

2011



USING THE ARC MODEL TO IDENTIFY THE "SWEET SPOT" FOR CEOS AND PRIVATE EQUITY INVESTORS

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Developed by Notch Partners, the ARC model helps operating executives source transactions most efficiently for private equity (“PE”) firms. While PE investors understand and appreciate the value of operating expertise to maximize returns, the deal sourcing process is often confusing and frustrating for both executives and investors and can result in wasted time and mismatched expectations. By providing a simple framework, Notch Partners’ ARC Model replaces inefficiency and lost time with definition and focus and helps to leverage the complementary skills and mindsets of industry leading operators and savvy investors.

Most private equity investors address “CEO-issues” after closing the deal. During the pre-close period, traditionally, many PE firms hire consultants to conduct market studies and put together a business plan for the intended *Target*. Some PE firms use Operating Partners to help evaluate the company and the existing management team. **Rarely does a PE investor kick off their hold period, with a “solid**

CEO plan,” or the “right CEO” ready to roll up his/her sleeves and execute on a vetted business plan. In most cases, if a new CEO is warranted, PE investors will retain an executive recruiter to find the best candidate who happens to be interested and available. The process can take 6-12 months after closing, and in many cases, time pressure and a sense of urgency can compromise the suitability of the candidate ultimately chosen.

Established in 2002, Notch Partners’ mission is based on the premise that through productive collaboration, *Deal Executives* (see *Key Terms* on p. 3) and private equity firms can optimize their deal sourcing efforts and as a natural consequence, achieve higher performance during ownership to maximize returns.

The ARC Model applies specifically to deal sourcing. Depicted in a Venn diagram, it illustrates that the intersection of the three circles represents the “sweet spot” for CEOs to source deals independently or in partnership with PE. Each circle represents a critical feature of deal sourcing success. 1) *Actionable*; 2) *Relevant* and 3) *Compelling*. In evaluating different potential deals, both CEOs and private equity firms need to consider each criterion independently and then find opportunities where the three intersect.



When considering a potential deal idea, thesis, or more broadly, a *deal opportunity set* (see *Key Terms* on p. 3), CEOs and PE firms should ask the following questions:

A: Is it Actionable? There is no better catalyst to a robust deal sourcing effort, than an *Actionable Target*, and preferably one that is not being auctioned by an investment bank. However, while a proprietary *Actionable* deal represents the “holy grail” for private equity firms, an auctioned deal is often just as attractive, as the process signifies that a sale is imminent. In other words, an auction situation is attractive because it is *Actionable*.

A motivated CEO can be the lynchpin if he/she can not only source a transaction that is Actionable, but also emerge as the most qualified executive to lead the company and create value post-acquisition, either as CEO, chair person, or active director. This leads us logically to the next circle.

R: Is it Relevant? There are two points of *relevance* in the ARC model: (1) *Relevance* between the CEO and a potential *Target*, and (2) *Relevance* between the *Target* and the private equity firm. With respect to (1), executives are highly *Relevant* to a deal when direct parallels exist between their experience and the value-creation plan for the *Target*. With the clock ticking during their hold period, PE investors want to see results quickly. There is no time to climb a steep learning curve. **PE owners place a high premium on executives who have “done it before” and have succeeded in the same industry, by executing similar strategies and operating initiatives.** For example, an attractive deal situation is one where the President/GM of a division has grown the business profitably but would like to carve it out and operate it independently, with the help of a private equity sponsor. The proposition is attractive because there

Key Terms

Deal Executive: a seasoned executive, usually a CEO, looking to partner with private equity to acquire, grow and lead a company to a successful exit

Deal Opportunity Set: an executive’s “universe” of relevant targets

Target: a company or division targeted for PE acquisition

Actionable: reasonably thought to be acquirable

Relevant: whether an investor’s or executive’s specific expertise can create value in an acquired target

Compelling: has exciting, untapped value-creation opportunities

is no more *Relevant* CEO to this deal situation than the existing CEO. He/she is not only knowledgeable about the company, but if motivated, can also be a powerful driver to get the deal done.

