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can be a substantial burden. By pushing hard for simplification, management can focus energy and resources on meeting customer expectations in its core business. Over time, this will free up the resources necessary to focus on priority projects and develop more attractive segments.

— Focus on the basics:

Recognize that the process of returning a distressed business to health can be a deliberate one and focus attention on the basic items such as production scheduling, customer profitability, inventory control and logistics. Review the underlying assumptions that are used and make sure that everyone agrees with the logic and any changes that are appropriate.

— Lack of vision and prioritization. Distressed businesses often operate day-to-day. It can be very difficult for managers to focus on key business issues and opportunities. Investors need to support the efforts of managers to take a step back, think through the key actions necessary to execute successfully and work through them methodically.

— Liquidity. You need more liquidity than you think! Everything takes longer than expected, and things that take longer cost more too. Providing enough liquidity to get through the inevitable problems that arise will make the turnaround process much easier, less stressful, and ultimately more profitable. ■

## Converging Worlds

by Benjamin Procter | partner, Watermill Group | p 781-398-9464 | e bprocter@watermill.com



Many investment professionals have recently commented on the convergence of hedge funds with venture capital and buyouts. All three investment vehicles are formed out of similar LPs, so on the surface we must wonder if mixing would really matter. But what do these new crossovers between these industries really mean,

good thing. The crossover could allow an investor to invest in X fund (call it a hedge fund), which will really be a portfolio of all three types of investments ranging from ventures to more traditional hedges to leveraged buyouts. However, as often happens, for every positive change, there is a corresponding problem. I would suggest the problem is this: as firms continue to branch into other types of non-specific funds, they lose their specialization.

This specialization is what has allowed the birth and maturation of both venture capital and leveraged

possess the necessary skills to provide companies with the focused attention that they need to flourish. In fact, they have become large private capital money managers.

This transformation has occurred partially because capital has continued to flow into name brand firms, drawing the economics more and more toward fees rather than capital gains. I do believe that we, in the finance industry, can all reflect on the troubling nature of these actions for all three segments as a whole. It is possible that as this trend evolves, investors will rebuke these cross-

**“We recognize there are a lot of events that are converging at this very moment, but we don’t see them as linked and we don’t see them as a crisis. We see them as hurdles that we obviously will need to overcome.”**

—James Rubin

particularly when put in the greater context of investing?

I would suggest it could mean that the traditional descriptions of these separate entities have continued to mix, and thus each category has become both inherently similar and at the same time individually weaker. The category of each type of investment has continued to blur as more firms attempt to handle more types of investing.

In theory, this could be a

buyouts. Deal professionals in both of these industries focus on certain sectors and certain stages of company development. A person who is good at helping a new venture necessarily is unlikely to be the same person who is good at helping a mature company, even if this company is in the same industry. The result of the blending between types of investments is that firms that have a fund playing in all three arenas, hedges, VC, and LBOs, become increasingly unlikely to

over investment strategies as non-core to GPs competencies. Much like oversized corporations divest divisions that are non-core to their model, investors will vote with their feet for focused investing. Regardless of whether or not this happens, the market will continue to evolve, and we must all remain vigilant in deciphering these new trends in alternative investing and the long term ramifications on each of our businesses. ■

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market companies. Failure to adequately address the tasks above can negatively impact company performance and thus value creation.

Beyond the obvious value that can be created by improving operations, our approach to Operational Investing offers another key benefit—it enhances the universe of potential investments. This source of value creation manifests itself through two avenues. First, the operational perspective we bring to potential investments enables us to see opportunities that investors with strictly financial backgrounds may overlook. Often this means we have little competition and may be able to purchase a business at a below-average multiple. Second, because we have the ability to supplement the skill-sets of existing management teams, we may be willing to pursue an acquisition that less operationally oriented investors would decline. Two recent investments we made illustrate these points.

In mid-2004 we acquired a highly concentrated manufacturer of specialized, machined castings. Most private equity firms were frightened by the concentration and declined to bid on the business despite the fact that it had just signed several multi-year contracts that were certain to boost sales and profitability significantly. I had lived with concentration in the past and believed this was a situation where the concentration issue could be managed effectively. Moreover, in conducting the due diligence, my team and I identified several significant capex projects with payback periods under six months. We knew that making these expenditures would quickly increase the bottom line over what was already predicted to be strong growth. No offense to some of my colleagues, but the typical banker would never have spotted this low hanging fruit. We ended up buying the company for slightly over 3.5 X trailing twelve months EBITDA and just recently received an offer to sell a minority stake

in it at a valuation representing greater than a 9X return. The reason for recounting this story is not to beat our chests but to point-out that less operationally oriented investors missed this opportunity and are likely to miss similar opportunities in the future.

