pilot's log
leadership in challenging times
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PILOTpartners announces the formation of a global resourcing partnership

2010 is finally winding down; one could argue that it isn't very different from 2009. The million dollar question (being American is still think firstly in dollars) is whether 2011 will mimic these past two years, or finally witness the 'rebirth' of private equity. Any predictions would very much welcome! Luckily for us, in this issue **Jon Moulton** does indeed give us some of his insight.

The fourth quarter has seen a further uptick in activity for PILOTpartners, though well below what people expected (hoped?). Mainland Europe still leads the UK, for a variety of reasons, but it too is a shadow of its former self. The basket cases remain Spain, Portugal, and Italy. France remains tough due to the 'social law' and the likely deal costs arising from it. Germany is probably in the best shape, though the tug between debt and equity being the tool to grow remains as strong as ever. The Nordics look OK, but not awe inspiring. If anything, Eastern and Central Europe are probably the strongest areas right now for us due to better valuations but remain hard sells to investment committees within smaller UK headquartered firms.

It was thought that there would be a plethora of good opportunities for stressed investors, and while there is some reasonable deal flow, prices haven't fallen far (if at all), suggesting that much money remains to be spent. Exacerbating this situation is some pressure from more...
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A New Year Message

James Wheeler sits down to crystal ball gaze with the ever resourceful Jon Moulton of Better Capital

Jon Moulton

According to Jon, global funds north of $10bn are still being raised, to many a private equity investor's bafflement. But Jon also foresees some events that could simultaneously build up to a "mechanism of breakdown" for the private equity market. But do not fret completely over your New Year's champers, there's always management fees….

Do you think that the private equity model of several years ago is truly dead, as is the thinking on the street, or like bankers' bonuses, life will revert to the old status quo? And if so, why?

The old private equity model is by no means dead. On the contrary, there are global funds north of $10bn being raised. And I cannot give you the answer that justifies this level of capital to be deployed.

However, there is already ¾ of a trillion dollars in dry gunpowder sitting in the industry. It's going to take the next decade to invest it. It just doesn't make sense to see so much being raised, especially since there are relatively low levels of debt available, which then brings down leverage possibilities.

It's bizarre that private equity deal valuations are higher than ever, with 2/3 equity and 1/3 debt producing multiples of up to 17 times EBITDA. There was an excellent recent study by the Ohio State University that reported that the private equity investment model shows no discrimination in both stable and unstable economic markets. The report also said that highly leveraged deals were the worst performing investments. The industry can do better!

With uncertainty looming over exit prospects and leveraged financing, what type of ROIs are firms expecting to achieve when an exit opportunity does arise?

In a recent electronic polling session I conducted at a conference, respondents on average said that three years ago they were betting on ROIs of 20%, now they are estimating about 11 % ROI. But when asked about actual ROIs their estimations were in single digits.

What I do see changing in the private equity model is the industry's level of liquidity over time. The industry will get smaller. Why? Because half of the total money raised in the private equity market went out between 2005 and 2007. That has created a wall of unrealized investments. If interest rates go up, there are going to be some serious casualties in private equity funds.

With many firms starting to feel pressure to invest money they would prefer not to return, and all seemingly pursuing the same sectors (healthcare, business services, etc.) what dangers and cliff edges do you foresee?

The nursing home and healthcare service sectors look very frothy at the moment, with multiples being on the high side all things considered. Being agnostic about interest levels, there may be some more retail and public sector outsourcing business opportunities, but when it comes to the turnaround space, where we specialise, a lot of this deal flow will be in the form of restructurings.

What about opportunities or anticipated events coming out of the Eurozone?

Many people would be surprised to know that the lowest level of corporate bankruptcy in Europe is in Ireland, then Greece, followed by Spain and Portugal. The reason being these markets aren't willing to crystallize losses. A serious reality check is required, especially with all the sleeping zombies on the banks' books.

Within stressed investing, everyone is pointing their fingers at the banking community's reluctance to pull plugs: should they be waiting for an inevitable tidal wave or should they be looking elsewhere?

If I had my way at the moment, I'd be headed to the Tiger economies, but Mrs. M isn't having it! That's where a lot of opportunities are cropping up, but I'm staying put and focusing on the UK.

