Transformational ownership: moving beyond 100 day plans

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The foundation for sustainable investment returns in private equity has always been improved operating performance. Businesses where efficiencies are created, margins are improved and innovative growth strategies are employed – in other words businesses that are demonstrably enhanced under private equity ownership – achieve higher valuations upon exit.

Historically, these initiatives have often boiled down to concrete steps taken early in the life of an investment, such as improved sourcing strategies, lean manufacturing, Six Sigma and de-layering. This has resulted in the concept of the '100-day plan' playing a central role in private equity industry parlance, particularly when discussing operating improvements.

The forces unleashed since the 2008 financial crisis have only reinforced the importance of value creation rooted in business-building capabilities. These skill sets were tested during the worst of the financial crisis, and it was clear which private equity teams were equipped to manage the difficult operating climate. The best private equity firms adapted to meet new realities.

The world, however, continues to change. Traditional operating drivers may no longer provide the lift they once did. All doubt about the difficulties the world would have resetting in the traditional cyclical manner after the Lehman Brothers collapse was laid to rest by the global economy's uneven journey over the past few years. Two distinct sets of dynamics are apparent: continued sluggish growth in Europe and the US and high growth in emerging economies that continue to close the wealth gap relative to developed nations. So even before a discussion of implementing so-called 100-day plans or similar measures to stimulate operational improvements, private equity firms need to rethink the organisational models needed

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to be effective in a two-speed global economy. Priorities and methods of execution inevitably will have to evolve, and the pace with which private equity firms attack improvement initiatives intensify.

The good news is that the private equity ownership model is particularly well suited for transition periods when dramatic adaptation is required. Private equity firms, at least the best ones, will build capabilities to work with management teams to respond quickly and flexibly to fluid competitive conditions on a global scale, which is obviously important not only during the early phases of an investment, but also throughout ownership.

Most private equity firms historically have looked at operating partners as variable cost resources, hiring senior executives for purpose-specific roles. However, with an increasing source of ongoing value addition derived from strategy and revenue enhancement and cost-reduction efforts, demand for a different type of operating executive is growing. This executive is a

deeply embedded, full-time member of the firm. He or she participates in every investment decision and is compensated on the strength of performance of the whole portfolio, rather than individual companies.

So a word of caution to those building or evaluating operating capabilities in the new competitive landscape: while many of the most easily measureable actions often take place in the early days of ownership, an effective business transformation does not begin, or end, in 100 days. It is ongoing and relentless. It starts long before a transaction closes; it is in full swing by day 1; and it never slows down before the company is sold.

Before the close: sourcing and investment decision-making

Sourcing investments with potential for operating improvement. Operational transformations begin with sourcing. The front end of the investment process is the optimal time to identify underperforming businesses that can be enhanced through more activist management initiatives and/or strategic repositioning.

A particularly fertile area for such investments is corporate divestitures. Non-core units of large corporations often possess great potential for operational value creation. Financial engineering skills alone are insufficient to dig deeper and ferret out quality divestiture opportunities. In most corporate carveout transactions, the structure and organisation of the business being acquired, not to mention the delicate employment issues and sensitive commercial disentanglement process, are highly complex.

Corporate sellers of non-core units look differently at firms with established operating capabilities as the potential owners of their divested businesses, especially if they retain an ongoing equity interest in, or have ongoing commercial agreements with, the division being sold. This was clearly the case in 1991 when IBM retained a minority stake in its printer and supplies businesses, which under CD&R ownership became Lexmark International. Our expertise to ensure the seamless distribution of Germany-based Merck KGaA high-margin specialty chemicals in Europe on favourable terms was a key factor in our selection as the buyer of VWR International from Merck. Similarly, when Ingersoll Rand agreed to sell us a 60 percent stake in its food refrigeration systems unit, the company in essence retained an option to participate in the upside associated with the future transformation of this non-core division. These and other examples underline the point: especially with divestitures, firms with full-time operating partners or dedicated internal portfolio teams with credible expertise to unearth new operating efficiencies or help managers grow their companies can be well positioned to build trust-based relationships with corporate sellers.

Operational investment decision-making. In addition to increasing the opportunity set of available businesses to acquire, operating capabilities play a key role in investment decision-making. High-quality operating capabilities mean that a private equity investor does not depend on mechanical financial modelling or the views of management consultants, as valuable as these are, in making investment judgments. No matter how rigorous the spreadsheet model, it can take you only so far in proving that the potential of capturing the identified operational improvements is achievable. The reality check that comes from years of experience running businesses is invaluable.

