

A former senior executive from Ontario Teachers' Pension Plan (OTPP) discusses the mission of the firm he co-founded, Toronto-based Peloton Capital Management. This interview with Steven Faraone includes the perspective he gained at influential direct private equity investor OTPP, investing through the COVID crisis, the deal flow benefits of being a long-term investor, and healthcare services as an essential business vertical.



Steven FaraoneManaging Partner,
Peloton Capital
Management



Ben GibbonsNational Private Equity
Industry Leader,
RSM Canada

Steve Faraone, Peloton Capital Management: I grew up in Western Canada—the Vancouver area—and went to University of British Columbia, then started out my career in banking within BMO. They had a merchant banking group. Some of the team there were presenting their strategy. I thought to myself, "That sounds like a pretty interesting line of work." You get to sit back, try to pick the best companies to work with, and make investments.

Gibbons: Tell us a little about your time at Teachers'—some of the interesting deals you worked on, what you're proud of, some of the accomplishments, etc.

Faraone: I joined Teachers' in 2002. [Former CEO] Jim Leech had just joined the prior year and was building out the private equity strategy. He had a mandate to really grow the direct investing capabilities of Teachers' [OTPP]. OTPP was doing a lot of fund investing and co-investing at that time, but they had a mandate to grow their direct sourcing and value creation. So, I thought, this is a great place to go and get some deal experience, to learn a bit. That was in 2002. I ended up staying the next 16-and-a-half years at OTPP. What kept me there so long was its tremendous culture and great people.

In the early days, everyone was a generalist. You would look at a book of industrials one day, then a financial services deal the next day, then a consumer deal the next day. And it was a lot of fun. The risk in that is that you make mistakes because you're not a sector expert. In 2007, we had a change in leadership at OTPP with a new head, [Erol Uzomeri], who is now one of the founders of Searchlight Capital. He made the decision to have us focus along sector lines and he asked me if I would do financial services. One of the first things I did was recruit Mike Murray, my co-founder at Peloton. I recruited him to join me in the effort to build out the financial services team. Then, after a few years, I was asked to take on the healthcare team as well. Then, I later took on consumer.

Powerhouses in PE

Some of my biggest accomplishments were actually in situations where you had a roadblock or a speed bump, where you had performance issues. A lot of being a good private equity investor is, how do you react to those issues? How do you partner with management and how do you navigate your way through it in a way that is successful?

Gibbons: What were the influences from your OTPP years that ultimately led you to Peloton?

Faraone: As you get more senior at OTPP, you start doing more internal things and more administrative things, which is fine. But I thought about, what do I really enjoy? I really enjoyed working with companies, investing in businesses and helping them grow. So, I wanted to make sure I could keep doing that. Mike and I both were at the stage where we wanted to take some risks, to do something entrepreneurial. The other piece was, I always found working with smaller companies more fulfilling, because they're not typically as sophisticated. There's more opportunity to add value and you can move the needle a little more easily. We saw this opportunity in the lower middle-market to take some of what we had been doing at OTPP and bring it to Peloton.

Gibbons: Was it a difficult transition from OTPP to Peloton?

Faraone: Even in my final few years there, we were buying businesses that would actually be in the Peloton sweet spot. And that was often a function of how competitive and highly valued the markets were. We found ourselves always wanting to go smaller, because you could buy a platform and grow it, and bring your multiple down through tuck-ins and things like that.

The other important part of Peloton is Stephen Smith. Stephen is the founder of First National Financial Corp., which is a publicly traded business. He's also involved in a number of other businesses. Mike and I have known Stephen now for over a decade. We did a deal with Stephen when we were at OTPP. When we left OTPP, we were looking for capital partners and we started talking to Stephen. One thing led to another, and he ended up coming in as our largest investor and also the Chairman of the firm and on the investment committee

Gibbons: Tell me about the name Peloton.

Faraone: Stephen and Mike and I are all cyclists. The Peloton in cycling is the group of riders who are working together, drafting off each other, and getting somewhere more efficiently.

