THE OPERATING PARTNER IN PRIVATE EQUITY

Successful strategies for value creators

Edited by
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Contents

Figures and tables vii

About the editor xi

Foreword xiii
By Richard Zannino and Karl Kurz, CCMP Capital Advisors, LLC

Introduction 1
By Tony Ecock, Welsh, Carson, Anderson & Stowe
Considerations for hiring full-time operating partners 1
Opportunity-rich environment 1
Advantages of having full-time, in-house operating partners 2
Key success factors 4
Conclusion 9

Section I: Setting up the operating group

Chapter one 13
Operating partner team models, profiles and compensation
By Andrew Fulton, AJF Executive Search and Miles Graham, 3i
Introduction 13
Designing an operating model and the operating partner’s role 13
Typical profiles 18
Compensation and profiles 19
Conclusion 21

Chapter two 23
Practices and innovations in operating partner groups
By Jason Caulfield and John Moore, Deloitte
Introduction 23
Recent trends 23
Operating team models 28
Innovations and cross-portfolio initiatives 29
Conclusions 30

Chapter three 31
Working with deal teams
By Conor Boden, Advent International
Introduction 31
The role of the operating partner 31
Key attributes for success 33
Choosing the right private equity firm 34
Executing successfully in private equity 34
What makes for an effective ongoing relationship? 35
Time commitment and length of relationship 36
Conclusion 38

Section II: Due diligence

Chapter four 41
Business/market due diligence
By Jay Lucas, The Lucas Group
Overview 41
Background 41
Traditional elements of analysis 41
The five drivers of value 43
Conclusion 46

Chapter five 47
Financial due diligence
By John Selvey and Jessica Scott, PricewaterhouseCoopers
Introduction 47
Planning and risk assessment 47
Access to information 50
Building blocks 52
Conclusion 56
## Contents

<table>
<thead>
<tr>
<th>Chapter six</th>
<th>59</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Tax due diligence</strong></td>
<td>59</td>
</tr>
<tr>
<td>By Dawn Marie Krause and Jason Thomas, PricewaterhouseCoopers</td>
<td>59</td>
</tr>
<tr>
<td>Introduction</td>
<td>59</td>
</tr>
<tr>
<td>Scoping to achieve maximum results</td>
<td>59</td>
</tr>
<tr>
<td>Interpreting a tax due diligence report</td>
<td>61</td>
</tr>
<tr>
<td>Vendor/sell-side due diligence</td>
<td>64</td>
</tr>
<tr>
<td>Conclusion</td>
<td>66</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Chapter seven</th>
<th>67</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Operational due diligence</strong></td>
<td>67</td>
</tr>
<tr>
<td>By Jason Caulfield and Matt Penny, Deloitte</td>
<td>67</td>
</tr>
<tr>
<td>Introduction</td>
<td>67</td>
</tr>
<tr>
<td>Risks and performance improvement potential</td>
<td>67</td>
</tr>
<tr>
<td>Carveout issues and costs</td>
<td>71</td>
</tr>
<tr>
<td>Merger synergies and integration challenges</td>
<td>73</td>
</tr>
<tr>
<td>Conclusions</td>
<td>75</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Chapter eight</th>
<th>77</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Financial due diligence, an operator’s approach</strong></td>
<td>77</td>
</tr>
<tr>
<td>By Shahriyar Rahmati, The Gores Group</td>
<td>77</td>
</tr>
<tr>
<td>Introduction</td>
<td>77</td>
</tr>
<tr>
<td>Income statement</td>
<td>77</td>
</tr>
<tr>
<td>Balance sheet</td>
<td>83</td>
</tr>
<tr>
<td>Conclusion</td>
<td>85</td>
</tr>
</tbody>
</table>

