cf | private equity

In Private Equity Buyouts Operational Expertise Is the Key to Unlocking Value

A Commonfund Forum Spotlight

A successful private equity buyout is often credited to shrewd financial diligence—overlooking sector-specific operating expertise where hidden value is uncovered.

Mega-buyouts may capture the headlines, but middle market private equity managers with sector-specific operational expertise capture hidden value and complement an investor's overall private equity allocation. That's the key message coming from a Commonfund Forum 2023 session dedicated to how specialist managers put hands-on operational skills to work turning companies around. The managers participating in the session were Rachel Spasser, Managing Director and Chief Marketing Officer, Accel-KKR, and Ray Whiteman, Managing Partner, Stellex Capital Management. Mark Hoeing, President, CF Private Equity, served as moderator. Excerpts from the session follow.

MANAGER PROFILES

Accel-KKR was formed in the latter 1990s as a joint venture between venture capital manager Accel Partners and private equity manager KKR. Today the firm is independent and headquartered in Menlo Park, California. The original investment focus was business-to-business technology, but today the focus has narrowed to business software applications, which Ms. Spasser points out has the benefit of being "sticky," i.e., software that companies in a range of markets rely on to run their business.

Stellex Capital Management is a middle market private equity firm based in New York. The firm invests in North America and Europe and follows a value strategy focused on four vertical markets: aerospace/defense/government services; industrial services; transportation, logistics and food services; and business services, the newest segment launched about 18 months ago. The firm was founded in 2014 and its portfolio currently totals some $2.7 billion.

SESSION HIGHLIGHTS

Mark Hoeing: In recent years, we at CF Private Equity, and our clients, have benefited from our emphasis on sector specialization. Rachel, you lead a team of operating specialists. Walk us through why sector specialization and operating skills are so important.

Rachel Spasser: Sector specialization makes an operating team much easier to run. Over the years we made a number of investments and we began to see the same patterns in a lot of our portfolio companies and that continues today. We started the operating team in 2013 to ensure that we could address the challenges and opportunities we identified across the portfolio. Software, as an industry, is relatively nascent. Often, the founders of software businesses have experience in a market, would identify a need and start a company to fill it. The founder would hire a neighbor's kid to code the first version of the application software. But the founder often didn't have a lot of experience building and running a business. We do, however, and specifically it's a lot of experience with software businesses. Our people have backgrounds in a combination of traditional consulting and operating roles in software companies and that's where we think a lot of the magic happens for us.

What we bring is an understanding of the maturation of software businesses over time and our goal is to accelerate that maturation process for our portfolio companies. That's how we think about the operating team: How do we grow those businesses from a financial perspective but also from a skills and capabilities perspective? We understand how to mature a business as quickly as possible—that is, to reach the founder's goals or the team's goals as quickly as possible. That's where the value creation opportunity lies.

Hoeing: That value creation opportunity, the underwriting of a particular investment—has that changed or evolved over time from your standpoint? Or has it remained fairly static?

Spasser: Absolutely it has evolved … private equity has evolved. At the onset it was much more of a financial diligence process with some dabbling in operational diligence. Now we do a lot of heavy-duty operational diligence to understand the capabilities of a company to get a sense for the talent and the level of process and discipline that exists within the business.

Another important piece is navigating economic cycles. Understanding a business operationally is very helpful because when you have to make changes you usually have to make them relatively quickly. With the right operating expertise, you know exactly where you can make the changes that are most likely to have a positive impact on EBITDA and cash flow today but won't handicap the business from being able to achieve its long-term potential.

Hoeing: Ray, can you outline the evolution of your approach to running an operating team inside a private equity firm? What kind of changes have you seen and how have you adapted to identify companies that are an ideal fit for you? What do you do to add value?

Ray Whiteman: When we look at a business, we need to have operating people alongside the investment team. They are an integral part of the diligence effort as they lay out the range of possibilities for a potential portfolio company. They also understand the middle market, which is a very different space than big company types of transactions. These are much smaller businesses that can be in the middle of nowhere. We need people to go out to these businesses and take a diagnostic look and then tell us what the art of the possible is.

We call it the "vaccination." We go in and inoculate these management teams and reorient the business to focus on products that will generate more cash while at the same time creating a much more transparent organization. Sometimes it sticks and sometimes it doesn't. When we look at the portfolio, we've probably changed out 70 percent of the management teams over time.

