

2018

Portfolio Operations Yearbook

Best practices for private equity value-creation

Privcap/Report

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About Privcap

Privcap is a media company that helps its clients create and distribute thought leadership content. We have a specific expertise in advising private capital firms on how best to create content in support of fundraisings, annual meetings and other communications touchpoints. We unlock the value of people and their ideas.

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Dave Noonan

National Director,
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The Real Power of Private Equity

In private equity today, money is cheap. In fact, the post-Great Recession boom in fundraising means that simply having a large pool of capital is no longer a great point of differentiation. What *does* differentiate a private equity firm is its ability to take that capital and, by virtue of its skill in running its portfolio companies, create real and lasting value.

This report is designed to support that effort. Along with our partners at Privcap, we've assembled some of the best minds in private equity to explain how they turn struggling or "good" companies into great ones. Whether through identifying and evaluating cost and risk, transforming technology, managing a carve-out, or executing a "roll-up" strategy, these pages articulate the challenges facing private equity's value-creation machine and how to overcome them.

The RSM team stands ready to help you along the way.

Enjoy the report,

Dave Noonan
RSM US LLP

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'PAGING' MR. COST SAVINGS

Although its portfolio company was growing strongly, Partners Group didn't hesitate to realize extra value by scrutinizing relatively small expenses

Private equity investors are fond of saying they "get their hands dirty" working closely with portfolio company management to improve operations. And yet, in reality, all are happiest when the companies seem to grow themselves and the job of creating value is, shall we say, easy.

It's not surprising, then, that a private equity firm may forget to reach for its full value-add toolkit when growth is robust. After all, who wants to squeeze out nickels and dimes when dollars are flowing in?

Partners Group does, says the firm's global head of business and financial services for its Industry Value Creation team, Lane McDonald. In an interview with Privcap, McDonald tells the story of a portfolio company that greatly benefited from a cost-savings plan, adding precious points of return to an investment that was already a home run.

Privcap: Describe a deal that benefited from a careful analysis of expenses and a resulting plan of action

Lane McDonald, Partners Group: I've never seen a company where there wasn't an opportunity to pick up a few pennies and dimes on the ground; you can always run a little tighter, a little more efficiently. We had one world-class, top-line-focused leadership team whose revenues had grown extremely quickly through organic and acquisitive growth. Typically, managing such growth usually takes up the bulk of management's bandwidth, meaning there may be even more of an opportunity to tighten up. The pace of growth in this case was a signal to all of us that there was probably at least a point or two of efficiency or integration EBITDA that we were leaving on the table.

During our onboarding process, we decided to bring in an entry-level, right-out-of-college expense expert just to focus on field expenses. Within the first

week, this person found that the company had been spending \$30,000 a year on pagers.

Pagers? Was this in the '80s?

McDonald: This was two years ago! We were shocked. What? We're spending \$30,000 a year on pagers? And with a fine-toothed comb, we discovered a few things like that. Not inappropriately, the company had just paid its bills and focused on growth, but with a little extra effort, the expense professional found \$400,000 worth of redundant expenses within his first year. The company had been moving so quickly that it hadn't had time to really stop and breathe and take a look.

Did the cost savings have an impact on the performance of the investment?

McDonald: Our job in the Industry Value Creation team is to constantly be looking for that next level. And frankly, for the companies that are doing better, the efficiencies you can gain are that much more powerful, because quickly that \$400,000 in cost savings that you found will multiply by eight, nine, 10, etc. when you exit, depending on your multiple. We ended up putting a larger program in place before we exited, and we found around \$11 million of cost savings all told, which, when you multiply it by the multiples that companies are going for these days, quickly becomes "real money." So that's the benefit of having a playbook of tactics that have paid off with other types of companies.

Beyond expenses, what's another example of a value enhancer that can be applied across portfolio companies?

McDonald: Pricing. With the advent of big data, the knowledge of customers has changed dramatically—be they B2B or B2C.

Lane McDonald
Global Head of Business
& Financial Services,
Partners Group



The Database of Destiny

Partners Group tracks its many value-creation plans across its global middle-market portfolio in a custom-built system called the Primera Database. According to McDonald, the firm has as many as 150 separate projects being tracked at any one time.

Members of the firm's Industry Value Creation team are primarily in charge of updating Primera and tracking the many company-level initiatives and KPIs.

The most important indicators vary from industry to industry. McDonald gives the example of early-childhood education, a sector in which Partners Group has invested.

"Employee engagement, teacher churn, and parent scuttlebutt—for lack of a more technical term—are really the first signs that something weird is going on at a center. Our job at IVC is, per company, per geography, to identify what the leading indicator is, because financial performance is very much a lagging indicator, and you've missed some signs along the way by the time that EBITDA starts to fall."

There's a lot of interesting things that you can do to flip the pricing equation on its head, to really make it a conversation about value rather than just a conversation about "Here's how much it costs to make, and here's my markup."

We've done a lot of projects around the efficiency of pricing, to pull that more through the revenue side. In partnership with the management team, we figure out what will be most impactful, what a company can digest, and what the field will adopt. ■

Sterling's Value-Add Network

Chicago-based Sterling Partners leverages a broad network of people both within and outside the firm to help its portfolio companies generate growth ideas and execute on an ever-iterating plan. Privcap spoke with principal Matt Hankins about the firm's approach to human capital, growth-strategy development, and M&A.

Matt Hankins
Principal,
Sterling Partners



Privcap: How has Sterling structured itself to add operational value to its portfolio companies?

Matt Hankins, Sterling Partners: We spend our time in three key areas: strategy, human capital, and capital structure and acquisitions. Those are the key areas that we focus on to add value. We have three folks within the firm who are exclusively focused on helping our portfolio companies with human capital. And by that I largely mean building out the board of directors, as well as senior-level executives. We really look to build out an independent board for our portfolio companies. We always try to have an outside chairman...an outside audit chair, and an outside compensation committee chairperson.

We also have an internal business development function that helps us look for both platform investments as well as add-ons.

How do you help the portfolio company management think about a board of directors hiring strategy?

Hankins: We sit down with the company and map out what skill sets could move the needle. Maybe it's somebody who really knows the customer. Maybe it's somebody who really knows the industry. Maybe it's somebody who really knows technology in the space. And we try to bring those thought partners around the table to stack the deck for the company so that CEO has people that he or she can call in those various functional areas.

Does the human-capital team get involved in due diligence?

Hankins: Yes. For example, when we were doing due diligence on our

infrastructure maintenance investment, DBi Services, Andrea Miller, a researcher on our human-capital team, was able to find a whole trove of former executives in industries like DBi and found for us what we would call a "river guide" or somebody to help us through due diligence and guide us through the ins and outs of the industry. And that was incredibly valuable to have that person sit beside us during diligence. The senior leadership team at DBi Services ultimately went on to hire this river guide as a senior executive at the company.

What is the Sterling approach to mapping out a strategy for growth?

Hankins: At the front end of an investment, once we have all of our key leadership identified and in place, we do a strategy session. We get together as a group at an offsite location with the board of directors, a bunch of the senior leaders of the company, maybe a customer or a supplier if there are valuable people in the ecosystem.

And then usually we will go through that process again, either once a year or every other year, to make sure that we're augmenting the strategy as the market evolves and as the company evolves.

How do you think about setting up key performance indicators for portfolio companies?

Hankins: It varies, but what is consistent is that we require the companies to submit financials, as well as some commentary and reporting around those financials, every month. There are companies where I'll get a daily report if it's a business that has day-to-day changes. There are companies where I'll do a call every two weeks

with the CEO. It really just depends on how rapidly the business evolves.

We have all that reporting go into a centralized database. We have an internal operating committee, and whenever we do a new investment, we meet and... establish our value-creation drivers. We are constantly going back to that operating committee and reporting on the progress of those value-creation drivers to make sure that we're creating value in the way that we originally anticipated.

How is your firm helping your portfolio company, infrastructure maintenance platform DBi Services, execute on a plan for growth?

Hankins: This was a business that we'd been monitoring for some time. It fits within industrial services, which is a subsegment of business services where we've had a long track record. When it came to market at the end of last year, we engaged quickly.

We were able to assemble some resources from our industrial services network, as well as leverage our human-capital team, to find a gentleman who used to be the president of a similar division of one of DBi's competitors and was in between professional opportunities. We engaged with him as a consultant to the deal team. We distilled all of that information to come up with our value-creation drivers for this particular investment and our thesis for the investment.

Additionally, M&A was a big component of the growth on this business. We acquired the assets of South Point, Ohio-based Mercier's Inc., a provider of on-track railroad vegetation management and herbicide applications, in late November 2016, and we have a second acquisition candidate under an LOI [letter of intent]. ■

Tech Integration and *Real* Value Creation

RSM's Dave Noonan explains how a focus on technology can reap long-term benefits—and bigger returns

Once the deal has closed, the real work begins.

While the architects of a merger or a buyout focus on growth and innovation, private equity and portfolio company leaders can also improve post-deal performance with judicious investments in technology integration. Bypassing them is a big mistake, and one that can be addressed by focusing on just one role—the CFO.

The CFO and finance team's mandates are no longer confined to number crunching, and now involve more responsibility for performance. A recent study by Oracle that sampled 1,900 finance decision-makers found that about 40 percent of finance leaders see their departments becoming more accountable for the success of the business. The office is also something of a backstop for regulatory and compliance issues. Consequently, the CFO often gets bogged down in labor-intensive processes that slow the flow of timely financial and management information. It doesn't have to be this way.

Modernized technology can help alleviate the CFO's burden and help produce great results. Updating operations to ensure the execution of best practices, enabled by modern integrated technology, can drive much-needed efficiencies. This allows organizations to focus on value-added initiatives while automating much of the time-consuming transactional workload.

While every company faces unique challenges, a few common reasons for not upgrading technology stand out. Those include lack of time or expertise and budgetary concerns. Yet it's critical that leaders understand the available tools and how to put them to use.

Using the right technology makes crucial financial information more accurate, improving budgeting and forecasting while making those processes quicker. Technology allows users to manipulate data in real time with far greater sophistication than spreadsheets.

To achieve the appropriate technology fit in a post-deal environment, first assess the new critical requirements and desired outcomes. Each requirement can overcome current pain points and enhance operating standards to reflect best practices. Selecting and implementing new technology should follow two basic principles: First, allow process enhancements to lead the implementation of technology; and second, integrate the technologies to ensure a single version of "truth" across all platforms in the organization.

A successful transformation connects organizational vision to strategy, delivering measurable performance improvements. That minimizes the rote, time-consuming aspects of the modern CFO's responsibilities and allows greater focus on realizing aspects of post-deal improvements—as envisioned by the deal creators in the first place. ■

DON'T BE A 'HACKER SNACK': CYBERSECURITY DONE RIGHT

— True cybersecurity isn't about preventing every threat; it's about properly handling the inevitable

Cyber thieves have a name for a firm that mistakes prevention for comprehensive threat planning—a "hacker snack." Hard on the outside, soft and gooey on the inside.

Unfortunately, too many firms are satisfying those illicit cravings.

The problem, says Daimon Geopfert, a principal at RSM US LLP, is that many firms started from the perspective that if their systems got breached, they did something wrong. The reality, Geopfert says, is that no firm can prevent all attacks.

