Private Equity Disciplines for the Corporation

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The world's leading private equity firms consistently have delivered internal rates of return twice as large as the S&P 500's over the past decade. Increasingly, the way they've achieved this is by adding value to the underlying operations they own as well as through financial structuring. And although the PE industry has suffered in the aftermath of the technology boom, top PE firms are continuing to add value to the companies under their ownership. The questions we've been asking are: What is it that the leading firms have done? How much of their approach could apply to publicly traded corporations?

In studying more than 2,000 private-equity transactions over the past 10 years, we've come to the following conclusion: Although PE firms do create a lot of value through financial engineering, the secret to the top performers' success lies in the rigor of the managerial discipline they exert and the performance culture they engender. How do they do it? They rigorously focus on accelerating growth in their businesses' value through just one or two key initiatives. They narrow their sights to widen their profits. Specifically:

- They clearly define their investment thesis and its time frame to fruition;
- They hire managers who act like owners;
- They focus management teams and their employees rigorously on just a few measures of success;
- They make their capital work hard and retire, sell, or otherwise redeploy underperforming assets quickly; and
- They make the center an active shareholder.

We believe these five management disciplines explain much of the success of the leading private-equity firms. And public company executives can adopt them to reap significantly greater returns.

DEFINE A THREE- TO FIVE-YEAR INVESTMENT THESIS

The first thing PE firms do when they acquire a business is define an investment thesis they believe will pay off in the medium term. They take a three- to five-year view, the amount of time they expect to hold the company. This differs from competing pressures at many corporations to hold a short-term view to meet quarterly or annual shareholder expectations, and, simultaneously, a long-term view that says, "We'll own this company forever." Rather, PE firms create a policy that states how they will make the business more valuable and realize benefits for owners before they exit the business. A good thesis is extraordinarily simple, and provides a much clearer basis for action than the typical financial target of "last year's earnings plus x%" that most public companies use. The fact that PE firms take this medium-term view allows them to out-invest competitors with short- and long-term views in whatever industry or business they happen to be.

Consider the simple investment thesis that Bain Capital used for contact lens maker Wesley

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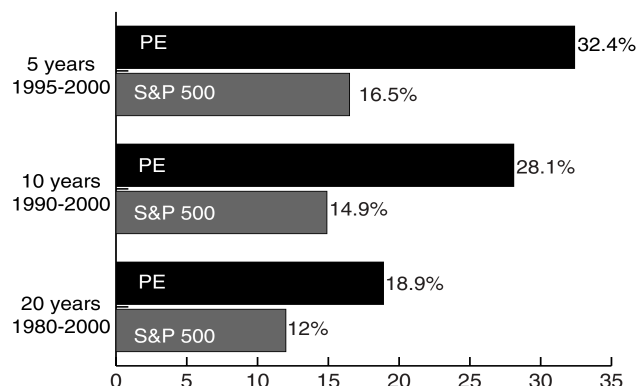
EXHIBIT

PE Firms Have Consistently Outperformed the S&P 500



Source: Venture Economics Information Services and Bloomberg.

Jessen, a company it bought from Schering-Plough in 1995. Over the years, Wesley Jessen had been a leader in specialty contact lenses (primarily colored lenses and toric lenses used to correct astigmatism). But in the early 1990s, it strayed into competing head-to-head in the mass market against two 800-pound gorillas, Johnson & Johnson and Bausch & Lomb, and wound up in a perilous cash position.

When Bain Capital acquired Wesley Jessen, it brought in a new management team to pursue a back-to-basics thesis: Return to the core specialty-lens business, and focus on core customers—eye doctors. A factory built to produce standard lenses was retooled to make specialty lenses. The company stopped serving unprofitable customers such as high-volume retail optometry chains, and began out-investing its competitors in the specialty market. Wesley Jessen cut spending on advertising and promotion, and eliminated many positions, including several levels of management in manufacturing. It simultaneously expanded its product range in specialty lenses and made selective acquisitions to bolster its leadership position in that core market.

The investment thesis proved a resounding success. On the strength of its turnaround, Wesley Jessen completed a successful initial public offering in 1997, creating a 45-fold return on equity for its investors in less than two years.

HIRE MANAGERS WHO ACT LIKE OWNERS

The management disciplines imposed by private-equity firms require a certain type of executive—one predisposed to act as an owner, not an administrator. They go for top talent, but they define that talent not only in terms of skills and track record but also attitude. PE firms hire for this specific profile, and they motivate their hires by giving them equity in the company they are running—so they truly become owners. Then the firms establish non-executive board governance for each portfolio company and give the board members equity too, thus aligning all interests around the disciplines.

To find the right talent, PE firms reach wide, looking well beyond the scope of their personal contacts. In one-half to three-quarters of cases, they appoint key executives from outside the company. They seek managers who, however experienced, are hungry for success and relish the challenge of transforming a company. PE firms also find ways to hold onto talent: They retain great CEOs by bringing them back into the fund or appointing them to newly acquired portfolio companies.

