MAKING MONEY THE OLD-FASHIONED WAY

Private equity firms need to add operating talent to their lineups in order to stay competitive. The most successful of these will share substantial ownership stakes with their new partners.

By David Snow

Investment bankers are good at many things, but redesigning the inventory control system at a building-supplies manufacturer, say, may not be one of them.

Having advised on the purchase, sale and financing of many businesses, investment bankers are deal-structure aces and capital-markets gurus, and they know a lot of people. These are valuable attributes to have in a private equity firm. Until recently, in fact, a great many private equity firms saw spectacular success based almost entirely on investment-bank-honed skills.

Today, however, deal-making talent is necessary, but it not sufficient for private equity success.

Significant changes in the market and economy have left many private equity firms staffed up for an opportunity that has come and gone. There is a somewhat pejorative bit of jargon for what many private equity firms did to produce returns in the erstwhile boom years: "financial engineering." This term connotes the application of leverage and the negotiation of sponsor-friendly capital structures, among other things. But it does not connote transforming and improving the core operations of a company.

Jacob Thomas (all)

When the economy was pointed up, the earnings growth at private-equity-backed portfolio companies largely took care of itself. This made the work of private equity general partners much easier, or at least it played to their strengths. Indeed, economic momentum, coupled with cheap and abundant debt, facilitated impressive feats of financial engineering throughout the early 2000's that allowed the private equity industry to grow to dimensions not previously imagined.

Most of the well-known private equity firms that raised funds in the early 2000s went on to produce spectacular returns. These firms were able to raise much larger subsequent funds because of their great success with the early 2000-vintage vehicles, which had the good fortune of having acquired solid companies on the way out of a recession. The subsequent strengthening of the economy and loosening of the debt markets meant that private equity firms were able to realize all kinds of value from their investments. Not only were these companies growing organically, their sponsors were able to pay themselves and their investors fat dividends through artful recapitalizations.

That game has changed, however, and as the economy and credit markets return to health after the Great Recession, the private equity playbook of the last cycle will not be closely consulted. Leverage can no longer be counted on to create sufficient value in a private equity investment. In addition, sea changes in technology and the interconnectedness of the global markets have left companies all over the world in need of more than just capital. They also need operational leadership and strategic redirection. The private equity firm of the future will be able to provide all of these elements.

Keeping customers happy

Mirroring the needs of their portfolio companies, what private equity firms need today above all else are partners who can indeed redesign the inventory control system at a building-supplies manufacturer. The stakes are high — if general partners can't help their portfolio companies perform better, their firms risk extinction in an increasingly Darwinian fund-raising market.

The institutional investors who back private equity funds are slowly beginning to emerge from the debris of the economic crisis. These limited partners have less money but more questions for their private equity fund managers. The good news for general partners is that private equity as an asset class remains relatively attractive to limited partners, recent headaches notwithstanding. But these investors are increasingly choosy about the kinds of fund managers they will back. They and their investment consultants are now armed with several cycles' worth of data on private equity fund performance, and have developed strong views on how to spot private equity groups that have special ingredients for producing above-average returns. Increasingly, these investors believe that operational excellence is chief among these ingredients. They are therefore keen to learn not simply how much value was created by general partnerships, but how the value was created. Leverage, momentum and luck are not the right answers.

Of course, over the history of private equity's development, it has always been difficult to find a general partner who didn't claim to be above all a business builder. Many private equity firms do indeed excel at building, changing and improving businesses. Others claim to, but have failed to fully cross-breed operating talent into their firm's DNA. In the private equity business, there's an old saw that would be funnier if it weren't painfully true: many firms began life as "four investment bankers and a Rolodex." But most have tried hard to evolve beyond this deal-maker genesis.

Structures created to deploy "operating guys" run a wide gamut across the private equity industry. One firm may have several senior full-time partners with industry-specific backgrounds working ceaselessly with portfolio companies to effect change and growth, while another firm will call a retired CEO in from the golf course once a quarter to offer advice and contacts. Both firms will claim operational prowess.

Broadly speaking, the evolution of the private equity industry beyond four-bankers-and-a-Rolodex has produced several species of operating strategy:

Talent on the board. Some private equity firms have added executives and former executives with years of experience in targeted industries to the boards of their management companies.

Special advisers. Executives with specific industry backgrounds often become advisers to one or more deals backed by a private equity firm.

Platform investing. Many private equity firms put together teams of executives specifically for building, acquiring or piecing together companies in targeted markets. In some cases, these executives will go on more than one "round trip" with a private equity sponsor.

Call in the consultants. Although they tend not to brag about this, many private equity firms hire business and strategy consultants to help them set strategic directions for their portfolio companies. This advice is paid for by the portfolio company itself. Some private equity firms, like Kohlberg Kravis Roberts, own affiliated business consulting firms that provide this work.

