NOTCH INSIGHTS

Using the ARC Model to Identify the ‘Sweet Spot’ for CEOs and Private Equity Investors

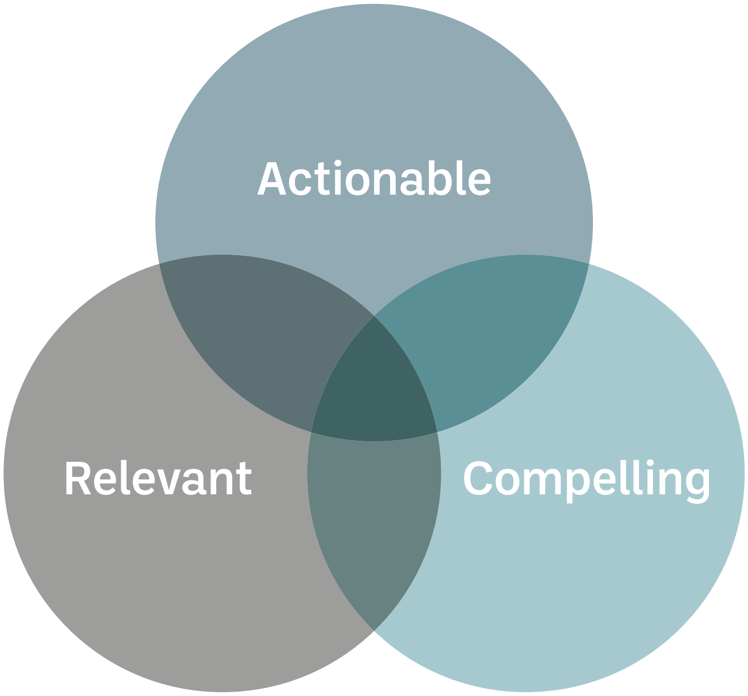
Notch Partners’ ARC model provides a simple yet powerful framework to help private equity investors and CEOs partner to source deal flow efficiently.

Developed by Notch Partners, the ARC model helps operating executives source transactions most efficiently for private equity (“PE”) firms. While PE investors understand and appreciate the value of operating expertise to maximize returns, the deal sourcing process is often confusing and frustrating for both executives and investors and can result in wasted time and mismatched expectations. By providing a simple framework, Notch Partners’ ARC model replaces inefficiency and lost time with definition and focus and helps to leverage the complementary skills and mindsets of industry leading operators and savvy investors.

The ARC model applies specifically to deal sourcing. Depicted in a Venn diagram, it illustrates that the intersection of the three circles represents the “sweet spot” for Deal Executives to source deals independently or in partnership with PE. Each circle represents a critical feature of deal sourcing success:

1) Actionable 2) Relevant 3) Compelling

In evaluating potential deals, both CEOs and private equity firms need to consider each criterion independently and then find opportunities where the three intersect.



When considering a potential deal idea, thesis, or more broadly, a Deal Opportunity Set, CEOs and PE firms should ask the following questions:

A: Is it Actionable?

There is no better catalyst to a robust deal sourcing effort than an Actionable Target, and preferably one that is not being auctioned by an investment bank. While a proprietary Actionable deal represents the "holy grail" for private equity firms, a soon-to-be auctioned deal is also attractive, as the process signifies that a sale is imminent. In other words, an auction situation is attractive because it is Actionable.

A motivated CEO can be the lynchpin if he/she can not only source a transaction that is Actionable, but also emerge as the most qualified executive to lead the company and create value post-acquisition, either as CEO, chairperson, or active director. This leads us logically to the next circle.

KEY TERMS

Deal Executive: a seasoned executive, usually a CEO, looking to partner with private equity to acquire, grow and lead a company to a successful exit

Deal Opportunity Set: an executive's "universe" of relevant targets

Target: a company or division targeted for PE acquisition

Actionable: reasonably thought to be acquirable

Relevant: whether an investor's or executive's specific expertise can create value in an acquired target

Compelling: has exciting, untapped value-creation opportunities

R: Is it Relevant?

There are two points of relevance in the ARC model: (1) Relevance between the CEO and a potential Target, and (2) Relevance between the Target and the private equity firm. With respect to (1), executives are highly Relevant to a deal when direct parallels exist between their experience and the value-creation plan for the Target. With the clock ticking during their hold period, PE investors want to see results quickly. There is no time to climb a steep learning curve. **PE owners place a high premium on executives who have "done it before" and have succeeded in the same industry, by executing similar strategies and operating initiatives.** For example, an attractive deal situation is one where the President/GM of a division has grown the business profitably but would like to carve it out and operate it independently, with the help of a private equity sponsor. The proposition is attractive because there is no more Relevant Deal Executive to this deal situation than the existing President. He/she is not only knowledgeable about the company, but if motivated, can also be a powerful driver to get the deal done.

The second important area of Relevance is the alignment between the Target(s) and the private equity firm. PE funds must acquire companies in accordance with their expertise and their investment mandate. Another obvious example of Relevance is the proposed deal size. There is no point in showing a $20M platform acquisition to a $20B fund. No matter how interesting or Actionable the Target is, a mega-fund cannot reasonably write an equity check that small. The Target's stage of development is another important consideration. Buyout funds generally do not invest in venture or seed-stage deals; many will not consider turnarounds, growth capital, or minority investments either. Another focal point is industry. For example, if a fund has historically invested in industrial companies, they may have difficulty getting comfortable with a restaurant or software acquisition. With neither the know-how nor the experience to acquire or manage such a company, the investor will need to conduct extra due diligence and rely on a strong, seasoned CEO and perhaps outside directors who can give them the confidence to get their feet wet in a new sector. Unlike check size or company stage, however, with respect to Relevance, the investors' lack of familiarity with an industry can be overcome by the executive's ability to show a highly Actionable and Compelling opportunity.

