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2017

Portfolio Operations Yearbook

Expert insights on successfully managing private equity investments

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Dave Noonan
Principal,
RSM US LLP

Operating Partners Dig Deeper

Not long ago, private equity portfolio companies began to see growth in raw, functional improvements spurred by operating partners from their private equity owners. Now those operating partners are becoming ever more sophisticated in their value-creation methods, particularly in terms of revenue and margin growth.

One recent area of greater focus has been to optimize a firm's finance functions to help portfolio companies close the books faster and forecast the business more accurately. Better, more timely forecasting typically means better outcomes.

But beyond improvements to the existing portfolio, operating partners today are being called upon to identify and find those synergies during merger integrations and add-on acquisitions to platform companies. Reducing expenses and realizing efficiencies is often critical to the success of an add-on strategy, making operating partners ever more prominent members of a value-creation team.

In today's competitive environment for private equity firms, operating partners need many skills: how to optimize the portfolio company finance office; how to hire the right people to get the job done; and, ultimately, realizing when a company is not performing well in those areas and how to address the issues.

In this 2017 Portfolio Operations Yearbook, operating experts share their successes and challenges. I trust you'll find many useful stories—and many ready answers—in these pages. Thanks for reading.

Privcap/Report

Privcap
David Snow
Co-founder & CEO
Gill Torren
Co-founder & President

Marketing & Sales
Michelle Diller
Director of Marketing & Events
Scott Pestronk
Sales & Client Relationships Coordinator
Erin McDonald
Marketing & Events Coordinator

Content
Matthew Malone
SVP, Content & Digital Strategy
Andrea Heisinger
Editor

Production & Design
Rachel Shim
Production & Design Coordinator
Benjamin Asbell
Production & Design Assistant
Nathan Pardee
Video Production Manager
Jake Hard
Production Assistant

Contacts
Editorial
David Snow / dsnow@privcap.com
Matthew Malone / mmalone@privcap.com
Andrea Heisinger / aheisinger@privcap.com

Sponsorships & Sales
Gill Torren / gtorren@privcap.com

For subscriptions, please call 855-PRIVCAP
or email subscribe@privcap.com

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www.privcap.com

Matthew Malone
SVP, Content & Digital Strategy, Privcap

Operating Partners: Undercover Value Creators

Operating partners, the engineers of private equity's value-creation machine, get little of the asset class' spotlight, but they should get much of the credit. Acquisitions and exits generate headlines, but operational improvements generate returns. And that, of course, is what matters most.

Today, fund managers tout their operational bona fides at every opportunity. Investors would be forgiven, in fact, for thinking that great operating partners grow on trees. And if that were so, this report would be a waste of paper—and your precious time.

But as we all know, the only thing that comes easy in operational improvement is frustration. Whether it's streamlining the back office or optimizing the supply chain, operators must exhibit dexterity and ingenuity. And even when they do that, they might fail.

This report is designed to help you avoid those failures. In these pages, we've assembled the collective wisdom of professionals who fought the battle and won, and we've profiled the research, technology, and strategies that helped them do so.

One of these professionals is Blackstone operating partner Gregory Beutler, who explains the challenge succinctly. "Up until 2005, there was a lot of low-hanging fruit—companies where you could easily craft a value-creation strategy," he says. "Today, we have to be more innovative in terms of driving differentiated growth in margins and cash flows."

I hope these stories will inspire that innovation, and give operating partners the credit they so richly deserve.

That's one improvement that's long past due.

Matthew Malone

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HOW BLACKSTONE CREATES VALUE THROUGH PROCUREMENT

An operating partner explains how the firm uses its scale to its advantage

As acquisition multiples hit all-time highs, private equity firms are constantly in search of new ways to create value in their portfolio companies. That's particularly so when you happen to be Blackstone, the world's largest alternative asset manager, with more than $340B under management.

"Up until 2005, there was a lot of low-hanging fruit, companies where you could easily craft a value-creation strategy," says Gregory Beutler, an operating partner at Blackstone. "Today, we have to be more innovative in terms of driving differentiated growth in margins and cash flows."

Yet Blackstone's sheer scale does give it certain advantages, especially when it comes to optimizing procurement and the supply chain. Here, Beutler explains how Blackstone leverages that scale to reduce costs at its more than 160 portfolio companies.

CREATE VISIBILITY

Blackstone uses BX Cube—proprietary software developed in 2005 by California-based SAP Ariba—to assemble, organize, and analyze spending data from its portfolio companies. The tool makes it possible to slice and dice around $35B of spend by region, supplier, and product. The platform has 75 mostly single-sourced categories for items like software, rental cars, healthcare benefits, and insurance.

ESTABLISH RELATIONSHIPS WITH KEY VENDORS

BX Cube data is used to find common spend. The firm then uses its scale to negotiate preferred pricing agreements with more than 75 key strategic vendors, typically single-sourced categories, for items like software, rental cares, healthcare benefits, and insurance.

Annually, about $5B is spent on buying supplies and services from these vendors, which include FedEx, Marsh, Dell/HP, and American Express. In addition to lower costs, these and other companies provide Blackstone with highly differentiated services.

"We have saved over $850M since we launched the system," says Beutler. "It's real money, and being amongst the top five to ten customers of a vendor gives us better economies of scale and relationships."

LEVERAGE E-SOURCING TO GET THE BEST VALUE

For other vendors, Blackstone had SAP Ariba develop an e-sourcing platform that automates the bidding process. Pre-qualified vendors simply log into the software and answer standardized questions, saving everyone hours of email back-and-forth, Beutler says.

Next, the portfolio company—in collaboration with Blackstone—hosts a live auction with a twist: Bidders compete to offer the lowest price for the product or service. When the auction is complete, Blackstone can decide whether to accept the lowest price or to walk away.

This year Blackstone expects to run about $1.5B worth of bidding events, which translates into 600 to 700 auctions. Year-to-date, the firm has saved about 14 percent using e-sourcing, according to Beutler.

ENABLE KNOWLEDGE SHARING

To keep everyone on the same page, Blackstone runs a shared chat group for procurement officers and arranges regular meetups to discuss issues like supply risk management. This best-practice sharing challenges each portfolio company to look at how they can improve their own procurement practices. "To create value, you've got to start with talent," Beutler says. "When you put world-class procurement leaders at portfolio companies, everything goes better and faster." ■

Why ESG's Next Frontier Could Be Animal Welfare

A foundation from Coller Capital's founder aims to add animal welfare to the ESG equation

There's nothing new about ESG, and—until earlier this year—not much more to be written about it.

Environmental, social, and corporate governance has been in the news for a variety of reasons, including several college and university endowments being urged by students to divest holdings the students find objectionable.

Privcap has covered it extensively—from discussions on how impact capital is a hard sell to whether investors should give up on striving to put capital into ESG-focused sectors.

But in mid-2016, an article that had all the earmarks of talking about "just another rich person creating a philanthropy to fund a cause near and dear to them" had a tidbit that stood out. Jeremy Coller, founder of Coller Capital, has started an eponymous foundation that's running an initiative intended to raise awareness about factory farming and its risks for investors.

Coller says the initiative's goal is to get farm animal welfare on the agenda of the PRI, the United Nations–backed network of fund managers pursuing sustainable investment strategies.

In the recently released Business Benchmark on Farm Animal Welfare 2015 annual report (Coller Capital was one of three organizations supporting its release), Tyson Foods CEO Donnie Smith notes that "ensuring proper animal welfare in a business environment is a top-down job that has to be woven into the company's culture."

Large food industry players such as McDonald's are listening to customer and public interest group demands for humane animal treatment. But what about private equity? Will other firms heed Coller's call to add farm animal welfare to the list of ESG standards? Some smaller firms, such as Equilibrium Capital, are already focusing on sustainable agriculture and food production.

Time will tell if others will jump on the bandwagon, although if potential investors in their funds ask about animal welfare standards, it's almost certain more PE firms will take notice. ■

How to Recognize Value and Avoid Disruptions in PE Transactions

Sometimes a merger integration doesn't go as planned. But those hiccups can largely be sidestepped with the right preparation, writes Paul Calamita, a partner at RSM US LLP.

