



**PRIVATE EQUITY
INTERNATIONAL**

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		
<i>By Richard Zannino and Karl Kurz, CCMP Capital Advisors, LLC</i>			
Introduction	1		
<i>By Tony Ecock, Welsh, Carson, Anderson & Stowe</i>			
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			
<i>By Andrew Fulton, AJF Executive Search and Miles Graham, 3i</i>			
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			
<i>By Jason Caulfield and John Moore, Deloitte</i>			
Introduction	23		
Recent trends		23	
Operating team models		28	
Innovations and cross-portfolio initiatives		29	
Conclusions		30	
Chapter three	31		
Working with deal teams			
<i>By Conor Boden, Advent International</i>			
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			
<i>By Jay Lucas, The Lucas Group</i>			
Overview		41	
Background		41	
Traditional elements of analysis		41	
The five drivers of value		43	
Conclusion		46	
Chapter five	47		
Financial due diligence			
<i>By John Selvey and Jessica Scott, PricewaterhouseCoopers</i>			
Introduction		47	
Planning and risk assessment		47	
Access to information		50	
Building blocks		52	
Conclusion		56	

Chapter fourteen	131	Chapter seventeen	165
Legal aspects in managing portfolio company senior management		Customer lifetime value: methodology and applications for operating partners	
<i>By Scott Price, Kirkland & Ellis, LLP</i>		<i>By Hilary Gosher and Nikitas Koutoupes, Insight Venture Partners</i>	
Introduction	131	Introduction	165
The goal of legal arrangements	131	Defining CLV and its components	165
The concept of 'fairness'	132	Implementing CLV to drive growth	167
Material provisions of legal documents	133	Using CLV post-investment	171
Severance	134	Conclusion	175
Restrictive covenants	135		
Dispute-resolution provisions	136	Section V: Operations	
Exiting the relationship	137	Chapter eighteen	179
Conclusion	138	Cost and cash management for private equity portfolio companies	
		<i>By Gary Matthews, Morgan Stanley Private Equity and David Hanfland, AT Kearney</i>	
Section IV: Growth		Introduction	179
Chapter fifteen	143	1. Set big goals... thoughtfully	179
Winning with customer insight		2. Think creatively	181
<i>By Chris Hsu and Derick Prelle, KKR Capstone, and Anne Beall, Beall Research and Training, Inc.</i>		3. Focus initial efforts	182
Introduction	143	4. Don't coach from the skybox	183
Asking the right questions	143	5. Value of outside perspectives	184
Limits to the researcher's crystal ball:		6. Aligning incentives and celebrating success	185
data interpretation and methodologies	145	Conclusion	187
Research project timelines	147		
Understanding what tools to use	148	Chapter nineteen	189
Focus groups	148	Working-capital and cash-flow management for operating partners	
Picking the right research partner	151	<i>By Nick Alvarez, Alvarez & Marsal and David Heidecorn, Catterton Partners</i>	
Conclusion	152	Introduction	189
		The stakes: management versus mismanagement	189
Chapter sixteen	155	Assessing the working-capital and cash-flow functions	190
Improving sales force effectiveness		Chasing the right targets	190
<i>By Steve Larned, Welsh, Carson, Anderson & Stowe and Pete Masloski, ZS Associates</i>		The need for an organisation-wide effort	191
Introduction	155	Getting it right	193
Assessing opportunity with performance data	155	The borrowing base: a double-edged sword	195
Leveraging a proprietary view of market potential	156	Thirteen-week treasury cash-flow forecast	195
Deploying and focusing resources	157	Conclusion	196
Optimising the talent base	160		
Driving focus with tools, incentives and metrics	161		
Conclusion	163		

Chapter twenty	199		
Developing a private equity procurement programme			
<i>By Jeff Gallant, Welsh, Carson, Anderson & Stowe</i>			
Introduction	199	Nature of the proposed transaction	219
1. Appoint an experienced leader	199	Key insurance issues	220
2. Conduct a discovery process	200	Key legal issues	221
3. Select a few trusted partners	202	Transition issues	222
4. Assess portfolio company procurement operations	202	Role of insurance in value creation	222
5. Develop the procurement plan	204	Conclusion	228
6. Execute and expand the programme	205		
7. Provide ongoing governance	206	Chapter twenty-three	229
Conclusion	207	Merger integration and carveouts	
		<i>By Gary Moran and Denis Picard, Alvarez & Marsal</i>	
Chapter twenty-one	209	Introduction	229
Portfolio purchasing of employee benefits		Linking integration strategy to value proposition	230
<i>By Jeff Cox and Shital Davé, Mercer Human Resource Consulting, and Jayne Binzer, Cerberus Operations and Advisory Company</i>		People: choose carefully and drive the desired culture	231
Introduction	209	Organising for a successful transition	231
Setting up a portfolio purchasing programme	209	Communicating effectively with key stakeholders	234
US medical portfolio purchasing	210	Getting IT right	235
Additional portfolio-programme opportunities	213	Conclusion	237
Risk management strategies	215		
Best practices	216	Chapter twenty-four	239
Conclusion	217	Information technology: integration and operational effectiveness	
		<i>By James Cashin and Daniel Wheadon, RSM McGladrey, Inc.</i>	
Chapter twenty-two	219	Introduction	239
Risk and insurance: due diligence and value-accretive portfolio strategies		Defining IT due diligence	239
<i>By Brian Casey, Aon</i>		Integration planning and governance	241
Introduction	219	Integration execution	242
		Post-close assessment and continuous improvement	243
		Conclusion	246
		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