When an operational assessment of the business is a key part of the evaluation process, the buyer conducts due diligence and contract negotiations more as a corporate or strategic buyer than as a pure financial sponsor. The most important due diligence question becomes: can the operating performance of the business be materially improved? The subsequent line of enquiry reflects the unique perspective of a professional with hands-on operating experience over a long period of time in a variety of industries and economic climates, not simply the analysis of a third-party management consultant.

The types of questions that are investigated include: what kind of business is it to manage? What are the inherent strengths or underutilised assets? What are the customer opportunities or attractive segments that require greater focus? Can the financial performance be altered through management action or will the business be overwhelmed by industry and market conditions? What can be done to manage the strengths and weaknesses in each element of the business system (for

example, R&D, manufacturing, distribution, marketing, sales, service)? Can distribution patterns change? Can the product lines be repositioned to meet shifting customer needs? What can be done to commercialise relevant technologies more rapidly? Can the restructuring process be accelerated?

As these questions suggest, determining value for a firm with the right operating capabilities becomes less a matter of discounted cash flow or EBITDA multiples or balance sheet ratios – although these are certainly important – and more a function of the operating professionals' assessment of the operational risks and earnings potential of acquisition candidates. During the course of due diligence, the role of the operating professional is to challenge the fundamental assumptions about how an acquisition target should conduct its business and what should be changed. This level of scrutiny, even before a transaction closes, can accelerate the transition of an acquired company to an independent, stand-alone business.

Strategically well-positioned businesses that are not achieving their full potential are often acquisition candidates, and understanding the reasons for the underperformance can mean the difference between a rewarding investment and walking away empty-handed. Many factors typically contribute to this underperformance, ranging from lack of management attention and insufficient capital resources to a narrow strategic view relative to a larger market opportunity, or a historical mandate to exclusively serve the interests of a corporate parent. To gain conviction for the transformational potential in instances like this, an operational perspective is necessary long before the business is acquired.

Rexel, a global wholesale distributor of electrical supplies, is a good illustration of the early value creation that results from including an operating viewpoint during due diligence. CD&R led an investor group in acquiring Rexel from luxury goods maker Pinault-Printemps-Redoute (now PPR). Electrical products distribution is an industry segment the firm knows intimately from prior investments. We had spent about 12 months of due diligence on a bid to acquire Hagemeyer, a €6 billion in sales global electrical products distributor headquartered in the Netherlands. We did not complete the Hagemayer transaction at the time, but the process gave us further insight into this industry and conviction about its attractive dynamics. (The Hagemeyer due diligence doubly paid off, as Rexel eventually acquired Hagemeyer in 2008).

Rexel's fragmented customer base, broad geographic diversity and global scale fit well with CD&R's experience in distribution businesses. Rexel had survived a very difficult industry downturn prior to our investment. While the company was both stable and profitable, based on our industry knowledge and prior investment experience in related businesses, we were able to identify more cost, productivity and growth opportunity than reflected in Rexel management's business plan. As the operating partner on the deal, I had to confirm that each identified initiative was achievable – before we agreed to invest. Today, Rexel is publicly traded, has doubled EBITDA under our ownership and is gaining momentum in fast-growing geographies and product areas.

Early execution

Once a transaction is announced, and often beginning before the deal is closed, an operating executive will work in a number of very important areas.

1. **Evaluating key executive talent.** A private equity operating executive charged with overseeing a portfolio company should move quickly to ensure that there is a strong leadership team throughout the organisation. Part of this process is the installation of a formal appraisal system that rigorously evaluates performance on a regular basis, and results in continually upgrading the breadth and depth of the executive management team.
2. **Gaining trust.** Operating capabilities may be threatening to a management team. However, they can also be a breath of fresh air after dealing with the more financially oriented. The ability to work with multiple management styles and build teams with high morale, while at the same time constantly assessing and reassessing the organisation structure and evaluating and upgrading management talent only comes from years of experience. To be effective, an operating partner's interactions with the portfolio company management team should never undermine autonomy and authority, but rather support a culture directed toward accelerated change and to increasing operating profit and revenue growth.

