Creating operational value to survive

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As the financial crisis made its mark, Heinrich Liechtenstein and Heino Meerkatt predicted a shakeout in the private equity industry.

In December 2008, as the financial crisis was beginning to strike, IESE Prof. Heinrich Liechtenstein and Boston Consulting Group senior partner and private-equity expert Heino Meerkatt predicted a **significant shakeout in the private equity industry**. At the time, the two financial experts foreshadowed the disappearance of 20 to 40 percent of private equity firms.

Since then, several firms have gone under, some have reduced their current fund commitments and others have cut back their teams, including senior partners.

Now Liechtenstein and Meerkatt, in their new white paper, "Time to Engage? or Fade Away: What All Owners Should Learn from the Shakeout in Private Equity," present strategies to keep afloat, derived from the firms that remain.

According to the authors, private-equity firms will only survive if they create business value through their companies' operational performance, as investors demonstrate that they will not invest in firms focused on value creation through financial leverage.

The paper points out that there has been an important increase in the number of private equity investors and that private equity remains one of the key assets for capital allocation.

However, the authors warn that financial leverage is out and that companies that fail to create operational value may soon disappear.

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Based on interviews with limited partners who recently committed capital to private-equity investments, the study describes the nine main levers that are vital for operational value creation.

Divided into two categories, table stakes, which are "must-have" elements that can be applied quickly, and differentiators, which are "make a difference" elements built on long-term experience, these levers address and challenge widespread practices in business management.

Must haves

The authors stress that one of the most important levers a company can employ to create operational value is to frequently evaluate top management. "Through our study, we learned that those companies that evaluate their CEO and other top managers on a yearly basis produce a higher ROI."

But evaluation is only useful if it has consequences. "Companies have to act, and this might mean supporting and developing managers, but it could also mean replacing them," says Liechtenstein.

Other levers mentioned include: a good business strategy, which the authors say requires a disruptive impulse to be developed; benefitting from the fact that private-equity firms are insiders in the companies in their portfolio; and having a sense of urgency.

Another important lever in operational value creation is incentives. According to the authors, research shows that there is a significant, positive impact on a company's performance when the equity stake held by managers increases. Research also shows that this equity stake is more effective than stock option programs at creating a share in downside risk.

Having the right board — one that has "firepower" — is also crucial. The authors highlight that boards that are smaller in size, meet at least nine times a year and have independent members had higher performances.

Making a difference

In addition to the table stakes levers, the authors also studied differentiators that draw investors. Although differentiators, which are related to experience and capabilities, require more time to implement, the authors urge that these levers are what really make the difference. "Even if a fund manager claims to apply all table stakes, it is the experience of

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how to do it that makes the difference," they point out.

The key drivers for these levers include sufficient business insight — an owner needs to find ways to obtain and update industry expertise to stay engaged, and geographical insight.

For example, restructuring a business with a manufacturing footprint in France, Germany and Russia requires very different skills from those needed for a business operating in the U.S and Mexico. As an owner, it is crucial to understand the risks and opportunities when investing in particular markets.

The authors stress that while implementing these short- and long-term strategies is easier if there is a dominant shareholder, as in private equity, all companies, regardless of ownership type, can adopt the value-adding principles discussed in the paper to ensure a continuous drive toward a long-term competitive position.

"Owners must take responsibility for ensuring that their businesses are creating sustainable value in order to prevent another crisis," the authors conclude.

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