



*Panel 2 (l-r): David Hoffman, Aron Schwartz, Christopher Lacovara, Daniel Collin, and Andrew Strauss*

## Panel 2

### **Operating a middle market company in an economic downturn**

Moderated by Christopher Lacovara of **Kohlberg & Company**, Panel 2 addressed the question of how to add value to portfolio companies during an economic downturn. Mr. Lacovara said that the risk of recession in the United States has been steadily increasing and that the next recession could be deeper and longer than the last two. Private equity firms need to be consistent in creating and preserving value and actively govern their portfolio companies. The panel identified add-on acquisitions as a great way to take advantage of a recession, allowing firms to pursue a growth strategy for a portfolio company that would not have been possible before the recession.



*Christopher Lacovara of Kohlberg & Company, LLC*



*Andrew Strauss of The Riverside Company*

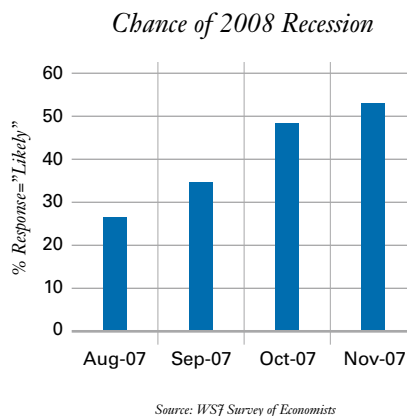
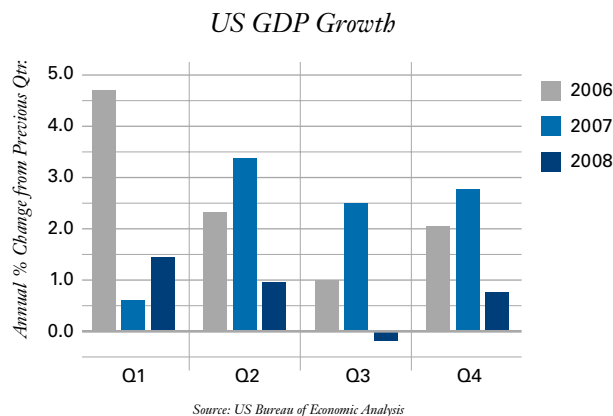
### Impact, sector by sector

Mr. Lacovara showed how recession could impact different sectors of the economy (figures 1 and 2). Mr. Lacovara believes that a middle market private equity firm should aim to construct a balanced portfolio. This can be challenging since some sectors that are relatively resistant to recession, such as food and utilities, typically fetch higher prices because they can support more leverage. Firms should also avoid being overly weighted in deeply cyclical sectors such as capital goods.

Mr. Lacovara showed how the effects of an economic downturn are magnified in the middle market. Typically, middle market companies are more sensitive to economic conditions, since even a modest decline in GDP can have a significant effect on free cash flow (figure 3).

Management resources and infrastructure are often strained in middle market companies, which can face challenges due to lack of product diversification, intense price competition from larger companies and a lack of liquidity.

**FIGURE 1: Growth is slowing while risk of recession is increasing**



- December ISM manufacturing index at 47.7 (contraction < 50).
- Next recession could be longer, deeper than previous two.

*“Management is the first line of defense for performance problems in a recession. This is going to be a big issue in the next recession for PE companies. Lots of management [teams] look very good in a growing market.... A lot of them look much worse when times change.”*

– Christopher Lacovara, **Kohlberg & Company**

### How to create and preserve value

The key to success for a private equity firm is to be consistent in creating and preserving value. David Hoffman of **Charterhouse Group**, which invests mostly in recession-resistant industries, identified eight key strategies for doing this in middle market companies in a recession:

- Maintain conservative capital structure; evaluate opportunities to reduce working capital
- Implement strong measurement tools and metrics
- Re-evaluate the company’s product and service offering constantly
- Enable managers to identify problems and potential challenges as early as possible

- Develop strategies for dealing with various levels of softness as measured by revenue and EBITDA triggers
- Utilize technology to lower cost structure
- Maintain morale; keep management energized with appropriate incentives and coaching
- Maintain a long-term vision

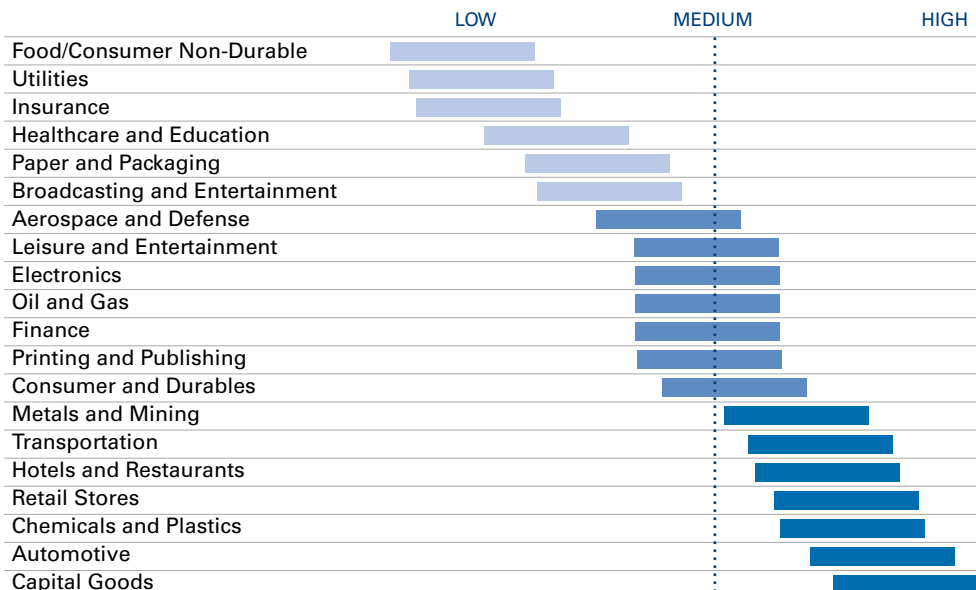
Daniel Collin of **Monomoy Capital Partners** outlined six further value-creation strategies in a downturn:

