had gotten a lot of attention. When I was approached about SolarEdge, we had already taken an investment in Astrum, which was doing solar installation, and so we were familiar with panel-level inverters.

And so we thought we were pretty familiar with what the lay of the land was there, what the advantages of string and micro-electronics were. We had good conversations where it was explained to me why SolarEdge's technology worked. They were actually doing something quite surprising and distinctive. And what became clear is their cost potential was much better than what anybody else could do.

And so we decided we were going to go forward and try to do an investment with them. With SolareEdge, first of all, we underwrote it based on their existing technology platform, with the expectation that we might exit in a trade sale.

And the management was very confident that they were going to roll out a revolutionary new technology. And they seemed to believe that an IPO was a possible exit. We would never be sad about that, but that was not something that we could count on. The management hit exactly every target that they set, and I have not had that experience before.

So they are growing their market share, their gross margins are excellent, they IPO-ed right on the plan they had intended, the company is continuing to outperform projections, and they've introduced this revolutionary new technology that I think is really going to disrupt the entire inverter market and possibly beyond. Power electronics get used everywhere, and I think there's a play for this in a wide array of industries.

And NewWorld remains an investor post-IPO?

Schick: NewWorld doesn't hold public stocks, so we distributed the stocks to our investor group as soon as the lockup period was over. ■

Aethon Energy Sees a 'Christmastime' Environment

A co-investment done with Redbird Capital to acquire assets of SM Energy is just one of many opportunities that the firm's founder, Albert Huddleston, sees in a volatile market

The environment in the oil and gas market—one of volatility with a measure of uncertainty—has the industry veterans at Aethon Energy excited because of some appealing investment opportunities.

One of these opportunities was the acquisition of the Arkansas-Louisiana-Texas assets from SM Energy with a co-investment from Redbird Capital. Aethon's founder and partner Albert Huddleston says the assets are a "nice bolt-on" to an existing Haynesville position and current properties, referring to the informal name for a shale rock formation spanning parts of the three adjoining states. "I see tremendous opportunity to acquire properties like SM with cash flow and upside. We are bullish on the long-term future of natural gas."

The Dallas-based firm was founded in 1990 with an operating bent, acting as both a private equity provider—investing its capital and that of others—and an operator of assets. Historically, Aethon has had family office partners in co-investments and has completed two previous transactions with Redbird, says Huddleston.

Aethon already had a position in the Haynesville Formation, so the acquisition of assets fit its strategy "to a T," he says. "We liked it before the prices collapsed late last year, and we like it even more today. I do feel like it's a Christmastime environment for us.... We have a significant pipeline of opportunities we're exploring." There could be other acquisitions that come up in the Haynesville Formation, taking advantage of the presence Aethon already has. "We know that once you buy in a neighborhood, there are opportunities to buy bolt-ons and buy other neighbors out," says Huddleston.

The assets from SM that were acquired along with the co-investment by Redbird include existing cash-flowing unconventional properties that have been de-risked, with exceptional upside, Huddleston explains, adding that over time, given Aethon's strategy—and regardless of any price increases in oil and gas—there should be profitability and the possibility for additional bolt-ons.

And because Aethon does all of its underwriting and execution in-house, doing the same types of transactions, Huddleston says, "it gives people looking to sell assets great confidence that we are credible and trustworthy buyers." ■

Mark Florian
Managing Director,
First Reserve

Building Mexico's Energy Infrastructure

First Reserve entered into a partnership with oil and gas giant Pemex to build infrastructure following the country's energy reforms. Managing director Mark Florian discusses how the mutual investment agreement came about.

Drawing on a relationship that goes back many years, First Reserve entered into a $1B partnership with Mexico's oil and gas exploration behemoth, Pemex, for infrastructure projects.

The largest global energy-focused private equity and infrastructure investment firm has owned companies that have operated in the service of Pemex, says managing director Mark Florian. First Reserve inked the agreement with Pemex to mutually invest in energy infrastructure for Mexico.

The relationship between the two entities includes a drilling company that has operated under Pemex for the past 10 years; the firm also has a couple of wind farms in the south of Mexico. "Pemex appreciated that we are an energy specialist," says Florian. A comprehensive set of energy reforms were passed in Mexico in 2014, opening the country to investments of foreign capital. He notes that First Reserve maintained a close dialogue with Pemex, which was interested in the firm's capital and expertise in energy infrastructure.

Los Ramones—expected to consist of 744 kilometers of natural gas pipelines—is the first investment done via the mutual investment agreement. First Reserve got in on the ground floor—as of May 2015, this was the first major investment that had occurred in partnership with Pemex since the energy reform, Florian says. "This is right down the strike zone of what we do at First Reserve."

Part of the aim of the Los Ramones pipelines is to aid in the transportation of natural gas around Mexico as the country strives to replace fuel oil, which is expensive and not as environmentally friendly, as a major source of power. The pipelines will take a large amount of gas from the U.S. across the Rio Grande and will bring it to receipt points in Mexico.

Pemex saw an opportunity to bring in foreign investment for two pipeline segments under construction in the Los Ramones project, Florian says, which is how its partnership with First Reserve came about. Despite the fluctuation of oil and gas prices and the long-term nature of investing in pipelines (the firm signed a 25-year contract), Florian says the project has a lot going for it: steady revenues, a good regulatory environment, great partners building the pipelines, experience in Mexico, and a stable return for investors.

