How private equity operations teams create value

Our latest private equity (PE) study highlights 10 principles of a successful PE relationship.

Most studies talk about the value that PE operations teams bring to portfolio companies from the perspective of fund managers and investors. We met with CEOs of portfolio companies to get the view from the inside.

"If everyone is moving forward together, then success takes care of itself."

This quote from legendary businessman and entrepreneur Henry Ford illustrates how CEOs of PE-backed companies generally see their relationship with PE funds' operations teams. In our recent interviews with CEOs of portfolio companies, most talk about the importance of collaboration and alignment to foster a working environment that increases deal success. In challenging situations, they say, the idea is to jointly identify potential problems and develop constructive solutions together, rather than finger-pointing and exposing shortcomings. Again, Ford's words come to mind: "Don't find fault. Find a remedy."

The rise of operational value creation

The era when PE was associated with mere financial engineering is a distant memory. After several cycles and events ranging from extraordinarily cheap capital to the credit crunch, most people in the industry argue that private equity creates value through underlying business and operational improvements.

This reliance on operational value creation has required PE firms to evolve their skill sets. Traditionally, PE professionals came from investment banking or financial roles. But in recent years, many PE funds have set up in-house teams of operational specialists. These teams take on various names—from operations team, portfolio support team, and value enhancement team to operating partners. Regardless of what they are called, they all have one thing in common: they employ professionals who typically come from industry or from strategic and operations-focused consulting firms. In this paper, we refer to them as PE operations teams, as opposed to the deal teams that focus on deal sourcing and execution. In some PE funds, especially in the mid-market space, these roles are blended into a single team.

There is significant research about the value that PE operations teams create, how the teams are structured, and how they interact with portfolio companies. However, most studies are carried out from the perspective of fund managers and investors. In contrast, we want to understand the relationship from the perspective of a portfolio company. With this in mind, we interviewed CEOs of portfolio companies that are under PE ownership to find out what works well, what doesn't work, and what could work better (see sidebar: About the study on page 2).

About the study

The Kearney Private Equity study consists of 20 survey questions, both quantitative and qualitative. The quantitative section addresses the structure of interactions between the PE operations team and the portfolio company (frequency and how many representatives), the type of expertise and support provided by the PE operations team (both actual and desired), and the style displayed during the interactions. The qualitative section addresses CEOs' perspectives on several topics, asking them to rank their degree of agreement. The survey was conducted online and in one-on-one interviews, with most CEOs preferring to be interviewed.