C: Is it Compelling?

While the most difficult to discern, this is the "x" factor that can drive a PE investor over the tipping point and motivate the deal team to push a transaction through its investment committee. Compelling features can be executive and/or company specific. For Targets, growing customer segments (e.g., baby boomers), positive trends (e.g., health and wellness), strong competitive positioning (e.g., a #1 niche player), and industry dynamics (e.g., fragmentation with no clear leader), all provide Compelling reasons for PE investors to get excited about a prospective deal. Executive-driven influences could include a strong industry reputation and/or successful private equity track record. The Compelling factor is the one "circle" in the diagram which can be impacted by one or both of the other two circles: Actionable and Relevant.

Case Study

A former CEO of a successful $500M PE- backed regional premium supermarket chain has recently resigned upon the company's successful sale to a large strategic acquirer. Energized to repeat his previous success, and unencumbered by any non-compete agreement, he is now looking to acquire and run another chain, in a different region, also in the premium category. His Target is experiencing revenue and profitability declines due to mismanagement. Because of his 30 years of experience in the supermarket sector, this CEO knows that the family who owns the Target is interested in selling, due to their lack of succession planning. In fact, having heard about the recent successful sale of his previous company, they have approached this CEO to help them sell it. Based on his review of the financials, property visits, and management meetings, he has developed a plan with specific action steps to address the operational issues, revitalize the brand, and grow the chain.

Actionable?

This situation ranks high due to the fact that there is a viable platform for sale. Potential for a proprietary transaction increases the attractiveness.

Relevant?

This CEO is uniquely qualified to acquire and run the Target platform. In addition to directly relevant premium supermarket experience, he understands the brand and its competitive positioning, and he holds many of the same vendor relationships. The key is to discuss this transaction with the appropriate PE investor: one who invests in similarly sized companies, has experience in retail (preferably supermarkets), and is willing to take on a turnaround.

Compelling?

The Compelling aspects of this deal are its level of Actionability, its proprietary nature, and the strength of the CEO. In addition to the high Relevance of his professional background, his recent successful private equity experience adds significant credibility to this deal initiative. Also very Compelling is the fact that he is knowledgeable about the Target and has already developed a turnaround plan, which leverages his proven abilities and experience. In so doing, he has both decreased risk for potential investors and solidified his own position in the deal – resulting in a win-win situation for all sides.

Role of the Deal Executive: Defining the Dialog

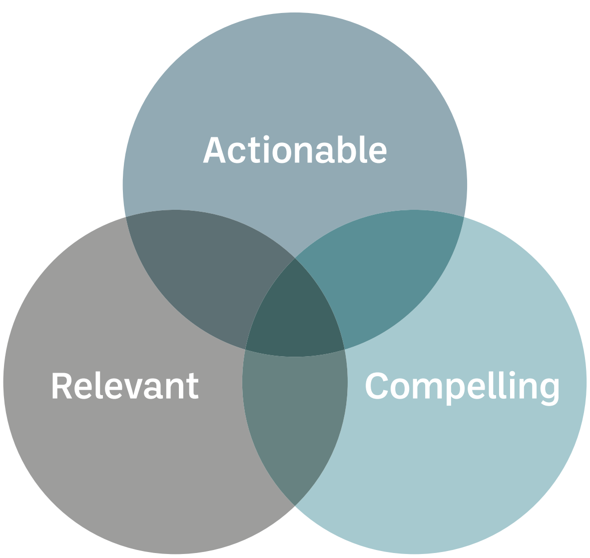
Deal Executives would benefit from internalizing the principles of the ARC model and orienting their dialog with PE investors accordingly. CEOs increase their odds for success by counter-balancing unavoidable weak spots in any given scenario with strong points they can control. For example, if a CEO's industry Relevance is weakened by a non-compete agreement, he/she can identify non-competitive situations where industry similarities or personal relationships make the executive Relevant. Or the CEO can offset this issue by finding not one, but several potential Targets, and upping the Actionability quotient by initiating discussions with sellers.

Actionability is key, and this is why the Actionable circle is positioned at the top of the ARC model. A productive first step for any Deal Executive is to start identifying potentially Actionable acquisitions which leverage his/her background of successful experiences. In the world of private equity, time and talent are precious resources; nothing galvanizes a PE firm's interest as completely as an Actionable platform acquisition.

For entrepreneurial CEOs, the ARC model is truly empowering and strategic. Finding the right Target and the right PE partner can be a frustrating exercise that can take months and sometimes years. Diligently screening deal opportunities for those that are Actionable, Relevant, and Compelling significantly increases the likelihood of a successful outcome.

Notch 'ARC Model'

The 'sweet spot' for executive-PE partnership exists at the intersection of three inter-related components



Actionable *Target Viability*

- How likely is the deal to happen? How quickly / easily?
- What are the major hurdles and gating factors to a successful platform acquisition? How can they be addressed?

Relevant *Executive-to-Target & Target-to Investor*

- Is the executive uniquely qualified to lead the company and execute the investment thesis?
- Is the target appropriate for the PE firm (e.g. size, stage, industry, etc.)?

Compelling *Thesis 'Intrigue Factor'*

- How exciting or interesting are the value creation opportunities?
- External factors include industry trends, competitive positioning, and market dynamics.
- Internal factors include 'easy wins' in operational or balance sheet transformations.
- Very highly Actionable and Relevant deals are usually considered Compelling.

Notch Partners is the preeminent provider of CEO-level talent to private equity firms seeking competitive advantage through proprietary deal flow, industry insider knowledge, and superior management teams. Notch cultivates high-impact relationships that result in superior returns for investors and transformative career opportunities for executives.

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