What people need to realise is that in today's market, the turnaround sector is thin. It represents 2% of the private equity market. You're looking at about €400m in deal flow per annum. Mainly because it is considered risky and not just anyone can build a network to execute the deals. To put this into perspective, Better Capital represents 25% of the European turnaround investment market.

Deal flow is there, it's just that the banks are handling the majority of the "turnarounds" internally. They're drip feeding or rolling over loans to keep companies on their books rather than lending fresh capital to new deals. You hear a lot about banks stretching covenants, adjusting term agreements and offering debt to equity swaps.

But all it will take is for interest rates to rise and this place will be packed.

It's been asked many times, but are there any signs that venture might be making a comeback?

Much to my regret, not likely. Venture funds returns can barely cover the fees. There is a shortage of good target companies in the UK, not money. There's an equity hole. We need companies to come forward and have management with backable backgrounds behind them.

The venture market needs a more anti-free market agenda backed with government support; not the penny packet quarter million here and million there. Many university spin-outs just fizzle away after the first year of investment since the company cannot survive on that investment alone. The professors aren't overly incentivized to make it work with many just returning to their jobs down the corridor.

What the UK venture market needs is critical mass in talent and complex technology. The UK has to become more attractive to lure the talent, like we see in California and Israel. We need more liberal employment regulation that gets rid of counterproductive quotas and that incorporates tax incentives to bring the foreign talent to the UK.

What trends do you see continuing or developing as a result of economic uncertainty?

There is an unprecedented amount of private equity investments, about two thirds, which are being realised through secondary buy-outs. This is creating a new world within the private equity market.

We're seeing some firms relying more than ever on management fees with the objective of raising new funds being a means to making more income.

We're also seeing in research reports that there is no consistency when it comes to fund performance. The last fund does not determine the performance of the next fund.

In 2007, you publicly predicted the economic downturn. What are your forecasts for the year ahead?

Interest rates and the health of sovereign debt will determine the fate of private equity. But it will be the interest rate that will determine everything: it's the mechanism of breakdown. Rising interest rates paired up with other events could lead to the UK running into pain immersion rather than pain aversion.

One of these events could be the collapse of sovereign debt markets, which would be contagious, making interest rates rise irrespective of political desires.

In the past, this type of event precipitates interest rate rises that go up in fast succession, from half a point, to three quarters of a point to suddenly two points. Currency instability in the Eurozone could also be adverse for the economy and for growth.

But if all goes well in 2011 we will at best see a weak year for the UK economy. I think we will see some civil unrest as unemployment rises closer to 9% paired with the VAT hike biting in alongside low levels of both capital expenditure and construction.

Private equity funds need to dig in [to make the best of their portfolios]. Money under management will start to go down. And people do not sell things when pricing is uncertain, so I suspect we will still see even more pass the parcel in the secondary buy-out space as other buyers are rare.

What should Change Management really mean to Private Equity?

Nic Vine

Change Management is surely just the internal actions in a company to execute the structure plan and correct the business processes, right? No, there's a lot more to it than this. The discipline of 'change management' is a broad church that covers everything from continuous improvement to corporate re-structuring, and it embraces all stakeholders, internal and external.

The private equity world inevitably triggers a lot of change. Private equity does not invest in or take control of a company just because it is running nicely; in the majority of cases the companies are under-performing or unable to expand, and the investor sees an opportunity for improvement which requires anything from modest adjustments to radical surgery. The investor is often an external stakeholder who is imposing change, for the benefit of the company and of course that investor. The change management needs to work effectively across this arms-length relationship.

There are countless books on the subject, covering the complexities of changing structure, process, product and service (and perhaps one day I might add another). Here I focus on three inter-linked factors for success that are often poorly addressed: People, Priorities and Sustainability. Most importantly, the crucial factor in successfully achieving any change is people.

This article is not a woolly argument for team-building sandcastles and a Perrin-esque resident wellness consultant; it is a spotlight on to risk reduction and speed of delivery during significant change brought about by external influences.

People

The single common factor across all change in all organisations and societies is people; and people can be very difficult, unpredictable, time-consuming, expensive, even dangerous. What you cannot do is get rid of them all! What you must do is understand their incentives – in this the Freakonomics boys were spot on.