### Section III: Managing the portfolio

<table>
<thead>
<tr>
<th>Chapter nine</th>
<th>89</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Working with portfolio companies</strong></td>
<td>89</td>
</tr>
<tr>
<td>By Scott Glickman and Sara Boyd, Graham Partners</td>
<td>89</td>
</tr>
<tr>
<td>Introduction</td>
<td>89</td>
</tr>
<tr>
<td>Pre-acquisition due diligence</td>
<td>90</td>
</tr>
<tr>
<td>On-boarding</td>
<td>91</td>
</tr>
<tr>
<td>Ownership</td>
<td>95</td>
</tr>
<tr>
<td>Exit</td>
<td>96</td>
</tr>
<tr>
<td>Conclusion</td>
<td>96</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Chapter ten</th>
<th>99</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Transformational ownership: moving beyond 100-day plans</strong></td>
<td>99</td>
</tr>
<tr>
<td>By Roberto Quarta, Clayton, Dubilier &amp; Rice</td>
<td>99</td>
</tr>
<tr>
<td>Introduction</td>
<td>99</td>
</tr>
</tbody>
</table>

Before the close: sourcing and investment decision-making 100
Early execution 102
Follow-through: shepherding the deal to exit 103
Conclusion 105

<table>
<thead>
<tr>
<th>Chapter eleven</th>
<th>107</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Selecting and developing portfolio company executives</strong></td>
<td>107</td>
</tr>
<tr>
<td>By Ric Andersen, Milestone Partners and Andy Rourke, Blake Street Group</td>
<td>107</td>
</tr>
<tr>
<td>Introduction</td>
<td>107</td>
</tr>
<tr>
<td>Selection in pre-deal due diligence and portfolio company executive hiring</td>
<td>107</td>
</tr>
<tr>
<td>Running an effective executive selection process</td>
<td>108</td>
</tr>
<tr>
<td>On-boarding and developing portfolio company executives</td>
<td>112</td>
</tr>
<tr>
<td>A final dose of ‘soft’</td>
<td>113</td>
</tr>
<tr>
<td>Conclusion</td>
<td>114</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Chapter twelve</th>
<th>115</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Financial leadership and assessment</strong></td>
<td>115</td>
</tr>
<tr>
<td>By John Jureller, General Atlantic LLC</td>
<td>115</td>
</tr>
<tr>
<td>Introduction</td>
<td>115</td>
</tr>
<tr>
<td>Assessing the CFO</td>
<td>115</td>
</tr>
<tr>
<td>Finance organisation competency</td>
<td>117</td>
</tr>
<tr>
<td>The scorecard</td>
<td>120</td>
</tr>
<tr>
<td>Conclusion</td>
<td>121</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Chapter thirteen</th>
<th>123</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Portfolio company management incentives</strong></td>
<td>123</td>
</tr>
<tr>
<td>By Marc Hodak, Hodak Value Advisors</td>
<td>123</td>
</tr>
<tr>
<td>The (sometimes hidden) power of incentives</td>
<td>123</td>
</tr>
<tr>
<td>Incentives and control</td>
<td>123</td>
</tr>
<tr>
<td>Why equity is not enough</td>
<td>123</td>
</tr>
<tr>
<td>Target variable compensation: the first step in incentive-plan design</td>
<td>124</td>
</tr>
<tr>
<td>Subjective measures for bonus distribution</td>
<td>126</td>
</tr>
<tr>
<td>Target-setting</td>
<td>126</td>
</tr>
<tr>
<td>Plan leverage</td>
<td>128</td>
</tr>
<tr>
<td>Management versus board’s role in establishing incentive plans</td>
<td>130</td>
</tr>
</tbody>
</table>
Chapter fourteen 131
Legal aspects in managing portfolio company senior management
By Scott Price, Kirkland & Ellis, LLP
Introduction 131
The goal of legal arrangements 131
The concept of ‘fairness’ 132
Material provisions of legal documents 133
Severance 134
Restrictive covenants 135
Dispute-resolution provisions 136
Exiting the relationship 137
Conclusion 138

Section IV: Growth
Chapter fifteen 143
Winning with customer insight
By Chris Hsu and Derick Prelle, KKR Capstone, and Anne Beall, Beall Research and Training, Inc.
Introduction 143
Asking the right questions 143
Limits to the researcher’s crystal ball: data interpretation and methodologies 145
Research project timelines 147
Understanding what tools to use 148
Focus groups 148
Picking the right research partner 151
Conclusion 152

