CEO PRIVATE EQUITY ROUNDTABLE

In conjunction with the Illinois Venture Capital Association Private Equity Annual Awards Dinner, Spencer Stuart's Private Equity Practice hosted its fifth annual CEO roundtable. The event brought together chief executive officers and board members from private equity-owned companies, family businesses and a few public companies for a candid roundtable discussion and brainstorming session.

The discussion focused on the state of private equity today and the implications for the industry of the economy and capital markets. Participants also talked about the business and talent challenges they have been facing in the current environment. **Gil Stenholm**, a leader in Spencer Stuart's Private Equity Practice and a member of the Board Services, Consumer Goods & Services and Industrial practices, hosted the event and moderated the discussion. Also attending from Spencer Stuart were **Christopher C. Nadherny**, who heads the firm's Digital & Direct Marketing Practice, and **Patrick B. Walsh**, leader of the firm's North American Industrial Practice.

CEO PRIVATE EQUITY ROUNDTABLE ATTENDEES

Ben Chereskin | Profile Capital Management
Rich Conti | Formerly Wilton Brands
Jamie Egasti | Formerly Folger's Coffee Company
Frank Feraco | Great Lakes Equity Partners
Rick Frier | Catalina Marketing Corporation
John Greisch | Hill-Rom Holdings
George Hamilton | Home Products International
Rick Lenny | Formerly Hershey Company
Tom Malkoski | Penford Corporation
Rick Marcantonio | Formerly G&K Services
Pat Moore | Smurfit-Stone Container Corporation
Bill Perez | Greenhill & Company
Mike Roberts | Formerly McDonald's Corporation
Sam Rovit | Bain & Company
Dan Scales | Little Lady Foods
Peter Shea | Formerly Icahn Enterprises
Dennis Shuler | Kellogg Company
Tom Sweeney | DLC
Ken Viellieu | Moelis & Company Holdings
Bill Waltz | Strategic Materials

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PRIVATE EQUITY: WHERE ARE WE NOW AND WHAT DOES THE FUTURE LOOK LIKE?

Ben Chereskin, a former Madison Dearborn partner who recently founded Profile Capital Management, started the session by providing an overview of the state of private equity and projections for the future of the industry. The private equity industry "has been profoundly affected by the crisis in the capital markets and its aftermath. Today, there are fewer transactions, and they are smaller. Lower prices are being paid with less leverage," said Chereskin. Other observations:

> Buyout volume was down 96 percent between 2007 and the LTM third quarter of 2009.
> The average transaction size fell by 87 percent in 2007 to the first-half run rate in 2009.
> Purchase price multiples went from 9.3 in 2007 to 5.9 in the third quarter of 2009.
> Leverage multiples dropped during the same period from 6 times to 4.6 times.
> Leverage lending dropped 70 percent in a 12-month period from 2007 to 2008.

In addition, the asset mix has moved toward nontraditional products, such as distressed debt, and off-shore investment opportunities. Private equity will continue to be impacted by the overhang of leverage loans that are going to mature between 2012 and 2017, peaking in the period between 2013 and 2015 and growing from approximately $35 billion to $350 billion in a four-year period.

Over the longer term, Chereskin said he sees three primary effects on the industry from these trends:

Endowments and state pension funds, which have been pillars of private equity funding, are in the process of making painful shifts in their underlying business models and asset allocation models. What does that mean for the industry? First, the private equity industry will consolidate; as many as 25 percent of firms won't be around anymore, by some estimates. "We're going to see the number of firms in the industry contract in the absolute, and that has never before happened in the buyout space of the industry," said Chereskin. Meanwhile, surviving firms are likely to narrow their strategies. In the "free money" era, he said, firms expanded their business models to pursue a variety of high-alpha strategies globally and across asset classes, and those will be pared back. "Investors are going to be much more selective about backing best-in-breed players of whatever scale," said Chereskin. As part of that consolidation, firms will continue to centralize and impose professional management structures. Consolidation also has implications for talent. For the first time in its history, the industry will have fewer people, Chereskin predicted. Firms built up their staffs as they grew in scope and geographic reach; now, as they pare back, they will need fewer people.

"There's going to be a focus on more traditional roles, for example, an operating CEO or board directors," he said. "There will probably be a narrowing of the various flavors of affiliation, simply because the range of activities is going to shrink. The fee base that firms have to spread around will be less, so they will focus on their core talent needs."

At the same time, executives will want to choose the private equity firms with which to affiliate even more carefully than before, paying close attention to firms' financial viability and stability. "The strategies of these firms are going to change and the culture of many firms is going to be under tremendous pressure. These folks for the most part never had to deal with tough times and now they're going to deal with it internally," he said.

