

UPPING THE ANTE FOR PRIVATE EQUITY:

Getting the Most Out Of Active Ownership

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Private Equity Emerges as an Economic Driver

The growth and success of private equity investing in recent years has been phenomenal. Investors have been repaid handsomely for their participation as limited partners...often realizing returns of more than 30% per year¹. Management of acquired companies have discovered that they can outpace their public company peers in total compensation by as much as 7-fold and more. And world capital markets have had to make dramatic adjustments as private equity invests \$200 billion a year while also absorbing another quarter trillion dollars in debt to satisfy their needs. All this, from virtually nothing 40 years ago.

One indication of the promising prospect for private equity is its ability to raise new capital. Consider Europe, where CVC Capital Partners has recently raised \$7.2 billion; Kohlberg Kravis Roberts & Company is preparing to close a \$5 billion fund; and Blackstone Group is in the process of raising \$11 billion for a global private equity fund.² In the U.S. private equity firms raised more than \$22 billion in the second quarter alone.³

Private Equity's Impact on the Global Economy

- Above-market rates of return
- Fund size on the rise
- Deal size on the rise

However, the payback for private equity comes not from capital raised, but from the capital deployed. Trends here are also up. In Canada, for example, buy-out activity in 2004 was up 46% over 2003.⁴ In the U.S., Venture Economics observes, "If the remainder of this year keeps pace with the first half, then 2005 is well on par to breaking the \$136.5 billion record that was set just last year."⁵

Additionally, transaction size is growing. Kohlberg Kravis Roberts & Company recently bought Canadian company Masonite for \$3.1 billion, while earlier this year Apax Partners, Apollo Management, Madison Dearborn Partners, and Permira

¹ Venture Economics. LBO Deal Volume Refuses to Bend. July 4, 2005.

² W2 Venture Economics. LBO Deal Volume Refuses to Bend. July 4, 2005.

all Street Journal. CVC Capital Partners Catches European Private-Equity Wave. August 1, 2005.

³ Wall Street Journal. LBOs Could Spoil the Corporate-Bond Party. August 1, 2005.

⁴ Goodman and Carr, LLP. Private Equity in Canada 2004; Volume 1: An In-Depth Review of the Market. p.21.

⁵ See above.

participated in a \$5 billion bid for Intelsat. Silver Lake Partners holds the record so far this year with an \$11 billion deal for SunGard Data Systems.

Challenges Facing Private Equity Firms

Yet despite recent successes, there are storm clouds on the horizon. McKinsey and Company consultants Neil Harper and Antoon Schneider warn of “a series of changes in the landscape where private equity firms have thrived.”⁶ Among them:

- An excess supply of capital is available, resulting in more competition for each investment, pricing pressure, marginal deals, and impatience on the part of limited partners.
- Innovative financial engineering skills are present in all the major firms, making sophisticated deal structure a commodity.
- Exit strategies are becoming more complicated. The IPO is not an automatic option.
- New competitors are emerging, such as hedge funds and corporate development offices.

Warning Signals

- Excess Capital
- Commoditization of deal structure
- Exit Complications
- New Competition

Source: McKinsey and Company

In his keynote address to the September 2004 *Private Equity Analyst Conference* in New York, Henry Kravis of Kohlberg Kravis Roberts & Company put the challenges this way:

The businesses we invest in today are better managed companies than those we invested in 10, 20, 30 years ago. And there is more transparency in business, so it is extremely hard to find a hidden jewel. None of us make money at the time of the

“None of us make money at the time of the acquisition. We only make money because we improve the operations of the newly acquired company....”

Henry Kravis

acquisition. We only make money because we improve the operations of the newly acquired company, and subsequently, if capital markets are strong, utilize this capital to our advantage. As a result, we’ve had to get more skilled at building businesses.⁷

Active Ownership: From Unlocking Value to Creating Value

Becoming skilled at building businesses implies a shift toward more active ownership on the part of investors. For Kravis it’s a blend of the tangible: 100-day plans and operating metrics; and the intangible: urgency and value creation. KKR’s tag-line nets out their approach in three words: proactive, patient, creative.

