Staying Committed to Private Equity Fiscal Fitness

Focusing on the core is the key to long-term viability for private equity firms; although staying ahead of the game requires attention and hard work.

By Mark Jones

As I type, I am growing increasingly sore as a result of one of those hare-brained ideas to which all weekend athletes occasionally fall victim. The sign at the local YMCA advertised "Intense Training," so I (over)confidently figured that meant an okay workout. After an hour of things that I simply don't do in my PE job — i.e., dozens of mountain climbers, up/downs, bear crawls, planks and rotating medicine ball whatchamacallits — I realized that I'm not as ready for primetime as I was during high school.

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The class instructor maintained casual conversation throughout the ordeal (I'm not sure how) and kept telling us the importance of focusing on our core muscles as every movement we make originates from our core. The core, she said, offers stability, balance and flexibility. Further, while most exercise routines focus on building particular muscles, we can optimize the strength and flexibility of each limb by creating a stable and strong base for those muscles. Perhaps as a way to take my mind off the agony of the moment, my thoughts wandered to how her advice might relate to my day job as a partner in a private equity firm.

Using the "four appendages" analogy, the arms and legs of a private equity shop arguably include limited partners, deal sources, debt providers and portfolio company management teams. These "core" constituencies are all critical to the long-term viability of a firm as they provide the lifeblood of any private equity group: investment opportunities as well as equity, debt and human capital. In each case, the maintenance and articulation of a strong and consistent core will serve the private equity firm well. Depending on the perspective of each "limb," however, the cornerstones of what is core can vary.

The vast majority of PE shops are funded by institutional limited partners. Pension funds, endowments, foundations and family offices alike seek out those GPs with a handful of core attributes. **Mac Hofeditz** is a partner with a leading global placement agent firm, **Probitas Partners**. With almost 20 years of experience, Mac knows the core reasons why limited partners choose a particular GP to entrust with its investors' capital. A proven, value-added track record with numerous high-return realizations, a significant financial commitment in the fund by the GP, a consistent team at the GP level and a constant investment strategy are at the top of any LP's due diligence checklist.

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According to Mac, "A PE firm that can demonstrate the

aforementioned characteristics to the LP community will have a good start on a successful fund raising process. Given the current economic and investment environment, the articulation of these core traits is vital."

The old adage that a private equity firm does the deals that it sees is more truth than clichÇ. ACG CapitalLink now features data on over 1,500 private equity firms and that population continues to grow. That numerical illustration of the maturation of the PE world reinforces the competitive state of the industry. Investment bankers and intermediaries have many choices when choosing which buyout shops to present a particular investment opportunity.

Two key criteria that intermediaries employ are the perceived fit of a firm with the company in question and the relationship between the intermediary and the private equity shop. An intermediary ultimately seeks to smoothly close a sell-side transaction at a premium valuation for its client. By narrowing the audience to those investors where there is a perceived strategic and cultural fit, intermediaries can maximize the chances of achieving their goals.

Strategic fit is not strictly limited to an industry as there are numerous PE shops who are industry agnostic and instead use deal or Ebitda size as a primary criteria. Cultural compatibility is equally important given that a selling process can be both stressful and time consuming with the resulting "marriage" leading to multi-year relationship. Given the impact of a disharmonious relationship on a transaction both before and after closing, the intermediary will often choose not to involve those private equity groups who are not viewed as like-minded with the seller. The intermediary's perspective on the firm's culture can often arise from its relationship with the PE group.

Andy Mason, a managing director with **VRA Partners**, sums it up succinctly when he relates that "buyout professionals would be wise to remember two key rules: one, competition from strategic and financial buyers is pervasive and two, databases have very long memories." I translate that to mean that those of us in the PE universe should be thoughtful and responsive to intermediaries and their clients and always remember our manners. (BlackBerrys, for example, should be checked at the break in a management meeting).

It would be a monumental understatement to say that credit is scarce in the current deal environment. Many lenders are out of the market, whether by virtue of public statements or in a de facto manner via vastly expanded LIBOR spreads and/or credit conservatism. Active lenders are, in many cases, only considering opportunities from those PE groups where there is an existing relationship and a perceived alignment of perspectives and core values. How does a PE group get on a lender's "A" list?

Brian Schneider, a principal with **Northstar Capital**, relates that Northstar "focuses on [private equity firms] with a proven track record in two key areas: one, adding value to their portfolio companies and two, treating all parties in the transaction, lenders included, as partners in the literal and figurative sense." The 2009 deal climate holds "certainty of close" at a level nearly equal to the amount and structure of the purchase price. For this reason, GPs must remember to nurture their relationships with a variety of debt providers and personify the core attributes that are so valuable to lenders such as Northstar.

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This past fall, River Associates completed two new platform company investments. In both cases, a highly competitive process reinforced the significance of what can often be the best (or worst) reference for a PE firm: portfolio company management teams. These teams may have been partners with a given PE shop for years, seen a variety of business conditions, executed an add-on acquisition, implemented complicated growth strategies, breached a covenant with a lender, dealt with personnel changes and a myriad of other thorny issues. Over time, the actions of private equity group speak loudly to these teams about the core values of their financial sponsor.

In both of our recent investments, the due diligence tables were turned and it was us that was under the microscope. Fortunately for my firm, we have always strived to treat our management teams as we hope to be treated ourselves, with professionalism and respect. My sense is that as private equity has become more of an established asset class, the "black box" that once surrounded the industry is more transparent than opaque. Intermediaries often recommend "reverse due diligence" as a matter of course and these reference checks can be the ultimate "tie breaker" when two or more GPs are comparable on purchase price, structure and certainty of close.

I'm not sure as to the timing of my next visit to the "Intense Training" class, but you can bet that I'll remain focused on my core—values and constituents alike.

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