Turnover of talent within firms will increase. Given the return potential, turnover within private equity firms traditionally has been very low. Two factors are likely to spur greater turnover in the future. First, there will be a generational transition as founders retire or take more limited roles in their firms, potentially spurring an influx of professional management from asset management or from Wall Street. Second, with returns constricted, firms no longer have "platinum handcuffs" on their top talent, creating uncertainty about firms' ability to retain talent.

New players with new business models will emerge. While the total number of firms will shrink, the industry is likely to see the emergence of new smaller and more focused firms offering a different investment focus and experimenting with new private equity models. "The fundamental model of the private equity firm worked so well for so long, firms basically organized themselves along the same principles," said Chereskin. "Now, we're going to see private equity firms launch with somewhat different compensation models that are designed to address the very explicit concerns of the traditional funding bases about the duration of commitments, the lack of control over decision making, including exits, and compensation."

As the economy and capital markets improve, private equity activity will increase, potentially creating a "bubblette" in mid 2011 to late 2012. "Some firms that raised capital between 2005 and 2007 and had a hard time deploying it, either because they were coping with operational issues or because of a lack of activity volume, will view this period as the last time they'll get a shot at putting capital to work. Others simply will want to reestablish their credentials as viable, active, relevant players in the market for fundraising purposes," said Chereskin. Once that period is over, there will likely be a permanent rebasing of the industry at a somewhat lower level that will support a more sustained, healthy, long-term, secular growth trend for the industry, but at a reduced volume.

STATE OF CAPITAL: INVESTMENT BANKING ACTIVITY

Ken Viellieu, managing director and head of the Chicago office of investment banking firm Moelis & Company, provided an update on the financial restructuring activity occurring in the private equity industry. "We're seeing the tail-end of the restructuring business," Viellieu said. During the past six to 12 months, harder hit companies have ended up in a major Chapter 11 restructuring, while less affected firms pursued what he called "amend-and-extend" restructuring, in which they amended agreements with lenders and took on a higher cost of capital in connection with those amendments. "The low interest rate environment has bailed out a lot of companies facing restructuring," he said.

The current environment has reduced some private equity firms' access to low-cost capital compared with strategic buyers, fueling strategic M&A. On the private equity side, deal sizes are smaller — $1 billion or $2 billion deals compared with the $10 billion deals of the past — and tend to be happening in robust, growing sectors such as healthcare, aerospace and defense, and education, he said. "After spending the past 12 to 18 months restructuring their portfolios, private equity firms are in the position to look at new investments, but they're not finding a lot of businesses on the market now," said Viellieu.

Good companies that are looking to sell are likely to find many potential buyers among private equity firms that have been focused on cleaning up their current portfolios and are ready to make new investments.

CHALLENGES FOR PORTFOLIO COMPANY CEOS

Sam Rovit, a partner with Bain & Company in Chicago, led a discussion on the challenges facing CEOs in the current environment and their approach to the business as they look to the future.

Starting with the credit crisis in 2007 and early 2008 and then the business slowdown, which reached its nadir in the first quarter of 2009, companies in some sectors found themselves in a "doom loop" characterized by falling demand, customers lagging on their payables and rising inventories, said Rovit. Companies with a weak strategic position and a weak balance sheet are unlikely to survive. "The question is whether those companies that are in a weak strategic position with a strong balance sheet can shuffle the deck. In past recessions, some of those companies have been able to take advantage of opportunities," said Rovit. "The problem is companies have very little visibility in terms of when demand is going to return; as a result, it's very, very difficult to plan."

The biggest single challenge for many businesses is predicting revenue growth, agreed **Rick Marcantonio**, former chairman and CEO of G&K Services. "Without having an idea of where revenue is headed, it makes running a business extremely difficult. Companies can do the obvious things to generate earnings improvement, including controlling capital spending, reducing expenses and driving massive productivity improvements, but without revenue growth going forward, where is value creation going to come from?"

Rovit asked the CEOs in the room about their priorities for the future; especially in an environment that remains uncertain, how they are thinking about the composition of their team, and how they are maintaining morale.

CEO PRIORITIES: IMPROVING PRODUCTIVITY AND PLANNING FOR GROWTH

With the top line continuing to be a challenge, **Dan Scales**, CEO of Little Lady Foods in Chicago, said his team has focused on the bottom line, making operations more productive and watching capital spending, but he also is looking to the future. "As much as there is a tendency to retrench and focus on cost savings in an environment like this, it is also a great time to prepare for what the future could be. Our strong balance sheet has given us the opportunity to do a lot of things that we typically would not have had," said Scales. "The current market also has allowed the company to invest back into the business, including new products and the opportunity to hire some really talented people."

