

# PIP SPEAK

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## IN THIS ISSUE:

As money continues to pour into the Private Equity asset class, investment managers are looking for ways to extract greater value from their portfolio companies. In this article, we review some implications for the use of advisers (who will need to bring a broader range of skills to the transaction) and outline how PIP can help.

## Private Equity: Making the most of your advisers <sup>1</sup>

In an increasingly competitive private equity market, how does one clinch the right deal and achieve superior returns? This is the key challenge facing Private Equity companies today.

Private Equity investments are all the rage. Globally, firms raised more than US\$150B last year (a rise of 50% over the previous year) and Australia was no exception to this trend, raising 75% more than it invested in 2005 according to AVCAL, the local industry association. This situation has been exacerbated by the “arrival” of large global players like Newbridge, Carlyle, KKR and JP Morgan (again) who are all now active in a region that was previously seen as non core. It is estimated that over \$15B is currently earmarked for equity investment in the region and looking for a home, although the rumoured acquisition of Coles (at time of going to press) might make a dent in that figure.

2005 AVCAL data also indicates that Australian Private Equity investments have historically outperformed more traditional assets, returning around 10.6%p.a. overall since 1987 (and late stage funds have done notably better, with a pooled return of 24.6%). However, since the flow of good deals appears unlikely to keep pace with the level of capital raising, the outlook for the industry may not be so benign.

### The emergence of winners curse

With increasingly savvy sellers and money “burning a hole in the pocket” of funds that have tapped into the buoyant market, Private Equity firms are finding it increasingly difficult to secure deals cheaply – particularly large

ones. The old methods of buying low and selling high in cyclical markets, or applying financial leverage tools, will not be sufficient to achieve target returns in future and there is an increasing perception that firms are already accepting lower returns on their funds merely in order to put the money to work. In some cases, the successful purchaser’s euphoria of winning a deal is rapidly overtaken by the nagging concern that they have overpaid.

### Developing a stronger investment thesis

Investment managers looking for other ways to extract maximum value from transactions are increasingly forced to take a more hands-on role in the value creation process in order to identify opportunities that others have not seen. Competitor roll-up plays, geographic expansion into contiguous markets, additional products and services; these are all becoming standard “investment theses” in a transaction and are increasingly being priced into deals in order to win. More sophisticated buyers are therefore looking to operational improvement opportunities in order to deliver top quartile returns.

### A new approach to advice

Traditional due diligence processes (focusing on risk mitigation and the validation of existing management plans) are ill-equipped to give a potential acquirer confidence around the

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<sup>1</sup> For more information on PIP Transaction Services, please contact Alasdair Johnston on +61 418 485 121 or [alasdair.johnston@pipint.com](mailto:alasdair.johnston@pipint.com)



existence or achievability of “up-side”. To be effective, this traditional approach needs to be supplemented by additional commercial and operational insights and execution skills. The solution lies in focusing advisers on adding real value, by bringing a broader set of skills to the transaction that incorporate three key elements:

1. Get the commercial due diligence team focused on the key strategic issues (early) in order to validate the investment thesis and give greater certainty around the projected cash flows.
2. Take a structured look at the operational improvement opportunities that could quickly deliver additional dollars to the bottom line.
3. Leverage execution skills to ensure that the benefits of operational improvement initiatives are delivered rapidly.

## 1. Focused commercial due diligence.

Most late-stage Private Equity deals already incorporate a degree of commercial due diligence. A market review indicating growth rates, shares and profitability by segment is typically the minimum requirement needed to “get the debt across the line”. However, the typical approach of such work arguably pays excessive attention to managing the liability of the adviser whilst adding very little to the purchaser’s understanding of the business. Every effort should be made to ensure that the information is accurate, but best practice focuses on providing a clear, balanced and quantified view of the prospects and opportunities of the potential acquisition. Source information will be partial, or even contradictory, but the adviser should nonetheless be expected to deal with this ambiguity and take a stance on the key issues.

