Portfolio value-adding by private equity houses:

Walking the walk or just talking the talk?

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Participants

Twenty five private equity houses - across a full range of sizes and styles of investment - provided input. In the tables and graphics below they have been divided into approximate size groups based on self-declared equity-cheques.

Name	Group/abbreviation
Octopus Ventures	Small cap
Maven Capital Partners	
YFM Private Equity	
ISIS Equity partners	Lower mid-market (LMM)
Lyceum Capital	
August Equity	
Dunedin Capital Partners	
HIG Capital	
Canter Equity Partners	
Chamonix Private Equity	
Baird Capital Partners Europe	
Total Capital Partners	
Macquarie	Upper mid-market (UMM)
HgCapital	
Nova Capital Management	
GMT Communications Partners	
AAC Capital Partners	
HSBC Private Equity	
ECI Partners	
Palamon Capital Partners	
Silverfleet Capital	
Duke Street	
3i	
CVC	Big buy-out (BBO)
Blackstone	

Executive summary

1. This study fills a gap in knowledge of value-adding practices across the mid-market

2. Private equity houses have a good record of adding greater value than public companies and over the last decade more houses have worked to improve this area. But more is demanded both by circumstances and LPs and there is a perception that plenty of value is being left on the table.

3. In many cases value-adding approaches emerged to handle tactical problems and have evolved piecemeal. Large ticket investors benefit from more manpower while small cap houses run much more on a shoestring. But mid-market investors have adopted variations on the large buy-out model when it comes to applying resources post-deal.

4. Almost all investors appear to supplement deal-makers with executive and advisory involvement and/or internal portfolio managers. But the on-going development of deal-makers to identify value-adding opportunities is mostly informal and probably sub-optimal.

5. Focusing all members of the investment team onto on-going value-adding requires a carefully balanced system of governance and incentives to suit the house strategy.

6. The most crucial balancing act facing investors is continuing to build partnerships with management while becoming more active in adding value.

7. Single investor attempts to create value cross-portfolio is difficult and rare. But more collaborative approaches are emerging.

8. The biggest challenge facing investors' value-creating efforts is weakness in execution due both to management blind spots and the skewed focus of investors.

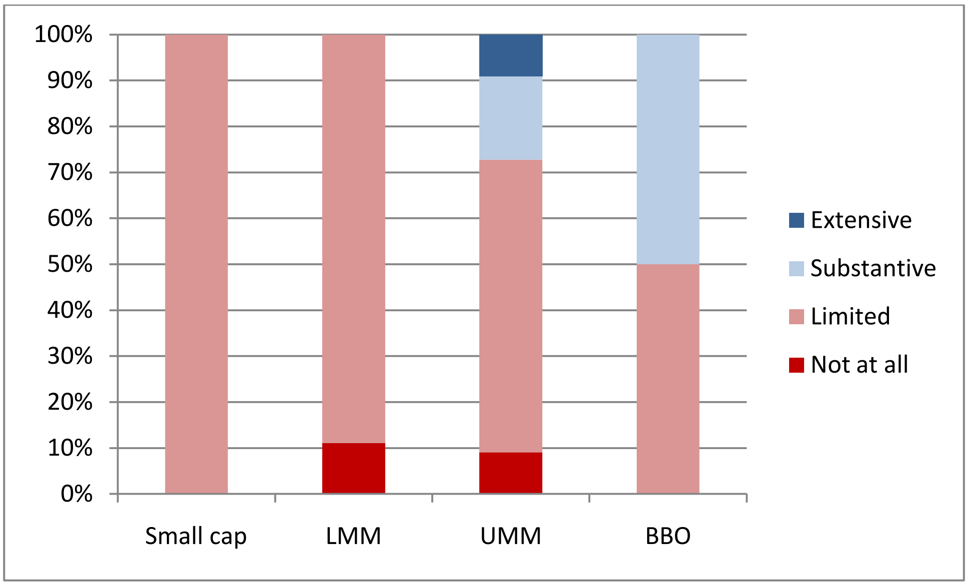
Contents

1. Introduction: purpose and caveats

There have been various studies over the last several years to assess portfolio value-adding practices by private equity houses. By way of a starting point, the annex summarises conclusions from some of them. What does this report try to do that is different?

A. Almost all the research has focused on large buy-outs. This one focuses primarily on mid-market issues and approaches. It would appear from your answers that knowledge of practices in this size range is limited:

Figure 1: How much knowledge do you have of value-adding practices at other PE houses? (% respondents)



B. Most of the studies focus mainly on the traditional areas of strategy, revenue, operations and financing. This report focuses more on the importance of *execution* of those things

C. Most assume that general best practices can be identified – I offer some ideas but observe plenty of dilemmas which may have no general right answer

The questionnaires and interviews from which this report draws its data and recommendations were full of insight. However:

- The data can only be meaningful in the context of the strategy of any individual house
- Many questions inevitably did not fit the circumstances of each GP and many could only be answered impressionistically
- The benchmarking data and its processing did not attempt or achieve the kind of rigour which would allow strong conclusions to be based upon it

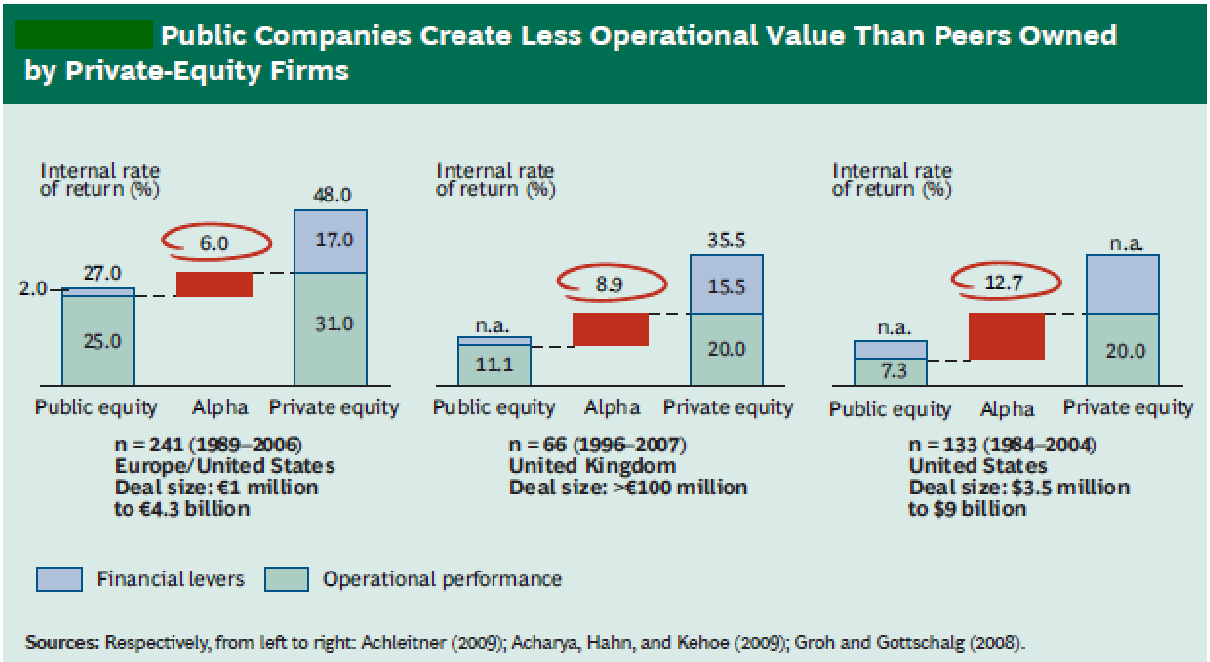
Please note that the examples I cite are not drawn primarily from this project – most were drawn from public sources, others from my advisory work.

2. The context of private equity value-adding

A. How good have private equity houses been at adding value?

There is an array of evidence that private equity ownership is capable of generating significant operational value – and at a rate higher than public companies:

Figure 2: Public vs. private equity value-added[1]



Barber & Goold attribute this to the strategic model of private equity, especially the 'buy to sell' focus which keeps managers and owners alert; makes it easier to define incentives against real results; reduces the temptations to add too much management overhead; builds expertise of deal-making within investors and creates real expertise in predicting cash flows.[2] Others have looked at the ability to select acquisitions and due diligence them; the development helpful financial structures; a more medium-term view of investments; better corporate governance.

Although most of this evidence comes from the world of large buy-outs, there is at least one large study which confirms the positive effects private equity can have on medium-sized firms. A comparison of management practices across thousands of mid-size manufacturing plants found that those owned by PE investors scored better than other privately held and publicly owned businesses, and reaped rewards in productivity and profitability.[3]

There is some debate, however, about the degree to which such out-performance is representative of the whole private equity community. Acharya and Kehoe note that whilst the

[1] BCG and IESE, *Time to engage - or fade away* (Feb 2010)
[2] Barber, F. & Goold, M. 'The Strategic Secret of Private Equity', *Harvard Business Review*, Volume 85, Number 9 (2007)
[3] Bloom, N, Raffaella S, and Van Reenen J. *Do Private Equity Owned Firms Have Better Management Practices?* Centre for Economic Performance Occasional Paper 24 (2009)

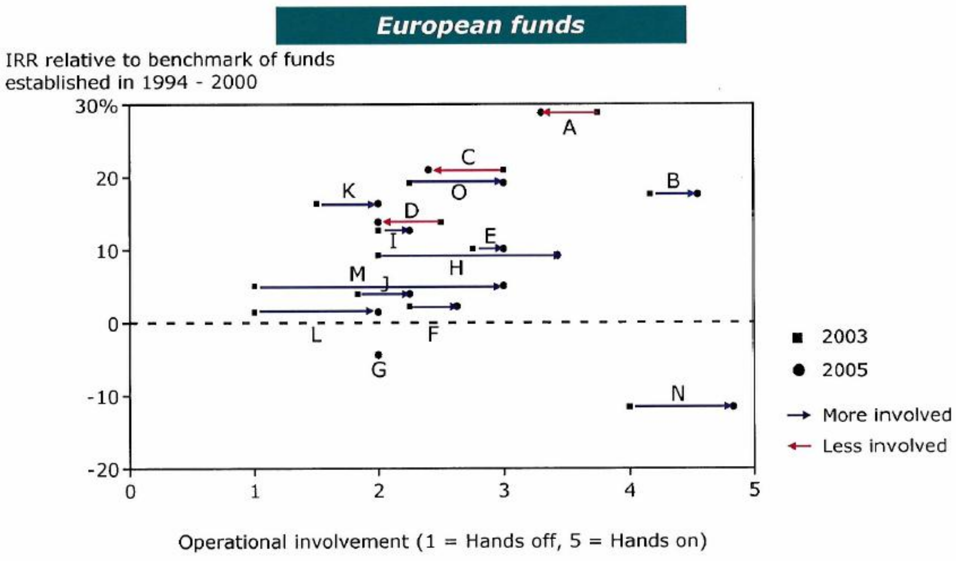
best investors seem to consistently outperform public markets even after adjusting for the effects of leverage and market timing, they also note that the *median* private equity house underperforms the public markets once fees are taken into account.[4]

Likewise, speaking at Super Return in Berlin, Christian Sievert, managing partner of Nordic PE firm Segulah, said private equity's track record did not back up claims that the asset class was skilled at introducing operational change. "We all say that we have a strong focus on operations, but do we really?" Sievert said. Quoting a survey of portfolio companies compiled by the Swedish Venture Capital Association, he noted that operational expertise was cited as the least valuable benefit of private equity ownership by investees. A separate EVCA study, meanwhile, showed that only a third of private equity investments improved revenues and profits through operational change, with the rest showing negligible or negative revenue and profit expansion.

B. How much has changed over the last decade?

The private equity industry has not been static. About a decade ago some of the larger firms began paying more attention to their added value for investees. A high profile case is KKR which, after some major losses on investments like Regal Cinemas, crafted a more activist approach: a separate portfolio management committee focused on investees; deal-makers were organised into sectoral teams; 100-day business plans were introduced; and an internal consulting division, Capstone, was created. Many US and European buy-out firms have moved in a similar direction:

Figure 3: Change in level of investor involvement with investees[5]



[4] Acharya, Hahn and Kehoe, *Corporate Governance and Value Creation: Evidence from Private Equity* (2008). Their key evidence on fund performance derives from Kaplan & Schoar, 'Private Equity Performance: Returns, Persistence, and Capital Flows', *Journal of Finance*, vol. 60, no. 4 (2005)
[5] Bain survey and research from 2008 presentation

Attempts to map these changes show how governance and especially operational/strategic work has expanded in relation to financial wizardry – and made investors' work more complex.

Figure 4: Shifts in private equity focus over time[6]

Investment model

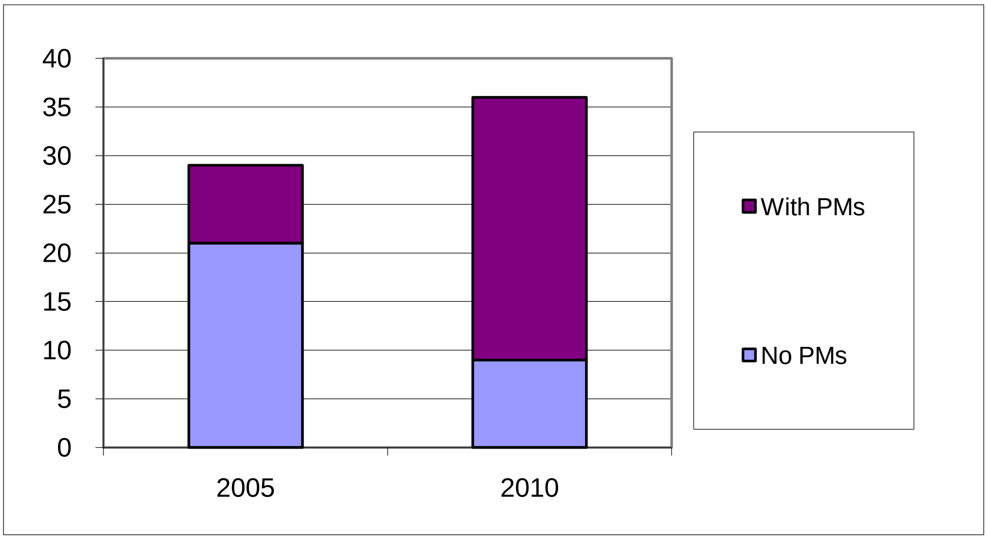
Emphasis has shifted over time

Drivers	1985	1995	2005	2010
Financial	✓✓✓	✓✓✓	✓✓✓✓	✓✓✓
Ownership/Governance	✓✓	✓✓	✓✓	✓✓✓
Operational/Strategic	✓	✓	✓✓✓	✓✓✓✓

A study by Burlington in 2005, across 20 PE houses, found this same trend present in the UK, including parts of the mid-market. All houses showing increased levels of intervention from three years previously.[7]

My own analysis of the internal structure of UK mid-market houses shows significant growth in portfolio management and value-add roles between 2005 and 2009. The definition of portfolio managers used is wide - and the changes in approach often shallow - but the trend is clear.