Chapter sixteen 155
Improving sales force effectiveness
By Steve Larned, Welsh, Carson, Anderson & Stowe and Pete Masloski, ZS Associates
Introduction 155
Assessing opportunity with performance data 155
Leveraging a proprietary view of market potential 156
Deploying and focusing resources 157
Optimising the talent base 160
Driving focus with tools, incentives and metrics 161
Conclusion 163

Chapter seventeen 165
Customer lifetime value: methodology and applications for operating partners
By Hilary Gosher and Nikitas Koutoupes, Insight Venture Partners
Introduction 165
Defining CLV and its components 165
Implementing CLV to drive growth 167
Using CLV post-investment 171
Conclusion 175

Section V: Operations
Chapter eighteen 179
Cost and cash management for private equity portfolio companies
By Gary Matthews, Morgan Stanley Private Equity and David Hanfland, AT Kearney
Introduction 179
1. Set big goals… thoughtfully 179
2. Think creatively 181
3. Focus initial efforts 182
4. Don’t coach from the skybox 183
5. Value of outside perspectives 184
6. Aligning incentives and celebrating success185
Conclusion 187

Chapter nineteen 189
Working-capital and cash-flow management for operating partners
By Nick Alvarez, Alvarez & Marsal and David Heidecorn, Catterton Partners
Introduction 189
The stakes: management versus mismanagement 189
Assessing the working-capital and cash-flow functions 190
Chasing the right targets 190
The need for an organisation-wide effort 191
Getting it right 193
The borrowing base: a double-edged sword 195
Thirteen-week treasury cash-flow forecast 195
Conclusion 196
<table>
<thead>
<tr>
<th>Chapter twenty</th>
<th>Developing a private equity procurement programme</th>
<th>199</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td><em>By Jeff Gallant, Welsh, Carson, Anderson &amp; Stowe</em></td>
<td></td>
</tr>
<tr>
<td>Introduction</td>
<td>199</td>
<td></td>
</tr>
<tr>
<td>1. Appoint an experienced leader</td>
<td>199</td>
<td></td>
</tr>
<tr>
<td>2. Conduct a discovery process</td>
<td>200</td>
<td></td>
</tr>
<tr>
<td>3. Select a few trusted partners</td>
<td>202</td>
<td></td>
</tr>
<tr>
<td>4. Assess portfolio company procurement operations</td>
<td>202</td>
<td></td>
</tr>
<tr>
<td>5. Develop the procurement plan</td>
<td>204</td>
<td></td>
</tr>
<tr>
<td>6. Execute and expand the programme</td>
<td>205</td>
<td></td>
</tr>
<tr>
<td>7. Provide ongoing governance</td>
<td>206</td>
<td></td>
</tr>
<tr>
<td>Conclusion</td>
<td>207</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Chapter twenty-one</th>
<th>Portfolio purchasing of employee benefits</th>
<th>209</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td><em>By Jeff Cox and Shital Davé, Mercer Human Resource Consulting, and Jayne Binzer, Cerberus Operations and Advisory Company</em></td>
<td></td>
</tr>
<tr>
<td>Introduction</td>
<td>209</td>
<td></td>
</tr>
<tr>
<td>Setting up a portfolio purchasing programme</td>
<td>209</td>
<td></td>
</tr>
<tr>
<td>US medical portfolio purchasing</td>
<td>210</td>
<td></td>
</tr>
<tr>
<td>Additional portfolio-programme opportunities</td>
<td>213</td>
<td></td>
</tr>
<tr>
<td>Risk management strategies</td>
<td>215</td>
<td></td>
</tr>
<tr>
<td>Best practices</td>
<td>216</td>
<td></td>
</tr>
<tr>
<td>Conclusion</td>
<td>217</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Chapter twenty-two</th>
<th>Risk and insurance: due diligence and value-accretive portfolio strategies</th>
<th>219</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td><em>By Brian Casey, Aon</em></td>
<td></td>
</tr>
<tr>
<td>Introduction</td>
<td>219</td>
<td></td>
</tr>
<tr>
<td>Nature of the proposed transaction</td>
<td>219</td>
<td></td>
</tr>
<tr>
<td>Key insurance issues</td>
<td>220</td>
<td></td>
</tr>
<tr>
<td>Key legal issues</td>
<td>221</td>
<td></td>
</tr>
<tr>
<td>Transition issues</td>
<td>222</td>
<td></td>
</tr>
<tr>
<td>Role of insurance in value creation</td>
<td>222</td>
<td></td>
</tr>
<tr>
<td>Conclusion</td>
<td>228</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Chapter twenty-three</th>
<th>Merger integration and carveouts</th>
<th>229</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td><em>By Gary Moran and Denis Picard, Alvarez &amp; Marsal</em></td>
<td></td>
</tr>
<tr>
<td>Introduction</td>
<td>229</td>
<td></td>
</tr>
<tr>
<td>Linking integration strategy to value proposition</td>
<td>230</td>
<td></td>
</tr>
<tr>
<td>People: choose carefully and drive the desired culture</td>
<td>231</td>
<td></td>
</tr>
<tr>
<td>Organising for a successful transition</td>
<td>231</td>
<td></td>
</tr>
<tr>
<td>Communicating effectively with key stakeholders</td>
<td>234</td>
<td></td>
</tr>
<tr>
<td>Getting IT right</td>
<td>235</td>
<td></td>
</tr>
<tr>
<td>Conclusion</td>
<td>237</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Chapter twenty-four</th>
<th>Information technology: integration and operational effectiveness</th>
<th>239</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td><em>By James Cashin and Daniel Wheadon, RSM McGladrey, Inc.</em></td>
<td></td>
</tr>
<tr>
<td>Introduction</td>
<td>239</td>
<td></td>
</tr>
<tr>
<td>Defining IT due diligence</td>
<td>239</td>
<td></td>
</tr>
<tr>
<td>Integration planning and governance</td>
<td>241</td>
<td></td>
</tr>
<tr>
<td>Integration execution</td>
<td>242</td>
<td></td>
</tr>
<tr>
<td>Post-close assessment and continuous improvement</td>
<td>243</td>
<td></td>
</tr>
<tr>
<td>Conclusion</td>
<td>246</td>
<td></td>
</tr>
</tbody>
</table>

