Assessing Operating Teams and Capabilities Across Different Private Equity Models

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Strategic Resource Group

Michael P. Borom
Managing Director, Head of Strategic Resource Group

Q4 2012

Introduction

This paper explores operational value creation in today's private equity ("PE") world and provides a framework for further discussion by providing: (i) a historical context for the development of operational value creation in private equity); (ii) a brief overview of what operational value creation means; (iii) perspectives on the tactics for driving operational value creation; (iv) context on the various operational models deployed; (v) an overview of the determinants for the different operating models; and (vi) recommendations to limited partners on how to assess an operations function in a PE firm.

Historical Context

A basic premise of private equity has been that private ownership can be more effective than public ownership at unlocking the potential or unrealized value of a company. In the 1980s, there were few experienced general partners ("GPs"), public market companies were valued in the mid-single digit multiples and leverage accrued to the benefit of the buyer. Value creation efforts were focused largely on opportunities to reduce corporate "bloat" and/or spin off non-core assets in partnership with existing management. This model proved successful and average net returns for U.S. buyout funds were north of 20%[1]. Success led to bigger and more expensive deals. Fueled by the availability of debt through the issuance of high-yield bonds, buyout funds paid up for "brand names," cash flow and growth. From average acquisition multiples of 5.5x EBITDA in the early-mid '80s, multiples increased to 8.3x by 1989.[2]

In the 1990s, GPs put greater emphasis on generating proprietary deal flow, developing detailed growth plans, lowering the cost of financing, using less leverage (the average equity contribution in buyouts increased from 10% in the '80s to 35%)[2] and investing with strong management teams. Growth plans generally focused on roll-ups, consolidation and geographic expansion. Following the recession in the early 1990s, PE

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[1] Preqin Performance Analyst – market benchmarks for U.S. focused buyout funds. Performance data is available for vintage 1984, 1986-1989.

[2] Kaplan, S. and Stromberg, P., 2008, "Leveraged Buyouts and Private Equity," Working Paper 14207, National Bureau of Economic Research; Standard & Poor's LCD.

activity and returns improved, then went through another downturn in the late 1990s and another cycle in the 2000s, largely driven again by abundant credit as acquisition multiples rose and attention was focused on creative financing and accretive acquisitions. While PE has been, and will likely continue to be, cyclical, and returns have seen a gradual decline as the asset class has matured and become increasingly competitive, *private equity remains one of the top-performing asset classes over the long-term*. Over the last 10 years ended December 31, 2011, PE has generated approximately 900 basis points of outperformance over the S&P 500 Index and top performing managers have generated almost 1,600 basis points of outperformance.[3] Private ownership continues to offer significant advantages over public equities, such as more control to effect change, better information, superior corporate governance, better ability to implement changes quickly unbound by quarter-to-quarter earnings and the flexibility to maximize value opportunely when selling/exiting. Several studies, including those by McKinsey & Co., The Boston Consulting Group and Oliver Gottschalg, a professor at the Icole des Hautes Itudes Commerciales (HEC) in Paris, identify operational improvement (as opposed to financial engineering) as the primary source of value creation and private equity outperformance, particularly during market turbulence.[4]

Going forward, PE should be able to continue to outperform other asset classes and generate attractive risk-adjusted returns, but the GP's ability to add significant value operationally and to transform companies strategically will be even more critical to sustainable growth. Many GPs have continued to evolve and refine their investment approach, including becoming more active operationally, deepening their industry specialization and relationships to improve sourcing and due diligence and focusing on opportunities to improve business processes. Resident operational expertise has become a key competitive advantage for many PE firms, allowing those with in-house teams to react rapidly to market changes and increase efficiencies across their business.

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[3] Cambridge Associates LLC, U.S. Private Equity Index® and Benchmark Statistics, Private Investments, December 31, 2011.