An additional danger with typical reviews is that they can take a “cookie cutter” approach and, as a consequence, fail to (i) address potential landmines and (ii) identify up-side opportunities in sufficient detail. Successful teams focus on deal-critical issues by

## The PIP Approach to Transaction Services has 3 distinctive features

### • Breadth of services offered:

- Strong team track record in commercial and operational due diligence
- Identification of the potential opportunity using the right blend of experience and independent analysis, supported by a rigorous methodology
- Audit of organisation’s change ability (skills, competencies, attitude, change wiring...)
- Execution support in delivering rapid and sustainable operational improvements, post-acquisition (including interim management as needed)
- Risk sharing on transactions through pay for performance or equity involvement (backing up their assessments so you know they are aligned)

### • Detailed knowledge of how operations work and deep understanding of specific industries

- Leader in operational improvement management
- Nearly 1,000 years of collective professional experience to draw on
- Extensive global network across a range of industries

### • Value driven approach to the private equity process

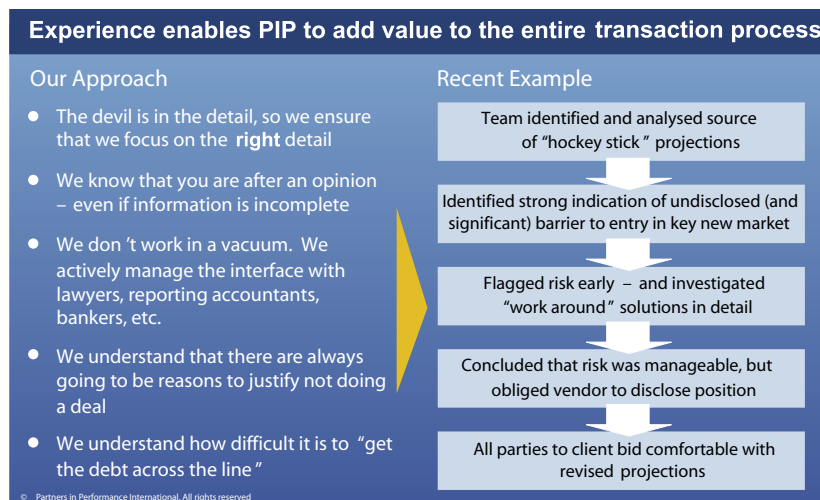
- Integrates closely with all advisers to the transaction
- Focuses on the value impacting issues
- Recognises that the purchaser wants an opinion – even where information is incomplete

- Evaluating the critical market assumptions (industry structure and dynamics, competitive position and behaviour) that underpin forecasts
- Leveraging the right blend of industry expertise and rigorous analysis to identify the critical opportunities (and risk mitigation strategies) associated with the transaction
- Stress testing and enhancing the core investment thesis.

## 2. Structured operational due diligence.

Operational performance improvement has long been one of the fundamental rationales for Private Equity (“we know

how to work your assets harder”) even if it has primarily been executed through the discipline of debt. Sellers will be happy to emphasise the up-side potential and, once the deal has reached the “tipping point”, the incumbent management will typically be a useful source of information on quantifying opportunities. This works well where (i) the pricing decision is still open when management comes onboard and (ii) the incumbent team has a clear understanding of the full opportunity in the first place. PIP’s experience suggests that these cases are increasingly rare.



As a result, the traditional process for validating the improvement potential relies on having industry experts estimate what the business can really achieve, supplemented by the purchaser's own understanding of the business. (The trend towards increased industry specialisation by PE firms is, in part, an effort to develop greater in-house expertise.)

This experience based approach should uncover the low hanging fruit (such as discretionary SG&A) where rules of thumb are typically quite effective. However, what is often missing is a comprehensive assessment of the operational drivers of the business and the improvement that could be achieved if the target company were at, or near, the technical limit. Establishing the technical limit requires detailed analysis (and a robust methodology) at the level of each key metric – and the source information is unlikely to be in the data that is initially made available for evaluation of the investment. Nevertheless, it is fundamental in order to establish “where the money is” and prioritise efforts post completion.