Figure 5: Number of UK mid-market houses analysed with some form of portfolio manager roles (PMs)

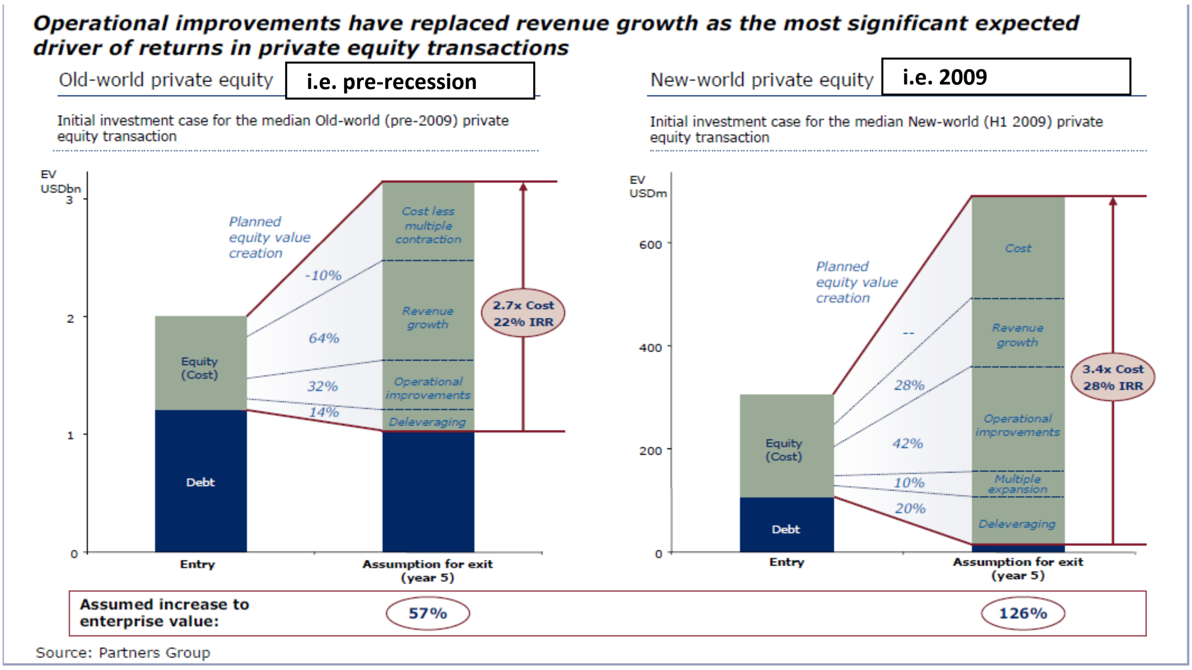


The effect of recession and credit crunch may also have an effect on value-adding strategies and internal structures. Some analysis by Partners Group of deal hypotheses pre- and post-crunch

[6] Source: Henderson Equity Partners, Investment Trust Forum 2009
[7] 'Hands-on investing: a route to returns?', Real Deals 10/02/2005

suggests that there has been a shift towards operational improvements as the key driver of value. While some of this may represent a response to difficult short term trading during 2008/9 and a dearth of debt, it is apparent anecdotally that the structural shift away from purely financial involvement is continuing.

Figure 6: Shifts in private equity investment hypotheses before and during the recession[8]



C. What lessons have already been learned?

Consultants to the larger, more activist, funds provide evidence and arguments that this more energetic approach is what differentiates the best performers from the under-performers. Some highlights of their analysis can be found in the Annex, but the common themes tend to be:

- Large up-front investment in due diligence using industry expertise from operating partners and/or consultants
- Investing with a value-creation plan in mind involving some mix of strategic changes, organic growth, acquisitions, productivity improvements, and operating cash flow enhancement
- Early management changes and upgrades as necessary
- The involvement of internal post-deal value creation teams drawn from former consultants and executives
- Testing/refinement of the plan in the first 100 days after investment
- Systems introduced to monitor plan achievement

Little of this would be new or controversial across the UK and European mid-market.

[8] Partners group, 'The new buyout. How the financial crisis is changing private equity', *Partners Group Research Flash* (November 2009)

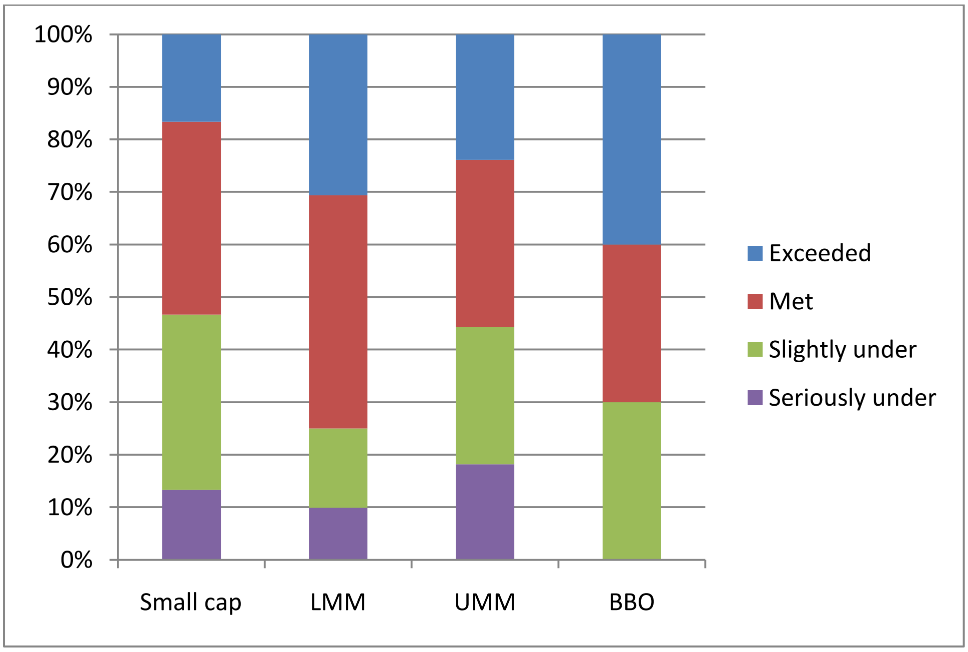
D. Is there still a need for significant change?

As the private equity community begins to deploy larger amounts of capital after the recession, there is little reason to believe that the investment model has changed radically. However, some forces are likely to maintain or intensify the emphasis on active value-adding:

- Limited partners have mobilised not only to exert pressure on fees and terms but some also claim also to be more thorough and critical in their due diligence on GP value-adding
- The ability to drive capital gains from leverage and multiple arbitrage has been reduced, placing more pressure on commercial/operational sources of value
- Public companies have also emerged from the recession leaner and meaner raising the benchmark against which PE investee performance will be judged
- Some companies which would benefit from private equity ownership are stuck on bank balance sheets and are more likely to be sold to secondary direct investors wholesale than to primary PE investors piecemeal

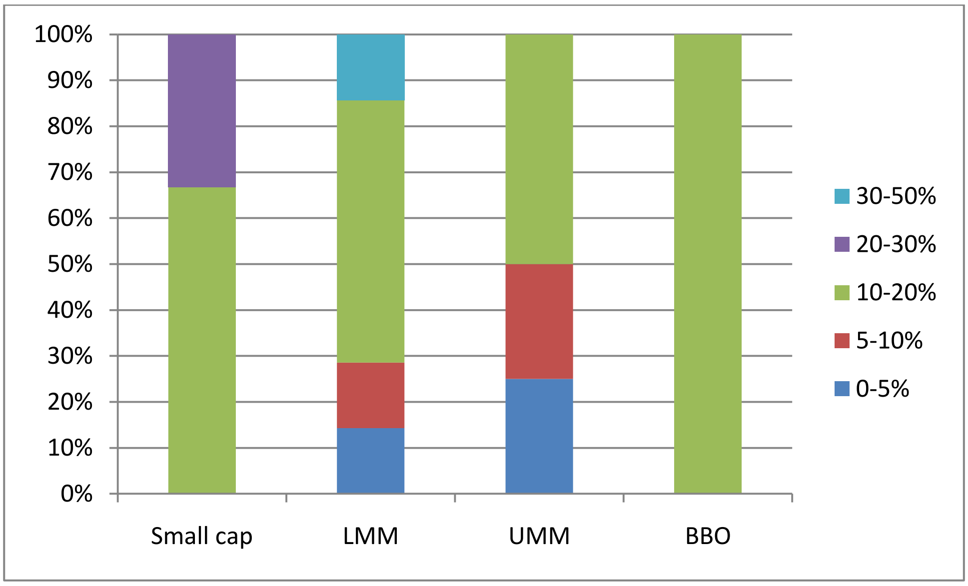
The performance of investees (see Figure 7) also suggests that to bring investment portfolios back to the level where they generate decent returns for investors and carry for GPs will involve on-going improvement efforts. As some respondents noted, the real proof of value-adding success will only become apparent when exits from current funds are achieved: there are already signs that IRRs will be appreciably lower than previous funds.

Figure 7: How many of your last ten investments (whether exited or not) have exceeded, met or fallen below expected commercial/operational performance? % investments



Likewise, the more subjective estimates of how much value has been 'left on the table' at exit creates a clear incentive to find new ways of generating value.

Figure 8: With the benefit of hindsight, how much potential economic value was NOT created/ realised in your last several exits due to imperfections in the value-adding approach across the deal cycle? (% respondents)



There is a longer term strategic issue to consider as well. Twenty years ago, emerging markets for private equity firms were places where non-mainstream enthusiasts went to pursue high risk high return strategies which were not, however, of great significance to mainstream investors. More recently, larger funds have created offices to invest into, say, Asian opportunities while some mid-market firms have built expertise in assisting investees to offshore production to low cost locations in China and elsewhere.

It is becoming apparent, however, that the activities of emerging country companies are spilling over in increasing ways into the economies of OECD countries, and not only as trade partners and acquirers. Successes in 'frugal production', 'reverse innovation' and fast scaling represent new management models to which European companies will have to respond.[9] Likewise, those companies are becoming active laboratories for *organisational* innovation which offer sources of productivity and profit which many European companies have been slow to tap.[10]

All in all, there is work to be done to maintain the profitability of private equity investing for LPs, GPs and management teams.

[9] See *The Economist* survey on 'Innovation in Emerging Markets' (17/04/2010) or *Globality* by Sikrin H, Hemerling J & Bhattacharya A (2008) for good summaries
[10] Semler in Brazil and HCL in India are good examples which have been written up

3. Sources of value

The seven areas below cover the issues and dilemmas of adding value, roughly moving from internal investor perspectives towards investee performance.

A. A strategic view of value-adding

When most private equity houses were founded they were marked out more by the entrepreneurial instincts of their founders than a well articulated sense of strategy for their own businesses. Those who have prospered have increasingly found ways of identifying and communicating their core strengths to LPs and potential investees. But across the mid-market many houses have found that a decent track record and some bright generalist minds are no longer enough for a sustainable business. So what strategy perspectives can be applied to these small specialised businesses?

(i) Where's your advantage?

McKinsey & Co has offered the definition of a strategy as an "integrated set of actions designed to create sustainable advantage over competitors". By that standard it is hard to identify a clear strategy in many PE houses based in the UK. Asides from a limited number of (genuine) sectoral specialists and some with capabilities which offer distinctive advantages (e.g. actively helping investees globalise) few houses offer memorable reasons to force intermediaries to show deals to only a single investor. When asked, serial chairmen of PE-backed businesses also struggle to distinguish between houses on anything but a tactical/personal basis.

The reason this happens is due to another imperative affecting small businesses – the need for flexibility. Strong commitment to a particular strategic stance might make it more difficult to react to new opportunities. But without commitment, there is no distinctiveness.

Managing that dilemma is not impossible. One approach is to move more nimbly than rivals to build specific capabilities – one UMM respondent with a long tradition of active portfolio management allocates individuals to watch over the various areas of value-adding but then uses that knowledge to mobilise the whole team onto hot themes as they become salient – for example cost-cutting over the last two years.

Another approach is to develop greater depth of insight and rigour in handling the most universal topics affecting investment value – creating investee strategic focus; understanding and improving management effectiveness; governance; incentives; handling leverage and cash flow.

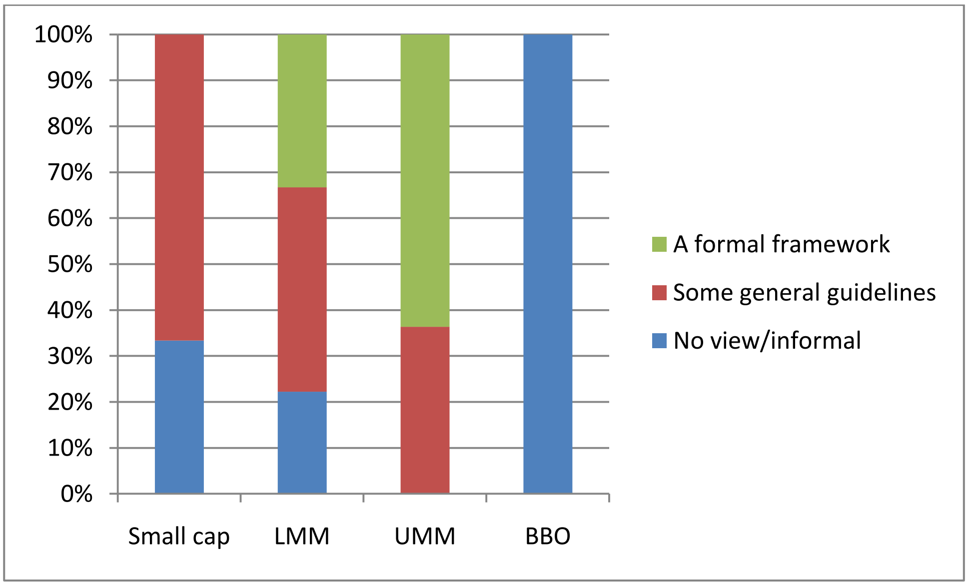
(ii) Best owners of the business?

One insight to emerge from the general strategy literature in recent years refers to the decision process by which an acquirer decides whether to buy, hold or sell a particular business. Traditional models (like the BCG matrix) focus mostly on the characteristics of the asset itself – is it a cash cow, a dog, a star? But a better question, especially in a competitive process, looks as much at the acquirer and asks 'Are we the best owners of this business?' In other words, do we have the capabilities and insights to add and extract more value to this business than anyone else? If the answer is 'no' then why waste resource on pursuing the deal and either be outbid or risk overpaying.

Reasons which could make an investor answer 'yes' to that question might be unique insights into the industry; a better network of contacts to handle certain challenges; unusual expertise in certain types of investee strategy (buy-and-build, roll-outs); ability to create synergies with other owned businesses; deep empathy for certain growth stages (going up the S curve, or refreshing orphan assets). For example, Greg Mondre, Managing Director at Silver Lake Partners in the USA describes their value-adding strategy thus: "There are a lot of private equity firms buying bad companies and making them OK. We choose to make investments in good companies and make them better."[11]

Figure 9 suggests that, leaving the two big buyout houses out of the issue, the likelihood of a PE house formalising its deal criteria in this strategic way increases with size.

