Private Equity Value Creation

Surviving and thriving in an economic downturn

During times of economic uncertainty, private equity firms are often tempted to change course and become 'creative' with the process of deal sourcing and portfolio company management. Some firms veer away from their core competencies to acquire a company in an industry that is allegedly "recession proof." Others will abandon the financial principles that have grounded their firms in sound investments in the years preceding the downturn. Below we present a framework that the private equity professional can apply when operating a fund, in particular in the midst of an economic downturn. Our analysis is based on our first hand experience with private equity transactions, in depth conversations and interviews with executives in the field. We've identified several guiding principles for creating value in this environment. These solutions are not cost prohibitive to implement and can be acted upon regardless of firm size.

1. Focus on Core Principles

Our experience has shown us that in times of economic downturn, private equity firms who outperform the competition focus on the core of their strategic platform. A rising tide can allow an erratic private equity firm to satisfy its limited partners with reasonable returns. However, during downturns, the non-focused firms who do not abide by internal assessment methodologies are often exposed as underperformers. An effective private equity firm focuses on its core to outperform its competition in four realms: Adherence to investment strategy, oversight of portfolio company management, effective utilization of outside resources and reinvestment in portfolio companies.

Adhere to your investment strategy

During an economic downturn, the firms that consistently outperform the competition and return higher than average IRR's to their limited partners are the firms that stick to their core strategies. Nearly every firm has a different mission statement and strategic initiative but at their core, the outperforming firms concentrate on investing in growth and creating value. Often in downturns, there are less deals to be made, making the deals that are left on the table increasingly competitive. Some firms will feel the pressure to put their committed capital to work, and, in the process, will sacrifice some of their core investment strategies. Through the past twenty years, the funds that weather cyclical downturns are the ones that adapt to changing economic environments without changing strategic direction.

Privately held companies are often reluctant to sell in economic downturns due to the state of the market and the belief that they will be able to sell for more when the cycle has passed. This intuitive phenomenon feeds into the underlying supply/demand issue; many firms are competing for fewer deals, ironically the same issue that drives up deal multiples in boom times. This can create situations where private equity professionals push for transactions which are normally not in their target profile. This is being seen in the United States where firms normally not specializing in turnaround buyouts are taking risks to acquire fundamentally flawed companies in the hopes of turning them around and maximizing return on investment. However, due to the internal organization of many of these private equity firms and the backgrounds of the professionals assigned to the company, the ideal infra-

structure to support a turnaround is not always present.

One private equity professional, who normally specializes in distressed deals observed that in his mind, the smartest thing he did was to decide early in career that even if it meant not completing a deal for over a year he would not stray from his investment strategy.

Put oversight of your portfolio company management in place

Proper oversight of portfolio company management should be in place at all times regardless of the economic environment. However, during downturns, the proper infrastructure connecting the private equity firm and the management team of the portfolio company can be a differentiating factor between firms that just stay afloat and firms that consistently produce above average returns for their limited partners. The professional tone of the relationship should be set immediately post-close and, at the very latest, at the first board meeting. The firm and management should agree upon performance metrics which will be used to evaluate company performance. Additionally, the interaction should agree on an initial 100 day plan during which a strategic and operational assessment will be performed and results reviewed with the board. Interactions between the firm and management should be ongoing and certainly not limited to periodic board meetings.

Best-in-class private equity firms have a post-close plan in place which establishes a governance standard within the timeframe of the initial 100 day plan. This governance standard establishes processes, outlines structures and relationships and defines roles in a manner which is clear to all stakeholders. An ideal governance standard will be based on guiding principles which should be agreed upon by both the private equity firm and the management team of the portfolio company. For example, the two parties can agree to a series of shared aspirations and the measurement and accountability metrics by which to achieve these objectives. Other guiding principles include the establishment of boundaries which allow management and ownership to have a degree of autonomy in the decision making process. Lastly a key principle which should be agreed upon is a code of conduct and an ethics framework.