We love to see businesses where there are no metrics anywhere. The person on the factory floor has no clue what the economic incentive is for him or her. We want CFOs who are able to create the financial operating plan so that the ops people can execute it. We want salespeople to be compensated on the same metrics as everyone else … a system where everyone in the company is paid based on the same numbers. They can see it every week, every month. This cross-pollination across the whole organization has been the linchpin to some of our strategies. We walk into so many businesses that just don't have that. Some people say that's too hard, but we look at it as the real opportunity to create value. The other piece of it is these are businesses that generally have some "hair" on them, meaning we're generally able to get them a little bit cheaper.

> *"Private equity has evolved. At the onset it was much more of a financial diligence process with some dabbling in operational diligence. Now we do a lot of heavy-duty operational diligence..*
>
> *– Rachel Spasser, Accel-KKR*

Hoeing: Rachel, when you underwrite a deal, how do you think about the future exit opportunity and how to drive returns?

Spasser: Generally, we are thinking in a three- to five-year framework from investment to exit but we may hold for another couple of years as we look at the trajectory of economic value creation. We've made a lot of investments where both growth and EBITDA continue to accelerate. We try to get to the point where we think the profile is ideal for an exit. We have trained management teams to think in three- to five-year increments as well and we also seek to motivate the leadership team to stay longer if needed to realize full value potential.

Hoeing: We know it's not all about economic value. It's also about creating a sustainable business. That brings up ESG. I am curious from your points of view: What's changed or evolved inside your practice as you think about ESG?

Whiteman: It's interesting because when you look at a lot of these small and middle market businesses, it really comes down to survival. So, first you have to get them on a stable footing. Then you start to think about some of the environmental, social and governance factors. The reality is that a number of these businesses are in the heartland, in small towns where the demographics are pretty homogeneous. You're not going to be able to do much about who wants to work at these businesses. But what you can do is look at your board and your executive team and the diversity models you can introduce at these levels. On the environmental side, after things are on a stable footing, you can start to measure things. Because a lot of these businesses don't measure much of anything. You have to teach them how to measure if they are going to fix environmental problems. ESG is often about implementing "the next phase" of the fix, which is to say, "OK, now we have a plan and here's how we're going to go about measuring the metrics that we need to keep an eye on."

Hoeing: How about from your side, Rachael? Do you see an evolution on the ESG front?

Spasser: Absolutely. We are beneficiaries of the fact that software has a pretty light footprint environmentally. That doesn't mean that we shouldn't do things. For instance, at every board meeting we have with our portfolio companies there would be 20 people in the room with 40 or 50 plastic bottles. We're eliminating those from our portfolio companies and from Accel-KKR. So, that's around the edges. Beyond that we have multiple initiatives in place.

About two years ago, we benchmarked our portfolio companies based on gender and minorities in their workforce at various levels. As a result, we created goals for our portfolio companies to increase diversity at all levels. Not surprisingly, at the entry level it's actually quite diverse. But as you move up, it gets less and less so. In response, we have an initiative to put diverse candidates on the boards of all our portfolio companies. I think we've made a lot more progress with women than we have with people of color and that's a need we are addressing going forward. We also run a Women in Leadership summit every year for women throughout the portfolio. We also have employer resource groups. Our companies are relatively small, usually a couple hundred people, so it's hard to run employer resource groups. But if we do it across the portfolio, we have the ability to create effective special interest resource groups for minorities, whether that's by gender, racial or ethnic background, or the LGBTQ community.

> *"We have operating people alongside the investment team … they understand the middle market, which is a very different space than big company types of transactions.*
>
> *– Ray Whiteman, Stellex Capital Management*

Hoeing: We've talked a lot about your strategies and how you add value. Let's get to the environment in which we find ourselves where the cost of debt has tripled or quadrupled at most companies. You've got inflation across labor and commodity inputs. How is this impacting your portfolio and your thought process around where you're investing?

Whiteman: We have 22 portfolio companies now. When we look across all of them from a top line perspective, we're not necessarily seeing a slowdown. What we have seen is input costs going up substantially more than we would have expected. We have been focused on that, but now we're starting to see that situation ease. We are also leveraging purchasing power across the portfolio to stem some of those cost increases. All of our business plans and the outlook for the remainder of the year are based on the backlogs of these businesses and that is kind of steady as she goes. No one is really seeing a slowdown in any material way.