Driving with a "dashboard." Among the most impor-

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tant trends of the past five years has been for private equity firms to provide centralized resources to their portfolio companies. This approach is often called a "dashboard" because it provides the general partnership with cross-portfolio control of costs and corporate governance. For example, a private equity firm may require all of its portfolio companies to buy into the same health care system, managed by specialist staff members at the general partner level. Besides seeking savings through group purchasing, an increasing number of private equity firms are hiring experts in capital markets, human resources, technology, communications and financial management specifically as resources to be used by portfolio company executives.

All of the above strategies are steps in the right direction and have on occasion been executed with great success by private equity firms. But the private equity firms best positioned to succeed in the long term will be the ones that fully weave operating talent into the fabric of their partnerships. This will be the firm model to beat as private equity regains its footing and again begins to play a major role in the corporate world. It is a model that will reshape the fortunes of many private companies as well as redraw the career maps of many talented executives.

The full operating-partner model will succeed most often because it creates the most powerful alignment of interests between the operators and the other members of the firm.

There are three layers of success in private equity — success of the deal, success of the fund, and success of the franchise or firm. The most powerful incentive structure ties a private equity professional to all three forms of success. In many cases, however, operating talent brought on board a private equity endeavor participates only in the upside of a specific deal or deals. It is, of course, essential that the, say, semiretired specialty-retail executive advising on a private equity firm's specialty-retail investment be given options in the company. But this advisory structure doesn't answer several important questions: Does the firm have the full attention and energy of this operating executive? If the investment goes sideways (as many have recently), will

this operating pro throw himself or herself into stabilizing the business? Is the success of this deal repeatable? Is a meaningful percentage of his or her net worth tied up in the deal? Does this person take a view on the future of the firm itself, its quality of deal flow, its adoption of industry-leading practices?

Crucially, can the private equity firm raise its next fund by showing that value was created by a hired gun?

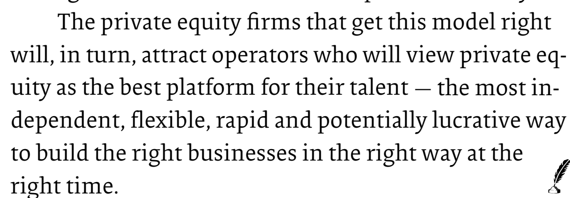
The private equity firm of the future is one in which the "operating guys" are full partners in the firm, sharing in the economics of each deal, each fund and the management company itself. These are full-time jobs,

not consulting assignments. An operating partner, correctly installed, is very involved in the investment committee — sourcing, reviewing and debating the merits of each investment opportunity, especially in his or her own area of expertise. The partner has made a significant investment of his or her personal wealth directly in the deal and in the fund that sponsored the deal. As a full partner in the firm, the operating guy cares deeply about the future of the franchise. Just as this partner seeks to improve the underlying portfolio companies, he or she also seeks to build a firm that is systematically good at building business in key industries, a firm that carries the keys to operating improvement from deal to deal and fund to fund, a firm that proves to investors that operating prowess is in its DNA.

That's the ideal, anyway. Consummating this ideal marriage of financial and operating skills is in many cases a big challenge for today's firms. Private equity is a relatively young industry, and therefore the problem of "founder economics" is pervasive. A person or group of people who have built very successful firms often find it difficult to pass ownership stakes and control to a broader group of people, including operating partners. Some of these founders wonder why they should give shares in the next fund to a group of people who largely were not responsible for the existence of a next fund. They would rather keep a retired CEO on the payroll than absorb the significant expense of luring a successful executive at the height of his or her career into the partnership.

But if these founders care about the future of the firms that they painstakingly built, they'll need to broaden ownership and create permanent, economically compelling roles for operators. The private equity opportunity has changed, and investor appetites for private equity funds have changed along with it. In the next 10 years, the top quartile will be populated by firms that have helped companies race ahead of the incredible changes roiling global business. To do this, they will need to partner with a limited number of executives who can see these changes coming, and who possess the brute managerial force to steer their companies to victory.

The private equity firms that get this model right will, in turn, attract operators who will view private equity as the best platform for their talent — the most independent, flexible, rapid and potentially lucrative way to build the right businesses in the right way at the right time.



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GENERATING CHANGE

CCMP Capital has found investment success by adding operating executives to the partnership

Greg Brenneman, the chairman of the private equity firm CCMP Capital, says the reason his firm's structure isn't more widely imitated is that most private equity veterans are possessed of the wrong kind of avarice.

To get through the often-painful process of giving ownership stakes to new partners in the name of future growth, "you have to be long-term greedy," Brenneman said.

Long-term greed may be what private equity firms will need in order to re-engineer themselves for a changed investment opportunity — an opportunity that requires operating expertise in addition to deal-making prowess.

Since 2008, the New York-based CCMP has added to its partnership three senior operating executives, including Brenneman. The results have been transformative, he says.

