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The value of in-house operations teams in private equity firms

INSEAD Independent Study Project

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Note

This report is the product of an independent study project conducted at INSEAD Business School by Coralie Hemptinne, Wharton MBA ‘10, and Veronique Hoflack, INSEAD MBA ‘09D, in the context of their MBA studies at INSEAD.

This report analyzes the value of in-house operations teams in private equity firms. It gives a description of the prevailing models for in-house operations teams, the pros and cons of each model and the challenges related to having an in-house operations team.

The report is based on a total of 55 interviews conducted between November 11 and December 16, 2009. The interviewees included general partners of large-capitalization and mid-capitalization private equity firms (48 interviews), top-tier management consulting firms (4 interviews), big-four accounting firms (2 interviews) and specialist advisors (1 interview). In total, interviews were conducted with 27 different private equity firms. The majority of respondents were functioning on the operating/portfolio management side (as opposed to the deal/transaction side).

With respect to the interviews conducted with general partners, there was a diverse representation in terms of:

Size of the private equity firm, i.e. large and mid-cap funds

Investment strategy/industry focus, i.e., focus on a few industries or geographies or generalist approach

Position within the firm:

- 40% of the interviewees held the position of senior managing director, managing director, managing partner, executive director, partner or investment director
- 17% of the interviewees were associate director, vice-president, principal or investment manager
- 42% of the interviewees were senior associate, associate or investment officer
- 2% of the interviewees held the position of analyst.

Of the seven other interviews conducted with advisors, 71% of the respondents were managing director, director or partner at their company. All were active in the private equity practice of their respective firms, and worked closely with private equity firms and portfolio companies.

This report is partially based on academic literature (see references), but mainly derives from interviews conducted with professionals knowledgeable on this topic. Whilst the report endeavors to provide a full, clear and objective perspective of the topic of in-house operations teams, much of the information is based on interviews and reflects the opinions of the individuals interviewed. All errors remain ours.

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Executive Summary

The recent worldwide financial and economic crisis has drastically changed the private equity landscape. The traditional private equity model was based on acquiring a company using a large amount of debt to generate the projected returns on investment. Since debt was readily available and inexpensive, private equity firms were primarily focused on financial engineering techniques. The deal teams consisted of partners with transaction and investment banking backgrounds, and with contacts in the financial community that could provide them with deal flow and access to debt.

With the tightening of the credit markets, the use of financial engineering has become increasingly difficult and the amount of financial leverage has been curtailed. The economic recession has caused many portfolio companies to underperform. According to a recently published report by Moody's, and to findings by The Boston Consulting Group and IESE Business School, over 50% of the deals done between 2004 and 2007 by big private equity funds were either in default or distress. Moreover, as the acquisition of large companies was becoming increasingly difficult, the competition for smaller deals intensified, pushing up prices and decreasing the chances of doing bargain deals.

These changes have forced private equity investors to rethink their business model, and to be not only more prudent, but also more creative in finding ways to create value. With the old days of quick financial engineering over, private equity firms have become more dependent on their ability to create value through strategic planning and operational improvement. In order for private equity funds to be successful, firms need both deep expertise in specific industry sectors and the ability to be operationally involved with the portfolio companies. Few private equity firms have proven to be successful in achieving operational improvement consistently over time.

In this paper, we examine the value for private equity firms of having an in-house operations team. First we define what we mean by an in-house operations team, followed by a discussion on in-house operations teams versus external advisors. Then we examine in which stages of the private equity process an in-house operations team is typically involved, both in the pre-acquisition and the post-acquisition process.

Included in our paper is a description of the key challenges that private equity firms face when having an in-house operations team, in particular the alignment between the operations team, the deal team and portfolio management, the incentive scheme of the operating professionals, and the transition period of starting an in-house operations team. We also examine how deep the involvement of an in-house operations team can be in the portfolio company, ranging from a fully integrated partner, to an in-house consultant, to a senior advisor at the board, or to an external advisor.

We then describe the most frequent models that private equity firms use for organizing and integrating their in-house operating professionals in the team: the industry expert / former senior executive model, the functional model and the generalist model. This is followed by an evaluation of the pros and cons of each model. We investigate which of the models is better. We also provide an overview of some of the main pitfalls to be avoided when setting up an in-house operations team.

Finally, we discuss how these operations teams might evolve in the future. We specifically focus on the sustainability of the in-house operations teams to drive operational improvement, and on the introduction of more junior professionals to the operations teams in private equity firms.

Introduction

The private equity industry in the eighties and the nineties was characterized by a heavy reliance on financial engineering skills; private equity firms were financial dealmakers that prioritized speed over sustainability of investment returns. However, the industry has changed dramatically over the past twenty years. Limited partners require private equity firms to add value beyond traditional debt financing techniques. The private equity industry has to cope with several challenges that weigh on the performance of the firms:

- Financial engineering levers (multiple arbitrage and financial leverage) and transaction skills have become a commodity, and are not a way to differentiate anymore. These skills are no longer sufficient to generate historic returns on investments – private equity firms must have access to operational expertise.
- Credit markets have tightened, with debt becoming scarce and more expensive, and with tighter covenants.
- Corporate scandals have increased the focus on good governance, leading corporate managers to surround themselves with advisors. This has resulted in increased publicity of deals and more accurate pricing, so that good buys have become scarcer.
- Competition in bids has led to high acquisition prices and has squeezed returns. The deal sourcing environment has become a less exclusive environment. Almost all major deals are decided by auction. Because of an abundance of money, many private equity firms have been competing for the best deals with less opportunity to buy low and sell high.
- Exiting a private equity investment has become harder with the near collapse of the IPO market.

Private equity firms can no longer rely solely on smart financial engineering or arbitrage to add post-deal value. Given that many major deals are decided by auction, there are fewer buyout bargains. And some previously arcane financial instruments, such as debt derivatives, have become standard offerings by leading investment banks. That leaves only one lever for value creation: improvement of a portfolio company’s performance. Here the focus is not only on bottom-line operational improvements, such as spend reduction, IT infrastructure optimization, organization simplification and business process optimization, but also on long-term strategic planning, in particularly devising the future direction of companies. Although value creation through operational improvement has always existed, its importance as a source of value has increased over time, and it is expected to become even more important over the next decade (Figure 1).

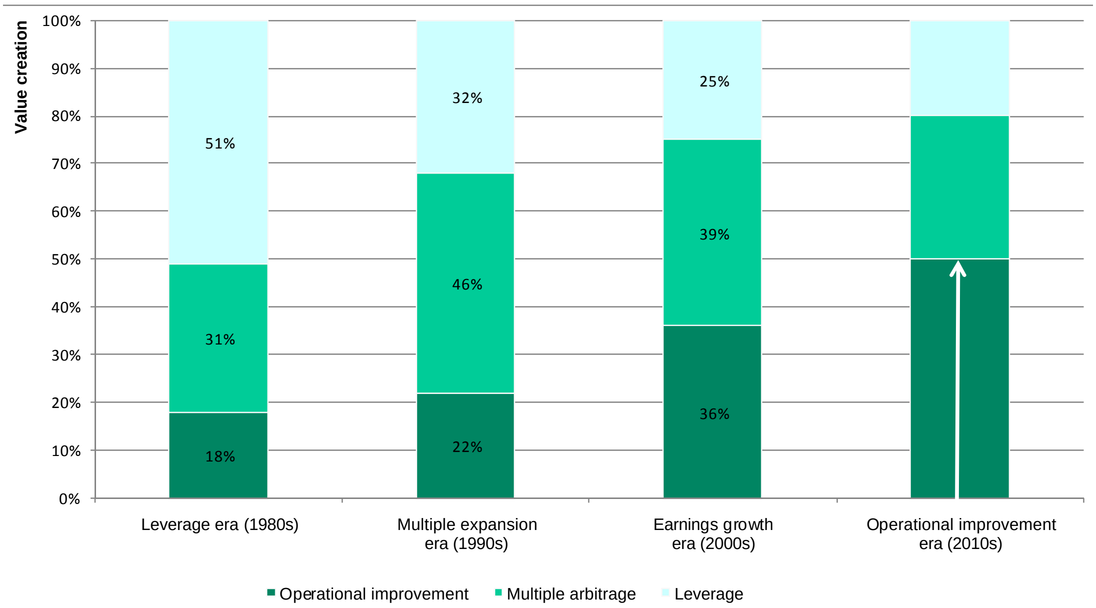


Figure 1: Over time, the way private equity creates value has shifted – Source: Brigl, Herrera, Meerkatt, Liechtenstein, Prats, & Rose, 2008

In the current challenging market environment, with leverage ratios significantly down compared to 2007 (Figure 2), private equity firms are looking to drive returns beyond what can be achieved through the use of financial engineering skills. Financial engineering no longer helps returns in the short run, nor does it create a sustainable competitive advantage in the long run.

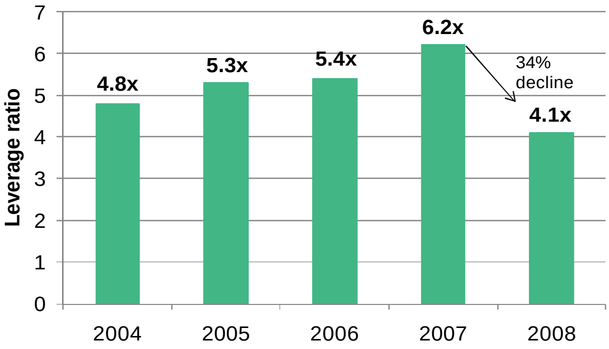


Figure 2: Leverage ratios in private equity deals have declined following the market correction – Source: Bye, Howland, & Matthews, 2009

According to a BCG/IESE analysis (Brigl, Herrera, Meerkatt, Liechtenstein, Prats, & Rose, 2008), 46% of the IRR is created through sales growth, 10% through an improvement in the EBIT margin, 21% through improvement in EBIT multiple, and 23% through net debt and the leverage effect (Figure 3).

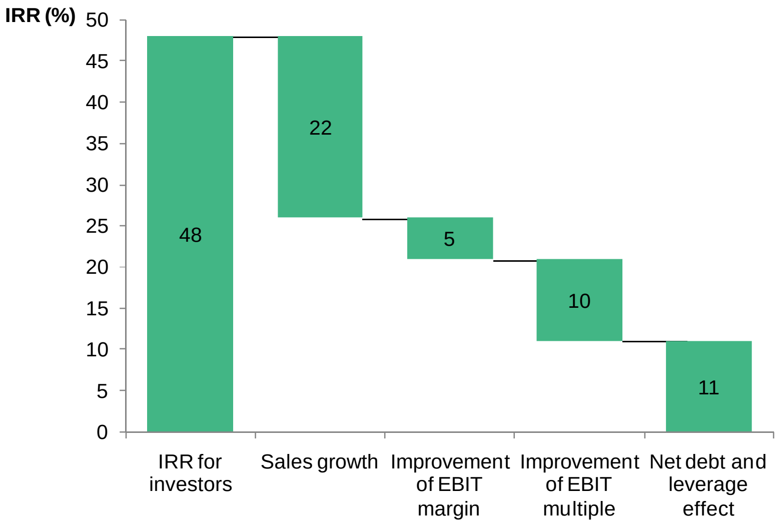


Figure 3: At many private equity firms, operational value (i.e., sales growth) is the main source of value creation – Source: Brigl, Herrera, Meerkatt, Liechtenstein, Prats, & Rose, 2008. Note: The analysis is based on financial data from 32 private equity companies in the portfolios of seven European private equity firms; the analysis compares enterprise value at the time of purchase with the value realized upon exit

It is clear that private equity firms are increasingly recognizing the value of operational improvements beyond financial leverage and multiple expansion. In Gotham Consulting Partners' 2008 Annual Private Equity Survey (Gotham Consulting Partners , 2008), 77% of the respondents cited "operational value improvement" as the most important value creation lever for the next five years. 54% of the respondents said that "operational value improvement" had become more important over the past five years.

There is also evidence that operational improvement practices help portfolio companies to outperform their peers. In "Corporate Governance and Value Creation: Evidence from Private Equity" (Acharya, Hahn, & Kehoe, 2008), outperforming deals are associated with high involvement of private equity houses during the early phase of the deal. In the article "Why some private equity firms do better than others" (McKinsey & Company), McKinsey research reveals a strong correlation between the outperformance of a portfolio company and the five steps taken by private equity firms to direct a portfolio company, namely:

1. seeking out expertise before committing to deals
2. instituting substantial and focused performance incentives
3. crafting better value creation plans and executing them better
4. devoting more hours to the initial stage of the deal, and
5. changing management early on if needed.

While there is ample literature on how private equity firms can outperform their peers, and on the importance of operational value creation, there is little evidence on how to capture maximum operational value. One trend is to hire operating partners and set up in-house operations teams. These operating partners do not necessarily have private equity knowledge, but they possess expert knowledge in a particular sector, or have the ability to drive change in a portfolio company.

The rationale for bringing in operating partners is twofold. First, touting operational partners is a good way for firms to woo management teams as well as limited partners, as competition for quality deals both from strategic and financial investors is considerable. Bringing extra capabilities to the bargaining table can help firms become more successful in winning deals or raising funds. Secondly, post-deal, operating partners focus on operational value creation, which is a key differentiating factor in today's market.

The motives for hiring operating partners seem valid, at least from a theoretical perspective. In reality, however, the picture is more blurred. There has been a proliferation of operating partners in private equity firms, and many of them have failed at integrating operating professionals in the team. Although there are some successful examples, few firms have been able to create operational value across their portfolio companies in a systematic and consistent way.

