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Time to Engage—or Fade Away

*What All Owners Should Learn from the Shakeout
in Private Equity*

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Time to Engage—or Fade Away

What All Owners Should Learn from the Shakeout in Private Equity

In December 2008, we predicted a significant shakeout in the private-equity industry leading to the disappearance of 20 to 40 percent of private-equity firms.¹ Since then, several private-equity firms have gone out of business, some have reduced their current fund commitments, and others have reduced their teams, including senior partners. In July 2009, we forecast that private equity's limited partners would—on average, but with significant variation—stay committed to this asset class or even increase their allocation relative to other asset classes.² In the past six months, limited partners have indicated that they are willing to commit new funds and in fact have done so.

At the same time, however, limited partners investing in private equity have been more forceful in defining the criteria and terms they expect and have made it clear that they will perform more sophisticated due diligence before committing new funds.³ In particular, they are scrutinizing the importance of operational value creation (EBITDA growth) versus financial levers (multiple expansion and deleveraging).⁴ “Operational value creation is the key element in private equity that will distinguish the winners from those that disappear,” said a limited partner—one of the largest investors in private-equity funds—interviewed during our research. “The time to bet on financial levers is over.” We believe that this shift toward an engaged (value-adding) model is also relevant for other companies, including public and family companies, which can learn valuable lessons from the best practices of private equity.

In this paper, we address the question of how private-equity firms—and, by extension, all owners—can add to the competitive position of their companies. To find the answer, we drew on our database of 3,000 capital commitments to private equity and conducted 20 in-depth interviews with limited partners who invest in private equity. In addition, we analyzed more than 100 academic articles examining the link between ownership type (public, family, and private equity) and governance practices and performance, and discussed the issue with experts at relevant research institutions.

The sources of value creation vary widely among private-equity firms. (See Exhibit 1.) Some of the largest funds have generated more than 75 percent of their internal rate of return (IRR) through operational value, while others have created more than two-thirds using financial levers. “Operational value creation is the result of a business mentality, and financial levers are the result of a trader mentality,” commented one of the limited partners we interviewed. Returns from deleveraging or multiple expansion are mainly a result of arbitrage between debt and equity holders or between buyers and sellers of equity.⁵ These levers create value for the shareholder but do not add to the competitive position of the company, nor are they sustainable. Adding sustainable value to the company can therefore only be done through operational value creation.

For this reason, limited partners will allocate their capital commitments increasingly to those private-equity funds that can prove their track record in operational value creation. For private-equity firms, it is a matter of survival to prove that they can do so. “They all say the same thing,” said another limited partner about private equity's business model for value creation, “but the differences among firms are huge.”

1. BCG and IESE (2008).

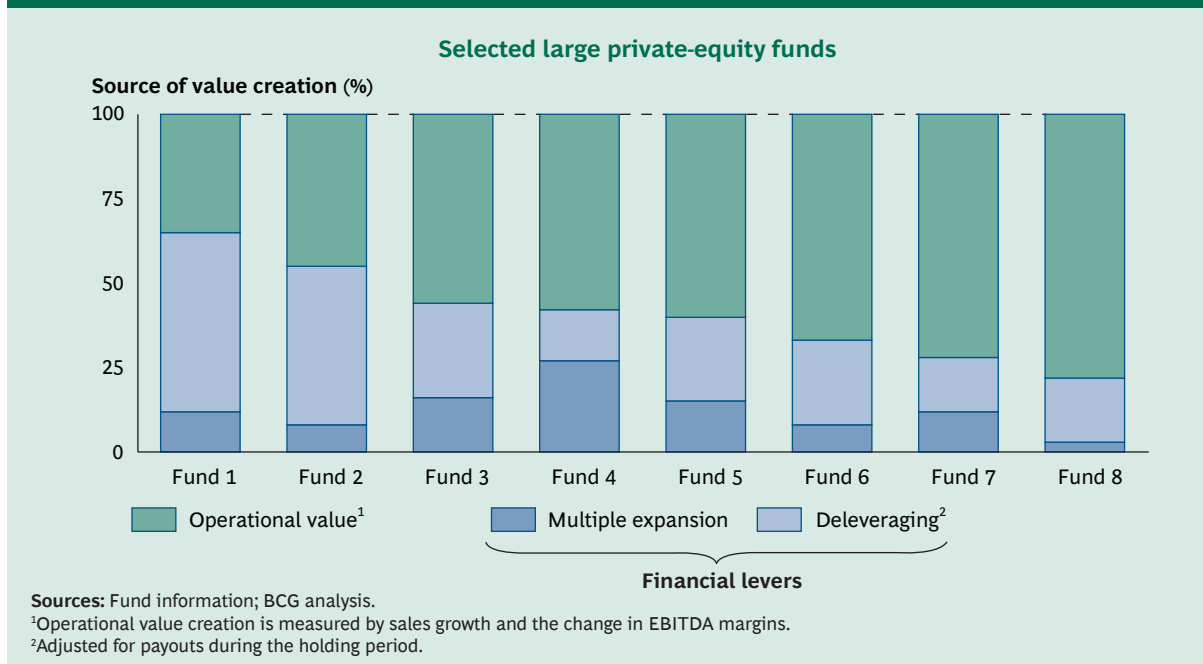
2. BCG and IESE (2009).