"We do worry about currency and inflation, but contracts take in those factors," says Florian. "We can de-risk."

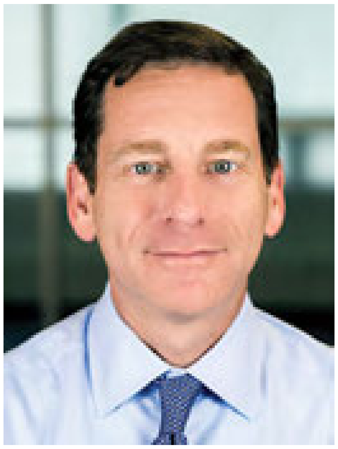
That being said, Florian adds that this is a construction project, so there are risks. He says there are generally "some things you scratch your head about," such as difficulty in getting long-term fixed-rate financing, but that in this case working with Pemex and the Mexican [regulatory] structure is quite favorable.

With all of the activity in Mexico's energy market, the need for capital to build infrastructure is vast. In addition to the natural gas pipeline projects, there is also the CFE [Comisión Federal de Electricidad] putting in a lot of pipeline for its power facilities, upgrading power facilities, and looking for investments.

"The energy reform that the current administration championed has opened a market really focused on the oil and gas side with Pemex and power with CFE," he says. "Now other [PE firms] such as ourselves can come in and make investments." ■

How Infra Expertise Led to the Neptune Power Deal

Ridgewood Private Equity Partners made its first investment in the submarine power-transmission cable between New Jersey and Long Island. Senior managing director Ross Posner explains the attraction of the deal.



Ross Posner
Senior Managing Director,
Ridgewood Private Equity Partners

When the opportunity arose to invest in the Neptune Regional Transmission System, Ridgewood Private Equity Partners jumped at the chance, as investors globally have been increasing their allocation to infrastructure.

This increasing competition has made strong industry relationships, proven experience, and the ability to act quickly key differentiating factors. "All of those elements were at play in our Neptune investment," says Ross Posner, senior managing director of Ridgewood PE. "[Power] transmission, like the broader infrastructure sector, has become more competitive, and we're not immune to that."

In December 2015 the power-transmission cable became the first investment made by the firm, which focuses on energy and infrastructure real assets. Ridgewood Private Equity Partners is a new offshoot of the Ridgewood Companies, joining Ridgewood Energy Corp.

Neptune, a 65-mile-long submarine power-transmission cable connecting New Jersey and Long Island, is under a long-term contract with the Long Island Power Authority (LIPA). Posner says that this investment is an ideal example of the kind of deals the firm will be doing. The investment was done on behalf of entities representing the State of Michigan Retirement Systems and a family office, according to a press release.

Posner comes to Ridgewood from Allstate Investments, where he led its global infrastructure and real asset PE investment team. He says that the Neptune investment had key elements that made it desirable, including that "it's a critical piece of infrastructure with a proven record of operating performance." Neptune came online in 2007, and Ridgewood bought shares from some initial shareholders who were involved in the company's development, some of whom were related service providers.

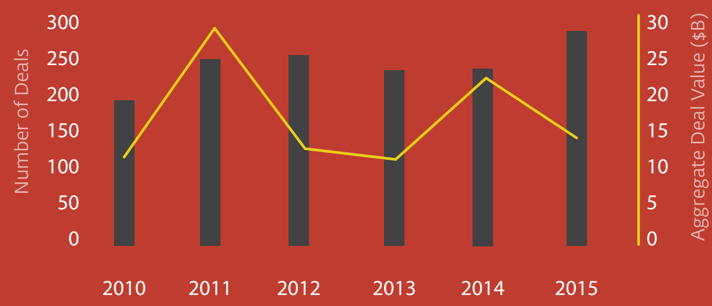
He says that the power line has had, on average, 98 percent or greater availability, typically providing 20 percent of the electricity on Long Island. The long-term contract with LIPA, combined with a prudent capital structure and strong operating performance, have "created a backdrop for a strong risk-adjusted return," Posner adds.

The anticipated hold period will be longer than a traditional PE energy investment where a project developer will sell once it reaches a certain milestone, and the investors were aware of that going in, he says.

Ridgewood plans to support the Neptune management as it continues to service LIPA, Posner explains. "It's a key piece of infrastructure that's been operating very well for a number of years." He says that Ridgewood will also continue to identify other opportunities for future investments. ■

Private Equity's Growing Role in U.S. Healthcare

The number of PE-backed healthcare buyouts surged in 2015, and exits by the asset class have dropped



PE-Backed Healthcare Buyouts Hit a High

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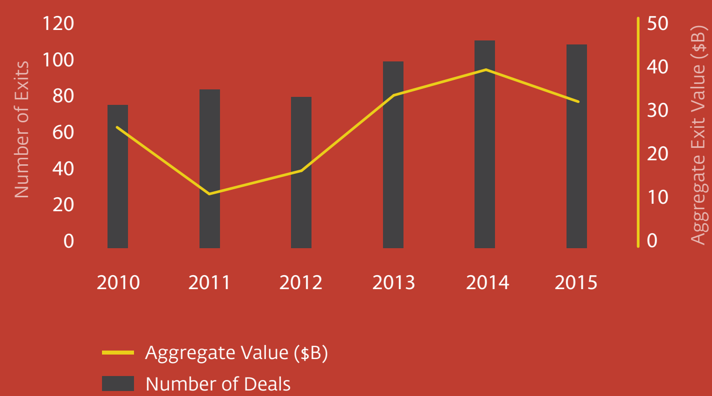
With 276 healthcare deals in the U.S. backed by the asset class, 2015 hit a five-year high, although the aggregate value of $14.1B was much lower than the 2011 peak of $28.4B.



