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'Badge' Value: Finding and Promoting Products That Inspire Customer Loyalty

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Alex Panos and his colleagues at TSG Consumer Partners, a San Francisco-based investment fund, believe that consumers will always be interested in products that enhance their lives, even if it means paying more than they have in the past. That philosophy has brought impressive results for TSG primarily in the beauty, food and beverage areas. Panos, who joined the 23-year-old firm in 1998, spoke with Knowledge@Wharton about the company's strategy, why it favors family-owned businesses, where to find opportunities in a recessionary economy and how to build up a brand, among other topics.

An edited transcript of the conversation follows.

Knowledge@Wharton: Our guest today is Alex Panos, managing director of TSG Consumer Partners. Alex, thank you so much for joining us. TSG was set up in 1987 as an investment fund focusing on the food, beverage and beauty industries. Could you help us understand what business opportunity you saw and what your strategy was?

Alex Panos: Sure. The firm was actually founded by two of my partners, Chuck Esserman and Gary Shansby, in 1987. I joined in 1998. I will describe what they saw in the market then and what I think applies today. There seemed to be a gap in the market. There were private equity funds using a lot of leverage and doing larger deals -- fewer of them. Venture capital funds were doing many deals, but all equity. Neither had a particular industry focus. The VC guys were business builders and the LBO guys were driving value primarily through leverage. So my partners saw an opportunity to focus on business building and driving value through growth. That seemed to be the opportunity. So it really is a hybrid. We do fewer investments and we use very little debt, if any, in our deals.

Knowledge@Wharton: Why did your partners pick that industry?

Panos: In consumer products there seems to be a lot of innovation. They saw an opportunity to find products where there would be strong loyalty, and premium products that were still affordable. So even in a down economy, people still might include them in their lives. Something we look for in all of our businesses to this day is an installed base, a product that works, that people enjoy; perhaps it somehow enhances their life and is -- we use the term -- an "affordable premium upgrade." So Vitaminwater -- one of our investments -- is an example of that, something that provides maybe a little bit more than what you were drinking before and that does not cost that much more.

Knowledge@Wharton: Are you finding that consumers are sticking with these products even in this down market?

Panos: People are always looking for value, especially in a market like this. But small luxuries we find do better even in a down market.

Knowledge@Wharton: How did the financial crisis affect your approach to investment and the kind of brands you were looking for?

Panos: We have some investments in premium beauty. Those can be very high priced beauty products -- $100 to $200 plus. Those are definitely more challenged in this market. Consumers are looking at value. Where even those products have done well, though, is in a channel like Home

Shopping Network or QVC, where QVC stands for Quality, Value and Convenience. [Consumers] still want these items, but they want to know that they are getting a good deal. So what we have seen is channel shopping, but still for high quality products.

Knowledge@Wharton: Down markets also create new opportunities. Have you encountered any of those as a result of the recession? And how have you taken advantage of those opportunities?

Panos: Great question. Yes, it's been actually an extraordinary year and a half for us. We have been as busy as we have ever been. We have done four transactions in the last 12 months. We found a special opportunity where the banks are out of the market and [there is] an opportunity to provide equity capital. Remember our strategy. We prefer healthy balance sheets. We don't use debt to drive growth. So we have been able to [identify] strong businesses that maybe found themselves a little over-leveraged. We come in and have provided a healthier balance sheet for them.

Knowledge@Wharton: Consumers may still adhere or gravitate to these "small luxuries," as you term them. The companies and the industries that you invest in are known for fickleness among consumers. In an industry where fashions and tastes change so quickly, how do you keep on top of that? How do your companies keep on top of that?

Panos: That's also a great question. Let me back up. We invest primarily in three areas -- food, beverage and beauty, and then other branded consumer products [such as the] pet and car care categories. I'll start with food and beverage. We have favored products that are nutrition oriented, "better-for-you" products, and in many cases are functional. So even when people are stressed, even when the economy is challenged, I think people want to enhance their lives and would like to try to eat better. It has been a unique opportunity to provide products that replace what people have.

