PEI Alternative Insight

PRIVATE EQUITY INTERNATIONAL

THE OPERATING PARTNER IN PRIVATE EQUITY

Successful strategies for value creators

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By Tony Ecock, Welsh, Carson, Anderson & Stowe

In 2008, I started a networking group exclusively for full-time, in-house operating partners at leading private equity firms. Three years later, the Private Equity Operating Partner Executive Network (PEOPEN) has over 350 members, representing at least half of the known population of full-time, in-house operating partners in private equity globally. Interacting with this diverse group of talented professionals has provided me with a terrific vantage point on the many different operating partner models and approaches for adding value to portfolio companies.

The potential benefits of bringing in-house a dedicated, full-time operating partner, or building a whole team of operating partner generalists or specialists, are many. The private equity firm, however, must be committed to the strategy and the operating executives they have hired. In general, the greater the commitment of the firm, the greater the results that will be achieved.

Considerations for hiring full-time operating partners

The bar for adding operating partners to the private equity firm payroll is very high. Most firms have a well-developed network of external operating resources such as board members, senior advisers, interim executives and consultants. These external resources bring specific expertise that can be scaled up or down as needed, and they are typically paid for directly by portfolio companies. Even at firms with large staffs of operating partners, external resources still account for the vast majority of portfolio company value-addition activity.

Beyond expertise, scalability and cost, the other important considerations for bringing operating partners in-house include:

- How will adding operating partners impact roles and responsibilities in their management of the portfolio?
  - In particular, who will 'own the deal' and the CEO relationship post-close?
  - What impact will introducing operating partners have on accountability for the success of a deal?
- Will current portfolio companies be receptive to operating partners' input?
- Will operating partners hinder the firm from attracting talented entrepreneurial management teams in deal origination?
- How will adding operating partners change the firm's culture? In which decisions, meetings and operating mechanisms will operating partners participate – and vote?

Adding a team of full-time, in-house operating partners fundamentally changes the private equity firm in both makeup and culture. It will be hard to reverse this decision.

The good news is it is easy to clear the bar. The opportunities to add value to a large portfolio of companies are almost limitless, and full-time, in-house operating partners are uniquely positioned to realise them.

Opportunity-rich environment

The portfolios at the top private equity firms are large and offer enormous potential for value creation relative to the cost of hiring full-time, in-house operating partners. For example, at any given time, the portfolio at Welsh, Carson, Anderson & Stowe (WCAS), where the latest equity fund was approximately $4 billion, might consist of 25 companies, 90,000 employees, $20 billion in revenue, $4 billion in supplier spend and $1 billion in cash employee-benefit costs. Achievable improvements add up quickly:

- 1 percent better pricing realisation equals $200 million.
- 5 percent savings on procurement equals $200 million.
- 5 percent savings on employee-benefit costs equals $50 million.

Whether a fund is highly diversified or concentrated, the opportunity for value creation is directly proportionate to total portfolio revenues and costs.

At WCAS, we have found that 'the more we look, the more we find'. For example, we had modest expectations when we first evaluated a cross-portfolio programme. Our portfolio consists of healthcare and business-services companies where people, not external purchases, comprise the highest percentage of costs. Most portfolio companies are large enough to have their own buying power. We anticipated moderate compliance due to concerns about switching suppliers and whether group buying could accommodate the unique needs of individual portfolio companies. All things considered, we estimated we could save $15 million to $20 million through the programme, enough to make the initiative worthwhile, but certainly not the homerun for which everyone was hoping.

Early results were more promising than expected. We found savings opportunities in more categories and greater percentage of savings. Even our largest portfolio companies, with the greatest purchasing scale, saved money. However, the real breakthrough came when we hired an experienced operating partner to focus on procurement. With his leadership, we have generated over $60 million in annual savings from WCAS-specific programmes. Another $250 million in savings has come from the portfolio companies themselves through the sharper focus brought to procurement. Most promising, we are now working as a team with procurement leaders across the portfolio. These leaders are contributing their own ideas and vendors to continuously expand the pie. This buy-in from our portfolio companies has been helpful in attracting external help from group-purchasing organisations, service providers and consultants who work on contingency fees and count on compliance for success. Every year, we ask our portfolio companies to budget additional savings from procurement. We have created one of those rare, virtuous cycles, which we could not have achieved without an in-house operating partner focused on procurement.

