L.E.K.

EXECUTIVE INSIGHTS

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Six Disciplines of Private Equity Any Corporation Can Use

Private equity holds several notable advantages over public ownership, not least its ability to boost equity returns through creative leverage structures. But the financial engineering for which private equity is well known cannot fully explain the difference in returns between the private and public sector (see figure 1). Rather, the key reason for the success of the private equity model is its unique ability to add value to a business through a singular focus on maximizing shareholder returns. It is managerial discipline and strong operational performance, not financial engineering, that explain private equity's impressive results.

To outsiders, this discipline can appear ruthless, but at its best, it pares corporate management down to its essential purpose. Free from quarterly earnings pressures and disclosure requirements and with an exit date firmly in sight, private equity executives face fewer temptations to empire build, less inertia associated with changing senior leadership, and fewer qualms about changing long-standing operating procedures or business practices. In publicly traded corporations, the multiple stakeholders influencing senior management make the pure pursuit of shareholder value creation an unrealistic objective. However, we believe that there are six specific disciplines from the private equity world that can be employed by any senior management team to improve performance.

Focused Investment Theses

Private equity firms begin the pursuit of transaction opportunities and strategic enhancements based on the identification of long-term trends and developments. Theses are formed on the basis of exogenous factors such as demographics (e.g., the aging of the population and the geographic dispersion of high-earning families will increase demand for personal emergency response systems); consumer tastes (e.g., environmentally conscious consumers value socially conscious products at the expense of performance and/or price); regulatory changes (e.g., the advent of accountable care organizations places a premium on medical technology with proven cost effectiveness); etc. The investment implications of long-term trends are vetted through thorough research and analysis. Strategic decisions are made through a systematic understanding of the second-and-third-order effects associated with long-term trends, and focused investment theses flow directly from this process.

In a corporate world, the application of such focused investment theses underpin optimal decision making. Strategic plans should be created based on long-term developments not short-term fads or opportunities, no matter how forceful the admonishments of commentators and analysts to respond to passing vogues. By applying the disciplines employed in the PE world to identify and exploit long-term trends, public corporations can dramatically improve long-term outcomes.

Six Disciplines of Private Equity Any Corporation Can Use was written by **Peter McKelvey**, President of L.E.K. Consulting's Americas Practice.
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Figure 1
U.S. Private Equity Index and Selected Benchmark Statistics

Index	3-year	5-Year	10-Year	15-Year	20-Year	25-year
Cambridge Associates LLC U.S. Private Equity Index	15.15	7.99	14.59	11.46	13.54	13.27
Barclay's Government/Credit Bond Index	6.10	5.50	5.06	5.91	6.17	7.11
Dow Jones Industrial Average	13.32	6.50	8.94	5.82	10.01	11.11
Dow Jones U.S. Small Cap Index	14.48	9.72	12.78	8.00	10.42	NA
Nasdaq Composite	10.86	7.47	9.31	3.92	8.08	9.05
S&P 500	12.67	5.81	8.53	4.27	8.53	9.91
Wilshire 5000 Total Market	12.82	6.27	9.32	4.72	8.63	9.89

Source: Cambridge Associates

Relationships, Relationships, Relationships

As every senior executive knows, the success of any sales strategy is the result of not only the value proposition of the product or service being offered, but also the long-term relationships that have been developed with customers. Private equity firms use a similar relationship-building strategy with the founder/CEOs of family-owned companies. These relationships are often developed over several years, long before an actual liquidity event is desired. The trust cultivated can often result in a "proprietary" deal for a PE firm, and the outcome is the higher returns associated with the avoidance of a competitive auction process.

For executives of public companies, this same discipline can be applied not only for M&A transactions, but also in the daily operation of a business. For example, the two most important relationships for most companies are with major suppliers and major customers. The corporate equivalent of a "proprietary" private equity deal can be an early heads up on an important technological change from a supplier or preferred access to new buying points within a customer organization. As in the PE world, long-term relationships forged internally and externally at public companies can lead to higher returns.

Objective and Systematic Analysis and Diligence

Private equity firms make investment decisions based on a systematic analysis of the facts and their implications. In an M&A context, this means finding a disciplined answer to the question: "Why is this business worth more to us than the next best buyer?" If the answer is, "It probably isn't," then a PE firm will walk away and avoid overpaying for an asset. In a strategic planning context, this means being thorough and disciplined in fact gathering to reduce uncertainties, which allows for an optimal risk/return trade-off to be made to support the long-term business objectives.