The central point is that imposed change is likely to be a high-risk approach. If the management and staff are not 'signed up' or 'enrolled' then there are the dangers of mis-implementation, back-sliding and sabotage. Even dictatorial regimes suffer from rebellion. Yet imposed change is often at the heart of the private equity model. So how do we square the circle?

The simple answer is in a single word: trust. With trust in place, mountains can be moved. The more complex answer is in how to achieve that trust. I recommend the following framework, which is adaptable to each individual circumstance:

The change is led & facilitated by a high-profile individual who is outside the company's operational management. They may be someone assigned from within the company, or an investor, or an external practitioner – the important point is that this change manager is experienced, dedicated, very visible and with no conflicts of interest. If they are not a subject matter expert in the company's business then they are better able to challenge and pose the 'dumb' questions without blinkers or assumptions or historical/emotional baggage, and they can act as an independent 'sense-checker' that the big picture is understandable by all.

There is open consultation throughout the company, even if the senior stakeholders (executive management & investors) already believe there is only one practical option; this starts to break down the "us and them" mindset, and just might provide extra insights from inside the company – at all stages there is a clear channel for any staff to raise constructive questions or suggestions, with responses provided swiftly and positively, and a clear understanding of the various timescales.

The senior stakeholders define a clear statement of their vision for the outcome and the expected high-level benefits – purely the 'what & why' without addressing the 'how, who, where & when' – this is communicated across the whole company.

This statement is expanded into a detailed business case that identifies all the different business approaches that could be taken, and examines the consequences of each measured against the expected benefits, and justifies the selected approach. The 'do nothing' option must be included to show the consequences (usually dire) of inaction.

The business case is summarised for each group of people in the company in a way that aligns with their interests and incentives, again being open to feedback, so that each group can identify their role in achieving a successful outcome.

There will be occasions where one or more groups are adversely affected. These groups must be briefed before everyone else to manage & contain any disquiet or disruption.

If the above is conducted in an honest, open and transparent manner, and if the senior stakeholders listen to

the staff, then people will feel they understand the issues and their part in making the change … even if they don't like it. The implementation can then proceed with a higher degree of confidence and a predictable timescale.

Here is a simple example to illustrate the incentive alignment. A global company operated training separately and differently in various geographical centres, largely for historical reasons. The vision was for a global service to manage and deliver training, the expected benefits being to provide more training for less overall cost with a move to online learning and a global view of effectiveness. The concern from the staff in the centres was it would cost money to 'go global' and there would be no local benefit. Indeed they feared for their jobs. The response was that with budgets going global, no visibility means no local budget; shared experience and resources across centres allows faster response to business needs and happier customers; the grind of delivering classroom training moves to the challenge of online training design and support; the local liaison is still needed and grows into broader HR support. So all the training staff had an opportunity to grow, and the company saved money and released stretched technical resources by replacing 5 systems with 1 system. Once the staff 'got' this, through a series of collaborative workshops, it was just a question of negotiating the global system functionality and migrating them from 'the way we've always done it' … and that part is another story.

Priorities

It is often the case that many things need changing in order to achieve the desired end result. This does not mean that all changes should be pursued at the same time. In fact, that approach is almost always a bad idea.

The essential advice especially in a crisis is to move more slowly and deliberately at the outset, rather than rushing off in a panic. The experience of sailing can provide useful metaphors for business, none more so than "hasty fixes usually causes more problems" (and yes, I do have real scars as evidence of learning).

So armed with a full understanding of the required outcome, and the rationale for it, the next step is to establish and understand the constraints and dependencies, both internal and external, that bear upon the actions. It is helpful, if possible, to gauge this against the contribution each change makes to the big picture.

A set of priorities can then be assigned, which depend upon the circumstances: you might choose to give top priority to the 'biggest win' to reduce the risk of that over-running; or you might choose to prioritise a couple of small 'quick-wins' to show early progress and boost morale. There are many variations, but without the preceding analysis there will probably be some chaos and much disappointment.

Just a word about 'paralysis by analysis' – it happens to the best of us … you should have seen me deciding on my mobile phone contract; the way to avoid it is to accept that decisions are made on the best information available at the time, rather than on perfect information, which is a rare animal.

