Privcap/ Report

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Getting Growth Right

Strategies for taking successful, PE-backed companies to the next level

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How PE Firms Help Companies Avoid 'Foolish' Growth

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For many companies, high growth means high-class problems.

Whatever the industry, rapidly growing companies often find they need to upgrade areas of the business that got overlooked while the business took off. The best private equity backers are experts at helping these companies transform into more mature, scalable businesses. That often entails shoring up the finance function and formalizing corporate governance.

The Finance Team as Strategic Partner

Russ Pyle, managing partner at Boston–based Guidepost Growth Equity, says of his portfolio companies: "Because they're bootstrapped entrepreneurial businesses, our companies tend to have two types of employees: employees who make stuff and employees who sell stuff… One of the places that they tend to underinvest is in finance."

Pyle says his firm encourages these companies to view the finance team less as a reporter of historical data and more as a provider of strategic guidance for the future. "Finance should help the senior leadership team understand what the KPIs are that they should really be looking at to drive better outcomes," he says.

Because of the underinvestment in the finance function, the entrepreneur who founded the company has difficulty figuring out the best way to add people and resources to meet growing customer demand. Brian Rich, managing partner of New York–based growth equity firm Catalyst Investors, says he often works with companies that have a great product but don't know how to profitably build out a sales team.

Rich adds: "You could quickly build a sales team and also experience great growth, but if your key ratios aren't in line, you are spending money foolishly."

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Founding CEOs that have been enjoying strong growth have often not deeply analyzed important dynamics linking costs to revenue growth. John Pennett, a partner at EisnerAmper LLP, stresses that this more sophisticated understanding needs to be in place ahead of an exit, because the acquirer will want to know where specifically to invest in the business. Having a deep understanding of the fully-burdened costs to deliver that revenue is critical in being able to talk about valuation of the business and forward-looking profits.

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>
> **-Brian Rich, Catalyst Investors**

"You need to be able to convince the person sitting across the table from you that you have a clear understanding of where the money is being spent, and what the ROI has been and is expected to be down the road," he says.

The process of more deeply understanding the particulars of revenue generation is also an important part of learning how to identify and company's best practices and make them replicable.

"A situation we often see is companies that are highly dependent on a couple of key sales executives," says Pyle. "We can help them take what has made those couple of reps very successful, and then make it into a repeatable sales process."

An Independent Board, Stronger Governance

In addition to helping to formalize a strategy around growth, the best private equity backers can help their portfolio companies to upgrade and formalize corporate governance, including the role of the board. A strong system for corporate governance is another feature that potential acquirers insist on.

Installing top-notch corporate governance involves many little things, Pennett says. "It involves having independent board members where you're getting good advice from experts in the field. It involves having audit committees, whistle-blower hotlines, documented policies and procedures, and SEC-ready financial statements."

Pyle tells the story of a company his firm backed that had a charismatic, tireless CEO who explained his board setup as, "Yeah, we have a board. We get together once a year over a nice dinner and a couple of bottles of wine, and we talk about the business."

"I said, 'That sounds like a delightful way to spend an evening, but that's not a board as we see it.'"

Guidepost helped the CEO to establish a board that included an independent director, and to set up compensation and audit committees.

Pyle says that when his CEO realized the benefits of this upgraded board and corporate governance, he was "over the moon." ■

Expert Q&A:

The Case for Both Sell- and Buy-Side Due Diligence

In a recent interview, John Ruckstuhl, who leads the transaction advisory services practice at EisnerAmper LLP, discusses how he works with private equity groups to perform buy-side and sell-side due diligence.

Privcap: With the demand to put capital to work, what is the impact on the deal market?

John Ruckstuhl, EisnerAmper LLP: In some cases, the availability of capital is increasing multiples. But it's also slowing the deal process down a little bit, especially private equity groups that don't get financing lined up early enough in the process. We see deals that get delayed because our clients are negotiating with the different providers.

There's a lot of competition, which is good. But like going to a diner, sometimes too many options can be a bad thing as well.

Do PE firms with better access to financing have an advantage?

It all comes down to speed of close so, yes, a private equity firm with financing lined up has an advantage. Other advantages are the strength of your bid. Many times, it's not just financial terms, not just multiples, but the right fit. What are you going to provide the company that they don't already have? We see many deals where the highest bid is not always the winner.