"If you're not focused on growth, then you don't have the building blocks in place to drive a sustainable and continuous performance and that's equally as true today," argued **George Hamilton**, CEO of Home Products International in Chicago. "A lot of companies today are facing the same situations that overleveraged or distressed companies have faced, and that is that they have to focus on the basics. They have to focus on the blocking and tackling in the short term, but once they get control over the metrics, they have to focus on growth."

The approach that **Jamie Egasti**, formerly CEO of the Folger's Coffee Company, has taken is to focus the organization on what customers and consumers value and, by extension, the areas of organizational capability that create sustainable advantage. "We reduced our head count significantly by focusing exclusively on driving organizational capability into the areas that drove value creation for consumers or for customers," he said. Innovation also is critical, whether it's product or marketing innovation that supports top-line growth or cost innovation.

A longer-term challenge for CEOs, said Rovit, will be maintaining the operational discipline and cost management practices imposed while companies were under duress. "What can companies do to maintain that level of discipline because, invariably, as times get better, costs start to migrate up," he asked the group.

Pat Moore, chairman and CEO of Smurfit Stone Container, said it is the responsibility of the CEO to ensure that the company has the processes in place to drive efficiencies on an ongoing basis. "The CEO should be continually challenging the organization to improve operational excellence, sales excellence, functional excellence, whatever it may be for their organization. If not, the organization will revert back to old habits," he said.

That attention to operational metrics is something that Great Lakes Equity Partners look for in all its CEOs, said **Frank Ferraco**, a partner in the firm. "Strength in operational metrics is critical when we look to hire a CEO for one of our portfolio companies. Do you speak the language? Have you done it? Have you ever been in trouble in a business before and could you fix it? Those are the things we look for. We have a certain set of metrics that we put across all of our portfolio companies because those ratios are good whether you are in the manufacturing of fertilizer or you're running a steel plant," he said.

To prepare for top-line growth in 2010, companies need to have a set of initiatives that go beyond shoring up the bottom line to creating opportunity for the future, said **Rich Conti**, formerly the CEO of Wilton Brands. "The organization has to understand that the crisis is temporary. There's a tendency for organizations to become insular and focus too much on the near term. As a CEO, you have to create an environment where people can see the recovery, they see the hope that stretches out beyond the current cost-cutting measures," he said. "People have an insatiable appetite for communication. CEOs need to be out in front, leading from the front lines, being vulnerable, answering the tough questions, and keeping the senior team aligned on the vision. What's the 12-month, 18-month, even 24-month vision? It may need to be adjusted from time to time, but everybody's got to understand here's where we're headed once we reach recovery; here's how what we're doing today supports the base to do that."

In addition to the general economic slowdown, Penford Corporation has had to respond to acute events specific to the company, including a flood, two droughts and a strike, during the past few years. "When facing challenges, CEOs have to lead from the front lines — on location with employees, customers and other key stakeholders," said **Tom Malkoski**, Penford's president and CEO. "What I've found is that to keep the organization motivated and on task and keep your team together, the CEO needs to be visible with employees, on the front lines, in plants and R&D centers. Walk around. Take time to answer questions, explain results, reinforce the company's direction and listen. Through direct contact, you will gain insights to make more informed decisions."

NEW PRESSURE ON BOARDS

CEOs also expressed concern about developments at the board level, particularly the demands on public company boards that can distract directors from strategic concerns.

Bill Perez, former president and CEO of the Wm. Wrigley Jr. Company, said he is concerned that boards will become more dysfunctional — and less focused on doing things that serve the business well in the long term — as they face more pressure from the government and shareholders to be active. As a result of this pressure, some boards are spending excessive time on unproductive activities. "In some compensation committee discussions, 30 percent of the time might be focused on what will drive the right performance and 70 percent is focused on the optics — what will be reported in the proxy," he said.

Free from much of that public market pressure, private company boards are able to move more quickly and tackle issues in greater depth, said **Rick Frier**, CFO of Catalina Marketing. "As a CFO of a public company, I used to report quarterly; now I report daily, which I like. I want board directors who understand my business. When it comes to board meetings, you're much more connected; it's much more of a dialogue about strategic issues."

All boards should make sure they are talking about what they want the company to look like over the long term, said **Mike Roberts**, former president and COO of McDonald's Corporation. "Boards spend a lot of time talking about things like 'what we can say, how we should say it, what should be printed, what the CEO will say in the press conference.' Boards, instead, should spend more time talking about strategic issues such as how the company will look a year from now after this acquisition. As someone said, I'm not buying a company because of what it does today; I'm buying a company because of what I think it can do tomorrow. The consumer is asking that, too. They don't want you to emerge from the recession the same company you were two years ago. They want you to be better. That's the challenge for private equity, for management and for boards to be thinking about: how does execution marry with innovation and the financial health one needs to do all this?"