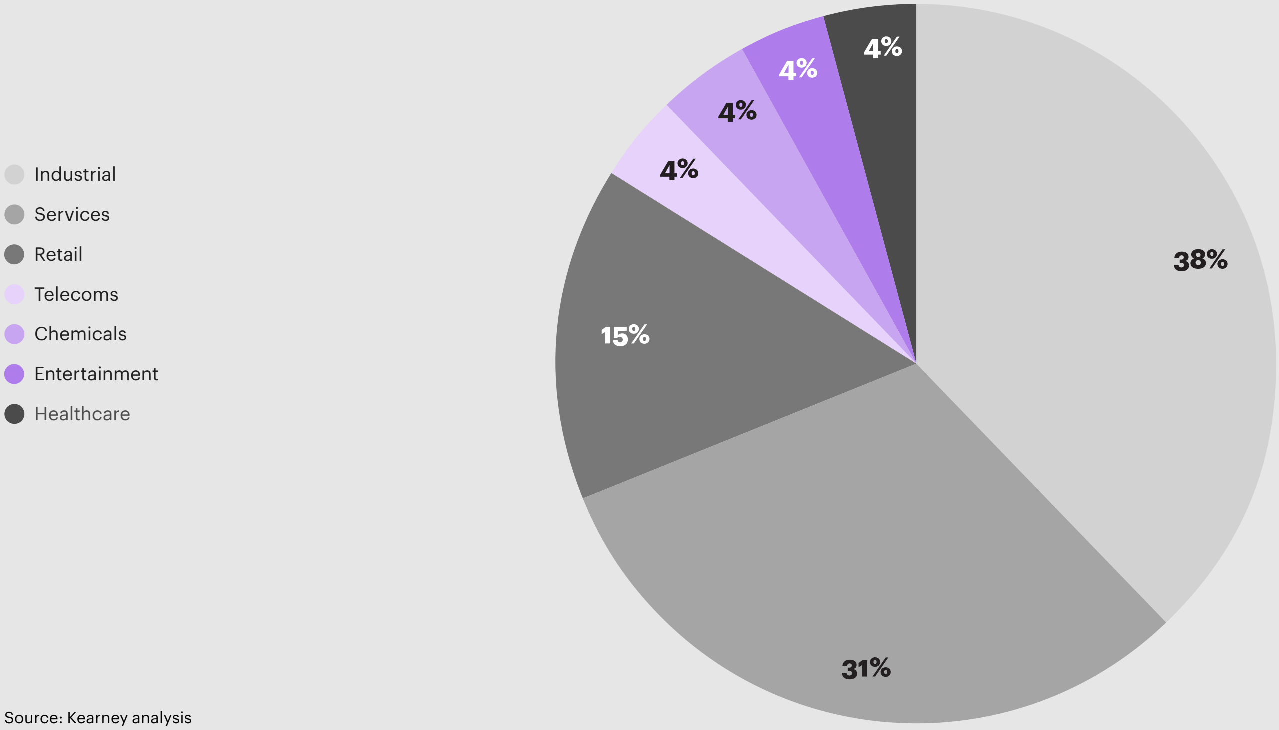
Our CEO study participants are from portfolio companies in a variety of sectors and geographies (see figure). The companies, ranging in size from about £250 million to £1 billion in revenues, are backed by PE funds of various sizes, from large funds (35 percent) and mid-market European funds (27 percent) to global mega funds (38 percent).

Companies are segmented based on financial performance, with each one defined as performing (58 percent) or underperforming (42 percent) based on CEOs' input and market data. CEOs are segmented based on their experience with private equity (65 percent first-time PE; 35 percent had one or more PE experiences) and on whether or not they were in place at the time of the acquisition (42 percent) or were brought in after the acquisition (58 percent).

The sample size of 26 equates to the number of CEOs who completed the survey in its entirety. Some additional respondents provided partial replies, and their comments are included in the paper but not in the survey database. The sample size is not large enough to be statistically representative. In addition, statistics alone cannot provide the answer to the multifaceted nature of the PE-CEO relationship. We therefore point out some observations from the quantitative analysis but focus more on the qualitative nature of the commentary.

Figure

Study participants are from a variety of sectors



Source: Kearney analysis

CEOs and PE: a complex relationship

The relationship between portfolio company CEOs and PE firms should be straightforward. The objective is to create value by improving business performance according to the investment thesis. Yet the dynamics between the two parties are often complicated by misunderstandings, confusing reporting structures, a lack of transparency, and ego battles. Both parties often fail to understand that the nature of the relationship formed at the board level is indeed triangular: the CEO, the PE deal team, and the PE operations team.

When a portfolio company is performing well, the relationship can be linear, with most of the interaction happening at board meetings under rigid governance. CEOs and their management teams are often given ample autonomy to run the business, as long as the deal team is satisfied with the delivery of the business plan. But when a portfolio company is underperforming and at immediate risk of a financial crisis—for instance in covenant breach situations, which were relatively common during the recent recession—PE shareholders often have little choice but to intervene. This usually means sending in the operations team, attempting a recovery, and often replacing management.

Replacing CEOs in portfolio companies has become an accepted practice, with data suggesting that 50 percent of PE transactions experience leadership changes. This track record has prompted a thriving recruitment business focused on the PE sector. Yet, studies indicate that replacing a CEO often means delays in improved business performance (especially in challenging business conditions), and supporting the incumbent CEO can lead to an earlier and more successful exit.