Is the debt market an indicator of the tail end of a cycle?

I think we have a good two years of runway left. We're seeing debt multiples creep up. After the 2008 crisis, we saw that the amount of debt in each deal decreased to where it was a 50-50 debt-to-equity multiple. Now we're seeing debt levels get up to 60, in some cases 70 percent.

What are the factors killing deals today?

It really comes down to preparation. You still see investment banks at the lower end of the middle market that don't mandate sell-side work. Typically, surprises come up in the financials. That's because management teams are over extended and either don't know their numbers as well as they should, or these are companies with relatively spotty financial reporting systems.

John Ruckstuhl
Managing Director,
Transaction Advisory Services Practice Leader,
EisnerAmper LLP

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For the buyer, what is needed in preparation for a sale?

A lot of times it comes down to understanding the metrics. With a financial buyer in the picture, helping them understand what's happening with the operations through the numbers is the best way to explain a business, especially to a non-operator. Numbers do wonders to explain key performance indicators that help to inform a buyer of the financial health of a company.

Why is sell-side due diligence important?

The biggest thing with sell-side due diligence is helping a company prepare. Investment bankers are helping the company with the process and evaluation of the industry. We focus on making the finance team smarter and more prepared— anticipating questions, developing answers, and identifying potential red flags in advance that can be mitigated up front.

For CEOs that are unfamiliar about what it takes to sell to a private equity firm, helping them understanding EBITDA, the value of their business based on the numbers, and the importance of managing cash flows is critical.

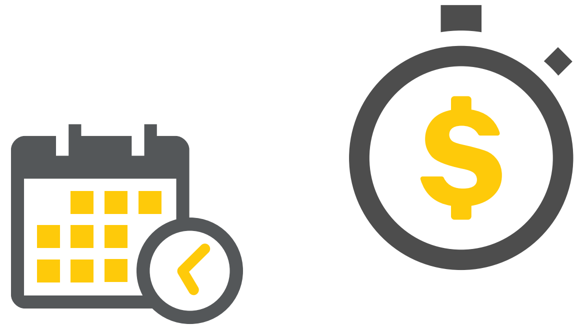
No surprises, in other words?

The worst thing that can happen is a surprise comes up, especially towards the end of the process, because then nobody wins. Also, just on speed of close, the longer a process goes, the more attention management starts devoting towards the transaction and not the business, and the greater the risk that the operations will suffer. And you get into this spiral of declining results. The buyer wants to reduce the purchase price, and the deal becomes the consuming factor, as opposed to what made you successful at the start—and that's the running of the business.

How should a buyer manage competitive bidders?

Most companies underestimate the amount of time and effort it takes to go through the process. It is an extensive process that takes months, if not a year, from when you first start engaging an investment banker and considering a transaction to when the deal will ultimately close.

Getting people to help you through that process is important—again, so you can focus your time on running the business and let other experts help you with the process. ■



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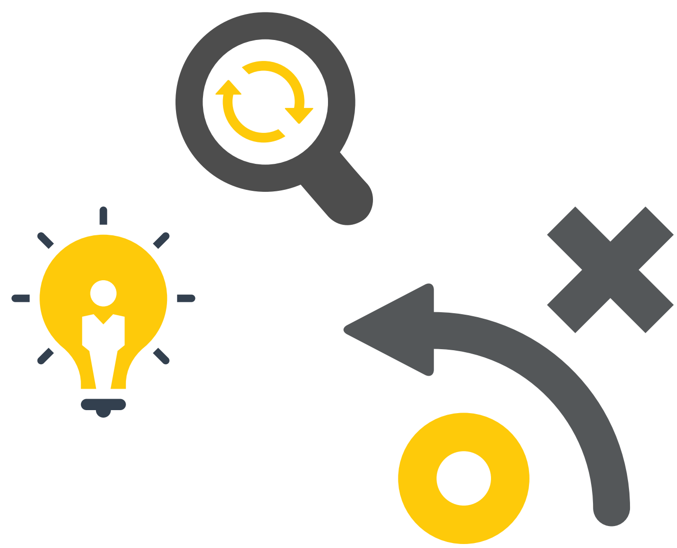

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