UNDERSTANDING INTERNATIONAL OPPORTUNITIES

Rovit said he has seen a spike in the number of companies interested in growing internationally in the past year. He and others talked about some of the considerations for companies contemplating an international expansion. Primary among these is the need to thoroughly understand the opportunity and challenges new markets present. "The rules of the game in your home market are relevant wherever you're going. If it's all about relative market share and competitive position, it's going to be the same if you're in a different market; so, going abroad for growth and being a number five or six player in a market is not a recipe for success," Rovit said. Secondly, leaders also need to be aware of the potential risks and challenges related to differences in language, culture, currencies and even time zones.

True international growth requires a long-term commitment that's done very deliberately over a long period of time with significant investment behind it, added Conti. As a result, it is more often undertaken by public companies that do not have the shorter term time horizon. "It's tough for middle-market companies to deliver international investment to begin with, but leaving that aside, I've seen a real difference from operating in the large, publicly traded world where you can take on expensive, long-term initiatives, whether it's international growth or fundamental innovation growth as opposed to applied innovation-based growth. In most cases, the private equity world forces companies to operate within an investment thesis that's three-, five-, or seven-year based, and doesn't give you a lot of room to make large, long-term based investments," he said.

THE CEO'S ROLE IN MANAGING TALENT

What role should the CEO play in identifying and nurturing executive talent in the organization? Hamilton said that CEOs should manage talent on two levels: first, by directly managing the CEO's direct reports and, second, by ensuring the organization has a strong enough culture that when new people join the company, they will be well-trained and ingrained in the culture.

Another area of CEO responsibility is to have a well-defined vision and a culture in which people feel they are part of the organization and feel empowered, said Scales. Good communication is also essential. With these ingredients, retention generally takes care of itself, he said. "When you have well-defined roles and responsibilities and a clear vision for the direction of the company, you'll retain talented people. Providing feedback also is critical. Now more than ever, we are rewarding people, even for the smallest wins, so that employees see our progress and feel like they are a part of our strategic plan."

THE VIEW FROM HUMAN RESOURCES

Dennis Shuler, a former chief human resources officer for The Walt Disney Company and Procter & Gamble who now has his own consulting business, shared his perspective on talent management and HR. Being an HR executive is an "active role, not a passive one," he said. "HR executives should have a point of view on the talent in the organization and what talent the company will need to support its strategy over the next three to five years."

Companies also should understand that their best people are the ones most likely to leave when the economy recovers. "Their stock options typically are under water, they know their market value, and they're just waiting for the right opportunity. HR leaders should be coaching their CEOs and executive team on how to ring-fence the best talent from departing when the market corrects and moves into growth mode," he said.

Finally, Shuler talked about the traits of successful CEOs. These include agility and the ability to create the external context that can help the organization deduce very quickly and easily the strategic choices on which to focus. A second attribute is balance — between short-term and long-term, between strategy and operational excellence, between the ability to grow revenue and keep costs in line. They should also have a consistent track record, evident not just during their tenure in a particular role but in the performance of the business over time. Finally, CEOs should have the ability to manage the tempo. "Your organizations are tired. People don't want to hear, 'Run faster; run harder.' They want to see possibilities."

CONCLUSION

The overriding theme emerging from the roundtable discussion was that, despite the ongoing challenges for CEOs in a private equity environment, running a portfolio company continues to be one of the most engaging and rewarding leadership experiences.

With private equity deal flow still below traditional levels, private equity owners and portfolio company CEOs need to take a longer-term view of the business and be more operationally focused. At the same time, CEOs must help their organizations focus on the efforts that will produce sustainable growth and performance in the longer term. In challenging times especially, CEOs should be visible with employees, answering questions and reinforcing the company's direction.

Spencer Stuart will host similar events throughout the year to bring together CEOs from portfolio companies, family companies and public companies for a candid discussion about the challenges and opportunities they face.

ABOUT SPENCER STUART

Spencer Stuart is one of the world's leading executive search consulting firms. Privately held since 1956, Spencer Stuart applies its extensive knowledge of industries, functions and talent to advise select clients — ranging from major multinationals to emerging companies to nonprofit organizations — and address their leadership requirements. Through 51 offices in 27 countries and a broad range of practice groups, Spencer Stuart consultants focus on senior-level executive search, board director appointments, succession planning and in-depth senior executive management assessments. For more information on Spencer Stuart, please visit www.spencerstuart.com.

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