Effectively utilize outside resources

As any company, a private equity firm functions most efficiently with the proper use of external resources. These resources include accountants, lawyers, consultants and outside advisors. For the purpose of this article, we will concentrate on the use of external and impartial board members. A characteristic of a successful firm is one that utilizes external experts on the board of directors of its portfolio companies. These individuals not only offer new perspectives but can also be valuable resources for deal sourcing if the company intends to grow through add-on acquisitions.

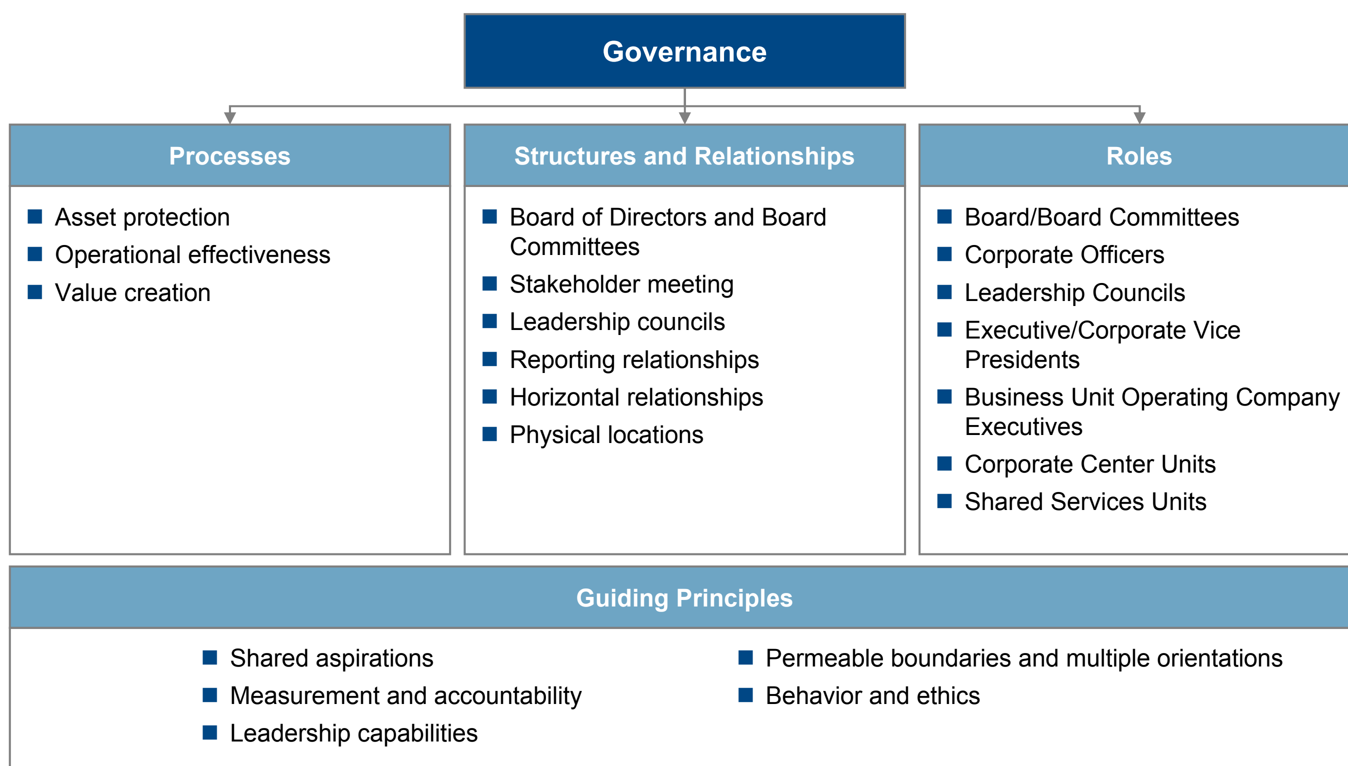

Exhibit 1: Governance framework

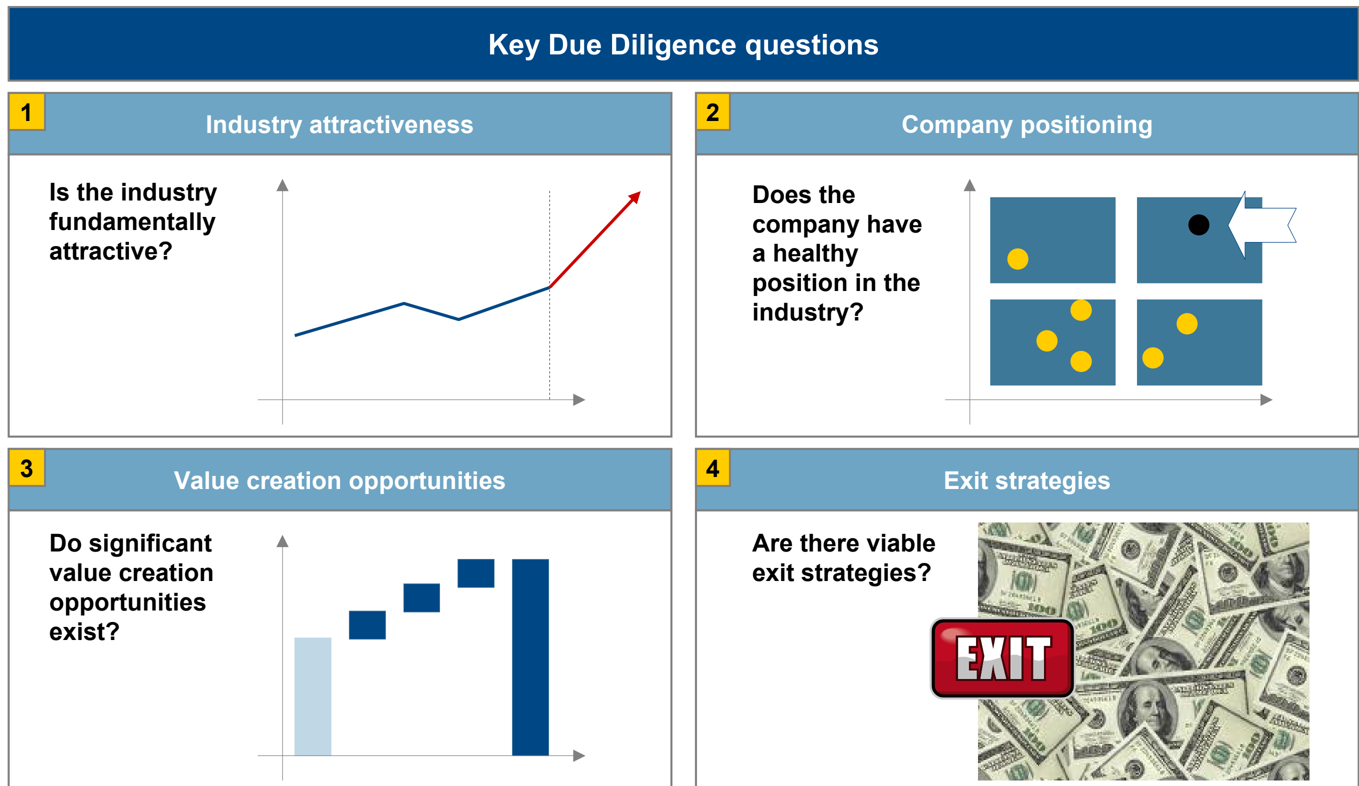

Exhibit 2: Key due diligence questions

Firms that are currently utilizing outside board representation most typically access these individuals through informal networks and industry contacts. Sometimes these outside resources can be of great value in mediating conflict between management and ownership. Private equity firms who are successful in using this organizational model draw heavily on the outside board members to frame corporate governance structure.

Reinvest in existing portfolio companies

Deal sourcing becomes exceedingly difficult during times of economic downturn. Private companies are reluctant to sell when the market is not strong and typically opt to wait out the downturn. In environments like this, outperforming private equity firms concentrate significant effort towards reinvestments in their current portfolios. This reinvestment is often manifested in add-on acquisitions where the firm adopts the role of a strategic buyer. Several firms hold 20% to 40% of their funds for the purpose of add-on acquisitions. This is a great way to increase EBITDA in a portfolio company without having to extensively source a deal through internal firm resources. Having this option in place also allows the management of the portfolio company to be proactive in bringing their companies to new levels. Empowered management teams can be an ideal conduit to maximizing value creation at a company level.