[4] Gottschalg, O. and Golding Capital Partners, 2011,"Private Equity Study: Finding Alpha 2.0," HEC-Paris; The Boston Consulting Group, 2012, "The 2012 Private-Equity Report: Engaging for Growth"; The McKinsey Quarterly, 2005 Number 1, "Why Some PE Firms Do Better Than Others."

In the current environment, GPs are pressed to further consider what the best operating model is, or how an existing one can be improved, as it applies to driving sustainable growth and margin improvement at each company in their portfolio.

Understanding Operational Value Creation

Operational value creation starts with identifying growth and operational improvement opportunities during due diligence and ends with effecting actual change post-investment.

Improvement always requires change. Breakthrough improvements nearly always require *fundamental* change, including rethinking how a business operates. Such change generally cuts across functions, departments and divisions and requires significant coordination. To assess PE operating capabilities in the context of creating value, an understanding of the fundamental elements of driving change in a company is important.

Importance of alignment

Change in an organization is difficult and requires an empowered, confident team that is fully informed, conscious of tradeoffs and flexible in its approach, constraints and structure. In a PE setting, it also requires full alignment across a broader set of critical stakeholders including management, the PE investment professionals and the PE operating professionals. The larger the degree of change, the more alignment required.

Like a three-legged stool, all elements are dependent on the others. While it may be possible to complete a project successfully without all three legs working together, driving fundamental breakthrough improvements is near impossible. At a minimum, lack of alignment across these groups will likely cause the time period for achieving meaningful EBITDA impacts from such change efforts to extend beyond the investment period of the PE firm.

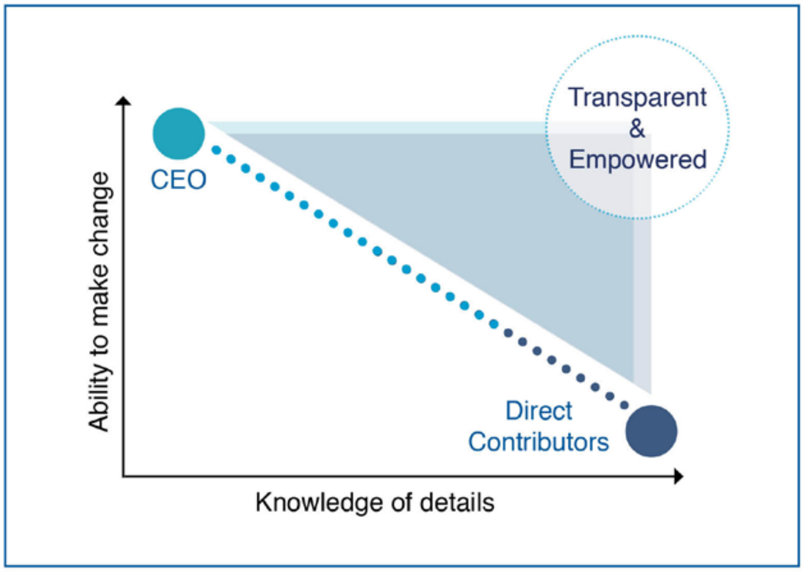
Operating professionals and investment professionals “underwrite” a management team’s industry knowledge, capabilities and historical track record during the diligence process. Most PE-backed deals, given the size and type of company, involve organizations with teams long in industry-specific legacy. Many leaders at the business “grew up” in the industry and many have spent their entire careers in the same company. The benefit is that management generally works very well together, knows the industry and understands the customer base. The negatives become apparent when the industry is subjected to shifts such as the introduction of price compression (e.g., by a new competitor), disruptive new technology, geographic changes or fundamental shifts in customer expectations. When changes in the landscape happen, or in the case where the PE firm desires the organization to change ahead of the competition, this familiarity and comfort with the status quo often becomes a detriment.