"This is a basic 80/20 problem. You can address 80 percent of your issues with 20 percent of your effort. Fixing that last 20 percent requires significant effort and expense and will never reach zero," Geopfert says.

Well-managed firms spend lots of effort to detect and correct breaches once the inevitable happens. That requires a holistic approach that goes well beyond efforts to protect every point of entry. Not only will it eventually fail; it often costs more than necessary, Geopfert says.

Ultimately, the prevent-at-all-costs approach starts with the wrong question: How do I keep everyone out? Instead, Geopfert says, firms should first ask: What am I trying to protect?

CODE RED

"We had one engagement recently where the client was running Windows ME."

Daimon Geopfert
Principal,
RSM US LLP

KNOW YOUR DATA

The holistic cybersecurity approach is based on three core efforts: Protect, Detect, Correct.

Protection goes beyond the traditional concepts familiar to anyone with a laptop—firewalls, anti-virus, and keeping software up to date. Instead, it first requires understanding the types of data your firm handles and figuring out what requires the greatest level of protection.

"You want to think in terms of 'layers of trust,'" Geopfert says. He says the best example comes from the physical world—an office building. When you enter a building, there's typically some form of security in the lobby, and then additional security protocols in place for sensitive areas like a data room.

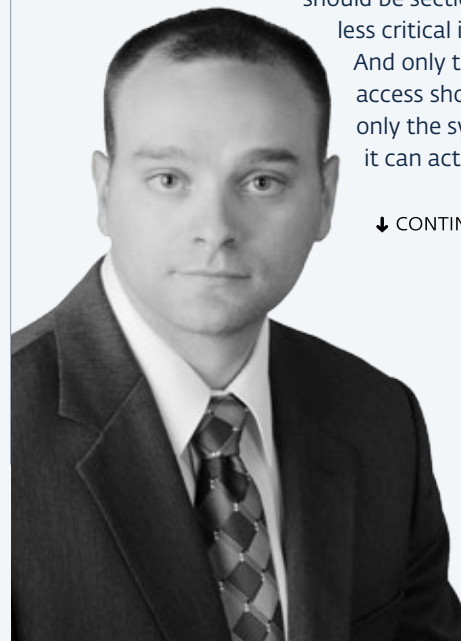
Yet that isn't how it often gets structured in the virtual world of data.

"It's like once you get past the security desk, everything is in the lobby," Geopfert says.

The layering approach acknowledges that some data is more sensitive than others and therefore should be sectioned off from less critical information.

And only those who need access should have it, and only the systems that need it can actually reach it.

↓ CONTINUES ON NEXT PAGE



KNOW WHAT'S NORMAL

Once you've prioritized and protected your data, you need to plan for the inevitable breach. Doing that requires pairing internal knowledge with software to define the normal and abnormal. Without that, there's no way to identify suspicious behavior. Geopfert says a Verizon study found that 87 percent of firms that experienced a breach had access to the information needed to detect it, but were incapable of identifying it.

Luckily, he says, much of the most critical data is often relatively static, so it's easiest to get a handle on it. Segmenting the critical data and systems away from day-to-day-user systems and data, which is typically "noisy" but less critical, helps bring the real issues into clearer focus.

"There are some very binary use cases—if thing 'X' happens, it's bad," Geopfert says. "To get to the point where you can detect nuanced issues, such as changes in user behavior, there's much more you have to do."

WARNING AHEAD

"I asked one client where their IT infrastructure was. They laughed."

Doing more involves using a combination of behavioral, trend, and heuristic information to define and trigger warnings. For instance, Geopfert says, picture a user who has never logged in before 7 a.m., never later than 7:30 p.m., has only touched five systems in the network, and only from three geographic locations. If that user logs in at 2:30 a.m. from a fourth location and proceeds to access other systems, then that should trigger an alarm. But a system can only be set up to "listen" for such events through careful study of existing patterns.

KNOW WHAT TO DO WHEN DISASTER STRIKES

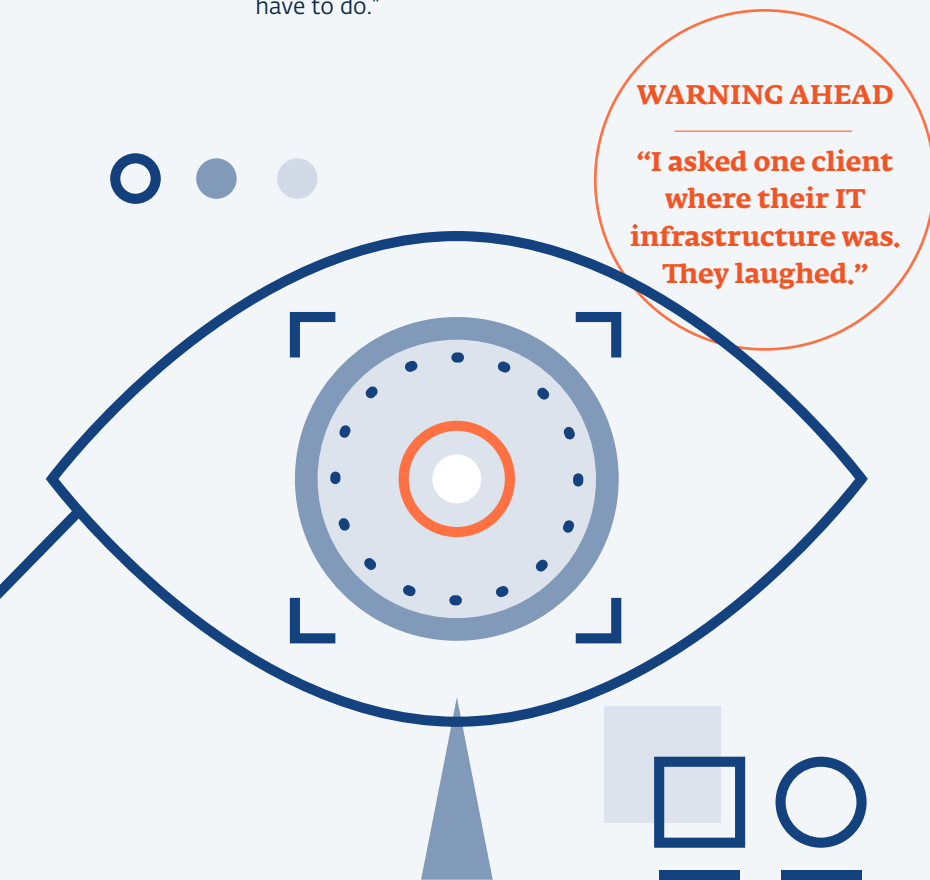
How a firm reacts when a breach occurs is as important as the steps meant to prevent and detect it. In fact, in combination with the layering approach detailed above, incident response is a key target of regulators, state attorneys general, and insurers—in other words, the groups that can make life after a breach particularly miserable.

The simplest advice, Geopfert says, is "Don't go it alone." Internal teams should not be tasked with cleaning up an attack once it occurs. They should be technically capable of identifying a breach and then putting a response in motion—calling law enforcement, shutting down systems, alerting the public—but shouldn't do the forensic work.

"Unless they're a Fortune 50 company, they probably don't have the budget to have that staff in-house," he says. "Most organizations that try to do this themselves throw up their hands after a couple of weeks and call in an outside firm. There have been cases when insurers won't pay fines because the firm didn't properly handle the fallout, and while they were attempting to do the right thing, they actually extended the duration and damage of the event."

The best firms will put together a great plan, often with a consultant, and then run through it a few times a year. A practical approach works best.

"Don't overthink it," Geopfert says. "One of my clients has everyone on the team bring in news articles of breaches. They throw them on the table, go through them, and discuss how they would respond. It's extremely effective." ■





Thriving in a Ravaging Energy Market

Senior partners from OnyxPoint Global Management and Kirkland & Ellis survey the landscape for energy M&A and restructuring opportunities

Although the outlook for the oil and gas market remains murky, M&A activity seems to be returning. More companies are seeking capital solutions, and the pace of restructurings is increasing. Privcap spoke with two veterans of the energy market to learn more about how these deals have come together. Shaia Hosseinzadeh is the managing partner at OnyxPoint Global Management. Andrew Calder is a partner in the Houston office of law firm Kirkland & Ellis. He specializes in mergers, acquisitions, and restructurings in the energy sector.

Privcap: I've heard an analogy that the oil and gas market today is a bit like "The Hunger Games," in which the weaker players are gradually getting killed off by the stronger players. Any truth to that?

Andrew Calder, Kirkland & Ellis: I definitely agree with the first part of the analogy, that the weak players have suffered badly. I'm not sure I would necessarily say the rest have thrived. I think clearly some players in the industry have been able to take advantage of some of the dislocation. But overall I think for many of the players in the industry, even if they had a healthier balance sheet going into this, they're certainly looking very nervously over their shoulders.

Shaia Hosseinzadeh, OnyxPoint Global Management: We've seen a large number of small startups created to commercialize on this newfound resource abundance in North America. This growth has been largely financed on the back of stable and high oil prices and easy credit. The debt-to-cash-flow ratio has increased from 1x pre-shale to 5x today. And now, obviously, we have seen a 60 percent collapse in oil prices.

The first wave of bankruptcies was largely companies that carried too much debt and had high-cost assets to begin with. Two years into the downturn, we have cut the fat, then the muscle, and are now going through the bone. With some \$150 billion of maturities looming, we need either price or production growth or we will see the next wave of reshuffling. Not all will be bankruptcies—this second wave will range from asset divestitures to basin consolidation to debt-for-equity conversions. The singular theme is to create financial flexibility, scale, and operating synergy in a lower-for-longer environment.

What have been some commonalities you've seen across different restructuring deals?

Calder: These deals center on two basic issues. One is the quality of your assets, the quality of the rocks. The second is the amount of debt you've used to finance operations. Those are really the two toggles that have caused issues on balance sheets. The weaker folks that had used a ton of debt are the first to go, because when the value of your asset drops, you're going to have a problem with servicing that leverage.

The ones that have done best had a prudent approach to leverage, and the best assets. It's just math.

Let's talk about deal flow dynamics. Who is showing up as potential investors in distressed restructurings?

Calder: You're starting to see true distressed hedge funds come in, as they always do when there's significant distress in any sector of the economy. This is what they do for a living. You see situations where they're sponsoring a plan or they're trying to do something to influence the restructuring or loan-to-own strategy.

What do you see driving deal flow over the next 12 months or so?

Hosseinzadeh: Increased volatility tends to be accompanied by multiple compression. You've got an environment today where oil prices have been on a roller coaster from \$27 to \$50 and then back down to \$40 and now back up to \$50 in just the year-to-date period. It's really difficult to price assets with this much volatility when few people can agree even roughly on what oil prices ought to be in the future. So cash buyers want a price concession.

At the same time, most commodity industries go through consolidation during down cycles. We expect the next wave of M&A to be driven by consolidation. There are three reasons why buyers might want to buy in this environment. First is to add to core positions and maybe divest non-core positions. Second, for some large players it's to buy cash flow or de-lever more cheaply than through the drill bit. Third, some private players may wish to use M&A as a way to access the public market to grow. ■

An Impact Investor Backed by a Buffett, to Support Women

Nathalie Molina Niño
Co-founder & CEO,
BRAVA Investments



BRAVA will target scalable companies in all stages of development and is planning on making impact investing accessible to the masses

Investors often associate impact investing with lower returns, a perception BRAVA Investments would very much like to change.

