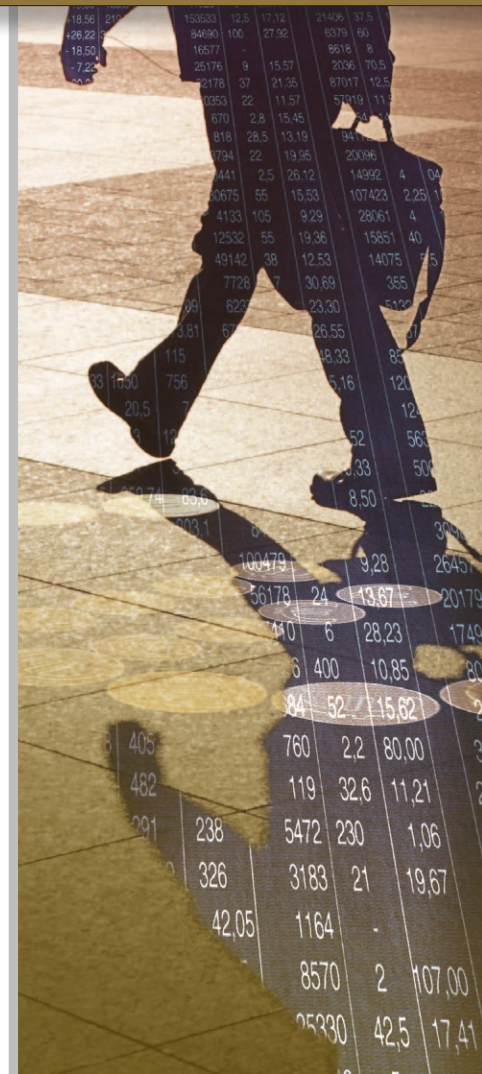


# Rating Operative Performance of PE Portfolio Companies

PE fund companies in Europe stage a post-recession comeback





Like countless other industries, Private Equity (PE) benefited handsomely from the credit bubble that reached its zenith in the “golden year” of 2007. When the bubble burst, however, the credit markets froze and a global recession took hold. PE firms retreated. A.T. Kearney’s latest study of the European PE industry finds that some PE fund companies are staging a post-recession comeback and outperforming their industry peers, primarily in slow-growth industries. Firms taking home the biggest prize are decidedly hands-off—turning over more and bigger responsibilities to their deal partners. And, perhaps most important, many of the strategies attributed to this PE comeback story will work for companies in other industries and geographies.

A review of PE transactions in four core European markets—the United Kingdom, DACH (Germany, Austria, Switzerland), France and the Nordic countries—illustrates the meteoric rise and fall of the PE industry during the recent past. Every indicator fell, from investment activity to exit levels and from fund-raising to fund returns (*see figure 1 on page 2*). Buyout deal activity worldwide collapsed from \$503 billion in 2007 to just \$81 billion in 2009, according to Thomson Reuters. In Europe, activity plunged at a compound rate of 62 percent. By comparison, buyout deals fell 66 percent in North America and just 32 percent in Asia.

After the decline, European PE firms were in unfamiliar territory. The industry was starved of new opportunities, forcing it to concentrate on

existing portfolios. Although 2010 showed signs of a slow recovery, it was by no means a return to the glory days. Indeed, the PE mantra in 2010 was to continue to pursue value, not to hunt aggressively for new opportunities.

This test for the European PE industry raised several questions:

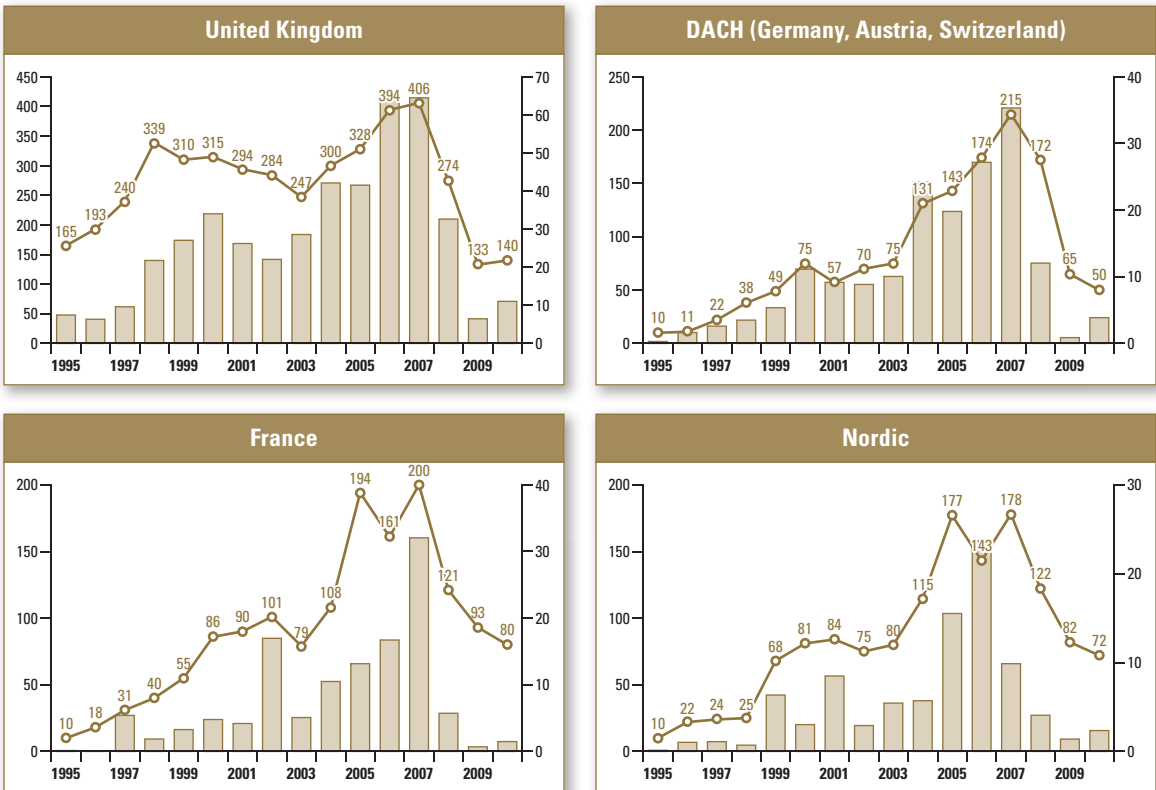
- How have PE-owned companies performed against public peers across European nations and industries?
- What are the different PE business models and which have been most successful during the crisis?
- Do common denominators of successful PE funds exist and can they be transferred to other companies?

A.T. Kearney sought answers to these questions. A study team was formed whose members

**Figure 1**  
The meteoric rise and fall of the PE industry

**PE transactions by completion date in focus regions, 1995-2010 TYD**  
(Number of transactions/cumulative disclosed deal value in €bn)

—○— Number of deals (left axis)  
■ Disclosed value, € billion (right axis)



Source: Dealogic, 13 September 2010

interviewed the major PE players and analyzed the recent financial performance of more than 100 European PE portfolio companies versus their public-industry peers in the four core regions (see sidebar: About the Study on page 4).

Although the A.T. Kearney study dealt solely with the European experience, the study team believes that the findings are relevant to other geographies. For example, the study results are likely to pertain to the North American and U.K. PE markets, which are at similar stages of maturity.

The study revealed the following:

1. PE fund companies generally outperform their public-industry peers, primarily in slow-growth industries, such as chemicals, large consumer goods and retail, manufacturing and business services
2. Contrary to popular belief, PE firms that take on a supervisory role—giving the deal partner responsibility from acquisition through exit—deliver more value by balancing growth and profitability
3. Success factors are transferable for those willing to learn from the PE masters

To this last point, key success factors include rigorous cash management and managerial discipline (making all capital work hard), a strong emphasis on reporting systems and, perhaps most important, employing managers who behave like owners. However, simply adopting the mechanics of adding value is not enough. These factors must become an integral part of the overall equation.

The following outlines the three major findings in more detail:

### 1. PE Fund Companies Outperform Public-Industry Peers

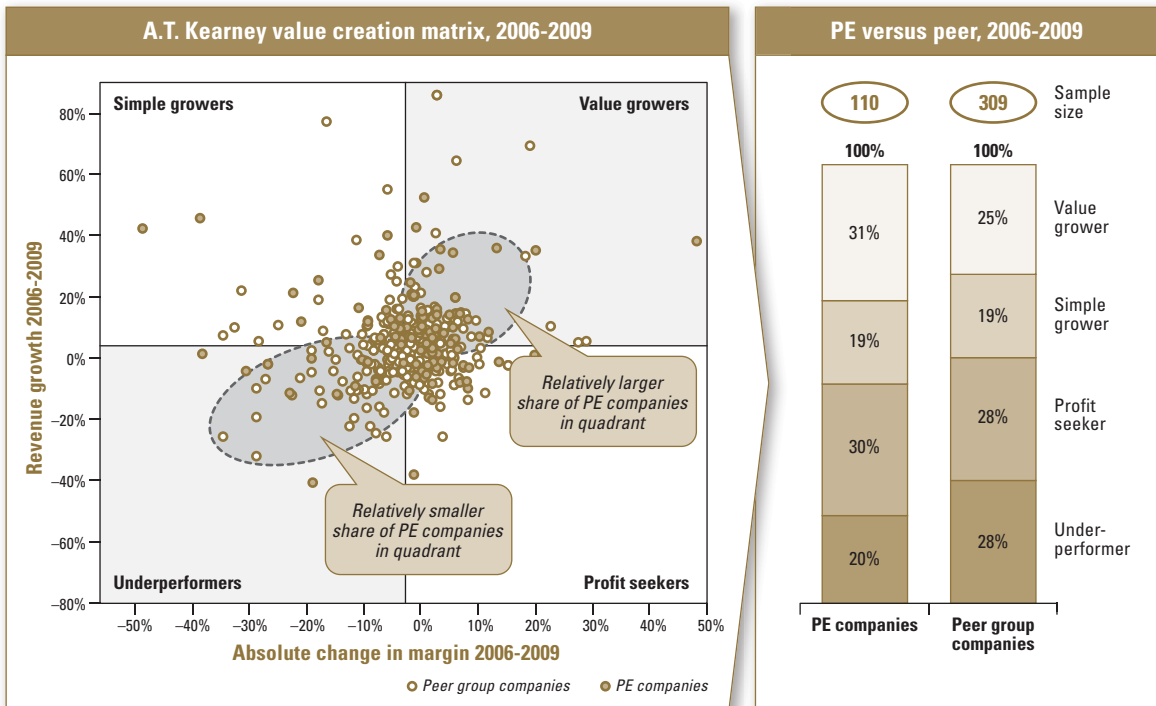
Since 2006, PE portfolio companies have outperformed their public-industry peers on key

financial metrics. PE portfolios have a higher share of *value growers* (31 percent compared to 25 percent in the peer group), defined as companies whose revenue and margin growth is above the peer average. They also have a lower proportion than the peer group of *underperformers* (20 percent versus 28 percent in the peer group), defined as companies whose growth in revenues and gross margins is below the peer average (see figure 2).

Except for the boom year 2008, PE fund companies have consistently delivered more revenue growth than their peers. Even during 2009, the crucial year of the crisis, the average decline in revenues was 3.8 percent for PE fund companies,

**Figure 2**

Since 2006, PE fund companies have outperformed industry peers



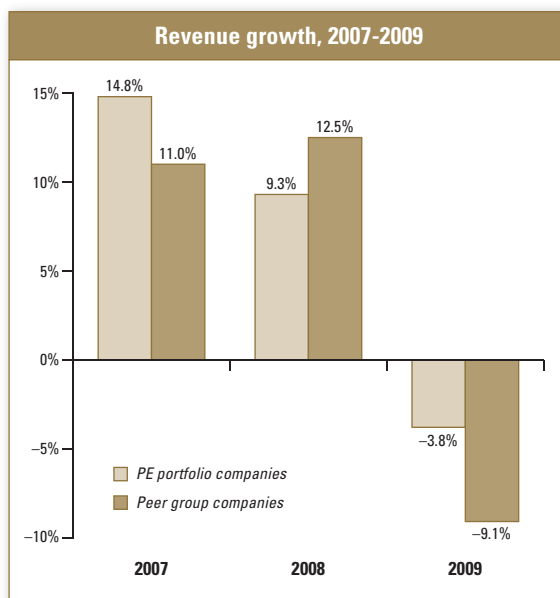
Note: Individual company position in the value creation matrix is defined by comparing to average growth and margin change within each company's industry. Averages that define quadrants in chart are overall averages for visual purposes. Source: A.T. Kearney Private Equity study, 2011

compared to 9.1 percent for peers (see figure 3).