The second important area of *Relevance* is the alignment between the *Target(s)* and the private equity firm. PE funds must acquire companies in accordance with their expertise and their investment charter, for example. Another obvious example of

Relevance is the proposed deal size. There is no point in showing a \$20M platform acquisition to a \$20B fund. No matter how interesting or *Actionable* the *Target* is, a mega-fund cannot reasonably write an equity check that small. The *Target's* stage of development is another important consideration. Buyout funds do not invest in venture or seed-stage deals; many will not consider turnarounds, growth capital, or minority investments either. Another focal point is industry. For example, if a fund has historically invested in industrial companies, they may have difficulty getting comfortable with a restaurant or software acquisition. With neither

the know-how nor the experience to acquire or manage such a company, the investor will need to conduct extra due diligence and rely on a strong, seasoned CEO and perhaps outside directors who can give them the confidence to get their feet wet in a new sector. Unlike check size or company stage, however, with respect to *Relevance*, the investors' lack of familiarity with an industry can be overcome by the executive's ability to show a highly *Actionable* and *Compelling* opportunity.

C: *Is it Compelling?* While the most difficult to discern, this is the “x” factor that can drive a PE investor over the tipping point and motivate the deal team to push a transaction through its investment committee. *Compelling* features can be executive and/or company specific. For *Targets*, growing customer segments (e.g., baby boomers), positive trends (e.g., health and wellness), strong competitive positioning (e.g., a #1 niche player), and industry dynamics (e.g., fragmentation with no clear leader), all provide *Compelling* reasons for PE investors to get excited about a prospective deal. Executive-driven influences could include a strong industry reputation

and/or a successful private equity track record. The *Compelling* factor is the one “circle” in the diagram which can be impacted by one or both of the other two circles: *Actionable* and *Relevant*.

Case Study:

A former CEO of a successful \$500M private equity backed regional premium supermarket chain has recently resigned upon the company's successful sale to a large strategic acquirer. Energized to repeat his previous success, and unencumbered by any non-compete agreement, he is now looking to acquire and run another chain, in a different region, also in the premium category. His target is experiencing revenue and profitability declines due to mismanagement. Because of his 30 years of experience in the supermarket sector, this CEO knows that the family who owns the competitor is interested in selling, due to their lack of succession planning. In fact, having heard about the recent successful sale of his previous company, they have approached this CEO to help them turn around their company and sell it.

Actionable? This situation ranks high due to the fact that there is a viable platform for sale. Potential for a proprietary transaction increases the attractiveness.

Relevant? This CEO is uniquely qualified to acquire and run the *Target* platform. In addition to directly relevant premium supermarket experience, he understands the brand and its competitive positioning, and he holds many of the same vendor relationships. The key is to discuss this transaction with the appropriate PE investor: one who invests in the middle market, has experience in retail (preferably supermarkets) and is willing to take on a turnaround.

Compelling? Interestingly, the most *Compelling* aspect of this deal is its level of *Actionability*, its proprietary nature and the strength of the CEO. In addition to the high *Relevance* of his professional

background, his recent successful private equity experience adds significant credibility to this deal initiative.

the finish line, than having high-level, unfocused discussions or chasing inappropriate targets with disinterested investors.

