The Ins and Outs of Performance Improvement

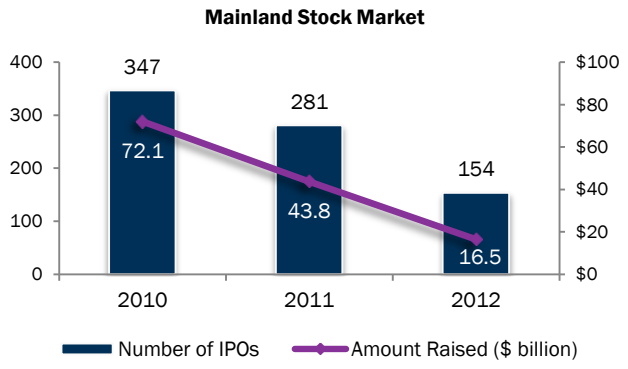
In the existing climate of challenges and uncertainty, never before has performance improvement been such a key driver to post-acquisition value enhancement. Market appreciation, leverage and arbitrage have taken a back seat and, for many funds, running portfolio companies efficiently has become the primary investment strategy. The adverse impact of the tightening credit market and the enforcement of more restrictive covenants have squeezed liquidity and profit, forcing private equity firms to review value creation methodologies as well as their exit strategies, particularly with a lull in Initial Public Offering ("IPO") activity.

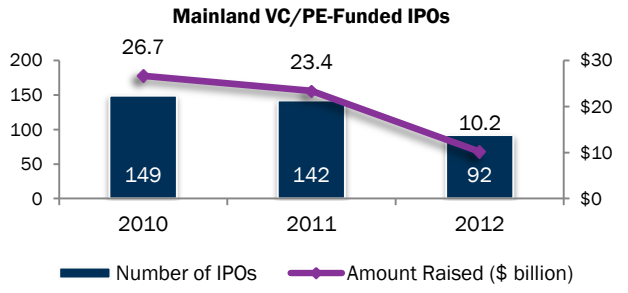
Consequently, the emphasis has moved to performance improvement. Whilst this is by no means a new concept, it now plays a pivotal role in value creation. The required core competencies have shifted from delivering short term growth to internal restructuring and operational improvement, thereby placing a premium on operational expertise, which raises the question – what is the most appropriate and cost effective operating model? Are in-house resources the way to go or does the flexibility and variable cost of external advisors provide a better solution? This question is applicable not only to the US and Europe, but also to Asia.

The Asian Private Equity Landscape

Private equity in Asia has been a growth market in recent times, but it too, has experienced a slowdown in activity as Asia faces many of the same problems as the rest of the world in finding avenues to achieve growth. Growing competition from corporate groups is pushing valuations upward in a bid to stay competitive, thus making it difficult to find undervalued assets. There is also less reliance on leverage compared to global counterparts, driven by more conservative Limited Partners (LPs). Adding to the problem in Asia is a backlog of IPO applications as a result of increasingly tight regulatory environments, and a moment of caution in light of a steady stream of corporate governance scandals. To quantify the deterioration of the IPO market, the number of global IPOs in 2012 stood at 768 against a figure of 1,225 in 2011. In China in 2012, there were 154 IPOs compared to 281 in 2011.[1] The IPO "freeze" by The China Securities Regulatory Commission now means there is a backlog of around 800 companies in the listing queue. For private equity investors, this has effectively cut off one major exit route.

Whilst a reduction in IPO opportunities has led to a more buoyant secondaries market, it is still an underdeveloped market in Asia and differing valuation expectations remain a problem. The prevalence of strategic buyouts as an exit option in the region necessitates value creation, since Asia's discerning pool of sizeable family-run conglomerates tends to be wary of paying high multiples for investments. Moreover, rising costs of commodities and labour in Southeast Asia has intensified the focus on operational improvement drivers.





Source: Zero2IPO, PE/VC Directory 2012

[1] Zero2IPO, PE/VC Directory 2012

Different Operating Models

Operating models differ from firm to firm: some already have internal capabilities, a number of firms outsource to external consultants, and an increasingly common structure is a hybrid of the two – as many small- to mid- market firms have some operational capability, but not enough to cope with the increasing day to day demands. What these individuals all have in common are the core skills that they possess to drive change and efficiency, namely strong analytical skills, management expertise, cash management and strategic planning.