Many industry analysts did not expect PE portfolio firms to retain profitability during the crisis. Yet in 56 percent of the cases reviewed, the PE-owned businesses delivered higher levels of profitability than their public peers—calculated before interest payments at EBIT (earnings before interest and taxes) and EBITDA (earnings before interest, taxes, depreciation and amortization) levels. This superior performance may be due to the ability to react faster to evolving market conditions, to perform a more realistic assessment of the changes required and, consequently, to develop more effective improvement measures. Interestingly, no correlation existed between deal size and company performance.

The greatest success stories are in stable but relatively slow-growth industries such as chemicals, consumer products and retail, manufacturing and business services (see figure 4). These industries appear to provide more opportunities for PE funds

**Figure 3**  
PE fund companies consistently deliver more revenue growth than peers



Note: Based on full sample of peer and PE fund companies, excluding outliers.  
Source: A.T. Kearney Private Equity study, 2011

## About the Study

A.T. Kearney reviewed 109 PE portfolio companies in four major European regions—DACH, the United Kingdom, France and the Nordic countries. The study team focused on the companies' operational performance from 2004 to 2009, looking at the changes in revenue and EBIT or EBITDA. For PE portfolio companies, the data are from publicly quoted funds (private investment, public entity or PIPE), company websites, Factiva, FAME and select companies to which the team had access.<sup>1</sup> The team com-

pared portfolio company data to:

- Market indicators (source: Economist Intelligence Unit)
- Public peers (source: Factiva, D&B, FAME)
- Private peers (source: Factiva, D&B, FAME)

Peer groups were constructed to be similar in amount of sales, industry or niche, and geography; for example, a company could have headquarters in Europe but possibly a wider footprint. The analysis does not include fund performance (money multiples or internal rate of return).

In addition, the team classified each fund as a supervisor or operator, based on fund research and expert opinion. Information was gathered from funds and their operative units and partners, leading globally active investors, financing banks, and senior executives (mostly CEOs) of PE firms.

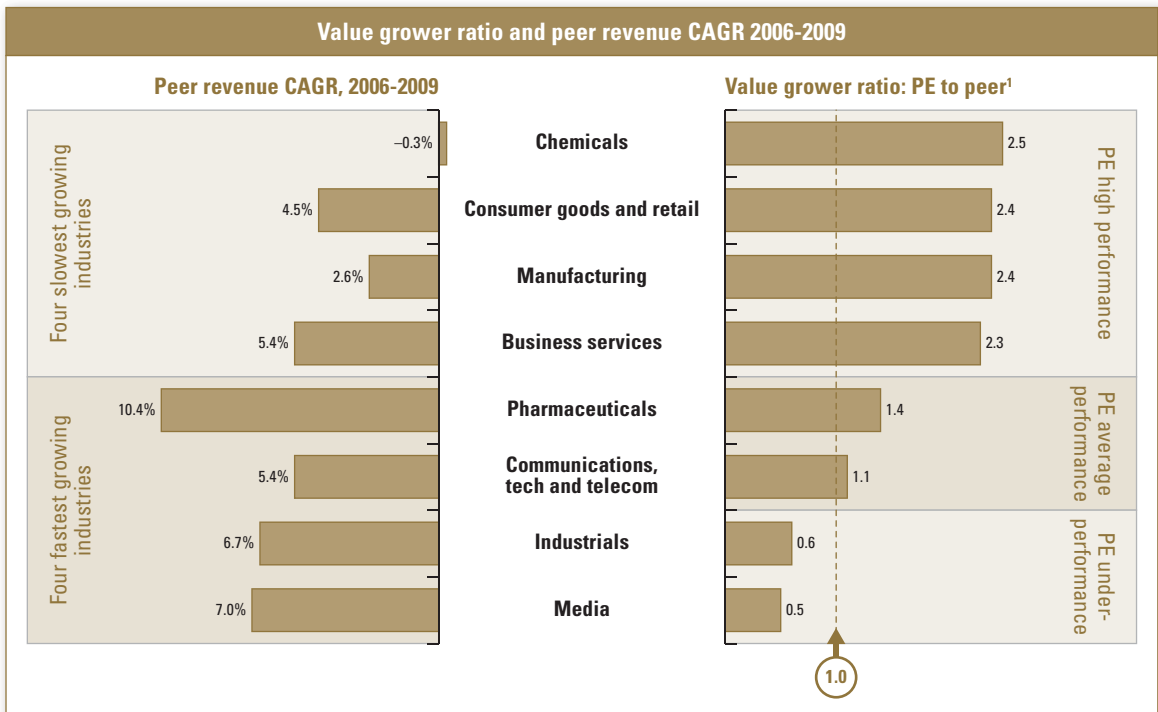
A tailored version of the A.T. Kearney value creation matrix illustrates the findings. It portrays gross margin development rather than adjusted market capitalization growth.