A great example -- one of my favorite examples -- is a company called Smart Balance. Margarine was an otherwise unhealthy category with no innovation for years and years, but a staple of people's diets. Smart Balance launched a margarine with no transfats that was clinically proven to improve your cholesterol ratio. It sold at a premium. So $2.49 for a one-pound tub of Smart Balance versus maybe $1 for one pound of Shedds or another unhealthy margarine. Consumers traded up for it. It was a chance to enhance their lives for a little bit of extra money.

Knowledge@Wharton: I notice that you have invested in products, brands -- I'll show my ignorance here because I have not heard of these, but I am fascinated by their names -- like Muscle Milk and Mona Vie. I have heard of Vitaminwater, but I would like to know what it is.

Panos: Sure. Muscle Milk is a protein shake. It was found primarily in gyms and sold as a powder that you would take home and turn into a shake. [It had a] strong management team. We saw an opportunity to help them as they diversified their channel and essentially delivered a ready-to-drink protein shake but available in what we call "the up and down the street channel," like delis and cafes.

Knowledge@Wharton: So beyond the gym.

Panos: Beyond the gym. And ultimately in grocery, which is where they are going today. It has been hugely successful. It's a ready-to-drink shake that is a good alternative to a bar. It's a meal replacement.

Knowledge@Wharton: Does it appeal mainly to men, given the name, or does it cross over?

Panos: Surprisingly, it has done really well with women. The reason is that it tastes really good and has high protein, and there isn't much else out there.

Mona Vie is an acai drink company sold through the multilevel channel. We have hundreds of thousands of distributors, and it is a nice source of income for them, much like an Amway. A nice source of income even in an economy like this. It is sold in a wine bottle of all things -- so a very premium product -- and sourced from Brazil. One or two shots a day deliver a nice dose of acai, which is a very high antioxidant. It is really an extraordinary product that people say enhances their lives and improves their health.

Knowledge@Wharton: And I take it the same with Vitaminwater?

Panos: Vitaminwater was a knockout success for us. When it was launched, it was a nice alternative to high fructose corn syrup-laden sodas. It provided more than water -- taste and some functionality -- and less than soda. It filled a nice place in the market. Actually, their top selling SKU, at least at the time we sold the business, was called Triple XXX, which is an acai SKU.

Knowledge@Wharton: I'm sure you get lots of different investment opportunities. Could you take one such investment, like Smart Balance, and talk us through how you identified that as an opportunity, how you worked with it and built it up as a brand?

Panos: Sure. We are always looking at new categories and seeing what is growing and what has innovation. It was as simple as, in this case, looking at the Nielsen data for the margarine category and seeing a company with extraordinary growth. Through a relationship, we were able to reach the CEO of Smart Balance who was 79 at the time. [We] brought him some ideas around how he could expand to other categories with the Smart Balance brand. As happens with many of my investments, over a period of three years we came to know each other very well and ultimately found a transaction that worked for all. At the time we invested, Smart Balance was primarily one SKU, but [was] very profitable and expanding.

Three years later, the company had several SKUs in the margarine category, [went] from a 4% share to a 25% share in margarine, and had launched five other categories with between 5% and 10% shares each. So for my business, the food business, the Holy Grail is a brand that can ultimately be a $1 billion brand by being in many categories. In the case of Smart Balance, it went from margarine to, of all things, mayonnaise, popcorn and cream cheese. The company has launched milk now and more categories [are] to come.

Knowledge@Wharton: What is it that you look for in the management of these companies that you invest in?

Panos: First, we try to back existing teams. We are really looking for founders who are passionate about their business. I actually favor family businesses. Many of the companies that I target are father-son teams or husband-wife teams or mother-daughter teams. [They] have the culture that we favor where the business is core to who they are ... and [involves] someone who is truly living their brand. That means a lot to us.