3. Institutional Limited Partners Association (2009).

4. Multiple expansion is measured by the change in the ratio of the value of the total enterprise to EBITDA. Deleveraging is measured by the change in net debt adjusted for dividends.

5. Multiple expansion can be attributed, in part, to operational value creation if a company gains higher growth momentum and the EBITDA multiple expands as a result. However, we consider most multiple effects to be due to changes in capital market expectations.

Exhibit 1. The Sources of Value Creation Vary Widely Among PE Firms



How to Create Operational Value as an Owner

To guide owners seeking to improve the competitive position of their companies, we have developed a framework comprising nine levers with an empirically proven impact on operational value. They can be divided into two categories:

- ◇ *Table Stakes:* the most fundamental levers that private-equity firms must have in order to be on the radar screen of investors. Relatively easy to prescribe and acquire, they can be applied relatively quickly.
- ◇ *Differentiators:* the levers that make a real difference to investors. Driven by capabilities and experience, these take longer to acquire.

Table Stakes

We have ranked table stakes according to the importance attributed to them in our interviews with limited partners investing in private equity. (See Exhibit 2 for the rankings of both table stakes and differentiators.)

Frequent Evaluation of Top Management. Research has proven that companies that evaluate their CEO and other top managers on a yearly basis produce a superior return on investment (ROI).⁶ The starting point for all owners is a performance evaluation of the current management to compare its capabilities with the company's future requirements. As one limited partner put it, "You need different managers for growth than for a cost-cutting period." There are several approaches to evaluating managers, including competency-based structured interviews, personality profiling, ability testing, team observations, 360-degree feedback, and reference checks.

An assessment of managers is only useful if it has consequences, from supporting and developing the company's existing managers to replacing them or modifying their responsibilities. However, owners often replace managers too late, either because they do not recognize the need for change or because they are reluctant to admit that they made a poor selection. Decisions at family-run companies involve the extra

6. Kula (2005); Nadler (2004); Lawler, Finegold, Benson, and Conger (2002).

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.

complication of the owner's personal or emotional involvement, which gives the company its unique identity but sometimes leads to avoidance of constructive conflict with management. In fact, there is a significant positive correlation between company performance and the forced replacement of managers with outsiders.⁷ This finding does not necessarily support a hire-and-fire approach, but it does argue for assessing management according to its match with the company's defined business strategy.

A Strategy That Yields a Quantum Leap Forward. If enacting strategy is already the core task of top management, why does it add value if the company's *owners* drive the definition and implementation of strategy? Our research and interviews suggest that the key reason is that a good strategy—one that is unique, surprising, and sustainable, and that disturbs market equilibrium—requires a disruptive impulse.⁸ Such a strategy results in a quantum leap forward in competitive position that is strongly correlated with sustainably high performance.⁹

It is rare for organizations to create such disruptive impulses themselves. Often they need a trigger event, either a crisis that threatens their very existence or a directive from the owner to force healthy change.¹⁰ In our interviews, limited partners said this was the second most important value-adding role of owners, after the evaluation of management.