Merger acquisitions and carve-out events require focus and rigor in order to deliver enhanced value to the emerging organization. Unfortunately, historical data shows that while many of these past transactions failed, even more failed to capitalize on their expected value, with the resulting transformation causing disruptions to key daily operations. To avoid these harmful missteps, your organization must implement a comprehensive strategy to not only avoid disrupting the day-to-day operations of the business, but to capture the deal value anticipated by the strategic investment.

A lack of integration success can be attributed to a host of factors. In some cases, companies focus too much on the deal itself, rather than the actual integration. Some organizations even attempt the post-close integration without detailed plans or testing of the critical integrating processes or systems. Others underestimate the level of effort necessary to complete the integration or the impact the effort has on its leadership and management team. Frequently, integrations simply fail because they are managed by people with a lack of merger or optimization experience or lack of bandwidth.

An effective approach when managing an integration is to maintain focus on four key cornerstones to ensure your organization quickly recognizes value and, at a minimum, avoids business disruptions. These cornerstones are: accelerating growth, capturing value, executing the integration, and managing the change.

Accelerating Growth

A successful integration is measured first by its ability to accelerate growth around the investment, whether it is an acquisition or a carve-out. This requires the identification, validation, and prioritization of the revenue or business growth opportunities identified as part of the initial investment thesis. In an effort to help achieve these targets, organizations must establish a structure to help manage and govern the integration process, supporting the growth strategy and empowering individuals to achieve the expected results. Aligning measurements and incentives with the growth strategy is critical to maintaining this focus.

In order to jump-start the integration, it's important at early stages to formulate the initial integration vision, as well as to identify key leaders and resources to spearhead the critical integration activities. When identifying these leaders, it's important to consider and leverage those executive and operational leaders within the acquired organization or target to gain key insights into the business and understand how the integration could affect the day-to-day operations of the business.

This integrated approach will help provide operational insights that impact and drive deal value, as well as highlight any operational risks that might need to be addressed prior to the integration.

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Capturing Value

In today's dynamic business environment, organizations must work quickly to identify and quantify costs, synergies, risks, and value drivers in order to maximize the value of the deal. It's important that organizations understand that the value of the deal is not just found in revenue or market growth initiatives, but also in cost and process optimization efforts. For this reason, it is important that organizations keep a keen eye on systems, underlying processes, and operations.

Early on, target operations, systems, and supporting processes must be assessed, along with the skills and capabilities of the management team, to evaluate their impact on the integration and identify opportunities to improve deal value and mitigate integration risk. It's important that throughout the integration effort, ownership and accountability of each synergy opportunity and risk is assigned and carefully tracked to ensure the anticipated benefits are realized.

Executing the Integration

Executing a successful integration with limited disruptions to daily operations begins with establishing an effective project management office (PMO). A critical step in every PMO is aligning the appropriate integration leadership across all levels of the effort. Leveraging the identified and prioritized deal synergies, the PMO should coordinate effectively with each project work stream to track and manage tasks, risks, interdependencies, and milestone deliverables, while also assessing the impact or disruption that this effort is having on the daily operations of the business.

An effective PMO and integration starts with planning, setting the course and articulating the strategy for the integrated company. It is important for the organization to determine the degree of integration and non-negotiables up front, as well as identify and protect core operations that are out of the integration's scope. Any "day one" necessities should be quickly identified and resolved, and a communication plan should be developed to execute early communications to keep the company informed on goals and progress of the overall effort. Integration planning requires careful identification and execution of requirements across all functions. Key integration risks and dependencies must be understood, and 100-day plans and potential quick wins should be developed and posted.

A desired future state must also be designed, with functional and operational "to be" perspectives that identify, value, and prioritize key integration initiatives and synergies. Leadership and organizational structures will require development, while also assessing cultural differences and developing necessary people-change programs.

After thorough planning, your organization should initiate integration plans by completing activities to achieve deal closure and day one requirements. The 100-day plan's quick wins should be delivered, as well as tactical integration plans.

As part of the implementation effort, be sure to align resources effectively, and be realistic with timelines and expectations. Effective planning will help ensure you do not lose sight of day-to-day operations and adversely impact the business. Thorough plans and resources must be in place, with realistic goals and targets that are managed aggressively during the execution phase.

Managing the Change

An integration is not only about processes and technology; it's also about people and culture. Strive to align cultures and build employee engagement, while developing plans to identify and retain key talent as well as optimize compensation and rewards. Core talent should be nurtured so that these individuals know their value and can assist with managing not only the day-to-day operations but the execution of the integration plan as well.

A key to managing change during the integration is developing a strategic and comprehensive communication campaign. All team members should feel involved or at least be aware of integration plans and how those plans would affect them.

Final Thoughts

An optimized transaction can deliver significant financial and operational value to an organization. For example, RSM US LLP advisors recently assisted with the merger integration for two $350M technology companies with duplicative functions and services. The RSM team worked closely with management and functional teams to identify savings opportunities, set goals, and define targets and organizational structures. After defining an integration approach, an annual $20M in savings was identified, as well as a consolidated staffing and organizational structure and defined future state service offerings and processes.

If your company chooses to acquire another business or initiate a carve-out, there is always room to gain additional value and, sometimes, a significant amount of room to optimize the transaction effectively. However, proper planning and execution are critical. With an experienced team, you can deliver on the investment thesis and help ensure that not only is the deal value realized, but day-to-day operations are managed without any adverse effects from the integration.

How KKR Creates Value Through Technology

Tech is being used by the private equity giant to de-risk and increase investments' value

Technology permeates nearly all aspects of our life. On the investing front, it is one of the sectors where both the end markets and growth are projected to be healthy for the foreseeable future. For portfolio companies, technology-related decisions are significant in both amount of spending and potential impact to the business.

KKR is keen to invest in building technology capabilities at the portfolio company level, says Derick Prelle, partner and managing director at KKR Capstone. The latter is not a subsidiary or an affiliate of KKR but is the firm's operating partner in creating value, determining strategic priorities, and executing operational changes for its 100+ portfolio companies. It operates under several consulting agreements with KKR and uses its name under a license, according to the company's filings.

"The uniqueness of Capstone is that it allows us to have several teams involved to provide operating support," says Prelle. "Over time we began to recognize that the portfolio companies deal with the same classes of problems, and resolving these could have a big effect on [profitability]."

To do this, Capstone has three kinds of professionals: industry leads to step into special situations, cross-portfolio program leaders, and the project resources team used to support value creation.

Prelle and Usman Rabbani, a director at KKR Capstone, explain the strategies used to both de-risk—reducing risk of security breaches and identifying gaps in existing technology infrastructure that could hamper operations or hinder growth—and to increase the value of the portfolio companies.

Derick Prelle
Partner, Managing Director,
KKR Capstone

Usman Rabbani
Director,
KKR Capstone

BUILD AN INTERNAL NETWORK

The portfolio companies, in total, have more than 300 senior IT executives globally who direct roughly $5B of hardware, software, and services spending per year. Prelle says KKR systematically invests time and effort to build and maintain "trust-based relationships and dialogue" with these executives. The relationships afford the firm an opportunity to do "rapid diligence" when a need arises, be it researching a major digital initiative, hiring a new CIO, or negotiating a new outsourcing contract. They also come in handy when KKR is evaluating a new investment into technology space and is looking for something like customer diligence.

DEVELOP PREFERRED PARTNERSHIPS

Over time, KKR has developed alliances with technology providers in various areas, including application development and cyberthreat assessment. The company is also "increasingly investing" in preferred partnerships in IT, telecom, software, hardware, and services for portfolio companies.

"The benefits of [such partnership] include getting the 'A team' from a technology provider, regardless of whether it is a large or small company [or] account, and both parties are being able to escalate quickly and amicably using the KKR relationship to resolve operational issues," says Rabbani.

SHARE BEST PRACTICES

Every two years, KKR holds a technology summit featuring keynote sessions by senior executives and Silicon Valley thought leaders, along with interactive breakout sessions that are anchored by common areas of interest, such as cybersecurity, talent, and analytics.

In the alternate year, the firm holds smaller, focused events zeroing in on a specific industry and functional areas.

