



Heads-Up Private Equity: Fresh Approach to Value Growth Needed

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For too long, private equity firms have been managed as investment vehicles, and not enough like businesses that need to succeed in a maturing market. The time is ripe for that to change and, to a large extent, that change is being foisted on today's players. In fact there is a good case to be made for today's private equity to take some of the medicine they have for so long told others to swallow.

The Old Business Model Did Well – For Then

Historically, private equity firms have operated a simple business model, comprising three basic components; find undervalued or poorly managed businesses, acquire them using cheap capital (primarily debt), and drop in big-name/known-quantity business leaders to clean up the acquired business. An elegant approach, and one that has delivered multiples on acquisition prices, has drawn in subsequent funds; and so perpetuated the success of most private equity firms to-date.

The value growth potential in buying an undervalued business is obvious, as is hiring known-quantity business leaders. However, it is the value growth in debt leverage that has really delivered for the private equity sector. Everyone knows that by taking on large amounts of debt in each deal, equity capital has been used to extend each fund's portfolio capacity, while at the same time delivering each acquiree's cash flow using only a relatively small equity capital outlay – leading to a highly magnified return on equity. A true win-win situation.

So what's the problem? Well, historically, the risk in taking on such levels of debt has been limited; traditionally-run private equity firms pay down that debt rapidly, over a few years, and well before situations become critical. Unfortunately, rapid debt pay-downs are not possible where there is a sudden onset of an unusually deep recession – and that's where we are today.

The credit crunch yawned out of control in October 2008 and, as demand cratered, the ability of many typical portfolio companies to cover interest evaporated in just a couple of months. Also, with access to debt continuing to tighten dramatically, many traditionally-run private equity firms have been turning to capital calls to limited partners to just keep their portfolio company equity stakes on life-support.

Life after Leverage

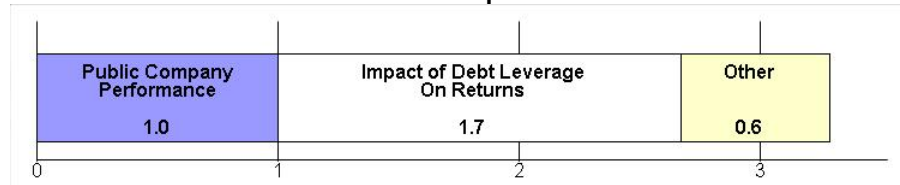
To map a path back to prosperity, it is important to acknowledge why traditional private equity became so attractive in the first place, and what caused so much capital to shift from public capital markets. It turns out that private equity, whilst not being the vultures they were painted as in the 1980s, are not quite as adept at business management as they have led others to believe.

How do we know this? We find the answer in the UK, where private equity is both prevalent and run along similar lines, with many of the same cast of actors, as in the US. The difference, however, is that in Europe the authorities are much more concerned with the 'fairness' of substantive wealth accumulation by individuals, and so regulators are attacking this whole approach to business ownership. In response, private equity has opened its books – and we can now see where value is really being created.

The most revealing insight is the magnitude of the role played to-date by debt leverage in portfolio company value growth. The chart below sets out the story from a study of portfolio company returns, conducted for the British Private Equity and Venture Capital Association by auditors Ernst & Young. A great deal of care appears to have been taken in the study to "normalise" the results; that is, only make comparisons between businesses in the same markets, and to isolate variances resulting from differing capital structures, etc.



Figure 1: Gross Investment Returns of PE Companies vs Public Stock Market Benchmarks



Source: British Private Equity and Venture Capital Association, Ernst & Young LLP

The story is shockingly simple – whilst returns from private equity businesses are, on average, 3.3x that of public businesses, over half of that higher level of return stems from the increased level of debt leverage. We can see this in the chart; investment returns for public businesses (again, normalised for market and capital structure factors) are indexed at 1.0, and the corresponding private equity business returns (after exit) is 3.3.

Now, if private equity's returns are 3.3x that of public company returns, clearly 1.0 of it would have been achieved by simply matching the operating performance of comparable public companies. Of the remaining 2.3 fold of higher returns on equity investment, however, the study found that 1.7 (or 73%) was directly as a result of the much larger debt to equity ratio. In layman's terms, portfolio company profits, after interest, flowed to a much smaller equity capital denominator – making returns on equity capital invested much higher than for comparable public businesses.

The remarkable insight is the conclusion. Only the remaining 0.6 multiple (or 27%) of higher returns for private equity businesses came from other things – *such as improved operational performance*.

Let's Add Operating Value Growth to *Our* Business Model

So, private equity ownership appears to add little to operational performance. While there is room to take issue with this first-of-a-kind study, such as the small data set, the results are actually intuitive (the study was limited to 28 portfolio companies, as the Association was determined to comply with "Walker Guidelines," and compare apples-to-apples and measure hard results following exits in substantive going concerns).

Think about it, what *operational* value growth capabilities do private equity firms *systematically* deploy to equip their portfolio companies to accelerate value growth – beyond a possible management replacement? The answer is almost always none.

Of course, should a private equity firm choose to systematically offer such a value growth accelerating 'secret sauce' to the companies they invest in, they would become highly differentiated in the private equity 'marketplace'. One likely result would be that acquisition values would be relatively lower for those firms with such a 'secret sauce', as the value growth message would attract management teams in companies up for sale, and some would be willing to forgo some sell value. Moreover, exit values would likely be higher; the 'secret sauce' will have an effect in actually growing value, and buyers would be more likely to believe a superior cash flow forecast, a key factor in valuation.

In short, forward-looking private equity firms must recognise that business model changes are on the horizon; and that with the current leverage environment, their trade must move beyond its traditional financial engineering focus. Indeed, the cheap capital aspect of traditional private equity business model has become a serious driver of equity wipeouts. From here, the forward-looking firms must develop approaches for systematically growing portfolio company operating value.

Such approaches can be viewed in two time frames; how to arm management teams to boost current and near-term performance, and how to arm them to boost long-term performance. These are both inter-related, and they require a melding of market management and economic skills – something traditional managers silo apart today. Management actions must be centered on granular cash flow views of their internal performance, in contrast to accounting profits (which are provably misleading). They must recognise that only 15% of a business' value is captured by the cash flow of the next three years; for substantive, discrete jumps in operating value, business managers must operate understanding that two-thirds to three-



quarters of business value is captured in the cash flow of the next 15 years. Long-range market management to maximise long-range cash flow is *the* core skill of the value-performing senior management team.

Most private equity firms intend to sell portfolio companies after four to six years, at which point they will only maximise their exit valuation if they make a solid case for another four to six years of accelerating cash flow growth. So, they are already looking at the right time spans; they just need management teams to be skilled at long-range market management to deliver such long-range cash flow performance.

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