In public environments, similar analytical processes are used to support major strategic initiatives. The difference is that the assumptions are often not supported with the same degree of analytical rigor as PE firms use, and can end up being too optimistic. Examples include revenue synergies and growth rates that are too rosy; cost savings opportunities that are either overstated or assumed to happen too quickly; and intangible costs that are underestimated such as culture clashes or key employee turnover. Although not immune to these same problems, PE firms will often balance the scale in their favor before committing capital through diligent and objective research and analysis.

Strategy Activation

The best M&A transactions and the best strategic initiatives always begin with both a well-articulated strategy and a plan that is ready to implement. Neither is sufficient on its own and both are necessary for success. Without an implementation plan, even the most intellectually pristine and analytically supported strategy will fail to yield its full promise. PE-owned firms do an outstanding job of realizing the full value of a strategy by doing the following:

- Clearly articulating strategic goals set by senior leadership to all levels of an organization
- Achieving consensus through the force of argument supported by market facts, not a top-down "do-as-I-say" approach
- Forming immediate tactical action plans to ensure expeditious outcomes
- Quantifying results both to motivate staff and ensure accountability

The results-oriented mindset in activating strategies is a distinguishing characteristic of successful private equity firms, but it is well within the grasp of public corporations as well.

Top-Flight Management Team

Any private equity executive will tell you that his or her confidence in an investment decision is as much about the quality of the management team as it is the attractiveness of the market or business model. Having the right leaders in the right positions at the right time is the single biggest source of value creation in a successful PE model. The converse is also true: failing to replace underperforming teams quickly enough can be perilous. One of L.E.K.'s private equity clients once observed: "Every time that we've replaced an underperforming CEO, I always ask myself why we waited so long."

Making tough personnel choices is easier in theory than it is in practice. Most boards and CEOs wait too long before taking action to replace a management team for several reasons including:

- **Natural human inclination:** Most of us prefer to give the incumbent the benefit of the doubt. To become a member of senior management in the first place, an executive must have had a strong record of success even if his or her skills no longer support future success. The "halo effect" around executives – in which an overall judgment of character influences assessments of specific (unrelated) skills – can lead to undue delay in recognizing underperformance.
- **Hippocratic oath:** "First, do no harm." Who is to say that the new team will be any better than the old? A fair question, but one that often is influenced by the "status quo bias," in which any change from a baseline is more likely to be perceived as a loss.
- **Transition costs:** Even a competent new team is going to take time to get up to speed and will consume significant board/CEO energy at the beginning. Are the known transition costs worth the unknown benefits?

Clearly, executives in PE firms are not immune to torpid oversight or undue delay caused by innate biases and well-meaning miscalculations. But in a world where optimizing shareholder returns is the only reason to exist, the selection of high-performing management teams is constantly under scrutiny.

Develop a Culture and Incentives Oriented Toward Performance

Finally, PE firms are world leaders at aligning management incentives to results. Senior executives employed by the portfolio companies of PE firms will earn the lion's share of their compensation through the same means as the PE firm: the appreciation of the equity value of the business. Because PE holding periods are relatively short (four to five years on average), a pending liquidity event always looms large and focuses the management team on results. And not only is a large share of executive pay tied to performance, but top managers are typically also required to put a significant amount of their own capital into the deal.

The discipline that comes from periodic liquidity events is difficult to replicate in a public corporation. Management stock options are the tool that represents the closest equivalent; however, often the return on options is as much the result of the overall performance of the public stock markets as it is the management team's performance. Although L.E.K. applauds stock options (and their close cousin, "indexed" options) as an important tool incenting public company management, other incentives tied directly to long-term cash flow should also be part of the mix.

In summary, L.E.K. is privileged to work with many high-performing PE firms and public corporations, and we have observed the six disciples outlined here in both equity models. The lessons from these six disciplines can apply to any organization – large or small; domestic or multinational; manufacturing or service – in virtually any sector of the economy. The difference between private and public ownership is that more often a PE environment creates the focus required to ensure consistent and diligent implementation. And the results are the rewards of higher shareholder returns.

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