SELECT THE BEST

Internally, KKR Capstone operating executives vet partners, vendors, and suppliers to ensure they are best in class, says Prelle. The potential partners are evaluated based on the ability to deliver superior subject matter expertise, a track record of driving value in companies, and fair compensation rates. ■

Getting the Most From Your Staffing Strategy

Paying attention to the people in your portfolio companies is crucial to the success of that business. Experts from ADP, 3i Group, and The Riverside Company explain how a PE firm can do this through having an intelligent staffing strategy, finding the right person to lead a growth-stage company (even if it's not the founder), parsing out weak links in small companies, and dealing with founders who aren't receptive to new strategies regarding staffing.

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The Panelists

Chris Capko
Vice President of Private Equity Strategy, ADP

Richard Relyea
Partner, Managing Director, 3i Group

Michael Thompson
Operating Partner, The Riverside Company

1

Good PE firms foster growth with an intelligent staffing strategy

Human capital is an important part of private equity—some might argue the most important part—especially when it comes to growth investing. Certainly growth companies have personnel needs that are more urgent than those of companies involved in late-stage buyouts or venture capital deals.

Good private equity firms understand this and devote a great deal of attention to installing human capital strategies that promote growth. This can be a delicate process. "It's always a tricky balance between investing for growth, putting in additional overhead costs, and allowing the business to pay for it," says Richard Relyea, a partner at 3i Group. "Often you're investing in a business ahead of growth, and you need to get the balance right so you're not overburdening the organizational structure."

PE firms also need to ensure that their company leaders understand which people are critical to the business and which people need to be replaced. They need leaders who are focused on value creation and growth and who will base staffing decisions on what's best for the company, not what's best for individual staff members.

"A lot of firms struggle to connect the dots between the management team and the team that's on the ground," points out Chris Capko, vice president of private equity strategy at ADP. "Are your people doing what they were hired to do? When we do an assessment, we often realize that 85 percent of back-office staff are spending their time doing things that are not strategic to the company."

2

A growth-stage company's founder may not be the right person to take it to the next level

Founders are understandably attached to the companies they've run since day one. So it's a delicate operation to ease out a founder if he's not the best person to lead the company in its growth stage.

"One of the mechanisms to help you get aligned in terms of transitions in leadership is an agreement about a phasing out of that person's role over time," Relyea says. This could involve a period where that founder would be moving into a different role, such as on the board or as more of a pure investor. "If you have a situation in which that works—where it's right for the business and it's an agreement you can reach—it's amazing how much more aligned your decision-making tends to be about what resources are needed."

If a founder understands that his company—where he may still have a lot of capital at work—needs a new set of leaders in place, the conversation about his step to the side will be far easier. It will be less easy if he considers his new investors a temporary partner in his personal quest for success.

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Human capital strategies should account for the "rule of one"

A small company usually has one person entering orders, one person doing accounts receivable, one or two people in customer service, a product-development person, an e-commerce manager, a buyer, and more. Investors must keep in mind that the company overall is only as good as the weakest link in this group.

"A company may decide, 'Hey, we're going to have a product-development investment thesis,'" says Michael Thompson, an operating partner at The Riverside Company. "Then all of a sudden it gets derailed, because no one purchased some necessary part." So the company is only as good as the individual who drives that particular function. For human-capital management in portfolio companies, Riverside identifies the functions that are critical to drive what the firm's strategy is. "We may not install direct redundancy with multiple people, but we certainly make sure we have additional oversight in those key areas," Thompson adds.

4

Often a founder needs to relinquish cherished roles to become a better CEO

A founder might be very good at developing the product or very good at selling it. But often that talent is not what the company needs to advance to the next level.

It pays to diagnose the founder's mindset before an investment, because odds are his role will change. "At least 80 percent of the time, we're trying to get the founder out of the functional discipline that they've been very adroit at," Thompson says. "And founders may struggle in that transition to bringing in talent, to letting go of some of the responsibility and decision-making."

When founders do struggle, sometimes dramatic actions have to be taken. Thompson recounts a specific example from the Riverside portfolio of a business that was sold based on that premise. "The CEO was outstanding as an innovator and product developer—but he really was never a CEO. His importance in this organization was embedded in product development. But we needed him to be a CEO, and we wanted to bring in somebody else on product development."

But Riverside knew that whoever they brought in would not be as good. So what did the firm do? "We transitioned that business to a strategic partner—not a financial partner—so they had some of those complementary resources," Thompson says. "That turned out to be a great result."

5

Some founders are receptive to new staffing strategies, some are not

When a firm presents a founder with a plan to get to the next level, often the founder readily agrees...sometimes not so much.

Capko says he's seen implementing new strategies go different ways. "I've seen firms come in very strong and founders be very receptive to that approach when GPs are really not looking for feedback, just looking for a receptive 'OK, that's great, we'll go with it.' I've also seen a strong game plan rolled out and then, once the GPs leave, the next day it's 'OK, we know they want to go in that direction, but we're still going to go this way.'"

He compares the strategy with a CEO to that of a manager of a successful baseball team. "What you do with a CEO, you sit down and say, 'What are you trying to do?' Some of them want to continue to create something great. Some say, 'I just want 3x my return on invested capital.'" ■

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Arsenal Finds the Right Balance in New Industrials Specialist

Michael Huff
Partner,
Arsenal Capital Partners

The firm added an operating partner to oversee its specialty industrials team, hoping to tap into his long career in the sector

When industrials and healthcare specialist Arsenal Capital Partners hired Michael Huff as an operating partner to work within the firm's specialty industrials group, the firm was tapping into his long career in the sector.

Huff has been in operating positions with numerous large companies in the industrials industry, including Citadel Plastic Holdings and at GE Plastics.

The new hire makes sense for Arsenal. The firm was raising its Fund IV with a target of $1.25B when Huff was brought on—a much larger amount than its previous fundraise in 2013 for Arsenal Capital Fund III LP, closing with $875M of committed capital. The new capital will be used to invest in companies that fit into Arsenal's exclusive focus on lower-middle-market transactions between $50M and $250M of enterprise value.

With a larger fund size, it is only natural Arsenal will need more talent to create value at portfolio companies. The firm currently has more than 10 operating partners, and Huff will have primary oversight responsibility for operations in the industrials group.

"We are always looking for great talent," says John Televantos, a partner who co-heads Arsenal's specialty industrials group. "[Huff] is well known in the industry, has great breadth and depth of experience, and has operated a company under private equity ownership, which is a positive."

Citadel Plastic was owned by middle-market firm HGGC and Charlesbank Capital Partners until June 2015, when global plastics supplier A. Schulman bought the company for $800M. Citadel grew revenue and EBITDA by roughly 70 percent, and HGGC credits Huff with much of the company's success.

Huff is already busy at Arsenal. The firm has made twice as many investments in the specialty chemical industry as other private equity firms have in the last five years.

"The thoughtful and collaborative approach demonstrated by Arsenal is a great fit," says Huff. "I look forward to driving additional enterprise value at Arsenal's portfolio companies."

Arsenal's specialty industrials investments include Kel-Tech, a provider of specialty chemicals and related services to oil and gas exploration and production companies; Flowchem, a provider of patented and environmentally friendly drag-reducing additive solutions and support services to crude oil and refined-products pipeline operators; and Chromaflo Technologies, the largest independent global pigment-dispersion provider to the architectural and industrial coatings and thermoset-composites industries, among others. ■

How an E&P Veteran Weathers a Down Market

Tall City Exploration announced a $300M equity infusion from Denham Capital in May 2016. But before that happened, it sold $1.2B of assets.

Tall City Exploration knows what it's like to sell assets when the oil and gas market is booming—and after the bottom falls out.

The Midland, Texas-based oil and gas exploration and production company shed two assets in the Permian Basin between November 2014 and November 2015. Demand was strong for the November 2014 sale of about 14,000 acres of leasehold in Reagan County, Texas, and 1,400 barrels of oil per day to an affiliate of American Energy Partners for $440M in cash and notes, says Gary Womack, Tall City's vice president of operations.

