

TEN LESSONS FOR ALL COMPANIES FROM PRIVATE EQUITY

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Since 2001, private equity firms have invested more than \$2 trillion to acquire or take stakes in some 11,000 companies around the world. The current credit environment may have slowed private equity investment this year, but the industry's footprint and influence remain enormous. Private equity's unique blend of risks, rewards, challenges and opportunities has changed the way that many people think about effectively operating a business.

What do the most successful private equity firms and their portfolio companies do right? What can all businesses learn from the private equity experience? Below are key findings from our discussions with leaders in this sector, summarized in the form of 10 lessons that can be learned from private equity.

1. HAVE AN ENGAGED AND KNOWLEDGEABLE BOARD

Of all the advantages of private equity, one of those most often cited is the strength and focus of the board of directors. Portfolio company boards tend to be smaller and

more hands-on — so everybody counts and must contribute. Investor representatives on boards meet frequently with management and can bring to bear the resources and contacts of their firms. Their outside directors typically provide valuable operational, functional or industry expertise, and can serve as mentors to the CEO.

Portfolio company boards also operate under fewer regulatory requirements than public companies and away from the scrutiny of external shareholders, analysts and the general public. Without these pressures and distractions, they have more time to devote to value-adding activities, according to private equity leaders.

Portfolio company directors also have significant equity stakes in their companies; beyond receiving options or stock as part of their compensation, they often invest their own money into the business. This, private equity executives say, aligns directors with shareholders and the management team and increases their focus on performance. “The biggest difference between public and private boards is that, essentially, there is one shareholder — it’s us and management. We’re partners. That is the ultimate level of accountability. We’re giving the CEO great resources in a focused, high-performance board, but we’re driving accountability and we’re measuring it,” said JP Conte, chairman and managing director of Genstar Capital.

2. DEVELOP A CLEAR AND COMPELLING PLAN FOR CHANGING THE BUSINESS

With valuations at high levels, private equity firms no longer can rely on financial engineering and sharp cost-cutting to create value. In most cases, portfolio companies must be strategically transformed and restructured to reach the level of profitable growth required to accomplish the exit strategy, whether it is selling the company or taking it public.

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Central to portfolio company success is reaching an agreement upfront between the board and management team about the potential for the business and defining a plan for getting there. Private equity firms use the extensive due diligence process to understand the business fundamentals and identify opportunities to improve performance. To make sure management buys into the plan and commits to its milestones, Aurora Capital Group hosts what it

calls an “outside-in session” with management after the transaction closes. “We literally spend an entire day with the management team and we turn the tables around. We share with them all of the work we’ve done underlying our investment decisions. The point of that meeting is to make sure that we all agree on a set of facts and data, and together define what full potential is for this business. We then create a blueprint that details who’s responsible for what and how fast,” said Aurora Capital Managing Partner John T. Mapes.

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3. ALIGN EQUITY HOLDERS AND THE MANAGEMENT TEAM AROUND THE BUSINESS OBJECTIVES

Portfolio company CEOs and their top executives typically have a significant amount of personal wealth tied up in the portfolio company. As a result, their interests are closely aligned with the interests of shareholders, and they have an incentive to accelerate the rate of change.

Private equity’s potential financial rewards tend to attract “economically motivated” managers. “That lines up well with investors,” Mapes said. “Investors want to get the biggest return in the fastest way humanly possible. If they aren’t set up that way, public companies will attract very good executives, but they may value things other than economics.”

With both management and directors heavily invested in the company, a true partnership develops between the CEO and the board, Conte said. “That leads to great communication about what’s going on at the company, sooner rather than later,” he said. John Samuel, who was CEO of Molnlycke Health Care, one of Apax Partners’ most successful deals, agreed: “With private equity, you need to be much more straightforward and open about the challenges you face, what you are doing about them and the likelihood of success.”

