

Practices and innovations in operating partner groups

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Introduction

The private equity industry is becoming increasingly competitive and investors are demanding more from private equity firms. Some GPs have responded to these demands by establishing, or strengthening, operational portfolio teams to support an increased emphasis on driving value through operational change. These operational teams are typically made up of former industrialists and management consultants who provide direct support to the portfolio company management. Since the onset of the 2007–2008 financial crisis, there has been a significant recruitment effort from private equity funds to establish operations teams or to bolster the capabilities of existing teams.

A wide variety of operating models have emerged – in size, skill set and functional depth. At the end of 2010, we sought to help make sense of these trends and emerging models by conducting an extensive survey of the industry.

Recent trends

A study of the role and structure of operations teams within private equity firms included 63 private equity firms (accounting for around 35 percent of the industry by AUM) and 20 LPs, covering a range of firm sizes, geographies and fund types in line with the general industry profile. Face-to-face and telephone interviews were conducted with operating partners using a structured questionnaire covering areas such as the history, size and structure, role and activities, performance and remuneration of the operations team. The majority of firms interviewed were based in the UK (50 percent) and the US (35 percent), followed by a smaller representative number of interviewees in Europe, Asia and the Middle East. Half of the firms interviewed had an AUM above $5 billion and the other half below $5 billion.

Development of operations teams

The research shows that around one-third of private equity firms have recently (since 2005) established an operational capability. Most of the new teams were established in smaller funds. Around 40 percent of private equity firms surveyed had already established operations teams (in place for longer than five years) – typically the larger, US heritage funds. Operations teams are better established in the US, being a more homogenous market, whereas Europe has been slower to adopt this model due to culture and the complexity of a fragmented market and varying languages (see Figure 2.1).

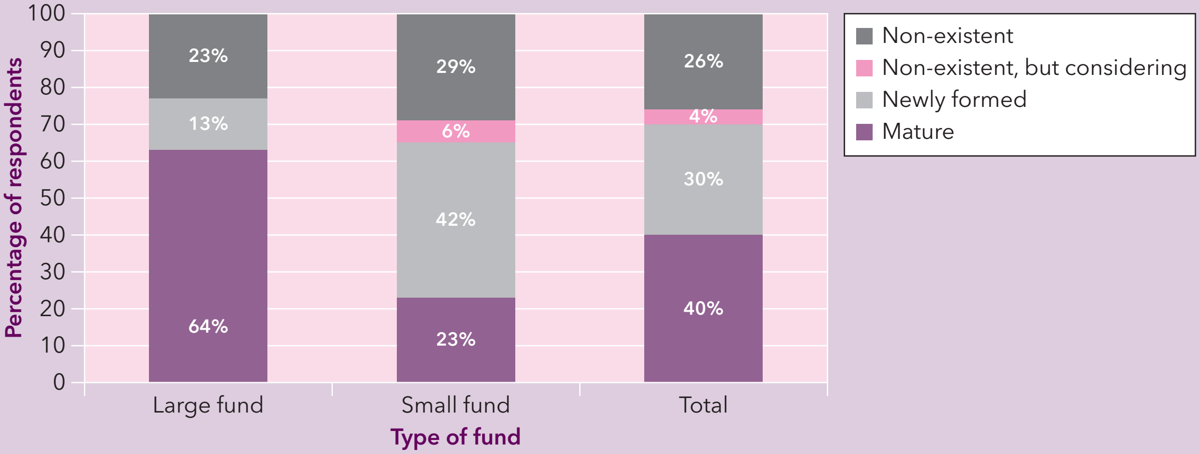
This trend reflects both LPs' increasing expectations of GPs and the increased competition for smaller deals in the middle-market segment. This has resulted in middle-market private equity firms needing to enhance their capabilities.

Size

The size of operations teams within private equity firms varies significantly across the industry. This is driven by the size of the portfolio, the maturity of the operations team and the fund's strategy/investment heritage.