The procurement programme has worked so well that it has become one of the foundations of our Resource Group strategy. It has built trust and credibility, opening doors for collaboration with portfolio companies on other areas. The programme is used not only by the companies we control, but also by those in which we own a minority stake. It has become a differentiator that can be referenced when doing new deals. After all, which CEO does not appreciate some 'free money' to invest in growth initiatives? Dozens of similar examples can be found at other private equity firms, in just about every business function, all made possible by the full-time focus of an in-house operating partner over a multi-year period.

Advantages of having full-time, in-house operating partners

Full-time, in-house operating partners can find and realise more value because their unique role gives them 'unfair' advantages, including:

1. *Focus.* Full-time, in-house operating partners have the luxury of waking up every day with a primary focus on adding incremental operating

Customer lifetime value: methodology and applications for operating partners

By Hilary Gosher and Nikitas Koutoupes, Insight Venture Partners

Introduction

Of all the analytical tools operating partners have at their disposal, customer lifetime value (CLV) analysis can be an important part of due diligence and useful for achieving operational excellence post-investment. This chapter outlines the methodology of CLV and how operating partners can use it to impact overall growth strategy in portfolio companies.

CLV is an increasingly utilised metric that combines many of the levers of growth and profitability in a single concept. It affords management and operating partners a long-term view of customers by taking into account the contribution the average customer will make to the bottom line of the business, from the moment they are acquired up until the last time they do business with the company. This analysis is relevant for any business where a customer makes a purchase more than once. It is also applicable across a wide range of B2B and B2C businesses. CLV can easily be determined once a customer has left or churned, but a key benefit of CLV is its predictive value.

Defining CLV and its components

Definitions

CLV is the net present value of expected net cash flows over the average customer's lifetime, less the cost to acquire that customer. This definition identifies the components that contribute to CLV, namely:

- *Customer retention rate.* To obtain the 'expected' net cash flows, the likelihood that a customer will conduct business with the company at a given point in time (by buying another product, renewing a subscription or paying maintenance) is calculated. Customer retention is therefore the first component of CLV and is the expected probability that a customer (or an expected percentage of the customer population) will conduct business with the company at a point in time after the original transaction. For example, of the 100 customers who sign up in month 0 for a monthly subscription, 95 percent remain in month 1, 80 percent remain in month 2 and so forth. Operating partners can establish a basis for what historical retention rates have been for a business by analysing retention trends over time, typically by cohort. A cohort is a group or class of customers that began transacting with the business during a specified period of time (for example, in October 2011 or in the fourth quarter of 2011) and cohort analysis examines the retention rate of this group. Cohort analysis is important to be able to project future retention rates which are a critical component of the CLV calculation. Trends can show, for example, decreasing customer loyalty for more recent cohorts, a situation where extrapolating data from older cohorts to calculate a projected retention rate could result in an overly optimistic forecast. Constant retention rates over time are likely to yield accurate forecasts because customer behaviour is not changing.
- *Average net income per user (ANIPU).* To calculate 'net cash flows', data is needed on how much a customer will pay at a given point in time, and how much it will cost to service this customer at that same point in time, on a fully

loaded basis. ANIPU represents the payments that a business receives from the average customer over a period of time (average revenue per user, or ARPU), minus the fully loaded cost to service that customer over the same time period (average cost per user, or ACPU). In situations where calculating ANIPU correctly is not possible as a result of data-collection constraints (through difficulties in procuring all customer transaction data over time, or obtaining accurate information on the costs to serve customers), only ARPU should be used, along with the rest of the steps described below to calculate CLV. Without ACPU information, the metric used is average customer lifetime revenue (LTR). LTR does not reflect the net cash flow contributed by the average customer but is still a valuable concept to use in driving operational changes in marketing optimisation.