4. BE DILIGENT ABOUT CASH FLOW MANAGEMENT

In most private equity situations, portfolio companies have high levels of debt, requiring constant attention to cash flow, spending levels, debt repayment and financial targets. “Cash is king” at portfolio companies, so finding new sources of revenue and controlling costs are top priorities for their CEOs. In practice, this means that portfolio company management is disciplined about concerns such as ensuring that capital spending proposals have a payback and improving receivables collection.

A key player in this effort is the chief financial officer, who typically has a commanding role in improving cash flow and driving value. Vivek Paul, partner in the Venture Group of Texas Pacific Group and formerly vice chairman of Bangalore-based Wipro, sees the CFO role as both consigliere and irritant to the CEO, whether the company is private or public. “CFOs are in the best position to challenge a CEO as to whether he can do more,” he said.

5. FOCUS ON GROWTH AND BUILDING VALUE

Having to answer to many investors and stakeholders and navigate myriad corporate demands, public company leaders can lose their focus on the business. The private equity environment removes some of those distractions and focuses the organization on a few clear objectives aimed at value creation. “I liked the directness of the approach, the total focus on value creation without having to water down your plan because one is worried about how investors might react,” said Samuel. “The great thing about private equity is that you never have to worry about the real agenda. The real agenda is ‘Make money. Create value.’ That’s it.”

In addition, the relationship between the board and management creates a culture of accountability for performance, private equity leaders say. “The performance demand on the CEO is more direct in private equity,” said Paul. While a public company director might present a concern indirectly in the form of CEO coaching, portfolio company

directors are more likely to be direct. “On the private equity side, you pick up the phone as soon as you feel there is value to be had and say, ‘I think we can do this a little bit better. Let me know if you need any help analyzing this.’ The conversation is much more direct,” he said.

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6. ACT DECISIVELY

While a portfolio company has to be far more focused on fewer goals and a well-defined end game, the alignment of its management and board makes it easier to mobilize the organization to accomplish those goals and make decisions quickly. Management teams and boards are analytical — ideas are presented and evaluated based on their potential impact on income or cash flow — and important decisions can be made without involving layers of management or external stakeholders.

Board members, particularly those from the private equity investor, speak frequently with management, helping to streamline decision making. “As the lead directors at our companies, we’re on the phone with our CEOs every week. The CEOs are running major businesses and often need to effect a lot of change on an accelerated basis. They want to bounce ideas off someone, and what’s more powerful than reflecting on an idea with your top shareholder who owns 70-plus percent of the company?” Conte said.

7. PLAN FOR THE LONGER TERM

Quarterly financial reporting is a fact of life for public companies and likely will continue to be. With this focus on quarterly results, however, the public environment can be hypercritical in the short-term and less strategically oriented. The finite time frame for achieving an exit strategy, typically three to five years, gives structure to portfolio company plans and encourages risk-taking that may pay off over the medium to longer term. Private equity tends to have a greater appetite for risk, making it easier for

portfolio companies to make dramatic moves or embark on fundamental changes in strategy.

Portfolio companies do have to hit short-term performance targets; they have bank payments to make and covenants to keep. At the same time, they have more room to make changes or investments for the long-term benefit of the company, even if they result in a bad quarter in the short term, private equity leaders say. “It’s not all about the next quarter of the current year; we take a three-year look at how we can make the company better,” Mapes said.

8. CULTIVATE A SENSE OF URGENCY

In a portfolio company, the leverage and alignment of management incentives with company performance combine to create a “burning platform for change.” This burning platform encourages an action-oriented culture, with a bias toward making decisions.

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“By its nature, the higher debt level creates a crisis. There’s not as much room for error when you have a levered balance sheet, so it makes management very proactive and creates an atmosphere that encourages people to make decisions and act. Public companies are relatively unlevered, and so the onus is on the CEO to create that atmosphere,” Conte said. In the private environment, there is more tolerance for making a mistake than for missing a promising opportunity, said Paul. “My sense is in public companies, there is a much higher cost of flubbing it and a much lower penalty for missing an opportunity. In other words, what’s not done doesn’t get punished,” he said.