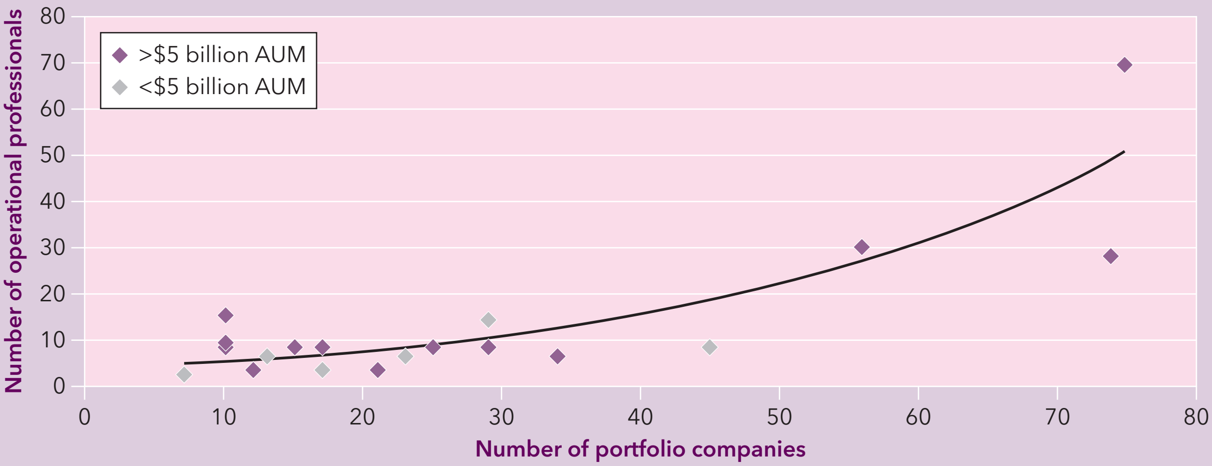
Established funds tend to operate at a ratio of between one and three portfolio companies per

Figure 2.1: **Maturity of operational capability in private equity firms**



Notes: Newly formed defined as operations teams established since 2005. Large funds defined as AUM greater than $5 billion, small funds defined as AUM below $5 billion.
Source: Deloitte analysis, PEI 300 2010.

Figure 2.2: **Mature operations teams* – scale versus activity**

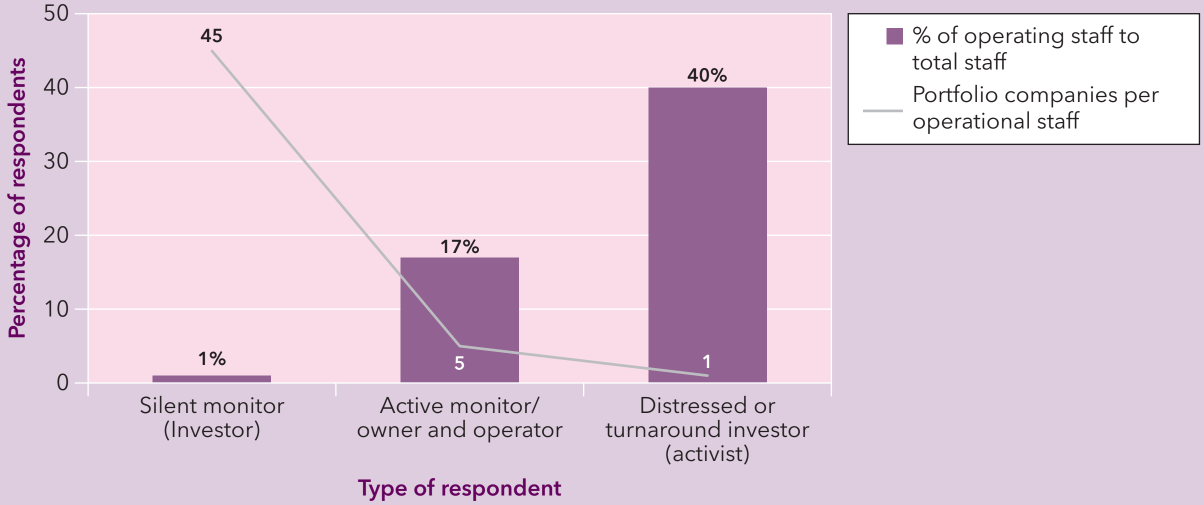


Note: * indicates without silent monitor/investor.
Source: Deloitte analysis.

operating professional, and commit 10 percent to 25 percent of their resources to operations. Some larger US funds with well-established operations teams can have up to 50 percent of their total headcount within their operations team, which is primarily involved in implementation of operational improvement initiatives, post-deal closing (see Figure 2.2).