Private-equity firms have the unique advantage of being able to use the momentum generated by a change in control to introduce new and previously unconsidered strategies. These are usually developed in a so-called 100-day program (also called a full-potential plan). The more time the firm can commit to such a program, the better the portfolio company's performance and returns.¹¹

In contrast, public companies must build on the yearly strategic-planning process. In a BCG internal study, several corporate clients said repeatedly that traditional corporate planning does not yield the desired quantum leap. "I know before we start the strategic planning what the outcome will be: a bit more than last year, but nothing overly ambitious," admitted one corporate planner. But public and family-run companies, too, can undertake strategy programs like those of private-equity firms. (See the sidebar "A 100-Day Private-Equity Program at a Public Company.")

Another advantage of private-equity firms is that they invest in companies with the clear intention of selling them after a certain period. They naturally have a buy-to-sell mentality that is directly correlated

7. Helfat and Bailey (2005); Kula (2005); Nadler (2004); Lawler, Finegold, Benson, and Conger (2002); Khurana and Nohria (2000).

8. BCG (2001).

9. BCG (2001).

10. Applegate (2007).

11. Acharya, Hahn, and Kehoe (2009).

A 100-Day Private-Equity Program at a Public Company

“If tomorrow we had a new owner, I know what I would do differently. But as the acting head of this successful company for more than ten years, how can I do something radically different next Monday?” asked the CEO of a large Nordic company, a leader in its industry.

Ultimately, he did do something different, launching a 100-day private-equity-type initiative involving a team of five corporate staff and about 20 business-unit managers. The outcome was game-changing initiatives that had been identified before but never acted upon. Those involved praised the approach:

- ◇ “This was a useful wakeup call for us.”
- ◇ “Particularly interesting for transforming corporate staffs.”
- ◇ “We have seen bold opportunities before, but this allowed us to really follow up on them.”
- ◇ “Today we see corporate staffs that are too demand driven. They also need to challenge the business-unit managers.”
- ◇ “We need to find ways to do a full revamp every three to five years.”

with performance. “Not only does ownership by a private-equity firm (which typically runs from three to seven years) give management the ability to take a long-term view, it also provides an indisputable point of proof at exit. In addition, it means that management will not jeopardize the value of the company by making short-term strategic decisions that are then left to its successors to justify or write off.” This statement by the chairman of the board of a large European company is supported by BCG’s research, which found that companies that engage in more M&A activity generate a 10.8 percent higher median annual return.¹²

The buy-to-sell mentality is something that public and family companies can learn from.¹³ For owners, the best time to sell is when they have made their maximum contribution to the competitive position of their company. Some leading family-owned companies regularly challenge businesses on their future potential and, if none can be demonstrated, sell them off. One family conglomerate has completely transformed itself using this approach. Most of the businesses that were owned in 1982 have been divested and many of today’s businesses were acquired in the past 25 years. “If we as a family believe that the peak of the life cycle is near, we will sell the business,” said the current chairman. “It could be that there is no strong potential for the business, or it could be that we just do not see it. The consequence will be the same.”

Closeness to the Business. “The greatest advantage for private-equity firms is that they are legal insiders,” said one of the leading investors in private equity in Europe. Here we see private equity adopting a best practice from family owners. In best-in-class family-owned businesses, the owners have a full understanding of operational and financial measures. Best-practice family boards also operate intensively in the field: there are regular meetings and site visits and the chairman keeps an office at the company. Evidence suggests that strong performance at family businesses is driven by the close presence of family members and a more active communications policy—in short, by an effective monitoring system.¹⁴

Unlike most family-run companies, however, private-equity firms also have the benefit of best-in-class key performance indicator (KPI) systems. Top firms have dedicated teams with experience in implementing a lean and tailored set of about ten KPIs. Rather than monitor standard financial metrics, they focus on a few financial and operational figures that reflect the true value drivers of the business’s long-term sustainable competitive position.

In addition, some private-equity firms hold weekly calls of all deal partners, with each reporting monthly on company performance and explaining deviations from the budget and the countermeasures taken.

12. BCG (2005).

13. Barber and Goold (2007); Faleye (2007); Bebchuk and Cohen (2005); Coates (1999); Nuttall (1999); Mahoney, Sundaramamurthy, and Mahoney (1997); Franks and Mayer (1996).