| About PEI          | 248                                               |     |
Figures and tables

Figures

Figure 1.1: Key issues for defining an operating team

Figure 2.1: Maturity of operational capability in private equity firms

Figure 2.2: Mature operations teams – scale versus activity

Figure 2.3: Operational staff ratios – scale versus activism

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

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

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

Figure 2.7: Operating team and portfolio company involvement models

Figure 4.1: Five drivers of value

Figure 7.1: Value chain and key diligence issues for a manufacturing business

Figure 7.2: Operating expense overview of benefit sensitivity

Figure 7.3: Benchmarking performance against comparator business

Figure 7.4: Common buyer, seller and shared objectives

Figure 7.5: Drivers of potential synergy

Figure 9.1: Tripartite alignment in a private equity deal

Figure 13.1: Bonus plan leverage

Figure 13.2: Conventional bonus plan

Figure 15.1: An incidence tree

Figure 15.2: Customer responses to the wording of questions
Figures and tables

Figure 15.3: Customer responses when given different response categories

Figure 16.1: An improvement in territory balance can increase sales by 2%-7%

Figure 16.2: Comparing performance in like territories provides basis for performance improvement actions

Figure 17.1: Average ARPU over time by cohort for a monthly subscription business

Figure 17.2: Annual revenue contribution from prior cohorts for an e-commerce business

Figure 17.3: Change in cohort churn for a monthly subscription business

Figure 17.4: Changes in CLV over time for two annual subscription companies

Figure 17.5: Sensitivity of the drivers of CLV

Figure 18.1: Ruthless competitor tableting gap analysis - cents per tablet

Figure 18.2: Strategic sourcing programme initiative prioritisation

Figure 18.3: Root-cause issues of DSO increase

Figure 18.4: Leadership dashboard

Figure 19.1: Example of internal benchmarking (by division)

Figure 19.2: Cash/working cash operating cycle

Figure 21.1: Portfolio purchasing value creation

Figure 21.2: Projected annual private equity portfolio US benefit spend

Figure 21.3: Projected annual US benefit savings for current portfolio company

Figure 21.4: Vendor selection draft work plan for a 401k programme

Figure 22.1: Key insurance issues in risk due diligence

Figure 22.2: Legal issues that often arise during risk diligence

Figure 22.3: Shared limit to apply above or in lieu of each portfolio company’s limit