Figure 9: To what extent is there a definite house view on what kind of companies and situations would most benefit from your collective skill sets if you invested? (% respondents)



[11] Their overall positioning is very explicit too 'Silver Lake is a private investment firm focused solely on making large-scale investments in leading technology companies.'

The work of Andrew Campbell and Michael Goold[12] suggests that acquirers need both (i) the right set of 'parenting propositions' (ways to add value in differentiated ways) and (ii) the skills to implement them without destroying more value than is created (e.g. by interfering unnecessarily with existing ways of doing things). They offer five main types of proposition:

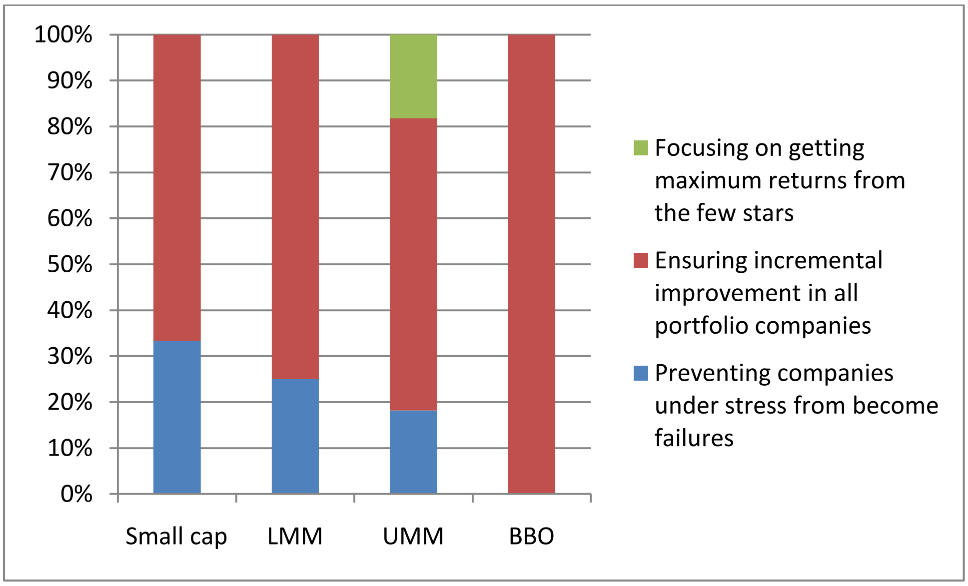
- 'Select propositions' Buying assets/talent for less than they would be worth under your ownership
- 'Build propositions' Helping expand the size and scope of investee activities more efficiently than otherwise
- 'Stretch propositions' Improving costs, quality, profits etc at a rate faster than the business could have done by itself
- 'Link propositions' Creating synergies between businesses
- 'Leverage propositions' Exploiting a central resource e.g. brand, relationships, rare skills, a patent

The first three seem more likely to play to PE strengths than the last two.

(iii) Strategy of handling portfolio value

Working with a portfolio of investments, one constant issue is the need to allocate scarce team time between companies whose needs and prospects are likely to vary both in general and across time. Whilst some decisions on where to focus attention can be made on a pragmatic and tactical basis, there will be occasions where choices (whether explicit or by default) imply a real strategic stance on the sources of value.

Figure 10: In practice, which kinds of cases attract more team focus in your house? (% respondents)



[12] E.g. Goold M, Campbell A & Alexander M, *Corporate Level Strategy* (1994)

Figure 10 suggests that most investors seek to look after all their investees relatively equally, with a minority who presumably devote considerable resource to prevent weak firms from failing.

Only a few UMM investors claimed to focus themselves more on getting maximum returns from real stars. Interestingly, Bain & Co's analysis of this issue leads to their conclusion that best practice (large buy-out) funds 'double down' on good deals rather than over-invest team time into bad deals. Their claim is that it is easier to turn a 2-3x deal into a 5x than to salvage 10% on a failed deal.[13]

(iv) Ability to execute

Although it is useful to think more clearly about the things which can make your house more differentiated and focused on the deals where you can add most value, strategy by itself can only go so far. Indeed strategising can crowd out less intellectually absorbing but more fundamental issues of execution by investors of their own strategies.

- How robust are our hiring and induction processes?
- Can we measure contribution of team members?
- Is our networking and hospitality actually effective?
- Do our DD scopes help us receive real insight from advisers? Are our processes for 100 day plans actually any good?
- Do we have a fine grained enough view of our value-adding approach?
- Are we happy fools with our time – do we have any evidence about what is worthwhile?
- Do chairmen/executives concur with our view of how good we are?
- Do we actually hear the bad news about our weaknesses/failures or make the time to understand and address them?

Unless PE houses are vastly different from most organisations, chances are that the execution of your house's strategy is far from optimised and there are gaps between what the team know adds value and what they actually do. A partner level investor at one (non-participating) buy-out house recounted how he decided to follow-up due diligence work done on twenty or so deals to see how findings had been used to add value post-deal. What he found was shocking – many of the risks identified had been ignored (some with major consequences) while many of the positive suggestions appeared not to have been followed up. It may or may not be a coincidence that his house has all but disappeared over the last two years but is nonetheless simply a more extreme version of a general phenomenon.

[13] See supporting chart in the Annex

B. How many is enough?

One determinant of potential activism with portfolio companies is the size of the investor team in relation to the number and size of investees. Benchmarking this is not an exact science: investee needs differ by size, situation and sector while each GP will have its own mix of deal-makers, portfolio managers, consultants, operating partners etc (see section C below). Nonetheless, the graphics below do offer some rough benchmarking and back-of-envelope calculations to compare houses overall.

Figure 11: Assets to overall investor team

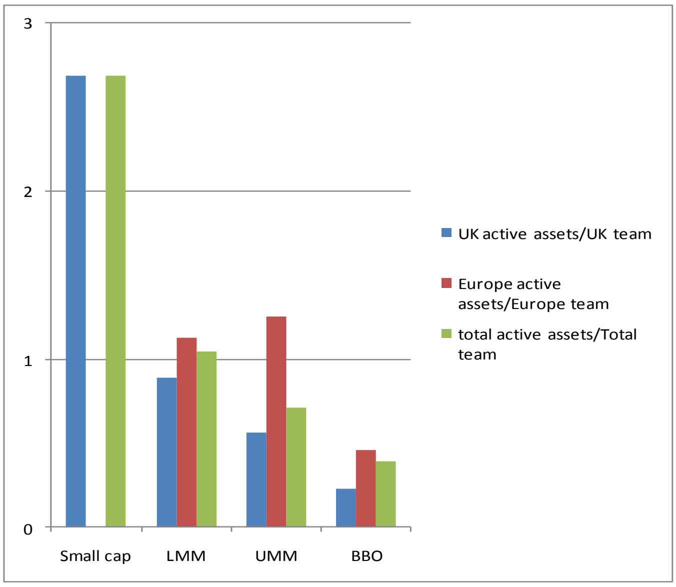
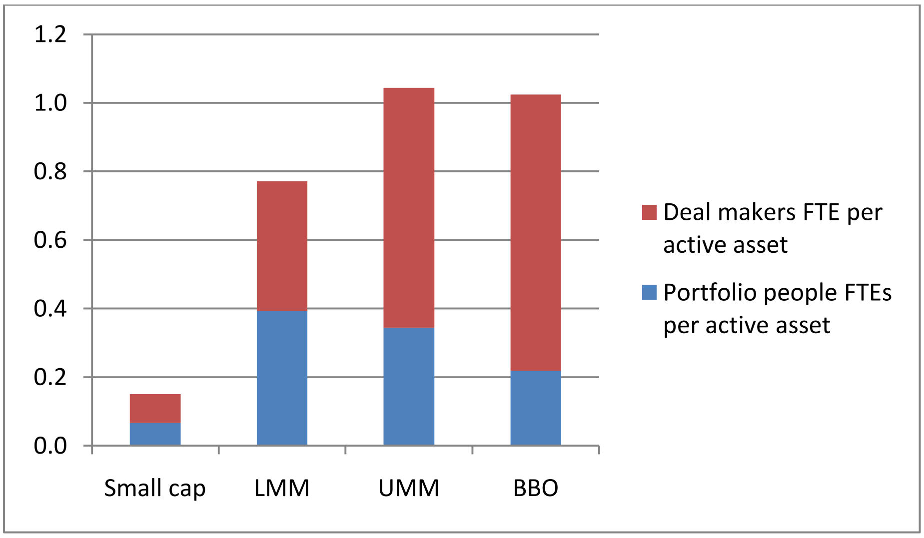


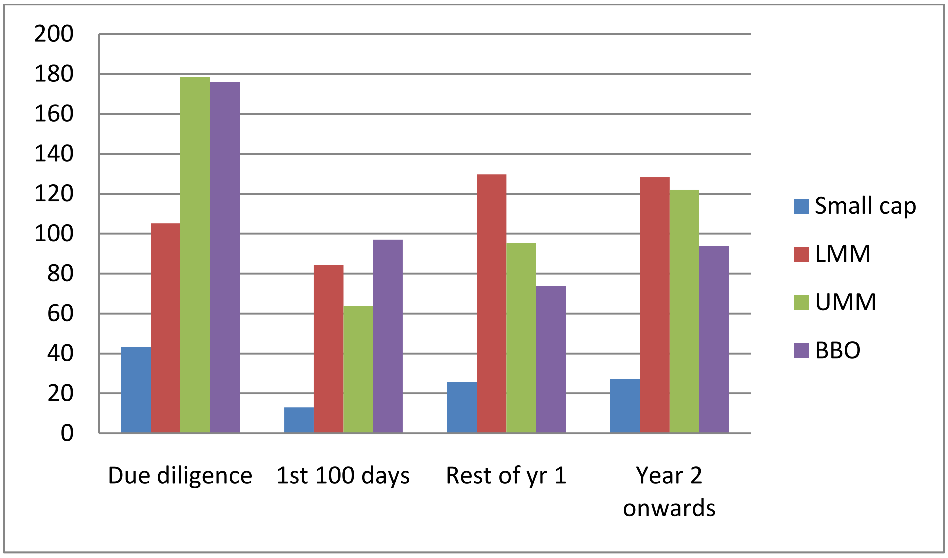
Figure 11 shows a fairly simple progression from the relatively larger number of assets per team member in small cap firms to the much lower number in BBO houses. That progression is less dramatic when time actually spent by deal-makers on existing investees is taken into account:

Figure 12: Full time equivalent (FTE) deal/portfolio team per asset



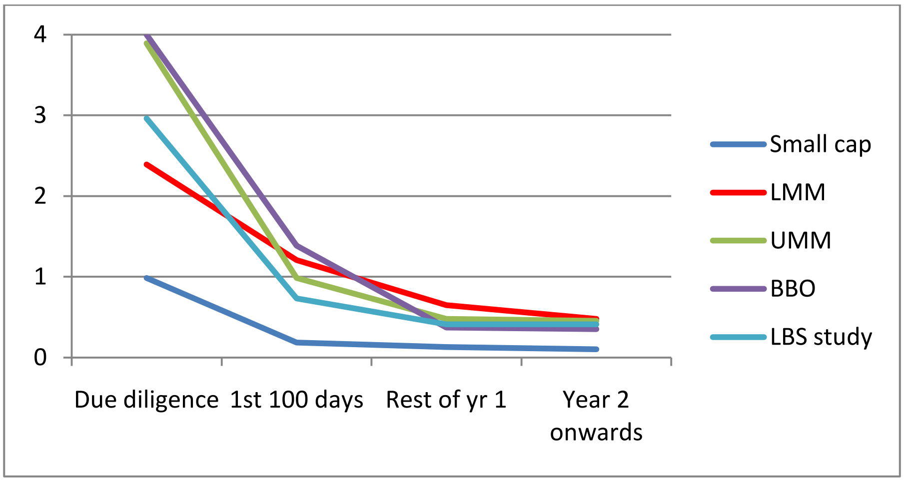
Small cap firms are significantly less well resourced to handle companies, but the gap between mid-market players and big buy-out houses appears smaller.[14] These numbers tally with evidence from other sources. A 2006 Real Deals roundtable found mid-market portfolio managers (from HgCapital, Gresham and 3i) with an average of 4 to 5.5 companies each[15]. As assets were sold off until 2008 that ratio fell to the numbers in Figure 12.

Figure 13: Partner + other staff resources by timing in the deal cycle (total hours)



As expected, larger investors typically deploy more internal resources in deal due diligence than small cap and LMM investors. That holds for small cap investors post-deal too, and fits their growth capital orientation. But the differences between LMM, UMM and BBO investors offers no pattern in favour of larger investors. That begs two questions. Are BBO investors relying more on investee resources and consultants to address value issues? Are LMM houses intervening too much and are those interventions the most efficient way of achieving a result?

Figure 14: FTE staff resource gradient vs. LBS BBO investors (FTE staff)



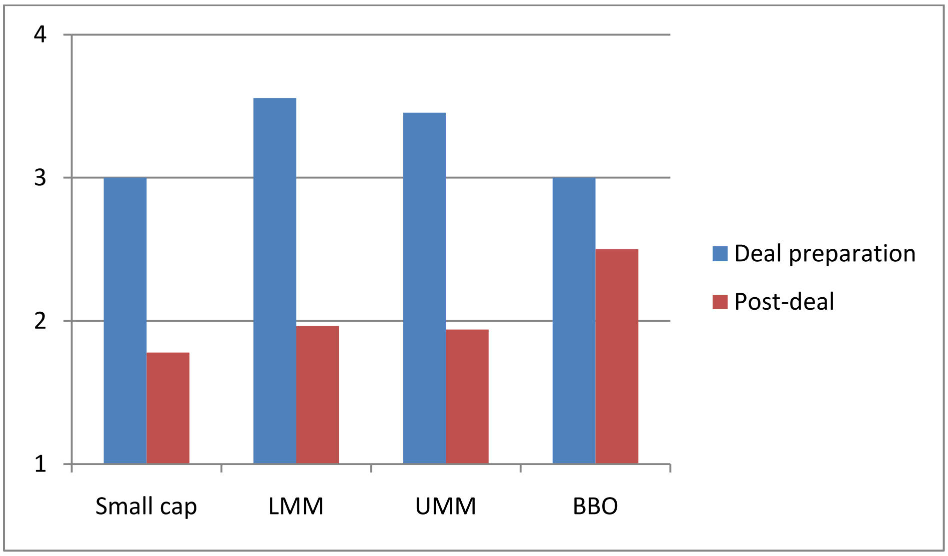
[14] BBO players would look, however, much more efficient were the calculation measuring capital managed per team member assuming, of course that returns are equivalent.