Impact investors have often addressed issues such as clean energy, combating childhood obesity, and microfinance. One area that has yet to be addressed on a larger scale is the financial health of women, says BRAVA chief executive Nathalia Molino Niño, a tech entrepreneur with a 20-year track record. In the U.S., women still make 21 percent less than their male counterparts, according to a BRAVA presentation.

BRAVA is a holding company launched last year in partnership with another impact investor, i(x) investments; other investors include high-net-worth individuals.

i(x) investments was co-founded by Howard Buffett, grandson of Warren Buffett and a former executive director of the Howard G. Buffett Foundation. The foundation invests over USD \$100 million annually to improve the lives of marginalized populations in Africa and Latin America.

BRAVA's goal is to make multiple "catalytic" investments in high-growth companies that are likely to significantly improve the financial health of women. It's focusing on businesses in the consumer, healthcare, and education sectors that are poised to produce "market or above" returns for investors, says Molina Niño. These particular industries are targeted because women usually make up the majority of the workforce or customer base.

"The most important thing for us is to make sure that the financial results are measured," she adds. "We apply a high level of scrutiny to gauge how many women are going to be impacted and how much money an investment will put in their pockets. She says there's no reason why that shouldn't come with a high return.

The holding company model affords BRAVA the flexibility to consider any companies that meet its mission-driven criterion and deliver considerable upside for investors. That said, BRAVA will generally focus on companies that require growth equity investments and that are likely to distribute dividends. Investments will typically be made in early- or late-stage companies with an average ticket of between \$5 million and \$20 million, says Par Lindstrom, who serves as CIO and managing partner at i(x) and as Brava's interim CIO. BRAVA will also consider early-stage companies with a clear mission and path to impacting women at scale.

BRAVA already has a sizable pipeline of deals and aims to do as many as four annually, says Lindstrom. The affiliation with i(x) provides access to proprietary deal flow and decades of cumulative operating experience across various sectors, according to Lindstrom. It will also seek partnerships with investment firms that specialize in its target sectors to enhance its due diligence, according to Lindstrom.

Even though no investments have yet made it through final due diligence, some of the companies that BRAVA researched in forming its investment thesis include an online startup that connects underemployed and unemployed women with tech jobs. Another is an online and bricks-and-mortar service that provides caregivers for the elderly by converting independent contractors to full-time employees with higher wages.

BRAVA hopes to go public after five years, says Lindstrom.

"The goal is to democratize access to investing geared towards benefiting women and make it available to everyone, not just high-net-worth individuals," Molina Niño says. ■

Blackstone's Culture of Compliance

The chief legal officer at Blackstone says the firm has made an enormous investment in its compliance program, but it all starts with culture

Having joined Blackstone in 2010 as the chief legal officer, John Finley has helped the firm manage risk as it has exploded in growth. A former senior M&A partner at the law firm of Simpson Thacher & Bartlett, where he was a member of the management committee, Finley has the complex job of overseeing the legal and compliance requirements for the largest alternative asset management firm in the world. In a recent interview with Privcap, Finley discussed his formula for compliance success, as well as his approach to the many risks the industry faces.

Privcap: Blackstone is such a large firm. How do you ensure that all your employees are focused on compliance?

John Finley, Blackstone: The foundation of a compliance program is culture. You can have great policies, but if you don't have the right culture, the policies are not worth anything. At Blackstone, the culture is set by Stephen Schwarzman, our founder and CEO. He establishes a culture of excellence, and that culture spreads to every part of the organization, including compliance.

How do you ensure that the culture of compliance is pushed throughout the entire organization?

Finley: In order to reinforce a culture of compliance here, we use training, talent, and technology. We try to have people focus on real-life problems, such as how would they handle a piece of confidential information and who could they talk to about it? We also use online training, which promotes consistency. Also, it's trackable. If a regulator comes in and says, "How do you know that everybody has gone through the training?" we've got that box checked.

The next important factor is talent. We have chief compliance officers for each of our business units. And they all have at least 10 years of experience. We have roughly doubled the size of our compliance team over the past five years.

The next factor is technology. Technology is such a critical part of an effective compliance program. For example, we have proprietary software for anti-money-laundering client reviews. This process used to be done manually.

What kinds of skills do good compliance officers need?

Finley: What we want is not a traffic cop but an opinion leader. The problems of compliance are never black and white. Solving problems involves subtleties. Compliance officers need to establish standards that are principled and effective. At Blackstone,

the ultimate insult is to be called mechanistic, because that means you're not thinking. You need to think about the purpose of a rule and how it applies to specific situations.

What are some key risks that you've been focused on?

Finley: When I first started at Blackstone, one of the compliance areas that was at the top of my list was FCPA [Foreign Corrupt Practices Act]. I knew that it was both a reputational risk and financial-damage risk. While the existing Blackstone anti-corruption process was good, I knew that we could make it better.

Large firms often can access multiple funds to do deals. How do you manage the risks associated with that allocation process?

Finley: As firms grow, they enter into different investment areas, and they need to be conscious of allocations. The risk is that allocations between different business units are not fair and reasonable. This is also an area that the SEC is very focused on. There are several policies that can work. You can use an allocation policy that is formulaic. For example, two business units would split the deal along pre-defined percentages. You can also allocate based on policies that set forth factors such as the target returns of the various funds. Whatever the rationale, the policies need to be carefully disclosed and documented. When the regulators come in, they want to check and see how you make allocation decisions.

How important is cybersecurity at Blackstone?

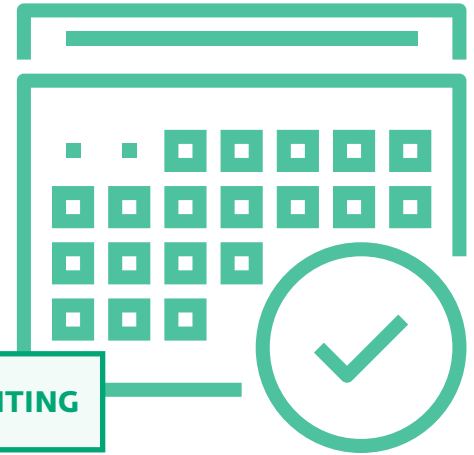
Finley: Cybersecurity is clearly one of the most important risks that the firm and the industry face. Mary Jo White, the ex-chair of the SEC, said that cybersecurity is the biggest risk to the financial system. Blackstone is investing tremendous resources in protection. We also have to be mindful that the SEC has their own way of looking at this issue. I would advise anyone preparing to improve their cybersecurity to think about the framework of the regulators. Even if you think you're doing a good job, that may not match the framework that regulators are looking for.

The regulators will ask: What are the protections of your information networks? What are the policies and procedures that you're putting in place? What's the training for these networks? How are you dealing with your vendors? What access do vendors have? What about remote access? If somebody does breach your system, how soon do you know? It is reckless to not focus on this area. ■

John Finley
CLO,
Blackstone

INSIGHTS FROM RSM

Revenue Recognition: ARE YOUR PORTFOLIO COMPANIES READY?



NEW CHANGES WILL IMPACT PORTFOLIO COMPANY ACCOUNTING

What do your portfolio companies need to be ready for?

As you may know, the effective date of the new revenue recognition guidance issued by the Financial Accounting Standards Board is fast approaching. The new guidance replaces virtually all legacy revenue recognition guidance with a fundamentally different comprehensive model and includes considerably more disclosure requirements. While the degree of change to an entity's recognition and measurement of revenue will vary depending on the nature of their revenue streams and the terms of the contracts with its customers, all entities will experience a significant degree of change with respect to complying with the new disclosure requirements.

When do your portfolio companies need to be ready?

If your portfolio company is a public business entity (PBE), the time to get ready is running short, because the new guidance is effective for PBEs in annual reporting periods beginning after December 15, 2017, and the interim periods within those years. However, if an entity is a PBE solely because its financial statements or financial information is included in a filing with the Securities and Exchange Commission (SEC) pursuant to certain SEC rules and regulations (e.g., an acquired private company when its financial statements must be included in the acquirer's filing with the SEC), it may choose to adopt the new guidance in accordance with either (a) the effective date otherwise applicable to PBEs or (b) the effective date applicable to private companies. The effective date for private companies is annual reporting periods beginning after December 15, 2018, and interim periods within subsequent annual periods.

While there is more time available for your private portfolio companies to get ready, don't let that time give you a false sense of security, given the significant effort that could be required to implement the new guidance.

How do you know if your portfolio companies are ready?

Communication, communication, communication. A key sign of readiness is whether a portfolio company has done all of the following:

- **Estimated the adjustments that must be made upon transition to the new guidance**
- **Drafted the disclosures required under the new guidance**
- **Reviewed the adjustments and disclosures with its auditor**

Depending on the circumstances, it may be appropriate for the PE firm to coordinate, or otherwise be actively involved in, the implementation efforts at its portfolio companies. For example, such involvement would be necessary if the PE firm desires consistency among some or all of its portfolio companies with respect to the judgments and estimates made by the portfolio companies during implementation and/or with respect to the transition method, practical expedients, and/or accounting policies elected by the portfolio companies. In addition, involvement by the PE firm may improve the efficiency of implementation by the portfolio companies in that what it learns from one portfolio company's implementation efforts might benefit the implementation efforts of other portfolio companies.

What if your portfolio companies are not yet ready?

Time is of the essence, and noncompliance is not an option if financial statements are prepared in accordance with generally accepted accounting principles. Make sure there are no further delays in achieving readiness. ■

Want the fine details? Check out the RSM Revenue Recognition Resource Center at www.rsmus.com/revrec.

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Why Advent Remains Bullish on Latin America

With Patrice Etlin of Advent International

Privcap: Your firm recently acquired Fortbras, which is a major auto-parts distributor in Brazil. Can you talk about how that deal came about and what your thesis is for its growth?

Patrice Etlin, Advent International: We've been looking at this sector for a couple of years now, and we source many transactions. We were always facing the issue of size. Fortbras is a consolidation of five companies that we bought at the same time and created a holding company on top of it to manage those five assets. This is a roughly \$10 billion market in Brazil today, and the thesis is you had a boom in the selling of new cars in Brazil back in 2006, '07, and '08 at the boom of the credit cycle there. The market there was selling close to four million new vehicles or cars per year. That transformed Brazil into the third-largest car market in the world.

Those cars are now getting out of guarantee from the manufacturers, and the customers that bought those cars are sourcing parts from third-party distributors like ours. Our company basically distributes to repair shops directly. A huge portion of our customer base—it's a company growing double digits in the middle of the crisis. We do a lot of opportunities for add-on and consolidations, so that's the way we look at this deal.

Where else in Latin America are you finding interesting opportunities?

Etlin: We established our presence in Colombia, opening our Bogotá office back in 2011, and it has developed into a great opportunity for us. We did six transactions there—all successful, large, and doing well. From Colombia, we are spending time in Peru and even Chile now. We recently concluded our first deal in Peru, which is an add-on of an existing portfolio company we have out of Colombia: a chemical distributor. The Andean region as a whole—and, again, particularly Colombia—has been very interesting for us.

What is the sentiment of your investors about the Latin American region?