Knowledge@Wharton: Someone else might say that they actually avoid family run businesses for reasons that we all know: They can be very incestuous; family members say they want outsiders to come in but they really aren't willing to give up any power or control; they have succession problems, intra family problems, etc. So I take it you have, in addition to being able to choose the right families, figured out a strategy for making that work?

Panos: Yes, we have somehow navigated that. Not every family business is for us, of course, but when it works, it works very well. What I look for are businesses that have been built brick by brick over many years, or at least are the culmination of many years of one or two businesses and that experience. In the case of Smart Balance, the founder had previously owned the Weight Watchers brand, which he sold to Heinz. He then started Smart Balance. So even Smart Balance was 30 years of being an entrepreneur and another previous 30-plus years of being a CPG [consumer packaged goods] executive. [The founder] worked closely with his son to develop this. They were quite a team, one of the best I have seen.

Knowledge@Wharton: Your investment activities have given you probably a ringside view of branding. What are some of the most important lessons about branding you have learned over the years?

Panos: Most of our businesses have established some sort of badge value where consumers are buying the product not just for what it does, but specifically because the company and the brand somehow seem to share values that the consumer has. Sometimes what you buy says as much about who you are. An example might be a recent investment, Pop Chips. Pop Chips is a potato chip that

is not baked. It is not fried. It is popped like popcorn. And it is only 100 calories a bag versus 300 or 400 calories for a typical chip, and it tastes great. That's what the product does. People buy it because they feel that the company is iconoclastic. The company has broken the mold. It's not the Frito Lay. And if you are that type of person, Pop Chips is a product for you. In addition, [you can] turn over the bag and see that the nutritionals are great. Favorite companies are able to send that message to consumers. It requires a certain amount of authenticity.

Knowledge@Wharton: Along those lines, do you feel that the trends these days towards better nutrition, green products, etc., are fads or do you think these suggest long standing changes and a shift in consumer values? Are consumers really interested in a healthier life style and a healthier environment and fair trade practices? Or is this going to go by the wayside when, say, there is another recession? How substantive are these values?

Panos: I think these are very important trends, and they will be long-term. Again, consumers will have a high bar, almost a double bottom line, of what they are looking for from the products they buy, both in ingredients and where their products are made and who is making them. What is the culture of the business? Is the company a good corporate citizen? Is it a positive member of the community? A great example, not an investment of ours, is Newman's Own, which is hugely successful.

Knowledge@Wharton: We are all aware of the Toyota recalls going on. This is every company's nightmare -- a product defect or some other problem. Has that ever happened to you? How would you deal with it if it happened to one of your companies?

Panos: Right. I think it almost relates to a Hippocratic oath. We definitely would not want any of our companies to do any harm. That is probably the number one tenet. So, certainly, when we make any investment, we do a lot of work to make sure that safety standards are at the highest level. We have not had an experience [like Toyota's] but you never know. So always take the high road as it relates to consumers and safety.

Knowledge@Wharton: Another major trend along with some of the others you described earlier is globalization. As companies become much more global, you often find outsourcing happening where suppliers take care of a lot of the manufacturing and operations although they are all still united under a common brand. How do you manage the risk that this introduces into a brand because now you have outsourced operators responsible for producing things that would be sold under your brand?

Panos: We have focused very much on products that are made here in the U.S. for a number of reasons. One, we favor U.S. jobs in our companies. And then, two, we can keep greater control of quality. Several of our companies have manufacturing, and in some of the industries, like beauty, there is a lot of capacity so we leverage co-packers. But we have been highly focused on U.S. manufacturing both for job growth and safety.

Knowledge@Wharton: A lot of business students dream about having a job like yours -- being a successful partner in an investment fund such as TSG. I'm just wondering, what keeps you up at night? When you think about your job, what pitfalls are there that you feel could await you?