<sup>1</sup> FAME stands for forecasting, analysis and modeling environment.

**Figure 4**

PE fund companies outperform peers in low-growth industries

Select industries



¹Ratio is share of value growers in PE group divided by share of value growers in peer group; a ratio above 1 implies a larger share of PE owned companies in the value grower quadrant compared to peer group.

Source: A.T. Kearney Private Equity study, 2011

to add value through deal structuring and business improvement. The scale of value growth is largely achieved through the stability of the business model and the predictability of its performance.

## 2. PE Firms that Employ a Supervisory Role Deliver More Value

To generate the expected level of returns, industry experts and leaders believe that the PE industry needs to be involved operationally in its companies. As a global PE fund partner told the team, “We definitely need to stay closer to our portfolio businesses, especially after the crisis.”

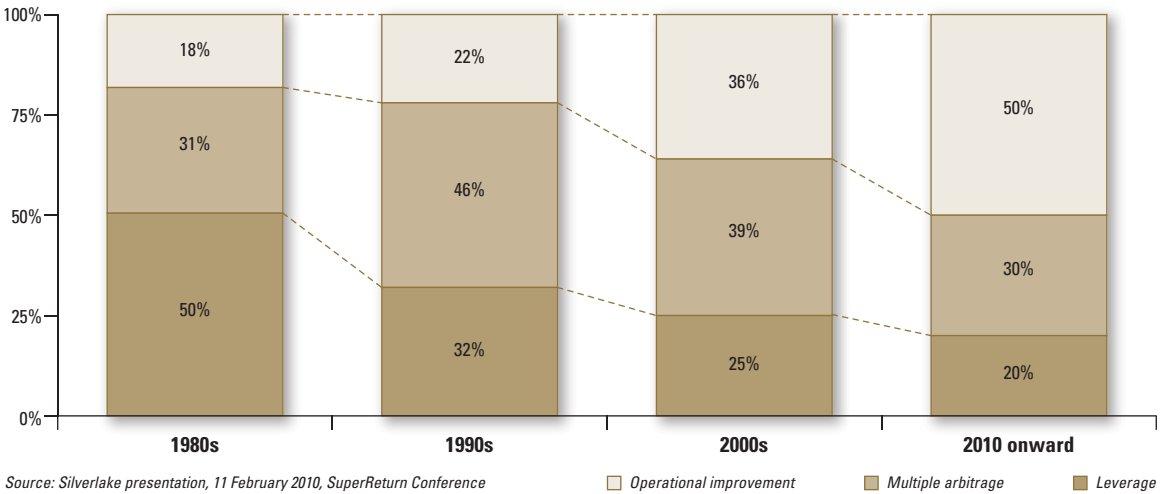
At the same time, they are well aware that closeness can be overdone. Another PE fund part-

ner said, “The right balance needs to be maintained between our operational involvement and the freedom that management must have.”

Figure 5 on page 6 shows experts views of the anticipated sources of future value. From the 1980s through 2010 and beyond, leverage and operational improvements are listed among the largest contributors of value. But what is the best way for the PE industry to deliver operational improvements and tap core value drivers? To understand why some PE portfolio companies perform better than others, the study team compared the leaders’ performance to that of companies that use a traditional PE governance model. The team considered three aspects of the governance model:

**Figure 5**

Operational improvements are considered among the largest contributors to future value



- Presence of an operational PE team and its interaction with management and the supervisory board
- Structure and composition of the PE team responsible for implementing the post-acquisition plan
- Tools and processes that drive the value-creation process

Two core PE models emerged: supervisors and operators (see figure 6). *Supervisors*, whose philosophy might well be “we trust management,” give the deal partner responsibility from acquisition through exit, essentially supporting the management business plan and working with the company at the board level. *Operators*, with a “we drive change” philosophy, field separate deal teams and operative teams, and propel change by being actively involved in managing the company. The following describes each model in more detail.

