



Private Equity: Industry Under Attack

Improving PE Success in a Changing Climate

A white paper by Gayle Turner
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Executive Summary

The Private Equity industry is under attack on many fronts. Pressure to reduce fees, market volatility, higher interest rates, and increased competition are just a few of the factors making it more difficult to continue to deliver the kinds of returns that have made PE so popular.

In the end, PE firms can bury their heads in the sand, run away—or adapt.

This white paper holds out three time-tested ideas that could help a PE firm deliver better returns.

The Author

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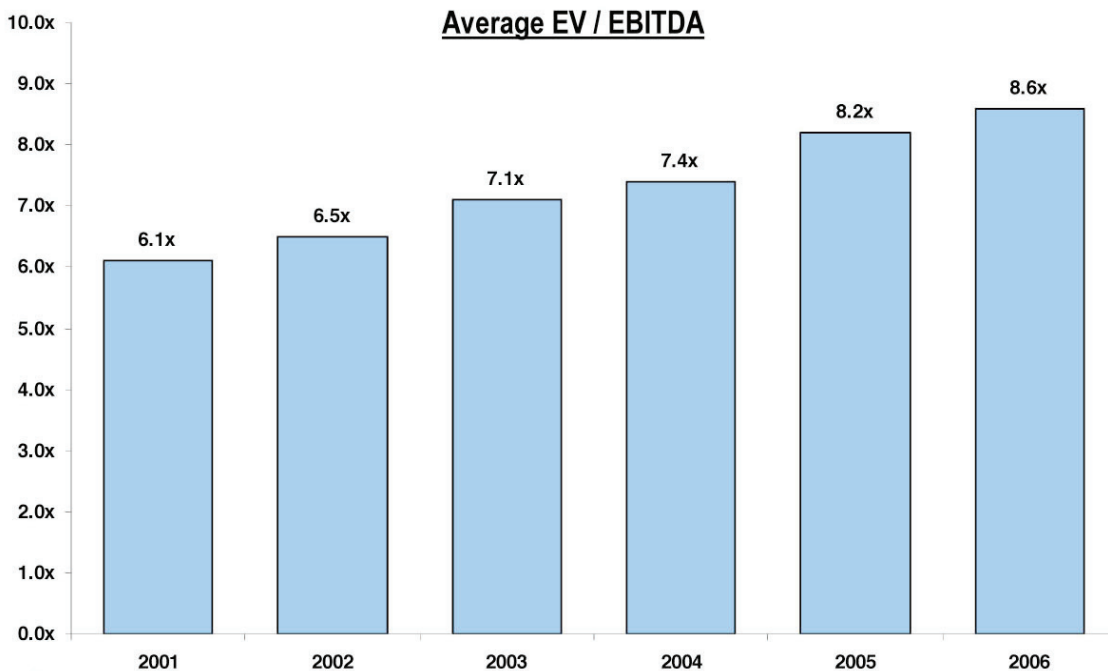
I. The Good Old Days

For the last 10 to 15 years, Private Equity firms have made money for themselves and their investors in a very elegant manner:

They have leveraged the equity funds that they have raised by taking advantage of (historically) very cheap interest rates to borrow the balance needed to buy a business. After acquisition they have strengthened a company’s financial and operational disciplines to improve performance, and then resold the business to reap significant profits. This model is similar to buying and flipping real estate in an expanding market.

The most desirable acquisition targets for PE firms have been businesses with a stable customer base and steady cash flow. The average purchase price paid for such a business in 2001 was 6.1 times EBITDA. Typically a firm would use money from their own fund to cover the first 20% of the purchase price, and borrow the remaining 80% to complete the funding of the acquisition.

If, for example a PE firm bought a business for 6 times EBITDA, the company’s operating cash flow would initially be used to service the debt and invest in selected projects to further boost profitability. The balance of each year’s remaining cash flow would then be used to reduce outstanding principle loan notes, thus further increasing next year’s free cash flow. Assuming no increase in volume or profitability the firm would probably repay a significant element of the initial debt within 4 years.