2. Conduct a Rigorous Pre-Deal Due Diligence

During times of economic downturn, successful private equity firms can rarely concentrate solely on financial engineering to add value to a portfolio company. Adding value means driving EBITDA growth through a mix of revenue growth and cost improvement realization. With financing tightening due to write-downs related to the subprime mortgage market, there is less room for error in the acquisition of a portfolio company. Because of this, the successful private equity firm will conduct a comprehensive due diligence of the target company assessing four key areas: industry attractiveness, company positioning, value creation opportunities and exit strategies.

Assess industry attractiveness from a dynamic perspective

A private equity firm should always thoroughly understand the market of the portfolio company that it is considering acquiring. This analysis should include an assessment of the market potential both in the geographic region where the target is located as well as other regions where expansion could be an option. The firm should look at the historical performance of the industry as related to major economic indicators in the country; does the market seem to move in line with the macro-economic growth of the country? Is there a pattern which can be identified?

Above all else the firm should focus on market projections over the duration of the expected holding period of the investment. This analysis should include threats and opportunities that the industry will be facing in the coming years which would force a company to make an operational or strategic adjustment.

Understand company positioning from primary sources

In addition to simply understanding the market dynamics, a properly prepared firm will have a comprehensive understanding of the target's positioning in its market. This process includes segmenting the industry by market share to understand how the target company is positioned relative to the competition. The analysis should also include a thorough understanding of the competitive positioning that the company enjoys in each of its business units.

Conducting secondary research and reading the Information Memorandum are not sufficient methods for understanding competitive positioning. A successful firm will draw upon interviews with suppliers, customers, industry experts and management in order to formulate an understanding of the competitive landscape that the company is facing. Primary interviews are often the best place to start when trying to understand how a company is differentiating itself from its competitors. Who better to understand the factors that go into buying a boat than a customer? Who better to understand the competitive dynamics in the graphics industry than a sign maker? The outperforming private equity firm will target these who are the most knowledgeable in the given field and go directly to the source of information.

Identify value creation opportunities pre-close

In times of economic downturn, the private equity firms that identify value creation opportunities pre-close will benefit from quick wins. Firms that wait until the first board meeting to discuss operational improvement areas and growth strategies are often the firms with lower returns and longer-than-desired holding periods.

A comprehensive due diligence program should include an initial business plan including in-depth operational improvement strategies. The plan should provide estimates for EBITDA improvements in terms of cost reduction and revenue growth as well as methods to increase capital efficiency to maximize ROE. Depending on access to the target company, the firm should strive to have a thorough understanding of potential improvements in materials, labor cost, working capital carrying cost and overhead as well as initial projections for revenue growth depending on identified growth factors. By putting a value creation study into place, the firm sets itself up for a more credible initial discussion for the first board meeting and can hit the ground running on optimizing its return on investment.

As part of assessing value creation opportunities, the buyer should consider the opportunities for redefining the current business model of the target. This is an approach which allows prospective buyers to find growth opportunities which are typically not reflected in the management business plans for the company. Strategic value creation opportunities can include spinning off parts of the value chain, strategic partnerships or alternative market entry opportunities. If these opportunities exist, the prospective buyer will benefit from the early identification of such opportunities.

Formulate condition-driven exit strategies

As the final aspect of a successful due diligence program, the private equity firm should assess how it will exit its investment in the portfolio company. In times of economic downturn it is more important than ever to fully grasp where the portfolio company should be at the end of the desired holding period. This assessment should take into account the core competencies of the company and whether these lend themselves to a particular exit strategy.

All avenues for exits should be initially considered, making explicit the conditions that will have to prevail at the end of the holding period to make the investment. A sale to a strategic buyer might not seem realistic at closing but, two years into the investment, the research performed pre-deal could lend itself to a credible strategy. The well prepared firm prepares a working exit strategy for each portfolio company pre-close and alters that plan through the holding period as needed.