The focus of our research is to better understand how to build successful relationships when companies are somewhere between clear business success and doomed business failure. Within this middle ground is where PE funds must:

— Ensure good businesses stay on track post acquisition, with everyone working toward a successful exit.

— Detect early warning signs of business performance deviating from the investment case and promptly take appropriate recovery actions.

— Strike a balance between support and challenge, develop a more active ownership approach, and interact more often with CEOs and their management teams in order to ensure transparency of performance, clarity of decision-making, and, ultimately, higher exit returns.

PE operations teams play a crucial role in the relationship between CEOs and the PE firm. They are often able to get closer to management than the deal team because they speak a similar business language. They can also provide hands-on support in crafting value creation plans.

Most CEOs tell us they favor working with operations teams, and the best relationships go well beyond monthly board meetings. However, their responses in our interviews are fairly polarized. For example, at one end of the spectrum, relationships are largely deemed positive for PE funds that support CEOs with a clear structure, agreed roles and responsibilities, and a working style that fuels business decisions by influencing and questioning rather than through direct control. At the other end, relationships are strained—and ultimately harm business performance—as PE operations teams take an interventionist role and a battle of egos ensues.

A balance of push and pull, or challenge and support, is very difficult to achieve. Many of the relationship issues are rooted in personality clashes and different working styles, especially when experienced, authoritative professionals sit on both sides of the table.

The CEOs in our study provide strong positive feedback, as well as a number of constructive criticisms that can help build stronger relationships between CEOs and their PE operations teams. This paper summarizes the CEO perspective. While this is clearly a one-sided view of the relationship, the findings provide a clear understanding of what CEOs expect from PE operations teams.

Ten principles of a successful PE relationship

It is clear from our discussions with CEOs that the situation of a portfolio company has a large influence on the relationship—and ultimately the deal's success. In some cases, CEOs of different companies in the portfolio of the same PE fund responded in different ways, illustrating how individual circumstances can dictate different interactions and behaviors within the same PE team. Despite this, some strong common themes emerged.

These 10 themes, or principles, are grouped into two sections. The first five focus on the "what"—the best structure for the interaction, the best time in the life cycle to get involved, and the ideal form of governance. The remaining five principles focus on the "how"—how to find the right interaction style, how to build productive relationships, and how to create an environment that supports strong performance and successful exits.

The what

1. Get involved early

The vast majority of CEOs (nearly 90 percent) think the PE operations team should get involved during the pre-acquisition due diligence phase. The rest want interaction to start as soon as practical after the transaction closes. In reality, in two-thirds of the cases, the PE operations team is brought in well after the transaction closes, and for underperforming businesses, the percentage is as high as 90 percent. While it is difficult to establish a cause-and-effect relationship between the timing of involvement and asset performance, early involvement is preferred by most CEOs.

One advantage of early involvement is that operations teams ask questions and probe potential business issues that are often missed during a traditional due diligence process. As one CEO of an underperforming asset explains it:

"The PE operations team helped structure the deal in a better way, allowing us to understand the potential exposure of the business to recession, and avoid overleverage, which became a key constraint."

There are differences in how incumbent CEOs and new CEOs (appointed after the transaction closed) view operations team involvement. New CEOs are generally more positive about the relationship, pointing to extensive interaction and alignment with the PE operations team during the recruitment process as a key reason for the successful relationship with the fund. Incumbent CEOs who are also positive about the relationship reach a similar level of alignment and intimacy through early engagement and interaction.

Generally speaking, CEOs prefer the model of PE firms that advocate for early involvement of the operations team in the due diligence phase, stressing the support the team can provide in helping select the right assets and develop the investment strategy. Yet, resource constraints play a role in deciding at what point of the deal life cycle the operations team gets involved (see sidebar on page 5: Setting up an operations team: lessons learned).

Setting up an operations team: lessons learned

The structure of a PE operations team depends on several factors, including the strategy of the fund, the size and type of investment, and the profile of the deal team. The following are best practices to consider when setting up a team.

