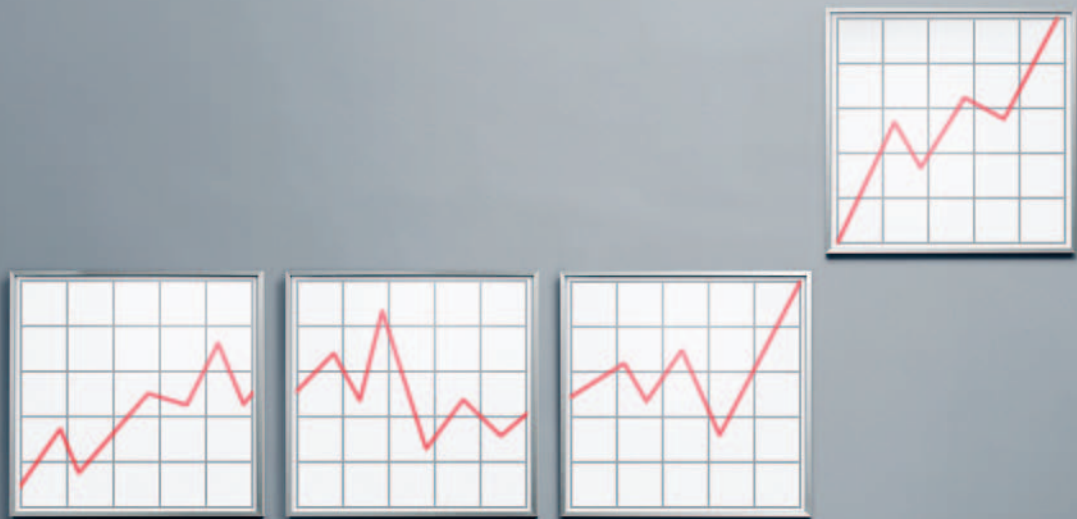


“Hands-Off” PE Firms: Why They Take Home the Biggest Prize

Private equity (PE) benefited handsomely from the credit bubble that peaked in 2007 and retreated when the bubble burst. Now A.T. Kearney’s latest study of the PE industry finds that some PE companies are not only enjoying a post-recession comeback but also outperforming their industry peers. What’s more, the hands-off firms—those that give clear guidance but stay at arm’s length from direct managerial responsibilities—are taking home the biggest prize.

For private equity firms, the traditional business model has been a stalwart—acquire the business, fix it, extract non-producing assets, invest in assets and activities that will increase the value of the firm, and exit at an optimal

point. But the industry suffered a calamitous collapse following the recession. Every indicator fell, from investment activity to exit levels, and from fundraising to fund returns. 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, PE firms were in unfamiliar territory. Starved of new opportunities, the industry was forced to concentrate on existing portfolios. Indeed, the PE mantra in 2010

*“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.”*

—Global PE fund partner

encouraged the pursuit of value, not the aggressive hunt for new opportunities.

This test for the PE industry raised several questions:

- How have PE-owned companies performed against public peers across main geographic regions and industries?
- What are the different PE business models, and which have been most successful during the crisis in EBIT/EBITDA performance?
- Do common denominators of successful PE funds exist, and can they be transferred to other companies?

A.T. Kearney formed a study team whose members 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 four European markets—the United Kingdom, DACH (Germany, Austria, Switzerland), France and the Nordic countries. Although the study dealt primarily with Western Europe, the findings are likely to pertain to the North American PE market, which is at a similar stage of maturity.