PE Healthcare Exits on a Roller-Coaster Ride

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The number of U.S. healthcare exits done by PE was growing, until a slight drop in both the number and aggregate value between 2014 and 2015.

Global PE Healthcare Managers Led by Bain, Audax

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The two names were among the most-active dealmakers worldwide.

Fund Manager	Number of Deals	Aggregate Value ($B)
Bain Capital	10	--
Audax Private Equity	10	0.3
Revelstoke Capital Partners	9	--
KKR	8	3.2
Apax Partners	8	--
Yukon Partners	8	--
Vaaka Partners	7	--
Clayton Dubilier & Rice	7	0.1
Ampersand Capital Partners	6	--
Shore Capital Partners	6	--

Three-Way Tie for Top Healthcare Fund Manager by Deal Value

—

The list of top managers globally includes a variety of well-known names, including Ally Bridge, Hillhouse, and Boyu, which all did one deal in 2015 having an aggregate value of $3.3B.

Fund Manager	Number of Deals	Aggregate Value ($B)
Ally Bridge Group	1	3.3
Hillhouse Capital Management	1	3.3
Boyu Capital	1	3.3
KKR	8	3.2
Pamplona Capital Management	3	2.7
Cinven	5	2.6
CVC Capital Partners	3	2.0
CITIC Private Equity Funds Management	4	1.8
YF Capital	2	1.7
Welsh, Carson, Anderson & Stowe	4	1.1

Source: preqin

Bringing Healthcare Services Under One Umbrella

With a series of add-on acquisitions, Webster Capital continues its platform expansion of an existing portfolio company, Epic Health Services

Consolidation of the healthcare-services sector became the thesis for a series of add-on acquisitions done by a private equity firm focused on that sector.

Webster Capital continues to build out its platform business, Epic Health Services, with an add-on acquisition of Unifour Nursing and a $130M refinancing to support portfolio company Behavior Health Holdings' acquisition of MedMark Services.

Webster Capital acquired Epic Health Services in September 2010 and has been expanding the platform business at a rapid rate, making more than a dozen add-on acquisitions since then, according to David Malm, co-managing partner at the firm. The company provides pediatric skilled nursing, therapy, and autism services in addition to a variety of adult home healthcare services such as personal care and behavioral health nursing.

Given the synergies between the two businesses, it is easy to see why Webster was attracted to Unifour Nursing, which provides personalized at-home healthcare options like private-duty nursing and personal care. With that acquisition, Epic Health Services now has a foothold in the southeastern part of the United States, where the company plans to expand even further.

"We have a strategy to consolidate the industry," Malm says. Coming on the heels of the Unifour transaction, Webster Capital announced its refinancing to support the acquisition of MedMark, an addiction-treatment and primary-care services provider.

Webster Capital was founded in 2003 and focuses on the branded consumer and healthcare-services sectors in companies that typically have between $3M and $15M in EBITDA. ■

Mining the Opportunities Created by the ACA

Steve Klinsky of New Mountain Capital says the Affordable Care Act has opened several opportunities for PE in the healthcare sector, including hospitals, home infusion, and home care

Privcap: Your firm invests in healthcare and is well-known for doing deep dives into sectors before going out and looking for deals. What are some of the key themes that you've identified that may translate into further deal opportunities?

Steve Klinsky, New Mountain Capital: Healthcare is an area that we've given a lot of time and attention since the early days of the firm. The second transaction we ever did, about 15 years ago, was building up the largest privately held chain of outpatient surgery centers. We had a medical device and pharma [investment] that was a very, very good success for the firm; we've helped health insurers sell health insurance policies with advanced software.

The basic themes for private equity are, we believe, in the unit growth of healthcare. Healthcare is getting more affordable in certain ways, but how do you avoid the reimbursement risk?

What is a recent deal you've done?

Klinsky: The most recent healthcare-related company we bought is a specialty distributor for the home infusion market. There are a million people [who are] chronically ill getting intravenous chemotherapy or pain management at home. That population is growing. When the nurse gets to the home, she needs a kit of parts from 200 different manufacturers, and we're the dominant provider that distributes the parts. We're not subject to reimbursement, but we benefit as the industry grows, so we're looking for those types of opportunities.

And in our public fund we've done very well in the healthcare space. One of the major correct judgments that the fund made was to invest in hospitals with the understanding that the Affordable Care Act could be good for hospitals. And it has been.

Why is the ACA going to be a net good for hospitals?

Klinsky: The basic answer is that if patients can actually pay their bill because they have insurance, it's better for the hospital who is providing the service than people using the emergency room who can't pay. And so the broadening of healthcare insurance to more people has actually been good for hospitals. That's through our public equity arm; we have not bought hospitals in private equity. But we've done well with it through our advantage public equity funds. ■

"The basic themes for private equity are, we believe, in the unit growth of healthcare. Healthcare is getting more affordable in certain ways, but how do you avoid the reimbursement risk?"

