Managing Against Time

The Distinct Discipline of Managing Private Equity-Controlled Companies – Part II

The fundamentals of private equity ownership have a crucial impact on the CEO task of managing private equity-controlled companies (PECCs). Consequently, the role of the CEO of a PECC is a distinct leadership discipline. This is the second of three papers to be posted.

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As described in my previous post*, Managing on Steroids (https://www.linkedin.com/pulse/managing-steroids-being-ceo-private-equity-portfolio-lilienfeldt),* the very discipline of managing private equity-controlled companies (PECCs) is fundamentally different from managing conventionally owned companies, i.e., listed or family-owned corporations.

The context in which a PECC operates is characterized by five business model attributes all centred around the time and timing:

1. An exit event is predefined and is the only source for realizing value creation for a PE fund.

2. The time-to-exit is predetermined and short. From entry to exit, the aspired time horizon is less than five years.

3. Success defined at exit is extremely ambitious and pre-set**.** Performance of private equity funds are specifically measured by *net-IRR* and *Money-Pay-Back* (MPB) multiples. The bar is high and disconnected from market performance.

4. The equity injection by the private equity ownership is not a *calculated* cost-of-capital expense, but a real and *expensed* cost factor.

5. The time of ownership by the private equity fund carries an explicit and expensed cost. This is in sharp contrast to conventionally owned companies, where time might be a very intangible cost.

The common denominator for these five fundamentals is the notion of *time*: The time to the exit event is given, the value creation requirements are time restricted and time carries a heavy and explicit cost. It is the time factor that drives the distinctness of the CEO role in private equity-owned companies.

As noted above, the performance of private equity funds is specifically measured by *net-IRR* and *Money-Pay-Back* (MPB) multiples. The bar is high: The return benchmarks of European PE funds from 1994-2012 show that the top quartile was 24% NET IRR and 1.9X MPB. The return requirements are absolute and disconnected from the general market performance during the lifespan of a fund.

Table 1. EUROPEAN IRR AND MBP RETURNS 1994-2012.

Benchmark Name	No. of Funds in Benchmark	As at
W Europe	273	Most Up-to-Date

Benchmarks Across Vintage Years:

Benchmarks	Called Up (%)	Distributed (%) - DPI	Remaining Value (%) - RVPI	Multiple (X)	Net IRR (%)
Median	**93.7**	**97.1**	**30**	**1.42**	**13**
Weighted	87.8	77.2	62.4	1.4	11
Average (Mean)	87.6	112.3	45.1	1.59	15.6
Standard Deviation	21.1	97.3	45.4	0.72	16.9
Pooled IRR * (122 funds)					11.4
Quartiles	**Called Up (%)**	**Distributed (%) - DPI**	**Remaining Value (%) - RVPI**	**Multiple (X)**	**Net IRR (%)**
Maximum	n/m	481	227.6	4.89	84
Top Quartile	n/m	179.2	84.8	1.91	24
Median	**93.7**	**97.1**	**30**	**1.42**	**13**
Bottom Quartile	n/m	26.3	0	1.11	6
Minimum	n/m	0	0	0.3	-28

* Pooled IRR is only calculated if there are at least 3 funds with cashflow data.

Source: Preqin Database, 273 W. European PE Funds 1994-2012
DPI: Distributed Paid In
RVPI: Residual Value to Paid In

To fully understand the discipline of managing PECCs, we need to understand how the time factor impacts the disciplines of strategy setting and operational execution; we then need to translate these, if possible, into a methodology that can be applied as a distinct principle for the management of PECC.

We have identified three fundamental implications for the task of managing PECCs:

I. Unlocking Growth

No doubt, the sources of value creation have shifted away from the era of significant leverage and creative financial instruments towards a combination of operational improvements and unlocking growth.

This is confirmed by a study conducted by IESE Business School outlining the value creation dynamics in private equity. The study of 32 portfolio companies in seven

European private equity funds concluded that of the total IRR of 48% generated during the time in question, the sources of the IRR value creation were as follows (Source: IESE/BCG: The Advantage of Persistence, How the Best PE Firms "Beat the Fade." Feb. 2008.):

- **Growth** (45% of value created)
  Growing the company organically as well as through acquisitions; again with the subsequent positive impact on the valuation multiples "earned" at exit given that growth generates "high quality" earnings.

- **Leverage/Financial engineering** (23% of value created)
  Ability to refinance and pay out proceeds to LPs (fund investors) during the holding period, hereby minimizing the cost of capital injected by leveraging the bankability of the unleveraged earnings/EBITDA.