The study revealed three major findings:

1. PE Fund Companies Outperform Public-Industry Peers

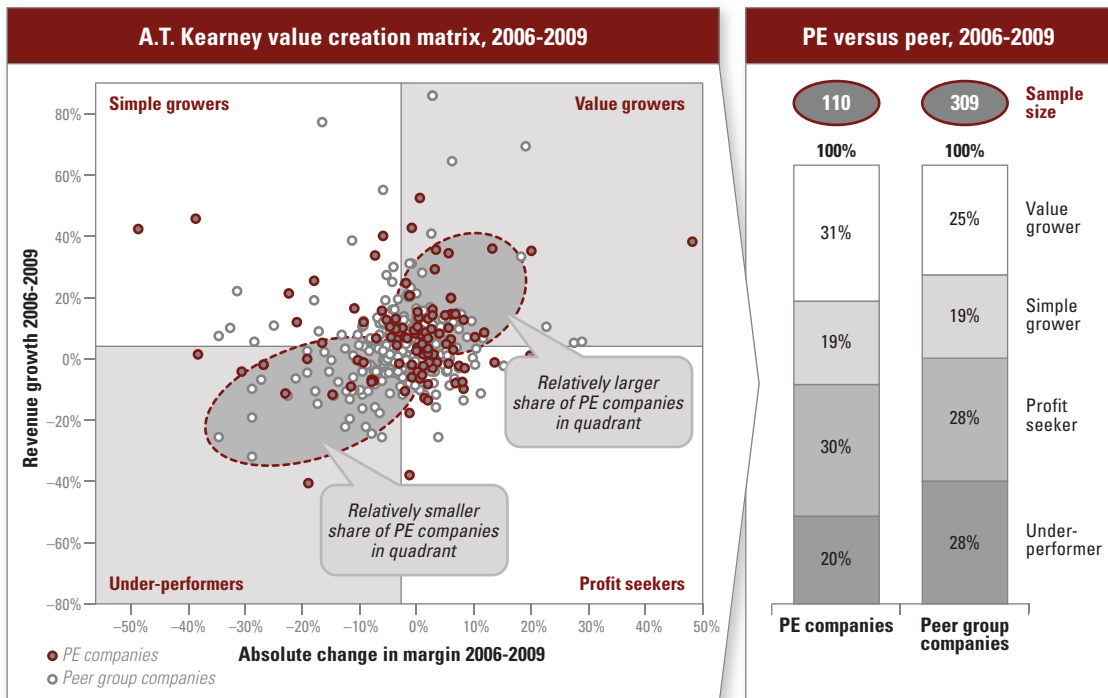
Since 2006, PE portfolio companies have outperformed their public-industry peers on key financial metrics. PE portfolios have a higher share of *value growers* (31 percent compared to 25 percent in the peer group), defined as companies whose revenue and margin growth is above the peer average. They also have a lower proportion of *under-performers* (20 percent versus 28 percent in the peer group), defined as companies whose growth in revenue and gross margin is below the peer average (*see figure 1*).

Except for the boom year of 2007, PE fund companies have consistently delivered more revenue growth than their peers. Even during 2009, at the height of the crisis, the average decline in revenue was 3.8 percent for PE fund companies, compared to 9.1 percent for peers.

Many industry analysts did not expect PE portfolio firms to retain profitability during the crisis. Yet 56 percent of the PE-owned businesses delivered higher profits than their

FIGURE 1

Since 2006, PE fund companies have outperformed industry peers



Note: Individual company position in the value creation matrix is defined by comparing average growth and margin change within each company's industry. Averages that define quadrants in the chart are overall averages for visual purposes.

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

public peers.¹ This superior performance may be due to an 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. These industries appear to provide more opportunities for PE funds to increase value through a so-called “full potential program,” which goes beyond comprehensive performance improvements to achieve maximum value via strate-

gic, organizational, operational and financial improvements.

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

To generate the expected returns, the PE industry needs to be involved operationally in its companies. As a global PE fund partner told the study team, “We definitely need to stay closer to our portfolio businesses, especially after the crisis.” At the same time, closeness can be overdone. Another PE fund partner asserted, “The right balance needs to be maintained between our operational involvement and the freedom that management must have.”

¹ Calculated before interest payments at EBIT (earnings before interest and taxes) and EBITDA (earnings before interest, taxes, depreciation and amortization) levels

Vertical View

What is the best way for the industry to deliver operational improvements and tap core value drivers? To understand why some 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:

- The operational PE team and its interactions with management and the supervisory board
- The 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 models emerged: supervisors and operators. *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 and operative teams, and propel change by being

actively involved in managing the company. The following describes each model in more detail (see figure 2).