Then came the downturn in oil and gas prices, and Tall City's sale of acreage and interests in wells in the Midland Basin was a much different story. "The Howard County [Texas] asset was a longer process; things semi-stabilized a year ago," says Womack, referring to Tall City's $803M sale to Moss Creek Resources. "We had a buyer approach us who made an acceptable offer. The volatility and pricing made sales more difficult in 2015. Now one of the challenges is there's a lot of discrepancy in buyers' and sellers' price expectations."

Denham Capital, which first met with and invested in the Tall City team back in 2012, had lengthy discussions with the company prior to its divestment of the two assets. According to Denham partner Jordan Marye, those at the firm struck a "philosophical and strategic overlap" with the management team at Tall City, and an agreement emerged. "They were starting a company, and we wanted to be there as a sponsor."

The firm committed $300M in equity to Tall City Exploration I, and in May announced a new $300M equity commitment to Tall City Exploration II. The new company will look for investments throughout the entire Permian Basin, located in a swath of Texas and New Mexico, rather than in specific parts like its previous iteration.

Womack says he's been around the oil and gas business for about 25 years and has seen a lot of ups and downs in the oil and gas market. There has been one difference in this down market, he continues: the magnitude. "The buildup as far as activity [in the Permian Basin] is several degrees of magnitude greater than what I've seen in the past." He adds that the downturns he's seen in his career are the same every time. "There's a little bit of infrastructure devastated, but then it's built back up, [and the] service industry takes the hardest hit. We're on the upside of that right now."

One difference between investments made from this second equity commitment from Denham Capital in 2016, versus the first equity commitment in 2012, centers on the exit strategy of assets. "The opportunities are more defined in the Permian because of the volume of drilling in the past five years," says Womack. "The main task this time is to do extremely good due diligence in anything that we buy. We need to manage price volatility.

"We all think that [oil and gas pricing] will work itself out, but the timing is uncertain. Now we're in a buying mode, buying acreage." ■

"The main task this time is to do extremely good due diligence in anything that we buy. We need to manage price volatility."

–Gary Womack, Tall City Exploration

Is Now the Time to Invest in AgTech?

This niche sector of agriculture investing is a market that some GPs claim is overlooked by private equity, which means greater opportunity for those already investing

Despite the growing global population and demand for food, agriculture is still an under-represented sector in private equity, but several specialist firms are pursuing agricultural technology as a source of outsized returns.

The thesis: AgTech will be the primary means to sustainably increase food production to meet the ever-growing demand.

Privcap spoke to two PE players actively providing growth capital to the agtech sector—New York–based Paine & Partners and California-and-Israel-based Pontifax Global Food and Agriculture Technology Fund—about opportunities they're excited about and why they find value in a sector so many others in private equity ignore.

An Untapped Market?

Historically, venture capital has been far more active in agriculture than private equity. According to data provider Preqin, PE buyout deals in the space fluctuated between 2010 and 2015, peaking in 2013 at $630M with 14 deals and falling to $363M in 13 deals in 2014. The number in 2015 was even lower. Comparatively, VC deals for agriculture increased more than tenfold, from $27M in 10 deals in 2010 to $384M in 40 deals in 2015.

"We've long believed that the agribusiness industry is underserved by PE," says Kevin Schwartz, president and founding partner of Paine & Partners—an active agriculture investor for more than 15 years, having closed its fourth and most recent food and agribusiness fund, at $893M, in 2014.

He says the food industry's strong fundamentals and macro factors like a booming population and an increasing focus on good nutrition present a great opportunity, but access to land and water are a long-term challenge. "There's a need to increase productivity in the value chain," he says.

Ben Belldegrun, a managing partner at Pontifax Global Food and Agriculture Technology Fund (known as Pontifax AgTech), puts it simply: The theme in agriculture investing is "doing more with less."

Where to Find the Best Opportunities

Pontifax AgTech and Paine & Partners both operate in the space between venture capital seed-stage and late-stage proven technologies that have yet to be commercialized. Belldegrun says there's very limited competition and, as a result, terms and valuations are reasonable, and the scarcity of capital relative to good opportunities means that co-investment opportunities abound.

Both firms stressed that success depends on having strong connection with farmers, which allows the investors to understand the market's needs and wants. "The current operating environment focuses farmers on what really makes a difference to the bottom line," says Belldegrun.

The value proposition of new approaches is critical, as farmers have many options when it comes to things such as seed technology—which Paine & Partners invests in—and limited money, he explains. Another piece of the puzzle to consider is whether a retailer will want to sell a particular product, such as a brand of seed. "If the retailer doesn't want to sell it, the farmer isn't going to grow it," Schwartz says.

Pontifax AgTech focuses on investments in the U.S. and Israel, agtech's global centers. The fund's portfolio runs the gamut, and includes companies focused on software, bio-based synthetic oils, and technologies used to provide an alternative to traditional chemical and labor-intensive crop-cultivation strategies.

The firm is particularly interested in precision farming and technology that streamlines the post-harvest supply chain. "Forty to 60 percent of all produce never makes its way to the table," says Philip Erlanger, the other managing partner at Pontifax AgTech. "We're spending a lot of time on the supply chain, from processing to food packaging." ■

Consumer Innovation at FFL: One Operating Partner's Tale

After a career in industries as varied as clothing and canned soup, Mark Sarvary decided to use his know-how to innovate a PE firm's consumer-facing portfolio companies

Mark Sarvary
Operating Partner,
FFL

BIO

Sarvary has led iconic consumer product businesses for nearly two decades. From 2008 to 2015 as president and CEO of Tempur Sealy, the international mattress and bedding company, he led a multi-chapter reinvention of the business, product line, and brand. From 2002 to 2007 Sarvary was EVP and president of Campbell's Soup North American Division, also holding global responsibility for Godiva Chocolatier. Previously, he led J.Crew, was president and general manager of the Nestlé Frozen Foods Division, and worked for Bain & Co. and IBM.

Privcap: Why did you decide to transition from the corporate world to private equity?

Mark Sarvary, FFL: At the end of my time at Tempur [Sealy], I was looking at a variety of different options. Chris Masto, founder of FFL, had been on the board of Tempur, and he and I discussed whether it would make sense for me to join FFL and be on the other side of the table, so to speak. Being part of the asset-management side was very intriguing, but so was the opportunity of working with a team that I knew well and that I respected very highly.

Is there a particular area within operations that you're focused on?

Sarvary: I'm particularly focused on areas that are consumer-facing. I've spent most of my career working on understanding consumer needs and marketing to them, and by providing products and innovations that better meet their needs.

What are some of the ways that you innovated an existing brand?

Sarvary: When I was at Stouffer's, we faced one of the things that had long been a problem with frozen foods—although they are convenient, people don't feel like they've "cooked" if they prepare a meal in a microwave. And so they feel reluctant to serve frozen meals to their family.

With this insight, in 1997 we launched a product line called Skillet Sensations. The idea was that instead of cooking it in the microwave, you cooked it in a pan. It required a completely different method of manufacturing—instead of being frozen in a block, it was frozen in pieces. It required different machinery, different distribution, and so on.

It was a very successful product launch, and it really did meet the need of providing consumers a product that was convenient but [also allowed] them to feel like they were cooking. It's an example of an innovation within a specific product area that brings in more users.

What changes did you make at Tempur Sealy?

Sarvary: When I first joined Tempur, there was only one type of bed. The problem was that about half the people who tried the Tempur bed said they didn't like it because it was too firm. So we developed and launched a softer version that we called the Tempur Cloud. The Cloud was sold alongside the existing product, and the incremental sales from that product doubled the size of the Tempur business.

