

3<sup>rd</sup> ANNUAL PRIVATE EQUITY  
ROUNDTABLE

---



**Spencer Stuart's** Private Equity Practice hosted its third annual **Private Equity Roundtable** in Chicago. The roundtable provided an opportunity for a candid discussion about issues facing private equity firms and their portfolio companies. Departing from the earlier roundtable events, which were limited to portfolio company CEOs, the group of 49 people who gathered at the **University of Chicago Graduate School of Business** included private equity partners, chief executives and other senior officers of portfolio companies. Representatives of audit, legal and consulting firms that work with private equity also participated.

Hosted by **Gil Stenholm**, a senior partner of Spencer Stuart, and moderated by **Steven N. Kaplan**, the Neubauer Family Professor of Entrepreneurship and Finance for the University of Chicago Graduate School of Business, the event featured a wide-ranging discussion on topics including governance and organizational structures for both private equity firms and portfolio companies, private equity investment approaches, and the essential qualities of successful portfolio company CEOs.

## PRIVATE EQUITY FIRM STRUCTURE AND GOVERNANCE

### **No one “right” way: How funds are organized**

How do private equity firms approach their investments and organize their internal teams? Increasingly, large firms are organizing themselves by industry, Kaplan observed. But is that the best approach?

Firms favoring the single industry approach say that, in an increasingly competitive world, CEOs have more questions for and require more guidance from their private equity investors. They also are looking for more help in key areas and want to tap a larger network of contacts. Firms specializing in a single industry contend that they have the deep expertise and broad contacts that portfolio company CEOs require. “You can’t be an expert in every industry,” explained **Alan L. Heller**, operating partner of **Water Street Healthcare Partners**, which focuses exclusively on the healthcare industry.

**F. Edward Gustafson**, executive vice president and chief operating officer of **D.P. Kelly & Associates**, said his firm focuses on the forward-looking strategy of potential investment targets as well as the strength of the CEO. “We invest in companies that have effective CEOs. If they have the right management team and the economics make sense, we work with them. We’re not exclusively in one industry. We look for companies with good management that know where they want to go.”

In addition to pursuing a variety of different investment strategies, private equity firms also organize themselves in different ways, depending on the talent they have and their investment style. Some firms

have specialized and distinct deal teams and management teams, while others use a single team to identify investment targets, close the deal and work with management once the investment is made.

The most appropriate organization depends on the firm's strategy and makeup, private equity partners said. For example, **Edgewater Funds**, whose partners are former CEOs, does not have separate operating and investment groups. "We try to staff our teams with people with operating backgrounds and financial backgrounds," said **David M. Tolmie**, an Edgewater Funds partner.

Other private equity firms, including Lake Capital, have separate teams for different activities. **Kevin J. Rowe**, principal and head of portfolio company services for the firm, explained that **Lake Capital** is organized into three silos: a business development team that identifies opportunities, a deal team of generalists, and a team of functional experts who can supplement portfolio company management with specialized expertise in areas such as marketing or finance.

### Is there a private equity model that is preferred by CEOs?

What do CEOs look for when evaluating potential private equity partners? **John E. Vaughan**, president and CEO of **Worknet**, said he looks at the culture and personality of private equity suitors, and whether the firm's industry and functional expertise complements that of his team, adding, "You're going to be married to them for a long time until the desired or target value is created."

Ultimately, it is the board's place to choose a private equity partner. That decision is in part

about the price the firms are willing to pay and in part about the state of the portfolio company. For example, a "broken" portfolio company that needs fixing requires different support than a healthy company that needs help getting to the next level. Observed **L. Dick Buell**, CEO of **Catalina Marketing Corporation (a Hellman & Friedman company)**, "The best investors are the ones who know the most about the company and have ideas for adding value. That is the firm that invests the most in understanding the business."

## PRIVATE EQUITY FIRM INVESTMENT STRATEGY AND TACTICS

### Different strategies for value creation

The next area that Kaplan pursued with the group was the topic of creating value. How do private equity firms see their contributions in terms of creating value, and how do CEOs view their contributions? "I try to focus my students on the question, 'Where is the extra value?' Once you have identified it, then you have to think about how you go get it," Kaplan explained. Then, he put the question to the group, "Does it happen upfront, does it happen down the road, or does it happen in both places?"

Private equity firms count business and market knowledge, access to financing and a network of contacts among their contributions. Said Heller, "We bring deep knowledge of businesses in the healthcare segment, contacts for business development, board members and investment capital."