9. DRAW ON EXPERT ADVISERS

When they are looking for investment opportunities or need advice during the due diligence process, private equity firms tap their networks of operating executives, advisory board members and board directors of other portfolio companies as resources. When a challenge arises or a portfolio

company needs help opening a new door, the CEO and board members are able to reach out across the family of portfolio companies to find the expertise they need.

Aurora Capital Group further leverages these resources through its annual CEO roundtable that brings together portfolio company CEOs to share ideas and discuss issues. “That has become a real winner for us and for our investors because value seems to be generated from those meetings,” Mapes said.

10. BACK THE INITIAL TEAM, BUT BE WILLING TO MAKE CHANGES WHEN NECESSARY

Many private equity firms invest in companies based on the strength of the management team. Others parachute trusted leaders into new investments or those that are struggling. Regardless of their approach, private equity firms recognize the critical importance of strong, effective leadership to the success of their investments. Firms typically regard their ability to assess management as a core competency.

One approach is to evaluate management within a few weeks of completing an investment. This helps the firm understand the quality of the executive team, identify any gaps in the organization’s capabilities and learn more about executives’ motivations and willingness to commit to the long-term plan. Early assessment also helps reveal issues that the private equity firm may need to manage, such as a CEO’s tendency to be overly optimistic. Another approach is to assess the performance of management six months into an investment to confirm that the right team is in place.

As the primary shareholder, a private equity firm can move quickly to replace an executive when necessary without having to worry about the reactions of analysts or the public. They are able to tap their CEO networks or bring in an executive-in-waiting if they need to make a change or supplement the existing team.

Still, removing an executive in a private equity environment is not done lightly. Private equity firms weigh these deci-

sions against the desire to protect their reputation with chief executives. “You want to make sure that you can attract great CEOs, and CEOs don’t want to feel that they’re walking into a situation with a trigger-happy bunch,” said Paul. “You try to be as supportive as you can be and, in some sense, you’re an accomplice to the problem because you’re much closer to the business than public company directors might be and, therefore, you do tend to be fairly understanding. On the other hand, if the problem is clear, there’s no inertia about making a change.”

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CONCLUSION

Portfolio companies enjoy a number of advantages when it comes to building efficient, high-growth businesses, including their ownership and compensation models, fewer competing distractions and the power of leverage. Meanwhile, public companies will not be free any time soon from quarterly financial reporting requirements, governance rules meant to drive accountability and transparency, or the demands of a larger pool of stakeholders. Nevertheless, private equity’s bottom-line focus can be adapted to the public environment. The following are the foundations of this approach.

A robust and engaged board of directors. A strong board that works effectively with the CEO to set strategy and holds the CEO accountable for results is essential to the success of any company, public or private. Attracting the very best directors — those with the leadership skills and relevant industry perspectives — begins with an effective nominating process. Wise boards will want to foresee where the company is headed in the future and take advantage of natural attrition to recruit directors with the expertise required to help the company respond to the new challenges and opportunities it will face.

A culture of urgency. In the absence of the high debt levels under which most portfolio companies operate, a public company CEO has to create a culture that is decisive and action-oriented. To do this, the CEO needs to work with the board and management to create a partnership based on performance, together defining the potential for the business, putting a blueprint in place and paying attention to the progress against the plan.

A compensation model that rewards performance.

While they may not be able to match the huge equity-based rewards that can be gained from a successful private equity venture, public companies can structure compensation in a way that rewards longer-term performance. That means less reliance on cash and more on performance-based equity compensation.

A talent assessment process that identifies and develops outstanding leaders.

Making a talent mistake in today’s business environment can have dramatic consequences for organizations, in the form of lack of strategy, missed market opportunities and poor execution. A primary responsibility of the board and CEO is to ensure that the company has succession-planning and assessment processes in place. Times of change, such as a major strategy shift or change in organizational structure, are natural opportunities to reflect on the strength of the management team, determine whether the right people are in each role and identify leadership gaps.

Private equity leaders naturally are proud of their success in turning around troubled companies and improving the performance of others, thus creating value for their investors, their management team and their companies. These 10 lessons from their experience suggest ways that all companies might perform at higher levels.

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