Summary

Private equity firms are on a constant search to increase the value of their holdings. But they must tread a fine line between operational aid that benefits the company and too much help that undermines its ability to stand on its own.

IN — AND OUT OF — CONTROL

Private equity funds are becoming more engaged with their portfolio companies. But there's a fine line between fostering and stifling.

BY BETSY NEVILLE, DAVID SMALSTIG AND DOUG DONSKY

Faced with a sluggish economy that puts pressure on profits and hinders early sales to buyers or public markets, private equity firms often have to keep companies in their portfolios longer than they would ordinarily prefer. But what should happen during these extended holding periods to increase the value of a company? How much assistance can a firm provide without undermining the company's ultimate independence? And what can a firm do during a prolonged period of ownership to reassure a company's key audiences — from management and rank-and-file employees to customers and investors — that their efforts continue to strengthen the portfolio company over time?

Taking a less hands-on approach may have been a less risky proposition when the economy was booming and portfolio holdings could be resold quickly and profitably. But these days, most companies are struggling to rebound from the recession, and if a PE fund is not responsive to the needs of a company on a real-time basis, its future value will be negatively impacted.

At the other extreme, some private equity firms react to hard times by immediately replacing management, slashing costs and assuming complete control of the business. But that, too, brings risks, including damaging employee morale, lowering productivity and slowing the timetable for getting the company in shape to be sold. Rather than being able to exit within four to seven years, the private equity owner might have to stay invested considerably longer, waiting for the new managers to establish the kind of track record that could attract buyers willing to pay a premium price.

Often the approach is to split the difference, not only keeping most or all of current management but also bringing in temporary outside help that can speed the rehabilitation of the company. The idea isn't to dictate changes but rather to aid in analyzing problems and developing solutions that the managers will embrace. If the ideal balance is struck, the company's management team will emerge with a record for succeeding despite adverse conditions, and the private equity firm may be able to take its leave on profitable terms — and to build a reputation for turning around troubled businesses, which can help it attract the next round of investors.

Particular success can be achieved when the PE fund and its specialist teams are brought in to

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work with management to improve particular areas of a company, providing expertise on human resources, information technology, merger integration or underperforming departments.

For example, Wynnchurch Capital, a private equity fund in Rosemont, Ill., recently accomplished a textbook transition, improving a portfolio company by providing management with targeted specialized assistance and developing a framework to drive improvement across the entire organization. In 2007, Wynnchurch acquired two struggling automotive rubber seal manufacturers, GDX Automotive and Metzeler Automotive North America, with the plan to merge the two operations into a newly formed company, Henniges Automotive. The potential efficiencies were substantial, but so were the challenges of combining the two businesses. Wynnchurch had to establish a new management organization, install new management processes and frameworks, dramatically improve operating efficiencies and quality, and replace two incompatible information systems that affected a range of essential functions — from accounting and purchasing to sales and customer relations.

During a merger, engaging the workforce, even unions, is key.

A major attraction of GDX was its strong customer base and product mix, but prior to the acquisition the company suffered from poor quality, inefficient manufacturing and significant operating losses. In some cases as much as 20% of the parts rolling off the production line were flawed and had to be scrapped, and the productivity of certain operations was half of industry averages. Management had to rebuild customer confidence in the business while also completing the integration of the two companies. Since the merger, Henniges has not missed a single launch date and has dramatically improved quality and efficiency. As a result the company has re-established itself as a preeminent global supplier.

Many of GDX's quality control and efficiency problems, says Wynnchurch partner Terry Theodore, stemmed from old-fashioned organizational structures and work practices. Management had not engaged the workforce to help solve performance issues and instead relied upon an archaic system of management-labor relationships. Changing that system was a priority, and Wynnchurch used the acquisition of GDX and its merger with Metzeler to engage the workforce, including the unions, to solve performance issues. The employees on the plant floor knew what the problems were, and so management provided them with the information, training and authority to solve issues quickly. The labor unions provided a highly constructive conduit to engage the workforce in a dialogue regarding required changes. In exchange for agreeing not to cut wages or health care benefits, the company was able

LINES OF COMMUNICATION

For Charles Ayres, a founding partner and chairman of Trilantic Capital Partners, sharing his vision with a company's managers is vital.

When we buy a company, probably the most important way we add value is by making sure the senior management team shares our vision. Of course, whenever possible we make this appraisal before a deal closes. Changing management midstream is hugely disruptive and costly, and it usually extends the time it takes to prepare a company for sale. Whereas private equity firms overall wind up replacing senior management about half the time, we keep our rate at around 20% by being very careful before we invest.