In the Rexel example, the management team embraced the CD&R investment case enthusiastically because we demonstrated that we knew what we were talking about when it came to the business. In other words, we spoke a common vocabulary informed by our operational perspective that accompanied the financial model. During the first year of ownership the company aggressively pursued operating improvement initiatives – some big, some small – covering a range of issues, including sales growth, purchasing optimisation, product mix enhancements, private label rollout, operating expense actions and working-capital management improvements. The company also executed a series of earnings accretive acquisitions, including the $750 million transformational purchase of GE Supply, establishing Rexel as the market leader both globally and in the US.

3. **Resetting expectations and establishing a rhythm.** A change in ownership offers a great opportunity to reconsider assumptions about how a company gains and sustains its competitive advantage. A fresh look at the business, unencumbered by legacy strategies and investments, is usually the starting point for good private equity investors, and often leads to reallocation of capital, new research and product priorities, emphasis on different market segments and sharper understanding of a company's competitive cost position.

   When a buyout occurs, it is a big event. Everyone from the CEO to first line supervisors in the field to vendors and customers expects change and a higher bar for performance. As industrial sociologists have known for years, this period of heightened expectations creates a wonderful climate for innovation. The first year of a buyout is an unparalleled chance for the management team, backed by the new owners, to demonstrate that things will change.

   This effect is well-illustrated by a study[1] by researchers at Harvard University who were conducting experiments on the relationship between productivity and work environment at a Western Electric plant in 1920s and 1930s. The study was originally commissioned to determine if increasing or decreasing the amount of light factory workers received increased or decreased worker productivity. What the researchers found was that productivity increased both when the amount of light increased, *and* when the amount of light decreased. The researchers concluded that the productivity gains were the result of attention from the research team and had nothing to do with the experimental variable. The takeaway here is not rocket science: people will work harder when they know someone is paying attention.

4. **Aligning interests to support the new plan.** While it is true that people work harder when they know someone is paying attention, the right financial incentives will have an even greater impact. Compensation needs to be shaped to support the initiatives that underpin the investment case. CD&R typically fine tunes bonus plans to link them closely to specific targets, as it did at WESCO (North American full-line wholesale distributor of electrical products), Jafra (a direct seller of personal care products in Mexico and the U.S.) and ServiceMaster (services provider to residential and commercial customers through TruGreen, Terminix, American Home Shield and other brands). At WESCO, sales bonuses were changed to reward gross margin dollars, rather than ROI targets that had allowed pay-off on stagnant sales. In the case of Jafra, senior management bonuses were refined to reflect a much heavier weighting for profitability improvement. Finally, a strategic priority for ServiceMaster, which serves more than 8 million customers, is customer retention. Holding on to customers is far more profitable than acquiring new ones. Bonus metrics tied to customer satisfaction levels have yielded positive results for the company in this critical area.
5. **Creating a sense of urgency.** Private equity owners bring a sense of urgency to the entire business. This reflects a realisation that global forces erode a company's competitive position every day that management does not act to deliver more value to its customers. Speed of execution itself becomes a competitive advantage that is squandered by companies that manage by committee and fail to seize opportunities.

[1] Western Electric Company. Hawthorne Studies Collection, Illumination study

Follow-through: shepherding the deal to exit

Perhaps the most significant value that an operating executive can bring to the typically impatient private equity asset class is the clear understanding that first-rate execution takes time, whereas second-rate execution will almost always be disruptive, costly and chaotic. This theme is likely to be heard increasingly as more private equity firms try out newly acquired operating capabilities. There is no question that the first 100 days of ownership are essential, but the fact is that a transformation can take years; 100 days are simply not enough. The operating executive's role is managing the investment throughout its various phases. Many responsibilities will continue, if not intensify, beyond the 100-day mark.

