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Retail
Savvy
Castanea Partners'
Brian Knez and Robert Smith
carry on a legacy of cracking the
code on consumer behavior
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Retail Savvy

Castanea Partners' Robert Smith grew up in the deal trade. The son of Richard Smith, who famously built General Cinema into one of the last great conglomerates, Robert spent much of his youth engaged in odd-jobs at the family business -- from inspecting bathrooms at the famed Shoppers World theatre in Framingham, Massachusetts, to later serving as a cashier and a film projector. By high school, he was driving trucks for General Cinema's bottling operations. When Smith re-joined General Cinema after college and a spell at Bain & Co., he was thrust into dealmaking.

Cover Photograph by Kelvin Ma

Castanea co-founder Brian Knez could also be considered a protege of Richard Smith. Both Knez and Robert joined General Cinema in the Eighties -- getting a first-hand look as the company established itself among the prominent white knights during the golden era of M&A. The pair got their feet wet working on the fabled Carter Hawley deal, in which General Cinema helped the company stave off successive hostile takeover attempts from Leslie Wexner and his retail powerhouse The Limited. It was the 1987 cash infusion into Carter Hawley, the second investment in the company in three years, that ultimately resulted in a control stake in Neiman Marcus, which was spun out of Carter Hawley later that same year.

Ask Smith and Knez what they picked up from their days at General Cinema, and their mutual background as operators is evident. At the same time, the two share an appreciation for value that suggests they chose an appropriate path in launching the consumer-focused private equity firm, Castanea Partners.

"One of the more important lessons was the idea of 'investment with involvement,'" Smith describes. "You have to understand the nature and flow of business cycles, but at the same time creating value is about being great stewards of the assets you control."

Adds Knez: "In the corporate environment, patience means one thing and in the private equity world, it means something else. To be successful at Harcourt Brace and Neiman Marcus, you had to filter out the vagaries of the market; it meant penalizing performance in the short term to build out the business for the long term."

To be sure, running General Cinema was in a lot of ways akin to managing a private equity firm. The company was just as active monetizing its assets -- be it the predecessor to Pepsi Bottling, Sunkist Soda, or minority investments in the likes of Cadbury Schweppes and Columbia Pictures -- as it was in accumulating trophy properties, such as Neiman Marcus or publishing giant Harcourt Brace. And while the public markets rarely appreciate the kind of patience Knez alludes to, at Castanea it has served the firm well.

This patience has been evident from the very beginning at Castanea. Rather than banking on their names in retail -- having ascended to the roles of co-CEOs at Harcourt General and Neiman Marcus -- the two opted to launch Castanea without any outside capital. The idea was to prove the model out and only then raise an institutional fund. An early Power Point presentation identifies that the firm's partners set aside $75 million, a sum that wouldn't spread the tight team too thin, allowing Castanea to make as many as six investments over a three- to five-year time horizon.

In addition to Knez and Smith, Harcourt vets Paul Gibbons and Peter Hoenigsberg and Bain Capital alum Steven Berg were among the early team. Partner Troy Stanfield, another Bain & Co. vet, was an early addition having joined in 2002.

Among Castanea's first investments were acquisitions of Brinker International carveout EatZi's, FUZE Beverages and Decision Resources, where Hoenigsberg

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currently resides today as CEO. All three were rolled into Castanea's debut institutional fund, a $207 million vehicle raised in 2004, with backing from the likes of Yale University, Princeton University and other endowments and pensions. Only Lee Munder Capital, a minority investment by Castanea, was not rolled into the institutional fund.

While Castanea has a healthy mix of investments in the education, information and marketing sectors, most, at the end of the day, have a consumer component. It's a characteristic that likely reflects Smith's and Knez's General Cinema DNA. In fact, it was Smith's grandfather, Philip Smith, who founded General Cinema and was among the first to couple his theaters with shopping centers.

Chestnuts Roasting

Cas•ta•nea: Latin for chestnut. Noun: a small genus of rough-barked trees or shrubs (family Fagaceae) native to temperate regions that includes the chestnut of eastern North America. The chestnut is symbolic for fertility, abundance and longevity.

Brian Knez and Robert Smith, in naming Castanea Partners, focused on the "chestnut" theme, a nod to General Cinema's former headquarters in Chestnut Hill, Mass. Jeffrey Lurie, another grandson of General Cinema founder Philip Smith, has also shown a fondness for the name. Before he bought the NFL's Philadelphia Eagles, Lurie founded LA film company Chestnut Hill Productions. Lurie, who still dabbles in entertainment, was credited as a producer for the Academy Award winning documentary Inside Job.

In many ways, this is reflected in Castanea's activity and the partners' ability to stimulate growth. Whether it's a coincidence or not, the firm has also shown a knack for being able to time the market, which no doubt goes back to the pair's ability to read and assess consumer sentiment. Fuze, for instance, was sold to Coca-Cola Co. in 2007. The sale followed a three-year holding period that saw revenues grow by roughly four times. Decision Resources, meanwhile, was sold that same year to Providence Equity Partners. Under Castanea and co-investor Boston Ventures, the pharmaceutical information company reportedly doubled its sales and tripled its profits in slightly more than three years.

Smith notes that the sale of Neiman Marcus in the fall of 2005, acquired by TPG Capital and Warburg Pincus for $5.1 billion, provided an early signal that the retail space was transitioning into a seller's market. "As we sold Neimans the ebullience was evident," Smith cites.

Castanea also unloaded Hanna Andersson in 2007, selling the company to the then publicly held Kellwood Co. for $175 million. Castanea had invested in the company in 2004 alongside Dorset Capital. According to Philip Iosca, former president and CEO of the childrenswear company, Hanna Andersson had received multiple indications of interest during Castanea's ownership, but the firm chose to hold onto the asset as it developed its infrastructure, and targeted growth through building out its online offerings and pursuing store openings.

