Testimony of Pamela B. Hendrickson
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The Committee on Small Business
Subcommittee on Investigations and Oversight
United States House of Representatives
Washington, DC
Thursday, March 26, 2009

Chairman Altmire, Ranking Member Fallin, and members of the subcommittee: Good morning. My name is Pam Hendrickson and I am the Chief Operating Officer of The Riverside Company, a private equity firm headquartered in Cleveland and New York, which invests in small businesses around the world. (To us "small businesses" are companies with annual revenues of approximately $35 to $40 million; the average number of employees at companies we buy is about 130.)

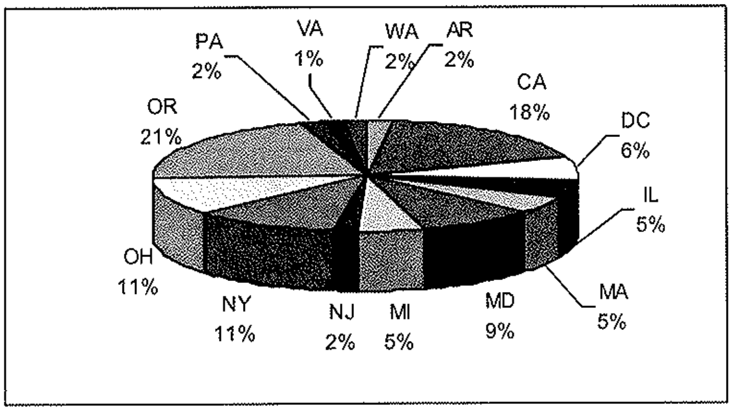
I appreciate this opportunity to share my perspective on how Riverside and others in our field add value to small businesses.

MEET THE RIVERSIDE COMPANY

If you read the newspapers lately, it seem as if some people have the impression that the private equity industry comprises of a cadre of former investment bankers who use financial black boxes to acquire companies in big cities on the coasts and then vaporize their assets and employees.

That is just simply not what we do. Our business model is highly dependent on our ability to generate gains for our investors by improving the underlying value of the companies we buy through sales and earnings growth. Because we invest a lot of our own personal money, our interests are strongly aligned with our investors.

Who are those investors? Nearly 40% of our assets under management come from 21 public and private pension funds and 10 college endowment funds based in 16 different states.



Our investors have entrusted $2.7 billon of assets to us, and have achieved a net internal rate of return (IRR) of 54% on the 46 investments we've realized (that is, on the companies we've sold). Because we focus on the small end of the middle market, the companies we work with are situated in communities all over the Unites States – cities such as Jacksonville, Florida and Minneapolis, Minnesota , as well as small towns like Oneida, New York (population 11,000); Ozark, Missouri (population 10,000); and Paris, Kentucky (population 9,000).

Unlike Venture Capital, which helps companies in the startup phase of their lifecycles, The Riverside Company helps companies that are in a later stage of development and are already profitable (with five years of positive earnings) move to the next level.

Many private equity firms have some sort of specialty; ours is size. We are the largest buyout firm focused solely on small companies. Since our founding 21 years ago, we've invested $1.8 billion in 211 "little leaders" of niche industries around the world; companies that seek to boost their growth through a partnership with Riverside. We do not participate in hostile takeovers. Today, we own 50 companies in the U.S. employing roughly 10,000 people.

That figure of 10,000 employees does not include our staff of nearly 200 employees worldwide, including 125 in the U.S. Our level of activity (we made 31 acquisitions and realized eight investments in 2008) requires a large staff of transactors and operators as well as our own support staff to handle functions like marketing, investor relations, human resources, finance and administration. Our staff is as geographically diverse as our portfolio; only 42 people, or 34% of our U.S. staff, are in New York City.