Although Brenneman never worked at a private equity firm before CCMP, he was well known throughout the industry as among the best turnaround executives for hire. Brenneman's success in leading the revitalization of Continental Airlines in the 1990s was the first big win for TPG Capital, the private equity firm that backed the deal.

Before making the decision to bring Brenneman on board, the senior partners of CCMP had been well aware that their firm was in a unique position to be re-engineered. Two years earlier, CCMP was spun off by JPMorgan, where the private equity division was called JPMorgan Partners. At one point the largest private equity firm in the world, the newly independent CCMP shuttered operations in India and Latin America, and its longtime chairman retired. The firm's president and CEO, Stephen Murray, began a search for someone to jointly oversee the firm with him. Murray, a veteran of the private equity and banking business, was looking for a partner who had the skill sets of a CEO, preferably someone who had a demonstrated track record of turning around a company's operations a few times, had acquired and divested businesses like an investor, and had done so in more than one industry.

Murray found his firm's next chairman among the leadership of CCMP's portfolio companies. Brenneman was CEO of Quiznos, the sandwich-shop chain, which he had been hired to lead after improving the performance of another private equity-owned chain, Burger King. Brenneman says he was impressed with the role Murray was offering him. He explained, "I was going to be chairman, a full member of the investment committee, a partner in the operating company, a

full partner in the carry of the firm."

In the last year, the firm has added two more people with C-suite backgrounds to its investment committee — Richard Zannino, the former CEO of Dow Jones & Company, and Karl Kurz, the former COO of the Anadarko Petroleum Corporation.

The difference between the roles that Brenneman, Zannino and Kurz play within CCMP and those of the sundry operating advisory gigs found at other private equity firms is material. As Brenneman explains: "What most firms do is hire an industry expert, like a retired CEO. They'll put him in and give him incentives based on the deals he works on. The problem is, that partner isn't focused on the success of the overall enterprise. Because we have fund-level incentives, Rich and Karl have already made huge contributions across our portfolio since they joined."

Project Generac

It wasn't long before Brenneman, the chairman and resident turnaround ace of CCMP, got busy turning around the operations of a challenged portfolio company. CCMP acquired Generac Power Systems in 2006 and has invested, along with several of its limited partner co-investors, $700 million in equity. In 2008, CCMP found itself the owner of an indebted producer of home standby power generators facing a steadily weakening economy. "We looked at it and said, 'Gee, looking forward, the first thing that is going to struggle will be a consumer durable business,' " Brenneman remembered.

Generac's CEO retired and was succeeded by the company's CFO, Aaron Jagdfeld. Brenneman, Jagdfeld and their team then drew up a plan for Generac that included far more than defensive cost-cutting. Generac would expand into a new line of business: portable generators. The company would also raise prices on its core products, despite some protests from management. "Aaron said there's no way we can raise prices — everyone will scream," said Brenneman, who insisted to his new CEO that Generac's customers would be flexible on pricing. "I told Aaron: 'Trust me on this. If it doesn't work, I will share the blame. And if it does work, you'll get 100 percent of the credit.' "

The plan worked. Generac today is No. 2 in the portable generation market, and its earnings before interest, taxes, depreciation and amortization (EBITDA) have increased 20 percent throughout the recession. In February, CCMP took Generac public, raising $247 million.

Generac's upward trajectory is attributable not only to operational initiatives. An additional $259 million in Generac's debt has been retired, thanks largely to the execution of CCMP's partners with deal-making and investment banking DNA. The private equity firm had structured its credit agreements with Generac's lenders so that CCMP had the ability to buy back debt at a discount and exchange it for equity. This capital markets activity, together with the recent IPO, has brought the company's net leverage to 4.6 times EBITDA from approximately 7 times EBITDA at the time of the buyout.

"We took a business that in normal circumstances would have been written down to 20 cents, 30 cents on the dollar, and took it public at 10 times EBITDA," Brenneman said.

Brenneman says that the decisions to raise prices and expand into a new market in an economic crisis were "hard to understand if you've never run a business."

That said, rather than step into the day-to-day operations of his portfolio companies, Brenneman prefers to help set strategy and let the portfolio-level executives, like Generac's Jagdfeld, execute. CCMP "was engaged, on the right items. When you're trying to run a business, the last thing you want is a guy sitting next to you telling you what to do."

Not that executives of CCMP's portfolio companies mind the advice. Brenneman says that more often than not he is approached by these CEOs for counsel. "Being a CEO is very lonely," he said. "They love the chance to sit down with someone who has been there before."

CCMP's greedy bet is that the value created in the dynamic between portfolio company CEOs and its operators will more than pay for the economic cost of letting these executives into the partnership. As Murray said, "We're betting our operating capabilities will increase the overall value created, and I'd much rather take a smaller slice of a bigger pie if it means getting more in absolute dollar terms."