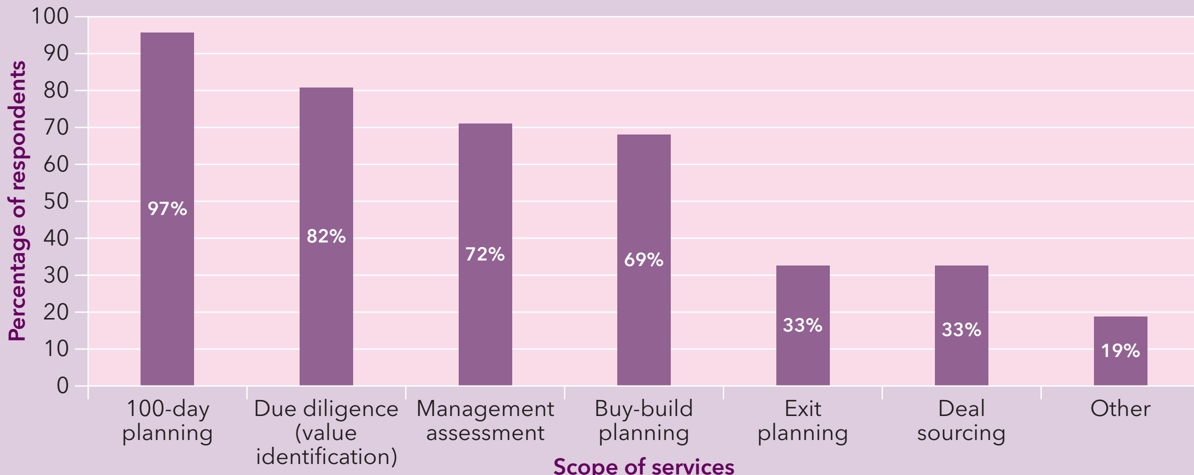
The fund's philosophy also dictates the size of its operations team. 'Silent monitors' – financial investors who leave all operational matters to management – tend to have very limited operations teams with very limited involvement, if any; involvement is usually limited to tracking operational performance. Turnaround funds typically

Figure 2.3: **Operational staff ratios – scale versus activism**



Source: Deloitte analysis.

Figure 2.4: **Pre-deal scope of services of operational professionals**



Source: Deloitte analysis.

have one operations team member per portfolio company (around 40 percent of the total head-count). (See Figure 2.3.)

Involvement throughout deal life cycle

The vast majority of operations teams in private equity firms surveyed are involved throughout the transaction life cycle, with less than 20 percent involved post-deal only. The operations team's input is sought in the initial valuation of the target and structuring of the deal through identification of operational risks, the validation of the operating model and the future cost base, and the identification of potential upside opportunities. Operations teams work closely with management in scoping the 100-day plan to ensure that any improvement plans are feasible and adequately resourced. They are also typically involved in providing an assessment of management (see Figure 2.4).

For bolt-on acquisitions and buy-and-build strategies, a deep understanding of the operating model and any potential synergies is critical.

Involvement of the operations team pre-deal also has additional, if less tangible, benefits. The operations team's ability to influence, and not alienate, management post-deal closing is highly dependent on the level of involvement they have pre-closing. Operations teams themselves are likely to perform better if they are involved pre-deal, having a full understanding of the key deal issues and being fully integrated into the investment thesis.

LPs' evolving requirements

In the past, many LPs focused heavily on IRR as a performance measure, with limited emphasis on assessing the risks required to achieve those returns. Following the 2007–2008 financial crisis, LPs have become more assertive and view value-creation capabilities as a distinct advantage. They are now focusing more on assessing the drivers and sources of their fund manager's investment returns. They want greater assurance over performance, both through revenue growth and operational and cost efficiencies, before they invest in a fund.