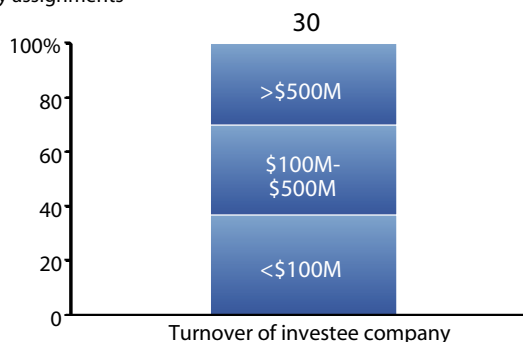
Traditional approaches are also weak in assessing management capabilities/systems and the extent to which they can drive change. Reporting Accountants may give comfort that the basic control mechanisms are in place and management discussions generally probe the issue (although there can be a reluctance to dwell on negative issues when pitching to management) but that still leaves a broad spectrum of possible outcomes. Failure to identify the areas that will need reinforcement post acquisition will result in delays to delivering the forecast improvement (at best) or a shortfall in the level and sustainability of the benefit. The consequences of this can be severe in terms of reduced returns and (in extreme cases) breached covenants.

The PIP approach adopts a proprietary framework to establish the effectiveness of the current “wiring” and identify the critical gaps that should be closed. Importantly, it focuses on the systems at all levels of the organisation, so that the purchaser is able to identify weaknesses in the process by which senior management intent is translated into operating level behaviours. Diagnostic work focuses on the metrics that are tracked at each level, the disciplines that are in place to ensure delivery against them, overlaps or gaps in accountability and the review processes that close the loop on performance against short term targets.

<sup>2</sup>In the current environment, where there is usually a structured sale involving more than one bidder, it may not be practical to complete operational due diligence prior to completion of the transaction. Advisers may be able to glean enough information to give directional guidance on improvement potential and change readiness of the organisation, but assumptions need to be rapidly validated once the transaction is complete.

## The PIP team has a strong track record for supporting transactions of all sizes

Advisory assignments



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### 3. Execution skills to capture operational improvements.

Private Equity firms do not generally have the time to manage the detail of operational improvement in their portfolio companies. Post acquisition, their traditional role is as a Board member and part-time advisor, with their direct involvement falling over time (typically to around 10% of the lead “partner’s” time, according to European and US research). Most private equity firms now recognise the importance of operational expertise, and some have developed a critical mass of these skills in-house by maintaining staffing levels above the industry norm (e.g. Archer and PEP in Australia) or even acquiring a consulting arm (KKR/Capstone). Others have preferred to remain lean and get their leverage from external professional advisors.

But what sort of help do portfolio companies need post transaction? Strong management teams rarely lack for ideas on how to improve operational efficiency – the issue is more typically one of excellence in execution [see back page on PIP survey result]. When considering external advisers, the key is therefore to ensure that they go beyond the typical identification and planning of opportunities. For real alignment, there is even a case for engaging them on a pay-for-results basis.

From years of working on operational improvement with leading organisations in a number of sectors, PIP has found that most organisations (including those with successful management teams) do not have the skills, processes, and controls to deliver and sustain operational improvement. We refer to this as the “wiring” of the organisation, as it effectively pre-determines the outcome of change. All too often, the absence of an effective performance management system that brings the right issues into focus (by reviewing performance and setting clear priorities and short-term targets) causes execution to fail.

The PIP approach builds a capability within the company that generates a fundamental uplift in performance. It achieves this, in part, by ensuring that management at all levels is focused on measuring and managing the critical levers of the business. It is striking how many organisations with a clear understanding of the key metrics at a high level are unable to drill down to the detail and identify the sources of inefficiency. Assigning clear accountability for the right KPIs at all levels and holding effective reviews around them will typically generate an improvement in results (“what gets measured, gets managed”) to the point at which the root cause of residual underperformance becomes clearer and can be addressed.