⁶ Harper, Neil W. C., and Antoon Schneider. Private Equity’s New Challenge: A changed competitive landscape calls for a new business model. McKinsey Quarterly, Web Exclusive, August 2004.

⁷ Kravis, Henry R. Keynote Speech. The Private Equity Analyst Conference. New York. September 22, 2004. See: <http://www.kkr.com>.

Other firms describe their approach to active ownership in ways that are consistent with the brand experience they expect to create. Blackstone Group, for example, has a proprietary financial reporting system used by all portfolio companies. This enables the firm's private equity professionals to conduct strategic, operational, and financial reviews of all companies in their portfolio using the same metrics. In addition, Blackstone leverages its portfolio strength to help member companies with everything from economies of scale in purchasing to best-practice knowledge sharing—anything to help improve the performance of each company in the portfolio.

Bain and Company has a four-pronged approach to building portfolio businesses that centers around a simple concept: “a clear hypothesis of how to make money.” Once it's clear to everyone involved how the business makes money, four strategies provide a consistent way of achieving that goal:

- Blueprint the path to value—create both short- and long-term plans.
- Hire hungry managers—find operating managers with an appetite for working in the spotlight that private ownership creates and offer compensation commensurate with performance.
- Measure what matters—focus on the metrics that truly give the business leverage.
- Make equity sweat—finance deals with a healthy dose of debt...up to 60%. (One gets the sense that there aren't a lot of luxury cars on the balance sheet of a Bain-financed deal.)

Bain and Company's approach is based on their experience with more than 2,000 private equity transactions.^{8,9}

One clear-cut conclusion to be drawn from a review of industry analyses and private equity firm reports is this: the ante has been raised. The better firms are finding powerful new ways to boost portfolio company performance. Adequate capital structure is still at the core of the private equity value proposition, but

The better firms are finding powerful new ways to boost portfolio company performance [beyond] adequate capital structure....

performance differentiators are emerging from other sources: sage experience, technical competence of consultants in other parts of the firm, systems and tools, access to networks of experienced CEOs and operating managers. In short, the best private equity firms seek to create more value through *active management* of all aspects of a portfolio company's business.

⁸ MacArthur, Hugh and Dan Haas. The New Masters of the Universe. The Wall Street Journal. July 26, 2005.

⁹ Lavalley, Pierre and Paul Rogers. Top Private Equity Firms Often Deliver World-Beating Results. Canadian Business. October 27, 2003.

Active Ownership Leads to Outperformance

Hard evidence to support the active ownership approach comes from McKinsey and Company consultants Joachim Heel and Conor Kehoe.¹⁰ Heel and Kehoe analyzed 60 transactions originating in 11 different private equity firms, “all boasting better-than-average track records.” All had been exited, giving the consultants the ability to calculate the actual financial performance of each investment. In approximately one-third of the deals either the effects of the market or arbitrage was at work. That is, the rising tide of a strong market was raising all boats (market effects); or the going-in price was below market, so the exit price looked good by comparison (arbitrage).

However, in two-thirds of the investments Heel and Kehoe analyzed, the performance of the companies themselves was the source of value. They didn’t just ride the market or sector up, they outperformed their peers. Specific actions taken by private equity firms *created* value.

Heel and Kehoe isolated five sources of value creation among the companies that out-performed their peers.

- Develop insight before committing to a deal.

Deal partners in the best deals accessed in-depth information about the company from as many sources as they could, including board members, management, and trusted external sources.

- Craft better value creation plans.

Successful deal partners used their insights into the company to develop their own performance management system. While this may put them in conflict with management’s perception of what needs to be done, the tension seems to be positive.

- Structure performance incentives.

The best deals had substantial performance incentives for a select group of senior managers—“usually a system of rewards equaling 15-20 percent of the total equity.”

- Invest time as well as money.

Partners who spend more time with the portfolio company during the first 100 days can expect to oversee outperforming deals upon exit. Partners in the top third in deal performance spent about 50% of their time in the first 100 hundred days; partners in the worst third spent under 25%.

