L.E.K.

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Six Ways Smart PE Firms are Mining Profits in a Challenging Environment

How can private equity (PE) firms continue to prosper in today's high-multiple, hyper-competitive deal landscape? That's the big question we will be exploring in a series of *Executive Insights* devoted to the challenge of creating value through transactions. We begin by identifying six ways in which successful PE firms are leveraging advantaged deal flow to succeed in a world where old-school proprietary deal flow no longer exists.

You might think these would be tough times for PE firms, and you would have many good reasons for believing so. Among them:

- Global growth remains sluggish
- PE firms are sitting on a record-high amount of cash, estimated at roughly $700 billion. That's a lot of dry powder, resulting in intense competition for attractive assets and high multiples
- Stock markets are soaring, providing public companies with cheap currency for acquisitions and adding to the already crowded pool of potential buyers
- Increasingly, the assets that come to market have already undergone the transformation from family ownership to professional management, leaving less hidden value for buyers
- Historically low interest rates suggest that future refinancing on more favorable terms is highly unlikely
- Finally, we live in an increasingly unstable world defined by political unrest and frequent economic shocks, further compounding systemic risk

And yet, despite these challenges, the PE industry is thriving and will likely continue to do so, delivering impressive results in the short term while dramatically outperforming public markets in the long term (see Figure 1).

So what are the best PE firms doing to deliver stellar returns? From our discussions with more than 150 PE firms, we observe that one key ingredient is advantaged deal flow, executed in one or several of the following ways:

- Choosing a winning sector early in its development
- Buying and building from a smaller platform
- Leveraging knowledge developed from owned and divested assets
- Deploying superior management
- Targeting underperforming companies

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Figure 1
U.S. Private Equity Index and Selected Benchmark Statistics

Index	5-Year	10-Year	15-Year	20-Year	25-year
Cambridge Associates LLC U.S. Private Equity Index	17.72	14.26	11.91	13.95	13.84
Dow Jones Industrial Average Index	17.83	7.63	5.34	10.48	10.75
Dow Jones U.S. Small Cap Index	22.02	10.07	9.92	11.52	N/A
Nasdaq Composite Index	19.16	7.97	3.36	9.59	9.70
S&P 500 Index	18.83	7.78	4.35	9.79	9.89
Wilshire 5000 Total Market Index	19.15	8.28	5.08	9.89	9.93

Source: Cambridge Associates. Data as of June 30, 2014.

- Performing equity carve-outs of orphan divisions of large corporations

Let's examine these six strategies one by one:

1. **Choosing a winning sector early in its development.** Self-evident, perhaps, but winning PE firms make understanding the future their focus. They develop an investment thesis based on an emerging trend or a looming regulatory shift — say, the passage of the Affordable Care Act in 2010. Next, they identify a strategic segment within the larger market that stands to benefit disproportionately in the new environment. With Obamacare, for example, demand for revenue cycle management services was poised to increase significantly, and this is a segment where many PE firms successfully invested over the past few years. Invest in the right platform and the upside potential is twofold: market growth and company development.

2. **Buying and building from a smaller platform.** Look for a quality target that may be missing key ingredients and also presenting opportunities to grow, organically or by acquisition. That could be a company with a solid U.S. presence, for instance, but without overseas markets. Or one that's small but offers entry into a market that's ripe for consolidation. Consider Carlyle Group's purchase of Service King, a regional automotive collision repair chain, in 2012. That was the beginning of a buying spree that totaled 18 acquisitions in two years. During that time Service King expanded from 47 locations in Texas to 177 across 20 states. It upgraded its finance and accounting departments, developed enterprise-wide supply partnerships and focused on improving relations with its main customers, the insurance companies. The result was a company whose annual revenues nearly tripled and EBITDA margins expanded.

3. **Leveraging knowledge developed from owned and divested assets.** Hard-won knowledge and experience gained from previous investments can be indispensable tools for unlocking value in later investments in the same industry. Consider Blackstone, which has been buying and selling hotel chains since 1990. Recent deals include Extended Stay (purchased in 2005, sold in 2007, purchased again in 2010); Motel 6 (purchased in 2012); Hilton Worldwide (purchased in 2007); and Hersha Hospitality Trust (purchased in 2014). Along the way, they've come to know their customers well; they've developed close relationships with a broad network of industry executives; and they've gained a sophisticated understanding of market vulnerabilities and hot spots. All that adds up to a tremendous advantage over less experienced players on the next hotel acquisition opportunity. It's like starting a touchdown drive on the 50-yard line instead of the 20.

4. **Deploying superior management.** Top quality management is a scarce and important resource, and increasingly valuable. In a competitive environment where so many other variables are subject to commoditization, identifying, recruiting and retaining top managers are all critical. Skillful leaders can't be streamlined, they can't be outsourced and they can't be replaced by new technology. Nor are they interchangeable. The best PE firms skillfully match specific management talent with the needs of specific assets.

5. **Targeting underperforming companies.** Assets with potential for value creation through operational or strategic improvements are often ignored by PE firms who don't have the capabilities or interest in making fundamental changes to the business. Many successful PE firms look for companies with significant operational or strategic issues that require wholesale changes to uncover hidden value. One example: Onex and its acquisition of Husky Injection Molding Systems, a company that supplies machinery for making plastic products, including food and beverage containers and medical components. Husky has changed hands several times in recent years, but Onex bought it first, in 2007, when the company was ripe for a significant overhaul. Onex set about improving manufacturing operations, reducing SG&A, developing new raw-material sourcing and reducing working capital, which allowed it to reap significant returns when it sold a much stronger Husky to its next buyer.

6. **Performing equity carve-outs of orphan divisions of large corporations.** These transactions typically require significant amounts of operational oversight as the carving out process can be challenging and involved. However, there may be legacy divisions suffering from lack of attention or investment, or perfectly viable operations that for one reason or another are no longer part of the parent company's core business. Similar to #5 above, these companies typically require a healthy dose of operational or strategic improvements to reach their full potential. For instance, Cerberus Capital Management found such an opportunity when it bought a majority stake in ATT's yellow pages business, YP, in 2012. Under Cerberus, YP regained its former luster and has become a critical channel for some of the largest technology companies to reach the small business market.

Conclusion

Fierce competition, an abundance of capital and high multiples demand more from PE firms to identify the best investment opportunities and to close deals quickly. Notwithstanding these challenges and well-conceived strategies for advantaged deal flow, the need to bring uncompromising discipline and rigor to vetting each investment opportunity cannot be underestimated. There is no substitute for independent, fact-based analysis that maximizes value and reduces buyers' risks that can be delivered to high-performing PE firms at an accelerated pace. In future *Executive Insights*, we'll share more of what we've learned about creating value through deals in a challenging environment.

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