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PE Industry Focus Shifts To Improving Portfolio Operations

BY GIADA CARDOLETTI

10/17/2006 – Improving portfolio operations is key to boosting returns today, according to a group of about 300 buyout executives who were surveyed on what approach they are taking in reaction to the changing private equity landscape.

Sponsored by Gotham Consulting Partners LLC, a New York-based consulting firm, the survey noted that financial engineering is taking a back seat to operational improvements.

Eighty-two percent of respondents said improving portfolio company operations was the most important means of generating returns, while only 31% viewed financial leverage as a very important tool for creating value.

"If a few years ago a portfolio company had a problem [private equity firms] would tell you: 'Oh, let management take care of it,'" said Gotham Managing Director Deepak Agrawal. "Over the last two years [buyout firms] have become much more involved in operational engineering. They simply don't have the luxury to let management make a mistake and then go back and fix it."

Some 64% of survey respondents said increased industry competition has forced them to change their investment strategy and become more specialized. Of those, 19% said they shifted focus to different size deals, while 12% said they expanded their focus to other industry sectors. 33% said they specialize in a selected sector to address growing competition.

"The competition in PE is forcing PE firms to look at different ways of doing things," Agrawal said.

To that end, most buyout shops said they have learned wherever possible to take advantage of competition rather than being outsmarted by it. In the case of the massive low-cost Chinese labor market, many PE firms said they have created opportunities for their portfolio companies rather than allow cheap labor to put them out of business. More than half the firms interviewed said they are tapping China as an opportunity to create value. Only 18% said the Chinese boom has had a negative impact on their business or future potential opportunities.

Still, the average time spent on operations during due diligence remains low, the survey shows.

The general partners surveyed said they spend 20% of their time on operational due diligence compared to 24% devoted to portfolio accounting.

The same is true for the amount of time a GP spends on new operational initiatives after the company is bought. Only 24% of their time is spent on such initiatives, compared to 28% for board-level reviews.

The survey respondents included 298 mostly buyout executives, of whom 16% had more than $2 billion of capital under management, 16% had $1 billion to $2 billion, 18% had $500 million to $1 billion, and the remaining 40% had between $100 million and $250 million.

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