



# The Good the Bad and the Ugly: Options for Private Equity in the Current Business Downturn

## About ForteCEO

We consider each of our clients a partner. We bring industry knowledge, specific operating expertise, a grasp of tangible issues and a dedication to problem solving to your project.

Our ForteCEO executives work alongside our clients to implement permanent change. Each one of our executives has at least 20 years of progressive experience as an owner or leader of successful businesses.

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**In this challenging economy, Private Equity Firms need to proactively assist businesses they own to maintain control of their own destinies, or risk letting lenders dictate their futures.**

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Private Equity owned businesses are tripping loan covenants, being asked to inject fresh equity, and filing for bankruptcy protection in record numbers. The carnage is likely to increase as the steep falloff in business accelerates in 2009. Even now lenders are staffing up their workout groups to prepare for the onslaught, and being more aggressive with troubled businesses.

In today's adverse business environment, is there anything that can be done to prevent getting to this stage? Despite not having a magic wand to fix the economy (growth makes up for a lot of evils) and get credit flowing again, there is something proactive private equity firms can do to improve the survival odds of their portfolio companies. Address the classic leadership dilemma in a new way.

Over the past year, thousands of middle market companies owned by private equity firms have lost key customers, experienced significant margin erosion and faced plummeting equity value. At ForteCEO - a consulting and interim leadership firm that works with underperforming and undermanaged businesses – we have worked with many of these companies and found they share a few characteristics:

- 1) The companies were purchased in recent years – post 2001 downturn.
- 2) The businesses had been thriving with strong upward earnings trends at the time of purchase.
- 3) The companies' pre-acquisition management teams were retained.

What happened? In every case we found two common factors:

- 1) A CEO who struggled to adapt to the changes required in a non-growth, declining environment; and
- 2) A Private Equity firm that failed to provide this leader with meaningful assistance in a timely manner.

This new environment requires different CEO skills and leadership strengths than during the recent growth heydays.

Most Private Equity firms follow a “CEO Led” strategy. The strong working partnerships they form with their business leaders are central to their strategy. They rely on their CEOs to be their primary eyes and ears in each of the many different industries in which they are invested. As material shareholders, these CEOs also have a strong financial incentive to build value. It’s a natural win/win. But, the current global downturn is thrusting PE portfolio companies into a rapidly changing landscape where they must rely on their businesses’ CEOs to accurately read economic and market changes and quickly adapt. This new environment requires different CEO skills and leadership strengths than during the recent growth heydays.

As 2009 unfolds, many CEOs who have not been at the helm during a downturn will be challenged. It is not uncommon for CEOs to be unable or unwilling to make the necessary changes to bring operating costs in line with reality because of personal relationships within the company or falsely believing that relief is just around the corner. The best CEOs look over the horizon and reposition their companies in advance of change. Unfortunately, too many leaders struggle to adapt, remaining in their comfort zones and insisting on staying a course that leads to declining performance, covenant defaults and huge time drains for their PE owners. When changes are made, they typically come so late that significant equity value and precious time are permanently lost.

#### **The Private Equity Owner / CEO Dilemma Escalates in a Business Downturn**

In any business downturn, but especially in one as severe as the current one, PE partners must objectively categorize their portfolio CEOs into three groups: The Good, The Bad and The Ugly. Since it is ultimately their CEOs who will lead these companies through the financial and economic pummeling that nearly all businesses are taking, more than ever, Private Equity firms have to be honest with themselves and their partners about their CEOs’ capabilities.

#### **The Good**

These are the CEOs that are already adapting to the adverse business conditions. They are creating new lines of revenue through new customer bases and new products or services. These CEOs are maintaining profits despite lower revenues. And they’re making sure to wring every dollar of cash flow out of the business to make sure non-cash assets don’t stay that way.

One side note: The Good title is not automatically earned by a CEO running a company in one of the few industries that are doing well in this difficult economy. Judge those CEOs’ performance more like you would any CEO in a growth industry.

#### Private Equity Assistance Required:

- 1) Open as many doors as possible for these CEOs. Concentrate on strategic financing and strengthening relationships with existing and potential new customers, and their board members or owners.

To keep control of your portfolio companies out of the hands of creditors, it is essential to intervene BEFORE they do.

- 2) Consider buying up competitors at rock bottom prices to consolidate beneath these CEOs – you'll avoid margin erosion from those who would have gone under and IRRs should be tremendous if the long-term industry opportunity is there.
- 3) Steal a game plan from public companies: consider salvaging portfolio companies with slipping performance by consolidating operations under your star CEOs.