I am focusing my discussion today primarily on our work in the U.S., but it is worth noting that while the LBO industry was born in America more than 25 years ago, it has been "exported" to most countries around the world. Most major private equity firms, including Riverside, remain American-owned but have expanded into other geographies that offer similarly attractive investment environments (that is, a stable government, capitalism, reasonable regulation, etc.).

After 21 years as an investor in small companies, Riverside has developed a fairly standard operating procedure that works well for the companies we buy. We typically double or triple the earnings of our investments, often by buying other companies to "add-on" to the parent company and by providing specific business expertise that enables our companies to expand. When we execute an add-on strategy, we work with one of our current investments to find, evaluate, and acquire related businesses as a means to support our companies' growth strategies. The add-ons provide opportunities for geographic expansion, new product lines or brands, new services, specialty management expertise, or market share gains. To date, we've invested in 163 U.S.-based companies, 78 of which have been add-ons. On average, we sell a company five years after acquiring it. Companies we've sold have seen an average improvement in sales of 96%, and an average improvement in earnings of 100%.

Private equity transactions can create value through any combination of three factors: earnings growth, multiple expansion (because we improve companies during our ownership we generally receive a higher multiple of earnings on exit than was paid for at acquisition), and balance sheet restructuring. Only 8% of Riverside's total profit in the U.S. has come from balance sheet restructuring (which typically entails paying down the debt used to finance the acquisition), leaving the majority of value to come about equally from earnings growth and multiple expansion. Therefore, our value to small businesses is not predicated on financial engineering or balance sheet restructuring, as often depicted by media coverage.

We have only done three dividend recaps in our 21 year history (paying a dividend to investors mid-ownership by re-leveraging the company and taking out equity). We are conservative in our debt positions relative to S&P's Leveraged Lending Review, which recently reported that average debt contributions for 2008 were 57%. Our average debt contribution for 2008 was 32%. The current leverage ratio for our U.S.-based companies is 2.9 times earnings compared to S&P's reported 4.5 times operating earnings.

At Riverside, we're earning a living by providing capital and operational resources to help our companies grow. I'd like to share with you some of the ways in which we do this...

CREATING VALUE

Many of the companies we acquire, 60% in fact, are sold to us by the companies' founders or family owners, who are seeking liquidity. These entrepreneurs have the majority of their net worth tied up in their company and need access to that money, most often for retirement and estate planning. Taking their companies public typically is not an option with such small companies. Without private equity, these founders would have drastically reduced options for continuing their businesses, handling succession planning, and securing for their children and grandchildren the rewards of their entrepreneurial successes.

Here are two poignant examples where our ability to deploy capital quickly was key to the continued growth of small businesses:

Riverside purchased CPI, a training company in Brookfield, Wisconsin, and Media Source, a promoter and seller of children's books in Plain City, Ohio, both from patriarchs who, sadly, were dying of cancer. In both situations, the families were unable or unwilling to take over the business. Both of these men wished to sell their companies quickly and without disruption, while also rewarding the existing senior management teams. Riverside was able to help achieve these goals in an expeditious manner. Since the transaction, CPI has increased sales by 25% through the addition of new training programs, international growth, and a modest price increase. Similarly, Media Source has increased sales by 30% due to increased subscriptions with existing customers and the hiring of additional sales representatives to further growth. Both companies are positioned for continued success.

Riverside also invests in companies and management teams that wish to take their businesses to the next level, but do not have the resources, capital, or know-how to do so. Such was the case with Universal SmartComp, a Washington, Pennsylvania-based company that operates a physical medicine network for workers' compensation medical claims. Riverside invested $15 million in the company in early 2008, and SmartComp has since grown both its sales and earnings by 50%, hiring 27 new employees (a 34% increase) to help expand sales.

