Private equity investors are catalysts for strategic change

These professional investors can fundamentally transform a company's growth strategy.

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Companies are most likely to embrace strategy changes when their performance falls below historical performance levels or the performance of comparable peers, according to the behavioral theory of the firm. Equally, companies that perform above such benchmarks are

unlikely to want to change tack. These dynamics, however, change when there's a private equity investor in the ownership structure.
Private equity investors typically take a majority stake in private, mature firms and aim to sell their stake for considerably more than they paid, about five years after entering firms. As such, they often have ambitious goals and aspirations for firms in their portfolios.

IESE professor Jeroen Neckebrouck, alongside coauthors Veroniek Collewaert, Tom Vanacker, Dries Bourgois and Sophie Manigart, tracks the results of such an approach in the paper "Same owner, different impact: How responses to performance feedback differ across a private equity investor's portfolio firms."

Private equity investors are known for drastically raising the bar regardless of the bottom line. As active investors, they primarily aim to foster growth strategies in mature firms with established business plans. And because their goal is to boost shareholder value within a given time frame, they tend to set aspirations for the company that go beyond the firm's history or industry average.

Because the returns to PE fund managers are linked to exceptional value creation, they're also less likely to become complacent when times are good.

How and when private equity investors push growth

The performance of the portfolio company, the size of the private equity investor's financial investment and the experience of the board members they appoint determine the growth path that PE investors push for: either internal growth through capital investments or external growth through acquisitions.

The authors find that when a portfolio company is underperforming, private equity investors with substantial stakes are more likely to encourage capital investments and discourage acquisitions. This is because investors generally do not view acquisitions as a viable way out of large performance shortfalls. As one investor explained, "If your company is in distress, the last thing you want to do is put another M&A target on top and add complexity and stress for the management team." Instead, it is better to first seek internal solutions to restore performance and minimize uncertainty.

However, when a firm's performance is better than expected or only underperforming slightly, acquisitions become a much more attractive option, particularly when investors hold a larger stake in the company. Acquisitions are costly and difficult, and come with myriad risks. Yet, when performance is on track, they can offer significant opportunities to improve management practices, bring in new capabilities and knowledge, leverage economies of scale and scope, and explore new domains.

A few addendums to these broad trends: more experienced board members tend to avoid acquisitions, somewhat counterintuitively. This may be because any unnecessary risk may affect their reputations. And when private equity investors hold smaller stakes in the company or appoint less experienced board members, their management strategies overall are less proactive.

Private equity investors have the potential to transform a firm's fortunes in a short period of time. Whether that growth strategy will be internally or externally focused will depend on the size of the investment, the experience of the private equity board members and the company's performance patterns.

About the research

Analyses and results were based on longitudinal data from 51 portfolio companies owned by a mid-sized European private equity investor, including data on specific performance targets and each firm's growth strategies.

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