Etlin: Brazil is the elephant in the room in terms of size, in terms of the number of managers and large managers that were developed and in business in Brazil over the last years.



Patrice Etlin

Managing Director & Co-Portfolio Manager,
Advent International

There was record fundraising for Brazil in 2010 and '11. Close to \$10 billion was raised there, and a lot of that money was raised into local funds that put the money to work at the peak of Brazil in terms of valuation, but also appreciation of the *real*. Of course, in general, that performance was poor. Some of those managers are out of business, and investors lost a significant amount in those cases. So there is a concern.

In terms of when they look at Mexico, investors always feel that the PE market there should be larger. It is a second economy in the region, but when you see the number of transactions compared to other markets, it is still very poorly penetrated in terms of PE activity there.

What do you think about when you are thinking about being bullish about the long-term prospects of private equity in Latin America? What facts or trends do you follow that make you feel bullish as an investor?

Etlin: When you look at long term, we will always have volatility. I think that's the first point also, to be clear about the region. If an investor is looking for stable growth, predictability, that's not Latin America.

But when you look at those markets, you have a middle class that is still expanding. You have consumers looking for new services. Credit should be more affordable, and that will bring additional consumption, industrialization, and huge opportunities on the infrastructure side. [There's] so much need that you can find growth on those infrastructure assets different than what you see in developed markets like here. ■

Slow-Cooked Success

INSIDE OAKTREE'S 23X RETURN FOOD DEAL

An investment that began as a debtor-in-possession financing of a bankrupt food company ended nine years later as a blockbuster success for Oaktree Capital Management. According to the Los Angeles-based firm, the startling turnaround was due largely to the successful execution of an add-on strategy combined with a rejuvenated corporate culture.

Cincinnati-based Pierre Foods had previously been owned by another large private equity firm, but by 2008 the company had fallen into financial disarray. "The company was at a fairly dark point in its life cycle," says Matt Wilson, a managing director and co-portfolio manager in Oaktree's Special Situations Group. "There was too much debt, there was uncertainty around the future of the business. But working in partnership with management, we took something that was a regional business in distress and created a world-class company."

Oaktree acquired Pierre Foods' debt and converted that via a bankruptcy process into full equity ownership of the business. Over the next nine years, Oaktree would invest roughly \$100 million into the renamed AdvancePierre Foods.

Leading the operational turnaround of the business was Dean Hollis, a senior advisor to Oaktree and veteran of the food and agricultural industry from his days as COO of Conagra Brands. AdvancePierre made and distributed largely pre-cooked food, much of it in the "handheld" categories. After a robust review of what food items were already in the portfolio, Oaktree led an aggressive buy-and-build strategy. "We saw the opportunity to say, 'What categories can we grow in? What products can we expand in? What customers can we expand in?'" says Hollis.

Word got out among middle-market, often family-owned food businesses that a well-financed buyer was on the prowl. "A lot of regional businesses, a lot of family-owned businesses that were looking for an exit, and a lot of them found us," says Wilson. "We could oftentimes go in and generate significant synergies in any acquisition we made, because we had a better model, a better cost structure, and we were able to capture a lot of value."

Oaktree came up with a corporate-culture, "continuous-improvement" standard called the "AdvancePierre Way" that was instilled across the company and pushed down into new acquisitions. "They immediately understood what our expectations were, what our focus was, how we measure, how we collaborate, and how we execute." As the top line of the business continued to grow, Oaktree took out some \$150 million in costs, largely through improvements to sourcing, the supply chain, and manufacturing.

The company was taken public in 2016 and, presaging an expected wave of consolidation in the food industry, was acquired by Tyson Food the following year. Oaktree made a reported 17 times its equity. Wilson says the exit "took longer than they usually do" but that his team and firm are nonetheless extremely proud of the result. ■



Managing Portfolio Companies' ESG Efforts

Four experts discuss how their firms instill ESG values into private equity investments



Alan Kao
Principal and Global Service Line Leader for Compliance, Strategy and Transaction Services, Ramboll Environ



Jackie Roberts
Chief Sustainability Officer, The Carlyle Group



Elizabeth Seeger
Director, Public Affairs, KKR



Lee Coker
ESG Officer, Oak Hill Capital Partners

Alan Kao, Ramboll Environ: What sectors have you found to have the best opportunities for ESG impact, and in what sectors has ESG been more of a challenge?

Jackie Roberts, The Carlyle Group: There are certain sectors, like oil and gas and industrials, in geographies like developing countries, where investment professionals are very sensitized to these issues, and they generally get a hard look in due diligence—whether it's looking at contingent environmental liabilities or labor issues in developing countries or operational risks. When I think about sectors where we can have an impact, we usually think about questions that start with “Where is what I call ‘private governance’ truly playing a role here?”

In a five-year hold period, we can look at where customer and competitor dynamics are changing the lay of the land. We look at this in terms of both the risks of falling behind new types of risks for that sector, and also where there are opportunities for developing new products or services. We see that a lot, for example, in the consumer sector. When you have a large retailer, like Walmart, scoring on sustainability, [ESG efforts] are all driven by different supplier relationships and buyers driving changes. I think that HR workforce strength issues are an area where our sector can play a major difference. For instance, our sector could have a big impact on gender diversity, racial diversity, health, and safety.

Kao: How do you get your arms around a large portfolio? How do you prioritize?

Lee Coker, Oak Hill Capital Partners: When I was at EDF [Environmental Defense Fund], we partnered with Oak Hill Capital's portfolio to answer that question for the firm and for the private equity sector more broadly. We narrowed it down to

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“Each time we’re thinking of an investment or particular industry, we’ll pull up the [ESG] guide and say, ‘Given the geography, are these questions relevant? If not, which ones should we add?’”

–Elizabeth Seeger, KKR

three things. The first was considering the current state of the business. What stage of investment is the company in? What are the business’s top priorities, and how could we tie in ESG initiatives into those activities? Another was where the opportunity is, from an environmental or social impact perspective. The next was a check to ensure that improving the ESG profile would also create significant financial value.

Elizabeth Seeger, KKR: At KKR we, early on in the process, developed a series of guidelines. Each time we’re thinking of an investment or particular industry, we’ll pull up the guide and say, “Given the geography, are these questions relevant? If not, which ones should we add?”

Roberts: I think the role of LPs in asking the hard questions about every company is certainly helpful in making sure [that], over time, this is disseminated throughout. The deal professionals have to continue developing this capacity and be trained to learn about [ESG] and see the value in being well-versed in the subject.

Kao: What are some specific examples of ESG strategies that you’ve successfully deployed?

Seeger: Two years ago, KKR Capstone hired a full-time energy engineer who works solely with KKR private equity portfolio companies and real estate portfolio companies to help them think through what is the business case for resource efficiency improvements, what vendors they can use, what are some of the best practices that others are applying. And so, by providing this resource and guidance, we’re really able to drive more progress.

The other is the Responsible Sourcing Initiative, which we’ve been running with BSR as our partner since 2010. And in that

case, we’ve been going to large numbers of portfolio companies, almost 30 companies, to help them assess what are their policies and procedures related to low-cost country sourcing.

Kao: Do any of your firms tie ESG factors to compensation or other incentives for the deal teams? And if not, do you think that that’s something that will be coming in the future?

Coker: Identification of ESG factors is integrated into the due diligence process and is included in investment committee memos. Deal teams are focused on these factors from the beginning of an investment to understand how these issues may impact the risk/return profile of the investment.

Seeger: In our case, compensation isn’t tied to any one particular KPI of any sort—ESG or not. It’s really evaluated on three criteria: commercial impact, living the firm values, and leading and managing people.

Kao: Have any of you been witness to losing a deal because you pressed a potential investment on ESG factors?

Roberts: No, but I think the reverse has been true, which is that we’ve had some deals come along, with a very strong ESG component, that have been highly sought after and we lost because it got bid up to a level that our deal teams felt like we couldn’t match it. ■

The Data-Driven CFO

How technology is transforming the role of today's finance chiefs

KEY TAKEAWAYS

1. Armed with game-changing data tools, CFOs can be key partners in adding value
2. During due diligence, gap analysis should also be applied to the finance team
3. Keep in mind that when the deal is done, the finance team is exhausted
4. GPs should collaborate with CFOs on the value-creation plan
5. Planning prevents wrong turns with new technology platforms

1 Armed with game-changing data tools, CFOs can be key partners in adding value

Many CFOs now play an important role in value creation at private equity portfolio companies. Equipped with powerful new tools for data analysis, they're helping make vital business decisions and drive their companies toward success.

CFOs can now be "more strategic and savvy, thanks to a proliferation of very sophisticated tools, from corporate performance management to business intelligence—even tools to help with little things like consolidations and closed process management," said Dave Noonan, a principal at RSM US.

Shahriyar Rahmati, managing director at Comvest Partners, called today's CFO "the quarterback of the portfolio company in a lot of ways," noting that the CFO is often the eyes and ears of the CEO and a key partner in planning strategy based on data. "Organizations have lots of data," he said. "Payroll, ERP, CRM systems—they spit out data all over the place. The question is: Is there somebody sitting in the middle of that data who understands the business, understands what everybody is trying to get done, can think about it in a rigorous way and then drive it using the technologies that are out there?"

And shift gears as the company accelerates. At the early stages in a company's evolution, CFOs have to pull the levers to fuel growth. Then, as a company matures, the CFO's focus turns to profitable growth and helping management make informed decisions, not only around opex but around sales, resource deployment, and other functions.

At this point, good CFOs kick it up a notch and become "data ninjas," said Kevin Masse, chief portfolio officer at TA Associates. "They're sitting at the nexus of all these different points of information, pulling it together, analyzing it, and teasing out the key takeaways so the rest of the management team can be more productive and impactful to the business. That's where I'm seeing the CFO role evolving, and it's driving a ton of performance."

2 During due diligence, gap analysis should also be applied to the finance team

These days, when GPs partner with the management team of a portfolio company to form a plan for value creation, the plan should involve the CFO's access to data. GPs should look at the CFO's current data practices and figure out ways to optimize them so that the management team can gather and analyze the data they need to compete better.

"Step one is traditional gap analysis," Rahmati said. "It's figuring out what the financial team does today and how effective it is, and then what they need. What are the key levers in the business? What does our investment thesis hinge upon? How do we work backward with management from that thesis to the few very key levers that the management team needs lots of insight and visibility around? It's usually connecting those that give us a framework that we drive to over time with that management team."

Often a company's data capabilities are all over the board. "Typically, they're not very sophisticated," Noonan said. "Typically, they're disjointed. Over time, they add third-party applications to solve point needs, and those are difficult to integrate and harness data from."

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Shahriyar Rahmati

Managing Director,
Operating Advisory Group,
Comvest Partners



Kevin Masse

Chief Portfolio Officer,
TA Associates



Dave Noonan

Principal, National Leader,
Private Equity Consulting,
RSM US LLP

Curing a Toothache

Rahmati recalled working with a leveraged dental clinic that was leaving money on the table. Patients would come in when they had an emergency, like a broken tooth. They would pay a few hundred dollars for the initial treatment, but often would not return afterward for follow-up care. When this happened, the clinic would miss out on \$3,000 to \$5,000 of additional work that it might have done—and that patients likely needed.