In other investments, we can help *create* small businesses by acquiring what we affectionately refer to as "corporate orphans." Occasionally, a large company has a non-core business division that suffers due to lack of capital and attention. Four years ago, Riverside acquired Justrite Manufacturing, located in Mattoon, Illinois, which manufactures safety products and containers that help prevent catastrophic industrial accidents. Formerly, Justrite was a business unit of Federal Signal. Since Justrite was acquired by Riverside, it has benefited significantly from increased attention and resources, recording sales and earnings growth of nearly 40%. Riverside supported the company with a temporary CEO (one of our operating executives) early in our investment, while we searched for a top management team. In addition, Riverside introduced Justrite to a consulting firm that helped it analyze pricing strategy, providing a fresh and professional analysis of opportunities to better align its pricing with its value proposition, thereby increasing profits. As the company continues to grow as a result of these initiatives, it has been able to keep jobs in Mattoon.

This example of in-house management expertise and relationships with valuable consulting services highlights the value-add provided by our operating team and the Riverside "Toolkit". We have 23 operating partners and executives available to assist our companies. In addition, we have pre-screened, proven consulting partners to help in specific areas such as sales growth, manufacturing, IT development, and so on.

In addition to supplying equity capital to our companies, Riverside brings to them a network of lenders with whom we've developed close relationships over the last two decades. We partner with lenders that will support our companies in good times and bad. They are willing to do this because we've only once lost principal on our senior debt in the 163 deals we've done in the U.S.

One situation where our strong lender relationship proved beneficial was with GE Antares, our partner lender for United Central Industrial Supply ("UCIS"), a Bristol, Virginia-based distributor of consumable coal mine supplies that we acquired in August 2004. Less than one year after our investment in UCIS, we found an attractive add-on opportunity that would enable it to broaden its product line and services. GE Antares made the transaction possible by supplying additional debt to the company. Because UCIS continued to perform well and was in good financial standing, GE Antares extended another term loan to the company for a second add-on acquisition, which enabled UCIS to improve its market position in the West. When Riverside ultimately sold UCIS to another private equity firm in April 2006, its leverage was only 2.4 times operating earnings. During our ownership of UCIS, the company increased organic sales and EBITDA by 40% and 90% (pro forma for acquisitions), respectively.

Another way in which we strengthen the companies that we acquire is through the introduction of more sophisticated financial and operational controls. To that end, we require annual audits to ensure the financial statements provided to our investors, lenders, and other stakeholders can be relied upon for decision making. We partner with Deloitte & Touche, McGladry Pullen and BDO Seidman, three large international accounting firms, to perform these audits. For the vast majority of our companies, these audits are the first detailed, in-depth audits ever done for their businesses – and any process and control improvements suggested by the auditors are acted upon by our management teams. In the Riverside Micro-Cap Fund alone, which was established in the summer of 2005, our portfolio companies have received over 20 unqualified opinions from our auditors, and no company has had a qualified opinion to date – a testament to the strong financial controls implemented after Riverside invests in a company.

A business that is not measured cannot be managed, and therefore we place great value on upgrading the financial organization and systems in every company in which we invest. This upgrading consists of hiring experienced, qualified financial leaders, investing in business systems, and ensuring assets are safeguarded.

Riverside's investment in Respiratory Care Services, Inc. (RCS), which provides respiratory care equipment and services to nursing homes and is headquartered in Carmel, Indiana, included the hiring of a very experienced CFO and Controller (the first CFO ever hired for this business), and the implementation of business software called Fast Track. The newly hired CFO and Controller have made great strides in improving financial controls including a rigorous budgeting process, weekly cash forecasting, tight management of accounts receivable, and improved billing processes. Utilizing the latest in handheld communication tools, the Fast Track software being implemented now at RCS replaces a completely paper based, manual system and will ensure that 30,000+ pieces of respiratory care equipment -- oxygen concentrators, nebulizers, CPAP machines, etc. -- are tracked and billed accurately and timely.