Source: JP Morgan



Hence, within a few short years, the PE firm could then elect to sell the business and realize a minimum 100% return on their equity investment, assuming they sold the company for no more than they originally paid for it. They would pay off the balance of borrowed funds, pay their investors their upfront-agreed minimum hurdle rate of return, take for themselves their element of agreed profits or “carried interest” (generally a minimum of 20%), and return any remaining balance to their investors.

In the foregoing scenario, a PE firm paid strict attention to

- (a) The acquisition’s finances to make sure they had an accurate picture of cash flow, and
- (b) The efficiency of the acquisition’s operations to assure the cash kept flowing.

Little attention to or investment in marketing was required because they didn’t need to grow the company to achieve excellent returns. They just needed to keep it moving along at its heretofore steady pace.

As I said, the PE industry has had a simple, very profitable and elegant business model.



II. Today

The PE industry has traditionally kept a low profile. However, events over the last few years have changed the world of private equity. You cannot make the kinds of returns the PE industry has realized without catching people's attention, and the industry is now becoming a victim of its own success.

Widely reported in the media, this success has drawn the attention of potential acquisition targets, investors, other financial professionals, and government regulatory agencies. The responses of each of these parties to these "extraordinary returns" will inevitably pose additional challenges to the current participants in the PE markets, both at home and abroad.

The industry's phenomenal success, coupled with some of the larger firms going public, is now shining some light onto the inner workings of the Private Equity Fund Manager. This resulting transparency is leading investors to ask for lower fees. Both the U.S. and EU governments are now scrutinizing the industry too. In fact, the U.S. Department of Justice is investigating suspected collusion in the bidding of deals. The Internal Revenue Service is eyeing the profits being made and considering changing the tax code to treat carried interest as income (35% +/-) rather than capital gains (15% +/-). The English Parliament held hearings (Summer 2007) on why PE firms should not be paying higher taxes.

Meanwhile, the U.S. economy is smack dab in the middle of the greatest transfer of wealth in the history of the world, with baby boomers looking for ways to make as much money as possible from their investments as they prepare to retire. Institutional, as well as individual investors, are hungry to reap significant returns. In short, today there is more money looking for a place to be put to work than ever before.

However, the era of cheap money may now be over. Uncertainty is sending the cost of money up. The August 2007 liquidity crisis is having an impact on the ability of P.E. Firms, particularly those in the middle market, to tap debt markets to fund their buyouts. The current level of M & A activity has slumped to a four year low. Investors' lack of enthusiasm for deals has severely reduced the amount of debt they are willing to put into a deal – 4.75 times cash flow, down from 6.2 times in the 2nd quarter of 2007 (S & P's Leveraged Commentary and Data). Similarly, the effective closure of the market for leveraged-buyout-related debt means they can't pressure companies to sell themselves.

Even before the US credit crunch crisis due to the sub-prime fallout, there were distinct signs that the cost of money was rising. Bill Conway, co-founder of The Carlyle Group, sees terrorism, rising oil prices, trade protectionism, as well as rising labor costs in China and India, as contributors to the end of global liquidity. In addition, the recent volatility in the value of the U.S. dollar and rising interest rates has created higher market risk in and of themselves.

There is now less low hanging fruit, as much has already been picked over. Owners of acquisition targets are reading of huge profits being made and are now demanding (and getting) more for their companies. The historic going rate of 6 times EBITDA is giving way to ever increasing multiples, adding yet another level of risk to the PE investor.

And, the media has portrayed private equity managers as predators negotiating deals that are, in the end, one-sided. Real or imagined, these fears are increasing the difficulty of finding appropriately priced investment opportunities.

Additional challenges are emerging, adding to the industry's woes:

- A “Just say NO to Private Equity Campaign” is making potential targets more aware of how they can ward off unwelcome advances.
- The re-appearance of “Stub Equity” requires the creation of separate acquisition vehicles, with additional tax and accounting headaches.

Investors' prior short-term perspective (do the deal at any price) and their apparent disregard of the now-emerging real risks remain unhealthy signs.