In another recent example, we purchased a manufacturer of attachments for earth moving equipment. The owner was motivated to sell because the business had grown to a size and complexity he was no longer comfortable overseeing—the business was clearly ready to make the transition from entrepreneurially managed to professionally managed. One of the primary outside investors we recruited was also a very gifted mechanical engineer who agreed to assist the business in transforming its manufacturing processes and product development. Coincidentally, it’s often our approach to solicit investors who possess unique skill-sets that can help a target company. As we approach

our second year of ownership, sales are up over 40% and EBITDA has increased by nearly 50%. Our capacity has increased significantly, and we are on target to introduce three new product lines in the coming year. Once again, this was a transaction for which we faced relatively little competition and paid under four times EBITDA. The less operationally oriented investors either dismissed this opportunity as too much work or never realized the hidden potential.

Properly applied, Operational Investing can be a significant value driver. As competition increases in all quarters of the private equity world, firms that make a commitment to both enhance their operational expertise and apply it are likely to benefit from improved performance and separate themselves from the “pop-corn crowd.” For more information on Stanwich Partners, please visit our web site at [www.stanwichpartners.com](http://www.stanwichpartners.com). ■



Jim is pictured on the right (holding the award) and Stan Straube, Executive Director for the NEERC, is on the left.

## 38 Years of Professional Excellence

Jim Gilreath, Founder and President of Gilreath Consultancy, Concord, MA, received the prestigious 2005 Professional Excellence Award from the New England Executive Resources Council at their Spring breakfast meeting held on March 22, 2006. Jim was honored for his

many contributions to the world of executive search during his thirty-eight years in the business. Gilreath Consultancy specializes in recruiting C-level executives for businesses acquired by private investors. Jim and his wife & business partner, Diane, reside in Concord, MA. ■



## Small to Mid-Sized Company CEO Hiring Tips & Tactics — Avoiding Disaster

by Jim Gilreath  
publisher, Search Beacon | p 978-287-4432 | e jim@gilreathsearch.com

LBO firms today look for a quality CEO and management team at the company they seek to acquire besides their target’s attractive EBITDA track record.

In this column I will address a private equity firm partner (and her/his colleagues) having to replace a CEO at one of their portfolio companies for unsatisfactory job performance or other reasons including resignation, death or poor health.

Here are my tips:

— Before you start networking within your circle of contacts or posting an edited version of the job specs, write a CEO job description of “must haves” by prioritizing the immediate (3–6 months) & longer—term (12–18 months) leadership duties and the needs of the portfolio company based on the 1–3 year business plan. Explain why the incumbent CEO is being replaced and include “sell” in this CEO spec as to why a qualified prospect should join your portfolio company, maybe even take a pay cut and put “skin in the game”, too.

— Create a self rating quiz of 18 or so of the most critical requirements of your CEO

position description including the following “Knockout Points” to pre-qualify candidates and have each CEO prospect rate herself/himself on a scale of 1 (lowest) to 10 (highest) on each requirement in the self-rating quiz. This can be completed by email and returned to you. Include these “Knockout Points” in your self rating quiz.

— Candidate must have been a CEO running a profitable company.

— Candidate must invest in your portfolio company’s stock.

— Candidate’s salary & bonus requirements must be within your range.

— Candidate must relocate his family to the company’s location.

— Candidate must produce verification of her/his degrees and certifications.

— Candidate must submit satisfactory professional references for you to check to verify their accomplishments, credentials and experience.

— You can add other “Knockout Points” to the above but we would typically

eliminate any candidate who rated the above quiz items below an 8 or 9.

— Too many 6 & 7 ratings on other quiz points and this candidate self destructs. With a completed self-rating quiz of mostly 8’s, 9’s & 10’s, you have the basis for a face to face interview with those candidates. At your meeting, have each candidate elaborate on her/his quiz answers and provide references who can (hopefully) verify the statements you are being given. You must protect any reference who rates your CEO candidate as unsatisfactory or a liar or worse.

— The candidate must not associate any specific reference with being responsible for the demise of her/his candidacy.

— Whichever firm partner will be the new CEO’s reporting superior should check the candidate’s references. This important function should not be delegated.