Here is a practical example of recovering from doing the wrong things for the right reasons. A division of a company had been criticised in an external audit, with a list of 12 required action areas. They rushed off to tackle all of them at once, because they had promised resolutions within a single tight deadline. However many of the areas were interdependent, requiring resources from the normal operation … duplication, confusion & frustration reigned. The recovery was to stop everything, look at the big picture and which actions best deliver against that, map out the sequence of actions according to dependencies and resourcing, construct a realistic timeline, and re-negotiate a sequence of deadlines with the external authority.

Sustainability

The evolving model for private equity, as seen by PILOTpartners and others recently, includes a longer-term involvement than has been common in the past – this suggests a measured approach to change management with an increased focus on the relationships and sustainability.

There is little point in making a change if that change does not 'stick'. The above advice on people and priorities will certainly contribute towards the sustainability of a change. Sometimes, however, more far-sighted forecasting is also required, verging on clairvoyance.

This forecasting might be as simple as analysing all the dependencies in the operation, or it might require sophisticated scenario modelling that looks at the company in the context of the whole economy. The important thing is not just to ask yourself 'what could go wrong in making this change?', but also to ask 'what could impact it after it's done, and how can we reduce that risk?'

Here is an example of structuring change to be sustainable in the face of evolving circumstances. An air travel organisation was moving into a new building and consequently changing its business processes from top to toe. The inter-connectedness of all the processes was so familiar to those at the coal-face that it was not discussed, meaning that a small variation in a planned change in one area would ripple through the whole process structure. The approach taken was two-fold: first to prioritise the definition of the connections between discrete business processes, rather than the processes themselves – if the connections are sustained then the whole structure is sustained. Second, to set up rolling reviews to capture and share lessons learned and sign-off on incremental improvements both during and after the changes.

Some final comments

It is well-known that people in general dislike change, that they prefer things to stay as they are. Conversely there are people who use change as a smoke-screen or excuse for poor performance.

The danger of 'continuous change' (a much-used phrase) is that it debilitates an organisation, demoralises individuals, sucks resources & budget, and at worst it is a Ponzi scheme of funding the next change with the savings from the current one and never delivering a penny to the bottom line.

We must recognise that the desirable status of a company is the steady-state operation that is profitable (in whatever terms are relevant to the business). Significant change moves the company from one steady-state to another, better-performing steady-state, whereas incremental change fine-tunes that steady-state via small and reversible adjustments.

This article represents my views, as a result of 16 years as an interim in 12 different organisations, after 20 years employment in 4 companies, and alongside 7 years as a trustee/chairman of a national charity. As with any views, they are of course open to challenge and debate, and I will be more than happy to engage in such; there is no single 'magic bullet' answer to getting change 'right'. What is highly desirable, and indeed practical, is to have a common, consistent & visible framework for action which is adapted to individual circumstances.

Profile: Nic Vine

Nic Vine, to quote the COO from his last interim assignment, is "an expert practitioner in Change Management who is able to roll up his sleeves and get things done". He typically works as a strategist, facilitator, communicator, planner & advisor alongside a senior management team or individual, and may take an interim executive management role where appropriate.

Nic started in industrial process control back in the 70s, after a physics & computing degree. This led, through a software company start-up, to applying similar disciplines in the 80s to market data services in City dealing rooms. Nic was the project manager for the first multi-feed market data screen (Telerate & Mullins) installed at the Bank of England. This in turn led to a directorship in a quantitative hedge fund in the 90s, running 24-hour model-driven trading systems, which was a springboard into freelance project, programme & change management across banks & market data providers and out into aviation & pharmaceuticals.

His many years experience from coal-faces to board rooms in a variety of industries have equipped him with a highly-structured analytical approach to problem-solving, coupled with the ability to communicate effectively at all levels in an organisation … along with a healthy dose of pragmatism and good humour.

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The Pilot's Log Q&A

Michael Gebauer, head of private equity practice with PILOTpartners, talks to Robert Deri, an interim Executive about internet mail order growth and his latest role as Group Finance Director for Scala Holdings plc and the process resulting in the successful sale of the business.

