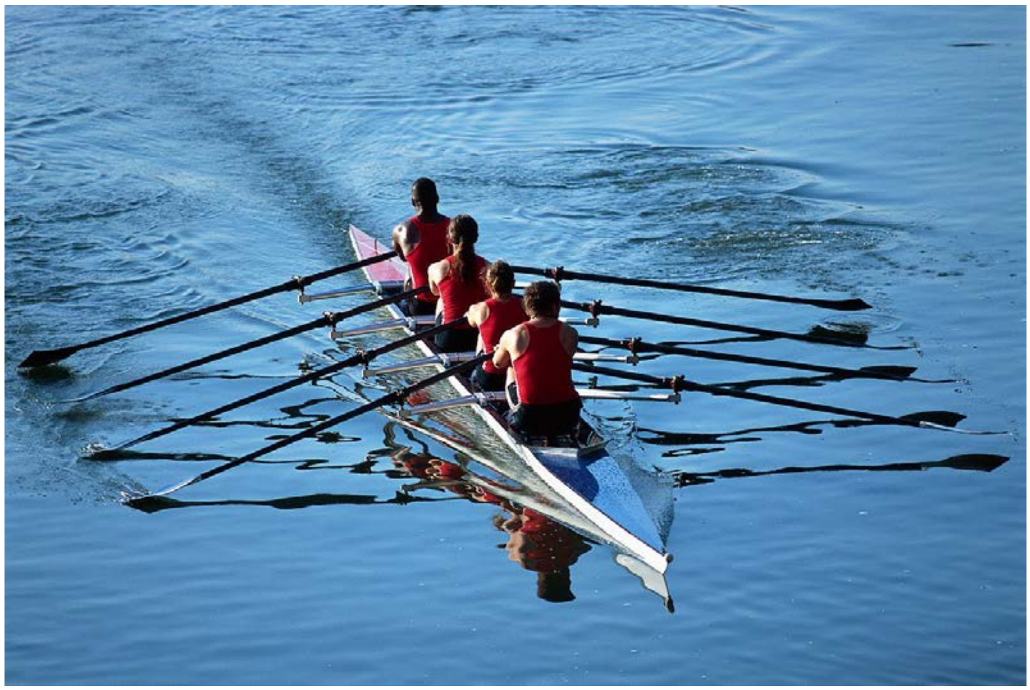
2015



BEST PRACTICES FOR PRIVATE EQUITY – OPERATING EXECUTIVE RELATIONSHIPS

A well-defined executive strategy is fast becoming a powerful competitive advantage for successful private equity firms. Based on almost a decade of experience, Notch Partners provides a "hit list" of best practices for PE investors to optimize their executive networks, relationships, and partnerships.

Best Practices for Private Equity – Operating Executive Relationships

A well-defined executive strategy is fast becoming a powerful competitive advantage for successful private equity (PE) firms. Based on almost a decade of experience, Notch Partners has developed a “hit list” of best practices for PE investors to optimize their executive networks, relationships and partnerships.

Proactive implementation of a well-defined executive program is critical for private equity success. Funds that leverage relevant experience and expertise from operating executives reap sustainable benefits during all phases of the investment cycle, which in turn leads to superior performance and fundraising prospects over the long-term.

In today’s environment, identifying and engaging executive talent is an essential component to every PE firm’s strategic plan; fund operators are subject to deeper scrutiny by LP’s who demand more rigorous investment discipline by the firm, and better operational leadership in the portfolio. Traditionally considered within the context of portfolio management roles, CEOs, CFOs, and experienced functional managers are now key resources who assist in sourcing, evaluating, and closing deals. Those firms able to integrate this type of operating expertise across their entire investment value chain are poised for greater success relative to their peers who leverage executive talent only in more traditional ways.

Integrating executives into the fabric of a private equity firm’s business model is neither simple nor straightforward. While most private equity firms have worked with operating executives, astute investors fully leverage a comprehensive range of potential C-level relationships. Since 2002, Notch Partners has helped private equity firms maximize the value of executive networking. In the course of working with PE funds and C-level executives, Notch has developed a set of best practices which is applicable to all investors, as they consider defining and implementing a sustainable operating executive strategy.

