Feature Presentation

Safe Sailing In Stormy Weather©

Speech and article by Kathleen A. Graham

Introduction:

Private equity professionals are in many ways like sailors from the clipper ship days. The private equity firms' General Partners, or GPs, are the owners of their ships, the captains of their crews. The investors' Limited Partners, or LPs, are the merchants, trusting these captains to deliver the goods their voyages promised.

The perfect storm of 2008 strained the relationship between the GPs and the LPs. Some of the stress emanated from the change in the stage of the economic cycle. The year 2007 was the top of an economic cycle as indicated by the rising salaries, the never ending talent shortages, and the booming business—ah, yes, those were the days! The year 2008 was the plunge to the bottom of an economic trough.

Some of those strains were the result of prior human decision-making errors: does the name Madoff and a host of others stir a memory or two?

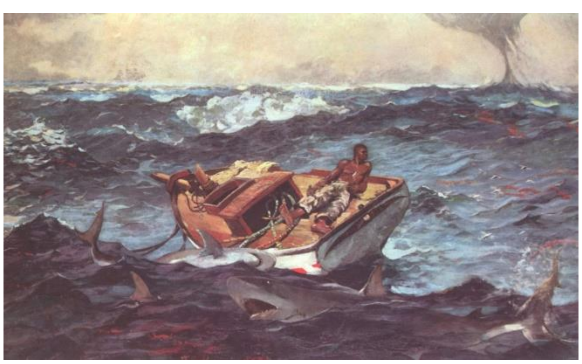
Of course, one can't forget the effect on GPs and LPs alike of the consequences of all that excess liquidity.

The end result: a lot of shipwrecks happened.

These shipwrecks have created an environment filled with negativity. Some of that negativity is justified.

A lot of that negativity makes it sound like the end of the world is near. NO—the the world of private equity is not ending. Yes, the losses that have been experienced and are being experienced are real. These losses, however, are changing the world of private equity, not ending it.

This article will cover the numerous ways for LPs to ride out these waves while staying actively involved in private equity investments.



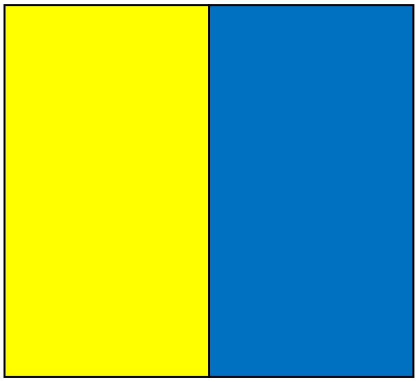
It will discuss the many approaches that are economically feasible for even cash-constrained GPs to smooth out their relationships with LPs, making their private equity journey more enjoyable and profitable.

A major focus will be on explaining the ways that GPs can harness their staff's energies to trim the sails of excess, right the ship's portfolio companies, while setting a course that avoids storm-filled vicinities.

Back in the clipper ship days, such behavior was called good seamanship. Good seamanship is what brings cargos to port safely.

Good seamanship today means using private equity human capital—which is who the LPs, GPs, and their crews are—to positively impact private equity investments so that GPs can sail through this stormy period focused on capturing gems that rough waters always churn up.

I WANT TO COMMUNICATE WITH YOU



Good seamanship utilizes a CAN DO approach:

- **C**ommunicate clearly and completely.
- **A**lign sails (interests and compensation).
- **N**avigate via better decision-making.
- **D**o due diligence.
- **O**perate efficiently.

By the way, the flags and their meanings used in this article are the actual maritime signal flags used by sailors now and throughout the centuries. Each flag's meaning appears above the flag.

COMMUNICATION:

The "C" in "CAN DO" is Communicate… clearly and completely. Sea captains communicate with their investors and others via a ship's log that gives a detailed accounting of their voyage. Historically that data was shared at the end of the journey. Now technology has moved the speed of communication to almost instantaneous feedback. In other words, because of technology, today's Captain's log is an ongoing almost always available source of information to those that need to know because they are invested in the voyage's success.