Figure 22.4: Shared limit to apply above each portfolio company’s limits and the shared excess limits
**Figures and tables**

**Figure 22.5:** Shared Side A policy for all portfolio companies

**Figure 22.6:** Typical property insurance portfolio programme

**Figure 23.1:** Integration team structure

**Figure 23.2:** Integration message platform

**Figure 24.1:** Frequency of changes made to IT systems in private equity portfolio companies

**Figure 24.2:** Frequency of implementation of strategies to optimise performance and reduce costs across all private equity portfolio companies

**Tables**

**Table 1.1:** Typical operating partner compensation by profile

**Table 5.1:** Example of a quality of earnings analysis

**Table 5.2:** Example of debt and debt-like items

**Table 8.1:** Revenue diligence items

**Table 8.2:** Sales compensation plan diligence items

**Table 8.3:** New products/markets revenue diligence items

**Table 8.4:** Material cost diligence items

**Table 8.5:** Labour costs diligence items

**Table 8.6:** Operating expenses diligence items

**Table 8.7:** Accounts receivable diligence items

**Table 8.8:** Inventory diligence items

**Table 8.9:** Accounts payable diligence items

**Table 8.10:** Capital expenditure diligence items

**Table 9.1:** On-boarding document table of contents

**Table 9.2:** Directors and officers (D&O) insurance policy
Table 11.1: Key quantitative scorecard elements

Table 15.1: Sample research project timelines

Table 15.2: Benefits and drawbacks of consumer research providers

Table 16.1: Sales force effectiveness

Table 17.1: CLV calculation for an annual subscription business

Table 17.2: CLV in a monthly subscription business

Table 20.1: Third-party sourcing approaches

Table 20.2: Private equity and portfolio company meeting schedule

Table 22.1: Breakdown of hypothetical premium dollar

Table 23.1: Template for documenting specific communication actions
In 2008, I started a networking group exclusively for full-time, in-house operating partners at leading private equity firms. Three years later, the Private Equity Operating Partner Executive Network (PEOPEN) has over 350 members, representing at least half of the known population of full-time, in-house operating partners in private equity globally. Interacting with this diverse group of talented professionals has provided me with a terrific vantage point on the many different operating partner models and approaches for adding value to portfolio companies.

The potential benefits of bringing in-house a dedicated, full-time operating partner, or building a whole team of operating partner generalists or specialists, are many. The private equity firm, however, must be committed to the strategy and the operating executives they have hired. In general, the greater the commitment of the firm, the greater the results that will be achieved.

Considerations for hiring full-time operating partners
The bar for adding operating partners to the private equity firm payroll is very high. Most firms have a well-developed network of external operating resources such as board members, senior advisers, interim executives and consultants. These external resources bring specific expertise that can be scaled up or down as needed, and they are typically paid for directly by portfolio companies. Even at firms with large staffs of operating partners, external resources still account for the vast majority of portfolio company value-addition activity.

Beyond expertise, scalability and cost, the other important considerations for bringing operating partners in-house include:

- How will adding operating partners impact roles and responsibilities in their management of the portfolio?
  - In particular, who will ‘own the deal’ and the CEO relationship post-close?
  - What impact will introducing operating partners have on accountability for the success of a deal?
- Will current portfolio companies be receptive to operating partners’ input?
- Will operating partners hinder the firm from attracting talented entrepreneurial management teams in deal origination?
- How will adding operating partners change the firm’s culture? In which decisions, meetings and operating mechanisms will operating partners participate – and vote?

Adding a team of full-time, in-house operating partners fundamentally changes the private equity firm in both makeup and culture. It will be hard to reverse this decision.

The good news is it is easy to clear the bar. The opportunities to add value to a large portfolio of companies are almost limitless, and full-time, in-house operating partners are uniquely positioned to realise them.