- Put a strong management team in place and support it.

If changes to management were needed, the partners in the most successful deals insisted on those changes prior to closing. Once the team was in place, partners put their efforts into finding ways to support the management team that they had backed.

Positive Attributes of Active Ownership

- Deep Insight
- Value creation plans
- Performance incentives
- Money + Time
- Strong management

Source: McKinsey and Company

¹⁰ Heel, Joachim, and Conor Kehoe. Why Some Private Equity Firms Do Better Than Others. The McKinsey Quarterly, 2005, Number 1.

Quite clearly, there is an art to active ownership. Firms that oversee outperforming companies continue to find new ways to improve performance through better planning, targeted operating improvements, and consistent execution against ambitious goals.

The Power of the Organization: Depth of Leadership is Key

As firms seek to exploit additional sources of leverage to enhance performance, one area—often overlooked, but deserving closer attention—is the culture and climate of the portfolio company. Research consistently shows that performance is higher

Financial performance was nearly four times better in companies when employees expressed highly favorable attitudes compared to companies where employees expressed poor attitudes.

Source: Watson Wyatt

when people “feel good” about where they work. This “feel-good” factor can be measured in a number of ways. For example, Watson Wyatt’s 2004/2005 WorkUSA study found that financial performance was nearly four times better in companies when employees expressed highly favorable attitudes compared to companies where employees expressed poor attitudes.¹¹ In addition to better financial performance, they found that favorable attitudes correlated positively with the organization’s ability to withstand crisis.

The Gallup Organization has created another measure, called “The Engagement Index”.¹² The Engagement Index measures such things as supportive relationships, clarity of performance expectations, and commitment. Companies in the top half of the Engagement Index show consistently superior performance over companies in the bottom half on a wide range of metrics, including profitability, productivity, customer satisfaction, employee retention, and safety.

But there is an added complexity here. Getting the “feel-good” factor right is not subject to a simple formula. People can be well-paid and still feel bad about the place they work. Employees can work on teams and still not feel any loyalty to the enterprise they work for. Companies can conduct employee surveys and put action plans in place to raise employee attitudes on key metrics and still not affect overall climate.

There is, however, one factor that is consistently present in top-performing companies, and that factor is high quality leadership.¹³ The emergence of the celebrity CEO over the past couple of decades has masked a more powerful insight

¹¹ Watson Wyatt 2004/2005 WorkUSA Report. www.watsonwyatt.com

¹² Coffman, Curt and Gabriel Gonzalez-Molina. Follow this Path: How the world’s greatest organizations drive growth by unleashing human potential. (New York: Warner Books, 2002).

¹³ Goleman, Daniel, Richard Boyatzis and Annie McKee. Primal Leadership: Realizing the power of emotional intelligence. (Boston: Harvard Business School Press, 2002).

into the role that leadership plays in delivering consistently high performance. The myth surrounding the celebrity CEO is that performance is the result of a single person. The reality is much different. Successful companies with or without celebrity CEOs are successful because of the depth of their leadership strength. The tone is set at the top, but the performance is assured by leaders throughout the organization.¹⁴

Consider the case of Jack Welch. When Welch was CEO of GE he was known as a bold decision maker. His willingness to downsize aggressively quickly earned him the moniker “Neutron Jack.” His relentless pursuit of industry leadership in each of GE’s businesses is generally seen as the cornerstone of GE’s strategy during his tenure. But while Welch was writing books and delivering pithy quotes to the press, he was also driving a quieter revolution inside GE. He was building a leadership cadre that enabled GE’s businesses to be resilient in the face of difficult decisions, which led directly to GE’s goal of being #1 or #2 in every industry in which they competed. Similar cases can be made for Roger Enrico at PepsiCo and Larry Bossidy at Allied Signal: they built strong and deep leadership capabilities within their companies to deliver consistent performance in highly competitive markets.