1. **Moving beyond cost-cutting.** Over the past decade private equity firms have been able to identify and hire strong managers to deploy an impressive array of techniques to manage cost and productivity. De-layering organisations, introducing Six Sigma and lean manufacturing disciplines, pursuing aggressive outsourcing strategies and other approaches have been a source of creating value. However, in today's difficult slow growth environment, the harder skills to master will be innovation and growth. Positioning a business to achieve top line growth can sometimes require sweeping changes. Not only do these types of changes take time to execute, but it will take time for private equity firms to shift investment approaches. Innovation and growth, however, will be more important sources of profitability than cost reduction and productivity in this new era, and those skills will be valued accordingly.
2. **Increasing exposure to rapidly growing economies.** We are in a two-speed world: developing economies are in third or fourth gear, while developed economies are in first gear. This is unlikely to change anytime soon. Given this reality, expanding portfolio company exposure to the favourable underlying growth trajectory of developing countries is very strategically valuable. However, it will be a monumental mistake for managers to rely exclusively on macroeconomic tailwinds. It is the responsibility of the private equity operating executive to ensure that the management team is thinking globally.
3. **Distinguishing between signals of temporary distress and real problems.** A true transformation cannot be produced by popping a company in a microwave oven. Changing strategies and people, not to mention products, technologies, channel strategies and marketing programmes, takes time. Rarely is a significant organisational decision undertaken without some form of crisis or severe shock resulting from it. You often must be willing to accept at least one more year of disappointing financial results. The difficulty is to determine whether these hiccups reflect the normal disruptions associated with a business transformation, or a truly dysfunctional strategy and portfolio company management team.
4. **Positioning a business for exit.** Having previously sat in the CEO chair, many private equity operating executives understand what a strategic buyer most highly values. Moreover, the value of an operating executive's Rolodex cannot be overstated. Most importantly, an effective operating executive will give buyers confidence that business performance is not financial smoke and mirrors.

CD&R's investment in Kinko's illustrates a complex, multi-stage business transition that required operating stewardship over the course of many years. Today, Kinko's is the leading document management company that serves many of the Fortune 500. That was far from being the case when CD&R acquired the company in 1996. The transformation occurred in three phases, each requiring distinct managerial skills.

Phase one required integration skills and involved rolling up 127 sub-chapter S corporations and partnerships into one unified corporate entity; easier said than done. This meant wrestling with 127 independent-minded founders of Kinko's. The business grew up without a strategic plan in mind. For example, Kinko's did not even have a common point of sales system. The machines throughout the 1,100 store network were all different. There was no single system of general ledgers, office staffing, sales forces and the like. It was hardly a true business.

Phase two required strong cost-management skills as we turned our attention to efficiencies and scale. The cost structure was rationalised by removing approximately 1,300 copy machines, aggressively pursuing new sourcing opportunities, implementing best practices across the 1,100

location branch network and streamlining corporate overhead. In this phase, the EBITDA margins doubled from 6 percent to 12 percent.

Phase three required the ability to ignite top-line growth by building a highly differentiated value proposition and a world class sales force that targeted large commercial accounts. In less than two years, corporate accounts grew to approximately 20 percent of Kinko's approximately $2 billion in revenues and were growing at double-digit rates on exit. It was confidence in the ability of Kinko's new sales organisation to increasingly penetrate the attractive corporate market that ultimately caught the attention of FedEx.

The $2.4 billion sale to FedEx marked the end of a seven-year ownership period, in which a range of challenges confronted the investment team as the transformation unfolded, and strong operating leadership was key to the result.

The foundation for success in private equity is and always will be its ability to generate superior risk-adjusted returns by making businesses perform better. In the final analysis, this is how private equity justifies its existence. More private equity firms today are investing in operating capabilities and those successful in building a strong industrial investment philosophy and post-acquisition value addition capabilities have a clear competitive advantage. In fact, nearly four out of five private equity firms agree that helping portfolio companies achieve operational improvements will be the key source of value creation over the next five years[2].

While there is broad agreement that increased operating engagement is important, there is no single operating model that works for all private equity firms. In fact you will be hard-pressed to find two that look exactly alike. The idea that the first 100 days of ownership should be the focal point of an operating partner's engagement seems like a very narrow view for such an adaptive asset class.

Increasingly, operating capabilities are deployed to great effect across the investment cycle, not just on the early execution of an investment. In order to make a difference on strategic and operational matters, the best private equity firms will find ways to engage more directly and frequently with portfolio management, offering support, advice and direction on core business processes like budgeting, capital deployment, pricing, corporate development, talent management and compensation. This all certainly must happen in the first 100 days of ownership. It needs to start before that and continue long afterwards.

A later version of this article was first published in *The Operating Partner in Private Equity* by PEI. The full book may be purchased at http://www.peimedia.com/operatingpartner.

[2] Bain & Co. Bain & Co. Global Private Equity Report 2011