In-house Operations Teams are Uniquely Positioned

With diminishing multiples, long term bottom line improvement requires innovative ways of enhancing value. A progressively active involvement with the portfolio company's operations has led to a different corporate structure for private equity firms. It is estimated that 70% of private equity firms have invested in operational resources and most firms have at least one operating partner on their payroll, generally a senior executive. This makes sense in many respects; the transparency, integration and ease of working between internal teams, familiarity with the portfolio and ability to keep knowledge in-house are all factors to consider. Internal teams are able to provide an investor perspective and share a common view on strategic direction, which can be absent in external advisors.

Many consider full time employees to be the most effective model as their goals are aligned to that of the fund, given that they are likely to be incentivised and compensated accordingly. As an internal resource, they can also be involved in investment decisions across the lifecycle. Portfolio companies may prefer to interact with professionals from the fund for continuity reasons as they can develop longer term relationships.

From a cost perspective, depending on the size and ownership structure of the fund, internal teams can be more economical than hiring external consultants. The investment in human capital is particularly worthwhile in large funds, where resources can work on several portfolio companies simultaneously. KKR, for instance, is understood to have more than 60 operational executives in KKR Capstone who work on operational improvements within their portfolio companies. Clearly there are fixed overheads associated with internal resourcing, which may not be financially viable for small- and mid- cap funds.

External Advisors Provide a Variable Cost

Smaller firms may find that in addition to cost, it is difficult to recruit the right resources. This is particularly the case in Asia, where finding the right management is considered one of the greatest challenges. They therefore turn to external advisors, be it a consulting firm or retired executives. Engaging external advisors provides access to a pool of skilled resources with industry capability, C-suite experience, a broader strategic perspective deriving from corporate rather than portfolio management experience, as well as the required analytical and organisational skills. External resources offer firms the ability to handpick the relevant expertise required for that particular portfolio company, enabling greater flexibility, as the need for operational support for some companies can be cyclical. Further to this, the geographical and cultural challenges of working in the region demand localised expertise that can sometimes be better provided by external advisors. Thus, consultants represent a variable cost resource which can be scaled up and down as required and are less of a burden to the fund's P&L, particularly as they are typically paid for by portfolio companies.

Advisors also have the capacity to focus solely on one company at a time, whereas internal resources may find themselves spread thinly across several portfolio companies, especially with increasing workloads brought about by extended holding periods. For example, one large firm has a team of just 28 operating executives working on over 200 companies. Although not all portfolio companies will require the same level of attention at any given time, for performance improvement initiatives to have maximum impact, companies need hands-on focus at certain stages. There will also be an increasing demand for operational executives to perform interim management roles, which will have a knock-on effect on the time spent on the remaining portfolio companies.

Additionally, the prolonged holding period of portfolio companies has placed greater importance on building and maintaining robust relationships with management. External advisors are well positioned to manage stakeholders and can drive change without the risk of straining relationships between the fund and portfolio company management.

Depending on the size of the external advisory firm, they may bring a large network of contacts and sizable pool of resources, increasing the likelihood of finding the expertise required. The larger advisory firms may also be able to provide complementary services such as investigative and financial due diligence, valuations and corporate governance improvement, meaning that they can act as a 'one-stop shop' and support private equity firms throughout the investment life cycle.

Firms have become creative in the way they use operating partners. For instance, there has been an increase in the number of advisor panels that private equity firms utilise, where they are able to call upon their panellists when required. Furthermore, the additional specialised capabilities that a panel of experts brings can also add weight in the deal or fund raising processes.

The disadvantages of using external advisors are the unfamiliarity of the fund, the potential to disconnect the deal team from the operational value creation process and the lack of goal alignment to the private equity firms, although the latter can be addressed by way of success fees.

One Size Does Not Fit All

There is no right or wrong answer on how to address increasing operational demands and no single operating partner model will be appropriate for all PE firms. In this uncertain market, what is certain is that the need to find advantageous ways to increase value and returns is critical, and the aggressive pursuit of performance improvement is an underutilised way to achieve it.

Nick Gronow
Senior Managing Director
+852 3768 4641
nick.gronow@fticonsulting.com

Laura Chung
Director
+852 3768 4603
laura.chung@fticonsulting.com