#### The Bad

These are the CEOs that might make it, or might need to be replaced. You don't know yet, performance has been tanking (but then whose hasn't?) and you don't have the same rapport with them you used to have. In fact things may have gotten quite tense between the CEOs and their PE owners. That being said, these same CEOs have performed very well up until this point in time, have earned the respect of their industry - with the contacts and track record of success to prove it, and are still in there slugging it out every day. They seem to be working harder but not really any smarter.

#### Private Equity Assistance Required:

- 1) Intervene now, before the performance of these CEOs and the businesses they are running turns from The Bad to The Ugly. To keep control of your portfolio companies out of the hands of creditors, it is essential to intervene BEFORE they do. Once a bank's workout group takes over, your destiny is no longer your own.
- 2) Help your CEOs to expand their business networks, including joining industry or other peer group boards of advisors. Even monthly roundtables with other CEOs running companies of similar size can be very advantageous. PE partners who facilitate these groups may find new company/CEO opportunities for their next fund.
- 3) Consider hiring a consultant or mentor to clone your CEOs' strengths and/or to fill the gaps for weaknesses. Surviving a downturn is a combination of removing massive amounts of operations costs combined with bringing in new sources of revenue. A tough job, especially when all the other A-players in the marketplace are trying to do the same thing. Often a CEO-team can be a tricky situation to pull off, but in a severe downturn it allows your CEO to divide and conquer and learn new skills through example and observation, not just through the school of hard knocks (on your dollars).

#### The Ugly

These CEOs are either deep in denial or entering survivor's withdrawal stages. They have missed so many projections and had so many business opportunities dry up on them that they are concentrating more on crafting excuses and on fighting for things like bonuses and salary maintenance despite performance. They are spending more time working to revise bank covenants than trying to meet them.

#### Private Equity Assistance Required:

- 1) Replace the CEO. It is nearly impossible for other employees in the company to get motivated behind any strategy or business initiative when their leader no longer believes a win is possible. The longer you wait to replace, the deeper the abyss the

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rest of the employees fall into, and the tougher the job for the CEOs’ ultimate replacement.

- 2) Decide how much time and resources your firm is willing to commit to this company based upon a realistic assessment of the business, often performed by an outside firm. Don’t get caught throwing good money after bad. Admit your mistakes, vow not to make them again, and move on to more promising opportunities.

Even with objectively categorizing the CEOs in your portfolio companies, why is it so difficult to take CEO-related action? Especially if you believe it would reverse declining performance! Usually private equity owners delay action for many months. Too often PE firms take no action until they are “encouraged” to do so by their lenders because of covenant violations.

#### Top Eight Private Equity Delayed-Action Factors

An informal survey conducted by ForteCEO indicated that most private equity firms watched a portfolio company decrease in value for three or more quarters before taking action. The top eight reasons cited for these private equity firms’ delays are as follows:

- **CEO Retention Track Record:** Most Private Equity firms have a stated philosophy of supporting their CEOs; not ditching them at the slightest misstep. PE firms need to reference these CEO relationships with new potential acquisitions. Ironically, many PE firms believed that proposing outside help would undermine their CEO partnerships, when this is one of the most common factors to move CEOs out of the “Bad” category back into “Good” territory.
- **Ride the Horse You Know:** Reliance on the CEO for industry specific, company specific and operational knowledge, as well as the belief that it is easier to “continue riding the horse you know” – despite continued underperformance.
- **Network Nuances:** Relationships between the CEO, key internal managers/salespeople and critical outside vendors and customers are essential and difficult to replace.
- **Industry Knowledge:** Resistance by the CEO to accept outside help because both the PE firm and outside advisors “do not understand how this industry works.”
- **Co-Owner CEO:** The CEO was also a shareholder (and possibly a board member), which grants them special dispensation.
- **Replacement Process Anxiety:** Concerns about a multi-month search for a permanent replacement (if that was necessary). Belief that “it costs too much and takes too long”, and fears that the search would become known by the incumbent, accelerating the CEOs’ retreat into The Ugly territory.
- **Bigger Fires to Fight:** A need to focus attention on other activities (raising the next fund, working with other portfolio companies that face issues as well as those that are performing well) and little time to “fix” the company.
- **Arms Length Dilemma:** PE firm is too close to the CEO to be objective, and yet not close enough to the situation to know what is really going on.