Five Recommendations

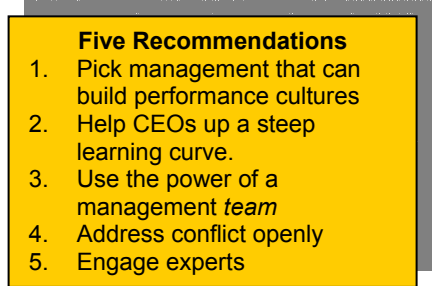
How can a private equity firm use organizational dynamics and leadership as tools for better performance in portfolio companies? Here are five recommendations.

1. Pick a management team with a track record for building strong, committed, performance-oriented cultures.

Perhaps the most significant decision that the active owner makes is the appointment of senior management. The leadership team of the portfolio company needs to build strategic capacity while it delivers against the very specific targets that ownership sets for it. Executives selected for this challenge should have experience building organizations with performance-oriented cultures. While no one is likely to treat this job lightly, research in the venture capital industry suggests that there is a wide range of rigor that goes into the selection process.¹⁵ Active ownership needs to go beyond selecting competent executives to run the key functions of the company. The opportunity exists to select executives who *as a team* will impact the performance of the entire organization.

2. Help your CEOs up a steep learning curve.

CEOs of newly acquired companies do not come to the job with an empty resume. In fact just the opposite: most have had an impressive track record running the very business that has been acquired. So what’s to learn? Three areas stand out: First is



Five Recommendations

1. Pick management that can build performance cultures
2. Help CEOs up a steep learning curve.
3. Use the power of a management *team*
4. Address conflict openly
5. Engage experts

¹⁴ Kotter, John P. and James L. Heskett. Corporate Culture and Performance. (Free Press, 1992).

¹⁵ For a research summary of this process in Venture Capital, see: Smart, Geoffrey H. The Art and Science of Human Capital Valuation. 1998. www.ghsmart.com.

managing the relationship with the new owners: new requirements, new relationships with people in powerful positions, new board relationships. Second, is learning to make decisions in a fishbowl. Private ownership removes the scrutiny of the analyst community, but it does not remove the CEO from scrutiny. Third, the CEO will typically need to learn how to execute more aggressive business plans—and to do so successfully without doing damage to the climate of the organization.

3. Use a strong management team as a strategic weapon.

Building a strong management team is not a one-time event. Once a strong management team is established there is continued opportunity to insure that the team functions optimally. Relationships among team members will continue to evolve. If things go too smoothly, it's probable that there is too much honeymoon and not enough debate going on at the top. On the other hand if things turn contentious within the senior team, it can send shockwaves through the company. An effective CEO will manage his or her way through most of these issues. However, there will be times when an outside perspective will be needed to keep the team members focused and aligned with the company's strategy.

4. Seek out conflict and address it openly.

There is a natural conflict between deal partners whose capital is at risk and management who has been hired to deploy that capital. As private equity firms take a more active role, that conflict may be expected to become more pronounced. Heel and Kehoe's research, for example, showed that one of the five keys to success is a strong management team in the portfolio company. Yet they also found that the better firms introduced a performance plan that sets higher standards than management's plan.

How is a strong management team likely to respond to its owners setting higher targets than they would have set for themselves? Will they rise to the challenge or resent the interference? If the deal partner can manage this conflict effectively, a stronger plan will emerge. If the conflict rages on (or festers), it can put performance at risk. As firms become increasingly active, the bedside manner of the deal partner will be a critical element in creating the right organizational climate to manage the relationship between the firm and the portfolio company.

5. Engage experts in organizational effectiveness, conflict mediation, executive alignment, and leadership coaching.

Most of the leadership and organizational issues that arise during the months and years a company is owned by a private equity firm can be resolved as part of the normal review processes that exist. However, there are three situations in which the use of an outside expert can be especially beneficial. One is unique to the private equity environment; the other two apply to both private and public companies.

