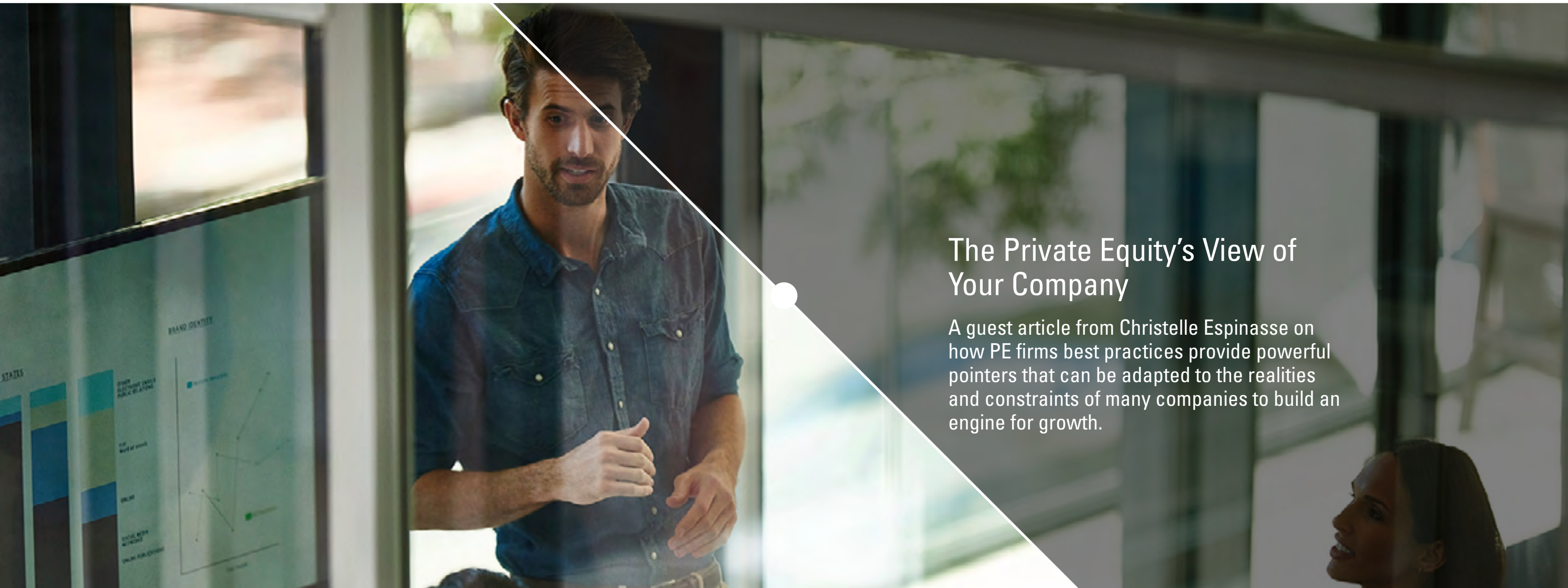

The Private Equity's View of Your Company

A guest article from Christelle Espinasse on how PE firms best practices provide powerful pointers that can be adapted to the realities and constraints of many companies to build an engine for growth.

'WHETHER IT'S BROKEN OR NOT, FIX IT – MAKE IT BETTER. NOT JUST PRODUCTS, BUT THE WHOLE COMPANY IF NECESSARY.' – BILL SAPORITO

One of the key, often understated, elements of value creation by some Private Equity (PE) firms for their portfolio companies is the ability, as an external investor (or that of any external advisor), to provide an 'outside in' perspective, at least in the first few months following the acquisition. This enables a business review through an objective and dispassionate prism i.e. in a very analytical, facts based, manner not hampered by the many cognitive biases of the leadership team that's already in place (e.g. rationalisation of past decisions and related emotional attachment, endowment effect, mental accounting, status quo or inside view, to name just a few).

All companies are in business to create value for their stakeholders. Some businesses successfully set the correct value creation course, and sustain it over time, while others fail. So take a few minutes today to put yourself in the shoes of an outside investor and his 'outside in' perspective of your business: What would they identify that needs to change about the activities your company is currently performing, or how would they create additional value above and beyond the way it is currently managed?