The key qualities that need to be present to make any communication clear and complete are:

- The communication needs to be CONTINUAL.
- The communication needs to be CONSTANT.
- The person in charge needs to be in CONTROL.

Communication is one of the major change areas in private equity. Recent reports suggest that LPs think that about 25% of existing private equity firms will be closing due to their inability to gain new funds. There's been a sea change in what LPs expect in GP communications.

LPs want at least quarterly updates at the portfolio company levels…or they won't invest. They want notice of companies in a portfolio facing unexpected situations…as that scenario occurs. They want more operational due diligence…or they won't invest.

Many GPs view these new LP demands as yet another item on their already overloaded plate of responsibilities. An alternative perspective is to recognize the changing tide. Just like the sea captains of old needed to adapt from turning in their logs every couple of years to a daily stream of ongoing exchanges, so too, technological advances has changed the way information will flow between GPs and LPs.

With a more continual flow of conversation almost a given between GPs and LPs going forward, how are the other key qualities of clear complete communication achieved? The word "constant" is defined as "regularly recurring". By establishing a standardized format for a report at the portfolio company information level that would be easy for LPs to read and that's sent at regularly occurring intervals, constant communication is achievable. If GPs use the data that they already receive regarding the firms in their portfolios to prepare such reports, costs are contained while providing a constant flow of communication.

Now how does the person in charge, the GP, maintain control of those flows? The answer is multi-dimensional as there are many different communication flows that the GP is involved in that impact LPs. For instance, a number of the waves in the perfect storm of '08 were generated by some outside service providers whose performance was inadequate. If a GP identifies a person in their firm that has that natural knack of "digging up the dirt," and then adds to their responsibilities the random spot checking of all outside service providers, LPs are satisfied while the private equity portfolio avoids some potential whirlpools. Furthermore, no additional staff was required to complete the spot checking and the GP doesn't have to add the task to his personal to-do list.

Internal flows of communication also need to be controlled by the GP. For example, in addition to the person doing the due diligence, another employee can be allocated LP communication when a portfolio company performs in an unexpected manner. This role can be added to her current responsibilities as a way to groom her for promotion. Because these individuals are growing into their new roles, they especially need to be monitored. Are there any other ways a GP needs to be in control of the communication?

If a GP doesn't understand the real internal flow of communication within the firm, social network analysis will provide a map of these types of relationships, which many times are not related to the title of the person. Once the real internal flow of communication is known, that flow can be controlled via an intranet system that enables the GP to monitor activities without micromanaging…and it costs peanuts to purchase and run.

Let's see: a GP has communications going to him from his portfolio companies, that's then being re-routed in some constant manner as communication with the LPs; there's communication going on between the GP's staff and outside service providers; there's communication going on between the GP's staff members and himself—the GP is communicating with a host of critical parties!

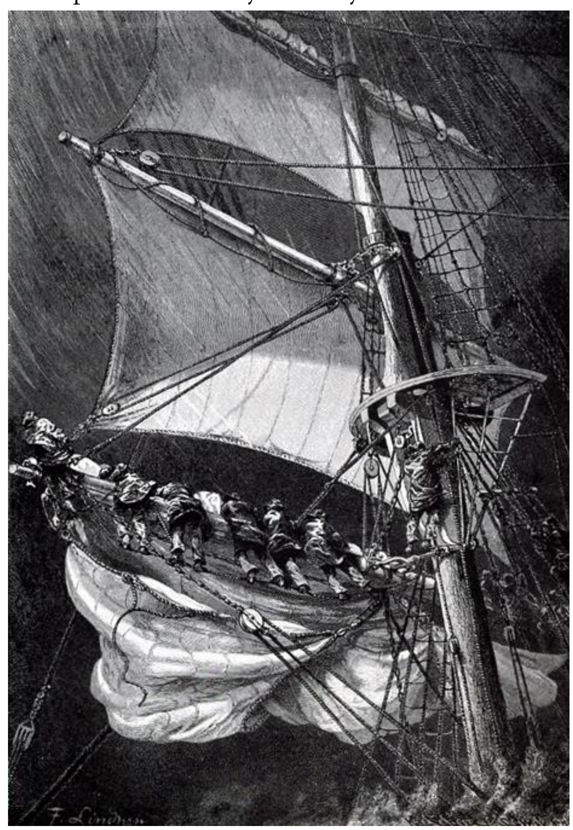
If any of this information becomes dated—which can happen in a fast changing environment such as today's weather—that misinformation could really hurt the bottom line. Hence, communicating clearly and completely needs to be a continual flow exchange of the latest information. One of the best and most affordable ways to maintain that database is a web-based customer relationship management (CRM) system.