Robert Deri

Robert Deri is an experienced Business Consultant and Interim who has specialized in leading major profit and cost improvement programmes as well as strategic change. Having trained as a Chartered Accountant with KPMG he has worked at senior levels in Retail including mail order and internet, Mobile telecoms, Computer gaming and Technology. Robert was on the Board at BT Mobile Communications, Group Finance Director at both Grattan plc and ZOO Digital plc, Director of Eddie Bauer UK Ltd and has experience of AIM listing, institutional fundraisings, VC transactions and international commercial negotiations. Robert is also Vice Chairman and Chair of the Audit Committee at Scarborough and North East Hospitals Trust.

Recently Robert was placed by PILOTpartners into Scala Holdings plc, a high class Italian fashion mail order business whose brands include Artigiano and Spirito.

Robert, the growth in on-line retailing is much talked about. What was Scala's position in the market and what was your brief?

Well unless you have been living on a different planet for the last few years, you will have been bombarded about e-commerce: from companies telling you about their offers on TV and radio, the numerous news stories about the "shift to e-comm", the hype that surrounds e-commerce companies, the huge valuations being given despite little or no profits and also the fact that everyone has increasing personal experience of buying something on the web.

Scala was founded as a mail order business in the mid 1990s selling high quality Italian designed ladies fashion. The founders sold the company in 2006 via a leveraged buy-out and the business has turnover of approximately £20m with about 30% on-line. Through a subsequent financial restructuring one of the major banks became the majority shareholder and the combination of factors including further investment requirement to fund on-line expansion and wider economic issues meant that the timing was appropriate for the stakeholders to explore an exit. My involvement was to ensure that the trading was being driven appropriately with the right focus on profitability and cash generation and to manage the sale process.

To what extent were you involved were you in the sale process?

I was fully consumed by the preparation, selection of partners and the due diligence processes to make it happen. One should never underestimate the importance of the planning and preparation for a sale. The financial information has to be of a high quality, telling the story of the business properly and the balance sheet has to be fully supported and substantiated. Potential buyers are looking for certainty in asset valuations and at the moment will tend to discount heavily unless the assets are properly justified. I worked closely with PwC in preparing the sale brochure and information memorandum and led management presentations to prospective buyers. In fact, looking back one of the most important aspects was systematically to look at the potential buyers and work through the individual potential benefits for them personally – whether it be particular synergies, increased buying power, back office efficiency etc and to quantify them accordingly.

What kind of buyers were interested?

There was a range including private equity and trade retailers. The retailers can be categorized as:

- High Street retailers looking to acquire remote shopping capability;
- On line retailers looking to expand and take advantage of greater economies of scale;
- On line retailers looking to expand into high margin fashion goods;
- Concession based retailers looking to develop alternative routes to market.

What is the rationale for existing retailers to buy a company such as this as opposed to just setting one up?

That's a good question and goes to the heart of internet and mail order retailing. You said that internet retailing is much talked about and it is true that the growth in this sector has been phenomenal. However despite lots of activity there are not many players making serious money. In fashion retailing for example you have to bear in mind that returns rates from customers will likely be in excess of 30%. Without an efficient reprocessing infrastructure this will be very costly to manage – and getting it wrong could be terminal! Also with the returns dynamic comes the skills of purchasing the right quantities and be able to reorder winning lines quickly. A contact centre infrastructure where costs can be flexed is vital – and in high quality brands this is not as simple as outsourcing to a low cost operator. One bidder for the company with over 400 shops nationwide said that acquiring Scala would leapfrog their internet business by 4 years as opposed to trying to grow it organically.

Many high street retailers have found it difficult to grow their internet operations profitably and for good reason: their warehouses are not geared for single pick operations to individual customers, they have no returns processing capability, they have no customer management information which analyses the profitability of customer acquisition by different types of marketing spend.... in short many have tried to mix two different business models without success. Probably the most successful at this has been Next with their High Street and Directory businesses; however the Directory grew from the Grattan mail order business and even then it was many years before it became profitable. What we are starting to see now are retailers trialling multi-channel strategies – supposed pure on line players have moved into sending paper out to customers. Whilst these may be dressed up as "Catazines" or "Specialogues" they still amount to printing and posting your offer out in the mail. It will be interesting to see how the dynamics work here in targeting what marketing activity is proving successful at driving profitable sales.

Do you see much ongoing corporate activity in the sector?