[15] 'The back room boys', *Real Deals* 30/11/2006

This lack of pattern might be just an anomaly of the small representation of BBO investors in participants. To check, I used comparable numbers from a recent study of BBO corporate governance[16]. The results suggest that the conclusion above is representative:

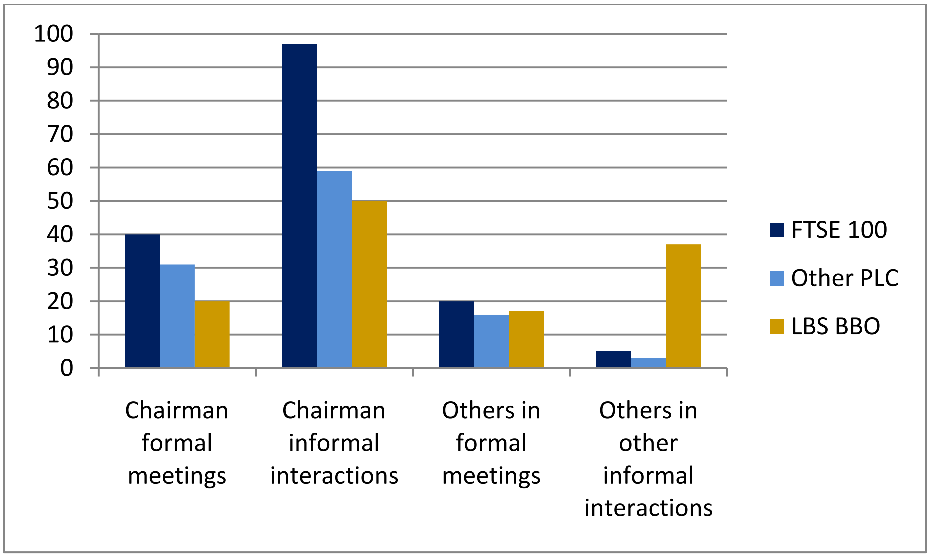
Larger investors are, however, more likely to spend on consultants , especially post-deal:

Figure 15: Use of consultants (1 = not at all; 4 = extensive)



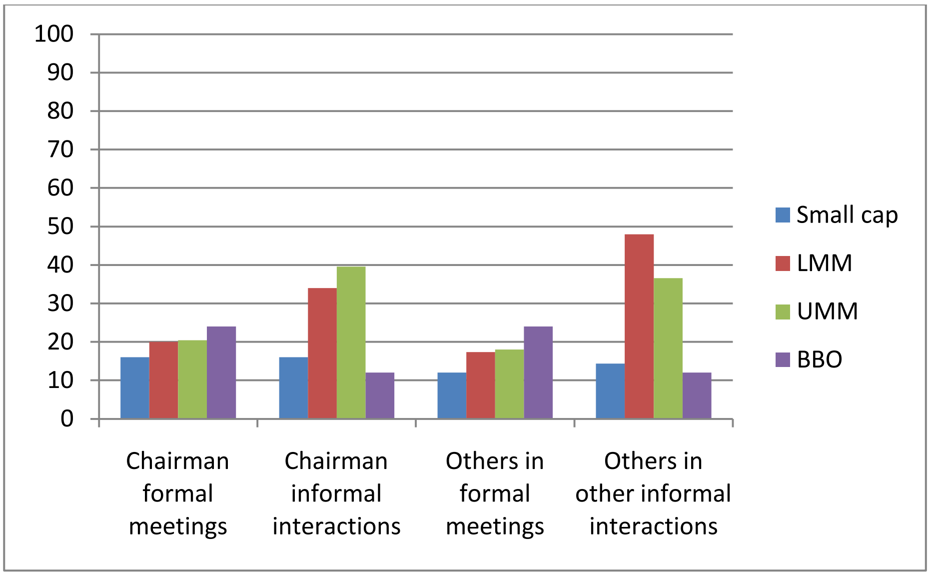
Another way of looking at post-deal involvement and resourcing is to consider the role of chairmen and other directors, both inside and outside the boardroom. Figure 16 is directly drawn from the same LBS study[17] while Figure 17 provides figures in comparable format from the current exercise.

Figure 16: Director days p.a. on boards – PLCs vs. LBS BBO investors



[16] Acharya V, Kehoe C & Reyner M, *Private Equity Vs Plc Boards* (LBS 2008)
[17] Acharya V, Kehoe C & Reyner M, *Private Equity Vs Plc Boards* (LBS 2008)

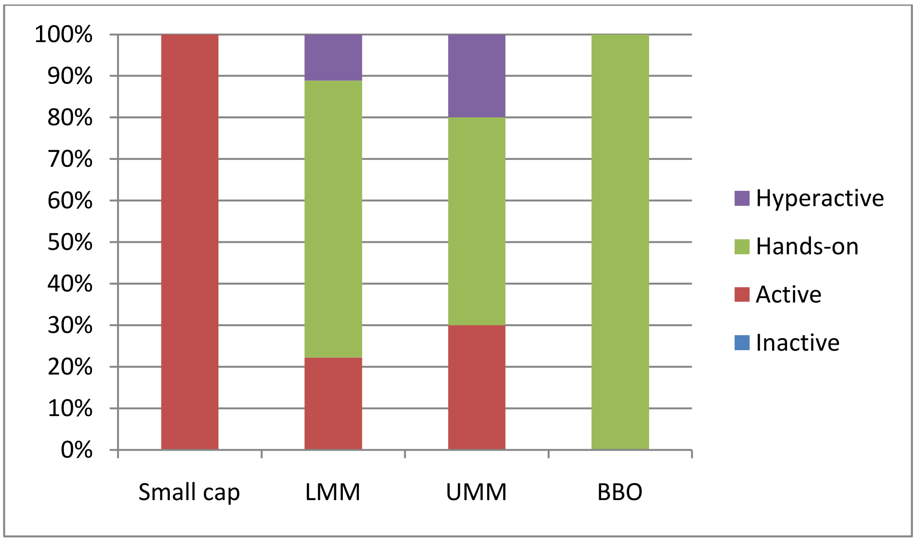
Figure 17: Director days p.a. on boards – this study's investors



The original study noted the peculiarity of private equity boards whereby investor directors were much more active compared with their PLC non-executive counterparts. That conclusion is borne out by Figure 17.

One final way of considering the degree of resourcing – and changing expectations – is through a comparison with an older categorisation of investor director activity.[18] Figure 18 shows how none of the respondents here would now fall into the inactive category and, apart from the small cap investors, most fit into Elango's 'active' group or the 'hyperactive' one I created to cover those whose resourcing exceeded even that.

Figure 18: Director activity according to Elango et al's definitions (% respondents)



[18] Elango B, Fried V, Hisrich R, & Polonchek A. 'How venture capital firms differ', *Journal of Business Venturing*, 10 (1995)

C. Balancing generalist and specialist resources

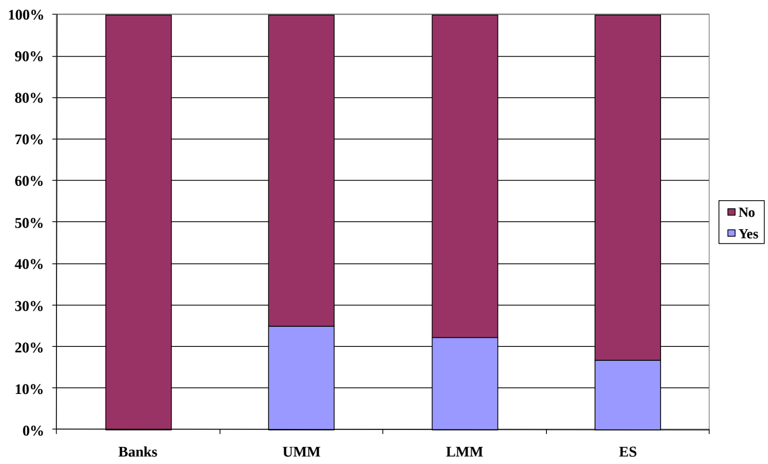
Assuming that most private equity houses are seeking to further increase the value they can add to investees on a range of non-financial issues, there are various options through which investor teams can achieve this: (i) add to the skills of deal-makers; (ii) leverage deal-maker skills by providing access to other (non-permanent) resources or, (iii), bring non-financial staff on board. Many houses, clearly, are doing all three simultaneously.

(i) Adding to the skills of deal-makers

There are a various ways through which PE houses try to build value-adding skills and also facilitate development of new talent:

- Allocation of team members to look after specific industry sectors, often with a prime focus on prospecting. Inevitably this can generate useful contacts, adviser links and substantive knowledge which can be applied post-deal. One respondent notes that informal meetings with sector experts usually generate surprisingly good insights
- Select new deal-makers who have greater than average experience on boards and/or empathy with entrepreneurs/managers
- On the job development can be provided by allowing junior members of the team to shadow their investor director colleagues on boards. However, this needs to be handled delicately and at least one large investor has scaled this practice back
- Internal briefing sessions on topics of current interest, provided by outside experts or based on team case studies. The purpose is to sharpen the ability of current and future investor directors to ask the right questions and spot opportunities for improvements
- Provide more formal training. This can be as specific as education on the legal duties of a director, a BVCA course, or a much more elaborate training. One prominent house employed McKinsey & Co to help develop and teach an entire value-adding framework. The internal value-adding team has since been responsible for evolving that framework and providing further insights to deal-makers

Figure 19: Has your firm organised any interview or assessment training for the investment team over the last three years? (% respondents)



- One area which has seen surprisingly little training is in assessing management teams, an activity which is seen as important, but where PE houses admit to weaknesses. Moreover, little effort is made to provide internal mentoring on such key skills[19]

(ii) Leverage deal-maker skills

The idea of tapping expertise to assist a core investor team is well understood, i.e. making use of experienced chairmen, former senior executives or consultants to generate deal flow, to identify improvements or to drive change.

What some houses find easier than others is obtaining good value in an efficient manner:

- How to find the right person pre-exclusivity to offer quick insight into market dynamics and the possibilities for value uplift: apart from well known databases might tools liked Linked-In provide a more proprietary route?
- Are the CVs we have collected from MBI candidates organised in any way that makes them accessible in a hurry?[20]
- How to discover whether the expertise we hope is there is in fact solid or whether it brings with it other baggage – are we thorough in finding out?
- When we take advice, do we have enough ways of triangulating what we have heard to be sure of the conclusions?
- If someone has been helpful in one stage but may not be as useful later how do we balance the sense of obligation with actual needs (and avoid the kind of court case which has cost Rutland time and money[21])

(iii) Creating in-house roles

Although a majority of PE houses have created non-financial roles of some sort, the approaches for doing so remain diverse. There is probably a consensus that a rigid separation between deal-makers and portfolio specialists is a bad thing. The effective demise of BOSIF, who followed such a model, will only have reinforced a sense of the dangers of non-cooperation.

On a more positive note, top end firms like KKR and Blackstone have a global matrix of expertise by sector and function/issue involving tens of people. As early movers they have subsequently seen staff poached by smaller houses, for example the move of Axel Eckhart from KKR Capstone to Montagu Private Equity (following previous stints in McKinsey & Co, industry and a German consultancy) or the move of Johan van de Steen from KKR Capstone to secondary direct house Vision Capital. Approaches continue to evolve – two large investors I know have tweaked their operational stance in ways that involves less direct hands-on involvement with business issues and a greater focus on facilitation and other softer interventions.

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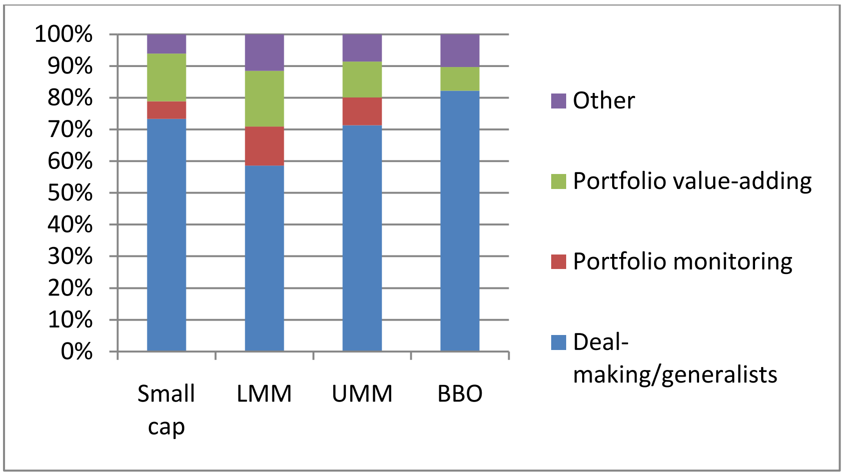
[19] Hicks M, *Handling Management Talent* (2006)
[20] The answer in many cases is no. See Hicks M, *Handling Management Talent* (2006)
[21] The deal in dispute was Harvey & Thompson, done in 2004

At a lower size level, however, it is not economic to employ so many people and the matrix is likely to be more virtual so in-house operations people need to be as much a facilitator of other resources as a doer. Where only one or two people are employed the question revolves around who would best fit that more diverse role. That may favour individuals who have worked across sector and functional lines as consultants or executives. One LMM house has built its non-financial roles around individuals who work mostly on commercial/ market issues, i.e. scanning the market in a quasi origination role, starting commercial DD and post-deal helping CEOs think through commercial issues. Pure operational work is outsourced.

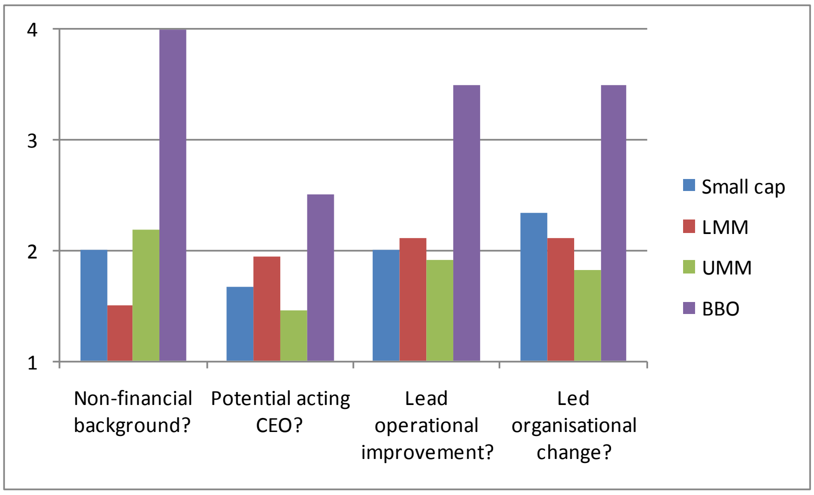
A more extreme version is the case of Parthenon Capital Partners in the USA who claim that of their 22 staff members just 40% come from a deal/finance background, with the rest split between industry and consulting backgrounds. Those non-financial people are not confined to non-financial roles but are fully integrated into the deal origination and execution.

Figure 20: Team composition (% of respondents' teams)



As Figure 20 suggests, no respondents reported a majority of non-deal makers within the team apart from the two secondary direct investors where, clearly, most effort is devoted to post-deal value-adding. Curiously, it was LMM houses who appeared to have diversified their teams most.

Figure 21: Portfolio team backgrounds/capabilities (1 = none have; 4 = all have)



But as Figure 21 shows, only some of those in portfolio roles in most PE houses come from non-financial backgrounds, and few are intended to be able to step into more hands-on executive roles. But many operations people within smaller investors are often tasked with looking after the more challenging cases when matters have gone beyond the comfort zones of deal-makers.