Steve Klinsky, New Mountain Capital

Bain Jump-Starts a *Pharma Services Platform*

The firm's acquisition of a manufacturing facility led to a portfolio company expansion, says principal Jeff Schwartz

Jeff Schwartz
Principal,
Bain Capital

When looking to build out its sterile compounding pharmacy services platform, Bain Capital saw an opportunity and formed a new company to take advantage of it.

That newly formed company is QuVa Pharma, which acquired a manufacturing facility serving the niche area of pharmaceuticals that provides ready-to-use compounded sterile preparations to hospitals across the U.S., and was created by Bain alongside both QuVa's CEO and chief development officer.

The market that QuVa covers is underserved, says Jeff Schwartz, a principal with Bain. "There is a desire for additional suppliers."

Schwartz says there is an immense opportunity for the platform to see organic growth. The future points to hospitals increasingly outsourcing to obtain these compounds, because their own pharmacies do not have the necessary facilities. QuVa will mix and deliver customized medications that hospitals cannot make, with the expectation that the platform company will become a leader in this niche industry.

The 30,000-square-foot facility in Texas that QuVa acquired will serve as the cornerstone of a platform for compounding pharmacy services. In addition to opening more locations and stimulating organic growth, Bain has plans to make add-on acquisitions to grow the platform business.

While the company's two co-founders will run the day-to-day operations of QuVa, Bain will remain a "highly engaged and active sponsor," says Schwartz. The firm's portfolio has included a number of healthcare investments, including HCA, Quintiles, and Emcure Pharmaceuticals. ■

Precision Medicine's Revolution

Dr. Joshua Bilenker, a practicing physician who also happens to be an operating partner at Aisling Capital, discusses his investment in Loxo Oncology, and the nexus of medicine and investment

"What we really create in the better companies is unequivocal clinical data—human data that show that there's a health outcome that's been impacted."

Dr. Joshua Bilenker
Operating Partner,
Aisling Capital

Privcap: What are the most exciting trends in oncology today?

Dr. Joshua Bilenker, Aisling Capital: I'd point you to two trends. One, Loxo is firmly implanted in is targeted therapy. People hear the terms "precision medicine" or "personalized medicine," and the idea is to understand cancer at a genetic level individually, and then to pair that patient with the right drug specifically designed for that cancer. A second trend [concerns] immuno-oncology, which is the idea of taking the brakes off the human immune system so that the body can "re-recognize" the cancer as foreign and use the immune system to attack it.

What did you learn about the healthcare business while you were an investor?

Bilenker: As an investor, when we think about the investment, we're basically conducting a trial in a pre-revenue company with a very high cash burn and a very complex regulatory space, and we're hoping that it works. In the life span of the investment, we're very unlikely to sell a product. What are we really creating with our risk capital? What we really create in the better companies is unequivocal clinical data—human data that show that there's a health outcome that's been impacted.

What would you say to an institutional investor interested in the biotech space who wants to put capital to work in the smartest way?

Bilenker: The great products, the great therapies, are well understood by everybody. Aligning with proven management teams that have created value, have created products that get approved—that's obviously an important box to check.

What is life like for you as a publicly traded company, and what do you predict on the horizon?

Bilenker: The capital markets have been very interested in taking more risk. Depending on how you do the math, there are probably about 200 companies now that didn't exist in the public markets before. Some of them probably went too early; many of them are not going to work. There's a lot of opportunity within the public markets.

Would many of these biotech companies have an easier life as privately held companies?

Bilenker: The path to liquidity for an institutional investor, whether venture or private equity, is really twofold in biotech. One is a trade sale to a strategic partner, a big pharma, a big biotech who needs that technology for their pipeline, or an IPO.

When the IPO window shuts down, there's one path. All the power shifts to the business-development groups at 20 or 30 large pharma, large biotechs, where those teams seem to be in a revolving door on a two-to-three-year cycle. They can't give you consistent advice as a company about what you need to show to be an attractive acquisition candidate. One thing we've seen in the financing of private companies is there's much broader syndication. There used to be this orderly handoff between series A, B, and C investors, every subsequent round paying a little more than the prior round. ■


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Even in a Financial Downturn, **a Luxury Soapmaker Gleams**

During the recession, premium brands in the hospitality sector performed better than mid- or lower-level offerings. Swander Pace's Mo Stout discusses the acquisition and exit of Gilchrist & Soames.

"We helped the business enter some large national and global accounts. We helped them upgrade their facilities. And we helped them develop a global presence within the market."

Mo Stout
Managing Director, Swander Pace

The tiny bars of soap and shampoo in hotel rooms can often be overlooked. One of those brands presented an opportunity to middle-market private equity firm Swander Pace Capital.

While the middle-market firm doesn't exclusively invest in hospitality businesses, it cleaned up in 2015 with its exit of luxury soap supplier Gilchrist & Soames, a London-based company that serves the four- and five-star hospitality industry.

"Luxury hotels is not a core focus area for us, but it is a channel that we've had a good experience with, and we would absolutely—with the right business—be happy to make further investments," says Mo Stout, managing director at Swander Pace.

The firm focuses exclusively on the consumer-products space with investments typically in the $20M to $40M range. The portfolio contains companies from several subsectors including beverages, branded food, food service, pet products, sporting goods, nutritional supplements, specialty apparel, and over-the-counter medicines.

Stout says a major part of the firm's investment thesis is to back great management teams and to help portfolio companies extend their footprint globally, using long-term relationships that Swander Pace has established in the supply chain and distribution worlds.