This untapped revenue was hidden in financial charts in the clinic's filing cabinets. "By taking those charts and moving them from paper to electronic and making them visible throughout the entire organization, the company was actually able to use a central outbound call center in combination with patient financing to make it more affordable to get those people back into the dental centers," said Rahmati. "The results were massive, from an enterprise profitability standpoint."

The dental practice was ultimately able to de-lever, perform a large dividend recap, and complete an acquisition. And it was all accomplished with the proceeds that came from making a single investment in data technology and putting in place a process that wasn't there before.

A Consulting Conundrum

Masse once worked with a software company that operated a sizable professional services organization generating about \$90 million in revenue. That sounds like a lot, but in fact the organization was lagging far behind industry benchmarks—and no one could figure out why. The consulting engagements simply were not generating the kind of profit margins that the firm expected.

The CFO was mystified. He couldn't find the cause of the problem in real time. And if and when he did pin it down, it was too late, because the project was done and the consultants had moved on to their next engagement.

"So we implemented an HR system that manages workflow inputs on an hourly basis," Masse said. "That enabled the company to manage utilization in real time. So if a particular resource is not fully utilized, the company can put that person back into the pool to be redeployed on another project."

By simply creating that awareness, the company was able to free up utilization and improve its professional services margin by about 10 percent.

A Healthy Solution

Noonan recalled working with a healthcare services business that had about 40 different sets of books in clinics around the country but had no way to pull them all together. Time was of the essence, because the company was trying to prepare itself for an acquisition by a private equity firm.

Each clinic closed its books on its own. Some did it monthly. Some did it quarterly. Some only annually. So the PE firm didn't have any real way to value the business. The firm simply could not get a good handle on what the company would look like going forward if it made the investment.

So the firm called in RSM and Noonan. "We consolidated the financial system and put in a nice reporting layer on top of it," he said. "We were able to bring all the data together on a monthly basis, close the books in seven to 10 days, and give the PE firm some financials that they could actually sink their teeth into."

“You don’t wake up on day three of the investment and there’s a terrific ERP system for them under their Christmas tree. It took a lot of work to get there.”

-Shahriyar Rahmati, Comvest Partners

Fixing these problems is an efficient way to add value, Noonan added. “We try to map where all the gaps are, and once the deal closes, we get into a deeper assessment phase and come up with a road map that lists solutions to close the gaps and meet the investment thesis, then a budget and timeline to execute against.”

3 Keep in mind that when the deal is done, the finance team is exhausted

Before embarking on any new initiatives, GPs might want to give the finance department a few days off: In the weeks leading up to the close, the CFO and team have been running flat out.

“There’s not a lot of sleep going on,” Rahmati said. “Then the deal closes and in comes the firm, resources ablaze, energy there, capital invested, and ready to go. And what about the finance team? They’re tired, right? Now, think about all the different initiatives we’re trying to execute—whether it’s a plant reconfiguration, investment in new products, a commercial enhancement, enablement of new strategies—all of those touch the finance team. So one of the arts of our role is to find all the things that stack on top of them and not kill them, because the risk-management element of this is huge. If you can do something over the course of six to nine months, you have a much higher probability of getting it right than racing to get it done in an arbitrarily short time frame.”

4 GPs should collaborate with CFOs on the value-creation plan

A successful value-creation plan requires buy-in. The way to get it from the finance team is to give them input. “We share diligence reports with our CFOs,” Masse said. “We’re very candid. And then we ask them to do an assessment on their business—strengths, weaknesses, what are the areas of need from a technology perspective, team perspective, workflow perspective? We collaborate with our teams. We’re not prescriptive.”

Management teams, including finance people, work better when they have at least part ownership of a plan. They also have to understand it. “Think about something as simple as debt,” Rahmati said. “A lot of the family-owned companies we buy are low-leverage, cash-rich businesses. Then we apply leverage post-transaction, one or two tiers of debt, sometimes a revolver, different reporting requirements, covenants, a definition of EBITDA that they have absolutely no understanding of necessarily. So we go to them bearing gifts, condensing that 163-page credit agreement into the five to 10 pages that really matter and walking them through it.”

New technologies help here as well. For a reasonable cost, a PE firm can now implement web-based tools that link to any number of databases, pull disparate data together, and deliver simple, elegant visualizations to the management team. Better still, having this sort of rigor in place adds dramatically to the value of the company.

5 Planning prevents wrong turns with new technology platforms

It’s one thing for a private equity sponsor to come into a portfolio company and install a world-class data system for the financial team. It’s another thing for that team to actually adopt that new data platform and get the most out of it. Fortunately, there are steps the sponsor can take to promote success.

“It’s a pretty preventable mistake,” Rahmati said. “If you built the system or you explained why the system was being put in place and did it in conjunction with your management team, you almost inevitably go through the why as you’re putting it in. You don’t wake up on day three of the investment and there’s a terrific ERP system for them under their Christmas tree. It took a lot of work to get there.”

Another important step is to get the functional line leaders involved in the implementation process early. “Make sure they see the changes that are being made and they understand how the system is going to be utilized and operated, whether it’s ERP or some sort of a BI solution,” Noonan said. “If they understand how it’s going to be used and their role in accessing data, by the time you go live it’s not a big bang, it’s not a two-week training exercise to teach people how to get an invoice out the door.”

Every new system is also an opportunity to assess how a company is doing what it’s doing to make recommendations and to import new potential, Masse said. “We get excited when we implement new systems, not only because it’s going to enable a new capability for a company but because it’s an opportunity to drive performance improvement in the business.” ■

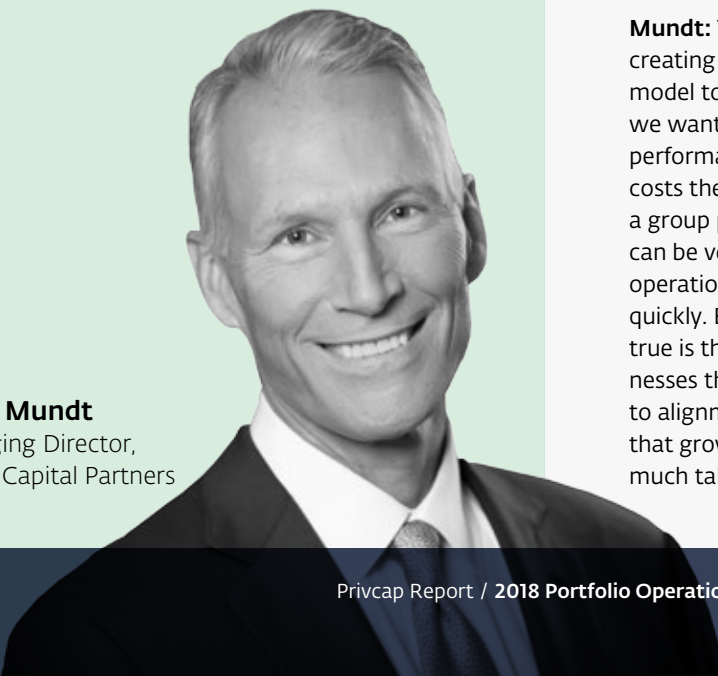
Vestar's Operational Approach

An interview with Kevin Mundt

Kevin Mundt, managing director at Vestar Partners, says his firm believes the first step in operational oversight comes from aligning the interests of Vestar and its portfolio company management teams. Over the firm's three-decade history, Vestar funds, which specialize in midmarket consumer products, healthcare services, business services, and industrial sectors, have completed 78 investments in companies with a total value of more than \$46 billion.

Kevin Mundt

Managing Director,
Vestar Capital Partners



Privcap: How has the firm structured its operating platform?

Kevin Mundt, Vestar Capital Partners: We take a three-pronged approach to support our investments. We have a robust resources team consisting of experienced business people with diverse backgrounds aligned with the vertical industries in which we invest. It's a pretty diverse stream of people with deep operating backgrounds. We focus on organizational development, possible business model changes, strategy, and operational improvements. We also work with a group of advisors who each have 25 to 30 years of experience as operating executives and skills that match up with our vertical industry groups. They're often called upon to do due diligence. We also have a broad network of external resources—people we can call on for specific instances where we need that expertise.


What is one of the most important things that happens in the first 100 days after you acquire a business?

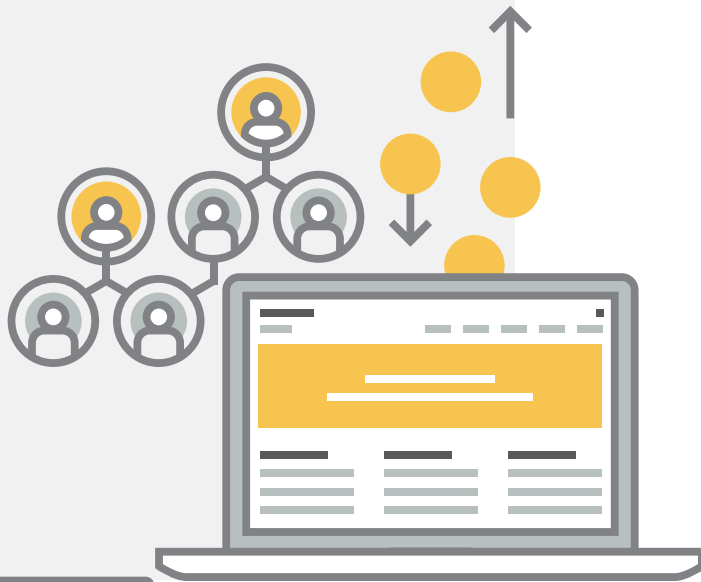
Mundt: There are several important factors, but the truth of the matter is that the paramount focus in the first period of ownership is alignment. We are not investing in turnaround situations, and we work as partners with strong management teams. We work hard on this in due diligence, but it's rare that a buyer can know as much as they want when acquiring a business—the seller will always know a little bit more. But our discussions with management go pretty deep into where we want to go, where we want to be able to fund and reallocate resources, and where we want to reinvest in areas of the business we want to develop. There may be some operational changes at first, but nothing is more important in that initial phase than alignment. It sets the stage for everything else we can do to support our management partners going forward.

What tool in your toolkit do you use the most? In other words, what value-add tactic has been consistently effective.

Mundt: The most successful consistent value-added tactic is creating incredible clarity around the strategy and business model to support it. That then defines the three to five areas we want to invest in to achieve improved financial and strategic performance in the portfolio company. We do try to help identify costs they can get rid of or reduce—for example, we'll work with a group purchasing organization, Procurement Advisors, which can be very helpful reducing the cost of maintenance, repair, and operations. Packaging is another area where we can find savings quickly. But we don't have a cookie-cutter approach. What is true is that the hardest thing to do in private equity is grow businesses that often have been around for decades, which gets back to alignment. Once we have a shared vision of how to create that growth strategically and profitably, everything else pretty much takes care of itself. ■

Using Data Analytics for Portfolio Company Hiring

 A proprietary data analytics system provides unique insights into the talent pool



As a private equity firm focused on rebuilding distressed manufacturing businesses in the U.S., American Industrial Partners' (AIP) hiring needs are much broader than those of a traditional PE firm. The good news is that through data analytics, they've developed a system that helps identify and nurture talent—and can help source deals, too.

AIP has 13 portfolio companies with \$7 billion of combined revenue and over 230 global manufacturing and distribution facilities. The process of gathering intelligence often starts before an acquisition is completed, at which time the team starts talking to people and using a variety of internal sources to collect information about the market, business processes used by the competitors, and their talent pool.