Regardless of the form CEO augmentation solutions take, the consensus is that the CEO must feel supported, not competed with or threatened, in order for the augmentation solutions to work.

### Top Three Private Equity Take-Action Triggers

In the same survey conducted by FortéCEO, the majority of private equity firms had replaced CEOs within some of their portfolio companies, despite the critical nature of the PE firm/CEO relationship. The following were the top three triggers that propelled the private equity firm to take decisive action. CEO interventions were usually a combination of bringing in outside assistance and/or replacing the existing CEO.

- 1) **Several quarters of missing plans** and investor expectations resulted in a loss of confidence between the Private Equity partners and their CEOs. A classic “performance reset loop” occurs which cements the loss of confidence beyond recovery. First, actual performance falls below plan. Then the CEO provides a new plan, and the PE firm must agree on new performance expectations. If results continue to underperform the (now reset) expectations, the loop is repeated. After several iterations, the CEO is not able to reset investor or lender expectations, and confidence in the CEO breaks down.
- 2) **Impending or recurring lender covenant violations**, and the fear that if the PE firm did not “gain control” of their companies, their loans would be moved to lenders’ Workout Groups which might require more equity or forced sale of the business at a fire sale price. Covenant violations also provided the Private Equity firms with an external reason (i.e. “it’s not us, it’s the bank”) to bring in outside assistance.
- 3) **Known, readily available, trusted outside resources**, or experienced operating partners within the private equity firm that can work full-time within the portfolio companies. This Resource-Ready trigger is the opposite of the dreaded executive search process that may or may not deliver a new hero to save the day and turn the company around. Once the Private Equity firms were personally familiar with the track records of various outside assistance options, they were much quicker to take proactive action to turn their underperforming portfolio companies and CEOs around. This is a logical step between “let’s give the CEO another quarter and see what happens” and doing a full blown, multi-month CEO search without fully understanding the company’s needs. And if a search is ultimately required, an interim CEO can bridge the gap.

### Making CEO Augmentation Work

Regardless of the form CEO augmentation solutions take, the consensus is that the CEO must feel supported, not competed with or threatened, in order for the augmentation solutions to work. Undoubtedly the PE firm/CEO relationship will be tested, and may need to be rebuilt, especially when company performance is declining. In this fragile state, the CEO augmentation resources should possess the following characteristics:

- **Relevant industry experience** running and renewing firms of a similar or larger size, allowing them to rapidly provide an objective appraisal of what is happening in the firm and options to renew the company.
- The ability to **rapidly build relationships with all stakeholders**, often having existing industry contacts of value to the company.

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- **C-Suite level expertise and high emotional intelligence (“EQ”)**; the ability to work *with* portfolio company CEOs in a non-threatening manner to help them regain control of the company, and rebuild confidence with the PE Partners.
- **Ready availability, and adequate time** to literally clone the CEOs’ strengths or fill in the CEOs’ weaknesses; buying time to find a permanent replacement, if necessary.
- **Consultative project / process management skills** to reestablish reliable financial and operational reporting and regular communications. Communication to owners and outside parties is essential to rebuilding trust and confidence, and must happen in advance of waiting for turnaround performance successes.
- The **expertise required to chart a path** to rebuilding equity value, serving the portfolio CEO’s economic interests, GP and LP interests, and Lenders. At the end of the day (or quarter or year), a return to positive performance will be required for the relationships and businesses to survive.

#### Time for Change

2009 promises to be a time of great change for many Private Equity companies, especially for founders and CEOs who have never weathered a downturn.

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The challenge for PE firms in 2009 is to take charge of their “problem” portfolio companies, and the CEOs running them, well before their lenders require them to bring in a workout firm. By doing so, Private Equity firms will retain the option for true business renewal and portfolio value creation – in essence controlling their own destinies as they navigate through what may end up being the toughest economic storm they have ever experienced.

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With ForteCEO’s Private Equity clients, we provide operating partners who deliver the following rapid results:

- **In the first 2 weeks:** An objective appraisal (our Business Assessment and 90-Day Action Plan) for the Private Equity firm and their lenders, detailing what is happening with the company and what is needed to renew the performance.
- **The next 90 days:** Industry expertise and hands-on renewal assistance for the company in decline to execute the 90-Day Action Plan and achieve results.
- The ability to work with the existing CEO, or replace them as needed.

To learn more about ForteCEO’s experience in creating value through positive change, please contact us at **847 291-9944** or [forteceo.com](http://forteceo.com).

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