ALIGNMENT (INTERESTS AND COMPENSATION):

The "A" in "CAN DO" is for aligning the private equity firm's sails. In stormy weather, a sea captain reefs – or shortens – his sails to stay upright. There are many ways to reef human capital costs, which is one of the largest expenses a private equity firm has.

However, each organization has its own unique human capital profile. Understanding the answers to the following questions before acting on cutting human capital costs will pay off handsomely.

- What is the firm's organizational structure? That structure is determined by:
  - ★ the size of the fund and the size of the individual investments.
  - ★ the range and depth of experience in the firm's staff.
  - ★ the diversity of the firm's staff, both geographically and culturally.
- How does the firm's organizational structure react to the different points in the economic cycle? The world economy is currently at the bottom of one cycle with green sprouts shooting up globally that are still tender enough to wither in a hard frost.
  - ★ How flexible is the firm's organizational structure in reacting to growth possibilities?
  - ★ How quickly can that structure switch reactions in response to volatility in that cycle?

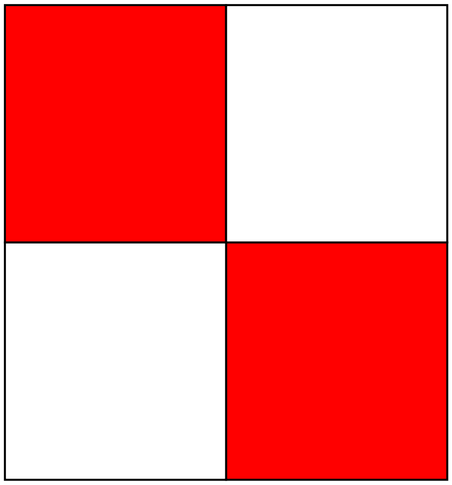


With the answers to the above questions, a GP can weigh the pros/cons and costs associated with the different human capital employment choices, which are:

- Location: does staff need to be all in one office? Can they work virtually? Can they be located in different areas domestically? Internationally? Both?
- Responsibilities: can they be sliced and diced in different ways? Or does one person have to perform all the functions?
- Relationship: does staff need to be full-time employees? Could some of them be part-time? Interns? Flex-time? Contractors? Outside service providers? Unemployed project workers?

Choosing the best option after considering these factors lets a private equity firm reef its sails without tearing the main sail accidentally, which is very important to avoid because if the main sail is torn, the GP can lose his ship.

You Are Sailing Into Danger



Cutting and adding staff is one of the most excruciating tasks senior management performs. If a private equity firm needs to layoff individuals, the firm should choose the ones that are:

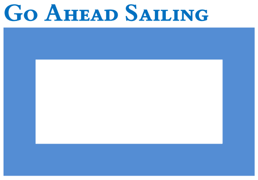
- redundant
- easily replaced by outside support
- marginal to begin with
- not a fit with the firm's culture
- new and not high potential.

Cutting deeper than this layer of individuals means risking hacking away at the firm's mail sail. If more costs still need to be cut, other options should be considered instead. Some examples of such options are: no bonuses, reduction in pay and/or benefits, smaller office, etc.