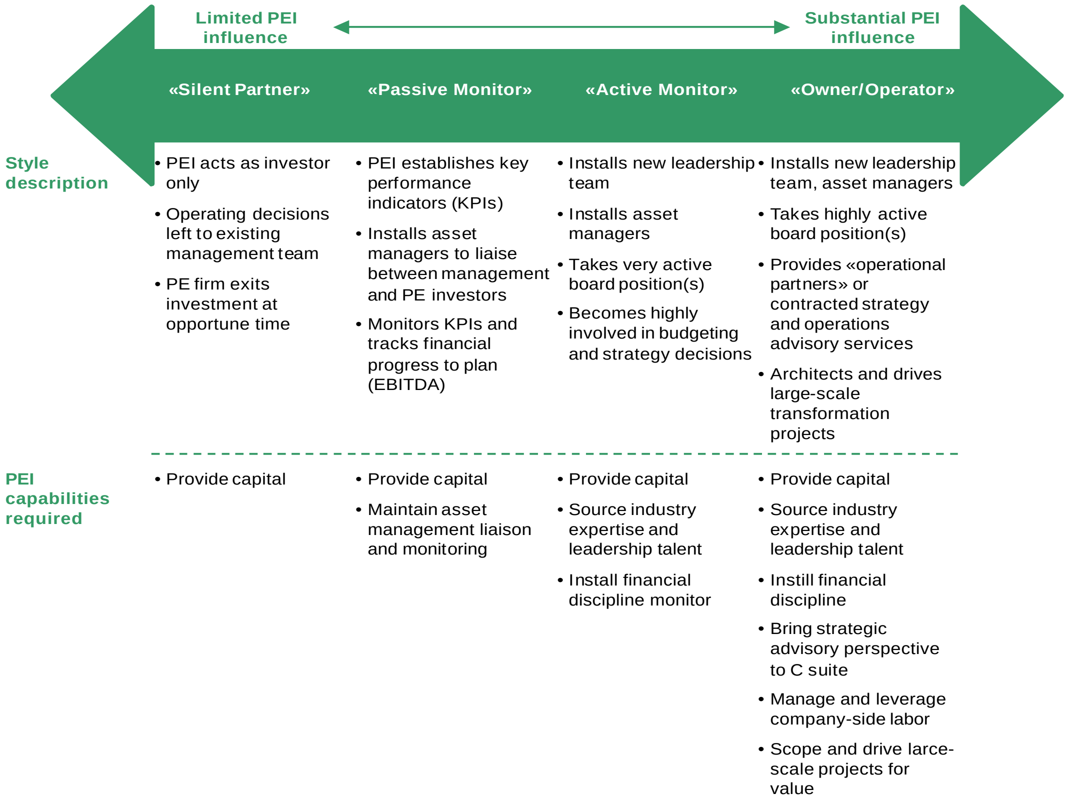
How private equity firms approach the value creation process is a key question for the industry going forward. Private equity firms must address the following three main questions, which have been at the center of our interviews and research:

1. Does an in-house operations team bring value — and how — compared to a deal team, external management consultants, or industry experts?
2. When adding in-house operating professionals, what organizational model creates the most value?
3. What are the key organizational features (e.g., incentives, roles and responsibilities, interactions and alignment with the deal team) of successful in-house operations teams?

I. What do we mean by an in-house operations team?

As financial leverage and multiple arbitrage have become more difficult to achieve, private equity firms are increasingly looking to differentiate themselves through operational value creation. There is no single formula for creating an operational advantage, as this will depend on various factors such as investment strategy, deal size and industry. However, a private equity firm looking to create a sustainable capability in improving the operations of the portfolio companies must:

1. Take an active role in the portfolio company. This active involvement ranges from interacting on a daily basis with management, to monitoring investments at the board level, reviewing company performance during portfolio committee, and putting professionals in place who work with the portfolio management (Figure 4).



	«Silent Partner»	«Passive Monitor»	«Active Monitor»	«Owner/Operator»
Style description	• PEI acts as investor only • Operating decisions left to existing management team • PE firm exits investment at opportune time	• PEI establishes key performance indicators (KPIs) • Installs asset managers to liaise between management and PE investors • Monitors KPIs and tracks financial progress to plan (EBITDA)	• Installs new leadership team • Installs asset managers • Takes very active board position(s) • Becomes highly involved in budgeting and strategy decisions	• Installs new leadership team, asset managers • Takes highly active board position(s) • Provides «operational partners» or contracted strategy and operations advisory services • Architects and drives large-scale transformation projects
PEI capabilities required	• Provide capital	• Provide capital • Maintain asset management liaison and monitoring	• Provide capital • Source industry expertise and leadership talent • Install financial discipline monitor	• Provide capital • Source industry expertise and leadership talent • Instill financial discipline • Bring strategic advisory perspective to C suite • Manage and leverage company-side labor • Scope and drive larce-scale projects for value

Figure 4: Levels of operational influence that private equity firms can exert on their portfolio companies – Source: Campbell, Legere, Ooi, & Sarma, 2008

2. Have access to professionals who are skilled in providing strategic and operational governance (professionals with an industry and/or consulting background), and are able to adapt these skills in a private equity context. The most common ways to secure this type of talent are through bringing in one's own operating partners, and contracting strategy and operations advisors. The former is referred to as an 'in-house' operations team.

Various names exist for these in-house operations teams, such as a portfolio (support) group, a portfolio team, a value creation team, and a value enhancement group. In the remainder of this paper, we will refer to "in-house" operations teams, or operating partners/professionals. The extent to which in-house operating partners are involved with portfolio companies, and their role in portfolio companies, may differ, but the key element is that they are employed by the private equity firm, do not belong to a network of independent senior advisors, and are not hired on a consulting basis.

Operating partners have significant experience as senior executives in corporate entities, consulting and/or private equity. Operating professionals help in strategic planning, operational improvement, and supervision of initiatives in portfolio companies. They leverage their analytical skills and/or industry knowledge to help address the issues portfolio companies are facing. This is generally done from a high-level strategic perspective. Operating partners may also support management in day-to-day operations. They will work with portfolio companies as interim managers, board members, chairman or consultants. Operating partners help companies by bringing a broader perspective gained while working with multiple portfolio companies, often in different industries. In the context of their experience in supporting portfolio companies, operating professionals can identify best practices, which they can leverage to create operational value across different industries.

Given the topic of our study, the in-house operations teams, as we define them, do not include professionals who focus on deal sourcing. Lastly, it must be noted that in some private equity firms, operating partners are supported by more junior operating professionals, who interact with portfolio companies on a daily basis.

II. Is having an in-house team better than relying on external support?

One of the key questions is whether and how an in-house operations team might bring additional value compared to a deal team, CEO-affiliated network, or external management/expertise such as management consultants and industry experts.

Arguments in favor of having in-house operations teams, as well as arguments that supported external involvement, were put forward during the interview process.

1. Arguments supporting the involvement of an in-house operations teams

Besides marketing reasons, a first argument to set up an in-house operations team is that operating professionals understand the private equity process, are more cash-focused, and work quicker because of their familiarity with portfolio companies and private equity houses. Even external consultants who have worked previously with private equity firms do not necessarily have a cash culture. In addition, value creation in a private equity context is fundamentally different than value creation in a public company. When a private equity firm closes a deal, it will look at how to position the company at exit (e.g., company split, IPO, sale to strategic/financial sponsor) and, accordingly, determine what value creation levers need to be worked on. Public companies will look at financial metrics such as return on capital employed, which is not relevant for a private equity firm that is mainly interested in the return relative to the initial equity put in.

Secondly, setting up an in-house operations team helps to ensure continuity and consistency. Internal operating professionals bring their network and maintain a long-term relationship with portfolio management. In contrast, high turnover in consulting firms makes it more challenging to maintain a long-term relationship with members of portfolio companies. The advantage of in-house teams is to keep information and knowledge from past deals (e.g., how to build a 100-day plan) inside the private equity firm.

Thirdly, relying on in-house operations teams permits private equity firms to design operational improvement initiatives while considering the broader context, including financial restructuring and exit strategies. For example, a massive cost cut reduction plan might create operational value in the short run, but also have a negative impact on the selling price at exit. A financial restructuring program might also overlook important operational improvement initiatives. Therefore, it is important to consider all pieces of value creation together instead of looking at each value creation lever on a standalone basis. This is more difficult to do when relying on multiple external advisors.

In the case of mid-cap funds that focus on a specific industry and of most large-cap funds, in-house operations teams allow the building of more in-depth in-house industry knowledge (e.g., sourcing, market economics, and a network of executives, shareholders and consumers). This allows a firm to make decisions more quickly, which can be critical to win a deal, for instance in the case of auctions, or turn a company around in a downturn. Advanced operational expertise also allows funds to invest in deals that require deep operational involvement, an area in which there generally is less competition with other private equity firms.

According to some interviewees, working with internal operating professionals is cheaper than working with external consultants, and leads to similar work products. This cost argument, however, very much depends on the size of the fund and the frequency of the need for external support.

Another argument in support of the use of internal operational experts is that external consultants are not always held accountable for the value creation achieved. External consultants will sometimes defend the quality of their recommendations by blaming the implementation process, while the incentive structure of operating partners can include an equity interest in the portfolio companies, which contributes to enhanced alignment. This lack of alignment is one of the largest drawbacks of external advisors.

Thanks to the involvement of in-house operating professionals, the deal team can spend more time on finding new angles to source deals. In-house professionals will spend a significant amount of time with portfolio companies, particularly in the first six to twelve months, while the deal team is moving from one deal to the next.

Moreover, the in-house operations team is an invaluable resource for portfolio management, since portfolio company CEOs are focused on day-to-day management and operational issues. Operating partners bring to bear their own expertise and the capabilities of the private equity organization without disenfranchising the management team. In contrast, company CEOs might be unfamiliar with the intricacies and realities of private equity ownership where there is a stronger emphasis on cash flow generation, and where the timeframe for tackling important issues is greatly compressed.

Some interviewees mentioned the difficulties associated with finding the right professionals in the market to provide this service. Although there are niche providers/experts in certain domains, such as treasury specialists, IT & HR specialists, or management consultants with good analytical skills, it is difficult to identify a single external resource that combines the three key elements that are important for creating operational value: outstanding analytical proficiency, general management expertise, and the perspective of an investor.

Finally, given their background in consulting or in the industry, in-house operating professionals generally understand the internal processes of portfolio companies (e.g., market expansion, marketing) better than deal professionals. This is particularly relevant in larger deals. The background of the private equity partners is also important. Even though deal professionals may have accumulated expertise through their involvement in dozens of deals, those professionals with consulting or operations background will be more inclined to (and more skilled at) providing strategic and operational governance. Those with financial/transactional backgrounds gravitate towards merger and acquisition strategies, such as acquisitions and roll-ups.

2. Arguments supporting a reliance solely on a deal team, external consultants or industry experts

A key reason put forward for not having internal operating professionals is that they can be costly given their high profile and seniority. This argument is especially valid for small or mid-market private equity firms.

Another argument that can favor the involvement of external consultants over in-house operating professionals relates to the breadth of expertise required. It is difficult for in-house operating professionals to have a high level of expertise in all relevant areas. In contrast, external consultants can provide expertise on specific industries, geographies or regulatory constraints. As a result, even if a private equity firm has in-house operating partners, it is likely that it will still rely to some extent on external advisors to complement the knowledge and capabilities of the in-house team. Some firms indicated that not having in-house operating partners is simply an application of the principle of the division of labor.

Another situation in which it can be useful to tap consultants' knowledge is when portfolio companies have worked with the consultant for a long time and consequently share considerable inside information, prior to the private equity firm coming in.

In some situations, limited internal operational capacity also explains the involvement of external consultants. Some firms prefer to limit in-house operational expertise, as the need for these services is cyclical. For instance, this is the case for firms that work with functional experts. For example, in the recent downturn, there was a huge demand for restructuring experts. However, this is an area of expertise that is likely to become less relevant when there is an upturn in the market. As in-house operations teams are often very lean, a firm might need to draw upon additional external resources to cope with the demands resulting from cyclical upturns.

In some cases, private equity houses indicated that they did not feel the need to pursue an in-house operating partner model because their deal partners were conversant in management, strategic and operational issues. This is especially true when the deal professionals have a consulting or industry background, as they may be better able to take a more hands-on approach. The role of the in-house operations team is mainly to make sure that things get implemented. A good management team and an involved deal team can follow up closely on implementation, so that there is less need for dedicated operating partners.

3. Overview of private equity firms' in-house operations teams

To source operational capabilities, private equity firms adopt many different approaches, which are variations of two extreme models. At one extreme, private equity firms decide not to have any in-house operational capability and rely solely on deal professionals who are responsible for deal sourcing, execution, and exit. Whenever there is a need for operational insights, the firm will hire external consultants or rely on a close network of advisors. Teams are relatively small and mainly consist of former investors and investment bankers. This approach is the equivalent of the old buyout model.

At the other extreme, a private equity firm might decide to have a large dedicated in-house operations team. In these cases the operating professionals will typically have a consulting or industry background, with extensive experience in operational and strategic topics. Their role within the private equity firm is to conduct the operational due diligence, to work hand-in-hand with portfolio management to identify operational value creation levers, and to help with implementation. They are normally very close to portfolio companies, and monitor all details of portfolio company management.