Opportunity-rich environment
The portfolios at the top private equity firms are large and offer enormous potential for value creation relative to the cost of hiring full-time, in-
house operating partners. For example, at any
given time, the portfolio at Welsh, Carson,
Anderson & Stowe (WCAS), where the latest equi-
ity fund was approximately $4 billion, might consist
of 25 companies, 90,000 employees, $20 billion in
revenue, $4 billion in supplier spend and $1 bil-
ion in cash employee-benefit costs. Achievable
improvements add up quickly:

• 1 percent better pricing realisation equals
  $200 million.
• 5 percent savings on procurement equals
  $200 million.
• 5 percent savings on employee-benefit costs
  equals $50 million.

Whether a fund is highly diversified or concentrat-
ed, the opportunity for value creation is directly
proportionate to total portfolio revenues and costs.

At WCAS, we have found that ‘the more we look,
the more we find’. For example, we had modest
expectations when we first evaluated a cross-portfo-
l.io programme. Our portfolio consists of healthcare
and business-services companies where people,
not external purchases, comprise the highest per-
centage of costs. Most portfolio companies are
large enough to have their own buying power. We
anticipated moderate compliance due to concerns
about switching suppliers and whether group buy-
ing could accommodate the unique needs of indi-
vidual portfolio companies. All things considered,
we estimated we could save $15 million to $20 mil-
lion through the programme, enough to make the
initiative worthwhile, but certainly not the homerun
for which everyone was hoping.

Early results were more promising than expected.
We found savings opportunities in more cate-
gories and greater percentage of savings. Even
our largest portfolio companies, with the greatest
purchasing scale, saved money. However, the real
breakthrough came when we hired an experi-
enced operating partner to focus on procurement.
With his leadership, we have generated over $60
million in annual savings from WCAS-specific pro-
grammes. Another $250 million in savings has
come from the portfolio companies themselves
through the sharper focus brought to procure-
ment. Most promising, we are now working as a
team with procurement leaders across the portfo-
ilio. These leaders are contributing their own ideas
and vendors to continuously expand the pie. This
buy-in from our portfolio companies has been
helpful in attracting external help from group-pur-
chasing organisations, service providers and con-
sultants who work on contingency fees and count
on compliance for success. Every year, we ask our
portfolio companies to budget additional savings
from procurement. We have created one of those
rare, virtuous cycles, which we could not have
achieved without an in-house operating partner
focused on procurement.

The procurement programme has worked so well
that it has become one of the foundations of our
Resource Group strategy. It has built trust and
credibility, opening doors for collaboration with
portfolio companies on other areas. The pro-
gramme is used not only by the companies we
control, but also by those in which we own a
minority stake. It has become a differentiator that
can be referenced when doing new deals. After
all, which CEO does not appreciate some ‘free
money’ to invest in growth initiatives? Dozens of
similar examples can be found at other private
equity firms, in just about every business function,
all made possible by the full-time focus of an in-
house operating partner over a multi-year period.

Advantages of having full-time,
in-house operating partners

Full-time, in-house operating partners can find
and realise more value because their unique role
gives them ‘unfair’ advantages, including:

1. Focus. Full-time, in-house operating partners
   have the luxury of waking up every day with a
   primary focus on adding incremental operating
Introduction

Of all the analytical tools operating partners have at their disposal, customer lifetime value (CLV) analysis can be an important part of due diligence and useful for achieving operational excellence post-investment. This chapter outlines the methodology of CLV and how operating partners can use it to impact overall growth strategy in portfolio companies.

CLV is an increasingly utilised metric that combines many of the levers of growth and profitability in a single concept. It affords management and operating partners a long-term view of customers by taking into account the contribution the average customer will make to the bottom line of the business, from the moment they are acquired up until the last time they do business with the company. This analysis is relevant for any business where a customer makes a purchase more than once. It is also applicable across a wide range of B2B and B2C businesses. CLV can easily be determined once a customer has left or churned, but a key benefit of CLV is its predictive value.