- Consolidate plants
- Outsource non-core aspects of the business
- Reduce G&A expense
- Reduce working capital
- Invest in growth investments and market share gains
- Seek add-on acquisitions

*“Every dollar you take out of the cost structure is one more dollar you can use to weather the storm in a recession.”*

– Daniel Collin, **Monomoy Capital Partners**

FIGURE 2: Impact of recession varies across industries



Source: Christopher Lacovara of Kohlberg & Company, LLC



*Aron Schwartz of Fenway Partners*



*Daniel Collin of Monomoy Capital Partners*

The panel discussed how outsourcing can potentially reduce costs. It is important to be cautious about outsourcing, particularly for a business that has proprietary processes that put them ahead of the competition. Andrew Strauss of **The Riverside Company** said that if outsourcing is a good option during the recession, it was probably a good option before the recession.

*“A recession gives you the opportunity to get things to happen that you thought should have happened [before a recession].”*

*– Andrew Strauss, The Riverside Company*

### **The importance of good governance**

The panelists agreed that recessions allow private equity firms to implement changes that company managers might not have been willing to consider before. It is also an ideal time to assess the current management team. Replacing a management team is not easy, but it can be important. The panel stressed that proper governance strategies need to be in place to support significant changes. Strategies need to be defined on day one, not introduced in the middle of the investment, which could signal distrust in management. Good governance practices include:

- Upgrading management if needed
- Planning for contingencies for a 180-day period in the budget of each portfolio company

- Increasing board and/or sponsor oversight
- Increasing audit committee oversight of monthly interim results
- Managing lender expectations and keeping lenders apprised of progress

The panelists stressed that it is not good practice to go 11 months without a clear picture of the financial status of the portfolio company. Surprising drops in earnings at the end of the year increase the risk of covenant default and make lenders uneasy. Internal audits with oversight by financial sponsors can address this risk and improve the quality of financials. Many middle market companies do not have the infrastructure to measure their performance actively, so private equity firms need to establish measurement systems within the company.

Even in recessions, exit strategies need to be kept in mind. According to Mr. Collin, the ability to exit in a downturn boils down to two factors: Do you have a good company that’s performing? Did you pay the right price for your investment? Mr. Collin says there is still robust activity in the middle market among companies with \$15 million or more in EBITDA. Mr. Collin also sees strategic buyers and European investors increasing their activities in the middle market. Mr. Lacovara agreed that the market has reached an inflection point that may stop lenders from committing, and that lack of leverage in the coming months will encourage strategic buyers to be more active players.



David Hoffman of Charterhouse Group

*“You can have a healthy portfolio company that comes to the end of its financing term and lenders aren’t there anymore, so suddenly you’re scrambling to find a new lender, even though the company’s financial prospects haven’t changed.”*

– David Hoffman, **Charterhouse Group**

### New opportunities

Lastly, the panel discussed new opportunities in the middle market. Aron Schwartz of **Fenway Partners** believes that in recessions, multiples

and EBITDAs contract, presenting tremendous buying opportunities. Usually, funds have their best performances during or immediately after a recession.

*“One of the nice things that happens in a recession is that leverage gets pulled back. In giddy times it’s possible for giddy bidders to pay high prices that leave everyone scratching their heads, and in that environment it’s tough to put money to work unless you’re willing to be just as optimistic. In a recession you have just the opposite, with EBITDA dollars and multiples coming down, creating great buying opportunities.”*

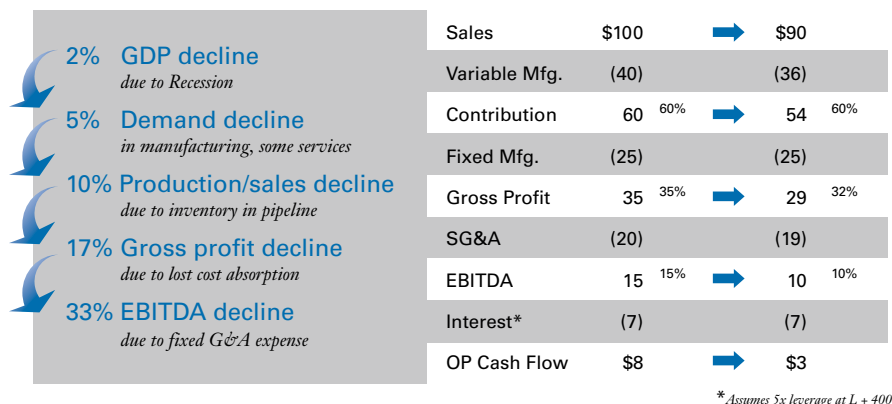
– Aron Schwartz, **Fenway Partners**

Mr. Schwartz listed some of the middle market opportunities that private equity firms should look for:

- Industrials and cyclicals
- Distressed businesses
- Public to private – companies abandoned by the market
- Add-on acquisitions

Panelists agreed that they could pursue growth strategies through add-on acquisitions that may not have been possible before the recession, but that there are significant psychological barriers to investing in a downturn.

FIGURE 3: Impact on a middle market company is magnified



Source: Christopher Lacovara of Koblberg & Company, LLC