Supervisory model. Traditional U.K.-based PE firms or those with banking roots tend to work with and through management at the board level—structuring the deal, including developing incentives, organizing the board, defining roles and responsibilities, agreeing on a post-acquisition midterm agenda and preparing for the exit. They adhere to a top-down model in which responsibility for driving value is assigned to the company's board.

The board includes a representative of the PE fund and an external non-executive chairperson. Leading firms 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 from the beginning; they often have a retainer-based relationship with the fund.

As an example, an office stationery distributor developed an ambitious growth-through-

FIGURE 2

Characteristics of PE business models: supervisors versus operators

	Supervisors	Operators
Business model	<ul style="list-style-type: none"> • Deal partner is responsible from acquisition to exit; no hand-over to operative partners • Top-down model: focus is on financial engineering and arbitrage • Board of directors includes PE fund representative and an external non-executive chairperson 	<ul style="list-style-type: none"> • Deal partner is responsible from acquisition to exit, but regularly involves operative partners • Earnings model: focus is on EBITDA growth • Board of directors includes owner-managers
Use of internal or external consultants	<ul style="list-style-type: none"> • No in-house operative capabilities • External expert managers are brought in and take full ownership 	<ul style="list-style-type: none"> • In-house operative capabilities • External consultants are brought in if expertise or capacity is needed
Main players	<ul style="list-style-type: none"> • BC Partners, Blackstone, Bridgepoint, Carlyle, Cinven, Montagu, Warburg Pincus 	<ul style="list-style-type: none"> • Advent, Bain, CD&R, Doughty Hanson, EQT, IK, KKR, Terra Firma, TPG

Note: EBITDA is earnings before interest, taxes, depreciation and amortization.

Source: A.T. Kearney analysis

acquisition strategy. The new owners liked the idea and agreed to support the management team. The company rapidly 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 to take full ownership of program execution.

Operator model. PE firms that use an operator's model often arrive armed with a change agenda and bring in their own teams of three to seven professionals (with backgrounds in line management and top-management consulting) to review the strategy and manage operations. The deal team devises the value-creation strategy during the pre-acquisition phase and the operative team acts as a sounding board to bounce ideas off as necessary. The professionals are either an integral part of the overall PE fund (such as 3i 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. Others (such as 3i and HgCapital) view consulting services as their means of delivering value to their portfolio companies. 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 its operative partners during the holding period.

For example, in one project, a plastics components manufacturer was carved out of a large multi-business conglomerate. The company was bogged down by complexity:

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, analytical and change-management experts were engaged to lead the effort—defining the road map, outlining improvement activities and executing the plan.

Using expert resources can produce significant results. But 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. Contrary to popular belief, supervisors proved more successful than operators in providing overall added value. Supervisors balance growth with profitability, resulting in the highest proportion of value growers leading to higher multiples at the exit (*see figure 3 on page 58*).

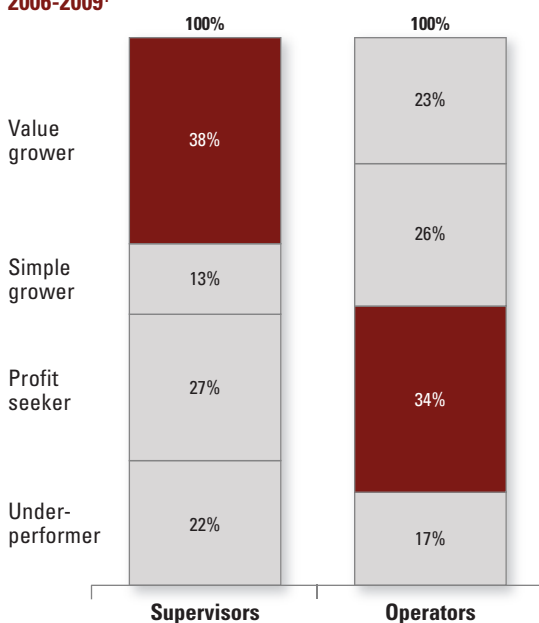
By comparison, operators appear to focus more on improving profitability and have a higher proportion of under-performers. Although this approach creates fewer value growers, it enables a more aggressive debt-repayment schedule, which in turn increases the overall return on investment.