**GTCR Golder Rauner Principal David A. Donnini** said the quality of GTCR's portfolio company CEO leaders is what makes the difference in creating

value for portfolio companies. “We invest a tremendous amount of time identifying great people. Those people drive better-than-average value, sometimes much better than average. Our business is about people.” Buell agreed, adding, “David’s being modest. The GTCR team brings ideas. They expand the CEO’s peripheral vision.”

### Finding the value

Discussing strategies and new ideas is an important way private equity firms add value, said **Ronald Kesselman**, strategic consultant to private equity groups for consumer products. “One of the biggest benefits of private equity is helping the CEO define value creation. The private equity firm should understand what activity creates more value, and those discussions should happen upfront.”

However, one value-creation strategy that can be difficult to determine early in the process is the opportunity for mergers and acquisitions. “Value is created through add-on acquisitions, which can be hard to quantify at the beginning,” said **Paul J. Lustig**, who was president and CEO of **Sara Lee Apparel (Hanes)** for 12 years and later served as president and CEO of the Keebler Snack Division of **Kellogg Company**.

Finally, private equity firms can add value by helping to impose a clear focus on the right business strategy. “Private equity can add value by deciding what not to do, which can free up resources for other activities,” said **Shaun Holliday**, operating partner of **Gryphon Investors** (former president of new business and innovation for **Newell Rubbermaid**).

### Paying on front end

In general, participants said it is more difficult today than in the past to “bake” profits into the deal structure. “I think you pay upfront for the benefits of financial engineering, whereas 15 to 20 years ago you probably didn’t,” observed **Wayne Moore**, partner and head of Midwest mergers and acquisitions for **Goldman Sachs & Company**. “For most assets that are sold, whether they are sold one-off or at auction, there is at least some kind of market test or market-related valuation exercise that the seller goes through to understand what the business is worth. Almost invariably, you’re going to pay on the front end for the pure benefits of capital structure.”

Are valuations coming down in light of the problems in the credit markets? Opinions varied about the degree to which valuations were being affected. Strategic buyers are better able to compete for deals than in the past and there are fewer investment opportunities, participants said. Inevitably, valuations will have to come down with the reduction in the borrowing power available to companies, said **Ken Viellieu**, managing director and head of the Chicago office of **Moelis & Co**. “We’re already seeing fewer companies coming up for sale because the valuations they previously sought are not realistic given the debt markets.”

## PORTFOLIO COMPANY STRUCTURE AND GOVERNANCE

### Smaller, more focused board a plus

Portfolio company boards tend to be smaller and more hands-on than their public company counterparts. As a result, directors in this environment

have to be highly motivated and engaged. They also need to bring expertise that complements the skills and experience of the management team.

**Kevin M. Swan**, partner for **Water Street Healthcare Partners**, recommended that private equity firms begin thinking about the board early on in their investment. “Try to get people who are overqualified and willing to be active board members,” he said.

Out of the public company spotlight, portfolio company boards are able to take a longer-term perspective on the business, roundtable participants said. “It can be tough to innovate in a public company environment. Private equity gives you more flexibility to think long-term,” said **Frank J. Feraco**, chairman and CEO of Value Management Group (formerly **Sterling Plumbing Group**). **Mark Sotir**, managing director of **Equity Group Investments** (formerly **Budget Group**), agreed. “Private equity kept pushing me to think long-term. Private equity can dig in deeper, find the problems a little faster.” Public company boards increasingly find themselves facing shareholder activists who have a different agenda or simply don’t agree with the direction of the company, observed **Andrew G. Balbirer**, executive vice president and chief financial officer of **CCC Information Services**. In some cases, that can be a good thing, but not always. “As a private company, it’s a lot less painful to resolve leadership issues without creating any more noise than necessary in the marketplace,” he said.

#### **PE Advantage: Faster decision making**

In addition to its ability to focus the management team and the organization as a whole on a few key objectives aimed at creating value, the private equity model also enables faster decision making, allowing portfolio companies to pounce on oppor-

tunities that a public company might not.

“In private equity, there is one agenda: creating value,” said **Marc C. Particelli**, chairman of the CoActive Marketing Group (formerly **Oak Hill Partners**). “There’s an intensity to that. In a public company, there are a variety of issues that distract from the focus or creativity.” **Jude D. Rake**, CEO of **Recycled Paper Greetings**, agreed, “It’s more about focus and agility. We make decisions in 15 minutes that in a public company would take six months and 40 people.” The speed of decision making in a private equity environment is much different than in a public environment, said **Tom A. Moore**, CEO of **Education Corporation of America**, a **Willis Stein & Partners** company. “It’s striking how fast decisions get made and how quickly you can align the organization.”