- **Multiple expansions** (21% of value created)
  Buy low-sell high. The ability to acquire assets in a low investment multiple environment and to sell the very same asset in an exit market with better investor sentiment.

- **Margin expansion** (11 % of value created)
  Improving the EBITDA margins through operational performance improvement initiatives and hereby improving the "quality of the earnings" with the subsequent positive impact on the valuation multiples applied at exit.

Unlocking growth is the single most important driver for value creation and without doubt a prerequisite for meeting the extremely high performance requirements in private equity. However, this emphasis on rapid growth leads to one of the less qualified criticisms of the PE ownership model, which is that PE funds demand profits at the expense of sustainable, long-term results. PE funds, critics claim, "drain" the longer-term prospects of the acquired companies by, for example, minimizing R&D and capital investments.

On the contrary, private equity funds would find it difficult if not impossible to meet investor requirements without a very strong future-looking revenue and EBITDA growth story. Especially for companies with historic and forward growth rates above industry peers, the valuation multiples obtained under PE management could be significantly higher than under conventional management.

In fact, PE funds and PECCs have to apply **two growth horizons** to obtain a growth-driven exit multiple:

- The *time-to-exit horizon*, aimed at optimizing the value of the company during the ownership through organic or acquisition-based growth, operating efficiency measures, etc.

- The post-exit *longer-term growth prospects,* built through a credible strategy that assures the next owner that the PECC will be able to sustain its

competitive advantage and growth.

II. Speed and Timing

Another criticism of the private equity business model is the claim of "shortism." In reality, the direct impact of the time factor for PECCs is that the leadership in private equity-owned companies has to undertake significantly more activities and in a much shorter period of time—but that is not the same as shortism.

The time horizon of the value-enhancement process of PECCs is dictated by the pre-determined (or at least aspirational) timing of the exit event. Contrary to the publicly listed companies, where the market capitalization is an aspirational financial "snapshot" at a specific point in time, the valuation of PECCs at the time of exit is obviously the *actual and realized "cash-in-the-bank" value creation.*

In the world of PECCs, the ability to *time* the execution and realization of value-creating actions within the given time horizon is critical. For the PECC, the implication of delayed or reduced value realization is either less "cash in the bank" for the investors or a delayed exit with the subsequently lower IRR (unless the added value creation during the delay can compensate for the time/value loss)**.**

III. Strategic and Operational Execution in Parallel

A third implication of the PE ownership model is that the solution and action space otherwise available to management rapidly fades the closer the company gets to the exit event.

Important strategic investments, such as critical and capital-intensive acquisitions or major CAPEX-intensive investment schemes, which under normal circumstances would make strategic sense, will often not create sufficient exit value within the available time horizon if they are too close to the exit. The time available is simply too short to justify such capital commitments as it could end up deflating the valuation at exit.

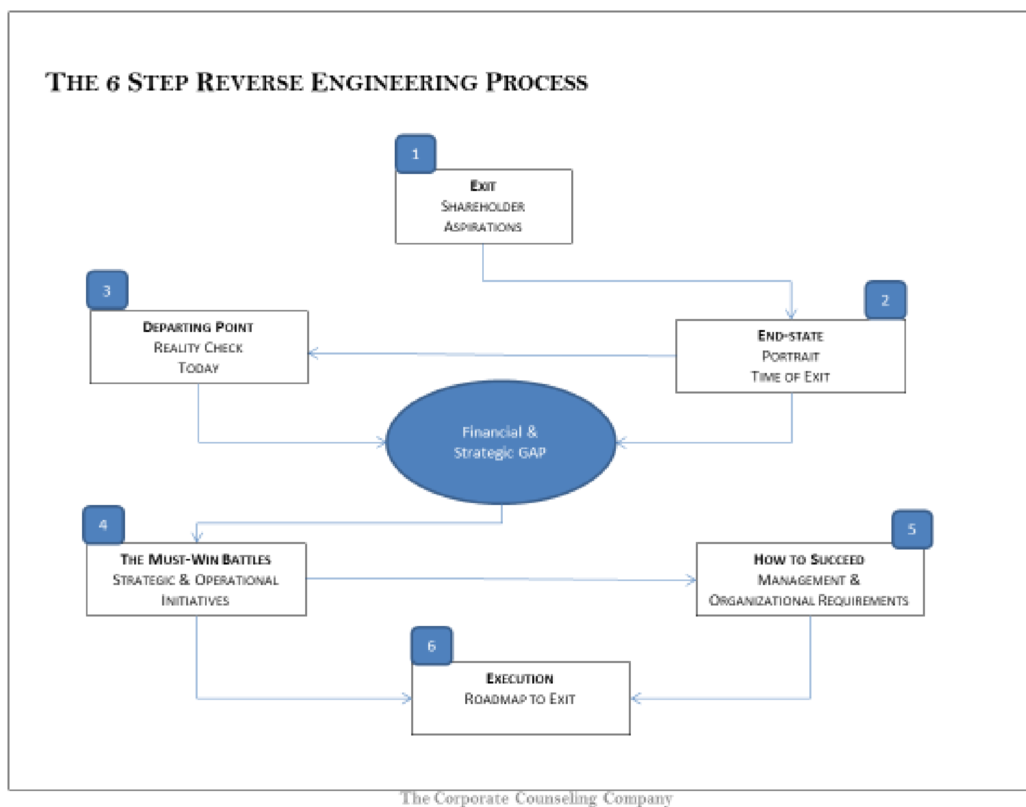
Consequently, management does not have the luxury to proceed down a sequential roadmap but has to execute often extremely ambitious operating margin improvement and cash-flow optimization plans within a very short period of time while *at the same time* initiating strategic investments, even in the very early stages of the new private equity ownership.