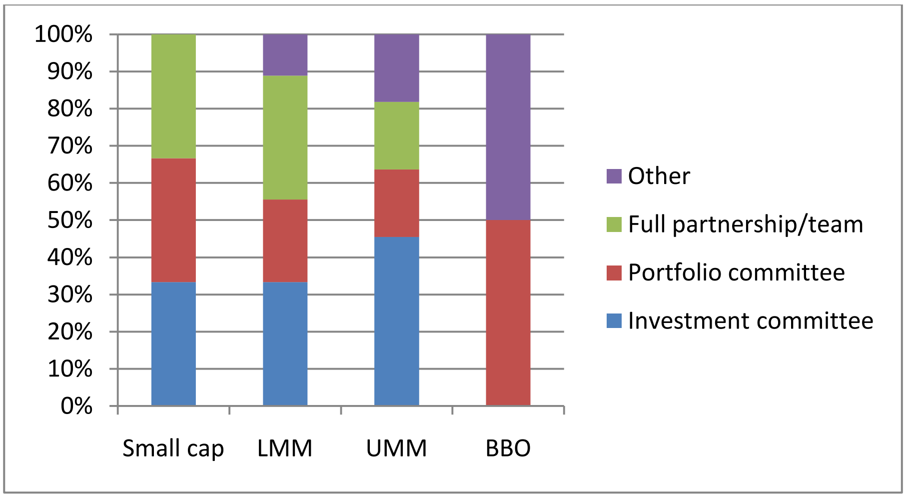
There is no single way of making this equation work. But the typical solution combines skills upgrading of deal-makers, tapping external resources and specialised internal roles in a way that matches the intended value-adding stance of the house. Some houses achieve this by involving deal and operations team members from start to finish on all deals and on all boards. Others by making sure deal-maker leads can ask enough questions to identify issues which then leads to internal/external experts being pulled in to provide answers. Yet others rely on up-front consulting support to identify the big issues early on so that governance and value-adding solutions can be crafted for each company.

D. Balancing PE governance with clear investor accountability

One aspect of organising investor teams is how to balance the desire for deal-maker autonomy (and their clear accountability for results pre- and post deal) with the need for risk management. Too little governance rigour can allow half-baked deals – and psychological biases – to generate losses; but a heavy-handed institutional approach can kill off the magic which skilled deal-makers can bring to constructing deals and relationships with management teams. Likewise, there is much to be said for continuity of an investor across the whole life cycle of a deal - but also some truth in the observation that value-adding in some companies slows down because the investor directors become too entrenched and comfortable.

One response to these dilemmas has been to experiment with governance structures:

Figure 22: Prime decision-making entity for value-adding decisions (% respondents)



As Figure 22 shows, a diversity of models has emerged – and my question anyway over-simplifies more subtle and complex arrangements. But there appears to be recognition that post-deal decisions may need to be handled in a different way than initial investment decisions. More of a challenge for many houses is ensuring that the focus and rigour that investment committees bring to new deals is replicated in considering key decisions about investees. It can be difficult to maintain the energy of value-adding and ensure that the full range of talents within a PE house is available for that task as well as the higher profile financial events.

Inevitably, incentives are highly relevant. One large investor has fewer checks and balances than comparable investors but provides shares of carry that net out all profits and losses attributable to an individual. They find this provides a purity of focus that they believe other investors fudge by creating team-based incentives.

The detail of which approach to pursue will depend on the detail of the overall value-adding framework, processes and phasing as well as how loosely or tightly individual investors are tied to them.

The basic phases are relatively common for primary PE investors: preparation of transaction; acquisition and initial induction; taking control, providing direction and mobilisation; on-going monitoring and value-adding; preparation and execution of exit. But exactly who is involved in each stage, how robust decisions are at each stage etc, can vary at the level of detail.

The overall framework is addressed in Section E, but is made real by a mix of programmatic activities (improving the business model using a variety of implicit or explicit frameworks) and handling events (navigating through the stages towards exit)

Balancing these various factors (and the various stakeholders) to create appropriate internal GP governance is multi-dimensional so an organisational design process may be required rather than a snap decision to shift, say, formal governance procedures alone.

E. More value-adding without weakened management accountability

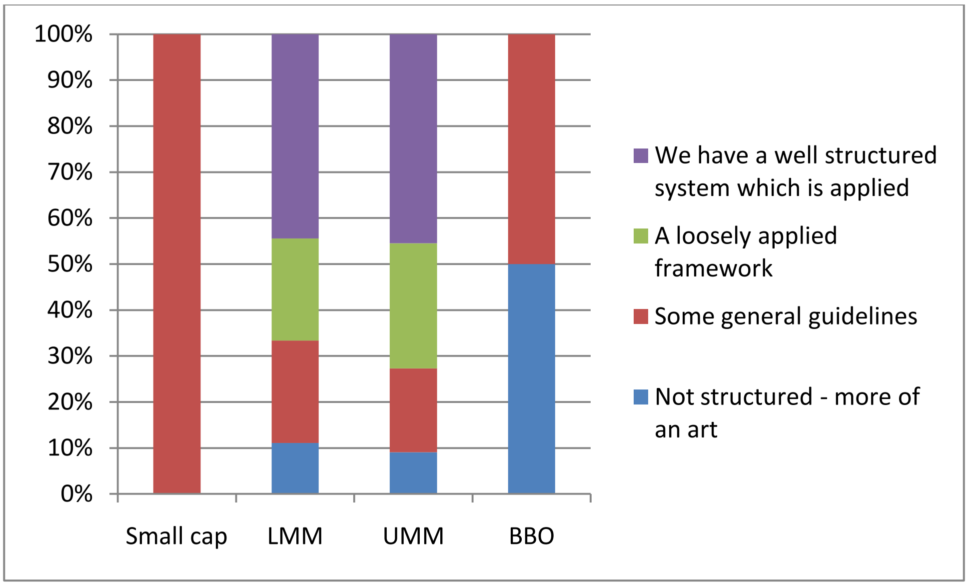
(i) The dilemma

It is difficult to imagine that any PE house would consider itself anything other than an active value-adder. Yet understanding what lies behind the talk is not always easy, not least because most investors are likely to adapt their approach for each investment. Moreover, almost every PE house tends to see partnership with management teams as a key strength. But in practice, living up to an active value-add stance whilst also maintaining the accountability of management is tricky. The sub-sections below try to provide some perspective and offer some avenues of possible improvement.

(ii) Overall views

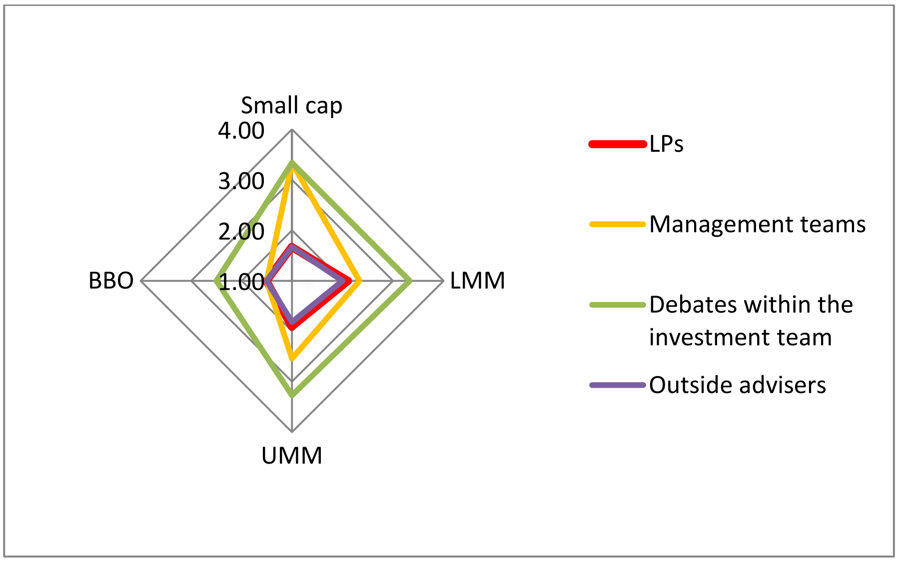
Even at high level, there appears to be a wide diversity of approaches to value-adding. It is now rare to have no structure at all, but a significant number of all houses are pursuing value-add through general guidelines. LMM and UMM houses are increasingly likely, however, to report some kind of system they are applying more or less consistently.

Figure 23: Formality of value-adding approach (% respondents)



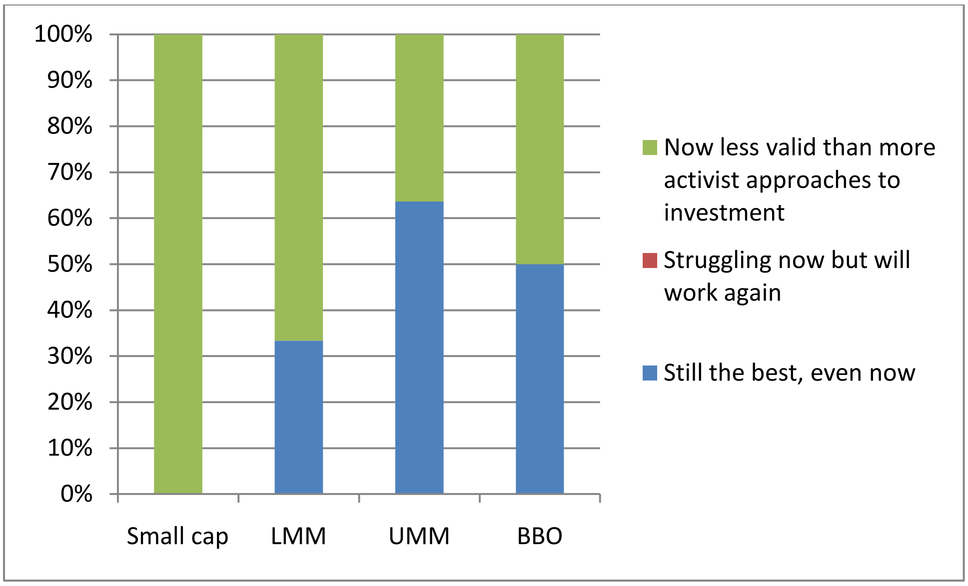
When asked about the reasons for the stance they have adopted, very few houses reckoned that LPs or outside advisers had influenced their current position. In regard to LPs this may be true in a direct sense, but LP interest has been growing and their assertiveness overall has risen over the last years, so their indirect influence may be larger than this result suggests. Slightly more of you felt that management teams had had a role, presumably through requesting or needing particular kinds of support. By far the biggest influence was seen as debates within the management team and perceptions of successes and failures on individual deals.

Figure 24: Causes of PVA stance (1= no influence; 4 = strong influence)



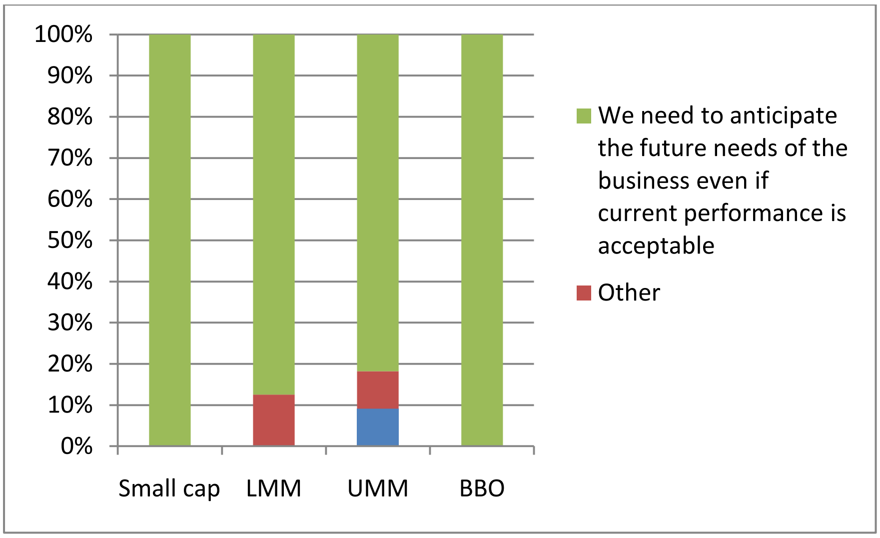
One sign of increasing confidence by investors in their relations with managers is the view that whilst management is important, the requirements of value-adding may override executives' views. I had expected that growth capital investors (i.e. small cap and some LMM funds) would be most likely to remain loyal to a traditional management-centric view while the houses typically pursuing larger more institutional buy-outs (UMM and BBO houses) would see managers as less central. In fact, as Figure 25 shows, almost the opposite is true – larger houses seem most attracted to the traditional MBO view.

Figure 25: Traditional MBO philosophy still best? (% respondents)



That result is curious but probably less decisive than the acid test of why managers might be removed. On this topic there was greater commonality of view – almost all houses felt that changing needs of the investment might require removal even if current performance was fine. As an attitude, that is quite a remove from the 'management friendly' positions trumpeted on websites. In practice, however, my observation is that unprovoked management removal is rare.

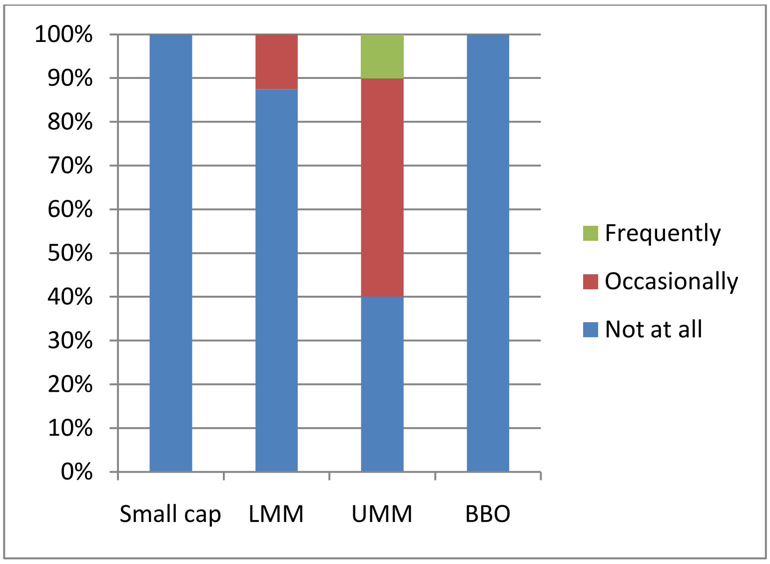
Figure 26: Stance on changing management (% respondents)



Were that not the case then it is difficult to imagine that NEDs and executives involved in PE deals would be as approving of management changes as they claim: in one major survey 80% felt that changes in post-deal management teams were justified or probably justified (although the proportion was lower amongst executives).[22]

One final acid test of activism is whether investors would ever second their own staff into investees. This appears to be rare except, curiously, by UMM houses.

Figure 27: How frequently have you seconded your own staff into investees for more than a month? (% respondents)



(iii) Are managers value optimisers?

A shift towards greater activism by investors is not simply a reflection of a perceived greater need to add value. It also implies two other conclusions that (a) managers left to themselves may not be able to optimise value creation and (b) investors can make a positive difference.