	Large and/or established in-house operations team High activism	In-house operations team under development Small operations team (3-5 operating partners)	No in-house operations team Low activism
Large funds (>$15bn capital raised in last 5 years)	• Bain Capital • Kohlberg Kravis Roberts • Texas Pacific Group • The Blackstone Group	• 3i • Advent International • Apax Partners • CVC Capital Partners	• Apollo Global Management • Goldman Sachs • Hellman & Friedman • The Carlyle Group • Warburg Pincus
Medium-sized funds (<$15bn capital raised in last 5 years)	• Cerberus Capital Management • Clayton, Dubilier & Rice • Doughty Hanson • Lion Capital • Sun Capital Partners • Terra Firma • Thomas H. Lee Partners	• Bridgepoint • Candover • Montagu • Oaktree Capital Management • PAI Partners • Permira • Silver Lake Partners	• Barclays Private Equity • Charterhouse Capital • Cinven • Nordic Capital • TA Associates

Figure 5: Overview of the operations team of selected large and medium-sized funds – Source: Private Equity International, 2009, interviews, own analysis

Many large funds have an in-house operations team (Figure 5). For example, Bain Capital, Kohlberg Kravis Roberts (KKR), Texas Pacific Group (TPG), The Blackstone Group (Blackstone), Apax Partners and CVC Capital Partners all have operating professionals, but in varying degrees of stage, size and type of involvement. The funds that have an extensive operations team are Bain Capital and KKR, followed by TPG. Blackstone started up its in-house operations team more recently. The other funds have smaller in-house operations teams. Apax Partners only recently introduced operating partners (beyond two operating partners who have been at the firm for a long time) because of its venture capital heritage and its deep sector focus. CVC Capital Partners is currently setting up its in-house operations team. Apollo Global Management, Goldman Sachs Principal Investment, Hellman & Friedman, The Carlyle Group and Warburg Pincus are large private equity players that do not have an in-house operations team. Nevertheless, Hellman & Friedman recruited an operating partner in 2007.

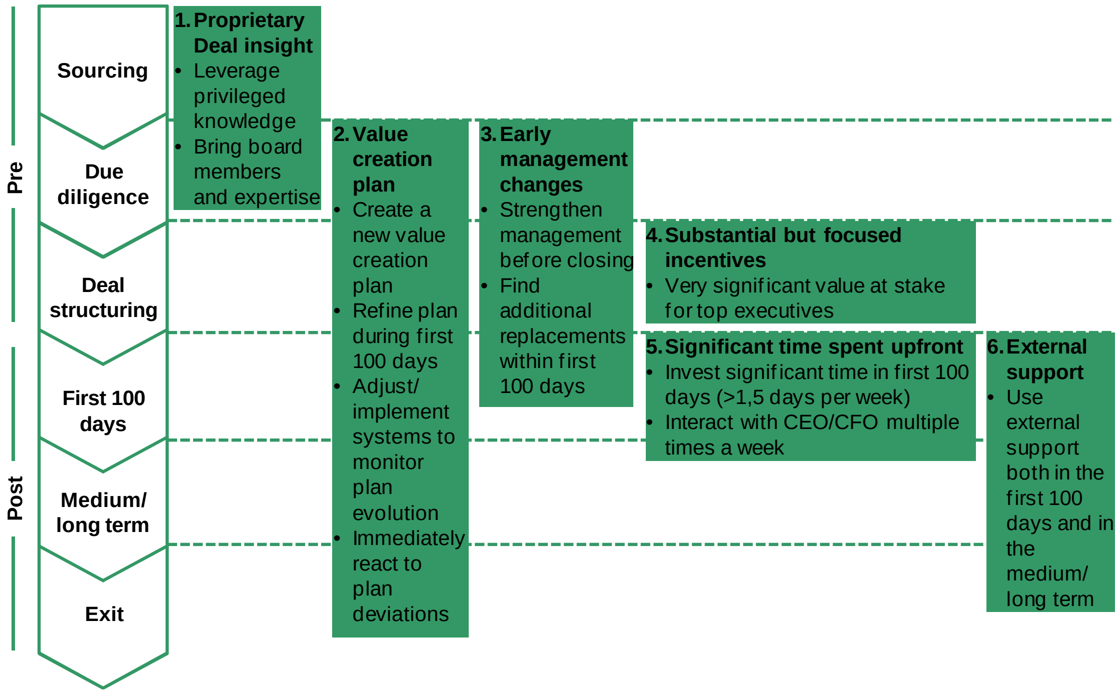
Most in-house operations teams of mid-cap private equity funds are not as developed as their counterparts in large-cap funds. Many mid-market funds, such as Charterhouse Capital, Cinven, Nordic Capital and TA Associates, do not have operating professionals, and rely on external professionals, a close network of experts/senior advisors, and/or a (hands-on) deal team.

Other mid-cap funds, such as Bridgepoint, Candover, Montagu, PAI Partners, Silver Lake Partners and Permira, have small in-house operations teams, typically comprising three to five senior operating partners. These operating partners will typically not be assigned to one portfolio company, but will oversee strategic and operational initiatives at different companies at the same time.

Finally, a few mid-cap private equity firms, such as Cerberus Capital Management, Clayton, Dubilier & Rice, Doughty Hanson, Terra Firma, Sun Capital Partners, Permira and Thomas H. Lee Partners, have more developed in-house operations teams or an active approach towards operational value creation.

III. In what stages of the private equity process is an in-house operations team involved?

In “Corporate Governance and Value Creation Evidence from Private Equity” (Acharya, Hahn, & Kehoe, 2008), McKinsey describes the steps in the private equity investment lifecycle in which a private equity firm can be involved operationally (Figure 6).



1. **Proprietary Deal insight**
   - Leverage privileged knowledge
   - Bring board members and expertise

2. **Value creation plan**
   - Create a new value creation plan
   - Refine plan during first 100 days
   - Adjust/ implement systems to monitor plan evolution
   - Immediately react to plan deviations

3. **Early management changes**
   - Strengthen management before closing
   - Find additional replacements within first 100 days

4. **Substantial but focused incentives**
   - Very significant value at stake for top executives

5. **Significant time spent upfront**
   - Invest significant time in first 100 days (>1,5 days per week)
   - Interact with CEO/CFO multiple times a week

6. **External support**
   - Use external support both in the first 100 days and in the medium/ long term

Figure 6: Operational involvement during the private equity lifecycle – Source: Acharya, Hahn, & Kehoe, 2008

We asked our interviewees when the in-house operations team was actually involved, and why the firm followed that modus operandi.

In general, many interviewees indicated that they felt it better to involve the in-house operations team early in the process, both in the pre-closing phase and in the first three to six months after closing. Doing so allows a good value creation plan to be built, with the identification of key deliverables and milestones. After this period, it is management’s main responsibility to implement the plan and deliver on what has been agreed. If management succeeds in doing so, the private equity firm and its operations team can be relatively hands-off. The advantages of deep involvement early on are that:

Time is invested immediately and not months or years after things (might) have gone wrong.
Time is invested in a plan that has an integrated view of the company with both strategic choices and operational levers.
When the plan is well thought out upfront, it may not need a lot of changes afterwards.

1. Involvement during the pre-acquisition phase (deal sourcing, due diligence, deal structuring)

Some private equity firms involve operating partners only after the acquisition. Others do exceptionally involve their operating partners prior to the acquisition, when some specific operating partner expertise can be leveraged during the due diligence phase. Their involvement is seldom systematic, and is determined either by operating partners who realize that stepping in could be valuable for portfolio companies, or by deal partners who request the expertise of operating partners. A third category of funds involve operating partners early on in the process, or at least when the deal has reached a certain degree of certainty (e.g., secured financing). The arguments favoring the involvement of operating partners prior to the acquisition include:

- Getting buy-in from operating professionals prior to the acquisition. Operating partners want to be involved when some important operational initiatives are underwritten. From a governance perspective, involvement of operating partners early on can minimize potential conflicts arising between the transaction team and operations team.
- Identifying value creation levers prior to doing the deal. Compared to the deal team, the operations team has a more realistic view on what can be done in the portfolio company and the time frames required. Sometimes operating partners also bring relevant industry expertise, which can help in the assessment of the feasibility of a buyout, or in determining the purchase price of a target.
- Getting started more quickly once the company has been acquired. The operations team will already have a familiarity with the business and management of portfolio companies, as well as with the upcoming challenges and initiatives to be implemented.
- Building relationships between portfolio management and operations team that endure once the company has been acquired.

The extent to which operating professionals are involved pre-acquisition depends upon the size of the team. A team consisting of three to five operating partners can hardly be deployed on both pre-acquisition and portfolio management work.

Operating partners can also play a role in deal sourcing, and leverage relevant information gathered via their network or while working with portfolio companies. When deals are identified by operating partners, they occasionally take the lead in the sourcing phase.

There is no set rule as to the involvement of the operations team in the due diligence process. When they are involved, they focus on the strategic and operational due diligence, as well as on human resources issues such as talent management. Generally, the transaction team leads the financial and legal due diligence process.

Operating partners are sometimes involved in the investment committee, and have a say in the final decision process, especially when operational issues can make or break the deal.

Usually they are not involved in the negotiations; although operational insights brought by the operations team are included in the investment thesis, actual negotiations are led by the deal team.

2. Involvement during signing and closing

There is usually a two-month period between the signing and closing of a deal. One of the most important tasks over that period is the development of a value creation plan and a 100-day plan. Operating partners are usually involved in this project, together with the portfolio management and deal team. The focus of the 100-day plan is to pinpoint key operating priorities, resource requirements, performance objectives, and tracking metrics, for the first major period of implementation, usually the first one to two years of private equity ownership. The 100-day plan is an important tool to ring-fence management, and to ensure there is an agreed plan to immediately improve the operations of the company post-acquisition. Although the operations team often takes the lead in this initiative, it is important to involve management and get management buy-in to the strategic plan and the operational improvement initiatives.

This phase is also important from a relationship-building perspective, as it sets the tone for how portfolio management and shareholders will interact, and how management can be expected to drive operational improvement initiatives. Moreover, some interviewees pointed out that operating partners are more skilled at managing various stakeholders, such as clients, suppliers and employees, which is critical during this phase of “uncertainty.”

An argument against involving operating partners prior to the acquisition is that operational resources are usually limited and can best be put to use post-acquisition in the portfolio companies, initiating value creation initiatives and following up on progress.

3. Involvement during the first 100 days

Involving the operations team during the first 100 days after acquisition is considered key. The operations team helps to initiate value creation programs and to drive change. Their involvement is usually more significant early on in the post-acquisition phase, and decreases progressively thereafter.

Three ways of involving operations teams after the acquisition are:

1. The transaction team owns the deal and involves operating professionals when needed.
2. The transaction team hands over the deal to the operations team, which takes the lead in interacting with portfolio companies. The transaction team is involved through board meetings, where they can challenge management, monitor progress, and give strategic advice.
3. The operations team and the transaction team work together as one team. Operating professionals are more involved in the day-to-day operations, or assume a role of chairman in the portfolio company, whereas transaction professionals have a more high-level role on the board.

When management is changed post-acquisition, operating partners are often brought in as interim managers and lead the company for usually six months to one year, until a suitable candidate is found.

4. Involvement in the medium and long term

Usually, the operations team’s involvement levels off one to two years after the acquisition. However, we have seen cases in which the operations team works on a daily basis with portfolio management during the entire holding period. This can encompass helping with the 100-day plan and launching operational improvements in the beginning, focusing on strategic issues, add-on acquisitions, divestures, and preparing the exit strategy in the medium and long term.

If the company’s performance is meeting or exceeding expectations, operating professionals are usually involved to a smaller extent. In these situations they will generally monitor performance from a board or steering committee level, and coach/support management on specific initiatives. Generally, weekly or bi-weekly touch points are organized between portfolio management and shareholders.

5. Involvement in the board of directors / supervisory board

In addition to the weekly or bi-weekly interaction of most private equity houses with portfolio management, most firms actively monitor their investments at the board level, and they rigorously review the performance of companies before the portfolio committee.

When asked whether operations teams sit, or should sit, on the board of directors of portfolio companies, interviewees’ answers varied depending on the profiles of the operating professionals, and the depth of the operations team’s involvement in the portfolio company.

When operating partners are former senior executives, they often have a seat on the board of directors. When they are deeply involved in portfolio companies, working with management on a daily basis, they often assume the role of chairman. That, however, does not prevent them from participating in board meetings as observing members, where they support management rather than challenge them.

An argument against putting operating partners as directors on the board is that they need to play two opposing roles with regard to portfolio management: one being a supporter, coach or challenger, and the other being a controller. Assigning both responsibilities to one person can create undesirable tensions between portfolio management and the shareholder. In order to overcome this issue, some private equity funds install on the board the "boss" of the operating partner who is working with the portfolio company on a daily basis, instead of the operating partner.

An argument sometimes put in favor of placing the operating partner on the board is that this person needs to have power over the management, although this might not be the case if he is overly familiar with management. While it is important for operating partners to have a good relationship with management, their role is to challenge management. Hence, placing the operating partner on the board will provide him with credibility when working with management.

IV. How deep is the involvement of an in-house operations team in portfolio companies?

1. Fully integrated operating partner

In the case of the fully integrated operating partner model, there is a clear distinction between the transaction partner and the operating partner, who work together to maximize the value of the portfolio company.

Fully integrated operating professionals often assume the role of an active chairman, in which they interact on a regular basis with portfolio management and spend substantial time on-site. Operating partners are usually involved with a portfolio company over the entire private equity investment lifecycle. They identify and vet opportunities, sit on investment committees, review investments, give high-level strategic guidance, and get involved in day-to-day operations. Their involvement in the due diligence phase allows them to build strong relationships with portfolio management that endure after the closing of the deal.

Clayton, Dubilier & Rice (CD&R) pioneered the financial partner/operating partner model. The firm was founded on the belief that the combination of financial and operating talent creates better businesses and better returns for investors than either financial talent or operational talent alone. Every deal team includes a financial partner (with background in investment banking or private equity) and an operating partner (with background in consulting or large corporations). The financial partner is responsible for leading the negotiations, and works hand-in-hand with the operating partner to conduct the due diligence of a business, understand the business model, and create an investment case that includes insights on how to improve the business over time strategically and operationally. The investment thesis describes levers to create operational value, not just financial engineering techniques, that allow the firm to be more aggressive in its business plan projections. CD&R is one of the few firms that from its inception saw that financial and operational capabilities needed to be integrated throughout the private equity investment lifecycle.