Planning for The End State

Conventional management models for strategy design and operational execution will typically follow the route of defining/reconfirming the vision, the objectives, the strategy and the subsequent actions. The foundation of such models is based on *the best possible outlook,* which fundamentally turns the strategy plan into a *strategic forecast*. The art of predicting and planning for a given horizon often becomes the *modus vivendi operandi* for the planning process.

PECCs do not have the luxury of a conventional forecasting-based methodology. The time and timing aspects as well as the request for realizable valuation impact by the time of the exit event disqualify the methodology.

What we propose is thus a radically different mindset: **The Mindset of Reverse Engineering**. This is a mindset grounded not in the concept of forecasting a plan into an assumption-based future, but instead reversing or "back-casting" a plan from the targeted/aspirational end-state of the corporation—at the time of the exit event—to its departing point. The fix point is thus the required future valuation at exit of the corporation translated into its financials, the attractiveness of its addressable markets, its competitive position, its growth prospects, its structural configuration etc.



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The critical questions to be addressed by management are thus:

Step 1: Shareholder Aspirations

- How much investor value must be realized at time of exit to satisfy the ownership return requirements?
- What is the aspired time-to-exit and how much time do we have to execute?

Step 2: End-State Portrait

- How will the company "look" at the time of the exit event to satisfy the ownership return requirements?
- How will the financial statements look at the time of the exit event?
- What strategic position in its competitive arena will the company have achieved at the time of the exit event?

Step 3: Point of Departure

- What is the reality of the financial performance of the company at the time of new ownership?
- What is the reality of the strategic positioning and potential of the company?
- What constraints in terms of time, capital, resources and skills are challenging the company's ability to "deliver" in due time?
- What are the financial, strategic and capability gaps of the company?

Step 4: Back-Casting the Must-Win Battles

- What strategic initiatives such as acquisitions and capital investments will be decisive in realizing success at the time of the exit event?
- What margin-expanding operational improvement actions will be decisive in realizing the financial return requirements at the time of the exit event?
- What is the required timing and sequencing of the company's strategic and operational initiatives to have full value impact at the time of the exit event?

Step 5: How to Succeed

- Is the CEO and senior management capable of succeeding within the context of the PE ownership model?
- Does the company have the required organizational capabilities to activate and execute the strategic and operational Must Win Battles?
- Are there structural, cultural, technological or mindset constraints that have to be "eliminated"?

Step 6: Execution Roadmap

- What is the subsequent roadmap of execution that will deliver the required value creation at the exit event?

The first real confrontation between the CEO of the PECC and the new PE ownership occurs the first time the investment case of the PE fund becomes transparent to him or her. The investment case of conventional PE Funds is often purely financial—and based on highly detailed LBO modelling tools. If one were to make one valid criticism of PE funds, it would be about this "spreadsheet" or "behind-the-desk"-based approach to building an investment case rather than building the investment case on an "in-the-machine-room" approach.

The reality check and moment of truth for the new PE ownership in terms of the order of magnitude of the challenge of the investment case only comes to surface *once the CEO has translated the investment case in the financial spreadsheet into the practical implications for the investment and return aspirations*.

In the third paper to be posted about "The Distinct Discipline of Managing Private Equity-Controlled Companies," we will address the importance but also the complications of assessing the right CEO and senior management teams of target companies pre- as well as post-acquisition. However, in the context of the criticality of time and timing in private equity, we will also discuss the cost or price of keeping wrong team members in place and especially the value destruction from lack of willingness to change leadership positions in due time.