Panos: I do two primary things in our business. One is, we are always looking for the next great thing and developing relationships with entrepreneurs and great companies. So we want to make sure we are part of top tier investments. That means meeting companies early. I should also step back and say that I view our mission as helping entrepreneurs build great brands. That doesn't necessarily mean we are invested in them. In other words, we spend a lot of time with companies that we are not invested in. It has led to great karma, a learning experience for us and great pleasure in seeing companies be successful. We enjoy doing that.

Once we make the investment, I want to do everything possible to help [the company] be even more successful. So how can we help our companies in every aspect of their business and bring them great resources? ... That is our starting point. We are highly motivated. But we are looking for case studies. We are looking to have case studies of helping an entrepreneur and a management team build a phenomenal business, in particular, businesses that somehow enhance people's lives. And so far it has worked out reasonably well.

Knowledge@Wharton: How much do you travel?

Panos: That is a good question. I will go wherever there is an opportunity. So I am on the road a lot. I had been in San Francisco for 10 years, but I was spending 100 plus days in New York. So that led me to open a New York office for us. And then ultimately I moved to New York. But, yes, I am on the road a lot.

Knowledge@Wharton: Are there any undersold markets where you would like to invest, but you haven't so far?

Panos: Our investment activity has been focused on, as we discussed, food, beverage and beauty. We have done some pet and we have done some household products. I believe that there are opportunities in apparel, accessories and other categories if we can avoid the fashion risk. So we will keep looking for brands that are long-term brands, not fads. We are really looking for, as a friend of mine described it, phenomenons -- things that have both consumer passion and consumer respect. I see them come about every few years.

Knowledge@Wharton: Just to get back to the question about branding. If you look at Procter & Gamble, they have been having a kind of tough time during this recession. Initially they didn't lower their prices, and they lost some consumers to more value oriented products. Now, I think, they are trying to meet consumers halfway and maybe lowering their prices a little, or enticing consumers with, say, more product in the same size package. But that is a very hard dance for them to do, given the fact that we have 10% plus unemployment, probably as high as 20% if you want to count it in different ways. So their brand is really under the gun. When you look at a company like Procter & Gamble, what do you think is going on in their heads? And what have you learned from a company like P&G that you can apply to the companies that you have invested in?

Panos: I admire Procter & Gamble and I admire the other large companies. But the challenge is that they move very slowly, and that creates extraordinary opportunity for us. The innovation may or may not come from inside. In fact, TSG has made a number of investments in snacks and beverages. You probably couldn't pick two categories that are dominated by such large players. In the case of snacks, Frito Lay, which is owned by Pepsi. And in the case of beverages, Pepsi and Coke. But we repeatedly go back into those categories and have had reasonable success. In the case of snacks, Terra Chips, Pop Chips, Garden of Eden and others to come. In the case of beverages, Vitaminwater, Mona Vie, Muscle Milk and some others on their way.

Knowledge@Wharton: So you are finding these niche markets that you grow. And the hope, I assume, is that they don't stay niche, that they become more mainstream.

Panos: Yes, I look at this often. I think this is the biggest challenge. How do you have a product that may appeal to influencers, early adopters, early on and keep their loyalty even when the product becomes mainstream? Apple is probably the greatest example. And Vitaminwater seems -- we are not an owner today -- but they seem to have done it as well. How did they do it? I think that consumers view it as a product that also shares their values. Again, it is a little bit iconoclastic.

Knowledge@Wharton: One last question. You are now investing your fifth fund with $900 million in capital. Where would you like to see TSG go in the future?

Panos: Well, first I should say that we have the best team we have ever had. We have an extraordinary group of partners and we certainly like to stick to our knitting. We favor the categories we are in, and we are always evaluating new ones. So we may see top tier investments in new categories. We are writing larger checks than we have ever written. We have a chance to buy even bigger businesses. We still want to support entrepreneurs with businesses of all sizes. So occasionally we will break the mold and do something smaller than we would otherwise do because we see a brand that can really change the game, so to speak. So continue to have consistent returns, continue to build great case studies of working with entrepreneurs, and invest in products that enhance people's lives, which is really the mission.