1) **Screen and evaluate executives thoughtfully**. Maximizing executive value requires a deep understanding of the investment opportunity followed by a thoughtful and thorough evaluation of potential executive partners based on specific needs of the deal or the portfolio company situation. Many private equity firms tap into their rolodexes or "expert networks" to access executive talent; the most tangible results occur for investors who carefully identify, vet, and select candidates with the most relevant knowledge base or experience. For example, while specific industry experience is an important dimension of relevance, other more subtle, yet compelling qualifications may include proven expertise in executing specific growth strategies (e.g., international expansion), solving certain problems, (e.g., customer concentration) or carrying out particular implementation initiatives (e.g., carving out complex and creating standalone systems). Referencing is also an important differentiator, where hiring decisions are based on appropriate questioning of qualified sources on germane issues and based on firsthand experience versus “buzz,” “soar value,” or hearsay, from second or third hand sources.

2) **Structure relationships flexibly**. Deal situations are dynamic and fraught with ambiguity. As a result, investors value flexibility from their executive partners. By the same token, many executives also share the desire for flexibility. Oftentimes, the most sought after leaders are those who categorize themselves as "semi-retired," and choose to remain actively engaged in a range of activities and projects, but purposely removed from consideration for all but the most compelling CEO opportunities. These executives vary widely in their needs and wants, relative to time commitment, geography, and nature of involvement. Many may be constrained by non-compete agreements and most are liable to change their minds regarding their activity set depending on any number of variables. PE firms who are willing to structure individual relationships will attract far more talent than those employing a cookie-cutter approach to executive engagement.

3) **Balance give and take**. During the past five years, the market for executives in private equity has evolved. In the past, few executives understood private equity, and only a fraction of those had the benefit of firsthand experience. Today, while few executives are experts in PE, investor exposure is no longer the exception. The most entrepreneurial, deal-savvy executives regularly field inquiries from multiple private equity firms, and adeptly discuss issues such as compensation and exclusivity. And while executives are still very much interested in working with private equity, some are confused when investors seek to tap into their knowledge or relationships on deal situations but offer nothing in return beyond a vague promise of a job or board seat "if a deal gets done." As such, providing free advice or working for "sweat equity" has become less compelling and executives now are expecting some show of commitment or compensation in return for their input. The most mutually rewarding CEO-PE relationships (formal or informal) are those where both sides consistently consider the relationship as a two-way street.

4) **Be genuine, honest and direct**. Like their private equity counterparts, top executives value ethics and integrity above all else. World class leaders have built their reputation on honesty and directness, and they expect to be treated the same way. While most have acquired companies in the past, for many, the volatile, fast-paced, and ambiguous nature of private equity deals is new and can be unsettling. Exacerbating this source of disconnect, private equity firms are most accustomed to dealing with CEOs within the context of an arms-length, buyer-seller relationship, where showing one's cards can be ill-advised. CEO-PE partnerships should be strategic; alignment is key and trust is imperative. Executives respect partners and colleagues who are forthright. While difficult, providing honest and at times, negative feedback in a candid yet professional manner is an effective differentiator to executives who appreciate hearing the truth and remember those who had the courage to deliver it.

5) **Exercise professionalism**. Standards for professionalism can be inconsistent between private equity and the corporate world. Customary behaviors or habits in investment banking and private equity circles may be

interpreted negatively by corporate executives. For example, certain routine meeting practices, (e.g., walking in and out, checking email, or canceling at the last minute) are by and large, commonplace in many private equity firms but not acceptable in the corporate world, particularly when interacting with a CEO. Responsiveness is also essential. When they send an email or call, CEOs expect to hear back in a timely fashion and want to be kept abreast of developments. For PE firms this means consistently observing certain formalities and erring on the side of conservatism when establishing standards for interaction with executives.

6) **Expand thinking and broaden investment opportunity sets.** While executives are often called upon to provide expertise, augment knowledge, or enhance capabilities in everyday situations, it can be transformational to align with seasoned operators to enter unfamiliar, unconventional, or complex deal situations, thereby significantly expanding the universe of viable investment opportunities. The ability to address situations previously considered too risky - such as those with weak incumbent management teams, those requiring turnarounds, and challenging carve-outs - can serve as a source of competitive differentiation with a highly relevant and skilled operator as a partner.