14. Amit and Liechtenstein (2009).

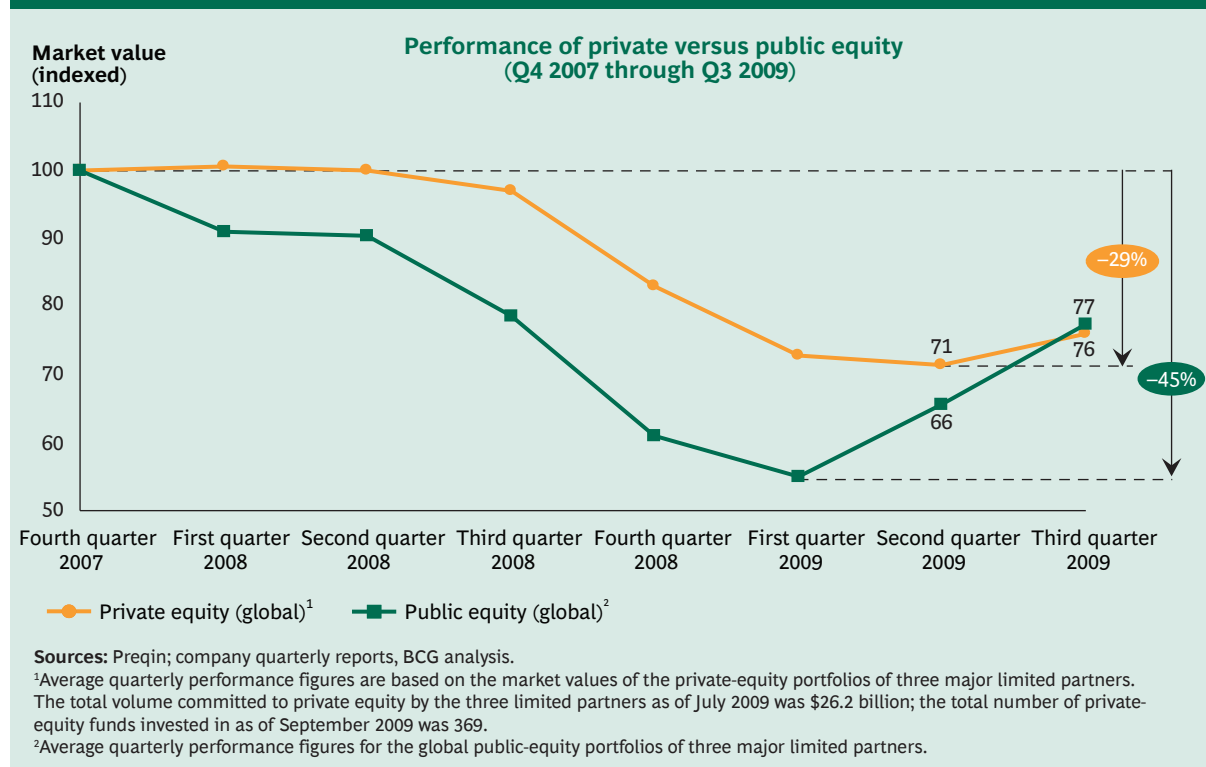
A Sense of Urgency. “We observed many private-equity firms already starting to prepare their portfolio companies by the end of 2007—way ahead of the Lehman collapse,” one limited partner told us. “During the financial crisis, these firms on average definitely responded more quickly than public and family companies, cutting costs and withdrawing from large growth investments,” said another investment manager. There was a consensus among our interviewees that private-equity owners reacted faster than their peers at public companies during the crisis. One of the reasons they did so was their higher level of debt, which created a heightened vigilance on risk. But more important for their own competitive position, it created a sense of urgency that prompted decisive action in response to the crisis.