- *Acquisition cost.* The definition of acquisition cost changes depends on the company analysed. Conceptually, however, it should incorporate all expenses associated with bringing a customer to transact with the company for the first time. For example, in an e-commerce company, all marketing campaign expenses resulting in a new customer transaction should be part of acquisition cost. In a software-as-a-service company or a software license sales business model, both sales and marketing costs should be taken into account, as well as hardware or implementation costs.
- *Discount rate.* The discount rate (r) used to calculate the present value of the ANIPU stream of payments should conceptually be equal to the cost of capital for the company. This will vary by industry and type of business. A simple way of getting to the right discount rate is to assume that the cost of equity for the company is equal to the expected return on equity for the investors, and then adjust the overall discount rate by the cost of any debt in the business.

Table 17.1: **CLV calculation for an annual subscription business**

	Time period										
	0	1	2	3	4	5	6	7	8	9	10
ARPU	$120	$120	$130	$130	$140	$140	$150	$150	$160	$160	$170
Less: ACPU	$60	$60	$65	$65	$70	$70	$75	$75	$80	$80	$80
ANIPU	$60	$60	$65	$65	$70	$70	$75	$75	$80	$80	$90
Average customer retention rate	100%	75%	55%	40%	30%	25%	18%	15%	10%	8%	5%
E (ANIPU)	$60	$45	$36	$26	$21	$18	$14	$11	$8	$6	$5
PV E(ANIPU)	$60	$39	$27	$17	$12	$9	$6	$4	$3	$2	$1
∑ PV ANIPU	$180	*(Discount rate 15%)*									
Less:											
Acquisition cost	$80										
Customer LTV	**$100**										

Source: Insight Venture Partners.

Cost and cash management for private equity portfolio companies

By Gary Matthews, Morgan Stanley Private Equity and David Hanfland, AT Kearney

Introduction

Two of the most formidable weapons operating partners have in their profit improvement arsenal – cost reduction and cash management – continue to be keys to success in private equity. These strategies work by leading to quicker reductions in heavy debt loads and lower risk investments. This explains why productivity improvements are often one of the first strategies employed to generate value. The stakes, however, are high. Poorly executed productivity efforts can alienate portfolio company management, sour relationships across the company and impact performance for the longer holding period.

Pursuing performance improvement in a portfolio company is significantly different from exercises commonly conducted in large, publicly owned companies. Most large corporations have deep benches to execute projects in a timely manner. This is typically not the case for portfolio companies that tend to be organisationally leaner. So, it often falls on the operating partner to work with the CEO and the management team to drive value creation by rationalising costs and improving cash flow.

Our experience has led us to six 'rules' for any operating partner seeking to successfully create cost reduction and cash management value within a portfolio company. These rules are discussed below.

1. Set big goals… thoughtfully

Setting aggressive goals forces portfolio company management to consider substantial changes, and often yields bigger results and greater value creation. Setting modest goals encourages incremental change and often yields more modest savings.

So, how high should the goals be?

The objective is to generate improvement goals that represent the far edge of the plausible, but still seen as achievable. If goals are seen as implausible it will be nearly impossible to secure management buy-in. Motivating a portfolio company team to reach audacious goals requires appealing to its logic, its emotions and, often, its pockets. One proven tactic for facilitating alignment and buy-in is to emphasise the potential personal payout associated with achieving a set of goals for stock- and option-holders.

For example, Morgan Stanley Private Equity has a grocery store company in our portfolio. In 2011, management worked hard to drive over $10 million of cost reductions. Part of their motivation started with the recognition that grocery industry multiples are in the 5.5x range today. Thus, $10 million of EBITDA savings translates into potentially $55 million of created equity value. This is a powerful incentive since the management team owns a substantial percentage of the company.