However, **J. Douglas Gray**, CEO of **Everett Smith Group** (formerly **Morgan Stanley**), argued that the gap between a well-run public company and a well-run portfolio company is not as vast as some may say. While private equity is resourceful, aggressive and ethical and has added much to modern management science, public companies today also can act aggressively in pursuit of creating value.

“Investors will support aggressive action today,” he said. Gray went on to add that corporate CEOs are just as competent as CEOs of private equity firms. “The public company CEOs and directors pander more than they should to Wall Street — such as complying with so-called ‘First Call’ estimates — rather than focusing the ‘Street’ on long-term value creation and innovation, for example.”

But, in practice, making dramatic changes in a public company can be more difficult because of quarterly financial expectations and its accountability to a larger and more diverse group of investors,

others said. **Donna Zarcone**, president and CEO of D.F. Zarcone & Associates and the former president and COO of **Harley-Davidson Financial Services**, sees a difference in the risk tolerance between public and private models. “Private equity is more willing to take calculated risks and to innovate. Public companies tend to be slower to innovate, and often take risks only when faced with low growth and declining share value,” she said.

“Private equity is willing to take more risks, faster,” agreed **Doug Pertz**, partner at **One Equity Partners** (formerly of **IMC Global**). In addition, private equity firms can provide assistance to portfolio companies when it is time to act because they often bring specialized expertise and complementary skills and resources, he said. For instance, portfolio companies often turn to private equity sponsors to help with mergers and acquisitions or for access to financing.

#### **Owners or renters: Finding the right CEO for the job**

What are the qualities or set of experiences that distinguish outstanding portfolio company CEOs? Private equity partners weighed in on what they look for in a portfolio company CEO.

Tolmie said he wants “owners,” not “renters,” to run Edgewater’s portfolio companies. “It’s a mentality. It’s a drive. It’s a commitment. It’s the sense that the person is fully engaged and understands his role is to get over the goal line. It includes the relentless pursuit of upgrading the rest of the team and a willingness to fight with the board when necessary.” CEOs who lack that level of commitment or engagement with the board are bound to butt heads with directors and, ultimately, lose their support, Vaughan said. “If the board perceives that you are not as committed as you should be, you will have a difficult relationship.”

**Love Goel**, chairman and CEO of **Growth Ventures Group**, said he was looking for four things during a recent search for the CEO of one of the firm’s portfolio companies: strong general management skills, including experience with different economic cycles and the proven ability to build strong teams; experience from the best-in-class companies in the sector; the ability to successfully navigate structural shifts in the marketplace; and cultural fit, which includes an entrepreneurial orientation and a focus on accountability.

Another important player in a portfolio company is the chief financial officer, who has a key role in improving cash flow and driving value. **Spencer Stuart** Chairman **Kevin Connelly**, who also leads the firm’s Financial Officer Practice in North America, said he generally sees little difference between public and portfolio companies in the desired skill-sets for CFOs. “Public companies tend to put a bigger premium on presentation skills and the ability to communicate well with investors and analysts, while portfolio companies look for CFOs with experience transforming a business.”

Several private equity partners said they often tap management teams that have proven themselves in previous ventures for new investments. But while that approach often is successful, firms should be careful not to push executives too far outside of their expertise, Goel said. “Sometimes you fall in love with a management team and you set them up for failure by asking them to stretch beyond their strengths.”

“Ultimately, the management teams that are most successful bring relevant skills, experiences and a track record of success to the opportunity, and are aligned with their private equity partners early on in developing the value-creation plan that they will

implement in partnership,” observed **James P. Ten-Broek**, managing director of Wind Point Partners. Donnini advised portfolio company management teams to work closely with the private equity firm early on to agree on the parameters that will be managed and measured. “What are the drivers of value? How do we track those? If you go into an investment with those parameters undefined, it is a recipe for a steep learning curve.”

## EXTERNAL FACTORS

### Six years later: The impact of the Sarbanes-Oxley Act

Although portfolio companies are not public and typically are not subject to all of the requirements of the Sarbanes-Oxley Act of 2002, the landmark legislation has had an impact on private companies. Those planning an initial public offering or even a sale to a strategic buyer often choose to comply with many SOX provisions in order to ease the transition from private to public and to identify potential issues early on, participants said.