Outside perspectives shared productively can shed valuable light on breakout opportunities and/or threats and the actions required to seize or avoid them. In today’s rapidly changing and ever shrinking world, these types of actions generally require an external catalyst, an agent of change that is comfortable with the disruptions that change brings with it. An organization going through material change needs shepherding. Frequently, management lacks the bandwidth and change management experience to be an effective shepherd, which is a role that can be filled by a PE firm’s investment team and operating partner or third party consultant working in concert.

Leveling the knowledge-power equation

In most companies, detailed knowledge of what is happening, how the organization works and what needs to change is greatest in the front lines (the “Individual Contributor”), but front line employees rarely have the ability or empowerment to drive meaningful change. Figure 1 illustrates the “Knowledge–Power Gap” and the challenge that PE firms and management regularly encounter with change.

Figure 1. The Knowledge – Power Gap



The analogy is the engine room of the ship. The engine room operator knows exactly what it takes to make the ship run, but lacks the perspective and authority to steer the ship in the right direction. At the other extreme, the CEO and his/her direct reports generally have the authority, power and perspective to effect change, but they can be too far removed from the necessary on-the-ground information (facts and operating details) to be able to make the necessary changes with differentiating speed. In the ship analogy, the captain can steer the ship but cannot fix the engine.

The distance between the people who know what needs to change and those with the ability, power and authority to drive that change is further confounded by organizational silos (functional, divisional, geographic), a particularly salient problem in roll-ups or companies with follow-on acquisitions. In the case of a ship, linking the bridge of the ship directly to the engine room and clearly defining roles resolves this.

This knowledge-power gap is especially important in highly dynamic environments when companies have to be better at anticipating both opportunities and challenges and driving faster sustainable change.

An operating partner as the "link"

One of the most important roles of an advisor, consultant or operating partner is to act as the link between the bridge and the engine room to facilitate change. This external party/influencer endeavors provide transparency up the organization and empowerment down to the front lines. An operating partner who is an integrated member of the PE firm and has gained credibility within the company organization – almost viewed as a member of the company – is best able to accomplish this.

An operating partner in this position is also able to help management focus on the change without becoming overly consumed by the chaos likely generated as a result of flattening out the levels of knowledge and ability to influence in an organization. Many managers sub-optimize the benefit of change by becoming overly distracted by the "chaos" and then very focused on controlling it. The PE operating partner helps with this dynamic by serving as an aligned, objective, outside influencer who keeps the company focused on the goal.

Tactics for Driving Operational Value Creation

From the perspective of the PE operating team, the process for driving operational value creation involves four steps. The first step starts with the due diligence process and includes the establishment of transparency with the management team through the sharing of diligence findings and open communications. Second, a PE operating team needs to earn management's respect through a successful, discrete project. This gives the management team the opportunity to engage with, understand and appreciate the operating team's capabilities. It also enables the team to build critical trust and mutual respect. Third, the investment team (which includes both operating and investment professionals) needs to develop a set of operating metrics that align with the operating priorities of the business. Beyond the obvious financial information, board packages must include a strong set of operating metrics which provide objective measures of progress on key initiatives and leading information as to the financial trends. The development of effective operating metrics is difficult and requires a strong partnership and engagement in the details. The final step builds upon this foundation, which should enable the PE operating team to seek big opportunities to drive breakout growth. Figure 2 illustrates "The Path to Change."

Figure 2. The Path to Change

Due diligence phase

In some firms, the operating team is involved from due diligence through exit and is an integrated part of the investment team. Almost the opposite end of this approach is an in-house team that assumes responsibility for managing the investment once the investment team has closed the transaction. Having a PE firm's operating professionals engaged with a portfolio company during due diligence can help validate and pressure-test underwriting theses such as time frame and magnitude of productivity efforts, service levels and metrics, operational effectiveness, sales force effectiveness and potential acquisition synergies among other opportunities. Being involved at this stage also helps in establishing key relationships with the management team so that by the time of closing, the collective team can be well down the initiative path and progressing aggressively towards a broader set of changes. Immediately following the closing of a transaction, the PE firm should share its diligence findings with the management team as part of the process of aligning everyone around the same set of operating priorities.

