Alternative Investments

What Public Companies Can Learn From Private Equity

By: Les Berglass, 10.06.10

While the world has been criticizing the investment community, companies run by private-equity funds have quietly outdone their publicly traded counterparts. In the five years ending last December, Thomson Reuters Private Equity Index (excluding venture capital) gained 6%, whereas the S&P dropped by around 1.5%. Even amid the recession's darkest hours, private equity posted modest gains, trumping stocks' downward trajectory.

Private vs. public might sound like an unfair analogy. After all, private-equity investors run their portfolios without the burden of public accountability. However, I believe that the principles of good management are universal, regardless of ownership structure. As head of an executive search firm that works with a wide assortment of companies, I have observed that many private equity leaders faithfully adhere to such practices, particularly in terms of defining and attaining goals, hiring talent and rewarding performance. Every company, ranging from mom-and-pop operations to global conglomerates, could learn a lot from private equity's focused approach to delivering long-term results.

From the moment of purchase, a private-equity firm clearly defines its objective for the new business. "We start out with a set of investment theses, and then identify the resources that we need to bring to support those objectives," says Sandra Horbach, head of the global consumer and retail team at the Carlyle Group, which has helped build such companies as Dunkin Donuts, CVC, and philosophy.

Apax Partners purchased Tommy Hilfiger in 2006 with a crystal clear vision for the apparel company: Make Tommy cool again in the U.S. Once synonymous with "urban chic," Tommy's sportswear lost its footing with the American consumer, but flourished in Europe. Given this dynamic, Apax tapped Fred Gehring, head of European sales, to run the entire company. Gehring regained control of the brand by buying back a handful of licensing deals and narrowing wholesale distribution, most notably through an exclusive agreement with **Macy**'s. Last March Apax sold Tommy to **Phillips-Van Heusen** (PVH) for approximately $3 billion, close to twice the price at purchase.

Tommy's success hardly occurred overnight, but evolved during four years of carefully reconstructing the brand. This is a typical approach for private equity, which operates under a time line ranging from three to seven years. Their broad time horizon enables companies to take larger immediate risks, rather than agonizing over quarterly performances.

Shortly after Irving Place Capital purchased a 50% share of Seven for All Mankind in 2005, the firm built new headquarters for the jeans manufacturer that included both a warehouse and a dying facility. "This may not have seemed to make sense economically in the short term, but served our larger goal to integrate capabilities," explains John Howard, founder and chief executive officer of the New York-based firm that

manages more than $4 billion in equity capital. Within three years, **VF Corp.** paid three times the original investment price for the strategy that Irving Place Capital put into action.

By contrast, public companies are often forced to function in a world that delivers immediate gratification to Wall Street, where a business strategy is only as strong as the last quarterly earnings report. Howard describes this scramble for short-term returns as "the difference between getting short energy bursts from sugar beverages to doing more fundamental exercises that build the body."

One classic example: **Starbucks** scattered expansion strategy--namely opening too many retail locations--before CEO Howard Schultz returned to initiate a turnaround.

The need to placate demanding shareholders may be partly unavoidable, yet public companies would better serve investors if they did not fixate on weekly or monthly numbers. When private-equity firm Wellspring Capital Management owned entertainment/retail chain Dave & Buster's, the firm may have reviewed margins regularly, but used the data as a tool to navigate toward their three- to four-year goals. You have to deal with short-term issues as they arrive but not at the expense of the longer-term outcome," explains Greg S. Feldman, managing partner of Wellspring Capital Management.

To help stave off Wall Street's fascination with minute-to-minute performance, retailing giant **Wal-Mart** has ceased to report monthly sales numbers.

Private equity takes a similar "big picture" attitude toward its search for management talent. Irving Place Capital's choice to bring in Mike Egeck as head of Seven for All Mankind sounded a bit unusual at the time. As an executive at VF Corp., a $7.6 billion apparel conglomerate with a roster of more than 30 mainstream brands, Egeck may not have seemed suited for a small premium denim company. However, his hands-on experience building smaller brands like Vans and North Face, worked perfectly with Seven's growth strategy. "He was somebody who had the skills to translate an entrepreneurial company into a more institutionalized and larger business, one that would be more palatable to the types of buyers we wanted to woo," says Howard.

CEOs are highly motivated to deliver for private equity. "We incent management teams with equity so that their interests are completely aligned with our investors," explains Horbach of Carlyle. "If they perform and execute, then they reap the rewards of ownership." That makes for a hefty payout when a company sells for, say, double or triple its initial price. The catch is that, like owners, management reaps the bulk of such rewards *after* their business has been sold at a premium. In the interim, most private-equity funds set up well-defined conditions for bonuses. At WellSpring, management receives generous options only when the company hits targeted internal rates of return.

During the ugliest days of the economic meltdown, many financial institutions took a different tack than this. The White House recently reported that 17 leading banks, including **Goldman Sachs** and **American International Group**, paid a total of $1.58 billion in bonuses.

Private-equity managers cannot afford to be so generous. After all, a failing management team--or even one with a high potential to leave the company--could seriously jeopardize valuation when it comes time to sell the business. That's why succession planning is also a must. Look at how the medical problems of legendary **Apple** founder Steve Jobs have collectively raised investor's blood pressure.

WellSpring requires its companies to submit a plan for succession within nine months of purchase. "We require management teams to make sure there is succession planning at every level, not just for the CEO," he says. "To me this is just an insurance policy for the future."

Once again, the guiding principle of private equity holds true: Keep your eyes fixed on the horizon.

Les Berglass is the founder of Berglass + Associates, an executive search firm focused on the consumer goods sector. Berglass + Associates private-equity clients include Carlyle, Irving Place Capital, Apax Capital Partners, Vestar Capital Partners, Catterton Partners and Financo.