Team profile. A generalist model is usually preferred, with the PE operations team having seniority and broad management experience. “It is important to have a senior operator in this role,” explains one study participant. “In previous deals, I had to put up with junior guys who spread their time around several businesses and would come in and tell us what to do. Frankly, I found this insulting.” A background in both consulting and senior management provides the ideal combination of soft skills and hard experience.

Team size. Interacting with one or two representatives of the PE operations team is ideal. It’s better to engage with fewer people but do so in a concentrated effort. When functional expertise is needed, it is customary to reach out to third-party consultants. In a generalist model, which many firms adopt, each team member looks after two to four portfolio companies. In a functional model (for example, procurement), each team member looks after six to eight companies.

Interactions. In the first two to three months of a deal, when PE operations teams are getting to know the business, the interactions should be almost on a daily basis. After that, weekly calls or meetings followed by ad-hoc working sessions are sufficient. Full-time involvement is generally not advised, unless it is for a specific project and for a short period of time; monthly involvement (typically during a board meeting) is not enough to generate value.

Timing. The most successful PE operations teams enter the picture before the deal or immediately after the deal closes. But, in reality, most operations teams get involved in the very late stages of due diligence, when there is a high probability that the deal will close. This avoids stretching resources too thin on deals that never come to fruition. The best relationships are those with strong alignment and co-ownership between the deal team and the operations team, as long as their roles are clarified up front to avoid misunderstandings.

Asset prioritization. PE operations teams allocate their time to portfolio companies based on the size of the fund equity check and the gap between current performance and full value potential. While most understand the advantage in making a good deal excellent rather than fixing a broken asset, there is a tendency to improve underperforming businesses for reputational purposes.

2. Work backward from the exit strategy

Although our study does not specifically address exit strategies, CEOs generally consider such strategies as vital to a deal's success. This is particularly relevant for mid-market funds given smaller businesses' emphasis on growth that often relies on acquisitions (buy and build) and therefore requires clarity and alignment on strategy. In particular, early understanding of which trade buyers could acquire the business at exit helps shape the strategy to develop a business that best fits these potential acquirers. "Without a clear exit strategy, the business may make the wrong decisions—for example, grow in an area that will depress the exit multiples or make it less attractive to trade buyers," one survey participant explains. "So an exit strategy is key to the support provided by the PE operations team: 100-day planning should be easy if proper strategy work has been done." Most CEOs who mention exit planning also support early involvement of the operations team.