Jim Baran, who heads talent acquisition at AIP, says the intelligence gathering continues throughout the life of the investment and allows AIP to stay on top of the competitive landscape and find new investment opportunities.

"The old way of managing the hiring process was to put out ads on LinkedIn or Monster and wait for responses," Baran says. "Now we can look at our talent management system and see where our talent is located and what competitors are doing. Data analytics is a huge step forward in talent management that helps with problem-solving and opens up a lot of what-if scenarios."

The system utilizes a custom design workflow to move the candidates through the process. It is designed to incorporate three distinct hiring models: active talent needs; trending hiring needs across multiple portfolio companies; and emerging capabilities and skill sets distinctly matched to future acquisitions.

A key part of talent acquisition for AIP is hiring and retaining the leadership of the portfolio company that serves as a "guidepost from chaos to order," says Baran.

"We are looking for emotional intelligence, complex problem-solving, and ability to lead in an emerging culture," he adds.

The company has some leaders that move from one portfolio company leadership role to another. It also relies on data analytics to map out the metrics that make people successful, and then uses that information in the hiring process.

"The challenge for us is to get our hands around what works in portfolio companies' culture," says Baran. ■

8 SIGNS YOU REALLY NEED IT DUE DILIGENCE



1 The team can't answer basic questions



It seems obvious, but even companies that appear extremely sophisticated often fall short. If you start asking simple questions—what type of sensitive data does your company possess, and how does it handle it?—and answers aren't forthcoming, dig deeper.

2 It is young and high-growth



New high-growth companies don't just outgrow office space—they often strain existing infrastructure, controls and processes.

3 It is in a highly regulated industry



Is the business in healthcare, consumer and retail, or financial services? Don't think twice—investigate deeply. At some point, a regulator is going to pay a visit.

4 It works with government agencies



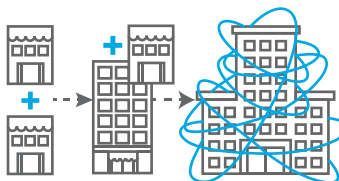
Privatization has been a boom for private equity investors, but doing business with government also means grappling with legacy or specialty government systems and rigid government standards and contracts.

5 It is dependent on cloud infrastructure



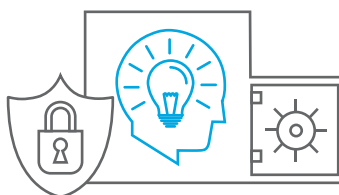
As cloud infrastructure has grown in popularity, so have the risks. The company should have a clear understanding of not just its own data management practices, but those of third-party providers as well.

6 It has grown through aggressive acquisition



The more a company is the sum of multiple acquisitions, the greater the risk of a rat's nest of systems, policies, and procedures. Make sure the integrations were performed well, or you risk unpleasant surprises.

7 Its main product is based on valuable intellectual property



If the company's core product is based on a secret sauce, you'd better make sure it is behind impenetrable lock and key.

8 It has service-level agreements (SLAs) with its clients



Commodity businesses may not handle sensitive data, but their ability to stay online and make good on their agreements is critical.

The Corinthian Value-Add

An interview with Peter Van Raalte

Peter Van Raalte, a co-founder and the CEO of Corinthian Capital, relishes the challenge of bringing a family-run business to the next level. The 12-year-old firm is often the first institutional investor in businesses with annual sales of \$50 million to \$250 million, and then creates value through board-level direction and strategic and financial planning, operational improvement, and capital investments that unlock new growth opportunities. Corinthian concentrates on the manufacturing, distribution, services, and consumer product sectors within North America. Here, Van Raalte explains the firm's operational strategy.

Privcap: How does your firm invest, and how does that influence your operating platform?

Peter Van Raalte, Corinthian Capital: At the most basic level, we take companies that might be very successful, but haven't been exposed to the latest operational advances or need help to become more sophisticated, and we help to professionalize them. That means we are usually buying family-owned businesses or companies that have achieved success beyond, perhaps, what their founder expected. In other words, companies where our support and partnership can really help to improve the operations of the business, and then have the potential to be sold to strategic buyers and other funds. When we get involved, many of these companies lack a lot of the infrastructure that you might expect in a business that has reached their size. They often lack reporting and operational metrics. The owners manage by walking around. In a lot of cases, when they started their businesses, it was a much simpler business. There may not be a professional CFO. It's "Here's my wife or my son or my best friend who's kept the books for the last 30 years." In a lot of cases, our work starts by trying to clean up functions like this by helping the owners find a high-quality CFO who understands reporting and metrics.

A lot of private equity firms are scared away from this niche by the poor quality of information, because they feel it requires too much work to determine the true cash flows. When we see that, we don't run the other way. Our competitive advantage is being able to roll up our sleeves and dig into the information that is available, knowing that because we're aligning our interests with the owners, we can work together to benefit the company and our investors.

What is one of the most important things that happens in the first 100 days after you acquire a business?

Van Raalte: We always prepare a 90-day plan, a 180-day plan, and a five-year model. We prepare a list of key items that we want to accomplish. Before the deal is even signed, we try to make sure management is on board, because if there isn't buy-in from the management team, making these types of changes isn't possible. We also need to recruit and fill the key spots in the organization that were lacking.

Next, we address the broad categories of operational problems, including capital projects. When an entrepreneur is ready to sell, they get conservative and reduce spending. They don't invest in systems or equipment and often leave key positions vacant, so there's a lot of low-hanging fruit for us to begin with. For new equipment, we start with an ROI and payback analysis. If we can spend \$2 million and that results in a \$1 million to \$2 million increase in EBITDA, that's a no-brainer. We also want to assure employees that things are going to improve under our ownership. These businesses are often run cheaper than we can run them at first, because if you only report to yourself, you don't need to indulge in detailed reporting. That doesn't work for us, so there's some upfront costs to get those types of activities off the ground. ■



Peter Van Raalte
Co-founder & CEO,
Corinthian Capital

DON'T FORGET THE TECH:

Successfully Managing a Carve-Out

**Failing to account for
technology integration
takes a carve-out from
challenging to impossible.
Three experts explain.**

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Why Not Paying Attention to Tech in a Carve-Out Could Cost You

Two experts on the nuances of carve-out transactions explain why paying attention to the ever-more-complex technology component, starting when the transitional service agreement (TSA) is drawn up, is crucial

When a corporate parent sells off a business unit in a carve-out transaction, parties on all sides of the deal work hard to make sure the company that's spun out doesn't spin out of control. A smooth transfer of technology is a crucial aspect to successful carve-outs, and experts say the importance of this transition represents an increasingly complex part of an always challenging process.

From the beginning of the process, the tech piece of the carve-out puzzle is multi-layered and provides opportunities to create value, though capitalizing on those opportunities requires detailed expertise and meticulous execution.

Benedict Rocchio, a partner on the venture capital team at Baird Capital, says it's crucial to understand how the parent corporation's organization of IT will affect the new standalone company. With a comprehensive assessment, often aided by third-party experts, buyers can set up a detailed plan to address every aspect of tech issues in a carve-out. That adds confidence as a TSA gets negotiated and signed. Rocchio says the process is increasingly complex as IT assumes greater importance in all aspects of a business.

"The biggest change in the last decade or so is how much the sophistication of corporate IT infrastructure has become," he says. "Even with the advent of the

Internet in the 1990s, corporate IT wasn't as robust. Now the level of technology that touches every aspect of business, both inside the walls and in terms of customer interaction, has become more complex. That poses a bigger challenge in a carve-out."

J.B. Cherry, a senior managing director at One Equity Partners and a veteran of several carve-out transactions, says a broad view of the technology dimension is vital to creating value in the carved-out company. Ensuring operational continuity is the first step.

"The business is up and running the day after you own it, and everything needs to be running smoothly," Cherry says. "You can't bounce checks. You have to make sure employees are paid, and all of those go back to the IT platforms."

A detailed understanding of the IT costs to the parent may also help reduce them in the new company. Cherry says the balance of the costs between the parent and the soon-to-be-independent company is often an area of increased cost risks.

"You need to understand what those costs are, and you need an analysis that says that at some point these functions can be performed independent of the parent," he says.

Third-party experts can often add value to the ultimate results of a carve-out, says Rocchio. While the general partners work on the best deal structure, the sophistication of current corporate IT is such that specialized expertise is crucial, he says.

With that level of detail, it's also possible to improve the IT framework of the new company, shedding cumbersome, sometimes costly or poorly integrated systems

in favor of more agile, often cloud-based solutions. While the transfer of licenses and other technology agreements may increase because the vendors take the opportunity to raise prices for a smaller customer, that's a point of negotiation. The new company doesn't have a blank slate for technology, but it can be organized efficiently and cost-effectively.

"It's an opportunity to build what you want when you're buying out what becomes a new business," Rocchio says. "This is a chance to get an ultra-modern IT system in place from the start, with all the possible cost and technological efficiencies."

Having the right people in place on the tech side is a critical piece of the puzzle. There's a balance to be struck between understanding the legacy IT and operational issues of the new business as they relate to the parent corporation and seizing the opportunity to modernize and install high-level tech talent throughout the carved-out company.

While many dealmakers cultivate and use networks of skilled IT managers to lead or supplement tech teams at newly carved-out companies, the human-capital costs—and potential value—often depend on the IT organization of the parent company, Cherry says.

"In many cases, the carved-out company has a head of technology or a chief financial officer who is already fluent in these systems and understands inherently what the parent is providing and what they lack," he says. "There are times you may have to add to the human-capital aspect of the deal, particularly if you have a parent company where the IT is done centrally. You may need to find someone who can think more strategically for the carve-out." ■

Why Technology Increasingly Complicates Carve-Outs—and What to Do About It

The key to technological success in a carve-out isn't found in the cloud on a new company's servers, but in the fine print of the paperwork that creates a new entity from a corporate parent. Usman Rabbani, a director who leads Technology, Media and Telecommunications at KKR Capstone, the firm's operations group, says the structure and quality of the transitional service agreement can materially impact the transaction and the buyer's ability to create value.

Privcap: Where do you set the foundations of a successful carve-out from the technology side?

Usman Rabbani, KKR Capstone: Technology is one piece of a very complex puzzle. We start with a 100-day plan for the new entity and try to focus, or refocus, on the top three to five things that make it a successful investment. One of the most important considerations is the actual transitional service agreement with the parent. Take the example of a large company like GE, which carved out its consumer finance business in Australia. The subdivision of GE we were purchasing lived atop the corporate parent's IT and systems infrastructure. That included quite a lot: hardware, data centers, software, telephony, third-party relationships, networks, and end-user applications. One of the biggest technology-related decisions was how to structure that TSA—and how to price it.

What are some of the biggest issues and potential complications in setting that up?

Rabbani: The pricing is where some commercial risk exists. Let's say a large corporation has a \$500M budget for technology, and five main divisions. That money isn't allocated equally in \$100 million chargebacks—it's never as clean as that—and internal allocations change over time, too. So one of the biggest considerations is what the corporate parent will charge the new standalone entity. You have to assess how the internal transfer pricing currently works, when software licenses and other major assets are up for renewal, which contracts can and can't be renegotiated, what servers are shared across other businesses that you're not buying, etc. There's a lot to sort out. Issues related to these complexities are probably the

biggest source of value creation—or value destruction—in a TSA.