Exhibit 3 shows the value of public- and private-equity investments for three major limited partners that invested in more than 370 global private-equity funds and a large number of public equities. The private-equity funds dropped less during the crisis (–29 percent) than the public-equity portfolio (–45 percent).¹⁵

Management Incentives with a Strong Element of Risk Sharing. Which of the different incentive systems, such as stock options or equity participation programs, enhance the competitive position of a company? Are incentives a real lever for high performance? Research confirms that there is a significant and positive impact on a company’s performance when the equity stake held by managers increases, and that these direct equity stakes are more effective than stock option programs at creating a share in downside risk.¹⁶ What’s more, a lack of participation in downside risk can lead to managerial underperformance and even fraud.¹⁷

Why is this the case? Or even more interesting, why is this *not* the case for some successful family-run

Exhibit 3. Companies Owned by Private-Equity Firms Fared Better During the Crisis



15. Valuations in private equity typically lag one quarter behind those in public equity. For the private-equity values, the multiples of public companies from the previous quarter were used. We understand that private-equity firms have some flexibility with regard to mark-to-market valuations, but we believe that the analysis is a good proxy for earnings performance.

16. For the effect of increased equity stake of managers, see BCG (2009) and Fahlenbrach and Stulz (2008). For direct equity stakes versus stock options, see Mehran (1995).

17. Johnson, Ryan, and Tian (2009); Chesney and Gibson (2005); Habib and Ljungqvist (2005).

companies that do not share equity with their managers? In these businesses, the family is deeply involved in risk assessment, and the CEO is not empowered to make decisions on risk (or any other major decisions). But in cases where the owner is not engaged in this way, we believe that alignment on risk must be created through incentives. “If the upside and downside risk is different for managers than for owners, the most logical way for managers to create value for themselves is to run a much higher risk profile than the owners would,” said one limited partner.

In private-equity deals, it is common practice for senior managers to invest between one and two times their annual salary into equity when the deal is structured, an amount up to five times higher than at comparable public companies.¹⁸

An Effective Board with Firepower. The relevance of boards greatly varies among public companies, family companies, and private-equity firms. In many jurisdictions, public companies have strict legal guidelines regarding the size and processes of their boards (including nonexecutive boards, where applicable). Family businesses have individual and diverse governance setups, whereas part of the private-equity firm’s business model (apart from the M&A function) is to oversee the boards of its portfolio companies.

The largest difference we found was in the firepower of the boards of private-equity firms compared with those of public and family companies. Private-equity firms have significant resources to support the activities of their boards because fees for management activities can be 2 percent of the fund’s value. These activities range from acquiring external industry and functional expertise to engaging a broad network of advisors. Without equivalent firepower, public boards cannot add to the competitive position of the company.

Another factor is board size and the resulting speed and efficiency with which decisions are made.¹⁹ Smaller boards are more efficient and can therefore make decisions more quickly. Empirical research indicates that companies with boards of five to seven members show better performance than their larger peers.²⁰ If a smaller board is not feasible, family companies and companies held by private-equity firms frequently put in place a separate shareholder committee.²¹

The board’s agenda determines how board members will spend their limited time. To achieve maximum impact on company performance, the agenda should be set by the whole board, not just by the CEO.²² The boards of private-equity firms spend substantially more time on operational business strategy than the boards of public companies. Driven by public-accountability requirements and bureaucratic structures, public companies waste too much time on nonstrategic issues such as compensation, compliance, and auditing.²³

The boards of top-performing companies meet at least nine times a year.²⁴ To ensure the necessary focus and dedication and allow for frequent meetings, board members should serve on no more than three different boards at the same time.²⁵

The majority of the board members should be independent to avoid conflicts of interest. In addition, in order to encourage scrutiny of management by the board, the appointment process should be free from CEO influence, and there should be fixed terms to encourage vigilance by ensuring turnover.²⁶ At private-equity firms, appointment to the board is free from CEO influence, a majority of members are indepen-

18. Leslie and Oyer (2008); Pass (2003); Kaplan (1989); Muscarella and Vetsuypens (1990).

19. Guest (2009); Eisenberg, Sundgren, and Wells (1998); Yermack (1996).

20. Yermack (1996).

21. Addison, Siebert, Wagner, and Wei (2000); Becht, Bolton, and Röell (2002).

22. Lawler, Finegold, Benson, and Conger (2002); Nadler, Behan, and Nadler (2005).

23. Acharya, Kehoe, and Reyner (2009).

24. Acharya, Kehoe, and Reyner (2009); Brick and Chidambaram (2007); Vafeas (1999).

25. Regierungskommission Deutscher Corporate Governance Kodex (2009); Loderer and Peyer (2001).

26. Regierungskommission Deutscher Corporate Governance Kodex (2009); INTES (2004); Finkelstein and Mooney (2003); U.S. Securities and Exchange Commission (2003); Warther (1998).

dent, and former CEOs are excluded from the chairmanship.