"We focused on three things, fundamentally, in terms of the value that we added," says Stout. "We helped the business enter some large national and global accounts. We helped them upgrade their facilities. And we helped them develop a global presence within the market."

Stout says his firm has cycle-tested and found that the luxury hotel industry performs better in economic downturns, making Gilchrist & Soames an attractive investment. And ultimately it became attractive to Guest Supply, a wholly owned subsidiary of Sysco Corporation that Swander Pace exited the investment to via a sale. ■

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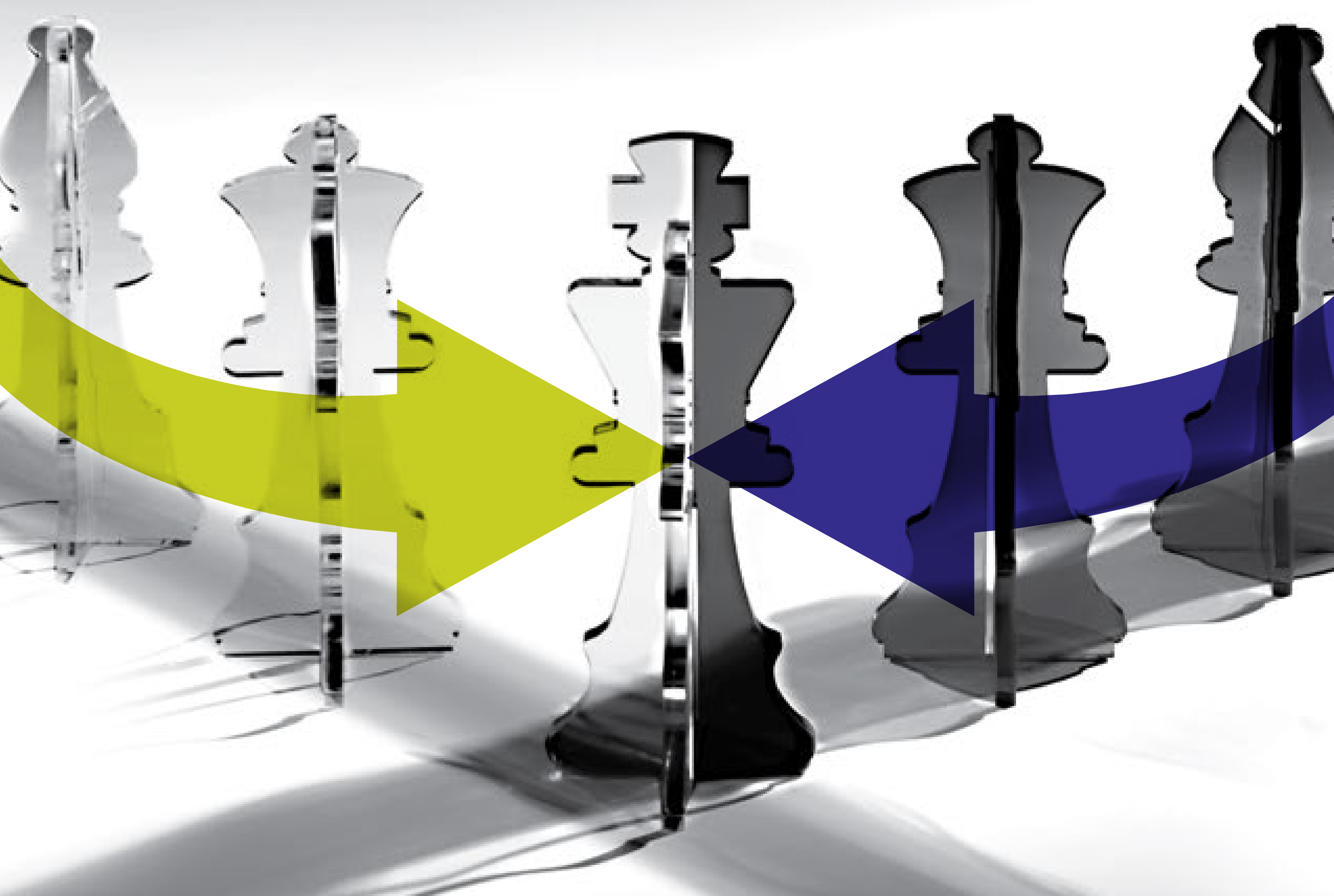


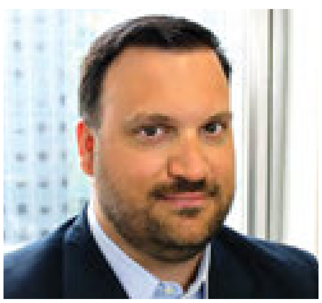
The 4 Big Reasons Private Equity Needs 'Better' Data

There are ways that the industry can streamline its dealmaking process, writes Matthew Porzio of Intralinks

1 Executing Quickly Is More Important Than Ever

Private equity professionals are always looking for ways to further advance and streamline the deal execution process. On the back of a record-breaking 2015 in terms of deal volume, strategics are coming into deals hot and heavy. Strategics are disciplined in industry knowledge, they have defined and well-thought-out acquisition lists, and they're ready for rapid execution. These strategics are facing increased pressure for revenue growth and are being as aggressive as ever to win deals that create value and fit with their strategy.