A challenge for operating partners, working intensely with companies on critical issues, can be balancing the time put towards due diligence efforts with the time required to effectuate meaningful change in existing portfolio companies.

Discrete project phase

Much attention has been focused on 100-day plans, which lay out what is to be done in the first 100 days following an acquisition. The actual deployment of a 100-day plan is highly variable and dependent upon the specific situation of a company. Some GPs utilize a standard 100-day plan across each of their portfolio companies to establish control and tackle areas identified for immediate cost reduction. This cookie-cutter approach is not the optimal solution and a more customized approach designed for the specific needs of each portfolio company is preferable. Assessing and developing a strong working relationship with management, jointly establishing operating and strategic priorities and designing an implementation plan should all be key objectives of the first 100 days. In particular, operating professionals should be resident at a portfolio company for an extended period of time, which gives them an ability to quickly confirm/form a better view of the business and any specific dynamics at work that may not have been obvious during due diligence. This can be extremely valuable in establishing strategic direction and priorities as well as making organizational changes if required. It is also important to recognize that adding value operationally to a company requires much longer-term engagement than just the first 100 days.

It is usually best for an operating partner(s) to engage in the business through a specific, strategic project sponsored by senior management and the board of directors. The immediate aim is to provide extra bandwidth for management and to help accelerate a critical initiative. Engaging in a discrete project, with a defined, limited scope, is critical for several reasons, chief among them credibility. Successfully driving important change requires deep, mutual respect between management and the operating team. During the course of diligence, management has earned the GP's respect; in the initial period after the acquisition, operating professionals and investment professionals need to earn theirs. Supporting a critical initiative through implementation begins to establish this respect, while helping an operating partner develop a greater understanding of the organization and its business. Through an initial project, operating partners can help bring knowledge on a specific topic up to management and help empower front-line employees to drive a determinate set of changes. In this way credibility with management is gained, while establishing a direct line to the CEO that the rest of the organization can see.

In addition to developing credibility, the support for and engagement in a discrete project serves two other purposes. First, it enables the operating partner to enter the company with minimal disruption and requires a lower level of alignment than breakthrough change. As mutual respect is built with management, a partnership and the alignment necessary for larger, more breakout initiatives is developed. Trying to undertake too significant a change without previously establishing respect and alignment will usually lead to failure. Second, the project opens the door for delving further into various aspects of the company, via access to data, processes and people in lower levels of the organization. Delving deeper is critical to discovering opportunities for breakthrough change. Organizations typically have business data (customers, products, processes, sales, headcount, etc.) which can reveal opportunities and challenges. Given that most companies are now fairly lean, management is generally too tied up running the business to take an entirely unbiased view at a wide set of data. For example, organizations can fall into the habit of replicating reports without thinking about the underlying information, particularly the exceptions or tails in the distributions.

A fresh look at the underlying business data can serve to develop hypotheses about opportunities and lead to an engaged and productive conversation with management. The intent should be to build an open dialogue around objective information, which should be both interesting and useful for management teams.

Operating metrics phase

During the discrete project phase, the operating partners will also work with the investment professionals and company management to design a set of operating metrics that all parties will use to monitor the success of the business. Too frequently, all focus is on purely financial metrics, which tend to be backward looking and are not very effective at identifying problems or opportunities before they actually occur. Portfolio company management teams generally welcome the development of these operating metrics since they speak the "language" of their business more effectively and highlight the willingness of the private equity firm to focus on more than just the financial aspects of the business. Establishing the proper operating metrics is not easy. It requires agreement around a set of operating priorities and then how best to measure success against those priorities. What is not measured will not be improved.