Differentiators

Empirical research and the views expressed by our interviewees indicate that what fosters company performance is the owner's track record, industry expertise, and experience in the region in which the company operates.²⁷

Ownership Experience. “Never do it for the first time,” said one limited partner about his investment criteria—meaning that he will not invest either in new funds or with new teams unless there is a track record of success. Even when a fund manager claims to have in place all the table stakes described above, it is experience that makes the difference.

This investor's advice is backed up by empirical evidence. In a 2005 analysis conducted at St. Gallen University of 1,130 private-equity transactions, the highest positive correlation with IRR performance, among many factors, was the “number of previous deals undertaken.”²⁸ This result was confirmed by another international research team in 2008.²⁹

Investors in private-equity firms have long acknowledged this correlation by investigating the track records of a firm's managers and then establishing so-called key-man clauses to link capital commitments to the continued presence of the most high-performing individuals.

Industry Expertise. Owners cannot judge whether management is making the right operational decisions and hold the CEO accountable unless they have sufficient insight themselves into the company's industry. Owners need to find ways to obtain and update industry expertise in order to stay engaged.

Once criticized for having only financial engineers on board, today many private-equity fund managers are including more industry experts on their teams. Leading private-equity firms also seek to ensure sufficient industry expertise on the portfolio company's board, either through their own specialized operating partners or through external senior-advisor networks. The limited partners we interviewed said that the variation in effectiveness of these senior advisors is huge, and that the challenge is to get them engaged in operational value creation. As one interviewee put it, “Just big names and three calls a year won't work. But if you really get them in the field, they are a tremendous value added.”

Regional Experience. An understanding of regional complexity is another crucial requirement for a value-adding owner. For example, restructuring a business with a manufacturing footprint in France, Germany, and Russia requires very different skills from those needed for a business operating in the United States and Mexico. It is crucial for owners to understand the risks and opportunities when investing in particular markets. Family companies with deep roots in local markets represent best practice when it comes to regional experience, but they sometimes lack the capabilities needed to build a global presence.

The limited partners behind private-equity funds are wary of “style drift”: the movement of fund managers into regions where they have no track record, no experienced team on the ground, and no connections in the relevant business community. (Examples of style drift are distressed funds created for opportunistic reasons and investments by private-equity firms in new geographic regions or new sectors, such as financial services.) As one limited partner said, “The sweet spot is very important: is the planned fund consistent with the experience of the fund managers?” To acquire the needed local expertise, private-equity firms are seeking partnerships with local firms when they enter new regions.

Implications for Private-Equity Firms

The survival of private-equity firms will depend on their ability to convince limited partners of their

27. Isakov and Weisskopf (2009); Lopez-de-Silanes and Phalippou (2008); Loos (2006); DeClercq and Dimov (2003).

28. Loos (2006).

29. Lopez-de-Silanes and Phalippou (2008).

performance in terms of the table stakes and differentiators described above. In our interviews, limited partners assessed the current performance of private-equity firms across the nine levers essential to enhancing operational value. “Top performer” and “rather good” ratings were earned by as many as 83 percent and as few as 53 percent of firms; “weak” and “rather weak” ratings were earned by as many as 47 percent and as few as 17 percent of firms. (See Exhibit 4.)