Another issue facing the industry is one that faces a majority of businesses, especially professional service firms. They are generally perceived to be undifferentiated from one another and are lumped into the same pot.

Consider the position of a business owner who wants to be bought: Why sell to one firm versus another for any reason other than price? Today, money itself is a commodity. Unless a PE firm can communicate a clear value proposition offering business owners additional benefits above and beyond price, then the only way to successfully close transactions will be to pay more than the competition.

The number of competitors is growing too, as other finance professionals seek a chance to make the kind of money PE firms have been pulling down. This growing competition is making it more difficult to find opportunities. Coupled with the higher multiples being paid, it is going to become increasingly difficult for the industry to sustain the kinds of returns delivered to date.

Summary: The old model is now encumbered in the following ways:

- The pressure to reduce fees.
- The threat of the IRS to tax carried interest as income rather than as a capital gain.
- The increasing cost of money.
- The recognition by companies that they can extract higher sale multiples.
- The recognition by companies that they do have other options when PE firms come knocking.
- The supply of potential acquisition targets is reducing.
- Deals are perceived as too one-sided.
- The problem of playing in a pack of undifferentiated players.

To continue to deliver the kinds of returns the industry has been generating, we at Beckett Advisors submit that PE professionals can't just watch the cash flow, cut expenses and make sure the company doesn't disrupt the pipeline. Now, they have to differentiate themselves in a more systematic way to affordably secure new properties for their portfolios, as well as, *invest as much in growing the top line of their portfolio properties as is invested in finance and operations.*



III. What PE Firms Can Do to Help Their Portfolio Companies Succeed

Because we've said that greater investment needs to be made in developing a focused marketing strategy, plan of attack, and disciplined execution, here are the elements that are often given insufficient attention and investment:

1. Each portfolio company needs a clear value proposition (a.k.a. a *brand promise*) communicating the value of doing business with them. All managers and employees who interact with customers need to "own" and embody the value proposition.

The brand's promise or value proposition should convey three types of benefits:

- Functional benefits (what your products and services do),
- Emotional benefits (the feelings you want people to have about doing business with your brand), and
- Self-expressive benefits (what it says about the people who buy the brand, use the brand, work for the brand, sell to the brand, invest in the brand).

Why? You get a bigger bang for the buck when the promise of the relationship goes beyond what a relationship does for the customer to also include how it feels to have a relationship with the brand. This applies to all brands—including services or products that have been categorized as commodities. Think about it—commodities are only commodities because someone hasn't invested in differentiating them so that a brand could be built.

2. Each portfolio company needs a marketing mix that aligns with and reinforces the expectations created by the brand's promise. Particularly, in terms of:
 - The way the brand or value proposition is promoted.
 - The experience of purchasing (or making a decision to work with) the brand or value proposition.
 - The manner in which the brand or value proposition is delivered.
 - The price customers pay for the brand or value proposition.
 - The experience of using the brand or value proposition.

You'll notice the deliberate use of brand versus products and services. As mentioned above, products and services sold as simply products and services become commoditized. Selling the brand pre-empts being forced to compete simply on price.

3. Lastly, each portfolio company needs a *disciplined* sales and marketing system, aligned with customer values and reinforcing the expectations created by the brand promise.

Numbers 1, 2 and 3 above are generic by their nature. The next section presents several concrete examples that show how additional profit opportunities were uncovered and faster growth was realized by truly understanding the benefits that customers really valued.



IV. Three Case Studies

Clearly understanding customers' values is key to:

- Sustaining a healthy professional services firm—like the PE business.
- Systematically growing the top lines of the companies within your portfolio.

To illustrate, we present below three case studies for:

A professional services firm with \$2+ million in annual sales

A manufacturer with \$30+ million in annual sales

A mining operation with \$2.4+ billion in annual sales

In each of the examples, the companies experienced significant revenue growth and increased profitability as a result of better understanding who their optimum customers were, and what those customers valued about their relationship with the company.

This understanding (achieved through Conjoint Analysis and Triangulation leveraged by independent third parties) allowed these three companies to focus and align their offerings to deliver what their customers valued most, and to price their offerings accordingly.