7) **Build relationships for the long term**. During an active deal situation, executive interaction occurs organically, as collaboration drives conversation. When a deal dies, however, investors need to be more proactive to maintain dialogue and momentum over the long term. While the stop-and-go nature of deals is understood and accepted by PE firms, the choppiness in communication can be confusing or disconcerting to executives. Whether or not there is any formal structure, the most productive relationships require patience and attention beyond the life of any particular project. Ongoing discussions could center on collaborative deal sourcing, idea generation, or even just periodic conversations to remain in touch. Investors and executives are often surprised by where these conversations can lead. Furthermore, staying in touch helps PE firms to stay abreast of executives' career movements and to remain top of mind, should a compelling deal idea surface on either side.

8) **Value executives beyond deal sourcing**. Almost every CEO who has attempted to network with private equity has been advised to "bring back a deal." It is no surprise that most executives are not experts at sourcing deals for private equity investment. Furthermore, many accomplished CEOs are able to gain traction with private equity firms without resorting to deal sourcing. PE firms that successfully affiliate with top tier CEOs focus first and foremost on establishing a relationship based on mutual interests and objectives. These investors recognize that executives can add value beyond sourcing deals and are interested in engaging more broadly and/or strategically with their private equity partners. Executives can lend expertise and experience to due diligence processes, make introductions to high impact suppliers or customers, or serve as mentors to portfolio management teams. Many may be "latent"

deal sourcers at the outset, and require some guidance and direction from their private equity partners before they are appropriately focused and can gin up deals independently.

9) **Maintain transparency**. Transparency is an important element to build trust with an executive. Keeping executives at arm's length sets a tone of formality and creates distance. Executives generally prefer to collaborate within the context of a true partnership, characterized by open, direct, and timely communication. That said, understandably, many firms are fundamentally cautious about whom they bring "into the fold." Nonetheless, PE firms should be intentional about the appropriate level of transparency for each of their executive relationships. Furthermore, direct real-time dialogue enables executives to react nimbly to fast changing deal situations. Maximum visibility into deal situations provides for more productive collaboration, experiential learning, and opportunities for sourcing ideas.

10) **Define and/or formalize relationships**. While many CEOs have interacted in some way with private equity firms, few can define or characterize their relationships beyond a series of interesting conversations or a short-term collaboration on a deal. Some executives are confused at the ambiguous, open-ended, yet discontinuous nature of these one-off interactions. Many private equity firms are cautious about formalizing relationships as they believe doing so will require more commitment (e.g., time, money, exclusivity) than they are able to provide. Interestingly, many CEOs care less about compensation than they do about clarity. As such, assigning roles (e.g., Senior Advisor, Operating Partner, Executive Advisor, Executive-in-Residence) within an Executive Program – even a loosely defined one - and formalizing the affiliation with a letter goes a long way toward managing expectations on both ends, and differentiating a PE firm from the many other firms seeking the attention of that executive. Providing a letter does not necessarily require a PE firm to commit beyond its comfort zone, as the terms of the arrangement can reflect a range of possible compensation scenarios.

When we asked LPs to rate the importance of various capabilities they look for when selecting GPs for their new fund commitments, having a repeatable formula and resources a PE firm can call on to create value post-acquisition came in at the top. Close behind were a rigorous due-diligence process that yields proprietary insights and a proven model for recruiting, retaining and motivating strong management teams.

Bain and Co. Global Private Equity Report

Conclusion

Private equity firms agree broadly that executives can add tremendous value to deal situations and portfolio companies. The most successful investors realize the extent to which a simple, yet robust executive strategy can create a sustainable proprietary advantage, not just on isolated deal situations, but across their entire business. Further, as the deal environment becomes increasingly competitive and as LP's demand greater visibility and higher performance, access to executive expertise is fast becoming a core function for truly strategic investors.

Developing, launching, and executing a consistently thoughtful executive strategy require time and ongoing attention - just as relationships with deal brokers and investment banks need to be nurtured. To that end, those firms dedicated to a proactive execution of an executive strategy may either hire a professional to oversee their program internally or outsource to specialized firms that focus on creating and leveraging executive relationships for private equity exclusively. Regardless of the approach, a robust executive strategy should be a key component of all PE firms that aspire to build companies and create value the "old fashioned way" - through capital investment and world class leadership.

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.

Mei-Mei Tuan
Managing Partner
mtuan@notchpartners.com
973-921-1229

Andrew Thompson
Managing Partner
athompson@notchpartners.com
973-921-0341

www.notchpartners.com