**Supervisors “we trust management.”** Most supervisor PE funds, especially traditional U.K. houses or those with banking roots, work actively

with management at the board level. In some jurisdictions, tax considerations might favor this governance model, which maintains the status of wealth-administrating vehicles.

PE funds focus on structuring the deal, organizing the board, defining the roles and responsibilities, and preparing for the exit. Responsibility for driving value during the holding period is assigned to the company’s board.

Effective supervisor-led boards have the experience and knowledge to provide value from the top down. The board includes a representative of the PE fund (often a member of the deal team) and an external non-executive chairperson (often a former manager in a similar industry). Leading houses tap an international network of industrial advisors (mostly former CEOs) who can act as non-executive members. In addition, board members are often already involved in due diligence and may have supported the deal during its genesis. They often have a retainer-based relationship with the fund.

Members dedicate significant time to working with management, gathering regularly to exchange views and best practices. They are investors themselves. Typically, 80 percent of board members support management.

The board uses financial transparency and operational efficiency measures to drive value. Management training events advocate best-in-class tools and harmonize effective approaches across the portfolio companies. Typical subjects are working capital optimization, procurement, sales effectiveness, manufacturing excellence and SG&A (sales, general and administrative) cost management.

An example might help illustrate how the Supervisor model works: An office stationery distributor developed an ambitious inorganic growth strategy that required substantial invest-

ment. The new owners liked the idea and agreed to support the management team, which had a strong track record in delivering double-digit growth through acquisitions. The company rapidly

*Many of the strategies attributed to this PE comeback story will work for companies in other industries and geographies.*

acquired more than half a dozen companies, including several competitors, and quickly recognized the need to unify operations and review its supply chain network. It brought in external management with supply chain expertise, which took full ownership of program execution.

**Figure 6**  
Characteristics of two PE governance models: supervisors and operators

	Supervisors	Operators
<b>Business model</b>	<ul style="list-style-type: none"> <li>Deal partner is responsible from acquisition to exit, no hand-off to operative partners</li> <li>Focus is on financial engineering and multiple arbitrage</li> <li>Board comprises former managers</li> </ul>	<ul style="list-style-type: none"> <li>Deal partner is typically responsible from acquisition to exit, but operative partners are regularly involved post acquisition</li> <li>Focus is on EBITDA growth</li> <li>Board comprises former managers and operative partners</li> </ul>
<b>Use of internal capabilities or external consultants</b>	<ul style="list-style-type: none"> <li>External consultants are brought in</li> <li>Internal expertise or capabilities are not used</li> </ul>	<ul style="list-style-type: none"> <li>Internal operative team leads the way</li> <li>External consultants are brought in if expertise or capacity is needed</li> </ul>
<b>Main players</b>	<ul style="list-style-type: none"> <li>BC Partners, Blackstone, Bridgepoint, Candover, Carlyle, Cinven, Montagu, Warburg Pincus, Doughty Hanson</li> </ul>	<ul style="list-style-type: none"> <li>IK, KKR, TPG, CD&amp;R, EQT, Advent, TPG, terrafirma</li> </ul>

Source: A.T. Kearney Private Equity study, 2011

*“We hire lots of former CEOs and they bring tremendous value. Sometimes, however, you could end up with two chefs in one kitchen and that creates unnecessary tension.”*

— Global PE fund partner

**Operators “we drive change.”** Operators have a change agenda and add their own dedicated teams to review the strategy and manage operations. Operational teams comprise three to seven professionals for an average European portfolio.

Operators have backgrounds in line-management and top-management consulting. The deal team devises the value-creation strategy during the pre-acquisition phase and the operative team acts as a sounding board as required. The operative professionals are either an integral part of the overall PE fund (such as Permira and HgCapital) or are employed by the fund under a separate arrangement (Advent and IK). KKR follows a unique model with its in-house, 50-person consultancy Capstone; its consultants are not considered part of the fund.

Teams are remunerated according to their employment status. In fee-based models (such as KKR and Advent), consulting services are charged to the portfolio company. Other funds view the consulting services as their means of delivering value to their portfolio companies (Permira and HgCapital).