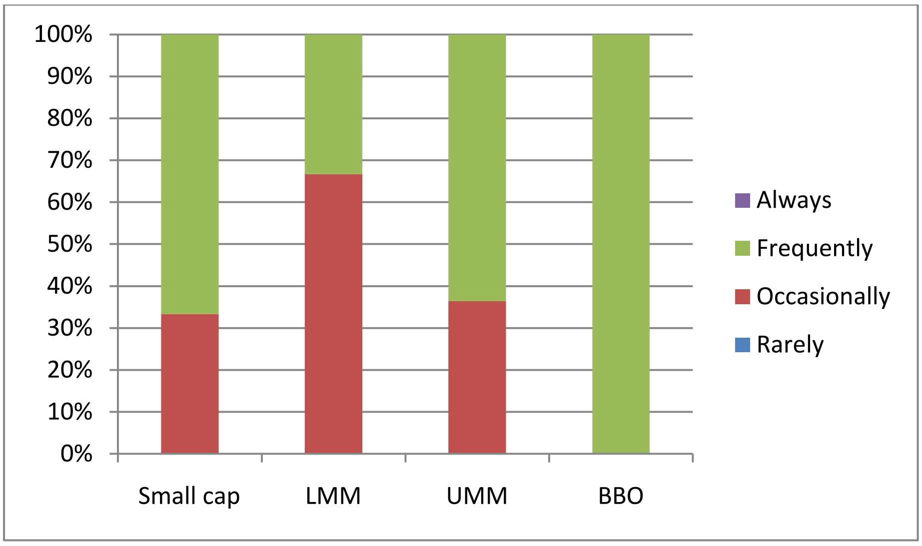
In the general management and psychology literature there is considerable discussion of the willingness and ability of managers to make rational decisions and execute them competently. Private equity has tried to address some key concerns through its model – i.e. removing the perverse incentives which can exist in public companies for managers to enrich themselves at the expense of shareholders; and taking more time to select appropriate managers. However, there are several reasons to believe that executive performance can be improved:

- Very often managers control the opportunity into which investors are entering and finding an optimum team may never be considered. Moreover, as the asset managers are obliged to remind us, 'past performance is no guarantee of future results', not least because the management challenges are almost certainly different from what an existing team (or an MBI one) has experienced before.

[22] Directorbank & Grant Thornton, *Private Equity: the Directors' View* (2008). 261 directors provided input.

- Management teams acting under stress are more likely to make snap decisions based on previous experience which may or may not be robust. As Figure 27 suggests, many decisions are made without a great deal of evidence, and even some of those who felt decisions were evidence-based noted that it was investors who had insisted upon this. Research evidence suggests that managers fail to take useful evidence into account because of lack of awareness, a lack of trust in the relevance of evidence to their situation and an inability to apply the evidence in practice.[23]

Figure 28: To what extent do you find investee managers take decisions based on good evidence of what has worked elsewhere? (% respondents)



- Companies operating under private equity ownership, with the PE tendency to relatively lean management teams and small head offices, will sometimes lack the central staff to investigate options as well as fatter organisations. The board must, therefore, play more of a role in providing challenge and assisting in prioritisation.

- Most companies are replete with issues that block their energy but very often these sit in a zone of high importance but low urgency which managers (and investors?) address too infrequently. This creates what may be the biggest single issue facing companies of all sizes.[24] In my advisory work on organisational effectiveness, management teams rarely dispute the existence or relevance of performance blocking issues but struggle to articulate the issues or address them as a team issue.

[23] E.g. Rynes S, *The Research-Practice Gap in I/O Psychology and Related Fields* in Kozlowski S (ed.), Oxford Handbook of Industrial and Organizational Psychology 4th edition (in press)
[24] See Pfeffer & Sutton R, *The Knowing-Doing Gap* (2000)

(iv) How can PE investors usefully intervene?

If investee improvement requires more than their managers to drive value, then how can PE houses actually get involved without inadvertently destroying value? In principle, the efforts to create PE teams who have more operational skills should raise the probability of success. However, three other conditions of success need to prevail:

1. An intervention needs to be the right one – the investor needs good reasons to believe the idea can solve the issue
2. The idea needs to be executable by the investee
3. The cost of the idea and its execution shouldn't exceed the benefits

As self-evident as those points may seem, they are met in practice less than might be hoped, as section G shows.

That being so, where are the moments when investors can play a role without undermining management's central role?

Building the plan together

The immediate post-deal period should be a relatively uncontroversial place to be deeply involved – there are (hopefully) plenty of due diligence recommendations to deal with, a working partnership needs to be built, and there is a natural expectation of change. Whether or not a formal framework is used, the two sides typically debate and confirm their views on what the 'full potential' of the business could be through to exit.

As the Annex suggests, the main analysts of value creation success all point to early direction changes and management change (where needed) as being especially valuable.

Under-performance

Where expectations have not been made clear from the start there is a risk that only under-performance will provide the excuse to challenge management's direction. If the strategy is failing then only the most incorrigible management teams will refuse to agree to greater investor involvement – assuming the bank hasn't forced the agenda first! The problem with this is evident – business decline takes time to appear so, by the time failure is obvious, the business (and the relationship with managers) may already be beyond recovery.

Demand-led

Management teams are often aware of their own limitations in certain areas and happy to allow investors to take the lead in certain areas – M&A, debt restructurings, CFO appointments. The same can apply where investors have built special capabilities (see below). As one small cap respondent noted 'We deal with small companies and entrepreneurial teams who need a lot of hand holding' – and presumably they are happy for the support.

The problem with this approach can be that some weaker teams are simply unaware of the difficulties they face and value outsiders can bring – and so may not ask for help at the right moment. We may also ask whether investor directors are the most cost effective resource to be using for any but the highest value activities.

Zones of expertise

Through exposure to multiple companies and situations, members of the investor team can develop expertise in some key value-adding areas such as financial controls, cash-flow management, certain tax issues, senior management recruitment, turnarounds et al. As discussed earlier, some firms deliberately create quite specific expertise in globalising revenues or buy-and-builds. In these circumstances it is reasonable for investors to be more assertive and they will presumably be able to provide good evidence for challenging management or insisting on taking the lead for a certain project.

Red lines

Some issues may be ones of such significance to value that, even if the PE house does not itself have the right expertise to provide a solution, it can offer reasons why minimum standard needs to be set for a key process – for example, key hires; financial reporting; health & safety; budgeting; working capital.

(v) Generating value from the boardroom

This list of circumstances is good as far as it goes, but it leaves a lot of grey space in regard to investees and circumstances which don't fit into those categories. What principles and approaches can guide 'normal' value-adding by investor directors?

The first is to avoid either a too laissez-passer or dictatorial stance. One PE house allowed its appointed chairman to achieve both at the same time – there was no challenge to investee management on its lack of strategy or inadequate sales infrastructure but quarterly board meetings were occasions instead for the chairman to issue instructions.

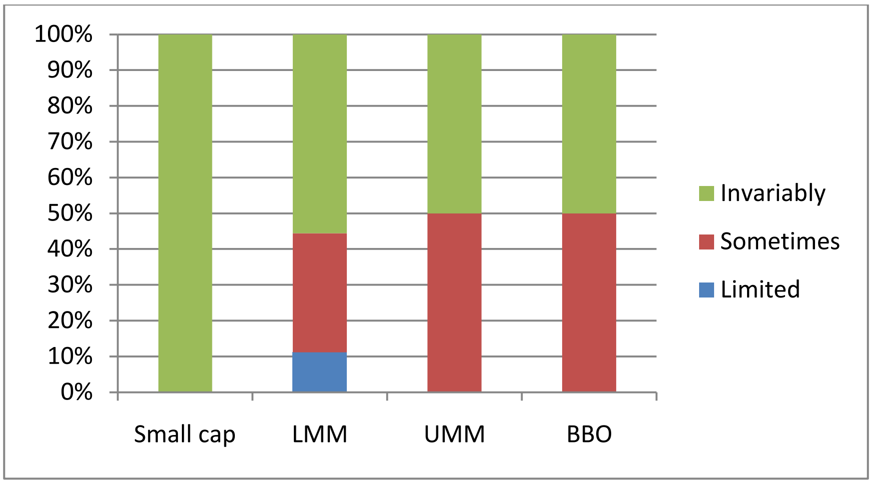
Instead some guiding principles are to:

- Think of the post-deal period as a joint learning process with the aim to identify the key value targets outside the business and release the energies inside the organisation – both with a very specific economic purpose.
- Build a stronger organisation, specifically one better able to solve its own problems. To do so not only builds management strength that will be visible to an eventual purchaser but can also save on consulting costs and help sustain the momentum to keep improving.
- Adopt a growth capital investor attitude, even if the deal is an IBO. That implies that decisions, whilst examined, questioned and even debated, are rarely overruled or imposed. This can cut across the habitual styles of some investors who are used to wielding power without necessarily considering the destructive effect it can have both on management performance and value.

More specifically, the investor director can assist the company achieve better visibility of its medium-term and short-term future, and better understanding of its internal value-adding mechanism, by:

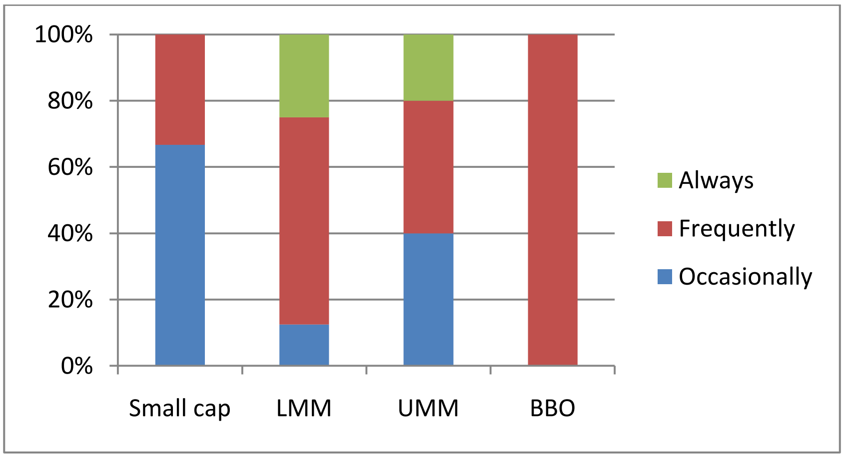
- Making sure that important but non-urgent issues are not forgotten, using checklists or KPIs. Figure 29 suggests that many KPIs have not been worked on sufficiently.

Figure 29: Where KPIs are used, how good have they been for anticipating future developments?



- Asking helpful questions, especially by drilling into the evidence behind a point of view, more than trying to provide answers.
- Helping companies be appropriately self-critical: very often bad news fails to travel from front-line to boardroom and serious efforts are required to smooth the way.
- Making use of benchmarking, user feedback and feedback not only to reach insights on functional capability, products, processes, organisational sentiment etc, but also to open discussions on more complex or awkward topics.

Figure 30: With the benefit of hindsight, how likely have you been to hear of issues/bottlenecks in portfolio companies before they impact on management accounts? (% respondents)



- Helping identify useful measures for an early warning system on client relationships, revenue and costs. Figure 30 suggests significant room for improvement in such systems.

F. How much mileage can be had from cross-portfolio activities?

Over the last years, the Blackstone Group has been publicly active in creating opportunities for investees to benefit through some form of collaboration with fellow investees:

- It set up a central buying cooperative to purchase office equipment, paper and other non-core supplies for the firm's portfolio companies and the system has created savings of 15% to 40% for some of Blackstone's companies. The purchasing group is independent of Blackstone, so companies can continue to use it after they are sold.[25]
- It created an automated web-based reporting system that is used by all its portfolio companies to feed information back to the firm. That information is then analyzed centrally, allowing Blackstone to detect trends and leading indicators for other companies in its portfolio.
- Most recently, it has created a healthcare group purchasing programme for its investees and is exploring how other non-Blackstone companies might join too.

But this level of activity across a portfolio (there are 40+ investees in the USA) is relatively rare amongst other houses, and even in the US portfolio-wide cost initiatives are typically treated with only moderate enthusiasm. A review at one forum for GP CFOs and COOs summarised the opportunities as follows:[26]

- Risk Management/Insurance – an area offering some reasonable savings
- Employee Health and Welfare – some difficulty of implementation and thin savings
- Indirect cost savings – where some savings could be achieved by leveraging volume
- Direct spend cost initiatives – the least likely category because materials tend to be company specific

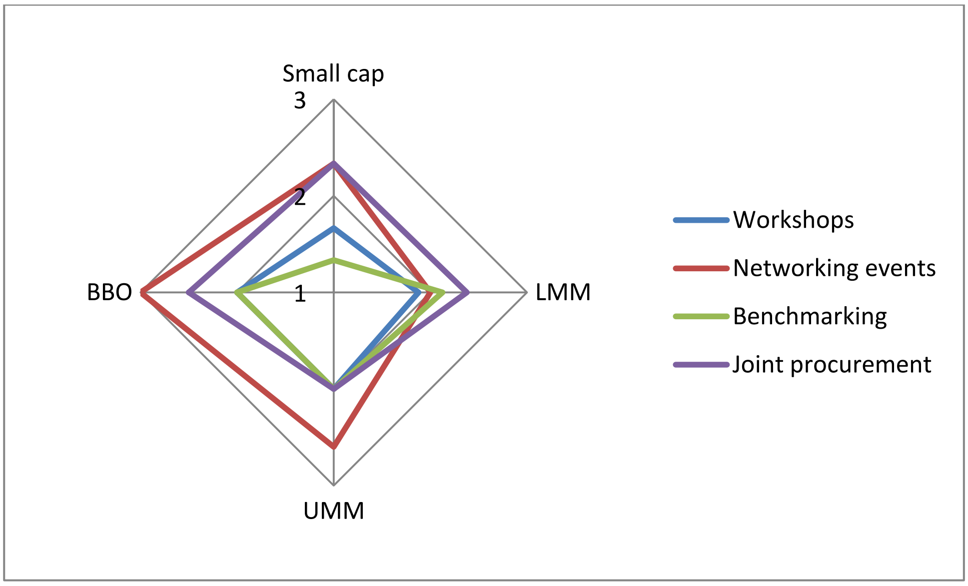
In the UK, the biggest initiative is probably BAPS (the Bridgepoint Affinity Purchasing Scheme) which has evolved into a scheme open to third party investors and their investees (Pepco). Otherwise, I am aware of only a few attempts at joint purchasing, with insurance being mentioned most frequently. Some GPs, who have attempted to test interest, without imposing a solution, found that the effort of coordinating companies with different priorities and appetites was high for benefits that might not be great.

Apart from direct financial savings, respondents to this study were also less than animated about bringing investees together in other ways. The most popular approach was creating networking events although, in practice, these can take a wide variety of forms (from golf trips in Portugal to earnest gatherings of CFOs to discuss accounting issues). The key challenge is to find topics for discussion which are of sufficiently general interest without becoming too bland. Cost control has been a good theme because almost all investees have had to look at this and some have more experience than others. But other themes might be sales effectiveness, tax issues,

[25] James Quella, quoted in 'Early Matters: Creating Value through Operations at Portfolio Companies' (symposium at Wharton Business School 2006)
[26] 'Challenges in Monitoring Portfolio Company Progress', slides from PEI's CFOs and COOs Forum, 2009

performance management et al. But as much as anything, the creation of a network of warm contacts who might be able to help each other with bilateral issues may be value enough.