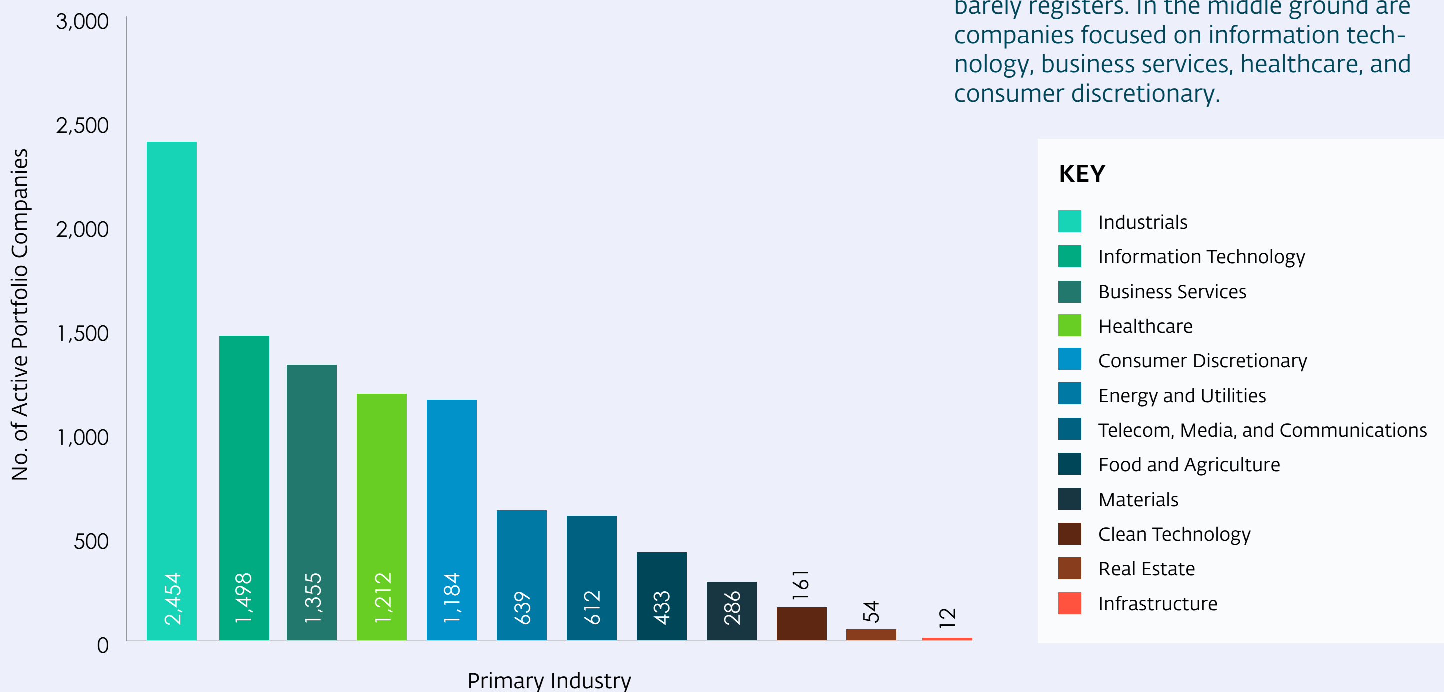
At the same time, we were also expanding distribution of the Tempur [-Pedic] adjustable bed base. These bases had not been popular in the U.S.; they were perceived to be like hospital beds. However, we knew they were selling well in some countries in Europe, so we expanded their distribution and made them a focus of our marketing. Today, over 50 percent of Tempur beds are sold with adjustable bases. ■

How Many Companies Are PE-Backed?

When it comes to the number of companies in the industrials sector, the answer is: a lot. Meanwhile, the average hold period for portfolio companies has remained steady.

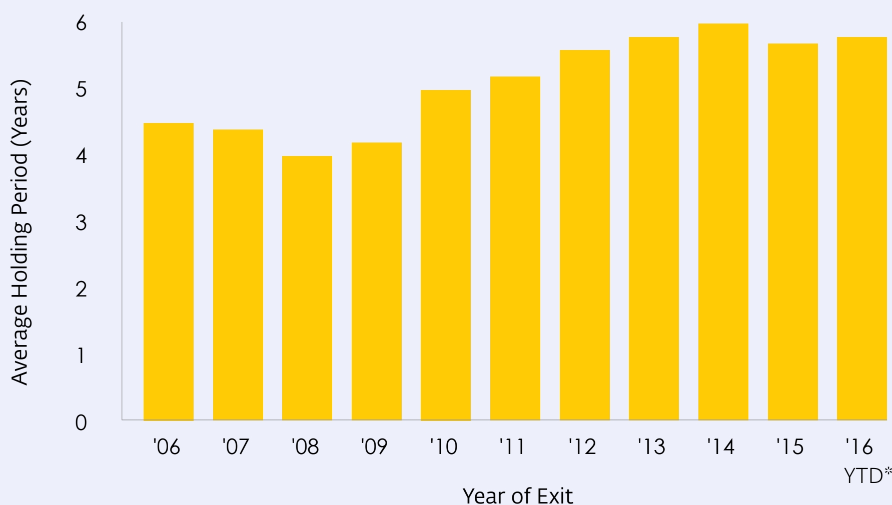
U.S. PE Buyout Firms Know What They Like

Among active portfolio companies held by PE firms, industrials rule and infrastructure barely registers. In the middle ground are companies focused on information technology, business services, healthcare, and consumer discretionary.



PE Portfolio Company Hold Periods Remain Longer

In 2008, hold periods globally at the time of exit were 4 years, on average. By 2014, that time period had crept up to 6 years, and so far in 2016 has declined slightly to 5.8 years.



* As of Sept. 8, 2016

Source:

A CFO Headache Cured:
Close Automation Technology

New technologies are taking the pain out of the deal close. But improving and modernizing the financial close is a process that requires an organization to be diligent.

The financial close is a complex process that continues to grow in importance as chief financial officers face increasing pressure to deliver timely information to the market and critical information to the internal organization.

"The challenge is the lack of automation and the lack of connectivity between disparate groups of people during a close," says Gavin Backos, a partner at RSM US LLP.

Those challenges mean CFOs often can't meet three critical needs—real-time monitoring of the close process; continuous improvement of the close process; and control, standardization, and scalability.

Backos says the best tools to meet those challenges are so-called close automation technologies such as BlackLine and Trintech.

"The technology drives some of the manual effort out of a close," Backos explains. "Every time you have a manual touch point in the close, there's a chance for error. It reduces the risks and enhances the close governance structure."

And for most organizations, implementation is more a matter of taking an existing close process and "mapping" it to the technology. What's more, the implementation process also challenges the firm to evaluate its existing workflow to cut out unnecessary steps. And once it's up and running, bottlenecks can be identified quickly, leading to iterative, continuous improvements.

"Most firms are constantly challenged and overburdened during financial close," Backos says. "It's a combination of poor process, weak technology, and limited improvements over time that creates this situation."

Indeed, improving the financial close is an evolution and a continuous cycle, Backos says. During this process, organizations pursue several outcomes to help implement a truly modernized close function:

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"Most firms are constantly challenged and over-burdened during financial close. It's a combination of poor process, weak technology, and limited improvements over time that creates this situation."

Gavin Backos
Partner,
RSM US LLP

Leveraging clearly defined activities: Disorganized and often misaligned activities generate continuous monthly "fire drills" for the finance organization. Designing a structured approach which leverages clearly defined activities for completion will enable the organization to move towards a leaner, more efficient close.

Enhancing policies, procedures, and processes: Labor-intensive and poorly defined processes often plague the close process. Developing and implementing well-defined, repeatable, and sustainable processes for the completion of activities lays the foundation for a top-decile close that is both fast and effective.

Enhancing financial controls: Controls are a common area of weakness due to companies' heavy reliance on manual controls and poorly defined close activities, increasing the risk of reporting and regulatory issues. Organizations can reduce control risk by increasing reliance on preventive controls and proactive error correction utilizing clearly defined responsibilities and close automation technology.

Improving reliability on data and financial reporting: Data integrity is a constant concern that directly impacts accurate review and timely analysis of financial information. Utilizing a structured approach aligned with state-of-the-art technology to capture, consolidate, and report quality data will enable leadership to properly balance speed, accuracy, and control.

Reducing the cycle time to close the books: Timely execution of closing activities directly impacts the availability of financial information for decision-making and value-added analysis activities. Reduced cycle times can only be achieved once the closing process is sustainable and can be effectively replicated month over month; speed and accuracy should never be considered interchangeable outcomes for the organization.