In order to maintain competiveness in the midst of this backdrop, financial sponsors need to leverage every asset at their disposal. Especially when sponsors compete with strategics for deals, strategics generally come in willing to pay more money in advance, as their investment outlook is generally longer-term than sponsors. The ability to make faster, more informed decisions and act upon the findings is a crucial driver to deal success—to commit to the deal faster or walk away from the deal faster.



Matthew Porzio
Vice President,
Strategy & Product
Marketing,
Intralinks

2 More Eyes on a Deal Means More Need for Centralized Data

Streamlining both buy-side and sell-side processes can prove extremely beneficial to getting deals done quicker. Most acquirers have attorneys and bankers on standby, ready to take a deal to market or assess an acquisition at a moment's notice. That same practice should be adopted with any technology services used for deal execution. Having a standardized pool of tools used for transaction management, including sourcing counterparty opportunities, managing transaction pipeline, and executing diligence and closing, can help any deal team immediately pivot on a market opportunity. Standardizing and centralizing these processes also provides deal teams with centralized dynamic data that provides a competitive edge.

3 Information Drives Everything, From Acquisition to Exit

The need for sophistication extends well beyond the deal process, both in communications with investors and with portfolio companies.

LPs increasingly demand greater transparency and consistency in reporting and information flow, and with the trend toward co-investing, they're increasingly taking part in the diligence process and helping define strategy. Likewise, much of the information flowing from your portfolio companies is used not only for management and reporting but as the foundation for due diligence when it's time to exit. Adopting a disciplined and operationalized system for information flow throughout an investment cycle is critical to minimizing gaps when a deal moves to market.

Having a single system to manage diligence, reporting, and ongoing data needs throughout a deal life cycle makes the process easier for parties.

4 Deal Sourcing Is Moving to the Next Level

Financial sponsors who are not leveraging technology to source additional deal flow are potentially missing the opportunity to greatly scale business-development efforts. You don't want to be the team keeping track of everything on spreadsheets or, worse yet, be like a firm I visited recently that had a big whiteboard with a note: *"Do Not Erase."*

Platforms like Intralinks Dealnexus provide curated deal flow from counterparties around the globe. It puts the world of deals in plain sight, with prospects raising their hand and saying, "I want investment. I need investment. I need to sell."

There's really no better or no purer form of deal sourcing than that, right? ■

For more information visit www.intralinks.com

The Right Way to Do Buy and Builds

Why rolling up add-on acquisitions into a platform company may not be as cut-and-dried as a PE firm envisions

The process of the add-on seems simple: A PE firm acquires a platform company, then it looks for companies that could be added on to fuel the platform's growth. But getting the details right takes expertise. Panelists talk through five points that can make or break a buy and build.

1

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 the firm can find 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 as $35M of EBITDA," says Jay Jester, managing director at Audax Private Equity. "That's a huge market—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, what you're doing is telling potential strategic acquirers, 'What we've just done, you're going to be able to do. We've already laid out the road map for you; we've put these businesses together,'" Belinfanti says. "Then the strategic says, 'Well, that's interesting. I know this can be done.'"

But a buy and build must be executed correctly. The strategy is not a get-rich-quick scheme. "The PE firms that do add-ons well are in that niche of identifying good CEOs who have add-on and acquisition-integration expertise," notes Dennis Cail, director of management consulting at RSM US LLP.

2

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 are up to their eyebrows in their business and 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.

Belinfanti says, "We're out there calling on companies and actively bringing targets back to our management teams to say, 'Is this something we should be interested in?'"

"The leaders we interact with at the lower end of the middle market, these are small companies, a lot of times 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—finding the right lender for the situation—and in deal sourcing, Jester says. "Finding exactly the right lender for exactly the right situation is really important. Sourcing is incredibly important. I think there are almost 4,000 different deal-sourcing firms just in the United States."

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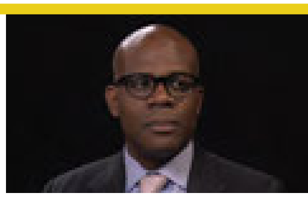
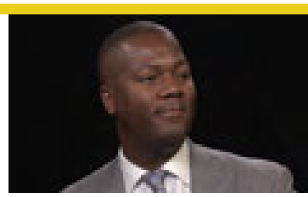
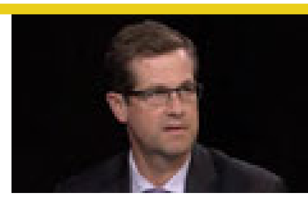


Gregory Belinfanti
Senior Managing Director,
One Equity Partners



Dennis Cail
Director, Management
Consulting, RSM US LLP



Jay Jester
Managing Director,
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—the cost of supporting your revenue growth—has continued to expand. Gross margins are fine now. The problem is, 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. This thesis is important not only to the firm but to the companies that the firm plans to approach.

"Once we have a thesis, we start calling people," Belinfanti says. "We'll start with a company that's the size we want to invest in. If you call that guy and just say, 'I want to buy your company,' he'll say, 'There are 100 guys out there who want to buy my company.' What we try to do is 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 managers and companies as possible. Over time, new introductions are made, and 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," RSM's Cail says.

That can be a tall order, Cail adds. A lot of operator-owners are skeptical of PE firms—and consulting firms—and have a hard time seeing value in the firm's thesis.

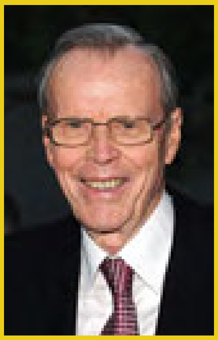
On the flip side, Cail says, firms must convince LPs that their sourcing techniques are sound. "GPs are lobbying for the same dollars as all the other PE firms when they're raising money. And one of the things these LPs want to know is how you source your deals."