Following my above suggestions will save you from wasting a lot of time with CEO candidates who are ultimately not worth your pursuing. ■

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PROFESSIONAL EXCELLENCE AWARD

SUMMER 2006  
volume 4, number 1

James M. Gilreath  
publisher/editor-in-chief

p (978) 287-4432  
e jim@gilreathsearch.com  
www.gilreathsearch.com

PO Box 310, 8 College Rd.  
Concord, MA 01742

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## Differences Between Distressed Investing and Traditional Buyouts

by **Erik B. Dykema** | principal, Metapoint Partners LP | p (978) 531-1398 x8 | e Erik.metapoint.com

In our experience, there are several key differences between fixing distressed businesses and improving healthy ones. Businesses that are in trouble are usually in trouble for a good reason. The old expression “good company, bad balance sheet” trivializes what will be required to fix the problems. An infusion of liquidity, the acquiescence of the company’s lenders, and a fresh start may not be enough.

For Metapoint’s first fifteen years, we focused on acquiring great businesses that were somewhat under-managed. The basic thesis was that by buying qual-

how different the approach would need to be!

Each situation is different and the same problems don’t exist in each business. However, we’ve seen many of the following differences in the approach required to improve distressed businesses vs. traditional buyouts:

— Management resources/ leadership. Cloudy business prospects, difficult working conditions, daily constraints, lack of professional opportunities and low pay may have driven away those people that are most capable of executing the turnaround. Typically, liquidity constraints

own experiences, we should have acted earlier to fill gaps by recruiting new executive leadership to build up management teams.

— Internal Communication. People tend to get tired of sharing bad news, and over time internal communication tends to break down. Different departments in a business can become preoccupied with dealing with their individual problems and less able to work with other areas to solve more fundamental issues. For example with no working capital to purchase raw materials, production meetings are of little value. Over time, however, the



ing the turnaround is critical, investors in distressed businesses need to work with their managers to develop a plan to communicate with key vendors. Suppliers need to be told when they’re going to get paid and convinced to negotiate short term cost savings in exchange for long term relationships.

“While those three stories will (knock on wood) have happy endings, the companies have taken longer to fix than expected, primarily because we underestimated how different the approach would need to be!”

ity companies that could be improved operationally through the recruitment of key managers, we would be able to generate attractive returns. Three years ago, we expanded our focus and began to invest in more distressed situations, and 3 of our last 6 acquisitions were either through foreclosure or bankruptcy. While those three stories will (knock on wood) have happy endings, the companies have taken longer to fix than expected, primarily because we underestimated

force a day-to-day focus and distract management from longer-term efforts to fix the business. While management teams may be capable of holding the business together on a daily basis, they may not have the energy, vision or ability to make the fundamental changes needed to address the root cause of the problems. Investors need to recognize when management gaps exist and be willing to make difficult decisions to address those problems. Reflecting on some of our

lack of a regular production meeting limits the communication and control between sales, corporate management and the factory. Investors in distressed businesses need to support their managers in establishing clear goals and building internal lines of communication.

— External Communication. Distressed businesses may have real weaknesses in communicating with suppliers. Since retaining support from sources of raw materials dur-

— Business complexity. Since distressed businesses are often fighting hard for revenues, many wind up with too many small customers and distinct product lines. While this causes many problems in its own right, small customers and non-core product lines also typically absorb disproportionate working capital—a scarce commodity in a troubled business. Since managers and employees are already suffering from multiple simultaneous problems, this unnecessary complexity

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## M&A and SOX: An Evolving Story

by **Dennis J. White** & **Marc Recht**

partners, McDermott Will & Emery LLP | p 617-535-4011 | e dwhite@mwe.com, mrecht@mwe.com

When Congress enacted the Sarbanes-Oxley Act (SOX) in 2002, the principal goal was to end perceived corporate abuses, not to influence M&A practice. The impact zone of the legislation, however, was more expansive than intended. The result: M&A practice has never been the same.

Soon after the passage of SOX commentators and practitioners noted the need for enhanced due diligence to determine whether a target had insider loans and to gauge a target’s internal controls, financial condition

The impact of SOX on M&A practice has not stopped there, however.

Section 404 of SOX mandates that issuers include in their annual reports a certification as to the internal control of entities acquired during the year. Buyers now have to think twice before acquiring companies in the fourth quarter.