SOX compliance is less expensive than it was even a couple of years ago, and portfolio companies planning to go public can benefit from the experience of public companies that already have gone through the compliance process, explained **James L. Coogan**, a partner with **KPMG**. “In terms of all the details and minutiae of adopting all of the audit controls, portfolio companies benefit from the fact that the public accounting firms and all of the rule makers have learned from the mistakes of the past. It’s a mistake in my mind for private equity companies to overinvest in compliance, but it nevertheless is less expensive than it was a couple of years ago.”

Still, the extensive reporting requirements and risks facing public company officers have caused some portfolio company management teams to decide not to take their companies public. “A lot of management teams don’t want to bear the risk associated with being a CEO or a CFO of a public company and, consequently, they would rather sell the business before it’s ready to be public,” observed **George Spencer**, a founder of **Seyen Capital** and formerly with **Adams Street Partners**. “From my standpoint, that is unfortunate, because we are cutting off businesses long before they need to be cut off, in terms of selling.”

### Is a change in the tax rate coming?

**Keith Villmow**, a partner at **Kirkland & Ellis**, talked about the likelihood that the tax treatment of carried interest would change in the short term, and how taxing carried interest at a higher rate might impact the industry. While it was not changed prior to the November 2008 presidential election, Congress and the next president likely will face pressure to increase the tax rate on carried interest as they seek to address the federal deficit, he said. “Right now, there’s a very favorable tax regime for private equity investments. I don’t know that we can count on that in the future,” observed Villmow.

How would a change in the tax treatment of carried interest impact private equity? Villmow said he does not think the viability of private equity would be jeopardized, but that an increase in the tax rate on carried interest could be a significant cost. “I think the industry will continue to prosper. There may be other ways to manage compensation so the private equity professionals won’t see a significant impact on the amount of income they are keeping. Ultimately, it’s a cost that is going to have to be managed if it is imposed on the industry.”

---

## ROUNDTABLE HOSTS



Gilbert R. Stenholm co-leads the Private Equity Practice. In addition to private equity, he's also a core member of the firm's Consumer Goods & Services Practice, which he founded in the late 1980s and served as the practice leader until early 2001. During his 28 years in executive search, Gil has focused on a variety of industries, including consumer products, industrial goods, healthcare and services. His clients include large, multinational public and family-owned companies as well as private equity firms and their portfolio companies. His search work includes CEO, COO, division president, board director and top-level functional assignments.

In addition to his search work, Gil authored two thought leadership pieces: "Rules of the Road for the New CEO" and "Positioning the Private Equity Portfolio Company CEO for Success." Gil also consults with clients on organizational, management assessment and compensation benchmarking projects, and is a member of the Board Services Practice. Gil is the client coordinator for a variety of private equity firms. Gil joined Spencer Stuart in 1980 after five years with Booz Allen & Hamilton in Chicago. Prior to Booz Allen & Hamilton, he served in roles with General Foods/Kraft, Baxter Travenol Laboratories and Masonite Corporation. Gil is a graduate of Bob Jones University. He is a member of the Illinois Venture Capital Association.



As chairman of Spencer Stuart, Kevin Connelly has both client-facing responsibilities and a firm leadership role. Within the firm, he is the elected representative of the partners, chairs the board and partners' meetings and is responsible for providing strategic perspective to the firm's business and finances. He is also an active search professional, consulting with clients on executive leadership succession and board projects and leads the firm's Financial Officer Practice in North America. Prior to becoming chairman, Kevin managed the firm's business in the United States, Japan, Canada and Mexico and had global oversight for the Industrial and Financial Services Practices. Earlier, he managed the firm's Chicago office and served on the board of directors.

Before joining Spencer Stuart, Kevin was chief operating officer and a member of the board of directors of Ganton Technologies, a supplier of engine and drivetrain components to the world's leading automobile manufacturers. He previously served as chief financial officer for Ganton. Earlier in his career, Kevin worked for Harris Bank/Bank of Montreal, where he held management positions in corporate finance, product marketing, middle market banking and credit cards. Kevin earned an M.B.A. from the Graduate School of Business at the University of Chicago and a bachelor's degree from Marquette University.