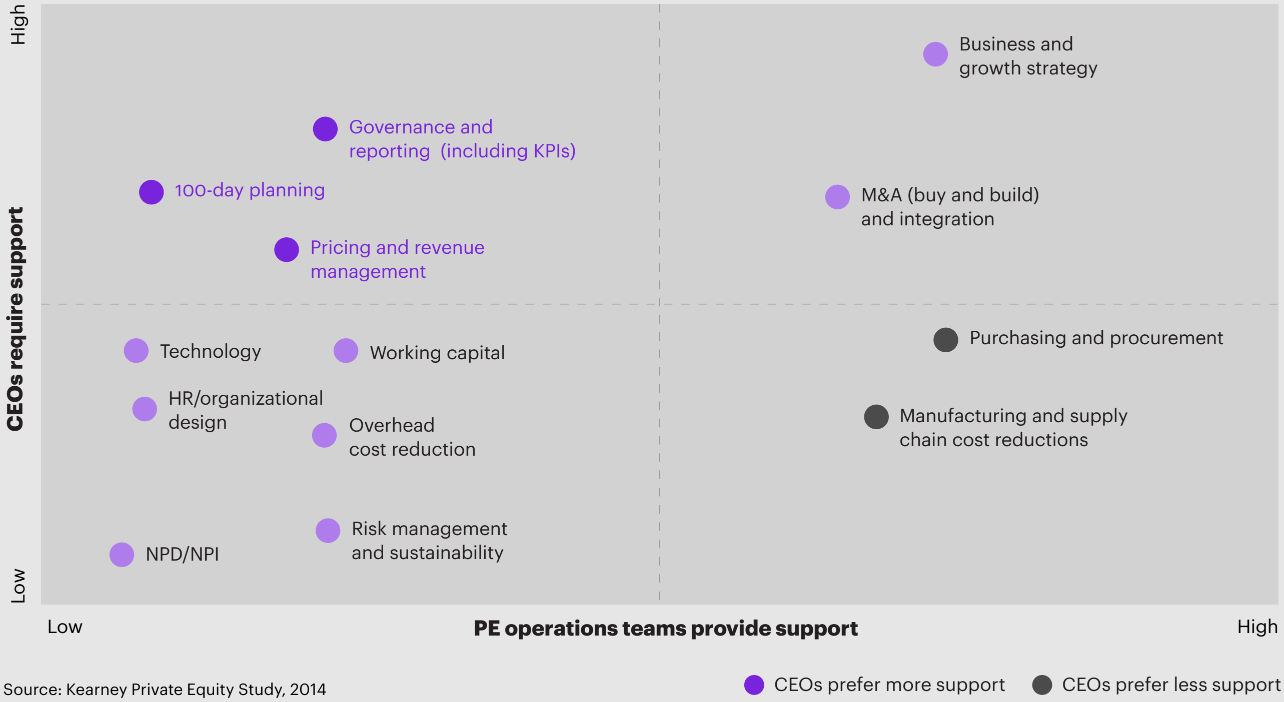
Operations teams often lift the focus to the bigger picture, working from the exit strategy backward and with a relentless focus on mid- to long-term value creation supported by a true business transformation agenda. When asked to identify the key areas of expertise that PE operations teams provide, the strongest ratings were on business and growth strategy and on M&A support and integration (see figure 1).

Two CEOs sum this up well:

"I really appreciated the opportunity to have a sounding board that could give me advice from a different perspective, with a strong focus on the exit."

"The PE operations team helped a lot in defining the exit strategy—which in our case was a business breakup—and in focusing our initiatives in that direction."

Figure 1
CEOs identify growth and M&A as top areas requiring operations team expertise



Source: Kearney Private Equity Study, 2014

3. Set up the rules of engagement early, and stick to them

Clear upfront rules of engagement, defined accountabilities, and efficient ways of working are essential to running a business. Most PE funds take pride in creating value through efficient governance. Yet more than 60 percent of CEOs say they do not have clear rules of engagement set up at the beginning. For underperforming firms, this number rises to 80 percent. Again, it is difficult to say whether the perceived lack of clarity leads to underperformance or whether the rules of engagement are torn apart once performance starts deteriorating. Regardless, more work needs to be done up front to determine how a portfolio company will be run if things go well and what interventions the PE fund should consider if performance slides.

Dealing with different PE representatives who have different objectives is an ongoing problem. For example, 40 percent of survey respondents say the roles of the deal team and the operations team are not always clear, and in some cases, they receive conflicting directions. One CEO states, “Sometimes it was unclear who I was to report performance and issues to and often had to repeat the same story multiple times.” This is more acute with mid-market funds, probably because of the limited size of the operations team and the blended nature of roles.

There were a few complaints about the rules of engagement being ignored when difficulties emerge. Three CEOs of underperforming businesses illustrate this point:

“Interaction was very situation-driven. If there were any rules, they were not respected. This created confusion, in particular with my staff.”

“When the situation became complicated, everything was focused on fixing the immediate problems—we totally lost sight of strategic initiatives.”

“I didn’t appreciate ‘the end justifies the means’ kind of attitude. The process was unnecessarily painful, and smoothing out some of the edges would have made for a much better outcome.”

For those brought in post-acquisition, there is an opportunity to improve this situation. “When I arrived, there were no clear rules of engagement,” explains one CEO. “The situation improved quickly though as I established some rules as a precondition of joining the business.”

Another pain point is dealing with too many people. Sixty percent of CEOs prefer to deal with one person from the operations team, with the rest limiting the number to two or three people. Yet, in reality, only 20 percent of CEOs deal with one person, and 12 percent say they interact with five or more people from the operations team. They also don’t appreciate when members of the operations team have a full-time presence in the business.