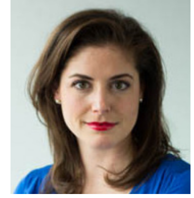
Increasing timely information to the business and market: CFOs are constantly faced with increasing pressure to deliver time-sensitive information to both the business and market. The organization must be prepared to meet these demands by leveraging enhanced processes and technology.

Encouraging complete transparency and performance management: Lack of governance and performance management allows the processes and technology that drive the close process to become antiquated, inefficient, and costly. Proper governance from leadership enables the organization to continuously improve the close process and keep pace with industry-leading practices. ■

With Dermatology, PE Targets Consolidation

Private equity is increasingly turning its attention to consolidation plays, as few doctors are specializing in the sector

John McKernan
Vice President,
The Riverside Company



Elizabeth Campbell
Vice President,
LLR Partners

As consumer demand for both cosmetic and medical dermatology continues to grow, so has the interest of private equity. Add to that a fragmented market, a trend of doctors retiring, and a dearth of newly licensed doctors coming into the field and there is an exciting consolidation play for investors.

"There is a mismatch between supply and demand, which sets the stage for growth," explains Elizabeth Campbell, vice president at LLR Partners.

The firm recently announced a $35M capital infusion for Schweiger Dermatology Group, a provider of medical, cosmetic, and surgical dermatology services in New York and New Jersey.

Sixty percent of dermatologists over the age of 60 are currently working out of solo practices, says Campbell. As these doctors look to transition into retirement, a sale to an acquisitive investor building a platform is attractive, because a private equity firm can afford to pay a premium for the practice, while the founder would otherwise have to settle for a steep discount to sell his or her practice to a junior-level partner.

"There is a confluence of factors to consolidate the industry," says John McKernan, vice president at The Riverside Company. McKernan expects dermatological demand to grow between 6 percent and 8 percent annually for the next five years.

In January, the firm invested in The Dermatology Group, a physician practice management company with locations throughout northern and central New Jersey.

Just as dermatologists leave the workforce, fewer doctors are opting to specialize in the space, and this shrinking pipeline is further constraining the sector.

Those are not the only challenges the sector is facing. With health insurance regulations and managed care continuing to become more complicated, dermatologists are finding more of their time is being spent on paperwork, such as back-office accounting, contracting, information technology, marketing, scheduling, and other services. As a result, they are able to spend less time treating patients. Turning over this part of the business to a private equity firm that has expertise frees up doctors to focus on medicine. That last factor is welcome news for baby boomers, who are reporting an increase in skin conditions, including cancers.

McKernan says only 10 percent of skin conditions are treated by dermatologists. That means these doctors are called upon to see only the most complicated of cases. Given the shrinking number of dermatologists combined with the increasing demand for them, private equity could play a significant part in managing this important part of the patient-care continuum. ■

Why Your Healthcare Strategy Should Include Dental

The industry has several attributes that make it a good fit for private equity

The dental space is continuing to attract private equity investment, as industry fragmentation, demographic trends, and provisions of the Affordable Care Act combine to make it particularly well suited for the PE operational improvement playbook.

"The U.S. dental industry is stable and growing, estimated to reach $168B by 2020," says Paul Murphy, a partner at Sentinel Capital Partners. "This growth has been driven by a number of factors, including increased enrollment in dental plans driven by population growth, increased awareness of the importance of dental health, expansion of dental plans offered by employers, and the increase of appearance enhancing and cosmetic dental procedures."

The dental space is also highly fragmented, making the subsector a prime target for continued consolidation. Murphy cites two main demographic shifts for this trend. First, aging baby-boomer dentists are looking to retire; second, the current younger generation of dentists tends to be more focused on practicing medicine rather than running the business side of his-and-her practices.

"Dental care demand has [also] traditionally been non-cyclical or less susceptible to broader market declines during recessions [than other sectors]," Murphy says.

Added to these market conditions is the impact of the Affordable Care Act, which includes several provisions related to oral health that are expected to increase the number of patients in the system. Legislation within the ACA requires that pediatric dental care is included as part of the minimum essential coverage for children and adolescents via state-run healthcare exchanges. Murphy estimates an additional four million patients will be covered as a result of the new law.

Sentinel Capital Partners recently exited one of its dental investments, adding to the firm's expertise in the growing subsector of healthcare. The firm recently sold portfolio company Northeast Dental Management (NEDM), a provider of dental-office support services in the Northeast and Mid-Atlantic, to strategic acquirer Dental Care Alliance for an undisclosed amount.

In addition to NEDM, Sentinel has invested in three other dental companies dating back to 2003. The firm's portfolio has included Castle Dental and Metro Dentalcare, both regional providers of dentistry-office support services; and ReachOut Healthcare America, provider of administrative support to mobile dentists.

With NEDM, which provides administrative staffing, human resources, purchasing, and financial and information-technology support services to locally branded dental offices, Sentinel pursued a full-force consolidation strategy.

Sentinel expanded the portfolio company's finance team significantly by adding several new vice presidents to help integrate the 24 add-on affiliations the firm acquired during its ownership. In three years, Sentinel increased the number of dental offices served by NEDM to 65 from 29. During that time, NEDM's footprint expanded to seven states from four states, including Maryland, Massachusetts, and Connecticut, while serving nearly 200,000 patients annually.

"We saw an opportunity to build the platform infrastructure and team necessary to consolidate dental practices in the Amtrak corridor, a region that was highly fragmented," Murphy explains. "The sale was not the result of an auction process. [The market for exits in general], and for the dental industry in particular, was very strong." ■

Operating Executives on the Move

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

Sean Maddock
Z Capital Group

Z Capital Adds Maddock to Operating Partner Roster

Sean Maddock has been appointed as a managing director and operating partner at Z Capital Group. He will serve as a member of the firm's Private Equity Investment/Operations Team focused on the management and oversight of portfolio company initiatives, including international luxury hotel and destination resort management.

Hidden Harbor Appoints Trent to Oversee Industrial Businesses

Ken Trent was hired as an operating partner by Hidden Harbor Capital Partners. He will be responsible for sourcing, evaluating, and driving the operational performance of industrial businesses, and has more than 15 years of experience as a CEO in the sector.

Former American Tire CEO Joins Soundcore Capital

William Berry, who was CEO of American Tire Distributors for six years, was hired as an operating partner by Soundcore Capital Partners. He will provide management and operating expertise to portfolio companies, focusing on specialty distribution and business services.

Velocity Operating Partner to Be CEO of First Acquisition

James Nolan, who has been the CEO of several life sciences companies, will lead global clinical CRO InClinica, the first deal for Velocity Fund Partners. Nolan is also a partner of the healthcare-focused firm.

Growth Equity Firm Mainsail Brings Salisbury on Board

William Salisbury will be the chief financial officer and an operating partner at Mainsail Partners, which invests exclusively in bootstrapped companies. He will be responsible for working with portfolio companies on financial planning, financial operations, and strategic investments.

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Martin Strobel
Advent International

Advent International Hires Former Baloise Executive

Martin Strobel, who was the former CEO of insurance and pensions group Baloise, was brought on as an operating partner by the global private equity firm. He had previously spent six years at Boston Consulting Group.

John Stang Brought On by Gridiron Capital

The firm hired Stang as an operating partner after his 30-year career as a successful leader and global CEO with a background in sales, channel and product development, and acquisition integration in several industrial sectors.

Paine & Partners Appoints Delaney as Strategic Advisor

The former EVP and COO of Potash Corporation of Saskatchewan, David Delaney, has joined the firm focused on food and agribusiness investments. He will work to identify new investment opportunities in the agribusiness and chemical sectors and serve in a leadership role at acquired companies.

Healthcare-Focused Pamplona Taps Pacala

Mark Pacala was hired by Pamplona Capital Management as an operating partner with a focus on healthcare. He has more than 20 years of experience in the healthcare industry, and most recently was a senior advisor in healthcare at Oak Hill Capital Partners.

Baletsa Announced as JMC Capital Operating Partner

Greg Baletsa, who has a background and training in Toyota Lean Manufacturing, will lead the Portfolio Operations Team at JMC Capital Partners. He will work with portfolio company leadership to develop human capital and the integration of add-on acquisitions.