The research showed that 71 percent of LPs surveyed felt that there was insufficient emphasis on improving portfolio businesses after a deal. LPs told us:

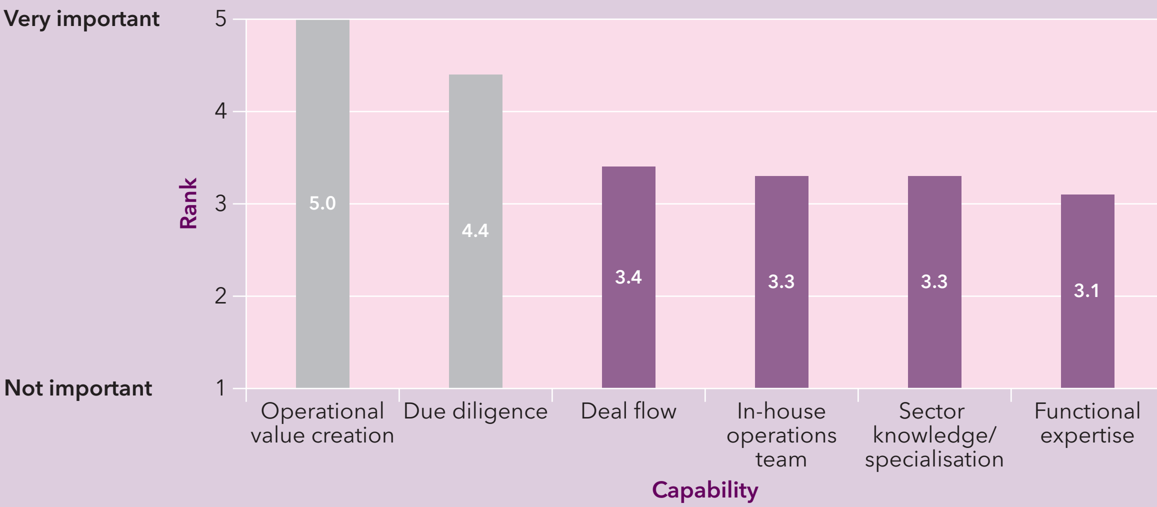
- Financial reengineering opportunities are limited these days and we have witnessed reputable private equity firms winding down because of over-leveraging and poor controls. We believe that private equity firms should have the capability to create or sustain value even during challenging times to remain competitive. Simply writing off assets or going through massive restructuring initiatives is not acceptable anymore.
- We look at the backgrounds of the firm's partners. We prefer a mix that includes operational or strategic/consulting backgrounds versus purely financial.
- We tend to prefer teams where the carried interest is spread across all/most investment professionals – including the 'operational partners' and below partner level.

In the Deloitte survey of LP requirements, operational value-creation and effective due diligence capabilities were shown to be the most important capabilities looked for in a GP. Interestingly, having an established in-house operations team was not seen as critical, as long as the private equity firm could demonstrate that it has a structured approach (see Figure 2.5). Cost-reduction and revenue-enhancement capabilities were regarded as equally important by LPs.

LPs are looking for involvement from operations teams throughout the transaction life cycle, and feel that operational due diligence, leading value creation and 100-day planning are the main areas where increased focus is required (see Figure 2.6).