All of this leads to a great deal of confusion and negative remarks about PE operations teams being intrusive and disruptive. We cannot say whether the interventions are justifiable or if they help create more upside value, but we can say that more alignment, engagement, and explanations of the reasons for interventions will go a long way toward building trust and stronger relationships.

4. Prioritize and focus—less is more

PE funds bring clarity, with 60 percent of CEOs saying PE operations teams are instrumental in establishing a clear structure of initiatives and bringing the right degree of focus. Interestingly, the level of clarity is higher in underperforming companies, we think because the teams are able to identify actions to improve performance. CEOs are particularly impressed when operations teams help identify what not to do, such as stopping implementation of an IT project draining money and resources.

However, demands can be overwhelming, with PE operations teams often pushing CEOs and their teams too hard toward multiple priorities. In fact, 60 percent say the operations teams are not sensitive to time and resource constraints. That number jumps to more than 80 percent for underperforming companies. While it is human nature to complain about and resist external pressures to work harder, the most successful operations teams recognize the resource constraints and break the initiatives into manageable "chunks" or waves of change in which the emphasis is more on helping and less on tracking progress. The best teams are those that roll up their sleeves and support management in getting the job done, rather than just ticking boxes on a status report.

Once the deal closes, operations teams are on hand to help develop 100-day plans. Many CEOs say they want more help as there is no real planning effort at the beginning of the relationship; rather, planning emerges during the deal life cycle. One CEO explains it this way: "The PE operations team should have provided more support in planning improvement initiatives instead of waiting for problems to occur. Also, their intervention should have been more structured."

5. Simplify governance, leverage KPIs

Only one-third of CEOs say PE owners provide a clear structure for key performance indicators (KPIs), and the number drops to 10 percent for those in underperforming companies. The level of clarity seems to correlate with the size of the fund, with mid-market funds being the worst offenders. Most CEOs say support in governance and developing KPIs is important, and they want operations teams to emphasize these more. "We received limited support in reporting tools for financial and operational performance," one CEO says. "While KPIs are put together by the business, they often are not aligned with what the PE team wants."

When setting up KPIs, don't overwhelm the business with data and reports. After all, less bureaucracy and paperwork are an advantage of PE ownership over large conglomerates. Every effort should be made to use the data available in the company, and if new measurements are created, it should be clear how they will help the PE fund and the portfolio company run the business.

Despite the issues discussed earlier, formal governance is normally well structured, with clear interactions at monthly board meetings. The situation seems to be more complicated when the company is owned by more than one fund, as management has to satisfy multiple reporting requirements. PE funds in a "club deal" arrangement should agree on common governance and reporting models.

The how

6. Listen and be patient—avoid a battle of egos

The strongest negative reactions from CEOs occur when they feel powerless and disenfranchised. This is particularly acute in the early phases of interactions when PE operations teams are perceived as dispensing advice and instructions without first investing time in understanding the business. Two CEOs summarize it this way:

"My management team was not respected. They were told what to do by people who understood nothing about our specific business sector. It got very dysfunctional, and egos got in the way."

"Operations teams should listen and be patient. Before putting ideas and suggestions on the table, they should spend more time understanding the business and what contributions they can bring. There is nothing more annoying than someone coming into our business and pretending they know more than we know."

By comparison, CEOs provide positive feedback when a PE operations team adopts an interactive style based on asking questions, influencing, and challenging. As one CEO states, "Success comes when PE operations teams influence management thinking without management even realizing it." Another CEO sums it up this way: "…these are very smart people asking very insightful and challenging questions, but in a humble way." This balance of authority and humility is essential to avoid a battle of egos that can destroy relationships.