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Of course, by now, everyone is well versed on what happened to the credit markets and subsequently consumer spending shortly after 2007. Iosca reflects, "It was a time when no one knew where the bottom was."

While Castanea was able to clear much of its portfolio ahead of the carnage that followed, like every PE firm in 2008 and 2009, it did face its share of challenges. Castanea acquired contemporary women's apparel designer and retailer Betsey Johnson during the tail end of the year and, also in 2007, picked up a control stake in high-end jewelry designer Ippolita.

Another lesson picked up from Richard Smith, or perhaps more of a world view, is a tendency toward optimism. Knez notes that the elder Smith would often say: "Anyone can kill a deal. The good investors find reasons to get deals done."

Smith, meanwhile, identifies that Castanea literally sees hundreds of opportunities each year. The challenge, he notes, isn't doing deals, per se, but "finding reasons to believe that we will be able to add value in a way that will differentiate the company."

Smith downplays the idea that Castanea foresaw the consumer meltdown that occurred in 2008 and 2009. "It was a frothy time; prices were high and companies were performing at cyclical peaks, so we began raising our internal hurdles," he says, but claims that neither he nor anyone else at Castanea foresaw exactly what would come next.

Still, the companies that Castanea backed just ahead of the collapse were able to survive at a time that the roof caved in on many consumer-facing businesses. Ippolita, for instance, was acquired in November 2007. Joseph Cavalcante, who was recently named CEO of the jewelry seller, describes that when Castanea first backed the business, it had fewer than 20 employees. "We were almost like a venture capital investment," cites Cavalcante, who joined the company two years prior to the Castanea investment.

Three and a half years later, with the great recession now in the rearview, Ippolita has grown to more than 80 employees. The company, this past March, was named by investment banking boutique Consensus Advisors, as one of its "next great brands."

Of course, the Neiman Marcus connection doesn't hurt either. "We were growing like crazy at Neiman's," Cavalcante says, citing that it's early performance reflected that the brand was resonating with consumers -- a fact that was not likely lost on either Knez or Smith.

At the depths of the downturn, throughout much of 2008, dealflow essentially dried up, especially for retail and consumer product companies. And while Smith says the firm largely sat on its hands that year, as soon as more visibility entered the market and consumer buying patterns again took shape, Castanea was among the earlier firms to act. A March, 2009 investment in Urban Decay was the result.

Knez describes that Castanea spent close to a year working with the cosmetic company prior to the actual deal. "It was an interesting opportunity then and even now to ascertain how the company would perform in an uncertain environment.... We were able to see how well it is positioned with its customer, which at the time gave us the confidence to invest."

Deal pros, now two years removed from early 2009, may forget just how touchy the markets were during this period. Castanea's investment in Urban Decay was announced on March 30, 2009, the same day the government effectively took over the auto industry when it turned away the restructuring plans of General Motors and Chrysler and ousted GM CEO Rick Wagoner. To invest in any consumer-facing asset at that time, underscores the Richard Smith chestnut that good investors find reasons to get deals done. Both Knez and Smith cite that the leap of faith has paid off, and that Urban Decay underscores the key factor they look for in consumer businesses -- namely a highly engaged customer.

Even as activity slowed, Castanea stayed ahead of the curve. The firm also brought in Marketspace founder Jeffrey Rayport as an operating partner in September, 2009, a leader in e-commerce who has proven valuable in prepping Castanea's portfolio companies for the social media opportunity.

Knez and Smith note that their aspirational brands, in particular, lend themselves to the new distribution channels and go-to-market strategies that are cropping up as a result of the social media explosion.

"We try to be very aware of the evolution," Smith describes, noting that disruptive strategies in retail should be viewed with an opportunistic as opposed to a suspicious eye. "We will pursue those strategies aggressively," he adds, citing Urban Decay and Donald J. Pliner as two companies that have already made digital inroads under the firm's watch.

Adds Knez, "All of this opens a huge new avenue for smaller brands; it allows these companies to cast much bigger shadows than their size would normally allow, so it's a significant game changer in that regard."

To be sure, Castanea is merely following in the footsteps of General Cinema, which confronted "new" technologies such as television and VCRs over its lifetime.

Based on the level of activity recently, Castanea has been able to find a level of comfort with where things currently stand in the market. Last year, the firm sealed two exits, selling Integrity Interactive Corp. to SAI Global and Medley Global Advisors to The Financial Times Group. The firm also secured a pair of deals last year, backing Health Resources and Vitamin Research Products, and subsequently merged the two branded nutritional supplement makers.

In 2011, Castanea jumped out of the gates, backing shoemaker Donald J. Pliner in February, Astor & Black Custom Clothiers in March, and Fitness Anywhere in April. Castanea, which still has roughly 40% remaining in its $575 million third fund, expects to stay busy.

While Castanea's co-heads see the credit markets loosening up, they know that it will be a long time before the consumer environment ever approaches the atmosphere of 2007. But that doesn't mean the firm isn't confident.

"It's still pretty choppy out there... It's still a tough environment for the more moderate customers," Smith observes. But as long as there is visibility, he says, brands that resonate with consumers will be protected.

The challenge, though, is making that call, especially when a company is either in transition or still ahead of the growth stage in its lifecycle -- the points at which Castanea prefers to enter. "There is no universal truth when it comes to backing consumer businesses," Knez says. "You just have to try to get underneath the value proposition in a very meaningful way. If you perceive that the customer is either highly engaged or could be, that's the most important factor." M&A