Another "control" that Riverside brings to our small companies is corporate governance. Each of our companies has a Board of Directors, often for the first time, and most have two Outside Directors that bring industry expertise and general business experience to the company. During our first few months of ownership, each of our companies develops a written strategic plan to provide a road map for growth. Our boards then help the companies to follow the plan by providing industry expertise and business smarts to look ahead and even around corners. And of course they make sure that we have the right

CEO and top management team, supported by the right capital structure, implementing the right strategic plan and the right incentives and rewards.

Our boards make sure that winners get rewarded appropriately, that losers get fired, and that the company legacy and culture is preserved. From our perspective, this is capitalism at its finest.

An example of a particularly effective board was that of Caprock Communications, which was acquired by Riverside in April 2002. Caprock is a Houston, Texas-based communications provider for the off-shore energy, maritime, construction and mining industries as well as disaster relief and government applications. After our investment, we added two Outside Directors to the Board: the CEO of a multinational oilfield services company and the head of a premier satellite technology consulting firm. The new director who had served as CEO of the oilfield services company brought excellent experience and was a good mentor to Caprock's first-time CEO, Peter Shaper. Additionally, he knew everyone in the oilfield business and made multiple introductions for Caprock. The consultant was one of the world's experts in Caprock's key satellite technology and introduced the company to Telematika, an Indonesian company that Caprock then acquired in September 2004 to establish an immediate and significant presence in the Southeast Asian market.

One challenge that our small companies constantly face is their relationship with large vendors. They are relatively small and aren't always very important customers. Because of that, they sometimes find it difficult to get good service and good pricing. We are able to help our small companies achieve big-company benefits through purchasing programs that give them access to top tier suppliers at discounted, "big company" rates. On a pooled basis our 50 U.S. portfolio companies spend approximately $25 million with FedEx, for example, and we negotiate discounts that reflect this level of spend, in a way that our individual companies could not. This program has proven to be a real safety net for one of our companies that was using DHL to ship their product, herbs such as thyme and basil, to customer distribution centers throughout the country. When DHL shut their doors in January, our company didn't skip a shipment, thanks to FedEx's ability to take on that business with a day's notice.

Participating in these purchasing programs also enables many of our companies to do a better job sourcing, simply by best-practice sharing. For example, we're currently facilitating a steering committee for the purchasing of corrugated cardboard, and have five companies sharing ideas on white paper standards for rate fluctuations, effective recycling programs, negotiating strategies and vendor relationships.

Another big--ticket item for our small companies involves healthcare benefits. Riverside understands the importance of providing benefits to our employees and has therefore taken an active interest by pooling our purchasing of benefits with partners, including United Healthcare for medical, Guardian for dental and SunLife for life and disability coverages.

Recognizing that "claims are claims" (that is, the cost of medical premiums is 100% correlated to what employees spend on healthcare); we believe that the best way to curb the cost of healthcare is to make employees better healthcare consumers. In the end, of course, that approach also makes for healthier employees. We help our U.S.-based companies tackle this challenge through development of three-year strategic plans for benefits. These plans are intended to address healthcare costs as well as education on trends and programs that will help employees develop healthier lifestyles. In fact, less than a month from now, Riverside along with our benefits broker and consultant, Oswald Companies, is hosting a (free) Human Resources Forum for all HR professionals within our portfolio. Since Riverside launched the healthcare program in 2006 we have held our PEPY (per employee per year) cost near flat, starting at $8,059 in 2006 and increasing less than 1% to $8,083 in 2009. In contrast, industry trend increases would have resulted in a 36.0% higher PEPY of $10,992.

One company that participated in this program is Nordco, a Milwaukee, Wisconsin-based manufacturer of railroad "maintenance-of-way" equipment. In fact, the United Steel

Workers of America, which represents many of Nordco's employees, complemented Riverside for continuing to offer "comparatively generous benefits" according to a September 2008 United States Government Accountability Office report on Private Equity.