Terra Firma also brings integrated operating partners to the portfolio companies. The operations team includes professionals with two categories of profiles. On the one hand, the Managing Director (MD), who typically is a former CEO, acts as a chairman in the portfolio companies. On the other hand, the Finance Director (FD) oversees processes and adapts the reporting structure. Every portfolio company is assigned an MD and a FD. Together with the deal partner, they are responsible for the performance of the company.

2. In-house consultant

Some private equity firms have a staff of internal consultants who work closely with individual portfolio companies for a short or long time. Those individuals usually have a background in consulting or long experience in a specific function such as purchasing, manufacturing, IT, human resources or marketing. Generally, in-house consultants are not assigned to a portfolio company over the entire investment lifecycle, but instead rotate across portfolio companies on a project basis. Those operating professionals are often full-time employees of the private equity firm. Except for senior in-house consultants, they usually do not have an equity stake in the fund. In-house consultants are typically brought into portfolio companies post-acquisition to work on specific projects, and are involved to a smaller extent in the diligence phase. They work with a company for between a few months and several years, providing analytic insight, strategic guidance, and support in execution.

One example of a private equity firm that adopts this strategy is Cerberus, in which a large part of the in-house operations team consists of in-house consultants who are deployed in portfolio companies whenever and wherever there is a need. They often lead specific value creation projects or step in to replace incumbent management until a permanent executive is found.

3. Senior advisor / board member

Senior advisors complement the expertise of the investment professionals, operating partners and in-house consultants. Senior advisors will have typically held leading positions in major corporations, and served on the boards of the portfolio companies, providing portfolio companies with additional operational and strategic advice. Contrary to the integrated operating partner or in-house consultant, they are not involved in the day-to-day operations of the portfolio company.

4. External advisor

External professionals are widely used by private equity firms that do not have an in-house operations team, or that need to complement the expertise of the in-house operating professionals. They are often involved in the diligence phase (e.g., market research, industry expertise), in building the 100-day plan, in designing the strategic, and value creation plan and in implementing specific value creation projects. External professionals are hired on a project basis and incentivized on a fee basis, which is sometimes conditional upon the achievement of pre-defined targets. Usually there is no long-term agreement between the external advisors and the private equity firm or portfolio company.

Depending on a portfolio company's needs, private equity firms typically draw external professionals from management consulting firms, accounting firms, specialist firms such as restructuring specialists, or industry experts. The ultimate selection of external advisors depends not only on their credentials but also on their relationship with the investment and operating professionals.

When selecting external advisors, large private equity firms tend to use top-tier firms more often than mid-market firms. Although there is no single way to choose between external advisors from top tier management consulting firms and specialist boutiques, one interviewee of a large-cap fund said: "These top-tier management consulting firms are very large, and they have a deep functional and sector knowledge. Whatever expertise you need, you have a high probability of finding it. And you know the standards of these companies. Moreover, sometimes you need a report from a top-tier consulting firm to go to the banks for financing." Other firms instead rely on boutique advisory firms for cost reasons. Private equity firms will also rely on specialist firms for some specific needs. For restructuring projects, for example, private equity firms often call upon Alix Partners or Alvarez & Marsal.

A number of private equity firms indicated that it is important that they exercise a degree of control over external consultants. As one of the interviewees explained: "If we do not have the knowledge or expertise in-house or we do not have the resources, then we will rely on external advisors. But we will always work very closely with them. We will never give a mandate to external consultants, and let them come back in 3 weeks' time to get the end result. We will try to remain very close to the day-to-day work, so we know what is happening and that the output is good."

It is important to note that it is the post-acquisition portfolio management that generally decides to bring in external advisors. Private equity firms can make suggestions, or help management source advisors, but portfolio companies have the final say, as they pay the advisor's fees.

V. What are the key challenges of having an in-house operations team?

1. Alignment between the deal team and operations team

It is important for the success of the deal that the deal team, operations team, and portfolio management work together towards the same objective, which is maximizing value at exit. In the case of conflicts, the deal team and operations team need to form a united front vis-à-vis portfolio management and external advisors. Conflicts might arise, for example, if portfolio management tries to play the deal team against the operations team because they do not like the operations team's involvement. In reality, alignment is not easy to achieve, and several situations were reported in which tensions developed between the deal team and operations team.

A first potential issue arises when the deal team does not want to admit they have encountered problems that the operating partners might be able to solve. This in turn prevents operating partners from stepping in and resolving the issue faced by the deal team. The willingness of deal professionals to admit that operating professionals can bring value to the situation will often depend upon the experience and credentials of the operating professionals themselves. Other situations arise where the operating partners are involved, but the deal professionals are perceived to be too interventionalist. These situations in which deal partners do not trust the operations team will often lead to conflicts.

A further issue that needs to be addressed is the question of who is responsible for managing the deal post-acquisition. Interviewees described three possible approaches.

1. Firstly, some private equity firms believe that the responsibility post-acquisition should remain in the hands of the deal team. The rationale is that once operating partners are involved, deal partners might no longer feel responsible for what is happening in portfolio companies because the monitoring of portfolio companies is split between the operations and the deal team. It is thus a challenge to ensure that deal partners assume responsibility for potential deal failures, and act as active investors from sourcing to exiting. Interviewees indicated that in order to resolve this issue, a deal partner will typically remain in the lead, and the operating partner will report to him.

2. Other firms indicated a different approach whereby the operations teams are involved, giving their buy-in pre-acquisition, and taking ownership of the deal post-acquisition. Interviewees noted that the current challenging environment makes a smooth handover from the deal team to the operations team more critical.

3. In a third approach, some firms indicated that the deal and operating partners shared ownership post-acquisition. These firms do not believe in models where the deal partner does the deal and then hands the management of the deal to the operations team. This is because, in their opinion, each side can then blame the other for problems encountered. To avoid this trap, interviewees recommended locking together the operating and deal partners.

The incentive structure is an important element in ensuring that the operations team and the deal team are aligned. The incentive scheme of the operating professionals can take one of three forms:

1. A carried interest tied to the entire fund's or to specific deals' performance.
2. A variable compensation based on the achievement of specific targets.
3. A combination of those two components.

Carried interest or variable compensation will usually be on top of a base salary.

Most funds offer their operating professionals the same incentive structure as their deal professionals, i.e., a compensation consisting of carried interest. This creates an environment in which an operating professional, who is not specifically involved in a transaction, but wants to challenge ideas in the investment thesis, is incentivized to do so.

How the compensation of the operating professionals compares to that of the deal professionals depends on how much they each create value. According to one firm, deal professionals often believe they generate most of the value by identifying investment opportunities and managing exits. However, if operating professionals can prove they are creating most of the value, it will be more difficult for the deal professionals to carve out a larger percentage of the total compensation.

A number of funds indicated that operating professionals are generally not paid as much as deal professionals because operating partners only work on operational value creation. Deal partners, on the other hand, work on all value levers, including financial leverage and multiple arbitrage.

It can be concluded that in order to align the deal and operations teams, it is important that firms determine clearly and up front, the roles of the two teams, namely: the role of the operations team, the interaction between the operations team and deal team, and the role of the deal team. The deal team's role is typically on the board, while the operations team will be involved in the day-to-day operations and report back to the deal team. The operations team needs to help prepare board meetings, in order to ensure that board meetings are run effectively and efficiently. It is important that the deal team trusts the operating partners, and finds the right balance of their involvement in the portfolio company. The operations team must proactively inform the deal team about its undertakings instead of acting on its own, while the deal team must support the operations team once agreements have been made in order not to undermine the credibility of the operations team in front of management.

2. Alignment between the operations team and portfolio companies' management

The role of the operations team vis-à-vis portfolio management can be delicate. On the one hand, a private equity firm wants to keep portfolio management accountable for performance. On the other hand, a private equity firm wants to challenge and ultimately influence or change the decision making of the line management.

Problems will arise if the operating partner is seen as doing the same job as the CEO due to an unclear split of responsibilities. To overcome this it is important that potential conflicts are discussed before they arise, and that early agreement is reached with the portfolio management on the roles and responsibilities of the operations team, the deal team, and management. Interviewees at funds where operations teams are largely involved post-acquisition pointed to the importance of setting the tone before the closing of a deal, on what initiatives the fund plans to implement, how it expects management to drive operational improvement, and how it plans to share the work between operating professionals and external consultants. Interviewees indicated that in cases where portfolio management does not like the involvement of the operations team, it will generally say so. In these cases it is then to the responsibility of the private equity firm to decide whether to reduce the involvement of the operations team, or whether it should change portfolio management.

In order to ensure good alignment between a private equity firm and portfolio management, most private equity firms provide incentives to management that motivate them to behave as an owner. Having the right management team in place is critical to the success of the deal. Private equity investors will retain senior managers capable of driving value growth, and replace those not up to the task. In most cases, management will be granted equity, typically around 5% to 10%. This equity is needed to ensure the private equity investor and the management team work towards a common objective, i.e., maximizing value at exit.

Some interviewees indicated that aligning portfolio management and private equity firms is not difficult if the incentive structure is well designed. If incumbent management is replaced, the new management will generally calculate the potential upsides, and often be willing to go into the deal and play by the rules of the private equity firm. This is especially true when the funds have experience with the operating model, and when this model has been proven to work well. In these cases, portfolio management will typically see advantages in the involvement of the operations team. Nevertheless, not all portfolio CEOs welcome operating partners or external advisors.

Another challenging aspect of operations / portfolio management alignment relates to the conducting of board meetings. Interviewees indicated that involving both deal and operating partners in board meetings ensures that portfolio companies are monitored proactively, and that the best decisions are ultimately made. This arises due to the deal partners' focus on achieving targets combined with the operating partners' deep knowledge of management. Operating partners' empathy with management may, however, lead to a lack of objectivity.

There is also a need for operating professionals to be diplomatic in their interactions with management of portfolio companies. One interviewee suggested that an operating partner should act as if they were a "senior member of a consulting company", advising management while at the same time giving management the feeling that the ideas have come from them.

In order to overcome misalignment, it is recommended that an operations team be seen as a resource that provides recommendations to portfolio management rather than imposes recommendations on management. The operations team typically works side-by-side with management, taking the role of navigator, catalyst and challenger. To avoid bypassing management, a steering committee consisting of shareholders and management is created. Usually, the operations team and management will report in consensus, and in case of opposing viewpoints, the steering committee can be used as a route to escalate decision making. In the worst case scenario, where management does not meet performance targets or does not follow orders set by the supervisory board or shareholders, or if the relationship between shareholders and management is too strained, the operations team members can be "upgraded" to interim management positions. In the current distressed environment, there is often a new, chief restructuring officer (CRO) board function created, in addition to the CFO. The CRO comes either from outside or from the operations team.

An interviewee concluded by summarizing the key elements to ensure smooth interaction between management and operating partners: efficient communication, appreciation of how operating partners can help to achieve results, and trust. To achieve trust, the interviewee noted, operating partners should, to some extent, be separated from the fund to enable them to obtain the information they require.

3. Transition from a pure transaction team to a combined transaction / operations team

Adding an in-house operations team to a fund can be difficult, and interviewees indicated it can take several years to get everything in the right place. Several reasons were given for this. Firstly, interviewees indicated that it is often difficult to source members of in-house operations teams that have the correct skill set. The operating partner often needs to have specific expertise, and to fit the culture of the firm. Secondly, operations teams are often created without a good alignment and integration with the deal team, and without the deal team being ready to give the operations team the appropriate role. For this reason it is important to agree upfront with the deal team about the appropriate role of the operations team.

The extent to which both teams are integrated (e.g., working in the same building, in the same team on a day-to-day basis, coordinating) will depend upon the private equity firm, the deal and the strength of the professionals involved. This is typically a process in transition, the evolution of which will depend on the one hand, on the firm’s ability to attract and retain experienced and skilled operating professionals, and on the other hand, on the alignment of the deal team and the role that has been created for the operating professionals.

Three different approaches to the respective roles of the deal and operations teams are discussed below. An explanation of the different factors motivating firms to adopt different approaches is also provided. The first approach recommends that the operations team and deal team work hand-in-hand, but that the deal team is ultimately responsible during the entire holding period. In a second approach, the operations and deal teams work hand-in-hand from sourcing to exit. In a third approach, the operations team alone is responsible for monitoring portfolio companies once the acquisition is completed.

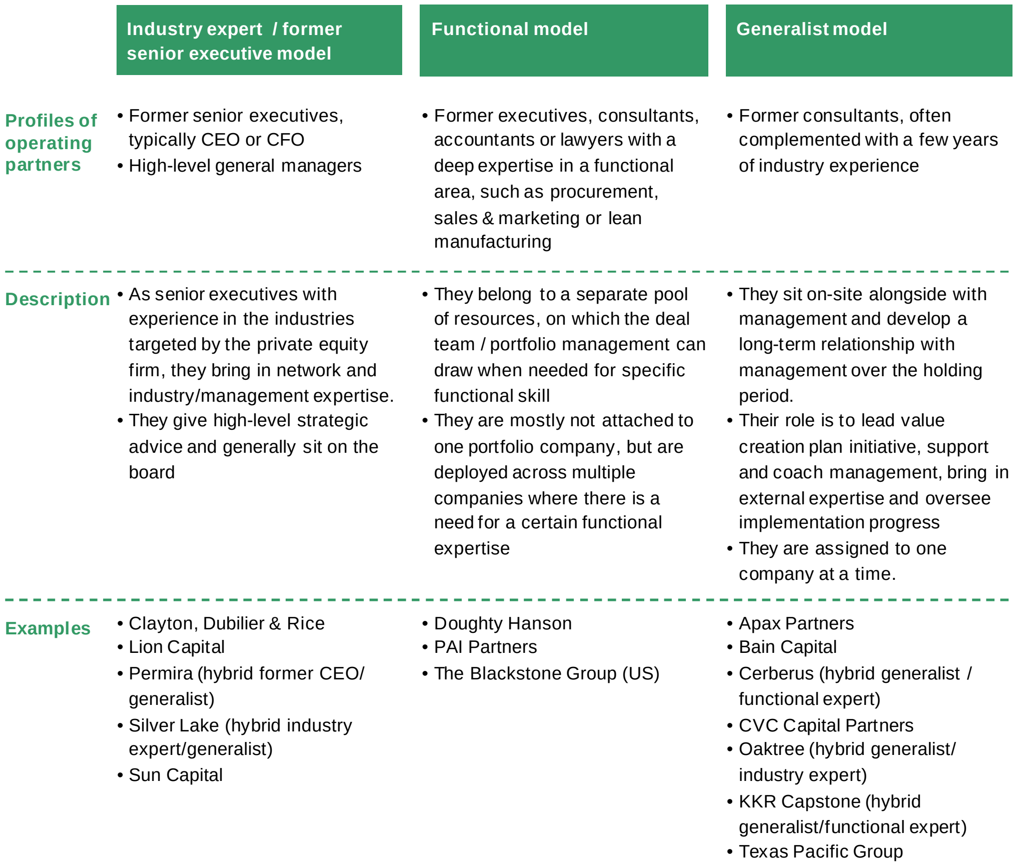
1. According to firms that recommend the deal team remain in the lead, operating partners work alongside the deal executive who makes the investment and remains responsible for the deal. In this approach, the operating partner’s role is to ensure that the business is functioning as well as it possibly can. In the case of a strong management team, or a deal partner with good industry knowledge, operating partners are not involved. Most private equity firms work with this model, where the deal partner owns the deal over the entire holding period.