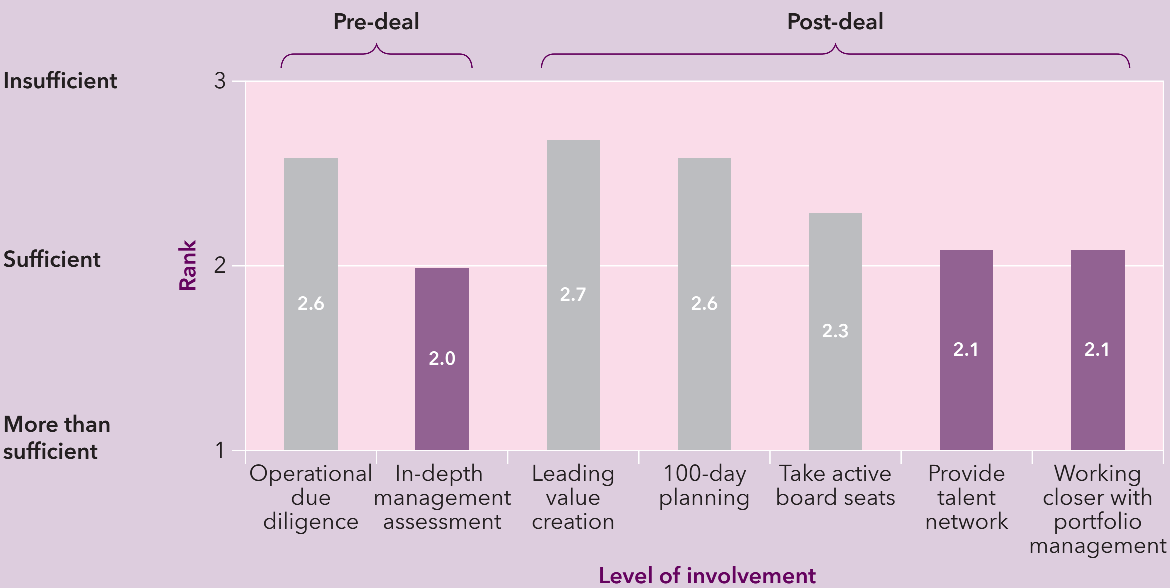
Although private equity firms with operations teams can often provide anecdotal evidence of how they have added value to portfolio companies, it is difficult for LPs to accurately quantify their impact on the bottom line, especially when the team is relatively new. In a recent Deloitte study of 20 distressed private equity-owned assets undergoing a review by lenders, we discovered that, where no operations team existed, in up to half of cases the private equity firm lost control of the asset and it was returned to the lenders. Where an operations team was actively involved in developing a coherent and robust recovery plan, all of the assets in the study were retained by the private equity firm. Although there are many other factors at play, results suggest that during a downturn, an operations team may help to retain the value of an investment.

Figure 2.5: **LP views on GP capabilities when making new fund commitments**



Source: Deloitte analysis.

Figure 2.6: **LP views on GP level of involvement throughout the transaction cycle**



Source: Deloitte analysis.

Operating team models

Prior to the existence of dedicated operations teams, investment professionals with limited operational background would have been responsible for all stages of the transaction. These professionals typically drew on external 'industrial advisers' to support deal sourcing, to conduct management assessment pre-deal closing and to monitor the portfolio company performance from due diligence through to exit.

Meanwhile, operations teams have since evolved from their earliest form, when operations professionals were typically only involved in supporting management post-deal, to the current model with most teams actively involved throughout the transaction life cycle.

Some large funds with more mature operations teams have further enhanced their capabilities, focusing on developing in-house teams of functional experts. Typical areas of functional expertise brought in-house include cash management and working capital, purchasing, supply chain, and sales and marketing. Certain other functional skills (for example, fast-moving technical areas such as e-commerce) need to be updated frequently, and as a result are often outsourced to external advisers. For smaller funds, the fixed cost of having in-house functional experts may not be justified, and for funds of all sizes additional resources may be required at times of peak workload and to cover specific skill areas.

These internal functional teams focus on developing and implementing the value plans of individual portfolio companies, as well achieving benefits across the portfolio, as discussed in the next section

Figure 2.7: **Operating team and portfolio company involvement models**

	Standard model	Operations team model		
	No operations team	Operations 'light'	Operations 'standard'	Operations 'plus'
Pre-deal				
Deal sourcing	□ △	□ △	□ △	□ △
Due diligence	□	□	□ ●	□ ●
Investment strategy	□	□	□ ●	□ ●
Management assessment	□ △	□ △	□ △ ●	□ △ ●
Transaction execution	□	□	□	□
Post-deal				
100-day planning	□	●	●	●
Monitoring/NED/advisory	□ △	□ △ ●	□ △ ●	□ △ ●
Value creation/turnaround			●	●
Functional advisory				●

□ Investment professionals △ Industrial adviser ● Operating partner/in-house operations

Source: Deloitte analysis.

of this chapter. A common model is to have a 'virtual' operations team consisting of an in-house team of generalist operating partners within the private equity firm, with additional resource (both generalist and functional) provided by external advisers as required. Commonly the private equity firm would develop a close relationship with preferred advisers to ensure the adviser has a good understanding of the private equity firm's approach and philosophy, and is well acquainted with its portfolio companies (see Figure 2.7).