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. "There are companies we've had conversations with for 15 years before they finally become that platform company." ■

Why Brokerage Houses May Be PE's Dream Opportunity

As regulations lead to an increase in some costs and risk for brokerage houses, private equity firms are taking note



Don Marron
Founder & Chairman, Lightyear Capital

It's a tough time to be a broker-dealer, and private equity smells an opportunity. Proposed regulatory changes, if approved, will expand a stockbroker's fiduciary duty to their clients, meaning greater legal risk and higher compliance costs for brokerage houses across the country. That reality, coupled with agitation among some investors for large financial institutions to simplify and shed assets, has made it a good time to be a private equity buyer.

The AIG Deal

In January, New York-based Lightyear Capital and PSP Investments, the Canadian pension fund manager, announced the purchase of AIG Advisor Group, the broker-dealer arm of AIG. In addition to the impact of regulatory changes, AIG has been under pressure from activist investor Carl Icahn to shed assets. "We were looking for another opportunity to be in this part of the business, and we found it in AIG," Don Marron, founder and chairman of Lightyear, says. "The business is taking advantage of the enormous trend of going from defined-benefit to defined-contribution [plans]." Look for Lightyear to follow the model it followed with Cetera Financial Group, an entity born from Lightyear's 2010 purchase of ING Group's broker-dealer arm, ING Advisor Network. Through acquisition and operational improvement, Lightyear successfully exited the company in 2014. As part of the AIG announcement, Lightyear appointed Cetera's former CEO, Valerie Brown, as executive chairman of Advisor Group.

A New Reality for BDs

The proposed regulatory changes would require broker-dealers to act in a client's "best interest," a tightening of the current standard, which only requires that a broker-dealer recommend a "suitable" investment. The inherent conflicts, real and imagined, of the traditional commission-based model, therefore, mean greater disclosures and legal exposure for broker-dealers. And the burdens are potentially greater for broker-dealers that are part of a larger organization that, like AIG, "makes" some of the financial products sold through its brokerage arm.

The ability to consolidate broker-dealers into a single independent entity, along with Lightyear's familiarity with fee-based revenue structures, made the deal irresistible to Marron, who had unsuccessfully sought to buy the AIG group once before, in 2009. "We concluded that, first of all, the scrutiny and potential changes from the Department of Labor will move you more toward third-party managers managing assets for a fee, which is our focus in any case," says Marron. Combined with the ongoing transition from defined-benefit to defined-contribution retirement plans and the aging of the U.S. population, the broker-dealer opportunity, it appears, is private equity's to lose. ■

David Conrod
Founder,
FocusPoint Private
Capital Group

The Case for *First-Time* Funds

A veteran placement agent explains why the smartest LPs seek to back new "teams and themes"

For more information visit www.fpcgllc.com

David Conrod, the founder of placement agent FocusPoint Private Capital Group, says private equity LPs are hungry for new teams to back, because the best of these can often produce significant returns. And yet determining which teams are likely to succeed is tricky, he says.

Privcap: What does the market look like for first-time private equity funds?

David Conrod, FocusPoint: A significant number of new management teams are being formed out of successful, high-quality private equity firms. When firms are successful, we see an acceleration of spin-outs and new firms launched. Whereas when times are not as buoyant, teams tend to stay together, which is somewhat contra-cyclical. The types of investors that gravitate to new funds are typically endowments, foundations, family offices, and recently some large institutional investors, particularly insurance companies. Additionally, investors having the confidence and judgment to support new managers with capital look to previous accomplishments. One can always have experience, but in some cases 10 years of experience may really only be the same single year of experience 10 times.

How do these investors get comfortable with a new team, albeit an accomplished one?

Conrod: They spend a substantial amount of time not only with the team but also confirming the investment thesis. We refer to it as "team and theme." These investors spend a great deal of time making reference calls as they look to connect the dots as to who they know that knows the talent under consideration. For our own due diligence, we seek to complete a minimum of 40 reference calls. In these calls, we also learn valuable information about the management team, and the value proposition becomes a thread that can be woven throughout their story.

Does it help for a new team to have one or two deals under its belt?

Conrod: A transaction provides visibility into a portfolio and will also compress the fundraising time frame.

With all the risks, why would an investor spend time vetting a first-time fund?

Conrod: One of the largest not-for-profit investors in the U.S. experienced a great deal of success with smaller first-time funds, which usually led to oversubscribed successor funds. It was quite apparent that these management teams are more motivated by carried interest, are operating within a larger deal opportunity set, and generally have smaller teams, enabling crisper decision-making with greater ability to influence outcomes. If the typical life cycle of a general partner is 15 to 20 years, with this evidence it may make sense to commit to a general partner in the first 10 years of its life.

There are also other advantages to being the first money in—investors can better drive economic terms. Supporting high-performing newly formed teams will also maintain a position of leadership in the industry, as many successful first-time funds become oversubscribed in fund two. The tricky part is having the judgment to back the right teams—that is what separates the cream from the milk. ■

Making a Local Brand a Regional Name

New York-based firm AUA has invested in a 110-unit Tex-Mex restaurant chain, with plans to expand throughout the Southeast

Steve Flyer
Partner,
AUA Private Equity Partners

When private equity firm AUA acquired Tijuana Flats, a Tex-Mex restaurant chain, the Florida-based chain already had its own brand of hot sauces and several locations in the state. Steve Flyer, the AUA partner who led the acquisition, says that the firm's thesis was to "take a local Florida brand and expand it, at a minimum, to a regional concept."