2. In cases where the deal and operations teams share responsibility from sourcing to exit, one interviewee emphasized the importance of the operating and financial partners working hand-in-hand. The operating partners are involved in bringing business knowledge from due diligence to investment committee approval. They ensure that the deal team understands what is achievable in terms of operational initiatives (e.g., productivity initiatives, capital efficiency improvement). An interviewee indicated that every partner, whether deal partner or operating partner, is a member of the global investment committee and has an equal say in the final decision making process. If an operating partner does not support an investment thesis because of a challenging execution, his vote will have the same weight as the vote of the deal partner. Post-closing, operating partners and management talk multiple times per week about the performance of the business and important upcoming decisions. Those decisions are then discussed between the operating partners and the financial partners. From the management perspective, operating partners and deal partners form one deal team.

3. In a third approach, the philosophy is that once a portfolio company is acquired, the operations team is responsible for the company. If the operations team needs functional help from deal professionals, for example on merger and acquisition projects, they can draw on the deal team. When deal activity shrinks, deal professionals will be more involved in portfolio companies in tasks such as financial restructuring or loan contracts renegotiation with banks. An example of this is CD&R, which usually transitions a portfolio company from the deal team to the operations team after acquisition.

VI. What models of operational involvement can be distinguished?

In this chapter, we describe three models that are often used to describe in-house operations teams: the industry expert model, the functional expert model, and the generalist model. A brief overview can be found in Figure 7.



	Industry expert / former senior executive model	Functional model	Generalist model
Profiles of operating partners	• Former senior executives, typically CEO or CFO • High-level general managers	• Former executives, consultants, accountants or lawyers with a deep expertise in a functional area, such as procurement, sales & marketing or lean manufacturing	• Former consultants, often complemented with a few years of industry experience
Description	• As senior executives with experience in the industries targeted by the private equity firm, they bring in network and industry/management expertise. • They give high-level strategic advice and generally sit on the board	• They belong to a separate pool of resources, on which the deal team / portfolio management can draw when needed for specific functional skill • They are mostly not attached to one portfolio company, but are deployed across multiple companies where there is a need for a certain functional expertise	• They sit on-site alongside with management and develop a long-term relationship with management over the holding period. • Their role is to lead value creation plan initiative, support and coach management, bring in external expertise and oversee implementation progress • They are assigned to one company at a time.
Examples	• Clayton, Dubilier & Rice • Lion Capital • Permira (hybrid former CEO/ generalist) • Silver Lake (hybrid industry expert/generalist) • Sun Capital	• Doughty Hanson • PAI Partners • The Blackstone Group (US)	• Apax Partners • Bain Capital • Cerberus (hybrid generalist / functional expert) • CVC Capital Partners • Oaktree (hybrid generalist/ industry expert) • KKR Capstone (hybrid generalist/functional expert) • Texas Pacific Group

Figure 7: Main operating models in private equity firms – Source: Interviews, own analysis

1. Industry expert / former senior executive model

Private equity firms are often connected to former senior executives with experience in the industries targeted by the firms. These senior executives were typically CEOs or CFOs of blue chip companies. Their network, industry and management expertise is valuable to the private equity firm. The qualities sought in these individuals are the ability to set strategies, lead change, inspire people, recruit talent, drive growth, and create value. Cultural fit between senior executives and the fund is important to ensure alignment of commitment, values, and motivation.

Former senior executives can provide valuable support in vetting investment opportunities and recruiting management talent when personal network, market knowledge and leadership experience constitute a competitive advantage. Besides deal sourcing, they are also often involved in assessing deals and value creation potential, in monitoring portfolio companies as board members, and providing advice on strategic and operational issues. Generally they do not have a coaching role and are not involved in portfolio companies on a daily basis.

Their role with portfolio companies ranges from informal consultancy to non-executive board membership. In most cases, these operating partners work as consultants of the private equity firm and have the opportunity to participate in the economics of the deal on which they are working. In the case of senior advisors, involvement in portfolio companies often consists of board membership in portfolio companies, and is sometimes associated with an equity stake in the overall fund. In some rare cases, the industry experts are fully integrated with the private equity fund. In other cases, private equity firms hire a talented senior executive to source deals in their former industry, and then install him as CEO to run an acquired company for a set period of time.

Few private equity firms have industry experts that are fully integrated into the firm and work alongside the transaction partner over the entire lifecycle of the investment. An example is Lion Capital, which has three operating partners who have 20+ years' senior management experience in large consumer goods and retail companies. These operating partners are fully integrated within Lion Capital and carry the same titles as members of the deal team. They are more involved in the portfolio companies than the traditional senior executive sitting on the board. Their role includes hiring talented management teams, being involved in the 100-day plan and strategic initiatives, seeking and prioritizing value creation levers, and supporting management and external advisors on implementation. Their network in the industry is extremely valuable to the portfolio companies, as is their understanding of the industry. These operating partners are usually involved in deal sourcing and portfolio management, but not in the diligence and deal negotiations.

In some cases, senior executives get involved in deals without having a prior relationship with the private equity firm. Given a deal that a fund is considering, that fund's investment professionals identify a list of senior executives who could support the firm both in the acquisition phase (understanding of the industry and the company), and in the post-investment phase (identification of value creation levers). Investment professionals who are focused on one specific industry are particularly likely to know senior executives who can support them in that context.

There is no single formula to bring industry experts into a private equity firm. Typically, they are selected by private equity firms as a result of their industry expertise, strategic insights, network and leadership experience. Notable examples of industry experts who have joined private equity firms include Jack Welsh, former CEO of General Electric, who joined CD&R as a special partner, and Lou Gerstner, former CEO of Big Blue, American Express Travel Related Services, RJR Nabisco and IBM, who is chairman of The Carlyle Group.

Industry experts are highly valued by most private equity firms, especially when deal professionals have limited sector focus. Industry experts are often involved post-acquisition to better understand the business characteristics of a potential target. As one interviewee mentioned: "We definitely call in industry experts. Being a generalist, we cannot cover all industry knowledge in-house. We know some industries better, but we do not specialize. A good dinner with an industry expert is probably worth ten times more than a report from a leading management consulting firm. And you can usually talk to industry experts for free. We are always keen to attract industry people who have a track record and can give us a lot of information about the industry. Sometimes they can spot opportunities in a certain industry because of their network. It is interesting to have their view on the dynamics of the industry, the performance of a company, etc. And if we find somebody that would be good for a specific transaction, then yes, we may hire that person."

Some interviewees mentioned the role of senior country advisors, who are very well connected in their country and do not necessarily have a certain industry expertise. Those senior country advisors are particularly useful in the deal sourcing process, and are remunerated based on deal identification.

2. Functional model

Private equity firms adopting a functional model often have the philosophy that the portfolio CEO and management run the business. The operations team will support management on managing the risk of the investment, supporting the management team with expertise it usually doesn't have itself, and creating a perspective on the business that the management doesn't have, especially around leverage and scale (cross-portfolio improvements programs).

The operating professionals who are hired in this model have a deep functional expertise, such as procurement, pricing, IT, sales force effectiveness, lean manufacturing / Six Sigma, or benefits. They are typically former senior consultants or executives with a functional expertise. They are generally full-time employees of the private equity firm and often belong to a separate pool of resources, which the deal team and portfolio management leverage on an ad hoc basis. Once brought into a portfolio company for a specific project, functional experts will work with that company for between a few months and several years, and provide analytical insights, strategic guidance and execution support. Generally functional experts are not assigned to one single portfolio company; instead they are placed in a company whenever there is a need for their functional expertise.

The Blackstone Group ("Blackstone") in the US strongly relies on functional experts, whom they associate with some generalists. Given Blackstone's size in the US and their large number of portfolio companies, they can easily leverage functional scale. The portfolio operations group consists of professionals with significant operating experience, who work with portfolio companies on specific operating issues. In addition to their senior functional experts, Blackstone has established a purchasing organization group and an equity healthcare group, which administer procurement programs of goods, services and healthcare services across portfolio companies. In Europe, Blackstone adopted a different approach and hired professionals with more generalist backgrounds. The portfolio operations group in Europe currently consists of two operating directors who are responsible for monitoring operational performance and strategy of European portfolio companies. Both directors have significant executive industry experience.

Doughty Hanson's Value Enhancement Group includes functional experts, i.e., seasoned professionals with expertise in finance, accounting, brand development, supply chain management, manufacturing or purchasing in the context of a position in management consulting or in corporations. After the acquisition of a company, the Value Enhancement Group meets the company's management, defines initiatives to be implemented in their specific area of expertise, and works with management to implement those initiatives.

A European buyout fund recently launched an initiative to improve purchasing and working capital management across its portfolio; that involved setting up a Portfolio Support Group with three functional experts in those domains.

3. Generalist model

The generalist model involves professionals with extensive experience in consulting, often complemented with a few years in general management. They typically work on site with portfolio management. Some private equity funds introduce associates who work on a day-to-day basis in portfolio companies, and who support senior operating partners with data gathering, analysis and performance monitoring. Generally, the operations team is involved in one company at a time, and develops a long-term relationship with management over the entire holding period.

The role of operations teams is threefold.

1. First, thanks to their experience with multiple companies, operating professionals develop a repeatable value creation plan, which they can they can apply from company to company.

2. Second, they build a network of experts, e.g., consultants, interim managers, industry advisors, which they can leverage on an ad hoc basis. This enables portfolio management to quickly find relevant experts in any situation, to better scope the project, and to be more demanding vis-à-vis external advisors. Their consulting background enables them to ask better questions and get more relevant information.

3. Third, they coach and support management. It is important to note that they are not replacing, advising, or directing management, or playing a "mother-in-law" role, but instead supporting and working hand-in-hand with them. Their role is similar to that of project managers in management consulting firms, except that the operations team acts as a principal — they are responsible for ensuring implementation.

The operations team supports management in designing the 100-day plan and in initiating a strategic blueprint process, often with the help of external consultants. That blueprint is an investment thesis for operational value creation and defines value creation levers over the next two to five years. Interviewees often referred to it as an integrated value creation plan.

In the generalist model, the operations team spends most of its time on managing portfolio companies, and is less involved pre-acquisition. Their level of involvement pre-closing depends on the fund: some funds involve the operations team as a result of their knowledge in operational improvement programs or management coaching approaches.

Generally, operating professionals are not given a board seat. This ensures that they do not compete against portfolio executives but rather always try to support them, whether in board meetings or throughout the implementation of the value creation plan.

Bain Capital is an example of the generalist model. Each portfolio company is assigned an operations team, which is involved with that company over the entire holding period. When interacting with portfolio companies, portfolio team members ensure they do not impose their presence but rather act as guests who get involved when invited to do so. Their philosophy is that portfolio companies' management should value the advice of the operations team and proactively seek it. The operations team works together with management to analyze the strengths and weaknesses of the company, identify a value creation plan, and develop a strategic plan for the long run. Working hand-in-hand is important in this type of model.

This model is close to that currently being implemented by CVC Capital Partners. Other funds, such as Texas Pacific Group (TPG), are also evolving from a functional to a generalist model. In Europe, TPG does not explicitly recruit operating professionals on a functional basis, although some professionals have some functional expertise. Vincenzo Morello, for example, Partner at TPG in London, and previously Managing Director at Alvarez & Marshal, has expertise in turnaround situations. In the US, TPG's operations team consists of a mix of functional experts and generalist professionals. It appears therefore that funds that were initially leaning towards a functional model are now getting close to an integrated value creation planning approach.

4. Hybrids

Many funds cannot be categorized as industry expert, functional or generalist models, as they include organizational features of several models. Among those variants, it is interesting to note that funds employing a partial functional or generalist model often involve industry experts, who are either senior advisors working with the fund or belong to the fund's network of senior executives. In the following sections we describe some important hybrids.

A. KKR

KKR established its in-house operations team in 2000, with the creation of Capstone. Capstone has been built with a number of functional experts and executive managers who work with the private equity firm's investment and portfolio management teams to improve companies' operations. These in-house executives focus on operational issues that have an immediate impact on the bottom line, such as manufacturing, product sourcing, sales and marketing. Typically, senior operating professionals of KKR Capstone have spent some years at a top-tier management consulting company, up to partner level, sometimes supplemented with a P&L responsibility role at a large corporation. A few KKR Capstone executives are outright industry hires. When they join KKR Capstone, the operating professionals bring their analytical skills, management experience, and network of niche specialists, to whom they can reach out when they need to complement their analytical and managerial skills. At a mid-level, KKR Capstone is looking for generalist profiles, with strong analytical capabilities. They are mostly former project managers or principals with a "distinctive" career track (top 5% consultants). KKR Capstone also started recruiting junior professionals a few years ago, with only two or three years of management consulting experience, often post-MBA hires.