FOCUS ON A FEW MEASURES

Top PE firms steadfastly resist measurement mania. They zero in on a few financial indicators: Those that most clearly reveal a company's progress in increasing its value.

PE firms watch cash more closely than earnings, knowing that cash remains a true barometer of financial performance, while earnings can be manipulated. And they prefer to calculate return on invested capital, which indicates actual return on the money put into a business, rather than fuzzier measures like return on accounting capital employed. However, managers in PE firms are careful to avoid imposing one set of measures across their entire portfolios, preferring to tailor measures to each business held. "We use *their* metrics, not our metrics," says James Coulter, founding partner of U.S. private-equity firm Texas Pacific Group. "You have to use performance measures that make sense for the business unit itself rather than some preconceived notion from the corporate center."

PE firms put teeth in their measures by tying the equity portion of their managers' compensation to the results of the managers' units, effectively making these executives owners. Often, management teams own 10% to 20% of the total equity in their businesses, through either direct investment or borrowings from the PE firm. Public company executives may believe they're doing the same thing when they grant options to their line managers, but they're usually not. Those arrangements typically give managers a stake in the parent company, not the unit. But there are ways for public companies to structure compensation as PE firms do. For instance, bonuses tied directly to the unit's performance, not the entire company, can be increased as a proportion of overall compensation, with an offsetting decrease in cash compensation.

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MAKE CAPITAL WORK HARD

On average, PE firms finance about 60% of their assets with debt, far more than the 40% typical at public companies. The high debt-to-equity ratio helps strengthen managers' focus on cash as a scarce resource. But PE firms also make capital work harder, looking at balance sheets not as static indicators of performance but as dynamic tools for growth. They expect all capital deployed in the business to earn strong returns; if it underperforms, they quickly redeploy it. This often means cutting pieces out of the business.

Consider how the U.S. firm GTCR Golder Rauner redeployed capital to turn around its SecurityLink unit. GTCR quickly established a single-minded investment thesis for the security systems company: Pursue rapid growth in carefully targeted regional markets, because regional market share, not national, was the key to profitability. This strategy created immediate opportunities to rework the balance sheet of the company. First, GTCR released capital by selling a third of SecurityLink's offices—those lying outside the target markets. Then it shifted capital previously tied up in serving dealer and mass-market channels, which were less profitable, and refocused it on building direct sales capabilities in the target regions. By focusing on fewer markets, the company was also able to dramatically reduce costs, cutting more than 1,000 sales and service jobs. The result? SecurityLink transformed itself from a loss maker to generate close to $100 million of pro forma pretax earnings in less than a year. GTCR next sold SecurityLink to alarm giant ADT, growing its investors' $135 million initial equity investment to $586 million in just 13 months.

MAKE THE CENTER AN ACTIVE SHAREHOLDER

As public companies grow, headquarters' role tends to shift toward administration, becoming, in essence, mere employers. This isn't so at successful PE firms, where corporate staffs view themselves as active shareholders, obligated to make investment decisions with a complete lack of sentimentality. PE firms maintain a willingness to swiftly sell or shut down a company if its performance falls too far behind plan or if the right opportunity knocks. "Every day you don't sell a portfolio company, you've made an implicit buy decision," says TPG's Coulter.

PE firms are equally unsentimental in their approach to their headquarters' staffs, seeing them as part of their transaction costs. Although their portfolios may represent several billions in revenue, their corporate centers are extremely lean. According to analysis conducted by Bain & Company, the average PE firm has just five head office employees per billion dollars of capital managed (the combined value of debt and equity), one-fourth the number at a typical corporate headquarters.

A POWERFUL AGENDA

Private-equity firms increasingly are tackling operational improvements and revenue opportunities to add value to the businesses they own. And they are achieving success by focusing on a straightforward, powerful, set of managerial disciplines that direct both what happens, and who makes it happen. The action agenda includes clearly defining a company's investment thesis; tracking its progress via a few key metrics; and quickly redeploying capital that underperforms. The people agenda is twofold: PE firm partners view their own role at the center of a portfolio of companies as that of dispassionate shareholder—willing, themselves, to exit and redeploy cash if businesses underperform. However, these same partners hire managers for each company with a bias for their company's odds of success—who have the skill and will to succeed. The center incents them to do so.

The good news for corporations is these disciplines travel. A few publicly traded companies, like General Electric and Montreal-based Power Corporation, have long managed their businesses with the rigor of private-equity firms—and with great success. More recently, companies like U.K. conglomerate GUS PLC are adopting the disciplines and getting results. Recounts GUS Group Chief Executive John Peace: "Investors were concerned that GUS was failing to manage major changes in the business—and they were right. We sat down and asked ourselves, is GUS really an unwieldy conglomerate, should it be broken up? Instead, we realized that there were a number of real jewels in GUS, genuine growth businesses that could provide a new focus for the group. Our role was to make sure that those businesses [delivered] to shareholders." With GUS's share price rising 75% since January 2000, in a declining market, some investors must feel that their order has been filled.

ENDNOTE

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