From "project to breakout": final phase

If the impact from a discrete project is as expected (e.g. acceleration of a key initiative or the operating partner has been a valuable, objective and aligned thought partner with practical suggestions) the initial project typically leads to another and then to a third. Over time, the progression enables an operating partner, in partnership with management and the board of directors, to raise the level of "knowledge" and "ability to make change" in the organization to drive progress. By starting small and probing further, breakout opportunities can be more creatively spotted across an organization, opportunities normally inhibited by silos or industry myopia. Similarly, a deeper understanding of the organization is developed, which is critical to driving change in an apolitical way.

These projects should lead to operating partners becoming indispensable, objective and aligned advisors to both the management team and the board of directors. At times, because of the close relationships, the awareness of the company and team and the ability to drive change in the business, operating partners can serve in interim management roles or join boards to remain involved in a more formal setting.

Leveraging the portfolio

Finally, there are many opportunities to leverage the broader firm across the portfolio. These opportunities may be captured across the life of the company depending on the priority, the stage of the business and the other competing efforts. Indirect spend presents one area of significant opportunity for cost savings and enhanced quality. Many Group Purchasing Organizations ("GPOs") have been formed and multiple private equity firms have formed leveraged procurement specialties and even separate organizations. Again, the model for leveraged procurement and cross-portfolio influence differs from firm to firm. Some PE firms force their companies to sign on for specific purchasing relationships while others simply make introductions. A hybrid approach has benefits. As an example, healthcare is one area with the potential to reduce the cost to the employer while improving patient outcomes. Some PE firms may be able to advise their portfolio companies directly on managing costs based on in-house experience in healthcare plan design and administration. However, to provide specific recommendations and help with the implementation, more PE firms are beginning to use external consultants who specialize and who can also be leveraged across portfolios. These outside specialists will provide a fee-free assessment of potential savings and work with companies directly to renegotiate contracts and improve plan design.

Alternative Operating Models

There are many different operating structures deployed across the various private equity firms. These structures, which have been covered in detail in other papers, including an extensive one by INSEAD[5], range from the systematic and routine use of external consultants to large, in-house staffs. In-house staffs can take the form of: (i) In-house Consultants – a team of consultants that operate in a "pyramid" structure with a team leader and a several junior consultants or analysts to manage projects; (ii) Specialist Resources – individuals with deep industry, technical, or functional expertise that work with individual portfolio companies on specific challenges and opportunities. Specialists also work on broader cross-portfolio opportunities to drive value such as extracting purchasing savings based on pooled leverage or sharing best practices; (iii) Resident ex-CEOs – retired executives who typically work on a part-time basis at the board level with management teams and the PE firm directors; (iv) Operating Managers – full-time, senior level individuals, typically with a mix of advisory and managerial experience, who partner with both senior management and company personnel to drive change through a series of projects; and (v) Interim Operators – former executives who assume full-time management roles within the portfolio companies. Each operating structure delivers value in different ways to enable the portfolio company to achieve higher growth rates, drive greater efficiency and productivity and/or lower the overall cost structure. Figure 3 illustrates some advantages and considerations of each operating model.

[5] Hemptine, C. and Hoflack, V., 2009, "The value of in-house operations teams in private equity firms," INSEAD Independent Study Project.

Figure 3. Operating Model Advantages and Considerations

	Advantage	Considerations
Operating Managers	• Combination of senior in-house consultant and interim operator • Engages deeply in partnership with portfolio company management rather than playing an executive role	• Will need to establish credibility with portfolio company management • Junior consultants are replaced with individuals from the portfolio company
Outside Consultants	• Can supplement operating capabilities or serve as primary vehicle for portfolio company support • Can ensure portfolio company "buy in" since they typically bear cost of engagement	• Disengaged from investment professionals • Less accountability, continuity and consistency • Information not retained within the firm
In-House Consultants	• Frequently deployed in every investment • Less senior team members vis-à-vis a consulting firm since no need for client acquisition	• Often use repeatable, generic approaches to best leverage skills of junior consultants • Can be disengaged from investment professionals
Specialist Resources	• High degree of expertise in specific technology or technical areas or in specific functional areas	• Number of portfolio companies that can leverage such a resource
Resident Ex-CEOs	• Brings deep industry experience, coaching to portfolio company senior executives and industry relationships • Provides contacts for access to capital, strategic partnerships and talent pools	• Typically a part-time, ad hoc role • Requires a high degree of alignment between the industries in which the firm invests and the executive's experience
Interim Operators	• Similar to resident ex-CEOs, but plays a hands-on, full-time role	• Replaces existing management and drives a focused agenda • Often used for distressed companies