Although KKR Capstone started off with a relatively functional model, the company has gradually evolved towards hiring generalists who can provide an integrated value creation plan. KKR's current model could be described as a generalist model, with generalist professionals being complemented with a selected number of functionalist experts on topics such as IT, lean manufacturing and procurement.

At KKR, Capstone executives operate over the entire value chain of a transaction, both in the pre-acquisition and post-acquisition phase. Prior to acquisition, Capstone executives are brought in when deal closing becomes relatively likely (e.g., secured access to financing); they are not involved in the early stage of due diligence. Operational executives become members of the deal team, which typically includes both transaction and operations resources, with specific responsibilities. Operating professionals leverage their experience to help the deal team understand strategic and operational characteristics of that potential investment; that analysis can sometimes justify a higher purchase price, giving the firm an edge in bidding wars. The 100-day plan is also primarily driven by the operating professional, in cooperation with portfolio management.

After the acquisition, KKR gets deeply involved in portfolio companies. The 100-day plan is therefore an important tool that focuses on prioritizing initiatives and driving quick change. Operating partners are responsible for leading problem solving and managing change in portfolio companies for about one year, after which KKR recruits managers to take over that role, and KKR's involvement moves to the board level. KKR believes that this deep involvement of the operations team is key to operational value creation.

KKR Capstone senior executive teams typically work in-depth with one portfolio company at a time, displaying a "nose-for-the money" orientation toward the largest potential opportunities, and rolling up their sleeves to lead critical initiatives and bottom-line directives. While the majority of KKR Capstone's work is performed without taking a formal title within portfolio companies, KKR Capstone executives can, in order to fill capability gaps, assume management roles when situations warrant.

KKR Capstone's compensation structure is similar to KKR's, including "dollars at work" in the funds. As a result, the interests of KKR Capstone executives are aligned with those of KKR deal professionals, as well with those of portfolio company management teams and KKR employees

Although there is no formal obligation to involve Capstone in every deal, most portfolio managers and fund managers embrace its operational expertise and bottom-line focus. One of the most valuable contributions is helping the portfolio companies develop actionable metrics to monitor performance, as few companies have good metrics in place. Financial statements are only a rear-view look at performance. Appropriate metrics in manufacturing, sales, distribution, purchasing, and other areas should look at business going forward, identify opportunities to improve operations, and measure progress towards goals.

There is tight integration between KKR's deal team, KKR Capstone, Senior Advisors and others. KKR Capstone leaders are members of KKR's Portfolio Management Committee. KKR's Senior Advisors have all held leading positions in major corporations and public agencies. They work in cooperation with KKR industry teams and KKR Capstone executives and portfolio company management throughout the private equity process, from conception and due diligence to operational improvement and exit. They also serve on boards and provide support and executive coaching to senior leaders at the portfolio companies.

In 2008, KKR launched a dedicated talent management effort to ensure that best-in-industry management teams and organizational capabilities are in place across the firm's private equity portfolio, since the quality of executive leadership has a direct impact on performance.

B. Cerberus Capital Management

Cerberus has an extensive in-house operations team, which represents about 30-40% of the firm's employees. Most operating professionals are in-house consultants, involved in portfolio companies when needed. According to Cerberus, relying on in-house consultants is efficient because they know Cerberus' philosophy, portfolio companies, and investment team. Besides in-house consultants, Cerberus has a few functional experts who focus on cross-portfolio initiatives, i.e., essentially purchasing. The operations team includes a third group of operating professionals, managers, who get involved in portfolio companies when needed. For example, when Cerberus bought Chrysler, Cerberus installed Robert Nardelli as CEO of Chrysler. When his role as CEO came to an end, he joined Cerberus as CEO of the operations team. Some Cerberus professionals oversee the entire portfolio, interacting with portfolio company management as board members, implementing initiatives by themselves, or involving in-house consultants to do so. Finally, a fifth category of professionals ensures consistency over the entire portfolio. Half of their time is spent on risk communication, helping management and board identify emerging risks, and ensure they do not develop into major issues. The other half of their time is spent on value creation, making sure that portfolio management is continuously identifying incremental value creation opportunities, prioritizing initiatives, and executing rigorously. Those professionals are the first point of contact when portfolio management has operational questions.

C. Silver Lake Partners

Silver Lake Partners, founded in 1999, is a buyout firm specialized in the technology sector. A recent investment was the acquisition of a majority stake in Skype. Silver Lake's operations team, the Value Creation Team, consists of 13 operating professionals, five of whom are on Silver Lake's payroll, with the remainder senior advisors. Silver Lake Partners recently hired a junior associate to give operating partners some leverage. The team is geographically dispersed to provide a social connection.

Silver Lake's focus on technology investments has largely determined its in-house operations team structure, which includes both consulting DNA and operational/technology expertise: all operating executives have both a consulting background and senior management experience (i.e., P&L responsibility) in a large technology company (i.e., revenues of above $500M). Their consulting background allows operating professionals to work with management in a style that is not patriarchal, and to ensure that portfolio management sees them as resources rather than controllers. Their experience in running a technology business makes operating professionals more credible, and cognizant of that industry's complex structure. The five operating executives may have a specific functional expertise, but that is not a dominant factor in recruiting.

The Value Creation Team works with management in a collaborative fashion; unless a company is in serious trouble, the team doesn't impose their presence on the portfolio company. They believe that most portfolio companies appreciate their support. They prioritize their involvement in portfolio companies to achieve the most impact given time spent.

5. No in-house operations team

Many private equity firms decide not to have an in-house operations team for several reasons, described elsewhere in this paper. An interesting example of a private equity fund that does not have a separate in-house operations team, but that still focuses on value creation through operational improvement, is Altor, a European mid-market firm founded in 2003. Given its operational focus, the company seeks investment opportunities with significant potential for operational improvement, or with turnaround needs.

Over half of deal professionals at Altor have a management consulting or industry background, whereas the other half have an investment or private equity background. For Altor it is important that the deal professionals combine financial and consulting competencies. Therefore, promotion to senior associate, director or partner requires demonstrating skills in operational, strategic and financial areas. Over time, deal professionals need to develop into a "complete, all-round person." Although in the early phase of their career, professionals are likely to develop skills in finance or operations, on-the-job learning allows them to learn other skills. For example, former bankers are involved in advising portfolio companies on their strategy and operations. Although deal professionals are highly involved in operational topics such as the 100-day plan, Altor also relies on external consultants and industry experts.

Altor professionals typically interact with portfolio companies as chairman of the board. Although they work actively with portfolio management, and are responsible for defining the value creation agenda, they do not have a project management role and are not involved in managing day-to-day operations, which is the task of portfolio management and external consultants. Prior to acquisition, Altor spends significant time identifying value creation levers, such as pricing and cost cutting. In the case of a turnaround, they develop a thorough and detailed implementation plan prior to acquisition. Altor is deeply involved in portfolio companies to implement the 100-day plan. Once it is implemented, Altor professionals spend on average one day per week in portfolio companies.

As Altor does not have a functional approach, they rely on external expertise if needed. In-house professionals are good at identifying the value creation potential of portfolio companies, and at assessing value capture possibilities. They rely on specialists to take care of implementation, and create a steering group to monitor progress and decide when to step in.

VII. What are the pros and cons of each model?

1. Industry expert / former senior executive model

The rationale for the former senior executive model is that these individuals bring their network, experience, expertise and knowledge of the industry.

This model, however, creates risks of conflict of governance between CEOs of portfolio companies and former senior executives. It is the portfolio CEO who should lead the company, but often the former senior executive wants to take on too much of the former's role and responsibilities, creating conflict of interests. One interviewee mentioned that both former consultants and former industrialists can add strategic and operational value, but that the particular challenge with industrialists is the integration in a professional services environment.

Although the industry expertise of the former senior executive is valuable, the former senior executive might give only high-level strategic advice without going too deep into the operations of the company. The former senior executive will generally not be involved in the day-to-day operations of the portfolio company, and the implementation of the value creation initiatives, which is one of the key roles of an in-house operations team. Because of the seniority of operating partners, the management of portfolio companies might have difficulties in proactively reaching out to them. Some interviewees argued that one can always bring in external industry expertise when needed without formally having industry experts on the payroll.

The relevance of an industry expert model was also challenged by some interviewees, who believed that industry expertise is less relevant than functional skills (e.g., turnaround, focus on cash) when portfolio companies are distressed or close to distress.

Critiques also highlighted the lack of scale and similar deals in a private equity company to justify having in-house industry experts. An exception is private equity firms that are industry focused. Organizing skills by industry requires having experts for nearly each deal, as there is only a limited repeatable pattern in the deals that private equity houses are doing. Moreover, as a private equity company is generally unable to determine what industries it will cover in the future, it never knows whether it has the right experts.

2. Functional model

Proponents of the functional model point out that expertise in certain functional capabilities (e.g., HR, lean manufacturing, IT, pricing, procurement, working capital management) can be easily transferred from one company to another. They also acknowledge that some functional expertise, such as strategic review, is more difficult to replicate. The functional model is especially attractive when a private equity firm has a critical mass of portfolio companies to which a certain functional improvement program can be adopted.

Drawbacks of the functional model may be that in-house functional experts do not have an integrated vision of a portfolio company, and may act like various parties building a house without a contractor. The functional experts are good at executing specific projects. However, they look at a company in a functional way, approaching each lever on a standalone basis. The full potential of a company is only created when an integrated value creation plan is drafted and implemented. The risk of lack of integration can be mitigated by the role that the board plays. When board members are given broad responsibility, where they interact on a regular basis with portfolio management, beyond the monthly or quarterly formal board meetings, they will usually have a good view on the opportunities and issues at the company.

Moreover, a private equity company may be limited in the number of functional areas it can cover. The most common areas are procurement, IT, sales and marketing. In addition, some functional skills, such as restructuring, depend on the economic context and are not needed on a recurring basis over a longer period of time.

Another potential disadvantage of this model is that functional expertise may involve a lot of innovation, especially in fields such as IT, procurement and marketing. The expertise of functionalists may start ageing after they are out of the industry for several years. Therefore, some interviewees argue that it is better to rely on external functional experts, in order to ensure that the capabilities remain state-of-the-art.

3. Generalist model

Assigning an in-house operating partner to each portfolio company holds that partner clearly accountable and incentivized to look after that company. After working with portfolio management to prioritize the initiatives to be implemented, he acts as a supporter, coach or catalyst to management rather than a controller or "mother-in-law."

An advantage of the generalist model is that operating partners are involved in the process early on. They are often involved pre-deal, and once the company has been acquired they immediately start building an integrated value creation plan. In contrast, operating partners may be brought in only when there are problems in the company, often several months or years after the acquisition.

One critique of this model is that the generalist can discourage the CEO by being too involved in daily operations. Some interviewees questioned the role of an operating professional who is put into a portfolio company for the entire holding period. Professionals who spend five days a week in the portfolio company are usually more junior, and are often not strong enough to really add value to the company. Although they can do some project management and follow up on implementation, they will often be seen as a spy for the CEO. Moreover, some interviewees pointed out that a portfolio company does not need this kind of intervention when the company is running well.

Critics of the generalist model also emphasize that allocating internal operating professionals for the entire holding period to one company requires higher carried interest (e.g., 30%), which is only the case for a certain number of private equity firms. They also mention that a separate in-house consulting team creates the risk of losing knowledge of best practices.

Another drawback of the generalist model is that it can only work well when dedicated operating professionals get highly involved in the portfolio companies, i.e., have daily interactions with management, and close follow-up of implementation progress. Some medium-sized private equity firms have implemented a "light" generalist model, i.e., a few operating partners with consulting and/or general management background. These operating partners were assigned to multiple portfolio companies, so they could only spend one or two days with each company: just enough time to know what is happening but not enough time to really get into the implementation.

Some interviewees also pointed out that close interaction with portfolio management might prevent the operating partners from being objective and challenging. There is the risk that the operating partner becomes too involved, too subjective, and shows too much empathy with management, thereby not always putting the fund's interests first. If this is the case, the question arises whether the operating partner will go far enough with management in unlocking the operational value.

The proponents of the generalist model mentioned that while this is a risk, it is not an insurmountable problem if the incentives of the operating partners are well aligned with the private equity firm's performance. Moreover, challenging the performance of the company is a role of the board, where the operating partners are sitting together with management and the deal team. The deal professionals are results-oriented, and will make sure that the portfolio companies keep performing according to plan. One interviewee pointed out that “it is all about check and balances”. The board serves as a mechanism to ensure that the performance of portfolio companies is proactively monitored, and that the right decisions are taken.

Some interviewees questioned the true added value of generalists, and expressed concerns that generalists do not always bring additional expertise to the table compared to functional or industry experts. Their role in identifying value creation levers was especially challenged, as many interviewees pointed out that deal professionals already have a lot of expertise in doing this. A deal professional who cannot point out the main value creation levers in a company should not do the deal. And although many acknowledge the role of the generalist in the implementation phase, few operating partners have enough time to get deep enough into the day-to-day operations and implementation.

VIII. Is one model better than the others?

As discussed above, every model has its advantages and drawbacks. The question then arises whether one model – if implemented well – gives a fund an edge over its competitors in generating higher returns.

We have seen success stories and failures with all three models, so no single model can guarantee success. With respect to implementation, a private equity firm needs to consider, among others:

1. Profile of the operating partners: Not only do they need the right experience and expertise, they also need to fit into the culture of the firm, and to be able to work with portfolio management in a collaborative way.