Please note that two of these three companies sell things that, quite often, are perceived to be commodities (collections and coal).



Case Study #1 - A Professional Services Firm With \$2+ Million In Annual Sales

Disciplined, Systematic Marketing Increases Sales by 60%

EGR collects money from healthcare facilities' patients. The President, Robert, had decades of experience in the industry. The business, while profitable, had reached a plateau. Robert was its best salesman and its best manager. However, he couldn't be everywhere at the same time. He hired salespeople, but they were unable to generate the level of sales he could. He decided he was wasting his money. He fired his sales force and started to sell again. Revenues increased, but he was spread too thin. Frustrated, Robert reached out for assistance. The following details the program that was put in place.

Step one was to interview Robert and his senior staff about why they thought their clients did business with them. Everyone with the exception of Robert believed it was because EGR could collect the most money for the lowest fee. Robert thought that, yes, low fees were important, but he believed EGR clients really appreciated the manner in which EGR staff treated their clients' patients (the clients' customers.) Robert considered his service to be an extension of the care patients received from his clients in the hospital, and that his clients valued the discretion and civility extended to their patients by EGR staff.

Utilizing Conjoint Analysis and Triangulation, independent third parties then interviewed the heads of billing at all of the hospitals EGR served and at hospitals that EGR wanted to serve. The research results showed that Robert was right: EGR customers valued the manner in which EGR collected the money more than how inexpensively they collected it. But the intelligence gathering techniques also uncovered a hidden value—an important disconnect between Robert's understanding of his customers' values and their own: *More than anything else, clients valued EGR's ability to forecast how much they were going to collect and when, so the billing managers' bosses, the CFOs, could accurately manage cash flow.*

Armed with this knowledge, EGR staff received training on how to develop and run an awareness building campaign educating their prospects of EGR's ability to help clients' collect self-pay receivables, manage their cash flow all the while strengthening hospital/patient relationships. Robert only courted those facilities whose management expressed appreciation of this value proposition. Targeting these qualified prospects increased the probability of acquiring new business, reduced travel expenses and minimized the lost opportunity costs of being out of the office.

Outcome:

Within one year of retooling its sales and marketing to be in alignment with customer values, clarifying its brand, and instituting a disciplined sales and marketing system, EGR increased gross revenue by 60%.



Case Study #2 - A Manufacturer With \$30+ Million In Annual Sales

Seeing Customer's Point of View Increases The Bottom Line By 22%

Roo Systems, manufactures security systems for commercial facilities. They're a second generation, family owned business. Dad retired but still keeps an eye on Lou and his brother, Chip, as they run the business from both coasts.

Having achieved significant market share in low-end systems, the two decided they needed to expand into high-end systems so they developed a new more robust system. Recognizing that brand names can play a role in terms of perceived value, Lou and Chip wanted to know how well their new offering would be received if they brought the system to market under their current brand.

Researchers met with Lou and Chip and several of their engineers, marketing and sales staff to ascertain internal viewpoints regarding their distribution network, installers and end-users' values about a relationship with Roo Systems, as well as, end-users' receptivity to a high-end system from the Roo brand.

The different departments had conflicting points of view about what their customers valued and how they would respond to the new system.

Using Conjoint Analysis and Triangulation, researchers then interviewed distributors, installers, end-users and influencers like architects and industry journalists across the country about their perceived value of Roo Systems' products and services.

Lou's suspicion that the market would not respond well to a BMW-class product from a Ford-like brand was validated. However, there existed an unsuspected disconnect between Roos' management team and their constituent groups. *An important hidden value was revealed by the independent research: Roo Systems' products were thought to be top of the class in their category, universally delivering better value for the dollar than their competitors.*

Outcome:

After researchers presented these findings, Lou announced price increases across the board. The result was a 22% increase in overall revenues with no discernable decrease in volume. Their pricing now matched customers' perceived value of their brand's value proposition.