Insights for the Executive

With numerous large cap private equity transactions falling through in the past year much attention has been paid to the seeming downfall of the private equity industry. What detractors fail to realize is that the industry is far more resilient than it is given credit for. Private equity has been around for over thirty years and has seen cyclical downturns, recessions and even double digit interest rates. The firms that have survived the downturns have been the ones that maintained their focus on core competencies and who made sure they are thoroughly aware of how to create value in their investments. Firms who continue to operate under these principles will continue to add value to their portfolio companies and will weather temporary setbacks in the credit market.

Economic downturns often have a detrimental impact on private equity deal-flow, however during such downturns attention is also drawn to the operating models which are highly successful. Well run firms often differentiate themselves and become the standard for best-in-class operations in the industry. The prescriptions which we have outlined are not unknown measures which will provide a quick fix. These recommendations are intuitive to some and many firms have incorporated various aspects of them into their approach. However it is the firms who design a strategy and framework around these recommendations who prove adept at creating value during economic downturns.

If you would like more information or to arrange an information discussion on the issues raised here and how they affect your business, please contact:

Austria
Stefan Hoeffinger
Tel: +43 1 5154132
Email: hoeffinger.stefan@adlittle.com

Belgium
Herman Vantrappen
Tel: +32 2 7617206
Email: vantrappen.herman@adlittle.com

CEE
Stefan Matthaei
Tel: +49 89 38088781
Email: matthaei.stefan@adlittle.com

China
Thomas Schiller
Tel: +86 21 64478866
Email: schiller.thomas@adlittle.com

France
Ignacio GarciaAlvez
Tel: +33 1 55742912
Email: garciaalves.ignacio@adlittle.com

Iberia
Alberto Aragones
Tel: +34 91 7027400
Email: aragones.alberto@adlittle.com

Italy
Mario Turner
Tel: +39 02 67376240
Email: turner.mario@adlittle.com

Japan
Makoto Terai
Tel: +81 3 34368941
Email: terai.makoto@adlittle.com

Korea
Bonjay Koo
Tel: +82 2 7202040
Email: koo.bonjay@adlittle.com

Malaysia, Singapore
Jeffrey Lai
Tel: +60 3 21646063
Email: lai.jeff@adlittle.com

Middle East
Thomas Kuruvilla
Tel: +971 4 329 7447
Email: kuruvilla.thomas@adlittle.com

Sweden
Petter Kilefors
Tel: +46 8 50306542
Email: kilefors.petter@adlittle.com

Switzerland
Thiemo Rehlaender
Tel: +41 44 7228925
Email: rehlaender.thiemo@adlittle.com

The Netherlands
Martijn Eikelenboom
Tel: +31 10 2018815
Email: eikelenboom.martijn@adlittle.com

United Kingdom
Barry Kanesu
Tel: +44 870 3366622
Email: kanesu.barry@adlittle.com

United States
Natan Shklyar
Tel: +1 212 6612500
Email: shklyar.natan@adlittle.com

Matthew Walsh is a Business Analyst in Arthur D. Little's New York office and member of the Strategy & Organization practice. He specializes in strategic and operational due diligence and portfolio company improvement projects.

Petter Kilefors is a Director in Arthur D. Little's Stockholm office and global leader of the Strategy & Organization practice. He has spent some 11 years at Arthur D. Little. His client work covers strategy, organization, change management, corporate finance and post merger integration.

Contacts

Matthew Walsh
Business Analyst
Private Equity Practice
Strategy & Organization Practice
New York
walsh.matthew@adlittle.com

Petter Kilefors
Director
Private Equity Practice
Strategy & Organization Practice
Stockholm
kilefors.petter@adlittle.com

About Arthur D. Little

Arthur D. Little, founded in 1886, is a global leader in management consultancy; linking strategy, innovation and technology with deep industry knowledge. We offer our clients sustainable solutions to their most complex business problems. Arthur D. Little has a collaborative client engagement style, exceptional people and a firm-wide commitment to quality and integrity. The firm has over 30 offices worldwide. With its partners Altran Technologies and Cambridge Consultants Ltd, Arthur D. Little has access to a network of over 16,000 professionals. Arthur D. Little is proud to serve many of the Fortune 100 companies globally, in addition to many other leading firms and public sector organisations. For further information please visit **www.adl.com**

Copyright © Arthur D. Little 2008. All rights reserved.