Figure 31: To what extent do you arrange any of the following across the portfolio? (1 =Not at all, 3 = Frequently)



G. The execution gap

(i) What's the problem?

There is plenty of evidence to suggest that strategic planning, even if it is necessary to avoid doing anything unwise, is not typically a prime changer of corporate value.[27] The fact is that few corporate strategies are genuinely surprising.

On the other hand, failure to successfully execute those strategies, especially improvement initiatives, is probably the biggest challenge facing ambitious private equity owners. Some unhappy facts support this view:

- Cost Reduction: Only 10% of 230 publicly announced programmes succeeded in creating sustained cost reductions; only 25% improved the ratio of costs to revenue[28]
- Lay-offs: There was no link between redundancies and subsequent return on assets between 1982-2000 in 500 firms[29]
- Lean: Organisations fail to capture up to half of the savings available through lean, Six Sigma or combined approaches[30]
- Re-engineering: 67% of projects produced mediocre, marginal or negative results[31]

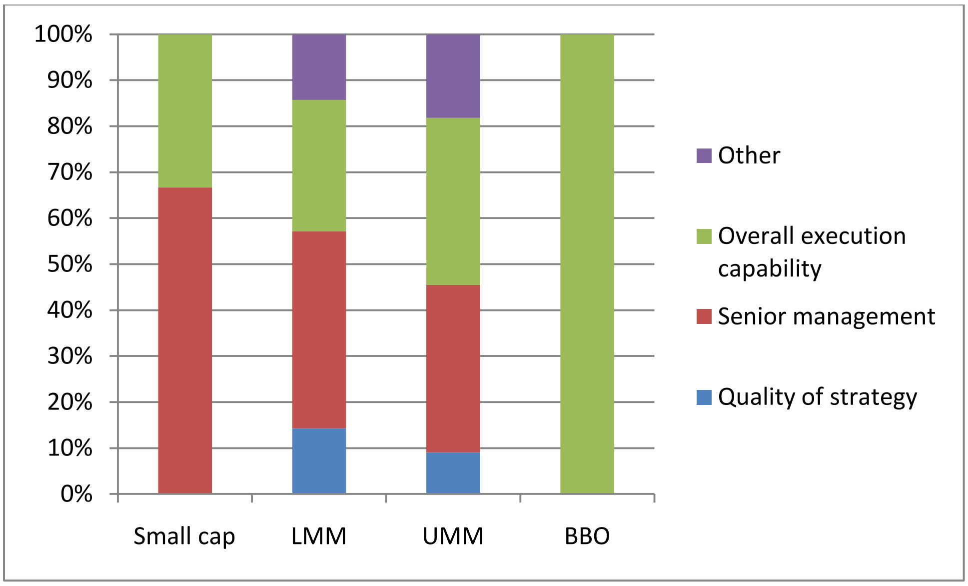
[27] See 'Strategy is Destiny?' in Pfeffer J & Sutton R, *Hard Facts* (2006)
[28] 'Managing Overhead Costs', *The McKinsey Quarterly* No.2, Nimocks SP et al
[29] Cascio W, *Responsible Restructuring* (2002)
[30] 'From Lean to Lasting', *The McKinsey Quarterly* 11/2008, Fine D et al
[31] 'How to Make Re-engineering Really Work', *Harvard Business Review* Nov 1993, Hall EA et al

- Acquisitions: As many as 70% of mergers are value-destroying for the acquiring company[32]
- Supply chain: Fewer than half of executives responsible for supply chains improvement projects believe they meet any strategic goal completely or nearly completely[33]
- IT: Implementations are more likely to be unsuccessful than successful and only 1 in 5 IT projects is likely to bring full satisfaction[34]
- CRM: No more than 35% of businesses said that their expectations of CRM implementation results had been met in any function[35]

All in all, making positive change happen is difficult.[36]

Respondents to this study seem to agree that execution (including the capability of senior management) is the critical issue too:

Figure 32: With the benefit of hindsight, what were the main causes of any unrealised value? (% respondents)



(ii) Why the problem?

The persistent nature of this problem suggests that both managers and investors may exhibit too great optimism when planning initiatives – or fail to ensure that businesses are able to execute. Why might that be so?

Management blind spots

In their work looking at management practices in mid-size manufacturing plans, McKinsey & Co and the Centre for Economic Performance at the LSE found that many managers over-estimate their management practices in operations, talent and performance management (all of which are central to executing consistently):

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[32] E.g. *Reasons for Frequent failure in Mergers and Acquisition*, Straub B, 2007
[33] 'Managing Global Supply Chains', *The McKinsey Quarterly*, July 2008, Survey
[34] Multiple studies reported by the Standish group (http://www.it-cortex.com/Stat_Failure_Rate.htm)
[35] 'How to Rescue CRM', *The McKinsey Quarterly* December 2002, Manuel Ebner et al
[36] See 'Change or die?' in Pfeffer J & Sutton R, *Hard Facts* (2006)

Figure 33: Perceptions and reality of management practices[37]

When looking at individual country scores it turned out that the UK has a longer tail of bad management practice than the obvious comparators (USA, Germany, France). Other research has also found larger gaps between real and believed business performance in the UK compared with other major economies.[38]

This may have several explanations:

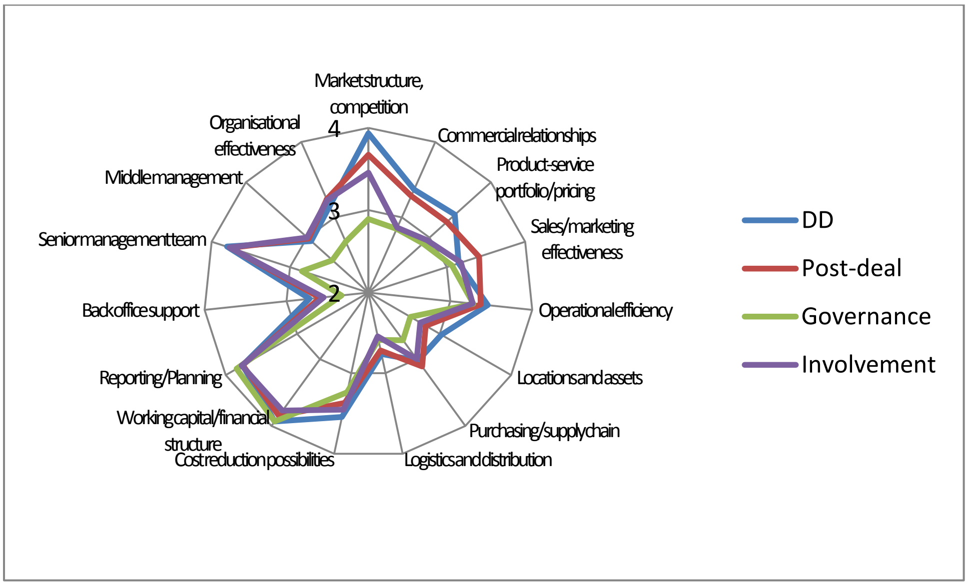
- Managers are simply unaware of what good practice looks like
- That lack of awareness can be especially acute in regard to execution focused issues which cut across functional boundaries
- There is typically no-one within the senior team who has clear ownership of organisational effectiveness – or great familiarity with how it can be built
- Even where plans are made to make organisational improvements, they often fall into the important but not urgent box and so are not implemented thoroughly
- An example would be in talent management where the issues which are more exciting (recruitment) can receive greater attention than the more important but apparently mundane areas of building capabilities and creating staff involvement
- Likewise, many firms employ staff surveys to gauge sentiment but the record of issues being properly understood, turned into pragmatic solution and then followed up is not good in most organisations

[37] Dowdy et al & Van Reenan et al, *Management Practice and Productivity: Why They Matter* (CEP presentation 2006)
[38] Delbridge, Gratton & Johnson, *The Exceptional Manager* (2006) citing large cross-border studies in manufacturing and service industries

PE investors' focus

Investors are not necessarily well-oriented to addressing this blind spot. Despite pointing to the problems of execution, investors remain very focused on commercial and financial issues – with some interest also in operational and supply chain - from due diligence through to exit.

Figure 34: Investor focus by business area and point in deal cycle (relative emphasis)

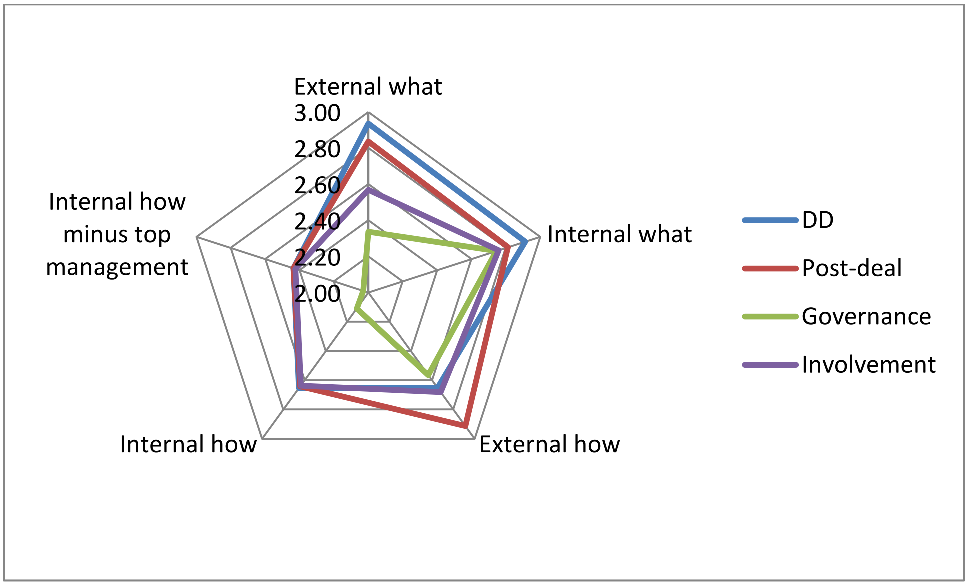


Those categories can be consolidated into broader areas:

- 'External what' – the strategic and commercial revenue drivers
- 'Internal what' – the drivers of operational and supply chain cost
- 'External how' – sales effectiveness
- 'Internal how' – the managerial and organisational drivers

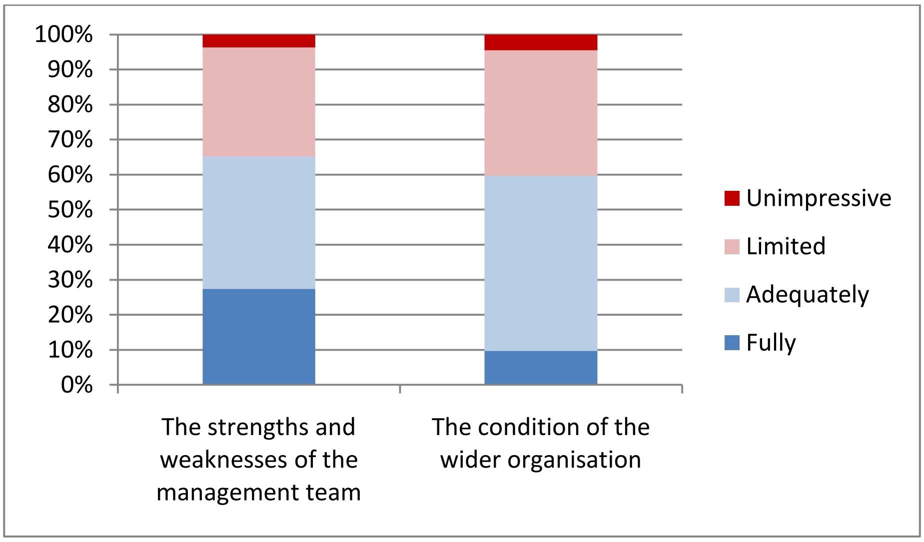
Figure 35 shows how investor focus on the 'whats' is far more pronounced than the 'hows'.

Figure 35: Investor focus by higher level business area (relative emphasis)



The exception to that statement is the emphasis which investors claim to place on understanding senior management. There may, however, be some self-delusion here because when chairmen and executives are asked they are not convinced that investors have a full understanding of them individually and collectively:

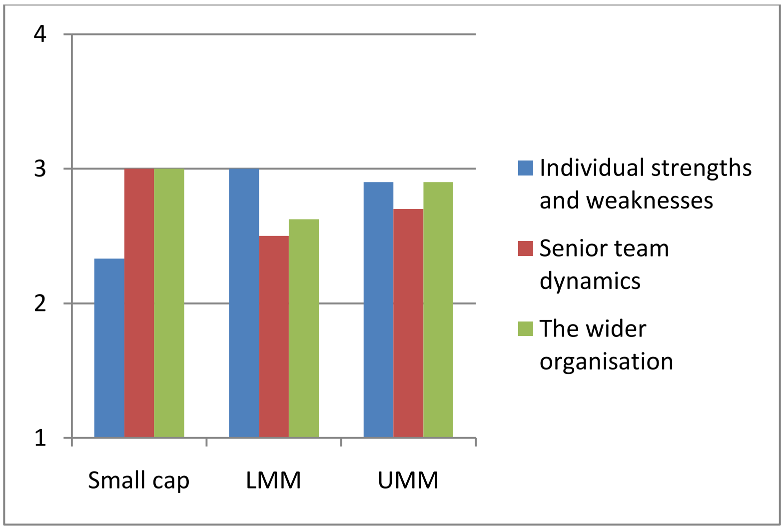
Figure 36: % of directors who think PE investors understood:[39]



My own more detailed work on this – both research and as a practitioner involved during DD and post-deal – also confirms the patchy coverage and limited depth of insight into management teams.[40]

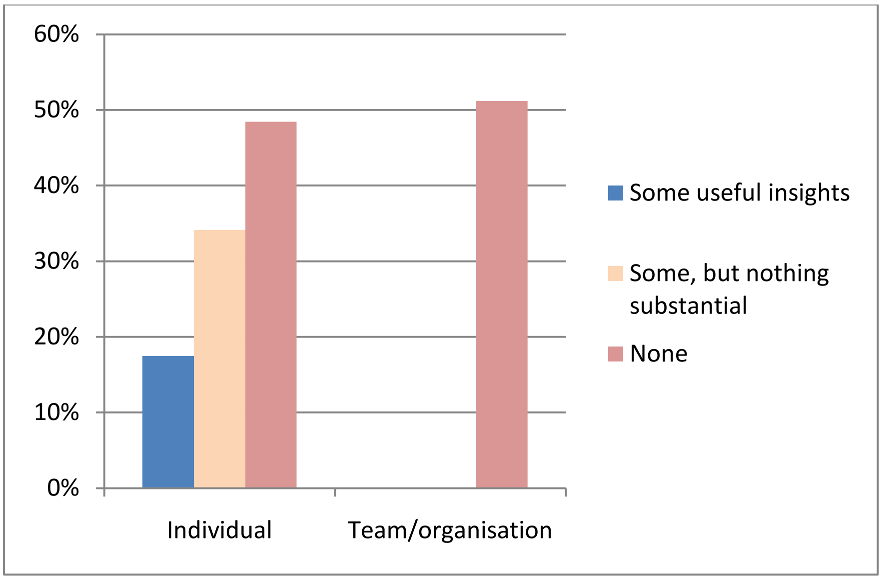
In this regard it is also instructive to contrast (optimistic) investor views on the feedback (and presumably value) they provide to management teams (Figure 37) with the much less positive perceptions of the teams themselves (Figure 38).