In partial response, the SEC staff issued a frequently asked question (FAQ) release in October 2004 in which they attempted to provide some relief. Issuers could



Dennis J. White



Marc Recht

companies with non-affiliated market capitalizations of \$75 million or more are characterized as “accelerated filers.” Such companies have had to include in their annual

to the end of their second fiscal quarter would place them over the threshold and force them to make an assessment and certification of their internal controls sooner than

“Issuers could exclude from their annual internal control report discussion of the controls of an acquired entity. That relief came with strings, however.”

and corporate governance practices. Public company buyers (and private equity buyers hoping to access the public markets) concluded that a target’s deficiencies in these areas would become their problems post-closing. The result was that such buyers sought more robust representations and warranties requiring SOX-like compliance from targets who did not yet have to comply with SOX. Well-advised private companies with a disposition event on the horizon updated their reporting and internal controls to become more appealing to prospective buyers.

exclude from their annual internal control report discussion of the controls of an acquired entity. That relief came with strings, however.

The issuer still had to describe the acquired business and the significance of the acquisition, could only exclude the assessment of the acquired company from one annual report, and could not postpone discussing whether the acquisition would require any material changes in its own internal controls.

Next, it is important to keep in mind that reporting

reports on Form 10-K a management report assessing internal controls since fiscal years that ended on or after November 15, 2004. Smaller public companies are more fortunate. Their compliance deadline has been extended twice, most recently to fiscal years ending on or after July 15, 2007.

However, as they approach the \$75 million market capitalization threshold, the luck of such small public companies can quickly evaporate. Such companies must consider whether a particular acquisition prior

expected—something they may be unequipped to do on an accelerated basis.

SOX has accomplished much of what it was designed to do—namely, to require a much sharper focus on corporate governance and accounting practices by those running public companies. However, by impacting M&A practice and transaction timing considerations, it has also had some far-reaching and unintended results. ■

## Operational Investing: Moving Beyond the Popcorn Crowd

by **Thomas A. Herrmann** | managing director, Stanwich Partners, LLC | p 203 834-7826 x 232 | e THerrmann@stanwichpartners.com

Not long ago, a prospective lender asked me to briefly describe our firm. “For example,” he asked, “are you popcorn investors?” When asked for clarification, he responded, “You know, you make an investment and then sit-back, eat popcorn and hope the show will be enjoyable.” Fortunately, after the laughter subsided, I had a ready response, “No, we’re Operational Investors.”

In the evolving world of private equity, it is clear that the concept of operational improvement as a source of value creation is gaining currency. What is less clear is what this concept means in practice when applied to the due diligence process and the management of portfolio companies.

At Stanwich Partners, we

firm which focuses on making key hires and monitoring their portfolio companies, we place our level of involvement much closer to that of the owner operator than that of the traditional PEG.

Our specific approach is further differentiated by the make-up of our firm and the level of monetary commitment demanded from our principals. Unlike most traditional private equity groups that continue to draw most of their key personnel from the ranks of commercial and investment banking, our key personnel are drawn primarily from operating backgrounds. In addition, our key personnel approach each investment with an understanding that, as a group, they must be prepared personally to put up a meaningful portion of the

requires that we remain highly informed and often actively participate with our management teams on understanding and implementing key managerial tasks. Typical forms of collaboration with our management teams include:

- Defining the organizational structure by clearly articulating reporting relationships and job descriptions.
- Setting clear performance objectives for critical employees and designing compensation plans that are well aligned to employees’ roles and objectives.
- Ensuring a comprehensive understanding of relevant industry and competitive dynamics to drive an efficient, focused strategic decision making process.



ment and implementation of marketing plans.

— Participating in key discussions and contract negotiations with customers and suppliers.

— Demonstrating a high degree of visibility to all key constituents.

Although many of the tasks outlined above may seem obvious, in our experience few traditional private equity firms become directly and

“Unlike most traditional private equity groups that continue to draw most of their key personnel from the ranks of commercial and investment banking, our key personnel are drawn primarily from operating backgrounds.”

practice what we internally refer to as Operational Investing. Broadly speaking, this term describes an operational emphasis that is much more intensive than that practiced by most private equity firms focusing on small to lower-tier middle market companies. On the continuum of involvement levels between the owner operator and the traditional private equity

equity required to complete a transaction. One practical affect of this is that we will not purchase a company unless one of our principals would feel comfortable running it directly, if this becomes necessary.

While we generally eschew day-to-day oversight of our portfolio companies, our operational investing approach

- Developing short and long-term facilities and capital spending plans.
- Assuming responsibility for all treasury functions and lending relationships.
- Assuring accurate short and long-term cash flow forecasts.
- Assisting in the develop-

materially involved in all of them. Often, private equity groups make the assumption that it is the responsibility of their “key hires” to carry out these tasks comprehensively. However, finding individuals with the talent and experience to carry them out can be difficult regardless of the size of the business. This becomes especially true with small to lower-tier middle

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