7. Help the CEO become the hero

The most successful PE operations teams challenge management—in a respectful way—and ensure that management gets full credit for the successes. These teams help CEOs succeed by highlighting business issues and facilitating discussions at the board level rather than taking on the challenge themselves. CEOs particularly value support in four areas (see figure 2):

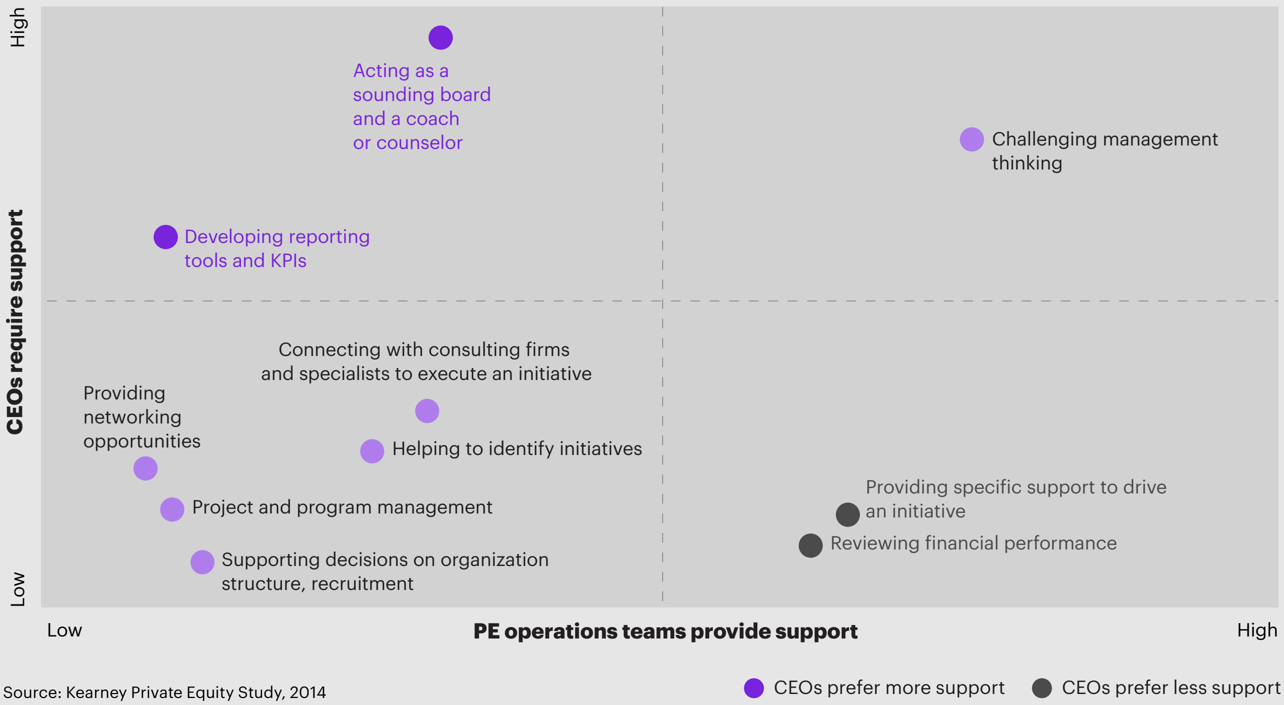
Experience
PE operations teams with multi-industry expertise act as "sounding boards" or sparring partners, bringing an external challenge to management thinking.

Networking
PE operations teams offer broader connections and a network of experts and consultants that can be rapidly deployed to support management.

Coaching the management team
PE operations teams have the necessary experience to provide coaching and support in new and challenging business environments, as long as they don't take control and micromanage.

Coaching the CEO
PE operations teams help CEOs who are new to PE change their focus from profit and loss to balance sheets and cash management. This is particularly beneficial for CEOs who are not familiar with the specific requirements in terms of governance, capital structure, and relationships with banks and investors. This helps strengthen the relationship from day one.

Figure 2
CEOs value additional support in coaching and reporting



Source: Kearney Private Equity Study, 2014

8. Work outside of board meetings

When asked about the ideal frequency of interactions with a PE operations team, 70 percent of CEOs express a desire to interact weekly, with 10 percent saying once a month at board meetings is plenty. Also, less formal working sessions are generally preferred as they allow operations teams to feel part of the management team, and the management team is often more inclined to accept their ideas.