Another way in which Riverside has supported Nordco over the last five years is by bringing add-on acquisition opportunities to the management team. In line with this "buy and build" strategy, Nordco has made three acquisitions: JER Overhaul, DAPCO Industries and DAPCO Technologies, and Central Power Products, Inc. As a result of these, as well as impressive growth from Nordco's core business, revenues have increased from $39 million in 2002 to $137 million in 2008 and employment increased from 106 to 343. Excluding "acquired" employees, employment increased by 116, or 51%.

Riverside also helps our companies by looking out for new opportunities that will enable them to further grow and develop. One example is GTI Diagnostics, which is based in Waukesha, Wisconsin and manufactures medical diagnostic test kits for transplantation, blood bank and coagulation laboratories. When we bought the company in July of last year, the CEO had great hopes for expansion, particularly into the large markets in China, but had neither the capital nor the expertise to make that happen. Riverside has a dedicated operating resource on the ground in China (the former President of Danaher-Asia) whose knowledge and experience has been instrumental in helping GTI. He is in China this week with the senior management team of GTI to begin the process of navigating the SFDA, the Chinese equivalent of the FDA, to qualify GTI's products in China. They are also meeting with several blood banks in China's major cities to understand their needs and educate them on the benefits of GTI's leading solutions. During the course of Riverside's hold period, we expect China to grow into a meaningful market for GTI's products. It is worth noting that GTI employs a highly skilled workforce in Wisconsin, and GTI's intent its not to have jobs follow the demand to Asia. If anything, GTI expects to grow its team in Wisconsin as demand for the company's products grows around the world.

CHALLENGES FACING PRIVATE EQUITY

As private equity continues to contribute an increasing percentage of GDP, it is understandably gaining the attention of regulatory bodies. Given the current economic climate, it seems that some of this increased attention is inevitable.

However, I would like to comment on a couple of areas where we have concerns, particularly with respect to FASB regulations. FASB 157, the so-called "mark to market" regulation, for example, does not allow us (as an industry) to apply the same methodology we use to evaluate potential acquisitions and exits as we do to value our unrealized investments. Instead, it applies a more public-company, academic approach to unrealized investments. As professionals with decades of experience evaluating small, private businesses, we worry that applying a more academic approach to valuations is actually less meaningful. It also could be doing investors a disservice because it implies some level of risk reduction that just doesn't exist in our world. This disparity is exacerbated by today's extremely volatile public equity market, because these methodologies assume that our assets are much more liquid than they actually are. Furthermore, it costs our investors approximately $500,000 more per year due to the additional time spent by our internal team, outside consultants, and auditors.

On another front, debt markets, despite our strong relationships with lenders, remain very tight. In the current environment, it is difficult for us to secure the debt we need to buy our small companies. We have, in fact, wondered whether there might be some form of partnership that we could structure with the SBA to provide debt at the fund level. Both the SBA and a wide range of small companies would then get the benefit of our capital, our global network, and our operating expertise.

Today's global recession represents a difficult test of our investment strategy: Buy "little leaders" and help them grow at an accelerated pace. So far, we're faring better than most. While U.S. GDP fell by 6% in the fourth quarter last year, our U.S. companies' revenues *increased* by 8% for the year. While five of our 49 companies owned at the end of 2008 did experience sales declines of greater than 10% from the prior year, 17 companies, or 35%, grew sales by greater than 10% from the prior year. Our companies have planned for a slower 2009, though the first two months of the year lead us to be cautiously optimistic, with continued growth of a modest 2% versus prior year. It is at times like these that our companies most appreciate the additional resources that Riverside can offer.

We bring a wide range of knowledge and expertise to bear – both from inside Riverside and outside – as we decide which companies should receive precious equity capital, and which should not. We're mindful that these are important decisions and we don't make them capriciously. We have a lot of skin in the game; our future as a firm is based on our track record – and we're only as good as our recent transactions indicate. Just as companies compete for our capital, so we have to compete for the investment capital of our limited partners, and it is a very democratic (small d) process. It isn't based on who you are in status or where you went to school. It is performance driven.

Thank you for your time.