Functional teams are commonly incentivised using more traditional structures of cash and equity ownership in the portfolio company rather than carried interest by deal or in the fund.

Innovations and cross-portfolio initiatives

Operations teams are beginning to focus on exploiting potential synergies across the portfolio and developing capabilities within the private equity firm that can be deployed across a number of portfolio companies. The survey showed that whereas almost all private equity firms interviewed pursued cross-portfolio initiatives on an opportunistic basis, just over 10 percent had a structured approach to identifying these opportunities. Over two-thirds of operations teams interviewed saw cross-portfolio opportunities as a key future area of focus.

The best results in pursuing cross-portfolio synergies are achieved if initiatives are adopted voluntarily by portfolio company management. However, significant encouragement and support is required from the operations team to drive the programme. Getting buy-in from portfolio company management can be a significant challenge, and is a key part of the role of the operations team.

The following are three examples of value-creation opportunities pursued by private equity firms:

Example 1: Low-cost country (LCC) sourcing capabilities

A number of private equity firms with a portfolio focused on manufactured products have established LCC sourcing capabilities, either by recruiting dedicated in-house resources or through partnerships. These teams are used to provide access to a low-cost supplier base with local procurement, supply chain and quality assurance support, and to support increased sales into emerging markets by providing market understanding given their local presence. In some cases, R&D and engineering functions within portfolio companies have also been moved offshore to low-cost countries, supported by these offshore teams.

Example 2: Aggregated procurement

Around 80 percent of private equity firms interviewed achieve economies of scale by employing procurement strategies across the portfolio. Indirect spending areas (for example, insurance, fleet cars, travel, office supplies and temporary labour) are the main area of focus, where sufficient commonality of spend exists across portfolio companies. Opportunities to aggregate direct spending (raw materials and bought-in finished goods) are limited due to the wide variety in the nature of business of portfolio companies. Savings achieved within each indirect spending category can be large (5 percent to 40 percent is not uncommon) but the total savings are often modest as indirect spending tends to comprise a small proportion of total procured spending.

Encouraging companies within the portfolio to participate in aggregated procurement schemes can be a challenge for the operations team – larger portfolio companies bring the scale and know-how required to achieve savings, but have less to gain than their smaller counterparts.

Private equity-focused buying groups, such as PepCo in the UK and Coretrust in the US, represent an alternative model for aggregated procurement. Portfolio companies are generally able to remain members of the buying group even after the private equity fund has exited its investment.

Example 3: Best practice sharing

Annual peer group meetings for the CEOs, CFOs or CPOs (chief procurement officers) of portfolio companies are often used to sharing best practice, discussing industry trends and identifying cross-portfolio opportunities. These events are usually well perceived by portfolio company management, but driving through tangible benefits post-conference requires significant effort by the private equity operations team. The cost of such events can be prohibitive, especially for global portfolios.

Strong management within one portfolio company can be leveraged across the whole portfolio, either in a coaching role, or by 'recycling' strong managers from exited deals within new investments.

Conclusions

Our survey research concludes the following points:

- There has been a distinct and recent focus in the private equity industry to establish or expand operational capability.
- The scale of operations teams depends on the level of investor activism and the volume of the portfolio.
- Qualitatively, we have seen operations teams providing value to investments through application of their expertise and external challenge. This skill is particularly valuable in a challenging economic environment.
- However, one needs to take care not to tilt the private equity fund to becoming too much of a 'corporate' and potentially undermine the entrepreneurialism of its portfolio company management team. ■

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__John Moore__ is a director in the Operations Due Diligence team at Deloitte. He works with both private equity investors and corporate M&A teams to identify operational issues pre-deal, and to help them develop and deliver value-creation plans post-deal. John specialises in the development and implementation of 100-day plans for private equity clients. Prior to joining Deloitte, he worked at AlixPartners where he conducted a number of post-deal 'diagnostic reviews' of portfolio companies and led the subsequent 100-day plan programmes. He has over 15 years experience as a management consultant, leading commercial and operational due diligence, post-merger integration and operations improvement programmes across a wide range of industries in Europe and the US. John has an MEng in Mechanical Engineering from Imperial College and qualified as a Chartered Mechanical Engineer in 2002.