---

## ABOUT SPENCER STUART

Spencer Stuart is one of the world's leading executive search consulting firms. Privately held since 1956, Spencer Stuart applies its extensive knowledge of industries, functions and talent to advise select clients — ranging from major multinationals to emerging companies to nonprofit organizations — and address their leadership requirements. Through 52 offices in 27 countries and a broad range of practice groups, Spencer Stuart consultants focus on senior-level executive search, board director appointments, succession planning and in-depth senior executive management assessments.

## SPENCER STUART PRIVATE EQUITY PRACTICE

The Spencer Stuart Private Equity Practice supports private equity firms and their portfolio companies in their quest for partners and principals, finance, marketing and administration professionals and experienced senior-level operating executives. During the past 10 years, consultants in the practice have completed more than 1,000 assignments for clients ranging from megafunds to startups. As strategic advisers to clients covering the full spectrum of investment stages and disciplines, Spencer Stuart consultants provide a range of specialized advisory services in addition to executive search, including:

- > Board services
- > Pre-acquisition human capital due diligence
- > Post-merger integration
- > Executive benchmarking
- > Management assessment

## SPENCER STUART OFFICE LOCATIONS

### **Amsterdam**

31 (o) 20.305.73.05

### **Frankfurt**

49 (o) 69.61.09.27.0

### **Milan**

39.02.771251

### **Sao Paulo**

55.11.3759.7700

### **Atlanta**

1.404.504.4400

### **Geneva**

41.22.312.36.38

### **Minneapolis/St. Paul**

1.612.313.2000

### **Shanghai**

86.21.2326.2828

### **Barcelona**

34.93.487.23.36

### **Hong Kong**

852.2521.8373

### **Montreal**

1.514.288.3377

### **Silicon Valley**

1.650.356.5500

### **Beijing**

86.10.6505.1031

### **Houston**

1.713.225.1621

### **Mumbai**

91.22.6616.1414

### **Singapore**

65.6586.1186

### **Bogota**

571.618.2488

### **Johannesburg**

27 (o) 11 707.9460

### **Munich**

49 (o) 89.45.55.53.0

### **Stamford**

1.203.324.6333

### **Boston**

1.617.531.5731

### **Leeds**

44 (o) 1937.547700

### **New York**

1.212.336.0200

### **Stockholm**

46.8.534.801.50

### **Brussels**

32.2.732.26.25

### **London**

44 (o) 20 7298.3333

### **Orange County**

1.949.930.8000

### **Sydney**

61.2.9240.0100

### **Budapest**

36.1.200.08.50

### **Los Angeles**

1.310.209.0610

### **Paris**

33 (o) 1.53.57.81.23

### **Tokyo**

81.3.3238.8901

### **Buenos Aires**

54.11.4310.9100

### **Madrid**

34.91.745.85.00

### **Philadelphia**

1.215.814.1600

### **Toronto**

1.416.361.0311

### **Calgary**

1.403.538.8658

### **Manchester**

44 (o) 161 499.6700

### **Prague**

420.221.411.341

### **Vienna**

43.1.36.88.700.0

### **Chicago**

1.312.822.0080

### **Melbourne**

61.3. 8661.0100

### **Rome**

39.06.802071

### **Warsaw**

48.22.321.02.00

### **Dallas**

1.214.672.5200

### **Mexico City**

52.55.5002.4950

### **San Francisco**

1.415.495.4141

### **Washington, D.C.**

1.202.639.8111

### **Dubai**

971.4.426.6500

### **Miami**

1.305.443.9911

### **Santiago**

56.2.940.2700

### **Zurich**

41.44.257.17.17

[www.spencerstuart.com](http://www.spencerstuart.com)

Amsterdam  
Atlanta  
Barcelona  
Beijing  
Bogota  
Boston  
Brussels  
Budapest  
Buenos Aires  
Calgary  
Chicago  
Dallas  
Dubai  
Frankfurt  
Geneva  
Hong Kong  
Houston  
Johannesburg  
Leeds  
London  
Los Angeles  
Madrid  
Manchester  
Melbourne  
Mexico City  
Miami  
Milan  
Minneapolis/St. Paul  
Montreal  
Mumbai  
Munich  
New York  
Orange County  
Paris  
Philadelphia  
Prague  
Rome  
San Francisco  
Santiago  
Sao Paulo  
Shanghai  
Silicon Valley  
Singapore  
Stamford  
Stockholm  
Sydney  
Tokyo  
Toronto  
Vienna  
Warsaw  
Washington, D.C.  
Zurich

SpencerStuart

[www.spencerstuart.com](http://www.spencerstuart.com)