GUEST ARTICLE

close. The company saw a lot of turnover in senior personnel and lenders—they obviously smelled something. The company had increasing supplier and customer concentration, and its fast growth allowed problems to be hidden. Perhaps most telling, they placed restrictions on talking to individuals throughout the organization during the due diligence.

On the accounting side, the company engaged in complex transactions and had complicated organizational structures. They created financials "offline" or delivered them in PDF format with excessive adjusting entries. And it always took a long time to get them to us.

This deal solidified our belief that values matter. We strive to do business as ethically as possible, and we look for the same in prospective sellers. While we've never seen fraud perpetrated on such a scale since, we've avoided plenty of fishy deals thanks to a much stronger fundamental approach. And we created a checklist called the "Profile for Indicators of Fraud" which we now use during every due diligence process. Our own systems, people, and processes are improving every day. We require that all prospective acquisitions allow us to spend at least three days on site with unfettered access to systems, files, employees, and facilities. These safeguards have strengthened our entire diligence process and made us better buyers. Because it can be so hard to detect, though, fraud is still the biggest issue that keeps us up at night.

2) Down Cycles Are No Excuse

The investment world attracts confident and competitive people. There's a fine line between those attributes and hubris. Many a general partner has lost money thinking they could fix fundamental problems at a company. We're no different. We once bought a leading company with strong market share in an industry with high barriers to entry. Better still, the company's strong management team had grown EBITDA despite a cyclical industry downturn—all while integrating four add-ons. We paid what we thought was a favorable price, knowing that there was a lot of room for operational improvements, industry consolidation and other trends favorable to the investment.

Then sales continued to decline. There were issues with management. In the end, we had to make more space on the bathroom wall. So what went wrong?

Well, we learned the hard way that market leadership is not worth much when the industry is unpredictable and low-margin. In this case, the down cycle in the industry masked the company's non-cyclical reasons for underperformance. Hence, what we thought was a relatively low multiple price became a clear lesson: Low multiples don't guarantee success, but may guarantee failure. Our biggest takeaway from this deal, however, was to avoid companies with declining sales. Such deals have rarely been kind to us.

3) Change Managers When Necessary

If management is bad or mediocre, change it. Now! When you do change managers, pay up for the best talent possible. On more than 140 platform deals, we have changed CEOs approximately two-thirds of the time, and CFOs 75 percent of the time. We've never felt that we moved too quickly, but we've often lamented that we should have moved sooner.

In one case, an outstanding CEO declined to remain on board and co-invest in the deal. This should have been a message. Instead, we started with a weak management team led by an internal sales manager who was unfit for a CEO role. At the end of Riverside's long and fruitless ownership, there had been three CEOs, three CFOs, and two law firms. We could never build a coherent and successful strategy due to all the movement at the top. As a result, a promising investment consumed years of staff time and resources while producing a small loss.

If you know you have to replace an executive, do it right away. We now use interim CEOs and CFOs when necessary, relying heavily on our internal operating partners and outside directors, and we search for the best people possible, paying top dollar whenever required. Choosing and incentivizing the right management is still the single most important thing we do.

4) Never Lose Control

We're not suggesting that you can wish away market fluctuations or avoid every pitfall. This is about controlling the things you can, like:

- **Avoiding businesses where you have no control over key third parties.** We once acquired a company that received 75 percent of its inventory from one source. Whenever that supplier had quality problems, they became ours. When they dumped inventory or raised prices, it wrought havoc on our company. In the end, the supplier situation contributed to a poor performance with the investment.
- **Changing IT systems.** One of our companies went through an IT implementation shortly after acquisition and just got it all wrong. For awhile the company was completely unable to track performance indicators and was flying blind! The system had problems that directly affected customers and the bottom line, including inaccurate inventory management, tardy product shipment, and billing errors.
- **Costs.** Especially at the start of a downturn it's crucial to cut expenses sooner rather than later. Often the management team that did well during the good times is reluctant to cut when sales start to head south. Over the years, we've built a large operating team to help management teams address these issues. At the same time, we've built the Riverside Toolkit, a group of more than 20 vetted resources that helps our portfolio become more effective in crucial areas like sales, manufacturing, and pricing.

5) Sell When You Can

We're in the business of maximizing investor returns. It's risky, and our investors can earn small returns on plenty of safer investments. You always think you can squeeze a bit more value out of a deal, even if it might be a lemon. We've found that if a deal is underperforming after two or three years of ownership and a buyer comes along offering a reasonable price, it's often best to get out right then and there. We have finite resources, so hanging on to middling performers is a waste of time and money. Several of our deals that have lost money could have been exited for a gain at one time, but we were greedy and in retrospect not as smart as we could have been.

We've taken steps to boost our exit process, most notably with the Riverside Realization Review. We developed this recently, after we underexited during the last bubble. The process forces us to justify not selling, rather than waiting for the "right time" or the perfect buyer. It's already helped us to kick start exit processes several times this year.

6) Be Committed To Making Mistakes

These painful lessons do not represent our biggest mistake—we're saving that for its very own guest article in 2012—but they do represent mistakes from which we've learned and improved. As we said, we're in the risk capital business, and we would not have been able to produce 23 years worth of superior returns while helping so many companies thrive if we never made a mistake. In a sense, we're committed to making new and different mistakes in the future, continuing to learn, and becoming even better investors. ❖

Stewart Kohl and Béla Szigethy are co-CEOs of The Riverside Company.

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