Absolutely. A number of internet retailers have expanded to the point where they need "step change" and this will be difficult for many of them to do organically. Warehousing and distribution are key costs and we are already seeing a number of joint venture type partnerships to leverage infrastructural capabilities. Distribution companies such as Hermes or Home Delivery Network have invested heavily recently and now offer competitive third party distribution to all sizes of players in the market with parcel tracking and dedicated delivery times including evenings and week ends. This has served to reduce a significant barrier to entry alongside other serviced solutions. It is reckoned that online expenditure grew by 15% to £21.2bn in 2009, compared to a stagnation in overall retail expenditure. People are becoming more and more used to shopping online and look to it for bargains as well as convenience. Although significant online expenditure growth is forecast it is likely to be a slower pace with the shopper population starting to become saturated, fewer new entrants gaining traction and certainly some market consolidation.

Thank you very much Robert. It sounds an exciting sector to be involved with and it looks like there will lots going on in the months ahead. Good news for you and for us as well!

SeniorManagementInternational

PILOTpartners announces the formation of a global resourcing partnership with a common focus on senior level interim executive resourcing, operating within a framework of common ethical and operational standards

After nearly ten years of hugely beneficial commercial collaborations with trusted, like-minded, specialist resourcing businesses all over the world, PILOTpartners is delighted to announce the formal inception of SenoirManagementInternational – three words joined up which singly and jointly all mean the same thing in all our languages.

In today's global corporate marketplace with the urgency explicitly demanded by our clients, it is now imperative to have rapid access to the best available senior management talent. The members of SeniorManagementInternational ('SMI') operate in partnership under a code of common ethics and standards of operational excellence. Today SMI now offers the strongest and deepest network of top flight interim executives available more or less anywhere in the world giving our clients genuinely global reach.

Additionally the members of SMI have associated relationships with interim executive resourcing businesses in other countries. The total numbers of interim executives now accessible totals more than 50,000 individuals.

SMI Members

Denmark	Nextt Management
France	ProCadres International
Germany	Alpha Management GmbH
Hungary	Interim Management Resourcing
Italy	Temporary Management & Capital Advisors
Japan	Japan Interim Management
Netherlands	de Roo Management & Advies
Spain	Global Management Task (GMT)
Sweden	Mason Management
Switzerland	Top Fifty Interim Management
United Kingdom	PILOTpartners
United States of America	ForteOne

Associated firms

The SMI members firms above have associated firms in the following countries: Austria; Brazil; Bulgaria; China; Czech Republic; Poland; Romania; Serbia; Slovakia; Slovenia; United Arab Emirates. Please contact us to make contact with these firms.

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mainstream firms dabbling in distressed situations. **Alan Thomas** of TheXtramarket could certainly shed more light on this for anyone interested in calling him - 07855 048 939.

Deal flow remains topic number one in all of our client meetings. Many houses want to unload underperforming investments, albeit at reasonable prices, if for no other reason than to justify the need to raise their next fund. The problem with secondaries remains the same as always – it's tough to make money the second (or third) time around, plus management will be more often than not no longer as incentivized or hungry as before. It's also a bit comic to see houses waiting impatiently for the banks to step up their restructuring efforts, while the banks seem to be defying logic calling for them to open the flood gates. Talk of a tsunami is forever being predicted 3-6 months from whenever the conversation is being held.

Pieces within this issue of Pilot's Log include:

- **Jon Moulton**, whose latest creation Better Capital is already impacting how private equity will function going forward, shares his many and pointed thoughts on where private equity is now, and where it's headed.
- **Nic Vine**, a leading interim change management executive, provides us with a very compelling behind-the-scenes argument on how change management should be viewed and utilized.
- **Rob Deri**, a very experienced consultant and interim CFO across a number of sectors within companies of varying financial stability, gives us his views on internet mail order / e-commerce as well as insights from his latest interim assignment.
- Lastly, we announce the official formation of **SeniorManagementInternational**, or SMI as we tend to say internally. SMI is the vehicle through which PILOTpartners supplements its European (and farther reaching) resourcing capabilities on behalf of all our clients whenever they need a senior international executive in a hurry, whether domiciled in the UK or in a specific country.

Here's to hoping everyone has an enjoyable holiday break and recharges their batteries for 2011!

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