Outside Consultants

Many PE firms (both large and mid-sized) often use third parties (e.g., management consulting firms, boutique advisory firms, execution-oriented consultancies) to help analyze an opportunity or implement an initiative. Depending upon the operating structure and philosophy of the PE firm, the use of consultants either supplements their operating capabilities or serves as the primary vehicle for providing support for their portfolio companies. Judicious use of outside consultants has the benefit of ensuring that portfolio companies "buy in" to the results of the consulting engagement since they typically bear the cost of the engagement.

In-house Consultants

A number of PE firms have built a team of "generalists" who have direct experience managing organizations and/or consulting experience. Typically these in-house consulting teams are run separately from the investment professionals and engage deeply with portfolio company management on a project basis, bringing both project management skills and analytical capacity. The structure of these teams generally resembles the highly pyramidal structure of a consulting firm, with the exception that there are fewer senior members, as client acquisition is a foregone conclusion. These teams often play a dual role of helping management and reporting back to the investment teams. They are frequently deployed in every investment, regardless of the type of company or point in the investment life cycle, using repeatable, generic approaches (e.g., 100 Day Plan, "Strategic Blueprint") to manage and best leverage the skills of the more junior consultants. The investment in a large, in-house consulting team makes sense when the portfolio of companies is large and complex enough to absorb the capacity of the team and make the standard tools valuable.

Specialist Resources

Other firms have invested in hiring individuals that have expertise in specific technology or technical areas (e.g., biotech, digital media) or in specific functional areas (e.g., sourcing, IT, HR) that they can deploy across a number of companies in their portfolio. The investment in these resources makes sense when the GP has a sufficient number of portfolio companies in industry sectors that could leverage the technology or technical expertise, or has a large enough number of companies to justify cross-portfolio initiatives such as leveraged procurement or healthcare cost management best practices.

Resident ex-CEOs

The key source of value that this model provides is the opportunity to tap into the executive's deep industry experience, provide a coach to portfolio company senior executives and leverage industry relationships and contacts for access to capital, potential strategic partnerships and talent pools. Typically, this is a part-time, ad hoc role and requires a high degree of alignment between the industries in which the PE firms invests and the executive's experience to be effective.

Operating Managers

This model draws upon individuals that tend to be a mix of those in the Interim Operator model and the senior members of the In-house Consultant model. Their role is to engage deeply in partnership with the leadership of the portfolio company, rather than play the executive role, and to mobilize the organization to implement top strategic growth, productivity and cost initiatives. More junior consultants are replaced with individuals from the operating company, provided the management team is convinced (or believes from the start) that their efforts will create value. Operating partners need to be extremely capable in order to lead less experienced "project" teams - many times the individuals provided by the company have deep domain knowledge but little to no experience with such project work - and must be able to work with the management to frame out initiatives, develop implementation plans, support the analytical approaches and motivate people at all levels of the organization to execute the initiatives. Operating partners also need to have the strong influencing skills of very good consultants and the intense focus on and tenacity for implementation of an excellent operator. These operators, as a rule, have excelled in both senior consulting and senior operating roles and should have demonstrable and auditable successes in their history. The Operating Manager model and the right experience of the operating partners allow a team to: (i) adapt their approach based on the needs of each individual portfolio company; (ii) expand management's bandwidth by rolling up their sleeves, engaging deeply at all levels of the organization by being on the ground at the company; (iii) quickly establish credibility with senior executives on the management team; and (iv) analyze the operating data in depth to identify opportunities and/or red flags. These are all critical elements in creating transparency, empowering organizations and driving breakout opportunities.