Defining CLV and its components

Definitions

CLV is the net present value of expected net cash flows over the average customer’s lifetime, less the cost to acquire that customer. This definition identifies the components that contribute to CLV, namely:

- **Customer retention rate.** To obtain the ‘expected’ net cash flows, the likelihood that a customer will conduct business with the company at a given point in time (by buying another product, renewing a subscription or paying maintenance) is calculated. Customer retention is therefore the first component of CLV and is the expected probability that a customer (or an expected percentage of the customer population) will conduct business with the company at a point in time after the original transaction. For example, of the 100 customers who sign up in month 0 for a monthly subscription, 95 percent remain in month 1, 80 percent remain in month 2 and so forth. Operating partners can establish a basis for what historical retention rates have been for a business by analysing retention trends over time, typically by cohort. A cohort is a group or class of customers that began transacting with the business during a specified period of time (for example, in October 2011 or in the fourth quarter of 2011) and cohort analysis examines the retention rate of this group. Cohort analysis is important to be able to project future retention rates which are a critical component of the CLV calculation. Trends can show, for example, decreasing customer loyalty for more recent cohorts, a situation where extrapolating data from older cohorts to calculate a projected retention rate could result in an overly optimistic forecast. Constant retention rates over time are likely to yield accurate forecasts because customer behaviour is not changing.

- **Average net income per user (ANIPU).** To calculate ‘net cash flows’, data is needed on how much a customer will pay at a given point in time, and how much it will cost to service this customer at that same point in time, on a fully
Section IV: Growth

loaded basis. ANIPU represents the payments that a business receives from the average customer over a period of time (average revenue per user, or ARPU), minus the fully loaded cost to service that customer over the same time period (average cost per user, or ACPU). In situations where calculating ANIPU correctly is not possible as a result of data-collection constraints (through difficulties in procuring all customer transaction data over time, or obtaining accurate information on the costs to serve customers), only ARPU should be used, along with the rest of the steps described below to calculate CLV. Without ACPU information, the metric used is average customer lifetime revenue (LTR). LTR does not reflect the net cash flow contributed by the average customer but is still a valuable concept to use in driving operational changes in marketing optimisation.

- **Acquisition cost.** The definition of acquisition cost changes depends on the company analysed. Conceptually, however, it should incorporate all expenses associated with bringing a customer to transact with the company for the first time. For example, in an e-commerce company, all marketing campaign expenses resulting in a new customer transaction should be part of acquisition cost. In a software-as-a-service company or a software license sales business model, both sales and marketing costs should be taken into account, as well as hardware or implementation costs.

- **Discount rate.** The discount rate (r) used to calculate the present value of the ANIPU stream of payments should conceptually be equal to the cost of capital for the company. This will vary by industry and type of business. A simple way of getting to the right discount rate is to assume that the cost of equity for the company is equal to the expected return on equity for the investors, and then adjust the overall discount rate by the cost of any debt in the business.

### Table 17.1: CLV calculation for an annual subscription business

<table>
<thead>
<tr>
<th>Time period</th>
<th>0</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
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<td>ARPU</td>
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<td>$120</td>
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<td>$130</td>
<td>$140</td>
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<td>$150</td>
<td>$150</td>
<td>$160</td>
<td>$160</td>
<td>$170</td>
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<tr>
<td>Less: ACPU</td>
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<td>$60</td>
<td>$65</td>
<td>$65</td>
<td>$70</td>
<td>$70</td>
<td>$75</td>
<td>$75</td>
<td>$80</td>
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<td>$80</td>
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<tr>
<td>ANIPU</td>
<td>$60</td>
<td>$60</td>
<td>$65</td>
<td>$65</td>
<td>$70</td>
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<td>$75</td>
<td>$75</td>
<td>$80</td>
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<td>$90</td>
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<tr>
<td>Average customer retention rate</td>
<td>100%</td>
<td>75%</td>
<td>55%</td>
<td>40%</td>
<td>30%</td>
<td>25%</td>
<td>18%</td>
<td>15%</td>
<td>10%</td>
<td>8%</td>
<td>5%</td>
</tr>
<tr>
<td>E (ANIPU)</td>
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<td>$45</td>
<td>$36</td>
<td>$26</td>
<td>$21</td>
<td>$18</td>
<td>$14</td>
<td>$11</td>
<td>$8</td>
<td>$6</td>
<td>$5</td>
</tr>
<tr>
<td>PV E(ANIPU)</td>
<td>$60</td>
<td>$39</td>
<td>$27</td>
<td>$17</td>
<td>$12</td>
<td>$9</td>
<td>$6</td>
<td>$4</td>
<td>$3</td>
<td>$2</td>
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<td>∑ PV ANIPU</td>
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<td>Acquisition cost</td>
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<td>Customer LTV</td>
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Source: Insight Venture Partners.
Introduction

