J.W. CHILDS
ASSOCIATES

Empowering Operating Partners

ADAM SUTTIN, PARTNER — J.W. CHILDS ASSOCIATES

As purchase prices climb, sponsors are counting on operating improvements more than ever to drive returns; alignment between Operating Partners and investment teams will determine whether or not they're successful.

As recently as last decade, a focus on value creation was still the exception across much of private equity and actually ran counter to the financial engineering strategies that provided the most reliable source of returns for many of the industry's biggest names. Fast forward to today, nearly ten years removed from 2008's credit-fueled financial crisis, and there are few if any firms that don't at least claim to focus on improving portfolio company operations. Yet, as it relates to the Operating Partners that are often counted on to drive this growth, relatively few firms have made the full leap necessary to ensure these teams have an equal voice and are empowered to create value across all stages of the investment lifecycle.

The value of an operational lens should be particularly pronounced as the investment landscape becomes more difficult

While this characterization may sting a good portion of the PE community, research suggests these operational efforts remain wildly inconsistent from firm to firm. Consultant Bain & Company, for instance, featured a survey within its 2016 Global Private Equity Report in which one in three Operating Partners polled identified that they do not have the full backing of their investment team. Three out of every five also claimed that the value-creation functions within their firms were not yet fully staffed or even focusing on the right priorities.

In many ways, these half-hearted efforts don't do justice to the immense impact Operating Partners can and do have – both at the partnership level and within portfolio companies. As a firm whose very model rests on the complementary and intertwined roles shared by our Operating Partners and investment teams, we've found that success on this front requires that the financial interests of our operations team are directly aligned to those of the fund – not just the deals they work on – and that our roster of former executives and CEOs are considered true "partners" in every sense of the word.

The value of an operational lens should be particularly pronounced as the investment landscape becomes more difficult for many. Median deal multiples were residing at 11.2x Ebitda as of September 30th, according to PitchBook Data, a full turn above the next closest average acquisition multiple over the previous decade. Leverage, meanwhile, has remained largely static as a percentage of enterprise value, which means there is that much more emphasis on operating improvements to drive IRRs. With multiple expansion no longer guaranteed as part of the investment calculus –

at least not in today's environment – it's critical that portfolio companies are being acquired with distinct growth strategies in mind.

A Winning Edge

In conversations with management teams or LPs, it's not uncommon to initially hear misconceptions around the exact role of Operating Partners. Many assume this team will "parachute in" during periods of stress or merely fill a governance function. Even those who understand how closely Operating Partners work with our companies still assume there is some kind of hand off that occurs, post close, in which the deal team passes the baton to the operators. This may be true for some firms, but this approach doesn't maximize the value available through a more integrated model. In a market in which assets are being priced to perfection, and even when material value is available at entry, the active contribution of industry executives and former CEOs can be instrumental when it comes to winning deals in the first place.

William Watts
Partner

Current Investments
Cycle Gear
RevZilla
Shoe Sensation

Select Exited Investments
Mattress Firm
The Tile Shop
Brookstone
Murray's Discount Auto Stores
Equinox Fitness Clubs
Bass Pro Shops

At the very outset, to cite one example, Operating Partners can inform and help refine the investment thesis that supports a bid. For instance, if we're exploring a retail investment, Bill Watts, one of the Partners at J.W. Childs, can very quickly deliver a SWOT analysis that roots out compelling growth opportunities others might overlook, while identifying unforeseen threats that the companies, themselves, may not have considered. With a track record that includes successful stops as an executive or board member at GNC, Mattress Firm, The Tile Shop, Bass Pro Shops and Equinox, among other retailers, his innate familiarity with the sector provides something of a sixth sense. Does the company have competitive advantages that will survive evolving consumer patterns? Are these patterns even being recognized and how will they influence margins or future merchandising strategies? Does the company compete with Amazon or does the potential exist that it one day will? How much white space is available to accommodate new store growth and at what point and what level does cannibalization eat into new store ROI? These are the types of questions that either arm the deal team to be more aggressive with their valuations or, alternatively, can save the fund from being exposed to transformational market shifts.

Operating Partners are also vital in building relationships with executive teams. All of our Operating Partners have participated in buyouts from each side of the table and can address any and all questions management teams may have. They deliver insights and understand challenges that are difficult to articulate to those without on-the-ground experience. And the credibility they bring often makes the difference in an auction when all else is equal and even on occasions when we don't submit the highest bid.

Setting a Course

In a separate analysis in Bain & Co.'s 2016 Global Private Equity Report, the consultancy highlighted the most common factors that sabotage value-creation plans. Among the top four were the skillset of the portfolio company management teams, a shift in industry dynamics, macroeconomic headwinds, and overly ambitious strategic plans. Each of these factors, at the same time, underscore the critical role Operating Partners play following an investment, whether it's setting ambitious strategies with a path for execution, supporting management with resources and experience, or helping companies course correct amid change.

Beyond merely helping companies survive when the unexpected occurs, Operating Partners instill the conviction necessary to make bold, calculated bets; driving initiatives that may go against the grain, but showcase the real value of patient capital. We acquired Mattress Firm in 2007, and a year later the entire economy was hobbled by the global financial crisis. Consumers deferred big-ticket purchases, and the company's same store sales nosedived. In the face of this uncertainty, when most other retailers were scaling back and closing stores, Bill Watts made the case that we should be accelerating our real estate development to take advantage of leases as much as 50% below market. The investment ultimately yielded a substantial return, but it just as easily could have been a total loss without trusted guidance and leadership. If Bill was simply a consultant or operator for hire, versus a true partner, he would not have had the sway necessary to convince the investment committee (his peers) that a follow-on commitment was prudent to fund this initiative.

Operating Partners instill the conviction necessary to make bold, calculated bets

More often than not, though, the value of an integrated Operating Partner model will take the form of small insights that collectively have a tremendous impact on the bottom line. When we acquired Cycle Gear, for instance, we adjusted retail prices on the private label line and added in-store kiosks for online ordering, increasing both margins and revenue. We also reduced the size and cost of catalogues sent to customers and improved the efficiency of the warehouse and distribution operations. These types of initiatives aren't exactly the low hanging fruit most associate with financial acquirers.

An Aligned Strategy

Some have taken issue with the idea that GPs refer to operating professionals as "partners" in the first place. SEC Director Andrew Bowden, for instance, observed at an industry conference two years ago that while they "may walk, talk, act and look" like representatives of the firm, most Operating Partners "are not usually treated as employees or affiliates of the manager."

This characterization couldn't be further from the truth at J.W. Childs. Our Operating Partners, as full partners in our funds, have as much at stake as our investment team and reap the same rewards on every successful investment, even those outside of their domain. On the deals they're directly involved with, the Operating Partners, alone, make incremental investments – on top of their fund commitments – to further buttress the incentive structure and provide a final measure of conviction ahead of closing. Our Operating Partners have to quite literally buy into a company they'll be overseeing.

As such, our Operating Partners have a hand in everything from pre-screening investments and due diligence to creating and executing the strategic plan that informs and drives our investment theses. It's a fully integrated model in which they can make as much of a difference in valuing and winning deals as they do in stewarding our portfolio companies to a successful outcome and exit. It's a model that fosters alignment, not only between the investment team and our Operating Partners, but also between our portfolio companies and our LPs.

Adam Suttin
Partner

Adam Suttin co-founded J.W. Childs Associates in 1995 after previously working at Thomas H. Lee Company from 1989 to 1995. Mr. Suttin received a B.S. degree, from the Wharton School of the University of Pennsylvania and a Bachelor of Applied Science, from the Moore School of Engineering of the University of Pennsylvania.