Having learned that the market would not accept a high-end offering under the Roo brand, Lou still had to decide whether to build a new brand from scratch or acquire an existing high-end brand. Lou and Chip ultimately decided on the latter—facilitated by the additional cash flow from the now appropriately priced brand.



Case Study #3 - A Mining Operation With \$2.4+ Billion In Annual Sales

Coking Coal Mines Add \$225M to Their Bottom Line

Relative to the world's largest mines, CNB Coal found itself in a new position after merging with two of its former competitors. Historically, the small mines had been forced to compete on price. In an effort to release as much profit as possible, management continually looked for ways to lower their costs, so they could undercut their competitors' prices. Individually, their focus had been efficiency, efficiency, efficiency. After the merger, management and staff alike continued to operate "as normal".

Coupled with this efficiency model mindset was CNB's perception that their product was inferior, as the characteristics of their coal were different from the largest provider. As such, they were happy when they were able to get 95% of what the leaders charged.

Jack, the new CEO of the combined mines, recognized that the newly enlarged company's circumstances presented a very different market perspective. He hired an independent firm to conduct a strategic audit to help in clearly understanding their new situation and discerning their strategic options.

Following interviews with Jack and his management team, researchers used Conjoint Analysis and Triangulation to interview, in person and over the phone, customers in Asia, Europe and throughout the Americas. More than 80% of their customers were interviewed.

As a result, a heretofore-unstated *appreciation* for the coal was uncovered. As one coking engineer summed-up, "*Sure, your coal is different, Laddie. But I need both to make my steel. Together you're like a ham sandwich. They're the bread and you're the ham.*" These sentiments were echoed—though not as colorfully—on every continent.

Outcome:

For the first time, CNB Coal realized they could move away from the inferior commodity perspective they had self-imposed. They were able to charge the same for their coal as their largest competitors. The 5% price increase represented just \$3.00/ton. However, CNB Coal shipped 75 million tons that year. Understanding what their customers' valued about their relationship translated into \$225 million that went straight to the bottom line.

The Role Of A Third Party In Uncovering What Customers Truly Value

On more than one occasion managers have asked, “Why can’t internal people gather this information?” The primary reason is customers have a relationship with internal staff and may be hesitant to be critical for fear of hurting feelings. They may be uncomfortable openly sharing their desires with those with whom they’re going to have to continue doing business. They may fear giving ammunition that may be used against them in future negotiations. Experience has shown customers are more likely to be candid with a perceived, unbiased third party. Thus, Triangulation can play a key role in increasing the success of your firm, as well as, the top-line growth of your portfolio companies.

Summary

Once the unvarnished truth about what customers’ value about their relationship with your portfolio brands is revealed, energies and resources can be better invested in reinforcing and clearly communicating that value to current and prospective customers. Fine-tuning of branding, marketing and sales can now take place. It’s a straightforward concept that is too often not thoroughly executed: Identify with whom you want to do business, uncover what they’re willing to buy, why they’re willing to buy, uncover the most potent marketing mix that will convey the most effective message to the market, and then sell it to them.

What this means to PE Firms:

The era of cheap money appears to be coming to an end, regulatory agencies circulate overhead, politicians look to extract additional taxes, and the fee structure is under attack. Right now, all these factors are coming together and will inevitably bring financial strains to the industry.

PE Firms thus have several choices:

1. Get out of the business.
2. Continue running their businesses as they have to-date, slowly selling them off when appropriate and waiting hopefully for the return of cheap money before investing again.
3. Improve, or at least fine-tune, their own reputations in the market so to differentiate themselves from the rest of the pack. A PE firm that can credibly demonstrate its success in repeatedly growing similar businesses will have an edge over firms that cannot.
4. Generate additional returns from their current (and future) investments by investing in marketing programs that obtain a better understanding of optimum customers, and what those customers value about their relationship with the brands. This understanding will allow your portfolio companies to focus and align their offerings to deliver what customers value most, and to price their products and services accordingly.

In the end, it comes down to: Bury your head in the sand, run away—or adapt. Adapt by investing similar resources in branding and marketing as are invested in finance and operations.



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