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

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

Introduction

By Tony Ecock, Welsh, Carson, Anderson & Stowe

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 equity fund was approximately \$4 billion, might consist of 25 companies, 90,000 employees, \$20 billion in revenue, \$4 billion in supplier spend and \$1 billion 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 concentrated, 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-portfolio programme. Our portfolio consists of healthcare and business-services companies where people, not external purchases, comprise the highest percentage 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 buying could accommodate the unique needs of individual portfolio companies. All things considered, we estimated we could save \$15 million to \$20 million 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 categories 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 experienced operating partner to focus on procurement. With his leadership, we have generated over \$60

million in annual savings from WCAS-specific programmes. Another \$250 million in savings has come from the portfolio companies themselves through the sharper focus brought to procurement. Most promising, we are now working as a team with procurement leaders across the portfolio. 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-purchasing organisations, service providers and consultants 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 programme 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

Customer lifetime value: methodology and applications for operating partners

By Hilary Gosher and Nikitas Koutoupes, *Insight Venture Partners*

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

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

	Time period										
	0	1	2	3	4	5	6	7	8	9	10
ARPU	\$120	\$120	\$130	\$130	\$140	\$140	\$150	\$150	\$160	\$160	\$170
Less: ACPU	\$60	\$60	\$65	\$65	\$70	\$70	\$75	\$75	\$80	\$80	\$80
ANIPU	\$60	\$60	\$65	\$65	\$70	\$70	\$75	\$75	\$80	\$80	\$90
Average customer retention rate	100%	75%	55%	40%	30%	25%	18%	15%	10%	8%	5%
E (ANIPU)	\$60	\$45	\$36	\$26	\$21	\$18	\$14	\$11	\$8	\$6	\$5
PV E(ANIPU)	\$60	\$39	\$27	\$17	\$12	\$9	\$6	\$4	\$3	\$2	\$1
Σ PV ANIPU	\$180	<i>(Discount rate 15%)</i>									
Less:											
Acquisition cost	\$80										
Customer LTV	\$100										

Source: Insight Venture Partners.

Cost and cash management for private equity portfolio companies

By Gary Matthews, Morgan Stanley Private Equity and David Hanfland, AT Kearney

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.

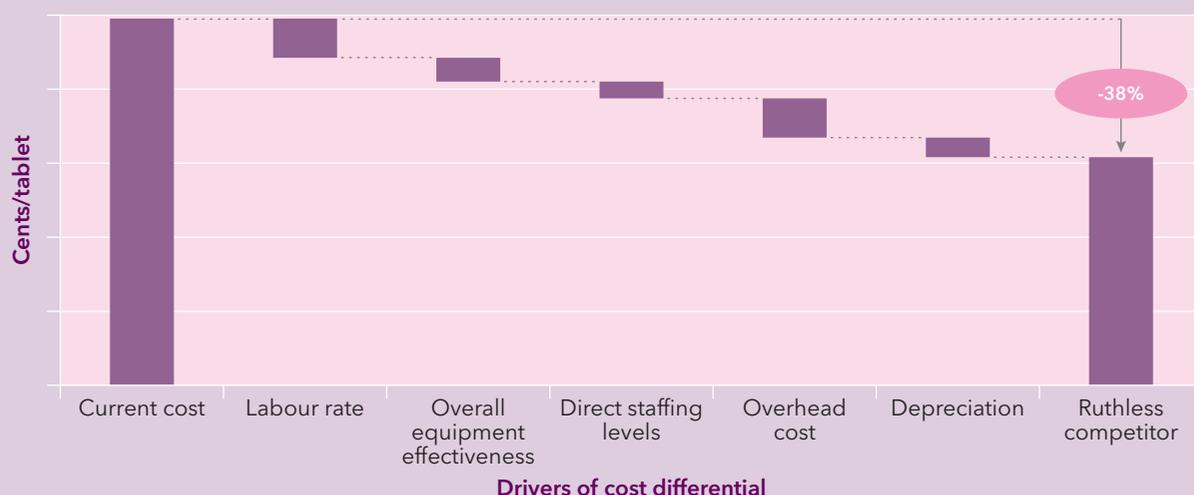
Successful companies anticipate how emerging competitors or technologies will - or can - change their industry and establish performance goals that allow them to prosper in new competitive environments.

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

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



Source: AT Kearney analysis.