The study team could not tie the success of the supervisor model, and its “classic PE DNA,” to a single factor; instead, there was a range of possible but difficult-to-verify explanations. For example, operators could be overly confident in their transformational capabilities and therefore invest in more difficult situations. Or operators are often tempted to expand their own empires instead of managing a network of best-in-class

FIGURE 3

Companies using a supervisory model deliver more value

Performance of supervisors versus operators, 2006-2009¹



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

professionals. 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 fully integrated, however, more capabilities may simply yield more confusion. For instance, a fully integrated operational team becomes 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 are truly aligned can companies reach their full potential.

In sum, 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 under-performers in the survey. Operators can overdo their involvement to the detriment of the company's potential for growth, or perhaps fail to invest adequately for future growth. In almost all cases, the winning model follows the investment strategy.

3. Success Factors Are Transferable

The financial crisis amplified the core competencies of the PE sector, and both PE-owned and public-industry companies can learn from the crisis. Five key success factors helped PE portfolio companies outperform market indicators and peers, no matter which model—supervisor or operator—they followed (*see figure 4*):

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

FIGURE 4

These basic principles of a PE firm will work for most corporations

Basic principles	Descriptions
Employ managers who act like owners	<ul style="list-style-type: none"> • Assign the right management (could vary during the holding period) • Align interests by providing managers with an equity stake • Retain great CEOs to guarantee superior and consistent returns (serial CEOs) in different economic cycles
Make capital work hard	<ul style="list-style-type: none"> • Operate with high but adequate debt-to-equity ratio to promote stability, strengthen managerial focus, and ensure that cash is considered a scarce resource • Redeploy unproductive capital
Install superior reporting	<ul style="list-style-type: none"> • Install customized reporting and early warning systems to measure what drives value and liquidity (cash is king) • Communicate regularly with management
Create a flexible investment plan	<ul style="list-style-type: none"> • Develop a three- to five-year investment plan with enough flexibility to adapt quickly to a changing environment • Execute plan with rigorous managerial discipline
Become an active shareholder	<ul style="list-style-type: none"> • Be preemptive, make decisions quickly, and communicate with the financial community • Define relationship with board, but do not get involved in day-to-day business • Be an unsentimental owner

Source: A.T. Kearney analysis

of a business opportunity. The difference is that owner-managers vote with their own money.

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 do two things: (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.

Install superior reporting. Managers within newly acquired portfolio companies may have only a vague idea of their cost basis. When a PE firm takes over, it immediately wants 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 by 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.

Create a flexible 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, 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-

Vertical View

year plan, or road map, to achieve the portfolio company's full potential and long-term success (including 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 molding 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 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 steps to the forefront when needed. Supervisory does not mean silent. Indeed, being an active shareholder means:

- Agreeing on a future vision and defining a “full potential plan”

- Responding quickly and preemptively to unpredictable events
- Providing strong and uncompromising leadership during major changes
- Communicating on a regular basis with the board, but having no involvement in the everyday business of the company
- Remaining an unsentimental owner (every day that a company is held, a buy decision has been made)

The Biggest Winners

At a time when the entire global finance industry is under fire, this study shows that the PE business model drives value well beyond financial wealth for owners. PE firms rejuvenate portfolio companies, creating jobs and opening new markets that benefit customers, employees, suppliers and the communities in which they operate. And, contrary to popular belief, more operative resources do not deliver more value. Instead, the classic PE model—selecting the company with the highest value potential and unlocking that potential with a smart combination of supervisory skills and best-in-class operations support—is the big winner. 🏆

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