Traditional approaches tend to emphasise the analysis, planning and, to a lesser extent, implementation of changes. In many cases, all initiatives are launched simultaneously without regard for the paralysis that this creates in the organisation. PIP recognises how difficult the change process can be, and supports management through both the implementation of wiring changes and the development and management of a pipeline of prioritised ideas. The

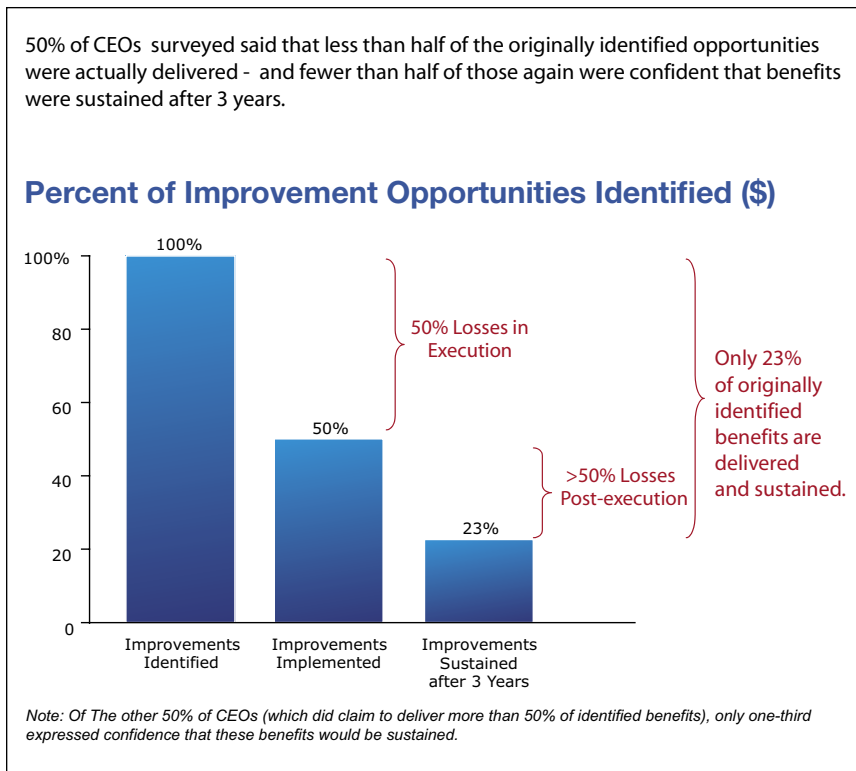
result is an organisation that not only delivers results faster than it would otherwise have done, but also sustains the improvement over time. Indeed, by transferring knowledge and skills to the organisation, it is well positioned to continue improving beyond the period of support.

## Conclusion

As the market heats up, there is a perception amongst some that “rogue” players are bidding up the price of assets to an unsustainable level. If this is the case, these companies are causing a temporary disruption to the market and will not survive in the long term. Nevertheless, more effective use of external advisers can enhance an investment manager’s ability to win deals and achieve top quartile returns by helping to manage risk, identify additional opportunities and deliver bottom line growth. If these “rogue” players are in fact better able to identify and extract the value than other bidders (based on superior advice and/or understanding) then they will end up the winners in the ensuing shake out. Time will tell who is right!

## Why execution support is important

### Key Findings of PIP survey<sup>3</sup>:



### Key Findings:

- 46% of respondents estimate that their organisation could increase profit by more than 15% if they were able to realise the full potential of the business improvement opportunities available to them, yet 50% of them achieve less than half of the amount identified above (failure to execute).
- Of the savings that are actually implemented, greater than two-thirds of the CEOs were uncertain if these implemented changes would stick. This represents a huge drop-off in potential profits from identified improvements, through implemented improvements, and then to sustained improvements.
- From a CEO perspective, the biggest challenge facing big business today in the area of business improvement, is the inadequacy of execution/implementation skills among managers and staff. Worryingly, few in the survey felt they had a solution to this problem.

<sup>3</sup>2006 survey of senior Australian management (\$250m+ turnover)

## Partners in Performance

Partners in Performance is a firm that builds better businesses. We deliver rapid performance improvements in industrial, resource, manufacturing and service companies, using specialist teams and a hands-on approach to lower costs and increase revenues.

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