Anecdotal evidence from our interviews indicates that improvement is needed in several areas:

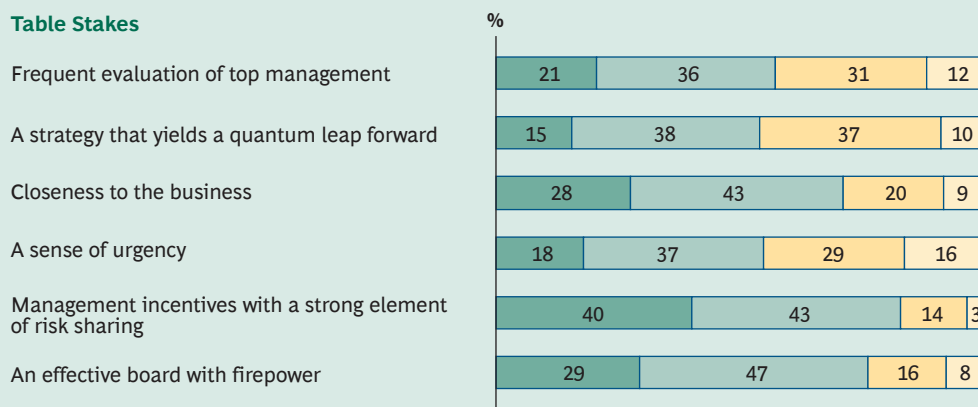
- ◇ All private-equity firms have evaluation of top management constantly on their agenda, but some focus too quickly and exclusively on replacement. As one limited partner said, “Sometimes you don’t need a rapid exchange. When a company is not doing well, the private-equity firm will sometimes replace the CEO more as a desperate move than anything else, without any significant effect.”
- ◇ Many firms miss the chance to define a clear strategy. According to one limited partner, “Having a clearly defined strategy for the portfolio company is decisive for value creation; it sounds obvious, but in most cases private-equity firms forget to define their strategy before jumping into operating mode.”
- ◇ The danger of KPIs is that not enough attention is paid to qualitative monitoring. Another limited partner said, “Private-equity firms have good systems in place, but sometimes they miss trends in the business and in the portfolio companies. This is not something you can monitor; it’s a matter of experience in the field.”

In the future, limited partners will focus their due diligence on a fund’s ability to create operational value. Indeed, some investors we spoke with were working on new checklists for scrutinizing funds against this criterion. This new emphasis will require private-equity firms to benchmark themselves against their own performance and the best practice of others.

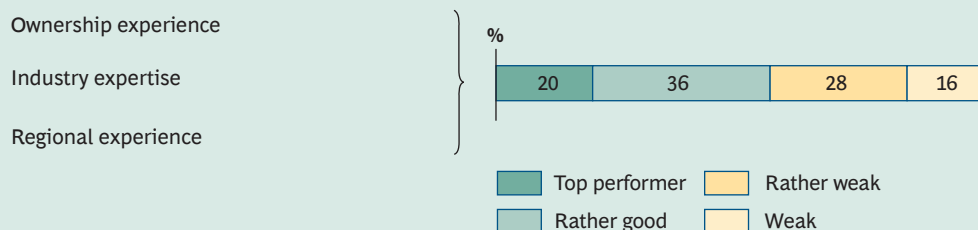
Exhibit 4. Many Private-Equity Firms Are Not Performing Well Across the Key Levers

Results from 20 in-depth interviews with limited partners

Table Stakes



Differentiators



Source: BCG analysis.

Implications for Public and Family-Owned Companies

We believe that the current economic crisis resulted from the increasing disengagement of owners from their businesses. In 1989, Michael C. Jensen predicted (in “Eclipse of the Public Corporation”) a long-term decline in the publicly held corporation because of the “central weakness of the large public corporation—the conflict between owners and managers over the control and use of corporate resources.”³⁰