Hoeing: Talk a little bit about your concern, or lack of concern, around opportunities for new investments when you think about leverage in the current environment.

Whiteman: We generally don't like to pay too much for our businesses, which kind of minimizes the impact. For our first fund, the average price was less than six times EBITDA. So, assuming you have three times leverage on that it gives you flexibility from a capital structure perspective. And then if you do what you're supposed to do to drive the value proposition you're quickly delevering. So, it really hasn't impacted us as much as it would if we paid 15 X for a business and you have eight turns of leverage on it. We can also enter through the secondary debt market to get control of a business. We've done that in the past where we bought the debt, took the business into bankruptcy and come back out on the other side with a delevered business. The middle market has also been more disciplined when it comes to the amount of leverage employed.

Hoeing: How about from your side, Rachel? Debt has been available for a long time for tech companies with high rates of return.

Spasser: Philosophically we're generally aligned with what Ray said although we don't pay 5 X for our businesses. We are pretty conservative in terms of the amount of leverage we use and for the very same reason: We want to give our management teams the ability to invest for growth. We don't want to hamstring them with too much debt. Higher rates have had an impact from a cash flow perspective, but it's minimal for most of our businesses. I would say new debt is not as free flowing as it was in the past but it's certainly available. And because our businesses are profitable, we still have the ability to get leverage. It's a lot harder if you are a high growth, no margin business. In terms of portfolio performance, some of the end markets we serve have been hit more materially by inflation than others. But the beauty of the software space is that we're not buying a lot of raw materials or inputs for our businesses. We have seen some impact around the edges, the cost of travel, for example.

But I can't think of a portfolio business that's not going to grow this year, just maybe not quite as fast as they did in 2020 or 2021.

This page intentionally left blank

Important Notes

Certain information contained herein has been obtained from or is based on third-party sources and, although believed to be reliable, has not been independently verified. Such information is as of the date indicated, if indicated, may not be complete, is subject to change and has not necessarily been updated. No representation or warranty, express or implied, is or will be given by The Common Fund for Nonprofit Organizations, any of its affiliates or any of its or their affiliates, trustees, directors, officers, employees or advisers (collectively referred to herein as "Commonfund") or any other person as to the accuracy or completeness of the information in any third-party materials. Accordingly, Commonfund shall not be liable for any direct, indirect or consequential loss or damage suffered by any person as a result of relying on any statement in, or omission from, such third-party materials, and any such liability is expressly disclaimed.

To the extent views presented forecast market activity, they may be based on many factors in addition to those explicitly stated herein. Forecasts of experts inevitably differ. Views attributed to third-parties are presented to demonstrate the existence of points of view, not as a basis for recommendations or as investment advice. Market and investment views of third-parties presented herein do not necessarily reflect the views of Commonfund, any manager retained by Commonfund to manage any investments for Commonfund (each, a "Manager") or any fund managed by any Commonfund entity (each, a "Fund"). Accordingly, the views presented herein may not be relied upon as an indication of trading intent on behalf of Commonfund, any Manager or any Fund.

Statements concerning Commonfund's views of possible future outcomes in any investment asset class or market, or of possible future economic developments, are not intended, and should not be construed, as forecasts or predictions of the future investment performance of any Fund. Such statements are also not intended as recommendations by any Commonfund entity or any Commonfund employee to the recipient of the presentation. It is Commonfund's policy that investment recommendations to its clients must be based on the investment objectives and risk tolerances of each individual client. All market outlook and similar statements are based upon information reasonably available as of the date of this presentation (unless an earlier date is stated with regard to particular information), and reasonably believed to be accurate by Commonfund. Commonfund disclaims any responsibility to provide the recipient of this presentation with updated or corrected information or statements. Past performance is not indicative of future results. For more information, please refer to Important Disclosures.

Published May 2023

A Commonfund Company

New York, NY 10017
San Francisco, CA 94111
London, United Kingdom
Beijing, China

15 Old Danbury Road
Wilton, CT 06897

Tel (646) 348-9201
Tel (415) 433-8800
Tel +44 (0) 20 7872 5504
Tel +86 10 5759 3208

Tel 888-TCF-Main
Tel (203) 563-5000