Greg Baletsa
JMC Capital Partners

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How Riverside Got Into Hot Water—and Hit It Big

The Riverside Company rode the shift to energy efficiency and a sound operational plan to success when it exited the company Eemax

"We were number one in three markets. We had tripled revenue and quintupled EBITDA in seven years, and we felt it was time to bring on the next buyers."

–Joe Manning, Riverside

In 2008, The Riverside Company sought to capitalize on the regulatory and consumer trend toward energy efficiency by investing in Eemax, a Connecticut-based manufacturer of tankless water heaters.

Not only did Eemax's products produce hot water with less electricity than the traditional standby water tanks in the majority of U.S. homes, but it also had yet to expand beyond its commercial client base. The secular shift toward energy efficiency and the untapped markets proved a winning combination—in December 2015, Riverside exited its Eemax investment with a sale to Atlanta-based Rheem Manufacturing. Terms of the deal were not disclosed.

Riverside grew the company organically, as well as through an acquisition. First, Riverside expanded Eemax's management, sales, and engineering teams, says Joe Manning, a principal at Riverside. Then the firm moved Eemax into a significantly larger manufacturing facility and committed capital to R&D so the company could develop new applications for its existing product line and, most importantly, expand its product portfolio.

Those new products included a tank to be used in manufacturing plants in case of a chemical spill or fire. Regulations require many plants to have warm water available in case of an accident, Manning explains. "It's really inefficient to have water sitting in a tank getting hot when it may only be used once every two months," he says. "Eemax is able to produce hot water on demand."

The second piece of the company's growth came from an add-on acquisition. In 2013, Eemax purchased Miami-based EcoSmart, which already had a residential electric tankless product and strong customer relationships. "The acquisition allowed Eemax to expand its sales channel, because EcoSmart was selling through big-box retails like Home Depot, Ace Hardware, and online through Amazon," says Manning.

Additionally, the acquisition grew Eemax globally, both through access to EcoSmart's Chinese manufacturing base and the company's distribution channels and expertise in Latin American countries, including Ecuador and Costa Rica.

When Riverside decided to sell Eemax, the company was a market leader in the commercial, residential, and industrial space for electric tankless water heaters. The sale was completed in December 2015 after seven years of ownership. "We were number one in three markets," Manning says. "We had tripled revenue and quintupled EBITDA in seven years, and we felt it was time to bring on the next buyers." ■

Four Tips for Successful Merger Integration

When you're a PE firm acquiring a company, you may have an outcome you want to achieve. RSM US LLP partner Greg Maddux and principal Christina Churchill outline four concerns to be aware of so your acquisition goes according to plan.

1 Start Early, and Follow Through

Also start with a well-defined strategy, where the real value is

Operating partners and the companies they're guiding often don't realize the effort required to realize true integration goals. "Sometimes they're just busy with day-to-day operations or are moving to the next deal," RSM's Greg Maddux says. "Unless you have a group focused on integration, with clear accountability and targets, there's the risk that it won't get fully accomplished, or it will get done more slowly. Accelerating results creates real value faster."

2 Be Able to Work Through Functional Challenges

Not all acquisitions are created equal

"When you have a merger of equals, the complexity goes up," Maddux says. He further expands on that thought, noting that in a major acquisition where a good-sized company is acquired, the stakes are even higher. For example, one manufacturing company owned by a PE firm acquired one of its competitors, and that company's owner-operator stayed on to assist with customer and supplier transition. However, the culture of the acquired business was much different than the buyer's. "It became bogged down," Maddux says of the merger. "The other executive had another objective. But he [also] had such a huge relationship with buyers and customers. The importance of being able to work through these types of integration challenges should not be underestimated."

3 Be Strategic

Take a step back and look at all of the merger's moving parts

It's important to envision what impacts the integration will have on the customers, vendors, employees, competitors, and stakeholders of the companies involved. For example, "rationalizing your vendors, doing cost savings—it's really a chance to go back in and look at things," RSM's Christina Churchill says. By doing that, you can negotiate changes with your vendors that could create savings, she notes. There may also be areas in the merging companies to look for software solutions, such as redundancies in programs or tools that are doing the same thing, and combine it across the whole organization.

4 Look at the People, Processes, and Technology

A balance among them is crucial to the success of a merger integration

A company will be at its most profitable when all three of these work well across the organization, says Churchill. People may not be in the right seat at an organization, and an operating partner can address that. "You should look at who you have," she explains. "How do we streamline things? How do we make sure we get actionable data quicker across the organization?" The technology component is also key. "You want to have the best tech for the combined organization, be able to convert your data in the best way, and be able to provide reporting. If you're able to operate in the best way possible, you're not impacting customers across the organization." ■

Why Subscription Commerce Should Terrify 'Old School' Consumer Brands

Peter Fader, a Wharton professor of marketing, explains why he believes subscription commerce companies are the future of retailing

Peter Fader
Frances and Pei-Yuan Chia Professor of Marketing,
The Wharton School of the University of Pennsylvania

Privcap: What is your view on subscription commerce, and how influential do you think this is going to be in the consumer and retail space?

Peter Fader, Wharton School: Subscription commerce is here to stay. The basic roots of subscription commerce, like so many things I talk about and I point companies toward, goes back to direct marketing. And if you think about the good old days—the Book of the Month Club and programs like that—it was very crude by today's standards, but the basic elements of it weren't really that different from what we're seeing today with the Beer of the Month Club or all these different kinds of [subscription] services that are out there.

They are a true "win-win-win." It's a good thing for every party involved. It's good for the consumers, because they will be gently reminded to buy things that they really should be buying more often but, for whatever reason, they're just not thinking about it. So they're better off. It's better for the companies, because not only do they get this recurring revenue, but they can learn more about the consumers' tastes because they'll have more interactions. They can curate a bit better for the consumer. It's also better for investors, because the data you get out of subscriptions is richer. It's more predictable and more actionable than just the occasional discretionary, random purchases that take place. It's a shame that subscription commerce took so long to take off. There are a lot of industries that resisted because "That's just not the way we do things."

But will there be some losers in the growth of subscription commerce? Will some of the legacy players that have been benefiting from selling in a less efficient way have their lunch slowly eaten as subscription commerce grows?

Fader: There's no question about it, and that's why we're seeing a lot of the big old players buying companies that have subscription capabilities. It just makes sense. They need to learn how to adapt to that world, and there's no reason why they can't. It's great to see big old-school retailers that are moving. They're maybe taking baby steps with a loyalty program...[to at] least start to be able to track the customers.

I really believe that it's not a matter of "Are we going to be a subscription player or not?" Everyone's going to have to be—or at least in many different businesses. Then, the question is, can we integrate it formally within our operations, or is it just going to be a separate part of the business? Obviously, the more it can be fully integrated, the better. We could get a more holistic view of the customer and get better data on it. We're going to be telling our kids, or our kids are going to tell their kids, about the quaint days before everything could be bought on subscription. Our grandkids aren't even going to believe it. ■

Avoiding Error in Portfolio Operations

Jim Corey of Blue Ridge Partners discusses trends in how private equity firms are growing their portfolio companies

Jim Corey
Co-founder and Managing Partner, Blue Ridge Partners

Privcap: What are some of the biggest trends in how private equity firms help their portfolio companies grow?

Jim Corey, Blue Ridge Partners: One is the engagement around issues related to top-line revenue growth earlier in the life cycle of the ownership of the asset. Asset prices are obviously a lot higher than they have been in the past, so accelerating growth is often an important part of the investment thesis. Another one is on the back end of that—it's near the time of exit. Maybe 12 months before exit, putting together a definition of the investable growth runway for the next owner is extremely impactful, because it increases the exit multiple.

Some larger firms have reduced their internal operating teams. What are some of the challenges they faced?

Corey: I think many of them discovered that it was impossible for them to keep current, sharp skills in all the different disciplines. If you think about the different set of talents they would have to have, and just thinking about it in terms of a revenue-growth context, can they maintain the pricing skills they need that are best in class? Pretty soon you realize those skills have atrophied a little bit.

Considering that private equity firms invest in a whole array of different industries, what are some commonalities for driving revenue growth?