How has the role and importance of technology changed in the time you've worked on carve-out transactions?

Rabbani: Technology...has a profound operational impact—you are essentially "standing up" a new company for which the technology backbone either doesn't exist or must be surgically removed from ongoing operations in the parent with-out breaking the parent company or the division being sold. The PE industry now must use multiple lenses to understand the technology impact on any potential deal. So many business processes are automated, and so many functions are tech-dependent.

What are some common tech issues that can be addressed in a TSA?

Rabbani: To increase flexibility and manage costs, we look at how much of the parent's legacy technology can be migrated to cloud-based applications. There are cloud-based solutions, services, and infrastructure available now that didn't exist five, 10, or 15 years ago when these companies built and deployed their technology platforms. Much of what's available now is more cost-effective and easier to scale up and down with revenue growth or contraction versus large fixed costs. Very often, for example, the new company won't need to own lots of hardware or invest in data centers. Another thing we also look at closely is software licenses. If the parent company is licensing software on a large scale, it may be able to get it on very favorable terms. Software suppliers will see the carve-out as an opportunity to create a new contract at higher prices. These factors need to be addressed, or they can lead to negative surprises. ■

Why IT Should Be at the Top of Your Carve-Out List

Experts from Platinum Equity charged with vetting and improving the operations of portfolio companies discuss the unique complexities of helping a carved-out business create standalone IT infrastructure

Privcap: What is the importance of getting IT right when trying to stand up a former corporate division as an independent business?

Stephanie Barter, Platinum Equity: The IT component of a carve-out can actually be the most important task. It needs to be in place in order for us to ultimately realize our value-creation plan. So when we've got a vision of how we will transform an organization, in many cases we can't start until that company is actually carved out from its parent. And in many cases, IT is the long pole in the tent. Until that can get done, there are many, many other next-step things that cannot be completed until that's taken care of. So when we think about this in terms of the project plan, this is always at the very beginning of the list.

Eric, what do you look for during due diligence in a carve-out situation?

Eric Yap, Platinum Equity: When we start our IT diligence, we try to understand how the business operates. We try to understand what complexities could be within the business that actually would drive complexities from an IT carve-out perspective. So a quick understanding of the lay of the land on the business side helps drive the same activity within IT diligence.

And then we dive down into the specifics of activities that need to be taken care of to actually separate the entity from the parent.

What are the key IT risks when separating a unit from its parent?

Yap: There's a risk that you don't have access to the knowledge that you need. And then there's also some contractual items—for example, a limited TSA period that could put risk on carve-out activity.

Barter: Every traditional systems-implementation or technology-conversion risk also applies to a carve-out. In a carve-out, you're getting something that you didn't build, getting something that you don't have full control over. So it accelerates risks to a unique place.

What are the human-capital challenges in transitioning the IT function from parent to carve-out?

Yap: It's deal-dependent. Your team is completely dependent on what is coming over and what is not coming over. And so in some deals, there are capabilities within IT organizations to take on the majority of the transition work themselves. But sometimes we're building IT organizations from the ground up, because you inherit no resources in the deal.

Barter: The Platinum team is a resource for the portfolio companies. We can bring very experienced resources. Tasks like separating email, separating back-office infrastructure, doing the systems conversions—these are things that our group has done hundreds of times, and there is a predictability. This makes a difference in your ability to predict the outcomes. ■

CD&R Leading the Way on Healthcare Divestitures

PE firms need to become carve-out specialists in order to make it in the sector

While healthcare has been a robust source of private equity deal flow, valuations are on the rise. As a result, firms are beginning to see the benefit of executing corporate divestitures as a source of dealmaking at relatively reasonable prices. Yet these complex deal structures often require an added layer of expertise for the private equity firm.

“Every divestiture, including those in healthcare, offers inherent complexities and nuances,” explains Derek Strum, a partner from Clayton Dubilier & Rice. “There is often an ongoing commercial and financial relationship with the seller, and the buyer must be a trusted steward for the business.”

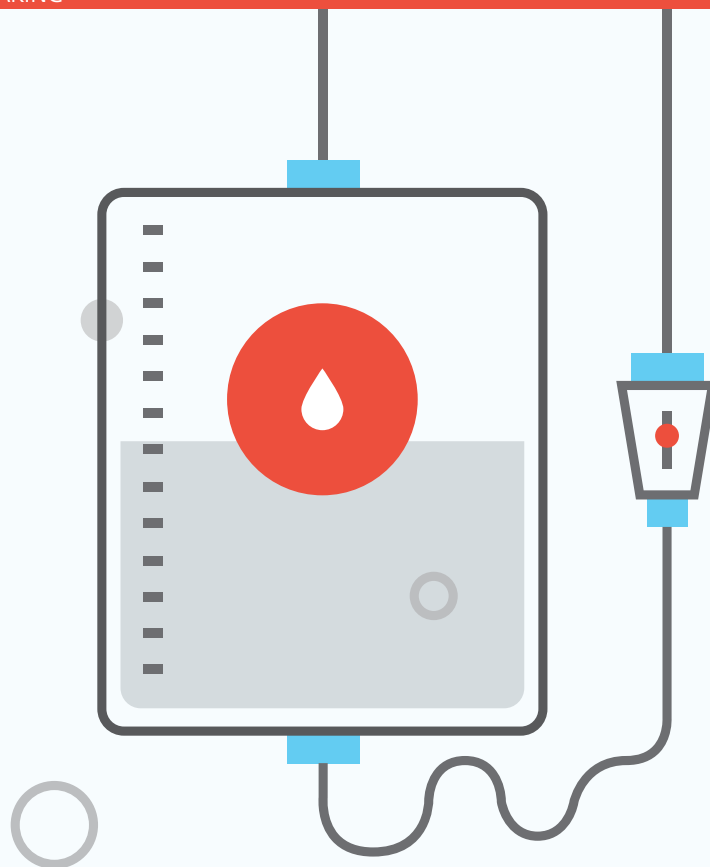
Carve-outs in the healthcare space often require passing FDA regulatory hurdles, which can take up to 24 months, on top of executing the deal itself and creating a standalone business. In the meantime, the owners of the newly formed entity must maintain the business and customer relationships.

For instance, government approval for healthcare companies to relocate facilities often takes many months. While waiting for approval, the new standalone business will need to continue to use a facility that now belongs to a different owner.

“You need that strong, positive relationship with the seller to ensure continuity for the new independent business,” explains Strum.

For CD&R, which recently closed its latest fund on \$10 billion in capital commitments, executing complex carve-outs is all in a typical day’s work. Strum estimates more than half of CD&R’s total number of deals in its 35-plus-year history have been carve-outs.

The firm most recently announced its agreement to acquire the dental digital business of Carestream. The company provides imaging systems and practice-management software for general and specialist dental practices worldwide. The new company will be named Carestream Dental.



Strum characterized this deal as a “carve-out of a carve-out,” noting the firm is not separating the entire dental segment from Carestream’s medical segment, but rather carving out the digital dental piece only. Carestream will keep the other parts of the dental business, creating further complexities in the carve-out.

CD&R will leverage its operational expertise to accelerate growth, including relying upon the expertise of advisor John Dineen, who led GE’s \$18 billion healthcare business. The firm will also work with deal partner CareCapital Advisors Ltd., a specialist investment platform focused on the dental and consumer sectors in Asia.

Strum says healthcare today, particularly for medical products and devices, is maturing and will continue to do so. That means companies will need to off-load non-core businesses that are underperforming their growth and profit potential. That, in turn, will offer an opportunity for private equity firms that can bring expertise in executing these types of complex deals, and in instituting significant operational capabilities, to create true value.

“We will continue to provide solution capital to these business units that have potential, but are lacking the focus and resources needed to optimize their success,” says Strum. ■

What's Behind the Surge in Software Deals?



The race toward digital transformation is driving rapid change in the software space—and that's driving interest from private equity

Experts from Autodesk, Thoma Bravo, and RSM US LLP discuss what smart investors need to know about the booming private equity opportunity in software, including what the most attractive sectors are, the exit environment, and key drivers of success.

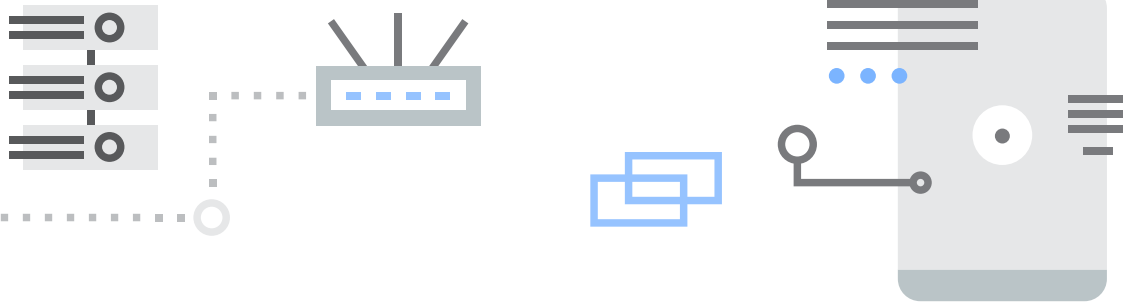
Privcap: There has been increasing momentum in the number of PE deals being done in the software space. What's driving this deal volume?

Arvinth Kumar, Thoma Bravo: Technology is a high-valuation environment, so prospective sellers are inclined to sell. Also, interest rates are very low, and there's a ton of cheap capital out there. What's more, software as an asset class—and technology more broadly—has really grown compared to other cyclical markets such as energy and retail. As digitization and automation have become more and more important globally, software has played an essential role in that transformation.

Rob, what are you seeing from your perspective? What's drawing buyers and sellers in today's market?

Rob McIntosh, Autodesk: One big driver of activity, particularly within some of the enterprise software markets, is changing business models. Companies are trying to drive more contemporary business models and platforms. Certainly there are a lot of startups that are active in developing great new cloud solutions. But in older businesses like Autodesk, we're seeing a big effort toward trying to drive a business model transition—i.e., moving from perpetual software to term-based software—as well as a transition from boxed software products and electronically delivered products to pure cloud-based products. So, within our sector, we've seen a tremendous amount of consolidation as older businesses try to cross that chasm, which requires new talent, new

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back-end systems, new delivery methods, maybe even new sales channels. Certainly, in older software businesses, that has been a huge driver for their M&A activity.

David, you talk to a number of clients active in this space. What are you seeing?

David Van Wert, RSM: Technology is now touching pretty much all industries, and that's leading to M&A opportunities, which is resulting in the constant change and disruption that we see. That's just the nature of the technology industry—rapid innovation refills the M&A pipeline. There's never a true shortage of good companies out there, compared to some other industries. In other industries, you might see a lull after a surge in M&A, because a lot of the best businesses have already been bought.

The healthcare software space is particularly active these days. What is the opportunity there?

Kumar: We're seeing four key themes: revenue cycle management, alternate payment models, data analytics, and the post-acute space. On the revenue cycle management side, there's an increased need for productivity and accuracy—for hospitals and providers to get paid faster and have fewer denials.