Figure 37: To what extent - based on the due diligence findings - do you provide substantive feedback to senior managers on (1 = none; 4 = extensive):



[39] Directorbank & Grant Thornton, *Private Equity: the Directors' View* (2008)
[40] Hicks M, *Taking Management to the Next Level* (2006)

Figure 38: Views on Chairmen, CEOs and FDs on the level of feedback received from PE investors on management and organisation issues (% respondents)



Related to this is the strong bias to treating 'management, management, management' as purely an issue of the top team. As one respondent suggested, they back 'jockeys not horses'. But if the real problem is overall ability of a business to execute its plans then focusing on only a few individuals may be myopic. Certainly attempts to measure the influence of managers' personalities on performance suggest that this can only explain about 10% of the performance.[41]

Much of the rest is almost certainly broader organisational effectiveness which, however, is less familiar territory for most investors and feels amorphous in comparison with talking to the top team. Managers, keen to negotiate equity on advantageous terms, are only too happy to cultivate the impression that performance rests primarily on their super-human efforts. The reality is that understanding and improving the capabilities of the horse may offer a bigger payback for racing performance than just talking to jockeys.

(iii) The opportunity

After a decade of experimenting with approaches to post-deal improvement, there are relatively few areas where investors can reasonably expect to generate improved performance across a majority of their portfolio and differentiate themselves in the eyes of managers and LPs.

Improvement of investees' ability to execute looks like an area which may both reduce risks of failure and offer significant upside. For investors to grasp this opportunity doesn't necessarily require the development of deep in-house expertise in organisational development. It does require some desire to learn enough to be able to ask the right questions and build the topic into due diligence, strategy processes, and board agendas.

[41] Stuart-Kotze R, *Performance* (2006) based on Mischel W, *Personality & Assessment* (1968)

4. Possible next steps

This report offers no single suggestion of best practice or benchmarks to strive towards. Much of the diversity of approaches is driven by rational choices about individual circumstances and competitive positioning. However, the evidence above suggests that there is still a gap between talking the talk of value-adding by investors and walking the walk. There appear to be a number of areas where further improvements can be sought:

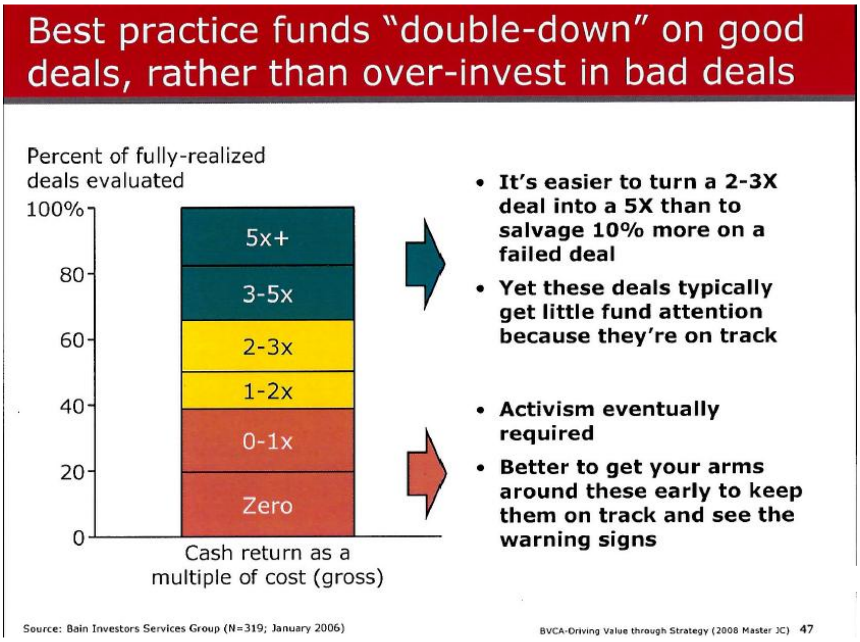
- Be more explicit about the trade-offs which have determined the specific value-adding stance, resourcing levels and deal-maker focus. Treat the balancing act as an organisation design issue to be debated and settled between the key stakeholders and revisited periodically.
- How clear are you on the most valuable parts of your existing processes and what else should be deemed as mandatory for any deal/investee team to review? Can checklists prevent important issues being forgotten when team members are under pressure?
- How well does your house actually execute its own model? How about checking the consistency and effectiveness of value delivery by getting feedback from internal and external parties.
- Are the ‘terms of engagement’ and expectations between you and management teams made explicit early on? Are the features and advantages of your stance communicated?
- If improving the consistency of execution is the biggest challenge to value-creation in investees, what do you need to learn, diagnose, facilitate and monitor to raise your probabilities of build successful businesses?

Annex: Research findings and consultant recommendations

Bain[42]

Some key findings are that:

- Interventions in year 1 yield higher returns than later interventions
- Funds that specialise in active value addition generate higher returns – In Europe and in the US
- 'Star funds' are more activist than others in defining 'full potential'. But differences are greater in the consistency of execution than in the basic ideas themselves



Features of more active funds:

1. In the 1st 6 months invest heavily to define the full potential of the company, including specific strategic objectives and financial targets, signed off by the fund and company management

2. Translate the full potential into an explicit plan with prioritised initiatives, timeline, metrics, milestones and accountabilities, again signed off by fund and company

3. Actively monitor progress of initiatives through a detailed dashboard, and frequently review with company management

4. Maintain a network of internal and external resources to support portfolio companies; deploy these resources actively across all deals

5. Have an explicit strategy and gear value creation towards it; rigorously assess sell vs. hold on an on-going basis

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[42] See Gadiesh O & MacArthur H, *Lessons from Private Equity* (2008) for an extensive overview of Bain's approach

McKinsey[43]

A joint study involving McKinsey & Co and LBS looked at 66 larger UK buy-outs over Euro 100 million, carried out by 'large mature buy-out houses'.

Key findings are that:

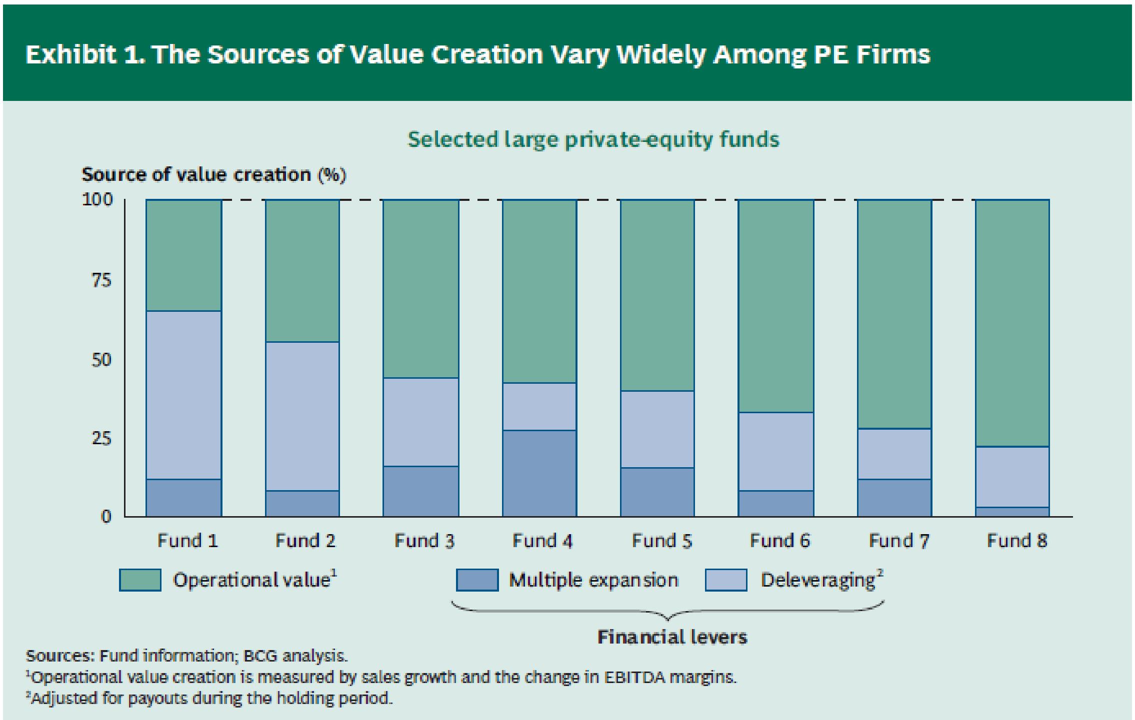
- The best correlation to alpha derived from changes in the first 100 days and from leveraging external support
- Organic deals outperform inorganic deals somewhat on both IRR and alpha; divestments appear to under-perform
- Within organic deals, margin improvement relevant to sector has the highest effect on alpha. The secondly is substantial sales growth
- The best deals saw substantial margin improvement in first year
- EV/EBITDA ratio improves substantially only for margin improvement deals
- Productivity initiatives, especially purchasing improvement, working capital and capex reduction, feature more prominently in margin deals. But so did initiatives for growth, i.e. pricing reviews, new channels more prominent
- Highest correlation with better performance was changes in management within the first 100 days and leveraging external support

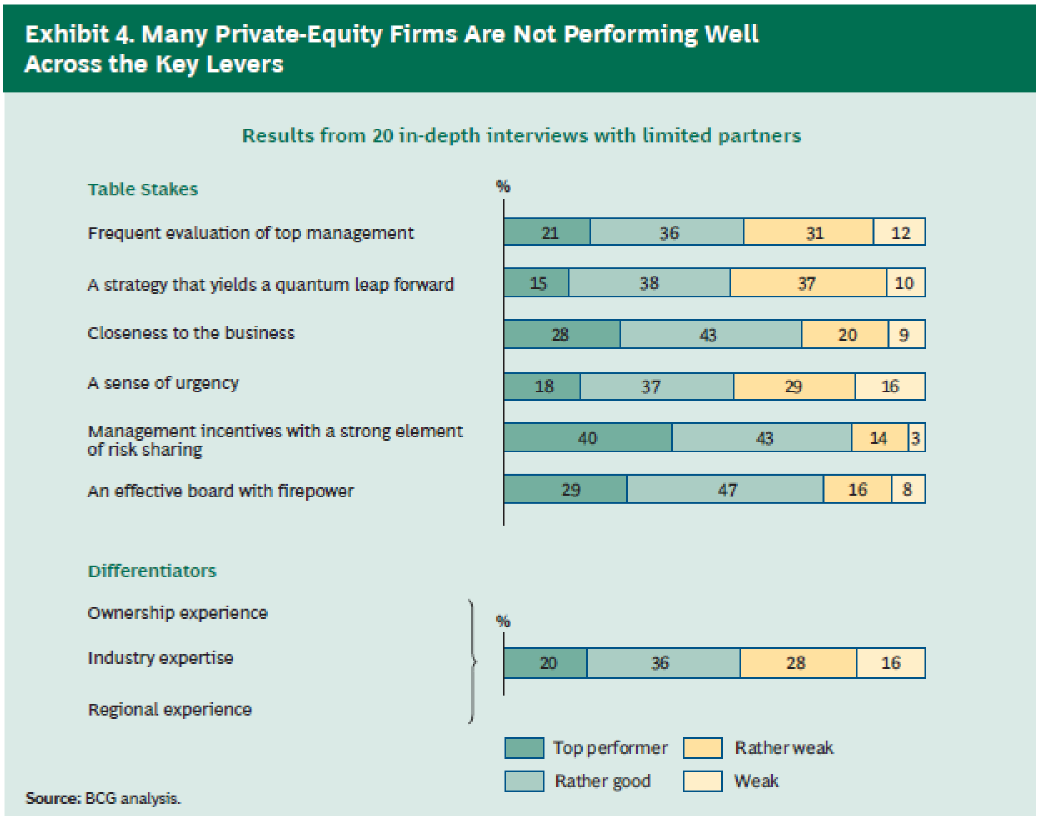
Features of better performing PE investments[44]

1. Tap industry expertise before investing
2. Strong performance incentives
3. Better value creation plan
4. More deal partner time (>50% in 1st 100 days vs. ~20% for lower performers)

[43] Acharya V & Kehoe C, *Corporate Governance and Value Creation* (LBS 2008); Acharya V, Kehoe C & Reyner M, *Private Equity Vs Plc Boards* (LBS 2008)
[44] Heel J & Kehoe C, 'Why Some Private Equity Firms do better than Others' (*McKinsey Quarterly* No.1 2005)

BCG/IESE[45]





45 BCG, IESE 'Time to Engage - or Fade Away' (February 2010)

Exhibit 2. What Owners Need in Order to Create Operational Value

Table Stakes

1. Frequent evaluation of top management
2. A strategy that yields a quantum leap forward
3. Closeness to the business
4. A sense of urgency
5. Management incentives with a strong element of risk sharing
6. An effective board with firepower

Differentiators

1. Ownership experience
2. Industry expertise
3. Regional experience

Source: BCG/IESE analysis.

Gottschalg et al[46]

In a study of 101 European buy-outs, value creation was found to depend on:

- The greater the level of 'strategic investment' of the acquiring buyout firm, the better the performance of the buy-out
- The greater the availability of critical information about the portfolio company's operations to acquiring GPs, the better the performance of the buy-out
- The greater the experience of the buy-out firm – both generally and in the specific industry, the better the return to invest effort
- There is a strong pay-off from linking incentives to performance measures

Ernst & Young[47]

Looked at 300 European exits with EVs over €150 million and found that valuations increased most with organic deals

Figure 2

Performance measures by investment strategy	Improve core	Growth	Buy & build
% of exits	38%	36%	26%
Profit CAGR	12%	18%	21%
Employment CAGR	2%	4%	15%
Productivity CAGR	9%	13%	8%
Valuation multiple increase	2.4	1.8	1.4
Hold period (years)	3.6	3.3	3.4
Source of profit growth (% of total)			
• organic revenue	40%	40%	40%
• cost reduction	50%	30%	20%
• M&A	10%	30%	40%

Note: All values are averages from entry to exit, weighted on profit or entry equity
Sample sizes vary by metric, according to data availability
Data excludes 7% of deals with other investment rationales

[46] Meier, Gottschalg and Brettel How Acquirers Contribute to Post-Investment Value Addition in Buyouts: A Resource Dependence Perspective, paper submitted to *Journal of Business Venturing* (2007)

[47] Ernst & Young, *Challenges in a new world. How do private equity investors create value?* A study of 2008 exits (2009)

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