The deal professionals often retain primary accountability for value creation from transaction to exit, complemented by operative team members. In some cases the deal team hands over responsibility to their operative partners during the holding period. Most operative teams have formal processes in place and standardized templates, such as:

- Standard reporting formats to harmonize reporting across the portfolio company, including to banks
- Working capital modules to ensure capital works hard
- 100-day plans to formalize the value-creation process during the holding period
- Tools to reduce purchasing costs
- Sales-effectiveness tools to achieve strong sales growth
- Mid-term reviews to follow the portfolio company’s progress

An example from the plastics industry will help illustrate how an operator model works. A plastics components manufacturer was carved out of a large multi-business conglomerate. “Complexity” was the key word within this company: It had a complex product portfolio, complex manufacturing processes and complex logistics. The new owners developed an aggressive business transformation and growth program, but the management team lacked the in-house capabilities to execute it. Accordingly, the operative team engaged analytical and change-management experts and led the effort to define a clear road map, outline detailed improvement activities and drive execution.

Using expert resources can undoubtedly produce significant results. However, the added value comes not from more resources alone, but from aligned and integrated resources. As one partner

of a global PE fund explained, “We always hire lots of former CEOs and they bring tremendous value. Sometimes, however, you could end up with two chefs in one kitchen and that creates unnecessary tension.”

**Supervisors win the prize, narrowly.** Our study found that contrary to popular belief, supervisors were more successful than operators in providing overall added value. Supervisors balance growth with profitability, resulting in the highest proportion of value growers (see figure 7). This strategy also results, however, in a large number of underperforming businesses. So, perhaps the hands-off trust that leads to success can also interfere with the team’s ability to spot negative trends.

By comparison, operators appear to focus more on improving profitability and have a lower

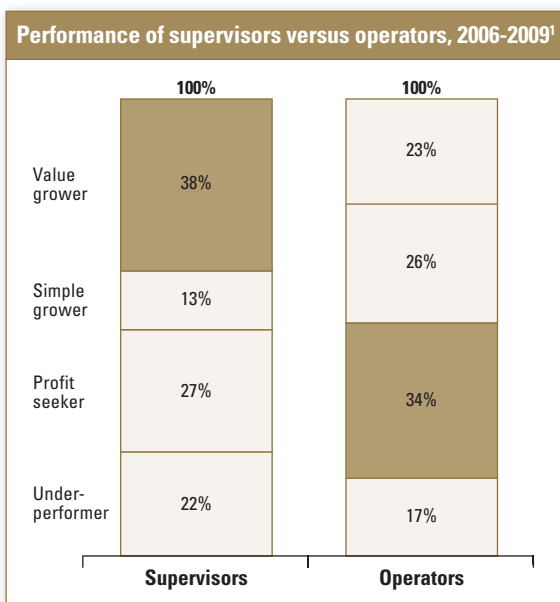
proportion of underperformers. Although this approach creates fewer value growers, it also enables a more aggressive debt-repayment schedule, which in turn significantly enhances the overall return on investment. Operators can recognize the need for intervention early and act quickly to prevent disasters.

The study team could not tie the success of the supervisor model, and its “classic PE DNA,” to a single factor; instead, there are a range of possible explanations, but they are difficult to verify. Perhaps operators are overly confident in their transformational capabilities and invest in more difficult situations. Another possibility is that operating capabilities may not always be fully integrated into the PE value chain. It is appealing to think that bringing more operating capabilities aboard will lead to better results. If they are not thoughtfully integrated, however, more capabilities may simply yield more confusion.

What does integration mean in this situation? An integrated operational team is part of the overall PE team and not a separate organization. It also does not run on a separate compensation and incentive scheme. Only when operational and deal teams—which should remain responsible from acquisition to exit—are truly aligned can companies reach their full potential. Another contributing element may be the temptation for operators to expand their own empires instead of managing a network of best-in-class professionals.

No single model is best for every investment, every time. What is needed is the right balance of each model’s sweet spots. The supervisor can be too remote from daily operations and miss important cues—hence the higher rate of underperformers in the survey. Operators can overdo their involvement to the detriment of growth or perhaps fail to invest adequately for future growth.

**Figure 7**  
Companies using a supervisory model deliver more value



<sup>1</sup>PE company sample size: 56 supervisor model, 53 operator model.  
Source: A.T. Kearney Private Equity study, 2011

The winning model follows the investment strategy and situation of each portfolio company.