Fraying relationships between firm members and management. Deterioration in the relationship between firm members and management rarely bursts onto the scene. Rather relations begin unraveling in small, seemingly insignificant ways: misinterpreted emails, failure to follow up, withheld information. Both parties can be (and usually are) guilty of such transgressions. If the ensuing suspicion and loss

of confidence is not dealt with soon enough, objectivity quickly erodes. In these situations, the outside consultant plays a vital role in restoring objectivity and enabling the parties to continue to work together. Not all differences or misperceptions between firm members and management require outside intervention, but when a deal partner starts to say, “We thought it might be rough with [executive’s name], but not this rough,” it’s usually time to look to outside help.

Lack of alignment among members of the management team. Lack of alignment is another organizational problem that can affect performance. Differing points of view are built into the roles that senior managers have. Finance, for example, wants to conserve cash while Marketing wants to use cash to invest in new product development and Sales wants to put more bodies on the street. Such differences are healthy during the planning process, but if they begin to interfere with execution, things have gone too far. Often there is a political component to lack of alignment. As one executive said about a colleague recently, “I’m not sure if she’s just trying to get her own way, or if she’s mounting a campaign to bring me down.” When powerful people are not aligned to a common direction, the performance of the organization is at risk. The outside consultant can help managers resolve their differences, realign their efforts, and in the process create an even stronger leadership team.

Lapses in individual performance. The management literature is full of titles warning of executive failure. It’s an all-too-common occurrence. But that doesn’t mean that failure can be accepted with a shrug of the shoulders. Just the opposite. Lapses in performance need to be addressed quickly and directly. When removing the executive is not an option, and attempts to help the executive get back on track are not producing the desired results, an outside consultant can be a critical resource to the deal partner. The outside consultant (typically known in these situations as an executive coach) works directly with the executive in a confidential 1:1 setting. A good coach will play a variety of roles from sounding board to confidante to strategist, all in service of this mission: to help the executive focus on those aspects of the job that will lead to better performance, and to make mature judgments about potentially conflicting messages that could be taking him or her in the wrong direction. It is an ambitious undertaking, but considering the alternative, it is almost always one worth pursuing.

There are common themes in each of these five recommendations: first, organizational dynamics can be managed to strategic advantage; second, allowing organizational issues to go unmanaged usually results in difficult situations—conflict, lack of alignment, power struggles—that can sabotage even the best-crafted deals; and third, the real benefit of addressing organizational issues is in helping owners and managers to refocus their energy around their shared commitment to making the business a success.

Final Thoughts

One of the facts of business life is that as industries grow, a small number of companies or firms tend to dominate. These firms set the tone for others to follow. However, in highly competitive markets conditions can change rapidly. Dominant firms can find themselves subject to competitive pressures, not only from their peers, but from others outside the industry.

There are indications that the private equity industry, in spite of its current success, is starting to feel the pinch of external competition. Hedge funds are beginning to take controlling interests in companies. At the same time, corporate development departments are increasingly making competitive offers for companies that private equity firms are targeting for their portfolios. In response to these threats, private equity is broadening its strategy of active ownership.

When private equity was in its infancy, it created value by leveraging the financial expertise of its partners. Over the years the value proposition has expanded to include expertise in operations, marketing, and other core functions. As firms now learn how to further improve performance by focusing on the “softer” elements of the enterprise—leadership, executive alignment, and employee commitment, for example—a new level of competitive advantage for portfolio companies is sure to be realized through faster decisions, better execution, and lasting results. And in private equity, what’s good for portfolio companies is always reflected in positive outcomes for the firm, its partners, and its investors.

About the Author



Richard C. Harris, PhD, is a consultant and author with clients in aerospace, financial services, media, oil and gas, and professional services. As an advisor to companies in these industries, he helps create talent development and retention strategies. As an executive coach, he works with senior executives as they formulate strategy and build their leadership teams around them. Formerly a senior executive in a privately held services firm in Boston, he was a member of the firm’s Board of Directors and Managing Director for its operations in London. His most recent article, “Who is the client for leadership development?” is published in the Emerging Ideas section of his website at www.rch-phd.com. He may be contacted about this paper at richard.harris@rch-phd.com.