Two of the most formidable weapons operating partners have in their profit improvement arsenal - cost reduction and cash management - continue to be keys to success in private equity. These strategies work by leading to quicker reductions in heavy debt loads and lower risk investments. This explains why productivity improvements are often one of the first strategies employed to generate value. The stakes, however, are high. Poorly executed productivity efforts can alienate portfolio company management, sour relationships across the company and impact performance for the longer holding period.

Pursuing performance improvement in a portfolio company is significantly different from exercises commonly conducted in large, publicly owned companies. Most large corporations have deep benches to execute projects in a timely manner. This is typically not the case for portfolio companies that tend to be organisationally leaner. So, it often falls on the operating partner to work with the CEO and the management team to drive value creation by rationalising costs and improving cash flow.

Our experience has led us to six ‘rules’ for any operating partner seeking to successfully create cost reduction and cash management value within a portfolio company. These rules are discussed below.

1. Set big goals... thoughtfully

Setting aggressive goals forces portfolio company management to consider substantial changes, and often yields bigger results and greater value creation. Setting modest goals encourages incremental change and often yields more modest savings.

So, how high should the goals be?

The objective is to generate improvement goals that represent the far edge of the plausible, but still seen as achievable. If goals are seen as implausible it will be nearly impossible to secure management buy-in. Motivating a portfolio company team to reach audacious goals requires appealing to its logic, its emotions and, often, its pockets. One proven tactic for facilitating alignment and buy-in is to emphasise the potential personal payout associated with achieving a set of goals for stock- and option-holders.

For example, Morgan Stanley Private Equity has a grocery store company in our portfolio. In 2011, management worked hard to drive over $10 million of cost reductions. Part of their motivation started with the recognition that grocery industry multiples are in the 5.5x range today. Thus, $10 million of EBITDA savings translates into potentially $55 million of created equity value. This is a powerful incentive since the management team owns a substantial percentage of the company.

Picking the right goals is as much a science as an art. It is an art to create a goal so clear that it can be ‘branded’ for internal use while still flexible enough that it can be sensitive to the nuances and peculiarities of the business. Setting goals is a science in the sense that bold targets need to be supported by an analytical fact base. This fact base
includes approaches like competitive benchmarking and ‘ruthless-competitor’ modelling.

**Benchmarking**

Benchmarking performance is a critical tool for identifying potential improvement areas and establishing a goal’s credibility. It is hard for management to argue that they should not be able to perform at a competitive level. For example, a recent benchmarking project AT Kearney conducted for a specialty retailer revealed that its average expense per square foot was $170 while direct competitors’ was $140 to $150 per square foot. Illustrating this differential to management allowed us to make a clear case that store efficiency was an issue and that a focused improvement programme was required.

Relevant competitive benchmarks are often available from the private equity firm as they are routinely used during the due diligence process as a tool to test the investment thesis.

A caveat here, however, is that benchmarks accurately document the ‘art of the status quo’ rather than the art of the possible. It is critical to understand whether or not a benchmark represents truly best practice or just conventional practice.

Successful companies anticipate how emerging competitors or technologies will - or can - change their industry and establish performance goals that allow them to prosper in new competitive environments.

**Ruthless-competitor modelling**

A ‘ruthless-competitor’ model is a useful tool for developing perspectives on how competitive cost structures can evolve. These models require analysis of the core elements of the business to show how a theoretical competitor would perform if unencumbered by legacy equipment, plant locations and support functions. Comparing the estimated costs of the theoretical ruthless competitor to existing costs of the business can be enlightening and helpful in setting bold cost-reduction targets.

The following example is an analysis of a pharmaceutical-tableting process. The company had relatively new equipment well suited to its needs, but

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**Figure 18.1: Ruthless competitor tableting gap analysis - cents per tablet**

- Source: AT Kearney analysis.