1. **Change the budgeting mind-set of last year's default assumption**, and re-set the discussion to challenge vigorously every dollar in the annual budget, thereby building a culture of cost management. Zero-Based-Budgeting (ZBB) is a tool often used to look for the most efficient return on spending, from the bottom up. It provides greater visibility on cost drivers and categorises each activity between "must have" (e.g. a legal or regulatory requirement), "required to have to support differentiating capabilities" and "nice to have". The objective is to eliminate as many "nice to have" expenses as possible, to help identify unproductive activities that can then reallocated to growth-related activities e.g. marketing, sales, and M&A.

2. **Instill a sense of urgency on cash generation capabilities**. This starts with a tight management of accounts receivables and payable, as well as an optimisation of inventories, linked to the abovementioned scrutinisation of lower-value discretionary expenses, and optimisation of high-value spending. This creates a different corporate mindset: stop managers trying to prove why something is the way it is, and start thinking actively about ways to make it better the way they would if money is was coming out of their own pocket. This includes a shift to "arguing things in" rather than "arguing things out" and the realisation that no spending is too small to be reviewed as one hundred small changes that save $100,000 apiece still add up to $10 million.

3. **Maintain a laser-like focus on long-term value creation**. Developing and implementing a strategy that will position the company for long-term growth and profitability involves making judicious choices: eliminating low-value activities now, to capture short-term cost benefits, while at the same time investing in the highest-potential ideas to create core value. This requires taking an objective and dispassionate view to decide what is really core to the business, where the growth potential lies, and how to capture it. Deciding what to stop doing is usually difficult for most businesses. The eponymous cognitive biases such as endowment, preference for status quo or emotional attachment easily blur what should be an objective and dispassionate assessment (e.g. exiting business lines that will no longer draw on the company's core strengths, and differentiating capabilities to be built going forward).

4. **Do not underestimate the need for speed**. The PE world exhibits a bias towards action, as exemplified in the eponymous 100-day program that they impose on their portfolio companies during the first few months of ownership. They view this time as the most critical to rapidly make decisions to implement the strategic changes they have identified, to the detriment of consensus building and alignment. Although most business do not have as much freedom and have to navigate layers of oversight, it is important to find the right balance between the need for consensus building and alignment to drive change, and the recognition that not acting fast enough carries an opportunity cost: waiting too long to implement necessary changes can profoundly impact the company's future outcomes.

5. **Select the right team**. Strong and effective leadership teams are so critical to the success of PE firms' investments that they sometimes invest in a company based of the strength of its management talent. The underperforming ones are promptly replaced: CEOs of one third of portfolio companies exit in the first 100 days. Middle managers are even more critical to the successful execution of a strategy. Talent management is not a frivolous activity – it is a must to success, and often businesses do not put the effort up-front to secure the right team.

6. **Select key metrics and set aggressive but realistic goals**. PE firms manage their portfolio companies by developing a select set of key measures, in few areas critical to the success of the acquired company. They then set clear and aggressive targets and track them, relentlessly. Many businesses already exhibit some performance tracking through key measures, but they are usually disconnected from long-term value creation. The long-term strategy should drive a set of specific initiatives, with explicit objectives that should then drive annual plans and budgets, i.e. there is a direct operational link between the strategy and the business.

7. **Align performance and incentives**. PE firms pay modest base salaries to their portfolio company managers, but add highly variable and annual bonuses based on company and individual performance, plus a long-term incentive compensation package tied to the returns realised upon exit. As a result, the fortunes of CEOs and their leadership teams are directly linked to the performance of their businesses; soaring when they succeed, but suffering when they fail to achieve objectives. Bonuses are only paid when the handful of aggressive but realistic performance targets are achieved, unlike bonuses at most businesses, which have become an expected part of overall compensation, irrespective of performance. Setting a tighter link between pay and performance, particularly over the long-term (instead of the current year) helps to truly reward star talent and stimulate a high-performance culture.

PE firms enjoy a number of natural advantages when it comes to building efficient, high-growth businesses, but some of their best practices provide powerful and broadly applicable pointers that can be adapted to the realities and constraints of many companies to build an engine for growth.

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