

KNOWLEDGE SHARING

Leveraging the portfolio

The next step in the evolution of operational value creation should be dubbed the 'portfolio approach', says **Fredrik Henzler** of Partners Group

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Henzler: GPs could establish centralised competency centres

Private equity assets under management have grown fivefold in the last 15 years. As the industry has matured, access to debt and the ability to structure transactions have stopped being key differentiators in a GP's ability to generate returns from their investments. Instead, investment returns are increasingly expected to come from operational improvements across a GP's portfolio – since 2010, upwards of 50 percent of private equity returns have derived from operational improvements, compared with less than 20 percent in the earliest days of private equity in the 1980s, according to a recent report by EY.

Consequently, the focus of LPs has also shifted to identifying GPs with the ability to add unique perspectives and generate value operationally during their holding period. These two factors have led private equity firms to significantly ramp up their value creation resources.

WHAT DOES BEST PRACTICE LOOK LIKE TODAY?

Today, many GPs have come as far as building up a team of operational specialists, often focused on specific functional roles. To be able to leverage these internal resources across their portfolio and to ensure complete alignment between deal teams and value creation teams throughout the investment cycle, best-in-class GPs have worked hard to fully integrate their operational teams into their organisation along the following lines:

- In-house operations teams with a range of expertise
- Integration into the entire investment lifecycle, from sourcing and due diligence, through the holding period to divestment, including Board representation during ownership
- Investment committee representation and empowerment through veto rights

- Incentivisation through compensation schemes that mirror those of deal teams
- Institutionalisation through a sophisticated set of tools, proven methods and a distinct set of values that are rolled out to portfolio companies.

WHAT WILL BEST PRACTICE LOOK LIKE TOMORROW?

At Partners Group, we believe the next step in the evolution of operational value creation should be dubbed the “portfolio approach”. It will entail GPs leveraging both their in-house resources as well as those of their investment portfolios. Indeed, there is enormous potential in the resources, capabilities and know-how of the management teams of companies within a portfolio that could be leveraged across the entire portfolio. GPs will evolve from “owners of a portfolio” to resource and knowledge-sharing platforms for their portfolio.

If we look at the three key dimensions of know-how, process and systems, the portfolio approach offers considerable advantages. Firstly, in addition to leveraging the know-how of a GP's internal and external value creation resources, the portfolio approach will allow GPs to unlock the deep functional, regional and industry expertise of management teams within their investment portfolio.

This could be achieved by facilitating direct exchange between management teams or by implementing systems such as digital knowledge-sharing platforms and granular expertise mapping across the portfolio. GPs could even go as far as establishing centralised competency centers that provide expertise for a specific industry, function or region. Such centres would allow GPs to leverage scale while ensuring consistent quality and speed in implementing cross-portfolio operational improvement initiatives.

Additionally, business-relevant customer and supplier data could be proactively

A BRIEF HISTORY OF VALUE CREATION

Up until the 2000s, the focus for many GPs was mainly on financial engineering and transaction speed as a means of generating value, while operational value creation was not yet part of the scope. During the early 2000s, leverage levels in LBOs decreased from peaks above 90 percent of the purchase price and investment horizons lengthened.

The growing relevance of operational involvement led to a more systematic approach to operational value creation, with many GPs starting to leverage external resources and expertise. In the past decade, as the industry has become increasingly sophisticated, value creation resources have been brought in-house, with GPs hiring advisory and operating partners laterally to build out their sector-specific, functional and regional expertise.

Most recently, the increase of liquidity in the market has led to stiff competition and steep acquisition price increases. On top of this, when purchasing companies at a high multiple, GPs are having to factor the potential effect of future multiple contraction into their underwriting assumptions. To justify higher purchase prices and differentiate themselves compared to other potential buyers, GPs have had to place even greater emphasis on operational value creation. Larger GPs in particular have started to systematically integrate dedicated value creation resources across the entire investment lifecycle, with operational value creation evolving from a key differentiator in fundraising to a critical part of a GP's ability to generate investment returns. ■

shared across the portfolio more systematically, giving all portfolio companies access to best-in-class resources in their non-core areas of expertise and potentially enabling faster transformation and growth.

Secondly, processes could be benchmarked and aligned across the portfolio to ensure efficiency and quality gains at the individual company level, but also to facilitate the implementation of portfolio-wide appraisals and improvements. For example, the impact of a cross-industry trend such as increasing digitisation could be assessed across an entire portfolio in the initial stages, with several of the findings and implementations also likely to be shared by multiple portfolio companies.

Finally, while best-in-class systems and tools will continue to be introduced at the individual company level, vast potential could be unlocked by rolling out shared systems throughout an entire portfolio. Portfolio-wide customer databases, for instance, could unlock potential in sales and procurement simply by providing access to larger data sets. A more granular operational monitoring and benchmarking system would enable GPs to measure, benchmark and improve companies in a fast and resource-efficient manner.

Much of this systematic approach to portfolio management may look familiar: it is what large corporates do when they acquire other businesses. It is important to note,

though, that in contrast to a conglomerate, the companies in a private equity portfolio are, of course, bought to be sold. Deep asset integration within a portfolio as in the case of successful conglomerates such as Danaher is hence not suitable for private equity.

Nonetheless, several industry trends favour a deeper level of integration of value creation practices as compared to today's standards. For example, holding periods have steadily increased since the financial crisis from a median of just above three years to over six in 2014, according to Preqin. In parallel, so-called "quick flips" have considerably decreased and now amount to below 20 percent of all transactions, as well as being almost exclusively the result of acquisitions by strategic buyers. In fact, sales to strategic buyers remain the dominant exit channel, whereas IPO values have halved since 2015, according to Preqin.

The portfolio approach embraces these trends. Besides enabling portfolio companies to accelerate their growth and transformation, it prepares and positions companies well for a sale through the dominant exit channel of a sale to a strategic buyer.

WHAT IS THE NEXT STEP?

To take value creation to the next level, GPs will need both scale and agility. Scale will be needed to create a large and diverse portfolio with sufficient potential to successfully implement a portfolio approach. Agility will be needed to ensure that a portfolio is able to weather an ever-changing environment. To date, there are but a few GPs that have both the necessary scale and a proven track record of value creation. However, as the industry-wide trend towards more sophisticated value creation models shows no sign of slowing, we believe we will see many GPs embracing the portfolio approach in the years to come. ■

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