2. Integration of the operations team into the firm: The operating partners need to be respected and not treated as secondary to the deal team. Moreover, they need to be deeply involved along the private equity lifecycle and not just brought in as firefighters in case of problems.

3. Governance model: The private equity firm needs to define clear roles and responsibilities for the operations team, deal team and portfolio management, to set up an incentive structure that fosters working on the common objective of maximum value creation, and to identify and manage potential conflicts upfront.

Most interviewees indicated there is no single best model. The type of model a fund chooses depends on factors such as the fund's investment strategy, size and culture.

1. Factors influencing choice

A. Investment strategy

The choice of a model for a portfolio company depends on the fund's investment strategy, i.e., level of sector focus, geographical spread of investments, performance of portfolio companies, strength of management teams, risk and complexity of investments, size of deals, and ownership stakes.

In the case of a fund that is focused on one or a few sectors, it might make sense to include industry experts in the operations team. For example, Lion Capital, which solely invests in the consumer goods and retail sectors, has three industry experts on its payroll that are former CEOs with extensive experience in the consumer goods and retail industry.

Funds that have a wide geographical presence need to account for language and cultural barriers. The more geographically disparate a portfolio, the less relevant the industry expert model, as in-house experts cannot grasp all geographical specifics. Hence, funds need to rely on experts to understand geographical and cultural specifics. We interviewed an American multibillion-dollar fund that invests in distressed opportunities (mispriced assets), who indicated that "most professionals have a finance background; they do not have any in-house operations team and solely rely on good management, senior advisors and external consultants".

When portfolio companies are in distress, a more hands-on approach is generally needed. TPG, for instance, invests in companies that need a turnaround. At the other extreme, if a fund is essentially investing in a business with stable cash flows and limited value creation potential, such as infrastructure, there is less of a need for in-house operating professionals. Hellman & Friedman, for example, buys high-growth businesses with good management, where an in-house operations team will not add significant value.

As far as funds investing in distressed opportunities are concerned, it is interesting to note that Oaktree and Cerberus have slightly different approaches towards in-house operations teams. Cerberus has an extensive in-house operations team, whereas Oaktree relies on external advisors to a larger extent. The difference can be partially explained by the fact that Oaktree's model is more recent, and also by the fact that Oaktree seeks investment opportunities with good management that is capable of running the company and creating value. On the other hand, in the case of Cerberus, changing management is more likely to be taken into consideration, as they can rely on their in-house operations team.

As we have just seen, the strength of the management of portfolio companies plays an important role in explaining the organizational model of a fund. Warburg Pincus, for example, is involved to a limited extent in operations, as their strategy is to invest in portfolio companies with good management. The same applies to Charterhouse, where the deal team owns the deal from beginning to end. Good management is a key element of Charterhouse's investment strategy; therefore Charterhouse spends significant time in the diligence phase to ensure they understand management's strategic plans. When investment professionals are not comfortable with management's ability to create value, they replace the management team. Charterhouse believes that the private equity professional's task is not to create operational value, but to source talented management, support them and challenge them, without imposing the presence of operating professionals.

Transaction complexity is another important factor in determining an organizational model. Bain Capital, for example, is involved in relatively complex deals, such as carve-outs, strategic repositioning, and add-on acquisitions. Such complex transactions require one operating partner over the entire holding period in the 100-day plan, strategic blueprint, merger and acquisition activities, and exit preparation.

Some private equity firms do not have operations team because either they are too small to bear the cost of operating partners, or because they do not get a controlling interest in the companies in which they invest. Goldman Sachs Principal Investment, for example, co-invests in infrastructure deals with funds that have operational capabilities and take care of operational improvement. For real estate deals, Goldman Sachs relies on its subsidiary, Archon, to manage assets, and has limited involvement in operational improvement.

B. Size of the private equity firm and funds

The size of a private equity firm and its funds also influences the choice of an operational model. Large in-house operations teams are heavy burdens on private equity firms' cost structure. Therefore, some private equity firms use management consultants as outsourced operations team, referred to as "retainer teams". They can be deployed in a flexible way across portfolio companies, without adding a structural fixed cost to the private equity firm.

The Carlyle Group, which is one of the world's largest private equity firms, has its assets under management split across 65 funds. Each fund has one of four investment strategies — buyout, growth capital, real estate or leveraged finance — and may focus on a specific geography. Funds share fundraising efforts, infrastructure and brand. As a result, on a fund basis, the private equity firm operates on a smaller scale than some of its competitors. Because of the focus of each fund (e.g., discipline, geography, sector), transaction professionals tend to be more specialized (e.g., by employing local people in each office), and can be hands-on with portfolio companies if needed.

Mid-market funds are increasingly interested in including a few operating partners on the team. Private equity firms such as Advent International, Montagu, HIG Capital, 3i, Doughty Hanson, Silver Lake Partners and Bridgepoint, are all committed to including operating partners on the team.

The question is then to understand whether the involvement of small operations teams is analogous to that of larger teams like those at Bain Capital or TPG. It seems that operating partners in mid-cap funds, who are typically former senior executives, play a big role in deal sourcing, but their involvement as advisors on operational or strategic questions is more limited than that of their counterparts in large-cap funds.

The importance of the size of a fund in determining its organizational approach to operational improvement is illustrated by the Blackstone Group. In the US, Blackstone has a large number of portfolio companies and of investment professionals, which allows it to reap economies of scale and to adopt a functional approach, whereas in Europe, the firm has fewer investments and follows a more generalist approach. The same goes for TPG, which in the US is more functional than in Europe.

C. Culture

Which model works well is highly dependent on the culture of the investment firm. Private equity firms that have a culture of being hands-on with deep operational involvement in the portfolio companies — which is translated in the profiles they recruit — indicate they do not always need to employ a large, separate in-house operations team. But these are also the firms that have an operational mindset, and show a larger appetite for operational involvement and bringing in dedicated in-house operating professionals.

Some private equity firms, mainly with American roots, have a financially driven mindset, and focus on financial engineering techniques. The majority of the investment professionals have a background in investment banking or private equity. Setting up an in-house operations team in such firms is a step that needs to be taken carefully, as integration of the operating partners in the deal team is extremely delicate.

Other firms, such as Bain Capital, Permira and Apax Partners, have a mixed balance of professionals with consulting, banking and industrial backgrounds. At Altor and CD&R, an operational mindset has been rooted in the firm since its inception. Such funds tend to be more welcoming to in-house operating professionals.

2. Discussion of the models

As described above, there is no optimal model in organizing an in-house operations team, and which model is better ultimately depends on the fund. In this section we describe two main findings that came out of our interviews:

1. Getting access to industry experts is valuable and recommended, especially when the deal team has little industry focus. These industry experts, however, do not necessarily need to be part of the private equity firm, and can easily be brought in for a specific deal.

2. Industry expertise is not enough. As industry experts are often former senior executives, they do not get deeply involved in the day-to-day operations and implementation of the strategic and operational initiatives. As implementation is key for the success of a deal, the private equity firm needs access to professionals with good analytical and project management skills. These can be either generalists or functional experts, depending on various factors.

Although there is no optimal model for organizing the in-house operations team, we observed a trend of involving more generalist professionals, with general management and/or consulting backgrounds.

Some large private equity houses that started off with a functional model are currently adding generalist professionals to overlook the portfolio and determine when to call in functional experts. A combination of a few generalists, in addition to functional experts, seems to work well. Much depends on the way operational value is best created. Functional experts are effective in realizing improvements in a certain domain, e.g., cost savings on sourcing, or productivity improvements in factories, by launching a Six Sigma project. The disadvantage of relying solely on functional experts is that they work on separate projects, and there is a lack of integration of their different initiatives. Generalists, who do not have a deep expertise in a certain functional area, will build an integrated value creation plan together with portfolio management and transaction professionals that contains all the levers the portfolio company needs to work on during the holding period. For the implementation of individual levers, the company then can decide which functional experts to call in, either from the external world (Bain Capital) or internally (KKR, TPG). It is important, however, that the generalist be able to spend adequate time with each portfolio company to keep oversight.

Some private equity firms believe a valuable approach is to involve both in-house/external industry experts and professionals with analytical skills, typically with a consulting background, prior to acquisition. This mix of skills is valuable because it combines professionals with good analytical and project management skills, and professionals, who understand the business, can make realistic assumptions, and challenge the business plan. Relying solely on analytical skills can lead to unrealistic plans or missed opportunities, while involving only industry experts can facilitate the production of good ideas but fail in the implementation phase.

Small and medium-sized private equity houses often lack the scale to set up a full in-house operations team with enough generalists to put at least one operating partner in each portfolio company. Some of these funds have adopted the generalist model, placing one operating partner in multiple portfolio companies, typically four or five. These in-house operations teams were often not successful, as the operating partner did not have enough time to get deeply involved with each portfolio company. Our findings therefore suggest, for a small team of operating partners, a preferable approach could be to opt for:

a functional model, where a few operating partners with the most needed functional skills can be deployed across the portfolio of a private equity firm; or

a focused generalist model, where the operating partners are only involved in a limited number of portfolio companies where they can have the largest impact.

IX. What are the top pitfalls of an in-house operations team?

In this chapter, we briefly summarize some common pitfalls in the set up of an in-house operations team that we determined from our interviews.

The first pitfall associated with using in-house operations teams was the lack of operational resources dedicated to driving change at portfolio companies. While an operating partner can make a significant difference when placed within a portfolio company by driving change and following up on implementation, they need sufficient time to focus and be involved with the portfolio company to achieve this. Ideally, an operating partner should work on one project, or with one portfolio company, at any single point in time. Deploying an operating partner across several portfolio companies (e.g., 4 - 5) simultaneously is generally not considered to be an effective use of their time and skills. In these situations the operating partner will often be limited to involvement in board meetings.

Second, interviewees indicated that a misalignment between the deal team and operations team could develop into major issues. Ideally, the deal team and operations team should adopt an integrated approach to a portfolio company, and work together to maximize the value of the company at exit. While each team should have clear roles and responsibilities, governance mechanisms should ensure that the teams interact effectively, and that this process runs smoothly. Regular and transparent communication between teams is seen as key. Less successful were instances where the teams worked in parallel, where the deal teams were not involved in operational value enhancement initiatives, and where both teams had different portfolio committee reviews.

A third pitfall was observed in cases where there was a misalignment between the operations team and portfolio management. There were many examples where operating partners attempted to take over the role of management, instead of supporting management. These conflicts often led to management leaving companies and board members leaving the board. Private equity firms should therefore be careful in the selection process of operating partners to ensure they have not only the necessary expertise and experience, but also the correct attitude to interact with portfolio management. This, in turn, can depend on the role the operating partner needs to fulfill with a portfolio company. Findings would suggest that many smaller funds have started an operations team but not spent enough time on recruiting and training operating professionals.

Problems might also arise in the case of a lack of flexibility of private equity firms and their in-house operations teams. Operating partners are very much involved in setting up repeatable models that can be transferred from one portfolio company to another. While there are a lot of advantages in rolling out repeatable models across companies, it is important to remain critical towards what can be done, as no two portfolio companies are the same. There are limits to repeatability, and it is important to adapt the model to the specifics of each company. Furthermore, a number of private equity firms indicated a desire to implement cross-portfolio optimization initiatives despite this not always being in the best interest of a particular portfolio company.

A last pitfall identified was the set up of an in-house operations team without buy-in from the entire deal team. It is important that the deal team is ready to give the operations team the correct role within a portfolio company. There is limited chance of success when an operations team is imposed on the deal team, with the latter not acknowledging the added value that can be brought by the operating partners, or when the deal team does not trust the operations team, and is too interventionist.

X. What will the future private equity landscape look like?

1. Sustainability of operational focus

With the increased focus on operational value creation after the global financial crisis, the question arises whether operational improvement will remain a sustainable part of value creation, or whether it is a temporary phenomenon and marketing tool to reassure limited partners.

Most interviewees acknowledge that having a successful operational value creation approach with a dedicated in-house operations team currently helps a private equity firm in its fundraising efforts, and limited partners become more concerned about a fund's ability to create value without increasing the risk profile. So although operating partners are good for marketing purposes, most firms have not designed their in-house operations team solely for marketing reasons. They clearly believe that an in-house operations team allows them to make better investments, and create more value, both in the short and long runs. Often an in-house operations team is also a selling point for management, as they usually take part in the upside.

In years to come, it will remain difficult to achieve high leverage or expand multiples by finding bargain deals. Therefore, value creation through operational improvement will remain a key focus of the private equity industry. In addition, as 2010 will most likely be a challenging year for portfolio companies, building restructuring skills in-house will be useful to help portfolio companies navigate through the economic downturn.

But ultimately, most interviewees indicated that they believed the private equity industry will recover from the financial crisis. There are signs that markets are improving, and there is already some potential to leverage deals. Nevertheless, it still remains difficult and expensive. Even if the private equity industry goes (partially) back to mid-2000 levels, most interviewees believed that operational improvement will remain an important value creation lever. It was a widely held view that in the post–financial crisis era, credit markets have become more prudent. No longer can a private equity firm buy a business that is not doing too badly and put a large amount of debt on it. Private equity firms appeared to understand that they will need to work harder for the money in the future. However, as one interviewee observed: “This doesn't mean that the world has turned upside down, and that the operating partners are going to run the private equity industry.”

2. Recruiting junior professionals

Until recently, the private equity industry was not typically interested in junior professionals. For the last few years, however, some funds have been increasingly recruiting junior analysts or associates with three to five years of consulting experience and little general management experience, who understand the consulting and problem-solving process, and can work independently. Portfolio work in these funds is shared between former senior executives, who sit on the board of portfolio companies and provide high-level directional advice, and junior resources, who take care of more analytic work. The funds that have experimented with this approach believe it allows senior professionals to get up to speed more quickly, and is particularly relevant for the implementation of large projects such as post-merger integration projects.