Interim Operators

Similar to the ex-CEO role, the interim operator approach relies upon industry and C-suite experience, but different than the ex-CEOs, these individuals play a hands-on, full-time role, regularly assuming direct responsibility for a key leadership position (e.g., CEO, COO, CFO). These operators replace existing management and are in the firm to aggressively drive a focused agenda built upon specific growth and/or cost initiatives.

Model Determinants

A PE firm's operational approach should be driven by three key determinants:

- Investment strategy
- Firm structure
- Engagement model

Investment strategy

Companies require different kinds of support at different stages in their evolution. The various characteristics of target companies (industry, size, stage, etc.) are perhaps the most determining factors in the design of an operating group.

Ideally, a PE firm's operational approach should be tied closely to its investment strategy, taking into account factors such as: (i) the health of the companies invested in (growth or distressed); (ii) the stage in the company's life cycle (early or later stage) at which the firm generally invests; (iii) the types of stakes the firm takes in businesses (majority or minority); and (iv) the industries invested in, with consideration given to whether or not highly specialized skills and knowledge are required.

For example, a PE firm taking active and majority positions in distressed, core manufacturing and service companies might be inclined to have a group of hands-on operators, such as Resident ex-CEOs or Interim Operators that tend to run companies rather than work with existing management teams on a collaborative basis. This is because management teams in such situations are often being replaced on a wholesale basis with new operators; a PE firm wants people whose operating approach and cadence they know and trust and with whom they are comfortable working. Further increasing the need for in-house management teams is the fact that, even with new management, many managers rarely or never experience the disruption associated with a truly distressed company, especially one emerging from bankruptcy, while there are certain individuals who have made a career out of performing in just such situations.

Alternatively, firm's that invest in later stage, larger growth companies typically invest in companies with successful management teams (thus, a track record of growth) in relatively healthy industries (thus, a positive outlook). In nearly all cases, these portfolio companies or investment targets have been doing many things right prior to the PE firm's ownership, and the PE firm often underwrites an investment based on the team continuing to do what has led to previous successes. As such, the involvement of the operating team is more of a partnership with management as opposed to actually becoming management. This requires a much different skill set across the team, specifically one more geared to influencing change by providing an objective perspective, extra bandwidth and a fresh perspective. These firms may choose a more generalist approach whose operating partners have cross-functional expertise and experience through consulting or operating backgrounds. The generalist approach puts a premium on leveraging the deep industry experience of the portfolio company and enhances collaboration.

One function where an in-house specialist may be optimal is the IT function, where the growing needs and rapid pace of change dictate much deeper domain experience and specialist technology experience across multiple industries. Where other specialist resources are required but on a more limited basis, such as in procurement, healthcare plan design or technical evaluations, it may make sense to engage outside firms who work under the direction of its operating partners.

Firm structure

Today's PE firm structures span a broad range of geographies, offices, disciplines, ownership structures and asset classes. The structure of the operating team should be designed to work effectively within the overall structure of the PE firm. Geographic and asset class coverage, communications and coordination with investment professionals and the commitment of firm leadership must all be considered to optimize the potential of the operating group. Additionally, establishing a productive partnership between an internal operating team and the PE firm's investment professionals requires the correct alignment economically, as well as structurally, and team compensation is an important consideration.

Compensation structures for operating professionals vary widely across the PE firms and comparisons are not perfect. Some PE firms view operating resources primarily as a cost center and, similar to external consultants, charge companies a fee for service. In other cases, such as the Interim CEO model, compensation is tied directly to the performance of the portfolio company, generally through salary and stock options/grants. At the other end of the spectrum, compensation for a PE firm's operating professionals may be more aligned and comparable to that of the investment professionals and linked to either the success of a specific company, or to the success of the entire fund, which encourages fluidity and re-allocation of resources across the entire portfolio as required.

