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Operators Standing By

One of the most common mantras heard around private equity firms is, “We have operational expertise.”

As private equity has become a more competitive industry, firms are looking for every possible advantage not only to make acquisitions, but also make good on them. Firms with operating expertise can generate deal flow through their operating professionals and dramatically alter the potential of the company by changing the way the company works. This top-line growth leads to generous returns on investment.

There are several ways for private equity firms to exert operational expertise. One method that has become increasingly popular, particularly among middle-market buyout experts, is to employ one or more operating experts at the firm. These professionals are typically former high-level executives that are experts in their industry. The private equity firm can then mold its strategy around the expertise of that person – acquiring companies in a sector in which the operating professional has a stellar background.

Another method is to hire outside consultants examine portfolio company operations. This technique is perhaps as old as private equity itself. Consulting firms like Bain & Co. and Boston Consulting Group pitch their services to companies in all types of industries. It’s easy to understand why private equity firms are largely staffed by former consultants who can work from an operating mindset.

Terrence Mullen, a managing director of New York-based Arsenal Capital Partners, is a big believer in the operational approach. His firm, which closed its debut fund last June on $300 million, employs several former AlliedSignal/Honeywell International executives, as well as former executives from Pharmacia Corp., Invensys and Medical Logistics, Inc. Mullen says when his firm got started in 2001, most limited partners weren’t quite sure what to make of their strategy.

“We pursue a strategy that most investors weren’t really contemplating a few years ago,” Mullen says.

Pursuing an operational-improvement strategy is not a new one, of course. Firms like Clayton, Dubilier & Rice have been doing it for years, so it just seems like everyone is now getting on board.

Consulting firms have been around just as long. But one consulting firm is now focusing almost exclusively on serving portfolio companies of private equity firms. New York-based Gotham Consulting Partners, which was founded in 2001, focuses on that niche largely because of the increased importance being placed by general partners on operational improvements.

“There has definitely been an increase in focus on operations [at private equity firms],” Deepak Agrawal, co-founder and managing director of Gotham Consulting Partners, says. “In order to gain competitive advantage, private equity firms need to quickly develop a strong understanding of the practical realities of front-line operations.”

Agrawal says even though private equity firms are increasingly looking at their portfolio companies’ operations, consulting firms like his are still in need because even if a firm has operational expertise, they may not understand or have resources to get into the nitty-gritty details of what makes a business tick.

“They understand what it takes to succeed in operating situations at board-level,” Agrawal says. “We work day-to-day with the private equity firm and the senior executives at the portfolio companies while also interfacing regularly with people on the shop floor. This approach creates a comprehensive snapshot that allows us to identify value opportunities and expose problems, both during the due diligence process as well as post-transaction.”

Consulting firms often work alongside firms with an operating bent, according to Jay Marshall, a co-managing principal at AlixPartners who leads the firm’s performance improvement practice. Some private equity firms with an operational bent may have only one or two operating professionals on their staff. If that’s the case, it’s impossible for them to become too deeply involved in any one portfolio company.

“The operating partner model – these folks can get stretched pretty thin,” Marshall says. “They can’t be everywhere at once. One of our selling points is that we worry only about that company.”

Mullen agrees that operating professionals can get too thinly stretched. His firm, which has eight operating professionals on staff, tries to have expertise in areas that most directly affect a company’s bottom line, such sales, marketing, supply chain management and manufacturing.

“We try to strengthen management teams, so we try to build an ‘A’ team and work with them,” Mullen says. “That combination can be effective.”

AlixPartners’ Marshall adds that private equity firms, even those with an operational bent, tend to perform better when they are given the freedom to do what they do best – acquire companies and sell them for a profit.

“I would say that private equity people have different DNA than people who fix companies,” Marshall says. “They’re good at finding and exiting deals but not necessarily good at fixing companies.”

Private equity firms have known this for a while. One traditional model of private equity is to invest in a strong company with a strong management team and if it doesn’t work out properly, replace the management team. That can be expensive and time consuming, however. Private equity firms are now looking at new models, such as having an operating professional on staff or using third-party consultants on a more regular basis.

Agrawal adds that private equity returns in the future will be driven by a firm’s ability to add the most value to a portfolio company.

“In the competitive buyout industry, every situation is an auction,” Agrawal says. “A private equity firm cannot buy a company and then become an absentee owner, hoping to achieve the greatest possible returns. You have to be engaged with the portfolio company right from the beginning to identify and prioritize key levers of value in operations in order to quickly generate superior and sustainable financial returns.”

Of all the ways a portfolio company can increase in value, its operations may be the only thing a private equity firm can truly control, Mullen adds. Sure, a firm can buy a company cheaply, put some leverage on it and hope a rising economy improves a company’s performance, but that won’t work in every economic environment.

“What we’ve gone through has been a very difficult economy and it has exposed the need to have an ability to fundamentally improve the performance of the business,” Mullen says. “I think, with an approach like this, you can influence all of those factors.”

Marshall agrees. In a tough economic environment, private equity firms need to get their hands dirty.

“When the economy is generally expanding, then private equity is an easier business,” Marshall says. “But, we’ve seen an economic climate where it’s more difficult for private equity firms to make returns. You have to roll up your sleeves and make these better companies.”