As mentioned earlier, the best operations teams are those that take time to understand the business and act as advisors and coaches; this cannot be achieved from monthly board meetings. CEOs also prefer assigning board seats to members of the PE deal team rather than the operations team. The reason: they can talk more freely to non-board members and not worry that information will be disclosed to the board.

9. Avoid the politics—"we're all in the same boat"

The signs of a broken relationship are pretty clear: lack of transparency, hiding bad news, lack of trust. It often starts with a request from the PE operations team for more details to justify some area of underperformance. To a CEO, such requests can seem like an interrogation and lead to hiding problems, rather than sharing them. This is the opposite of what is required. "The mantra of interaction with PE should be 'no surprises—either bad or good,'" one CEO explains. "The relationship should be open and constructive, so when a real business issue comes up, we can ensure the focus is on finding a solution."

A COO of an underperforming company explains it this way: "My CEO felt that passing detailed information to the PE operations team was 'leaking' material that should have been kept within the business. I wanted to share some details, but had to watch what was being disclosed." This was the reverse of another CEO's experience: "The best support was working together to resolve a financial crisis related to our rapid growth. We were sharing all information and the operations team was constructive rather than pointing to our mistakes. We were all in the same boat and had to survive the storm."

Problems often arise when PE operations teams are spread too thin over a large number of portfolio companies. CEOs can feel like victims of "seagull management" (managers "fly in, make a lot of noise, dump on everyone, and then fly out"). Another threat to the relationship is when operations teams ask for vast amounts of information without first explaining how it will be used. To CEOs, it appears the team is more interested in reporting back to the PE fund rather than helping the business. This is exacerbated in underperforming situations. Two CEOs describe it in this way:

"The PE operations team went into too much detail, leading to a disconnection with management, who no longer felt they had ownership or control… It felt like they were too keen to help, just to be able to justify their own existence."

"My predecessor CEO started hiding things when he felt a 'spy approach' from the operations team. This lack of transparency is the biggest obstacle. The operations team should explain why they need the information."

10. Trust management or change management

PE operations team members are typically experienced managers with the skills to step in to replace the CEO. In some cases, especially with turnaround funds, key positions in the portfolio company are taken by PE representatives on an interim basis. It is not unusual for CEOs to feel threatened. In particular, we heard about operations teams that start working across the business, often bypassing normal governance structures and demanding action from second- and third-level managers. As one CEO explains it:

"My staff was intimidated and confused when approached directly for action that may not be in line with what management had agreed on." Another CEO was even more explicit: "Interventions should be far less intrusive. We have a team that is here to do a job. Sometimes guidance is helpful, but not armies of people who come in and do our jobs."

We heard the strongest opinions from those who view PE operations teams as having a strategic transformation agenda, leaving tactical day-to-day operations to management. In our view, operations teams can challenge and put pressure on certain activities, but should do so through the CEO and in full alignment with existing governance. CEOs are skeptical of operations teams that provide specific support to drive an initiative unless they have an area of expertise that is not covered by management or existing consultants. For example, operations team support is not usually appreciated in purchasing or manufacturing.

It is interesting to note that some PE funds evaluate candidates for an operations team by gauging their desire to become CXO; those with a strong desire are ruled out. The ideal candidate has been a CXO in the past, but now has different career aspirations and motivations. This way, clashes with incumbent management are less likely to occur.

A view from the inside

The 10 principles outlined in this paper are based on a view from the inside—how CEOs of portfolio companies perceive the relationship with PE operations teams. When the relationship is structured in a productive way, it can increase the chances of success for incumbent CEOs and prevent the need for leadership changes, which often delay the journey toward a positive exit. The relationship between the two is often complicated and can even be antagonistic. But for the PE teams and CEOs that take the time to get to know each other, and respect each other's contributions, the chance of achieving successful deals is far higher.

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