Active Ownership in the Private Equity Industry – A Key to Superior Returns

A WHITEPAPER BY OPX PARTNERS

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Executive Summary

Private Equity (PE) as an ownership model and industry has thrived over the past decades, largely due to a combination of three factors – deal-making and structuring skills, the ability to take a long term view on value creation and the ability to incentivise management to align on the owner's objectives.

Over the last decade, the level of sophistication and skill of PE funds has increased substantially – as has the inflow of capital into the sector. In 2018 assets worth USD 3.4 trillion were under management by PE funds – an all-time record. In combination with a low growth macro-economic environment, these factors have resulted in an increasingly mature market with intensified competition for deals and, as a consequence, declining fund returns.

In this context, the PE players' ability to ensure strong execution in individual portfolio companies, referred to in the industry as 'active ownership' is increasingly important to realising value. Most PE firms today talk about themselves as 'active owners', and the concept of an 'ownership toolbox' is increasingly established in the industry.

However, there is rarely a comprehensive approach to active ownership deployed consistently across the entire portfolio of a PE firm or deployed throughout the life cycle of a portfolio company – there are a few cases where such a 'best practice' model is fully deployed. The approach to active ownership is still to a large extent at the discretion of individual deal teams.

At OPX Partners, based on our experience working with PE firms and their portfolio companies on such matters, we realised that there is substantial interest regarding best practice in creating and applying a consistent and structured 'life cycle' approach and toolkit to active ownership.

To develop a perspective on these questions, OPX Partners has over the past 6 months interviewed over 50 PE partners, industrial advisors and portfolio company CEOs, reviewed existing research and drawn on our own extensive experience working with a large number of companies owned by the best PE firms in Northern Europe. We would like to thank the many contributors to this report for their time, and open and honest sharing of valuable learnings and insights from both successful and less successful situations.

The results are summarised in this whitepaper on active ownership, and we welcome the opportunity to meet and discuss these findings and their implications in more detail.

The Findings

We define active ownership as the structured and ongoing engagement of the owner (in this context represented by the PE General Partner) in matters of strategy, organisation, and governance, throughout the holding period of an investment.

The strong consensus emerging from our interviews is that good active ownership is, and will increasingly be, a key factor in generating superior investment returns. And that good active ownership begins well before a company is acquired, and continues all the way to exit.

We have seen that there are 5 critical phases in the life of a portfolio company where good versus poor active ownership can be truly decisive in determining the ultimate value creation of an investment.

1. Pre-transaction: Due diligence, deal structuring and preparing for initial ownership

Commercial, financial and legal due diligence is well established practices within PE firms. However, our interviews highlighted 3 particularly important factors at this stage to ensure deals can be value-creating:

- **A clear and validated investment thesis based on underlying market fundamentals.** As the pace of disruption and reshaping of industries increases – and as PE firms increasingly invest in growth cases – the understanding of underlying industry trends, threats and opportunities is becoming even more important. A clear and validated investment thesis – understanding the key value drivers, potential structural moves, growth opportunities and taking into account the starting point of the company – is important in making the right decisions.

- A good understanding of the 'how' of the value creation journey. Being clear on the key strategic themes (e.g. accelerated organic growth, restructuring, or productivity focus) resulting from the investment thesis – and translating these into key actions required to create value, and what it will require from the team, is crucial in understanding the realism of the investment thesis.

- A thorough assessment of current management, particularly the CEO, and the organizational capacity. A thorough and fact-based assessment of the strength and suitability of the CEO and management team, and the wider organizational capacity to deliver on the strategic themes are critical to the ability to subsequently create value.

2. Initial ownership: Creating the platform for value creation

A change in ownership provides a great opportunity for change, this is a time when portfolio company management will expect – and are open to – change. This is an opportunity for new owners to set the platform for future value creation. Central to this is to establish the right team and mobilise them around a shared, 'management-owned' plan. Most owners work with some sort of Value Creation Plan concept. However, best practice employs a comprehensive approach during this initial ownership period:

- Develop an overall strategy and plan that strengthens the company's competitive position, ensuring growth and profitability (the Value Creation Plan – "VCP").

- Secure a strong and incentivized management capable of executing the plan.

- Ensure appropriate talent in the wider organization.

3. Acceleration: Building momentum and accelerating operational results

The typical cycle of ownership often means that a PE owner spends most time with the company during the initial ownership period / 'the first 100 days'. It is not uncommon that owners then take a step back, i.e. hand over to management and the Board and expect that the plan is now being implemented. Often problems that emerge are a result of the owner and Board being too distant and failing to detect early warning signals. Thus, it is important to 'hit the ground running', ensuring momentum and accelerating operational results. A strong active ownership model is critical in this phase. Our interviews have shown that there are two important factors to establishing and maintaining strong performance through the execution phase of a holding:

- An effective and active governance model which aligns Board, management and owner to focus on value creation *and* ensures the Board and owners stay close to operations.

- Relevant external competence to support the journey, e.g. industrial advisors, external Board members, specialist in-house resources or consultants.

4. Intervention: Active Ownership and decisive intervention when required

The experienced PE partners and industrial advisors we talked to firmly believe that it is almost always better to take strong and rapid action when there is a lapse in performance – to 'overreact' rather than to 'wait and hope'. PE players who are best at this will typically have a 'turnaround machinery' ready to go, including an in-house operations team, an interim CEO candidate proven in turnaround situations, and a preferred consulting partner.

5. Review and exit: Proactive exit preparation and execution

The external environment evolves, and the initial plan may become outdated or new opportunities and priorities appear over time. To avoid getting stuck on the initial investment thesis most PE players conduct 'mid-term reviews'. However quite often these reviews primarily provide a status update of execution of the initial plan, and an update on the market environment. In our experience, backed up by our expert interviews, mid-term reviews provide more value if they also include an evaluation of value creation opportunities beyond the initial plan, and an assessment of organizational capabilities required to deliver on potential priorities. The robustness of such a review is often enhanced by bringing in 'fresh eyes' to the process. By doing so, PE firms can, in a structured and proactive fashion, build momentum that increases value at exit.

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