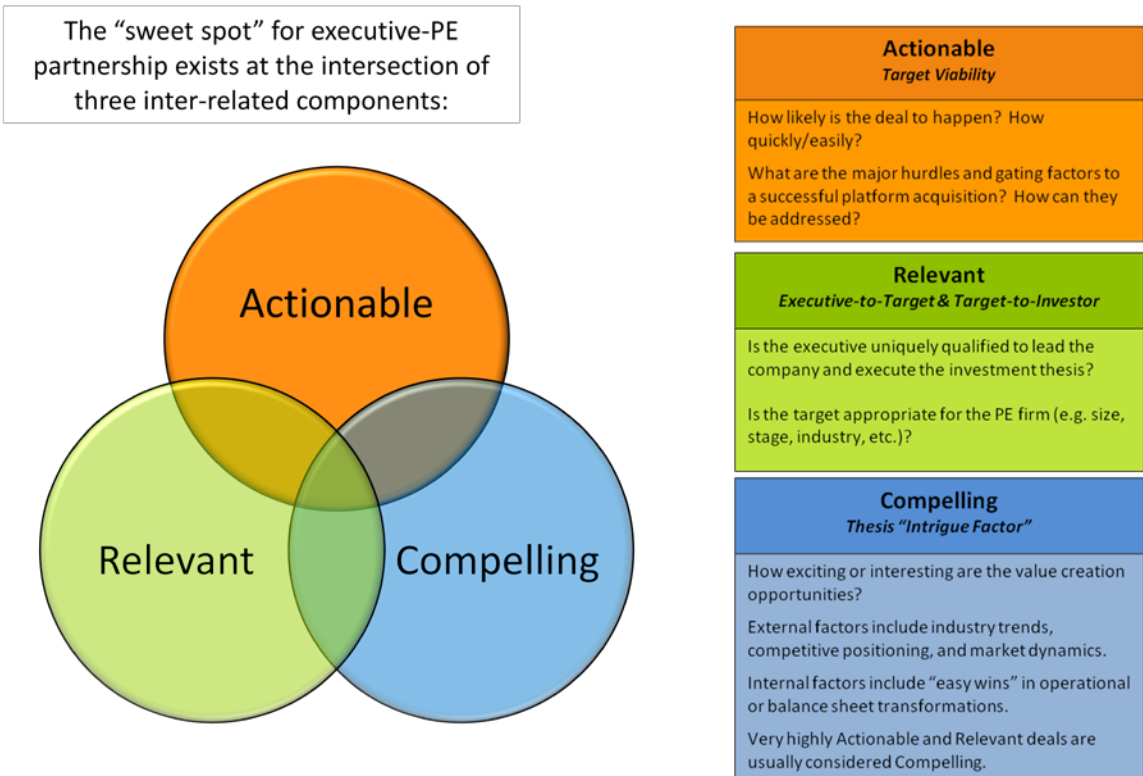
Role of the *Deal Executive*: Defining the Dialog

CEOs looking to “buy and build” a company with a private equity investor would benefit from internalizing the principles of the ARC model and orienting their dialog with PE investors accordingly. While there are some factors beyond their control, CEOs increase their odds for success by counterbalancing unavoidable weak spots in any given scenario with strong points they can control. For example, if a CEO’s industry *Relevance* is weakened by a non-compete agreement, he/she can identify non-competitive situations where industry similarities or personal relationships make the executive *Relevant*. Or the CEO can offset this issue by finding not one, but several potential *Targets*, and upping the *Actionability* quotient by initiating discussions with sellers.

Actionability is key, and this is why the *Actionable* circle is positioned at the top of the ARC model. A productive first step for any *Deal Executive* is to start identifying potentially *Actionable* acquisitions which leverage his/her background of successful experiences. In the world of private equity, time and talent are precious resources; nothing galvanizes a PE firm’s interest as completely as an *Actionable* platform acquisition.

For entrepreneurial CEOs, the ARC model is truly empowering and strategic. Finding the right *Target* and the right PE partner can be a frustrating exercise that can take months and sometimes years. Through facilitating hundreds of executive interactions with private equity firms, Notch Partners has observed that executives experience much more productive outcomes by speaking and negotiating with sellers and driving the right deal to

Notch “ARC” Model



Established in 2002, Notch Partners LLC is the pre-eminent provider of leadership capital and management-led buyout strategies for private equity firms. Our mission is to maximize our clients’ returns in every stage of the investment process through high impact relationships with industry-leading C-level executives.

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