### 3. Success Factors are Transferable

The recent financial crisis has amplified the core competencies of the PE sector and both PE-owned and public-industry companies can learn from this crisis. Five key success factors helped PE portfolio companies outperform market indicators and peers, no matter which model—supervisors or operators—they followed:

#### Employ managers who behave like owners.

Some PE funds develop an “A team” of executives who parachute into one portfolio company after another. These serial CEOs have a different mentality from those in either public or family-owned companies. They typically have a 5 to 10 percent stake in the business (a larger stake in mid-cap transactions) and truly act like owners. PE funds can recreate this mindset by:

- Strengthening portfolio-management teams to support the execution of emergency plans
- Building further capabilities by hiring operative partners and portfolio-company board members
- Installing the right management team, which may vary during the holding period
- Turning managers into owners by offering them equity stakes
- Retaining great CEOs, which is perhaps the best guarantee for superior and consistent returns
- Developing a cadre of serial CEOs

Ownership fundamentally changes a manager’s perspective on the attractiveness and risks of a business opportunity. The difference is that owner-managers vote with their own money. For a steel castings equipment manufacturer, this ownership view led to the success of an aggressive investment program designed to reduce the company’s short-term financial performance. The goal,

to break into a previously unattainable segment profitably, created the expected temporary decline in EBITDA and eventually delivered strong growth in both the top line and in margins, driven by performance in the target segment.

**Make capital work hard.** This means a relentless focus on cash—repaying debt or accelerating repayment to avoid breaching bank covenants. Accordingly, CEOs focus on accounts payable, receivables, minimizing inventory and investing in what will pay back. To make capital work hard, CEOs will: (1) operate with high but adequate debt-to-equity ratios to ensure cash reserves and provide stability in times of turmoil, and (2) redeploy unproductive capital. For example, a processing company freed up substantial funds by improving its credit terms and reducing bad debts and then used the cash to improve customer service and increase its marketing efforts. Similarly, a fashion retailer freed up capital by convincing some manufacturers to retain ownership of the goods until the retailer sold them, thus, the retailer avoided making up-front payments.

**Install superior reporting.** Managers within newly acquired portfolio companies may have only a vague idea of their cost basis. When PE firms take over, they immediately want to know what happens, when, where and how. With good reports, an alert CEO will spot early indicators of change and adjust the operating position accordingly, eliminating shifts or reducing capacity. Such CEOs define key performance indicators (KPIs), install reporting and early warning systems, measure what drives value and liquidity, and communicate regularly with the financial community.

As one example, the CEO of a European consumer goods manufacturer set up an operational performance tracking process for its network of warehouses and logistics depots. Armed with tracking data (visibility) and KPIs, the company

was able to share best practices and improve performance without tapping into the additional investment in its original business plan.

#### Create an adaptable investment plan.

Contrary to popular belief, PE firms think about the long term, not simply the holding period before their exit. Indeed, a sizeable investment program is a cornerstone of many deals. The investment may seek to drive growth by entering new markets, broadening R&D or making acquisitions. The fund may also invest to upgrade or rationalize the company's operating footprint by expanding capacity or relocating, among other options. Regardless of the focus of the investment, wise PE firms begin planning early and are ready to move at the time of the acquisition. They remain watchful by establishing a three-to-five-year plan, or roadmap, to achieve the portfolio company's full potential and long-term success (it includes go and no-go checkpoints). And they are flexible, able to adapt quickly to a changing environment and execute with rigorous managerial discipline, regardless of the model.

As an example, an injection-moulding company adopted an aggressive manufacturing-improvement program that included expanding capacity in Western Europe and relocating one manufacturing site to Eastern Europe. But the hard-hit automotive industry represented more than half of its customer base, so the company and its owners developed a flexible investment

program that allowed them to detect early signs of the crisis and scale back or postpone investments that otherwise would have crippled the company financially.

**Become an active shareholder.** Even firms using the supervisory model understand the importance of being an active shareholder. They bring in an industry captain or the board will step to the forefront when needed. Supervisory does not mean silent. Indeed, being active shareholders means:

- Responding quickly and pre-emptively to unpredictable events
- Providing strong and uncompromising leadership during major changes
- Communicating regularly with the board, but having no involvement in daily business
- Remaining an unsentimental owner (every day a company is held is a buy decision)

#### Conclusion

At a time when the entire global finance industry is under fire, this study shows that the PE business model drives value well beyond wealth creation for the owners. PE firms rejuvenate portfolio companies, create jobs and open new markets that benefit customers, employees, suppliers and the communities in which they operate. Furthermore, the PE model has proven to be resilient. When the PE industry's very survival was questioned, it bounced back and led its portfolio companies to outperform their peers.

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