Corey: One is the importance of analyzing basic performance and having the right kind of metrics to understand how you're doing relative to your expectations, your benchmarks. And having that kind of data available to analyze the effectiveness of the current sales organization.

What would be some smart questions for an LP to ask a GP that's trying to differentiate itself from the many other GPs out there?

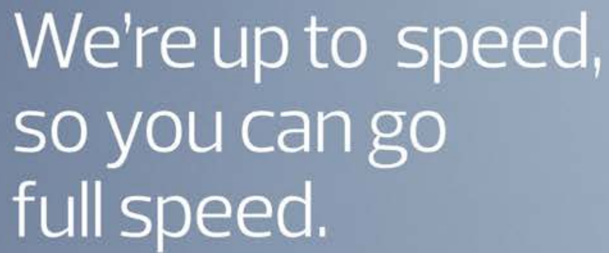
Corey: One, I would ask how they manage the ecosystem of skills they have available to them, and try to measure whether they're balanced effectively between internal resources and external resources.

I would also ask about full life-cycle engagement around the topic of revenue growth. Lots of studies have shown that revenue growth drives about 60 percent of all value creation over a five-year holding period. So it's critically important that it get done right, given where asset prices are at.

Most GPs say they have a robust plan for value creation. These can be, in fact, very robust systems, or they can be sort of window dressing that tells LPs what they want to hear. What's an example of window dressing that you would be skeptical of if it were described to you?

Corey: I think a lot of sponsors describe individual situations they made a difference in, and of course, that's important. But a much more impactful way to think about that is developing more sustainable processes that work across the whole portfolio.

Do they have the ecosystem design? Do they have the metrics in place? It's a methodology. That is what's powerful, and the window dressing might distract from that. ■



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Steve Millner
Managing Principal,
Gen II Fund Services

Scott Zimmerman
Leader, Americas,
EY

Ian Cameron
COO,
Washington State Investment Board

What GPs Need to Be 'Cutting-Edge'

Privcap: There's a huge demand for data about portfolio companies and many other aspects of the private equity business, and yet there's a real challenge in easily sharing it with regulators and investors. What are some of the main challenges?

Steven Millner, Gen II Fund Services: We still don't have good standards. ILPA and others are starting to think about that, but for large consumers of data, they're actually putting out their own requests and saying, "Here's what we'd like to see, and here's when we'd like to see it."

Ian, speaking of large consumers of data, your organization—Washington State Investment Board—is one of the largest LPs in the world. You have relationships with many managers. Talk about the challenge of sorting all the data that comes your way, making it useful, and sharing it.

Ian Cameron, Washington State Investment Board: We're looking at our entire portfolio, all the asset classes, and we're looking and examining risks across all of them. In order to be able to have private equity feed into that—beyond the operational information we need to know how that fund is functioning—we need to get down to portfolio-level data. That has to be available to us so we can look at our concentration risk. We can look at liquidity risk, leverage, and all those different things. That's what's really shifting in the pension space. I think sovereigns are probably a bit ahead of us, but that's where you're seeing an accumulation of that data in order to analyze your entire portfolio and make sure your risk-weighted returns are where they want to be.

In order to get that—how we get that and how we process it—our challenge is trying to figure that out. We've developed a data warehouse that we utilize extensively. We use a platform called Tableau to draw that information and put it in a usable format for our investors. But I think that's the key—private equity funds need to be able to provide that data in a timely way, first of all, and in a common format that can be easily uploaded and brought in. And the struggle with private equity is always timeliness, because you're going to get some lag factors. But we can factor that in. It's about grabbing that data and bringing it into our warehouse first so that we can use it.

Steve, do either of you see resistance from either GPs or the portfolio companies in sharing data in a useful and a timely manner?

Millner: There are a couple of driving issues. We have some clients, private equity fund clients, who may own 25 percent or 30 percent of a portfolio company

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Investors are demanding more transparency and better data. Three experts survey the existing landscape and discuss the path forward.

"We're early innings on this, but the train has left the station."

–Steve Millner, Gen II Fund Services, on making data accessible

(i.e., they're not in control). They have a different seat at the table in terms of asking for information than someone who's a control investor. Separate and apart, we fill out something called a Form PF, [for a] private fund, in an SEC filing. Depending on the size of the fund, the data actually gets into the portfolio companies. So when we try to get the data from the portfolio companies, there is sometimes reluctance.

Ian, you work for a public institution that is subject to Freedom of Information Act requests. Is there ever a tension between the idea of sharing data with partners and the thought that this might get out there from a Freedom of Information Act request?

Cameron: If I was a GP, I'd absolutely be concerned about it. There are exemptions, though, that protect trade secrets and protect competitive advantages that GPs may have. So it doesn't become immediately publicly available, and that's helpful to us. That's what GPs are trying to balance: How much transparency can I provide into the marketplace without giving up the "secret sauce" that makes me a special GP that you want to be a part of?

Scott Zimmerman, EY: Ian may have a certain data set that's really important to him. The management may have another one. Those that are resisting transparency—I think, historically, transparency tends to win, and those who embrace it early tend to get ahead of the market and figure out how to use that transparency to their own advantage.

Cameron: I agree. I think what we're talking about here is it's a moving train, and if you're getting on it, that train's going to keep going forward. I think it is digitization. Think about some of the processes that still exist in private equity—how capital call notices are delivered. All those things are just ripe for change. Then, the next step for us—once we are able to gather this data and put it into a usable format—is putting it into a desktop. But ultimately our investment team, like any investment manager, travels: They're going to want it on mobile devices and to be able to access this. I think that's exactly what Scott's talking about as this moves forward.

Millner: We're early innings on this, but the train has left the station.

Zimmerman: I think they are very much in the sweet spot of where things are going to go. I love what you just said: The train has left the station. It's moving. Who's going to jump on, and who's going to get there first? ■

The Role *of the* Operating Partner

Z Capital invests in middle-market companies it thinks it can add value to. Managing director and operating partner Tim Clayton explains the firm's strategies for investments and exits.

Tim Clayton
Managing Director & Operating Partner, Z Capital

Privcap: At Z Capital, each operating partner "owns" their own vertical. How does that work?

Tim Clayton, Z Capital: They really own their own disciplines, if you will, and they apply that discipline across a number of different industry verticals. Z Capital is a very opportunistic, value-oriented firm, so we look at a number of different companies that go across a number of different industries. There's no one industry we concentrate on, but the different members of the operating partners can apply that expertise to all these different companies. So we'll have an operating partner whose primary background and expertise is in supply-chain management and manufacturing. So companies that have those elements—he'll spend a lot of time working with those management teams.

We have another one who's focused on more marketing capabilities, others that are focused on IT, and another focused on human resources. Then, mine is the CFO or the financial-oriented disciplines within a company. We all work together to improve the activities and operations of the different companies.

What kind of companies does Z Capital look for?

Clayton: We will look across spectrums for companies that have a value—it's a value-oriented type of strategy at the firm, but very opportunistic also. So we'll look for things that need performance improvement or turnaround capability. That's why the operating partners are there—to help drive those value enhancements and turnaround types of initiatives. We'll look for companies that might just have a bad balance sheet situation or others that might need growth capital, and we utilize the firm's capabilities and intense research capabilities to find tuck-in acquisitions to help drive the scale of those businesses to help add value. It's any number of those different types of companies that we would look for, without any real industry concentration.

While you look for great companies anywhere, is there a particular sector or business size that Z Capital gravitates toward?

Clayton: Yes, definitely middle-market companies. I would say we like more of what I'll call traditional businesses: manufacturing, distribution, or marketing kinds of companies. We don't do a lot of high-tech or healthcare types of companies, but the vast array of businesses we'll get involved with are those traditional middle-market types of businesses.

What would your firm consider an ideal exit?

Clayton: Again, I would say it carries on that opportunistic theme. There's not necessarily a perfect exit we look for. The MSDP [an auto parts manufacturer] transaction that we exited this year, we sold to a larger private equity firm. Others might be sold to a strategic acquirer, if you will. Others might have a going-public type of opportunity. We really look across the spectrums for the best opportunity for that exit. ■