Picking the right goals is as much a science as an art. It is an art to create a goal so clear that it can be 'branded' for internal use while still flexible enough that it can be sensitive to the nuances and peculiarities of the business. Setting goals is a science in the sense that bold targets need to be supported by an analytical fact base. This fact base includes approaches like competitive benchmarking and 'ruthless-competitor' modelling.

Benchmarking

Benchmarking performance is a critical tool for identifying potential improvement areas and establishing a goal's credibility. It is hard for management to argue that they should not be able to perform at a competitive level. For example, a recent benchmarking project AT Kearney conducted for a specialty retailer revealed that its average expense per square foot was $170 while direct competitors' was $140 to $150 per square foot. Illustrating this differential to management allowed us to make a clear case that store efficiency was an issue and that a focused improvement programme was required.

Relevant competitive benchmarks are often available from the private equity firm as they are routinely used during the due diligence process as a tool to test the investment thesis.

A caveat here, however, is that benchmarks accurately document the 'art of the status quo' rather than the art of the possible. It is critical to understand whether or not a benchmark represents truly best practice or just conventional practice.

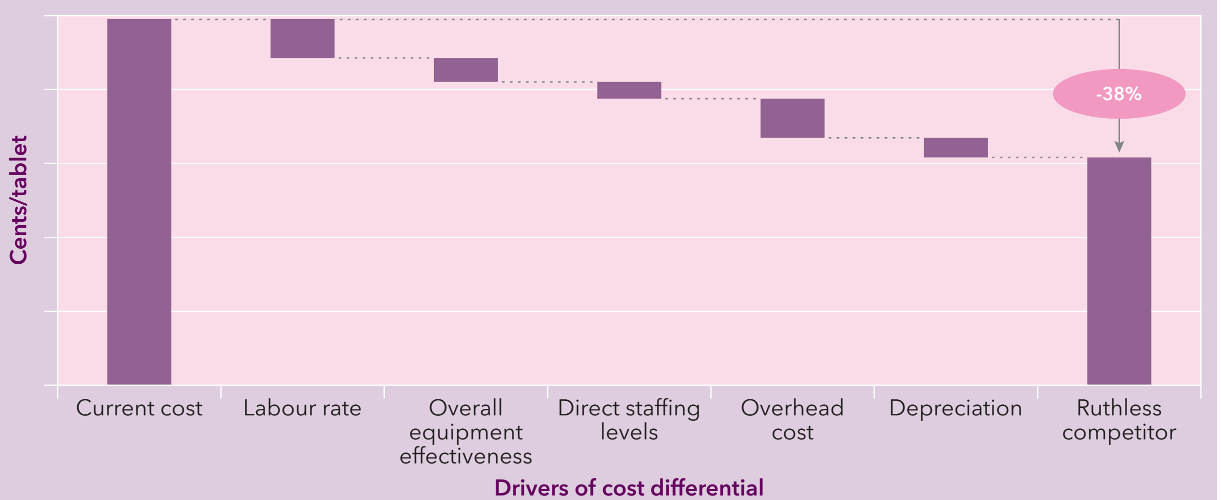
Successful companies anticipate how emerging competitors or technologies will – or can – change their industry and establish performance goals that allow them to prosper in new competitive environments.

Ruthless-competitor modelling

A 'ruthless-competitor' model is a useful tool for developing perspectives on how competitive cost structures can evolve. These models require analysis of the core elements of the business to show how a theoretical competitor would perform if unencumbered by legacy equipment, plant locations and support functions. Comparing the estimated costs of the theoretical ruthless competitor to existing costs of the business can be enlightening and helpful in setting bold cost-reduction targets.

The following example is an analysis of a pharmaceutical-tableting process. The company had relatively new equipment well suited to its needs, but

Figure 18.1: **Ruthless competitor tableting gap analysis – cents per tablet**



Source: AT Kearney analysis.