Then we try not to get involved in daily operations. We won't hire or fire a plant supervisor, for example, because you can run into lots of problems trying to shadow-manage every company in your portfolio. Yet we do follow the progress of our companies very closely. The closer you can get to being on the same page as a company's management team, the better your chance of working together to increase that company's value.

We once owned a company called Nimbus, based in Virginia. The management was particularly good at communicating with and supporting employees. I remember going to a company picnic where the CEO, other managers, board members and I put corn and burgers on the plates of employees. Later we talked to them and answered their questions. You don't always get that level of communication and trust between company managers and private equity investors, but when you do, it's a beautiful thing.

to establish flexible work rules that allowed Henniges to dramatically improve quality, delivery times and efficiencies. One example of these changes involved a union practice known as bumping. Whenever a job opened up, union rules dictated that the employee with the most seniority could take the position. This encouraged workers to shift jobs whenever they wanted a change of routine, which meant that most employees didn't stay in one place long enough to develop the expertise to optimize performance.

Yet even with that essential compromise in place, countless additional details had to be taken care of in merging the two companies — from getting the new technology system up and running and training employees to use it, to changing plant signs and all communications to carry the new name of the combined company, Henniges Automotive. All the while, managers had to assure customers that changes were being made in an organized way that would not disrupt production.

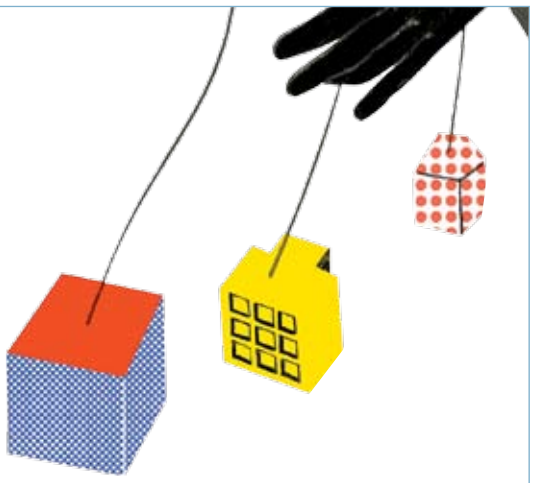
The merged company's CEO, who had worked with Wynnchurch on a prior investment, and the CFO, who had worked for Metzeler, oversaw the massive overhaul. But Wynnchurch also brought in its teams of specialist advisors to help create uniform systems for accounting, human resources information technology conversions and other functions. In most cases the advisors stayed for less than 12 months, working closely with Henniges's management to develop sustainable systems that were built by and for the management team. With the two companies effectively integrated and poised to take part in the auto industry's rebound, the company has performed exceptionally well and won several new programs with its major customers.

THE IMPORTANCE OF COMMUNICATIONS

Regardless of how the relationship between the PE firm and the portfolio company is structured, the mere arrival of a new owner always causes a stir. Therefore, establishing an effective communications strategy is crucial — though it's often beyond the capabilities of a newly acquired company's existing communications team. Handling announcements of layoffs and other cost-cutting measures clumsily, for example, may provoke job actions by unions and denunciations from local politicians and media. To limit a backlash, PE firms can lend support by helping the portfolio company conduct a thorough assessment of its many stakeholders, determining who they are and how they're connected to the business. For example, this could include an evaluation of how town officials will likely react to a significant reduction in workforce. If the team knows what to expect, it may be able to address and/or mitigate concerns before a public announcement by stressing the potential long-term benefits of necessary cutbacks.

CONSIDER THE BROADER MESSAGE

More complications can arise if the new owner isn't sensitive to the company's long-term relationships or commitments. For example, a company may have a long history of supporting hospitals or other philanthropic causes. If a private equity firm, in its cost-cutting efforts, simply eliminates that support, it may be taken as a sign that the company's new owners are not interested in the community's welfare. Similarly, the decision to relocate a company's headquarters



can be a communications disaster without careful preparation. Proactive communications aimed at building relationships with these stakeholders from the onset can establish a baseline of understanding and support that can preempt negative outcomes.

All such communications tasks are difficult for a company's management to handle at a time when the business is struggling to rebuild. But with the support of the private equity firm, management can handle all these delicate jobs to pave the way for a smoother transition and preempt unforeseen interferences — ultimately succeeding in the task of enhancing a company's value.

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