The chain was founded in Winter Park, Fla., in 1995 and now boasts 110 units in six states and is part of a larger investment strategy established by founder Andy Unanue when he started the firm in 2009.

"Part of our investment strategy is looking at Hispanic-oriented companies, partly by virtue of [AUA managing partner] Andy Unanue's background—as former COO of his family's business, Goya Foods," says Flyer.

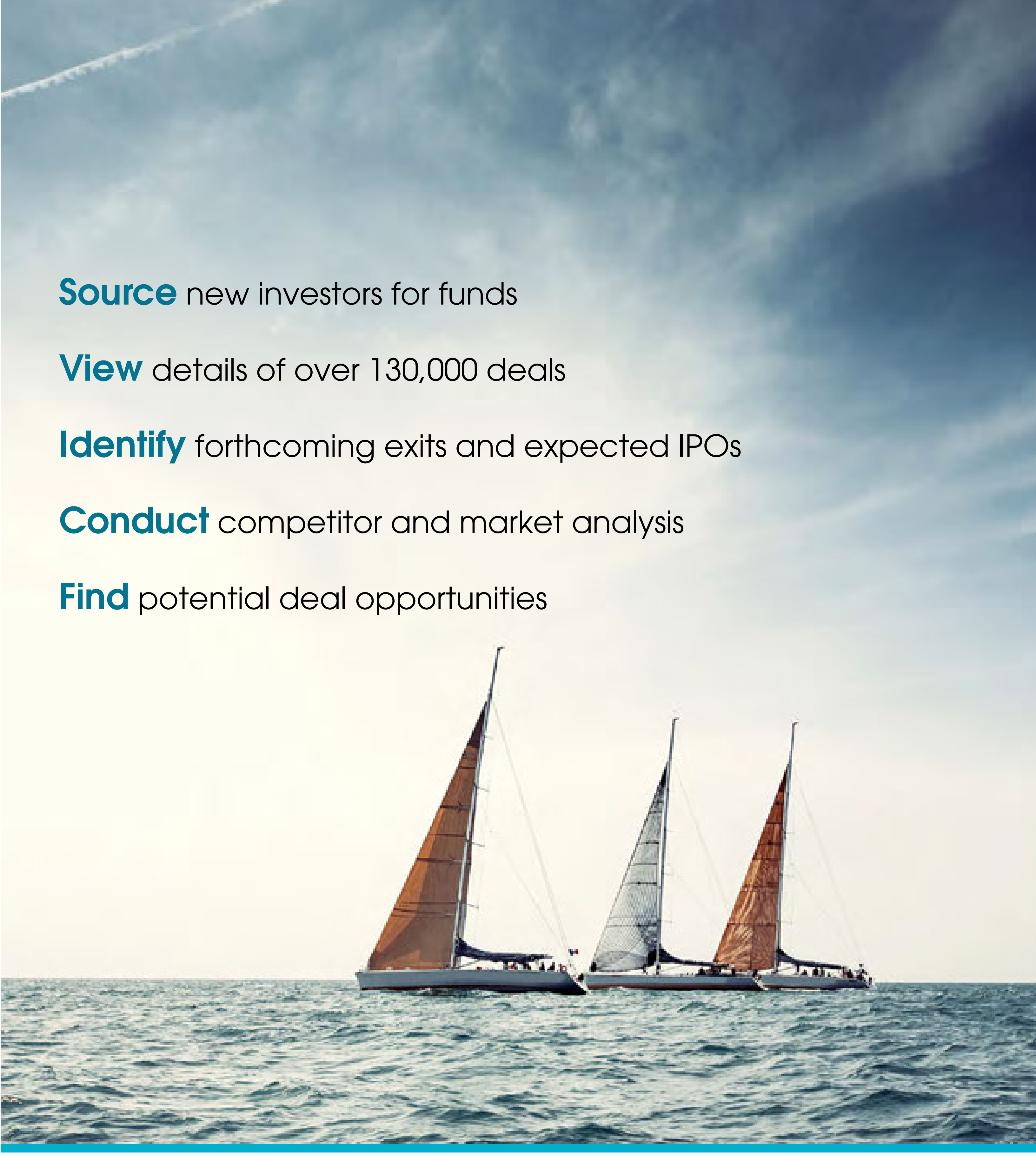
At his former firm, Flyer was an investor in the El Pollo Loco restaurant chain and served on its board of directors.

AUA invests in businesses that generate anywhere between $5M and $40M in EBITDA, with average investments between $20M to $25M, and Flyer says Tijuana Flats falls in line with that average range. The restaurant's two original partners, Brian Wheeler and Camp Fitch, will remain with the company—something Flyer says was crucial to the deal.

The restaurant chain joins a portfolio of companies that are market leaders among Hispanic consumers, including Raymundo's Food Group, Blue Star Media, Associated Food Holdings, and Trufoods.

Flyer says part of what attracted the firm to Tijuana Flats was the culture and the customer experience.

"You have to have good, fresh products, and we do," says Flyer. "But you also need to provide an experience for the guest so they feel welcome and important." ■



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