As for adding staff out of that vast sea of choices available today, the rules there haven't changed with the weather. To hire the individuals that are the best fit for a specific private equity firm:

- Look for a history of verifiable past successes as that track record is the best indicator of future behavior.
- Skills are important but so too is attitude and the ability to work well with others.
- A person might be fantastic but the person also needs to naturally fit into the firm's culture.

Go Ahead Sailing



After a private equity firm has: chosen the structure that keeps its human capital costs the lowest possible, hired the best crew, and let the others swim away, the questions becomes: how does a firm incentivize and compensate staff in choppy seas? There are many opinions and information on private equity compensation allocations: which approach should be best practice? How much should be allotted to each of the compensation components, which are: base, bonus, carry, and benefits?

With so much flux, it's too difficult to identify what the best practice compensation standard will be going forward. In this type of environment, it's best to:

- Mimic a key competitors' system so that star crew can't be shanghai'd elsewhere.
- Identify values and objectives that are deemed essential to the firm's culture and then tie incentives to achieving those states.
- "Stretch" your star performers by assigning them additional responsibilities that will grow their compensation worth in the future…like the person given the spot checking of outside vendors on page 3 and the individual given the role of smoothing LP relationships when troublesome news needs to be conveyed on page 4.
- Place as much of compensation cost into the future as possible in terms of handcuffs on those deemed future captains. Retain flexibility to change the structure once the economic seas calm and the new best practice compensation horizon emerges.

Navigation:

The "N" in "CAN DO" is for "Navigate". Take that helm, GPs, and steer that ship away from dangers and into profitability! Navigation is all about decision-making, which is a separate article all in its own right. In fact, in the 1st Quarter 2009 issue of *HQ Financial Views* can be found Tim Kelly's excellent article "Decision Making and Market Crises." Kelly's a senior partner with a global private equity money management firm so his commentary is even more pertinent given his background.

DUE DILIGENCE:

The "D" in "CAN DO" is for Do your Due Diligence. The ship captains of old used to do their due diligence by reading their charts, using a sextant to calculate latitude and an hourglass to identify longitude, and keeping a sharp-eyed crew member in the crow's nest lookout. With such due diligence, these captains didn't lose their way nor their crews. With such due diligence, these captains brought their promised cargo safely to port, pleasing their investors tremendously.

Conducting due diligence on human capital saves a lot of lost energies and avoids serious losses to the portfolios for both GPs and LPs. There are a number of tools in addition to the usual calculations and background checks that GPs can use to check out potential staff. LPs can use these very same tools to check out potential private equity firms to enhance their probability of choosing a well-run ship. These tools are:

- former employees/bosses
- customers
- clients
- suppliers
- market intelligence firms
- …and the best one, the Internet.

There is almost nothing secret anymore. It's absolutely surprising how much information is available on just about anyone via Google and other similar search engines. A review of that data will usually show any red flags that prompt further investigation before taking any action.

For GPs: some red flag hiring warnings are:

- no Internet mention outside of what the individual has personally posted.
- conflicting information on the Internet and other sources.
- too many jobs.
- no one willing to give a reference.

For LPs: some red flag private equity firm warnings are:

- repeated turnover.
- flat structure: mostly seniors and juniors – no middle layer of employees.
- lawsuits.
- lots of investments.

OPERATIONS:

The "O" in "CAN DO" is for "OPERATE EFFICIENTLY". If a ship isn't built well, the captain, crew, and cargo will be lost. The GPs' operations are key to their success. There are many inexpensive ways to increase operational efficiencies, some of which are:

- a website with client passkey access where clients can check the daily NAVs, etc. on specific investment companies and the portfolio in general.
- a web-based CRM system for all staff to keep their records, reports, etc. that updates at least hourly so personnel can see relevant input from others and management can view progress.
- outside services to augment employees' efforts.
- the best staff for the GP and the best private equity firm in the desired strategy for the LP.
- an incentive system that stretches an individual and rewards the desired behaviors and outcomes.

To summarize, in a perfect storm in a negative environment, there's so much that smart GPs and LPs CAN DO to grow their portfolios by utilizing their human capital more effectively.