An additional challenging element is the fact that PE firms have well established career paths for investment professionals, with many such paths beginning prior to an individual going to business school, and, as a result, the investment professionals have long and deep relationships within the firm. The operating professionals, on the other hand, frequently come from a variety of backgrounds, and development of relationships and operating cadence and integration within the firm is sometimes a difficult and lengthy process. In addition, there will likely be less continuity in team of operating professionals, since members may come from and go to portfolio companies or other operating businesses with some frequency. While this has the benefit of sharpening operating skills, it can add challenge to compensation structures.

Engagement model

Each PE firm has a different method for engagement with their portfolio companies. Some are extremely directive, some are very hands off, and some are more collaborative with management. These approaches are part of the firm's reputation and are articulated to management teams during the due diligence process. The operating approach must be built with this in mind. For example, if a firm is very collaborative, then building a team of pure operators who need to be in charge to effectuate change would not be an optimal solution. Where the engagement model is to work collaboratively with management teams, projects and cross-portfolio efforts must be developed and implemented while gaining buy-in from company management teams. Using a collaborative approach with management dictates operating professionals with well-refined consulting skills for influencing combined with a practical orientation and bias for action that regularly comes as a result of challenging operating experiences.

Assessing the Operational Capability of a Firm

There is no one right approach to enhancing value operationally. The key question limited partners ("LPs") should consider is: "Does the GP have an operating capability that aligns with its investment strategy, approach to managing portfolio companies and overall culture?" Ultimately, an LP must be comfortable that the operating capability drives differential value through: (i) acceleration and enhancement of improvements; (ii) identification of, and action on, breakout opportunities; (iii) support of businesses managing through difficult competitive environments; and (iv) development of new and sustainable resources and capabilities within and across portfolio companies.

Since there is no one right answer to creating operating value, there is no cookie-cutter approach to assessing effectiveness in this area. Portfolio company performance (good or bad) presented to LPs may or may not have had anything to do with the PE firm's investment and/or operating team. Many times a great management team, the right industry at the right time, a new product or macro-economic tailwinds can be spun as operating value-added. Conversely, great operating achievements can be offset by industry, competitive and macro-economic headwinds, and act only as a hold your ground measure. As such, it is necessary to ask the right questions and probe sufficiently to ensure a proper understanding of the drivers underpinning such efforts.

In assessing operational capabilities across PE firms, LPs should review the results, diligence the teams and understand the choices that firms have made with regard to their models. It is recommended that LPs consider the following analysis:

(1) Assess the fit between the approach chosen and the key determinants.

   a. Is the operating approach aligned with the strategy and engagement model?
   b. Is the operating approach sustainable? Do the compensation structure and professional development opportunities for operating professionals fit with the structure and culture of the firm?

(2) Evaluate the role the operating group played in the outcome. This is difficult to determine and requires more than "filling out a spreadsheet." Real improvements might be masked in a difficult environment, or the primary driver of success may be a strong market.

   a. Evaluate each portfolio company and the extent to which operating partners accelerated the pace of change and their overall effectiveness in implementation and embedding capabilities at the company.
   b. Interview portfolio company management teams. Discuss the role of the operating partners and how they have interacted with the management. Ask management to assess the effectiveness of the approach.

We hope this paper has given you a different perspective on how and why operating groups are established, as well as the ability to assess the appropriateness and effectiveness of such teams.

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THL Thomas H. Lee Partners
est. 1974

For more information, please contact:

Gregory A. White
gwhite@thl.com

Beverly A. Berman
bberman@thl.com

100 Federal Street
35th Floor
Boston, MA 02110
(617) 227-1050