Critiques of this approach point to the fact that operations teams are small with little institutional knowledge, and therefore depend on the knowledge of external professionals who are brought in. As junior professionals have little experience, critiques recommend portfolio work be managed only by former senior executives, and that the work of junior resources be carried out by external consultants. Also mentioned was the issue of age difference, which can make communication and positioning challenging.

Conclusion

How can a private equity firm maximize its return on investment? With a tightened credit market and fewer opportunities to find good bargains because of increased competition, private equity firms are increasingly turning to operational improvement as a way to create value and achieve projected returns.

The concepts of operational value creation and in-house operations teams are not new, and some private equity firms have been focusing on value creation beyond financial engineering for a longer period of time. However, few firms have been able to create operational value in their portfolio companies in a consistent and systematic way. Moreover, large differences exist in how private equity firms have set up in-house operations teams, the roles and responsibilities of the operating partners, and how deeply they are involved in portfolio companies. Over the past two years, the topic of operational value creation has been heavily debated, and many private equity firms have recently introduced operating partners in addition to transaction teams.

The question then arises of whether one given approach maximizes operational value in portfolio companies. Should funds set up in-house operations teams, or are the same returns achievable when relying on external industry experts and advisors? What are the best profiles of operating professionals? How big should the operations team be? These questions are of great interest to the private equity industry, but answers are not always apparent. Although our interviews showed there was no single recipe to successfully create operational value and install in-house operations teams, we identified key guidelines that private equity firms need to take into account in the context of operational improvement and operating partners.

The decision to set up an in-house operations team will depend upon a number of factors. The first factor is the fund's investment strategy, as creating operational value is sometimes not needed or impossible for private equity firms. The second factor is a firm's ability to ensure efficient interactions and split of responsibilities among the transaction team, operating professionals, portfolio management and external advisors. A third factor involves the economics of relying on in-house operating professionals versus outsourcing to external parties. For some small and mid-cap funds, setting up in-house operations teams represents a heavy burden on the fund's balance sheet. In the mid-cap market, we observed that operating professionals are increasingly included on the team.

In-house operations teams can range from a fully-fledged, dedicated in-house operations team, to one operating partner. The choice of an organizational model derives from several elements. Firstly, a fund's investment strategy and size will determine the required profile of operating partners (e.g., industry/functional expertise, general management experience, seniority, geographical focus), size of the operations team, and their level of interaction with industry and external advisors. In recruiting operating partners, it is important to ensure they have soft skills to deal with multiple stakeholders (e.g., deal team and portfolio management) and support portfolio management. Culture also plays a role, as some private equity funds do not believe in the added value of setting up a team to take care of operational improvement. Many private equity firms have failed at successfully introducing in-house operations teams, or have had to overcome the initial resistance of the transaction team.

Once operating professionals are chosen, a private equity firm needs to realize the potentially challenging interactions among the operations team, the transaction team and portfolio management. To avoid potential issues, alignment and clear definition of all roles and responsibilities should be obtained upfront. The operations team should also be incentivized so as to ensure motivation, accountability and avoid competition with the deal team.

Many private equity firms have recently hired operating partners to replace incumbent portfolio management, or lead big restructuring programs. The question therefore arises whether this approach will ultimately lead to operational value creation. Although in the short run using operating partners as firefighters might improve the performance of portfolio companies, it is not generally observed to create sustainable operational value in the long run.

Appendices

1. Private equity firm rankings - List of top 50 private equity firms

No	Name of firm	Capital raised in last 5 years ($ bn)	No	Name of firm	Capital raised in last 5 years ($ bn)
1	TPG	52,35	26	Bridgepoint	10,87
2	Goldman Sachs Principal Investment Area	48,99	27	EQT Partners	10,82
3	The Carlyle Group	47,73	28	Madison Dearborn Partners	10,60
4	Kohlberg Kravis Roberts	40,46	29	Charterhouse Capital	10,56
5	Apollo Global Management	35,18	30	Teachers' Private Capital	10,24
6	Bain Capital	34,95	31	Thomas H. Lee Partners	10,21
7	CVC Capital Partners	33,73	32	Cinven	10,17
8	The Blackstone Group	30,80	33	Onex	9,59
9	Warburg Pincus	23,00	34	Riverstone Holdings	9,40
10	Apax Partners	21,33	35	AXA Private Equity	9,37
11	First Reserve Corporation	20,89	36	JC Flowers & Co.	8,90
12	3i Group	18,39	37	Oaktree Capital Management	8,85
13	American Capital	17,99	38	BC Partners	8,75
14	Hellman & Friedman	17,90	39	Candover	8,45
15	Providence Equity Partners	16,36	40	Welsh Carson Anderson & Stowe	8,42
16	Advent International	16,13	41	Nordic Capital	8,18
17	Terra Firma	14,21	42	WL Ross & Co.	7,77
18	General Atlantic	14,10	43	Lindsay Goldberg	7,69
19	Fortress Investment Group	14,08	44	Sun Capital Partners	7,50
20	Silver Lake	14,00	45	NGP Energy Capital Mgt.	7,47
21	Cerberus Capital Management	13,90	46	AlpInvest Partners	7,26
22	Permira	12,67	47	Kelso & Co.	7,20
23	Clayton Dubilier & Rice	11,72	48	Citi Alternative Investments	7,08
24	Lehman Brothers	11,71	49	Marfin Investment Group	6,86
25	PAI Partners	11,50	50	MatlinPatterson	6,83

Source: Private Equity International

2. Profile of selected private equity firms

Name of firm	Capital under management ($ mil)		Sum of inv. in current portfolio ($ mil)	Avg inv. per company ($ mil)	Stage breakdown (% of all investments)	Industry breakdown (% of all investments)	Geographical breakdown (% of all investments)
3i Group	21 269,9	(as of 06/30/2008)	3 979,7	16,4	Expansion (28%) LBO (26%) MBO (14%)	Industrial/Energy (15%) Consumer Related (14%) Medical/Health (13%)	UK (43%) Germany (10%) Spain (7%)
Advent International	10 000,0	(as of 03/31/2007)	1 331,3	15,0	LBO (49%) Expansion (20%) Later Stage (6%)	Consumer Related (24%) Financial Services (20%) Medical/Health (8%)	US (51%) UK (10%) Brazil (7%)
Altor Equity Partners	834,0	(as of 06/30/2006)	858,2	31,8	LBO (100%)	Manufacturing (42%) Medical/Health (28%) Computer Hardware (10%)	Sweden (55%) Denmark (22%) US (10%)
Apax Partners	35 000,0	(as of 03/31/2008)	9 238,8	68,9	LBO (59%) Expansion (10%) Pending Acquisition (9%)	Consumer Related (28%) Manufacturing (12%) Internet Specific (11%)	US (29%) UK (26%) Canada (22%)
Apollo Global Management	41 596,9	(estimated)	4 613,6	153,8	LBO (70%) Acquisition for Expansion (10%) Open Market Purchase (7%)	Consumer Related (30%) Industrial/Energy (27%) Manufacturing (12%)	US (99%) Switzerland (1%) India (.3%)
Bain Capital	27 000,0	(as of 12/05/2006)	5 240,5	79,4	LBO (77%) Acquisition for Expansion (6%) Secondary Buyout (5%)	Consumer Related (34%) Business Services (12%) Medical/Health (10%)	US (81%) Canada (11%) Japan (4%)
Bridgepoint	8 000,0	(as of 07/27/2007)	144,0	4,0	LBO (77%) Expansion (8%) MBO (8%)	Consumer Related (28%) Manufacturing (14%) Industrial/Energy (13%)	UK (69%) Germany (8%) Italy (6%)
Candover	13 017,4	(as of 03/31/2009)	3 100,2	134,8	MBO (31%) LBO (25%) Acquisition (18%)	Consumer Related (32%) Manufacturing (14%) Transportation (12%)	UK (38%) Spain (11%) France (11%)
Cerberus Capital Management	7 000,0	(as of 12/01/2001)	2 161,7	72,1	LBO (84%) Acquisition (10%) Acquisition for Expansion (3%)	Transportation (75%) Consumer Related (10%) Financial Services (8%)	US (76%) Canada (9%) Japan (8%)
Charterhouse Capital	15 685,6	(as of 09/30/2009)	21,8	1,2	LBO (40%) MBO (28%) Expansion (22%)	Consumer Related (55%) Business Services (33%) Semiconductor/Electronics (6%)	France (52%) UK (38%) US (10%)
Cinven	8 771,4	(as of 03/31/2009)	1 916,2	95,8	LBO (61%) MBO (15%) Secondary Buyout (11%)	Consumer Related (41%) Industrial/Energy (17%) Manufacturing (15%)	UK (53%) Netherlands (21%) US (12%)
Clayton Dubilier & Rice	5 098,0	(as of 06/30/2001)	3 153,8	262,8	LBO (72%) PIPE (12%) Recap or Turnaround (10%)	Transportation (23%) Medical/Health (18%) Consumer Related (15%)	US (85%) Germany (8%) UK (5%)
CVC Capital Partners	40 144,4	(as of 03/31/2009)	6 683,1	196,6	LBO (46%) Acquisition (24%) Secondary Buyout (13%)	Consumer Related (32%) Other (31%) Transportation (8%)	Germany (29%) US (25%) Netherlands (14%)
Goldman Sachs & Co	23 620,8	(as of 03/31/2003)	3 573,4	20,7	LBO (36%) Expansion (23%) VC Partnership (8%)	Financial Services (23%) Communications (16%) Internet Specific (12%)	US (55%) Canada (11%) South Korea (6%)

Name of firm	Capital under management ($ mil)		Sum of inv. in current portfolio ($ mil)	Avg inv. per company ($ mil)	Stage breakdown (% of all investments)	Industry breakdown (% of all investments)	Geographical breakdown (% of all investments)
Hellman & Friedman	8 000,0	(as of 12/31/2004)	922,8	40,1	LBO (36%) Acquisition (22%) Acquisition for Expansion (14%)	Computer Software (23%) Business Services (17%) Financial Services (14%)	US (72%) Germany (13%) Bermuda (10%)
Kohlberg Kravis Roberts	27 000,0	(as of 12/05/2006)	5 603,0	109,9	LBO (90%) Acquisition (2%) Expansion (2%)	Consumer Related (39%) Construction (15%) Computer Software (10%)	US (88%) France (5%) Canada (3%)
Lion Capital	5 529,2	(estimated)	386,3	27,6	LBO (83%) PIPE (13%) Acquisition for Expansion (2%)	Consumer Related (69%) Business Services (15%) Internet Specific (13%)	UK (49%) Belgium (31%) France (12%)
Nordic Capital	4 751,7	(as of 12/31/2006)	592,1	26,9	LBO (64%) Recap or Turnarounf (20%) MBO (11%)	Medical/Health (43%) Industrial/Energy (25%) Biotechnology (9%)	Sweden (54%) Norway (28%) Switzerland (9%)
Oaktree Capital Management	40 281,0	(as of 05/02/2007)	233,1	9,7	LBO (41%) PIPE (24%) Expansion (13%)	Consumer Related (16%) Utilities (15%) Internet Specific (14%)	US (84%) Japan (7%) Canada (2%)
PAI Partners	15 843,9	(estimated)	306,3	21,9	LBO (80%) Expansion (10%) Other Acquisition (5%)	Consumer Related (49%) Utilities (15%) Biotechnology (11%)	France (81%) Spain (8%) Canada (3%)
Permira	12 000,0	(as of 09/21/2006)	4 789,6	145,1	LBO (59%) PIPE (13%) Acquisition for Expansion (12%)	Financial Services (23%) Industrial/Energy (20%) Medical/Health (18%)	Japan (17%) UK (15%) Hong Kong (13%)
Silver Lake	5 900,0	(as of 12/05/2006)	987,1	61,7	LBO (76%) Expansion (11%) PIPE (7%)	Computer Software (37%) Computer Hardware (28%) Internet Specific (16%)	US (83%) Luxembourg (17%)
Sun Capital Partners	700,0	(as of 01/21/2004)	612,5	8,3	LBO (95%) Other (2%) Acquisition for Expansion (1%)	Consumer Related (60%) Industrial/Energy (39%) Other (1%)	US (99.7%) Canada (.2%) Japan (.1%)
Terra Firma	4 179,7	(as of 03/31/2009)	4 171,1	521,4	LBO (67%) Acquisition for Expansion (22%) Recap or Turnaround (11%)	Transportation (77%) Consumer Related (18%) Agriculture/Forestry/Fishing (3%)	Ireland (77%) UK (20%) Australia (3%)
The Blackstone Group	68 787,4	(estimated)	13 837,3	182,1	LBO (61%) Secondary Buyout (14%) Acquisition for Expansion (11%)	Consumer Related (35%) Transportation (18%) Industrial/Energy (9%)	US (72%) UK (11%) Germany (8%)
The Carlyle Group	91 521,0	(as of 09/30/2008)	28 383,6	112,2	LBO (74%) Secondary Buyout (5%) Acquisition for Expansion (5%)	Transportation (19%) Medical/Health (19%) Industrial/Energy (16%)	US (73%) France (4%) China (3%)
TPG	30 000,0	(as of 07/26/2007)	2 522,1	61,5	LBO (47%) Pending Acquisition (16%) Acquisition for Expansion (12%)	Industrial/Energy (32%) Medical/Health (15%) Consumer Related (10%)	US (79%) Russia (9%) Bermuda (4%)
Warburg Pincus	10 000,0	(as of 12/05/2006)	14 491,8	87,3	PIPE (21%) Expansion (20%) Acquisition for Expansion (18%)	Industrial/Energy (20%) Medical/Health (11%) Communications (11%)	US (61%) UK (8%) India (5%)

Source: Thomson Reuters

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