Gibbons: Talk about your long-term capital approach and your relatively distinctive fund structure.

Faraone: Mike and I both found at OTPP that we often saw unique deal flow or proprietary deal flow because of the long-term capital profile that OTPP had: founders, families and CEOs that were

looking for that eight- to 10-year partner, not the three- to five- or six-year partner. We thought that was a real, tangible advantage. At Peloton, we have a 15-year fund life, which is five years longer than a typical private equity fund. It doesn't mean we have to hold things for a very long period of time, but we have flexibility to say, "We're in year five or year four, and we want to go for another three to four to five years," which is a nice optionality to have. We often saw businesses being sold by one private equity firm and acquired by another, and the two groups would both do well. You start to think about how, if the original group had continued to own that business, what would be the returns? Then, I'd say that there are a lot of great firms in Canada, but a lot of them have moved up in deal size. They've gotten bigger. And, in the lower middle-market, the competitive dynamic relative to the U.S. especially is pretty good.

Gibbons: Your broader strategy involves healthcare, financial services and consumer products. But Peloton's first three transactions were in healthcare. Why is that?

Faraone: We've spent the most amount of time in financial services and healthcare services. When we look at our pipeline, it's actually been pretty equally weighted. So, we haven't intentionally been looking to do healthcare services. What we like about all three of our businesses is that, first of all, healthcare services are relatively essential. Even in times of COVID, it's a good place to be, because these services are needed and they can't be deferred. So, there are great macro trends, and these are fragmented industries where we could pursue a buy-and-build strategy, which Mike and I did a lot of at OTPP. Then, the last point is that, for all three of them, we've partnered with founders. We're the first outside capital that's come in.

Gibbons: What do you think LPs found attractive about the Peloton story?

Faraone: I think team, track record, strategy, and then, pipeline. When we were out fundraising, the early lesson was that you need to have all four of those things before someone will invest or commit to your fund. One of the things that was important was having Stephen Smith's involvement. He helped to get us started and really helped bring credibility as we went out to fundraise. This allowed us to recruit a team, allowed us to attract other investors, and allowed us to do deals as well.

Gibbons: So, what have you seen change over the last 12 months? Has COVID changed your approach to investing?

Faraone: We've probably shifted a little bit more toward essential businesses that have a strong essential component to them. We now have the ability to diligence and to interact on multiple deals at the same time with virtual formats. You can actually do more diligence meetings, more manager meetings. You don't have to fly, spend the night in a hotel, meet that next day, and then fly back. You can literally spend three or four hours with a management team, take a break or not, and then get on with the next one.

Gibbons: What were the challenges and opportunities during COVID for your portfolio companies?

Faraone: It was very challenging. I remember the Sunday night where we decided to close all the dental clinics across Canada. We could still do emergency [procedures], but it was a bit of an uncertain time. We didn't know how everything was going to play out. The veterinary business stayed open and pivoted, as pet owners know, to curbside service right away. That actually was fine. Then, the third business is a fertility platform. We actually didn't own it when COVID first hit. We invested over the summer. They did have to shut down as well in the initial days. So, trying times for sure.

Gibbons: I'm curious about the community aspect of Peloton. You signed up for the Principles for Responsible Investing [PRI], which is becoming a much more important factor in the private equity community.

Faraone: OTPP was one of the early movers on ESG as an important topic. Early on, we were incorporating ESG assessments into our investment memos. When Mike and I left to form Peloton, that mindset continued. We think PRI aligns with better long-term investment outcomes and it's good risk management.

Gibbons: How do you push some of those principles down to the management teams?

Faraone: The first thing you can do is put ESG up as a board agenda topic. That can generate a lot of good discussion and generate awareness. Then, the second thing, what we're still perfecting, is what are the right metrics we should be focused on: health and safety, whistleblower hotlines, diversity and inclusion?

Gibbons: How will Peloton thrive over the next five years?

Faraone: You really need to make sure you have a differentiated strategy and approach. You need to work very closely over the long-term with your management teams to create value. ■

