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GUEST ARTICLE

Value Creation Becomes More Important Than Ever

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The handwriting has been on the wall for a long time, but a lackluster economy and ongoing financial turmoil have underscored the broad trend that has fundamentally altered how private equity investors make money. Private equity firms can no longer rely solely on the power of leverage and ever-expanding price-earnings multiples to generate superior returns.

More private equity firms wielding more capital have bid up acquisition prices, putting pressure on potential investment gains. Lenders have grown cautious and more discriminating. Faced with these conditions, private equity firms are reckoning with the reality that active intervention to boost the operational performance of their portfolio companies is the only controllable way they have to create value. Our data suggest that private equity firms that intervene early and effectively deliver returns that are more than double those produced by firms that do not get involved initially.

Many private equity firms have already taken the first crucial step: They know they must become portfolio activists. In recent surveys, respondents from nearly four out of five firms agreed that helping their portfolio companies achieve operational improvements will be the key source of value creation over the next five years. More than 75 percent said they have begun to increase their involvement in portfolio company management, typically by beefing up standard financial and operating performance reporting.

Pitfalls

Some firms used the downturn to go further, assembling dedicated internal portfolio teams to ferret out new growth potential in their portfolio companies and helping their managers to achieve them. But bringing talent and resources together to unlock value in their portfolio companies has led many into one or more of these common pitfalls:

- Processes break down in the hand-off from the deal team, which manages the pre-acquisition due diligence and consummates the buyout, to the portfolio team, which takes charge of implementing the value-creation plan.
- Mistrust arises between the private equity owners and their portfolio company CEOs and senior managers, who are wary of the prying eyes of the "portfolio police" on their businesses.
- Private equity firms that own complex portfolios with international holdings face challenges finding talent with the right blend of management experience, industry or functional expertise, and cultural awareness to serve their portfolio companies' widely varying needs.

The search for a perfect solution can leave private equity firms floundering. Some act too hastily, throwing resources at the challenge without resolving how best to deploy them. They cycle through one approach after another without settling on one that works. Still others endlessly debate how to get started, assembling reams of data and losing precious time.

Our experience working with a wide range of private equity firms around the world has shown that there is no single "killer app" that is right for all circumstances. Rather than try to do everything at once, private equity firms might borrow a page from Calvin Coolidge's playbook and do something at once. Specifically, those that set out to become portfolio company value creators can begin by adopting a prevalent approach that best suits their unique combination of firm and portfolio company characteristics.

Choosing the right model hinges on five factors. The first is the house style and dominant investment thesis. Does the firm look for challenging turnaround situations? Or does it buy strong companies with strong management teams in search of breakthrough performance? The second consideration is the size of the portfolio. What is its total value and how many companies does it include? Third is the portfolio's complexity. Does it include companies that span several industry sectors, geographies and business challenges? The fourth is to assess its portfolio companies' potential to realize strategic and operational gains. Are they likely to produce only marginal improvements or are they capable of achieving major transformations? Finally, the firm needs to appraise the strength of the companies in its portfolio. How healthy are they financially? Are there gaps in their senior management teams that need to be plugged?

A prevalent approach is a starting point and a guide for action, not the ultimate destination. Because it captures the most common situations a firm and its portfolio companies face, the approach a private equity firm chooses becomes the foundation for developing the disciplines of a repeatable model.

Six Approaches

Bain has identified six approaches that suit a full array of portfolio management needs, from limited oversight of performance to more hands-on involvement in setting a new strategy and actually running the business.

1. **Monitors play a broad supervisory role.** They typically have a board seat, sign off on management strategy and determine which metrics of business performance they will track and with what frequency. Every private equity firm needs to be able to take on this minimally invasive oversight responsibility and it is a common starting point. Indeed, for some that prefer to maintain a light approach and delegate most key decisions to portfolio company management, it may even satisfy their needs.

2. **Seasoned mentors help portfolio company management define their value-creation plan and priorities.** They bring their

GUEST ARTICLE

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expertise to bear by providing strategic and operational advice to their CEOs and serving as a sounding board to management in critical areas. This approach tends to work best in situations where portfolio company CEOs are new to private equity and would benefit from the support of an experienced adviser but does not require a hands-on executive chairman.

3. Facilitators work with their portfolio companies to map out a value-creation plan and define the priority initiatives they will need to undertake to achieve it. Then, they help bring in external support the portfolio company may lack. These firms tend to acquire smaller companies that have strong executive teams and solid value-creation plans at a conceptual level but need hands-on support to translate the plan into "Monday morning" action and facilitate its implementation.

4. Owner-operators take a more interventionist approach, setting their portfolio companies' strategic direction, defining operational priorities and engaging deeply in the day-to-day running of the business. Typically, the private equity firm will name one or more of its own to take on senior executive roles and assume ultimate decision-making authority on most major issues. Situations best suited for this model are those where the portfolio company needs a major change in strategic direction and there are gaps in the management team, or the CEO is inexperienced working with private equity owners.

5. Functional experts deploy their portfolio teams to play an active role in specific areas of the day-to-day operations of the business. This approach is well suited to private equity firms that invest in companies that have significant opportunities to improve profit margins by parachuting in experts who are skilled in high value-added areas—such as procurement, Six Sigma process reengineering or supply chain management—that are not specific to a single company or industry. As they refine their approach, they roll out their expertise across the entire portfolio.

6. Strategic architects take a far more comprehensive role in shaping their portfolio company value-creation initiatives and leading their implementation. Private equity firms that commit to this approach typically see a need to overhaul the portfolio company's strategy because the company is in distress, its profit pools have shifted or they perceive an opportunity to reshape an industry.

We've observed that as private equity firms learn to apply their prevalent approach to help their portfolio companies knock down barriers and seize opportunities, their competence as value creators grows and evolves. So, too, does their confidence in their ability to expand and strengthen their portfolio management teams, as the technical, strategic, cultural and financial situations they encounter require them to add in-house specialists incrementally, forge relationships with outside advisers or recruit talented industry insiders.

Growing in this organic, experience-driven manner enables firms to shift confidently from the initial phase of following a single prevalent approach to a second phase—adeptly pursuing multiple approaches. Getting to this stage requires PE firms to anticipate the unique needs of each portfolio company and customize their approach and resources to meet them. It also calls for sophisticated assessment and decision-making skills to be flexible and responsive.

By mixing and matching approaches and resources, private equity firms ultimately evolve into a third phase, becoming master value creators. At this more advanced level, PE firms can dynamically flex their approach to suit portfolio company needs at any stage in the ownership life cycle—from creating a post-acquisition blueprint to paving the path to an exit three to five years later. The hurdle at this stage is having the ability to combine fact-based insights about the business with the emotional intelligence required to read the needs of their portfolio company management teams in order to achieve a great plan within a performance culture that delivers over the entire life of the deal.

Possessing the elusive traits of emotional intelligence allows directors to move beyond the binary tough-love approach of either motivating portfolio company management teams with attractive incentives for hitting their targets or firing those that don't measure up. Instead, these elite value creators will use a broad array of inducements, backed up with the right combination of in-house support, external advisers or specialized experts to work collaboratively on delivering the full potential of the business. They coach management on implementation where they can, supplement their skills where called for or supplant them when they must.

It takes patience, exposure to a wide range of issues presented by their portfolio companies and smart investment in their own capabilities before private equity firms can master the art of value creation. Few firms are yet adept at putting these higher-order techniques to work. But as the challenges to extract value from their portfolio companies continue to compound, the time to get started is now. ❖

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