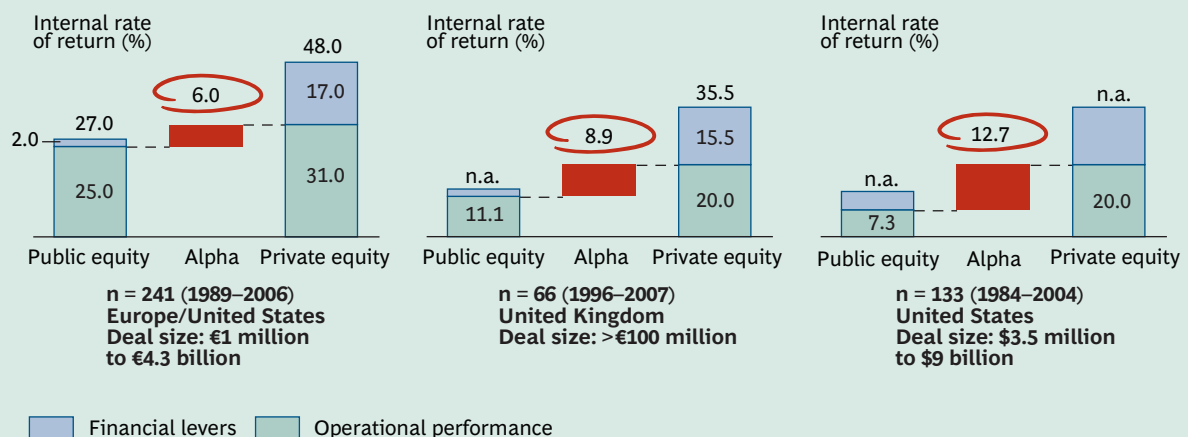
Public companies with a major shareholder have a structural advantage in overcoming this type of disengagement because they pay close attention to the business, and these companies do outperform relative to their peers.³¹ This finding is in line with recent academic studies comparing the operational performance of public companies with their private-equity peers, which, by definition, have a major shareholder. According to three different studies, private-equity-owned firms outperform their public counterparts in operational value creation by 6 to 12.7 percentage points per year, depending on the characteristics of the sample used.³² (See Exhibit 5.)

The differences are, in our opinion, a function of table stakes and differentiators. These levers are easier to apply when there is a dominant shareholder, as in private equity, or when public companies have a large investor. But all companies, regardless of ownership type, can adopt the value-adding principles discussed in this paper to ensure a continuous striving for a long-term sustainable competitive position.

We believe that private equity sets a good example in terms of the following levers:

- ◇ *Providing boards with firepower.* Private-equity firms empower boards to drive the agenda of board meetings and to acquire the systems, platforms, and resources needed to gain a deep understanding of the business.
- ◇ *Evaluating top management yearly in a sophisticated way.* The limited partners we interviewed said that the biggest shortfall of public companies—after a lack of firepower in their boards—is that in some countries, evaluation of top managers during the five-year contract period is rare.
- ◇ *Implementing a 100-day program.* In contrast to the standard strategic-planning process at public

Exhibit 5. Public Companies Create Less Operational Value Than Peers Owned by Private-Equity Firms



Sources: Respectively, from left to right: Achleitner (2009); Acharya, Hahn, and Kehoe (2009); Groh and Gottschalg (2008).

30. Jensen (1989).

31. BCG (2006).

32. Achleitner (2009); Acharya, Hahn, and Kehoe (2009); Groh and Gottschalg (2008).

companies, these programs foster the buy-to-sell mentality of best-practice firms.

- ◇ *Selecting board members with extensive ownership experience and knowledge of the industry and region.* Every board should include a member with previous experience on several boards, a member with deep knowledge of the industry, and a member who understands the specific regional challenges that the company faces.
- ◇ *Ensuring that top management has a significant equity stake in the company.* The CEO and potentially some other senior managers should have an equity stake of at least a year's salary.

Engage—or Fade Away

The private-equity industry has shown that owners with a dedication to operational value creation build a larger market share in the industry than those that create value through financial levers. And operational value creation is a product of engaged ownership. We believe that in the future, businesses with engaged owners will enjoy a superior competitive position and that competitors with disengaged owners will fall back, ultimately yielding a lower equity return. Moreover, to prevent another crisis, owners must take responsibility for ensuring that their businesses are creating value sustainably.

The financial crisis exposed deep flaws in governance models and, in particular, a lack of oversight by the owners of public companies. In the United States, Congress is considering various measures to overhaul corporate governance and incentive schemes. In the United Kingdom, the Walker Review has criticized institutional investors' lack of engagement and recommended that fund managers be required to commit to a new Stewardship Code, publish voting records, and work together more effectively to influence companies.³³

Limited partners in private equity and other institutional investors who have learned the lessons of the financial crisis will base their investment decisions more and more on whether the owners or representative of the owners (that is, a private-equity firm, a fund's managers, or the board of a public company) are truly engaged. Any owner of a family-run company, any board member, and any private-equity manager must therefore ask: "How can I add to the competitive position of my company?"

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