Sweet Success

THE LEAD | November 29, 2017

Thanksgiving weekend included this family's first trip to Hershey, Pa. For three little girls HersheyPark and Chocolate World were candy-coated nirvana. Life doesn't get sweeter than designing your own chocolate bar. Sprinkles? Butterscotch chips? Yum.

For adult vacationers the story of Milton Hershey's entrepreneurial journey was educational. His formal schooling ended in fourth grade. Two failed candy businesses preceded his Lancaster Caramel Company. An encounter with German chocolate-making machinery at the World Columbian Exposition in 1893 proved pivotal. Milton sold Lancaster Caramel and eventually did for chocolate what Henry Ford did for cars.

Our Hershey experience mirrored a recent private equity annual meeting we attended. The sponsor is one of the top middle market firms in the industry. As with many of its peers, 2017 was a good year to sell portfolio companies. A frothy credit market and hypercompetitive auctions helped boost exit multiples and overall returns.

As Milton Hershey discovered, business ventures are never guaranteed success. Several investments of our sponsor client ended up erasing shareholder value. Yet the partners were honest about the reasons for these failures. And focused intently on learning from their mistakes.

They also spoke forcefully about the drivers of positive realizations. First was revenue expansion.

All things flow from there. Management teams commit fully to this effort, the best seeking creative ways to enhance the sales process. Particularly for entrepreneur-led companies, it's about solving client problems in innovative ways.

Add-on acquisitions are accretive to the top-line. As we've covered in a special report [link], buying smaller businesses at lower ebitda multiples than that of the original platform company helps blend down the overall exit multiple.

But tack-ons also serve to expand product offerings. Hershey bought the H.B. Reese Candy Company in 1963. Today Reese's is the largest confection brand in the U.S.

Improving margins is also a key ingredient to growing value. This can be achieved through both cost reduction and (selectively) higher prices. Critical to Milton Hershey's early success was building his chocolate factory in the heart of the Pennsylvania farmland. Fresh milk could be trucked in by local farmers cheaply and in bulk.

What did PE partners view as the biggest threat to returns? Disruptive technological change. Before Hershey, chocolate candy was mostly batch-made and expensive. Its patented technique allowed raw milk to be stabilized and processed in volume.

In the end, of course, it's all about the customer. Tastes evolve and needs change. Companies must adapt to these trends, whether backed by private equity sponsors or not. And their lenders must figure out who the winners and losers will be.

In the car headed home from the Hershey adventure, we asked our four-year old: “So what was your favorite part of the trip, Elizabeth?” She thought for a moment. “I liked the chocolate.”