That gets to the second theme, which is alternate payment models. There's been a shift to value-based reimbursements, so if you have good outcomes as a provider, you can get paid more. If you have bad outcomes and people keep coming back or stay

in very expensive settings, you get paid less by insurance companies and by the government. There are a lot of technology companies that help assist in that transition.

Third is data analytics. There are lots of systems in healthcare that don't talk to each other, so lots of data gets lost in translation. It's critical to be able to, first, gather data, second, to understand what it's saying, and then, third, to make it actionable. There are a bunch of companies that can help with that.

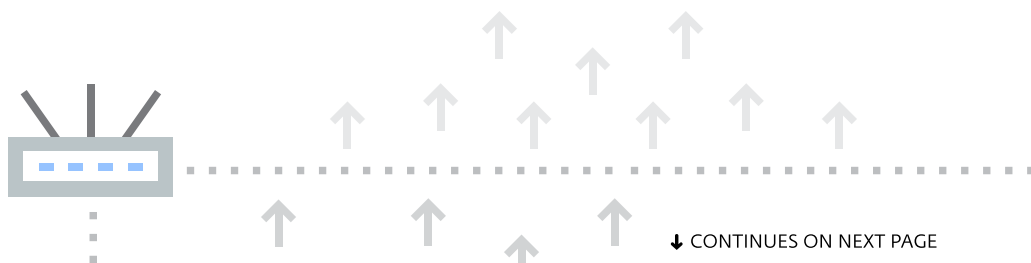
Finally, there is the post-acute space. In-patient hospitals are trying to shift to lower-cost settings post-acute. So they're expanding care across the continuum into home health and into building nursing facilities and long-term-care facilities. There's an aging population with chronic conditions who need to be cared for in an increasing volume, given the baby boomer phenomenon. Having healthcare technology systems that can help address that has become an increasing focus for healthcare investors.

There is also growing interest in cybersecurity. David, can you talk a little bit about that opportunity?

Van Wert: Cybersecurity is in the headlines on a daily basis, most recently with the Russian hacking of the DNC

[Democratic National Committee]. I think all of that creates a lot of hype and brings new entrants into the market. One interesting trend that we've been seeing is that cybersecurity companies are also becoming targets, just because of the confidentiality of the information they have access to. That can be extremely damaging to the reputation of the business, and it can also crater a business whose core competency is cybersecurity. I'd liken it to the front page of the *Wall Street Journal* saying, "David Van Wert doesn't know how to balance his checkbook." I think that would be extremely damaging to my reputation as an accountant.

Just given the threat to some of these cybersecurity businesses, that leads to additional risk to corporate acquirers or private equity acquirers that are looking to invest in these types of businesses. You don't want to take on a time bomb or a land mine. Also, from an M&A perspective, there has been a lot of froth in the market for security. There has been significant activity and high multiples. And given all the new entrants, I would expect that there will continue to be very active M&A activity in the cybersecurity subsector. But I think we will see the best businesses being acquired, and a lot of the pretenders that have gotten in just jumping on the bandwagon will be falling off.



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What about older software companies looking to adopt new models? What is the opportunity, and what types of companies are doing this?

McIntosh: Anybody who follows [Wall] Street can see that companies on a term-based pricing model are typically more highly rewarded. It's a good model for shareholders, because it's a more reliable business model. It also ends up being the right model for your customers, because you're able to provide a more minimal upfront capital investment. We've seen a number of companies starting up and entering our space and others, because the cost to create these companies is lower than it's ever been before. Startups can leverage platforms like ours or Salesforce...to get to scale a lot faster than they could if they were to build a traditional enterprise software company.

What does the deal environment look like today in terms of buyers and sellers?

Van Wert: Given that multiples are still very high, based on historical averages, the market is very attractive to sellers. One thing that is probably keeping buyers and sellers apart is the lack of preparedness among sellers. Sellers might say, "Yeah, we're going to get a great multiple here and a great purchase price." But they haven't really done the blocking and tackling to prepare for a sale. We've seen the technology industry lag other industries in adoption of sell-side diligence. In terms of who's really calling the shots in a deal, I would say any transaction is a negotiation, when it comes down to it. And it probably depends on what type of deal you're talking about. For instance, a seller probably has much more negotiating power if it's a non-exclusive auction transaction versus a proprietary deal versus maybe a minority investment, where it truly is a partnership going

forward and no one wants to draw blood from the other party during the transaction.

Arvinth, what are you seeing in the deal environment?

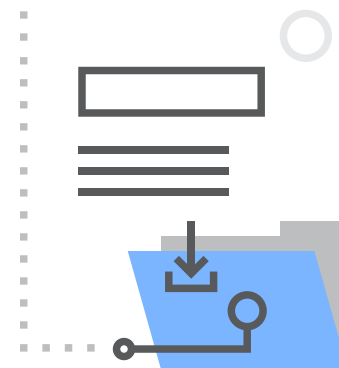
Kumar: It's pretty bifurcated. On the one hand, we're seeing very high-quality private companies not traded in the public markets. There's a scarcity of good assets out there—companies with a lot of recurring revenue, very high retention rates, stable end markets, pricing power, high EBITDA margins, high growth margins. There's not that many of them, especially in the size range that we transact in. So there's a supply/demand imbalance. On the other hand, on the public side there have been a bunch of transactions where companies came out with very hot IPOs but were not mature, not super well-run, and they keep missing quarters of earnings. So we've seen a huge amount of growth in take-privates by activist investors just because of poor guidance and missing numbers consistently.

Rob, can you talk about the deployment of capital and what's driving volume?

McIntosh: Traditionally, we haven't seen a lot of private equity players involved in our space. Maybe the attractiveness of the sector is increasing, but it used to be that when we came to bid on a deal, if a private equity player was involved, they typically couldn't move that fast or they just had tertiary interest. But recently we've seen private equity players coming in and bidding much more than the strategics. Maybe my sample set is small, but I probably had five to 10 transactions in the last year where the sponsors were outbidding the strategics—in some cases by a factor of two to one. So it does seem like there's some amount of capital overhang here that's driving activity.

As an investor, how do you protect yourself in a market like this with high valuations and a lot of competition for deals? How do you make money?

Kumar: It's tough. We're seeing a lot more competition [from] tier-three-type sponsors that haven't been in software technology trying to get in, and they're just overpaying, which they know and we know. We only buy the right assets where we can add value through operational improvements. These are companies that have very high revenue quality, but are just not managing the business the right way. We also try to focus on companies that have a fragmented end market where we can do M&A to either extend product lines or buy competitors or go into new geographies. And that adds more earnings that you can borrow more against. Software has great characteristics in that respect. ■



Where to Look for Your Next Digital Media CEO

A CEO for a multiplatform media company does not necessarily need to have worked in traditional print media



"Over the last 12 months we have seen private equity firms looking for CEOs, VPs, and chief marketing officers who know how to innovate and transform in a multiplatform space," she says. "You don't necessarily need someone who worked 20 years in a newspaper—it could be a leader who switches from e-commerce or consumer business to digital media."

"At the end of the day, there is a lot of appetite for someone who has an eclectic background, a high aptitude to navigate change, knows how to engage consumers and move in different directions based on what is happening in the market."

For candidates, the attraction to working for a private-equity-owned firm is the prospect of less "red tape," particularly for those coming from large public companies, she says.

"There is a lot of motivation to be part of a portfolio business—the pace is quick and it requires attention to detail," says DeCastro. Executives also see the exposure as a résumé builder.

A big part of attracting and retaining talent at the portfolio company is the opportunity to later transition to a role within the PE firm itself or within another portfolio business. The key to doing so—and to executing the required turnaround—is building a strong relationship with private equity management, DeCastro notes.

On the compensation side, executives have been more open to reducing the cash component of the offer in exchange for equity participation.

The contracts also usually tie the compensation to the company's performance, providing an incentive for the executives to do their best.

"Especially coming from large institutions with a lot of structure, people really like the value-creation opportunity," says DeCastro. ■

Hiring at portfolio companies in the digital media space is up as private equity firms increasingly seek out "traditional" media plays in need of a turnaround.

Faced with a shortage of qualified prospects in the industry, PE firms are becoming more open to bringing in C-level executives from other industries, says Jennifer DeCastro, a former principal with Korn Ferry International, an executive search firm in New York, who conducts C-level searches for mid-cap companies in digital media, publishing, cable, and advertising, among other sectors. (DeCastro is now a partner with the search firm True Search.)

The Spinout Chief

A Conversation with Ridgemont's COO

Ridgemont Equity Partners' chief operating officer, Ed Balogh, discusses how he built the operational side of the firm from scratch when the group spun out from Bank of America

Privcap: How did you end up launching Ridgemont out of Bank of America?

Ed Balogh, Ridgemont Equity Partners: Our firm's genesis within Bank of America and its predecessors, NCNB and NationsBank, dates to 1993. I was a CPA at PriceWaterhouse before joining NationsBank in 1995 to support the firm's private equity business. I quickly became the controller for several corporate finance and investment banking lines of business, but I really gravitated to the private equity business, Banc of America Capital Investors. I joined BACI in 1998 and later became the CFO. After Bank of America acquired Merrill Lynch, the BACI platform merged with the Merrill Lynch Global Private Equity business. During this time, I became the COO of the combined BAML Capital Partners. That experience served me well, as the former BACI partnership spun out to form Ridgemont Equity Partners in 2010.

What did that spinout require from you?

Balogh: As the CFO of BACI, my responsibilities were similar to my counterparts at independent private equity firms. As Ridgemont was formed, we felt good about our finance functions, but systems still needed to be implemented. While I managed operational elements during the integration with Merrill Lynch, after the spinout I became a COO in every sense. While I certainly had ideas of my own, I sought advice from our attorneys and my peers at other private equity firms of a similar size. My team and I went about putting into place Ridgemont's middle and back office. This included the HR department, with a payroll system, a health insurance benefit program, and 401(k) plans. We also implemented online treasury management, travel and entertainment expense reporting, and financial reporting systems.

I wore a general counsel hat as well. While I'm not a lawyer, I am in the weeds with these documents, coordinating with outside counsel. During fundraising, while keeping our senior partners apprised of the negotiations with our LPs, I negotiated all the partnership agreements and side letters. I'm also one of four senior-level members on our valuation committee, which approves all the valuations for our portfolio companies in a certain fund on a quarterly basis.

When we were required to register with the SEC in 2012, I also became our firm's chief compliance officer. In terms of IT, we use an outsourced service provider that charges by the hour, which by the end of the year adds up to the compensation for a seasoned, if not senior, tech executive. This also eliminates the risk of an in-house CTO not staying abreast of technology changes or leaving the firm.

You don't outsource your fund administration. How did you build your in-house team?

Balogh: I don't feel comfortable with a third-party administrator, given the complexity of some of our vehicles. I am also concerned that an outside administrator may have turnover in their staff, which may lead to inconsistent levels of service. We have a great team, and we use an industry-leading financial-reporting-technology platform. Our controller joined us from Bank of America's tax department when we formed Ridgemont. We later added an assistant controller out of a public accounting firm before we closed our first independent fund in 2012.

In 2013, we continued to institutionalize Ridgemont by hiring a vice president of investor relations. She came to us having had experience at two middle-market firms, and she was instrumental in helping us raise our second fund that we closed at \$995 million in 2015, up from our debut fund of \$735 million. ■



Ed Balogh
Chief Operating Officer,
Ridgemont Equity Partners