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CORPORATE FINANCE

What private-equity strategy planners can teach public companies

Successful PE firms model practices that would benefit any multibusiness enterprise—as well as some that break the public-company mold.

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In many respects, successful private-equity (PE) firms seem to defy economic logic. They acquire most of their businesses through some form of auction, where competitive bidding drives prices above what other potential buyers are willing to pay. Because they manage portfolios of discrete businesses, their acquisitions rarely reap substantial synergies. Their ability to survive, let alone thrive, depends on sustaining returns that attract limited partners to reinvest every few years. And unlike traditionally organized public companies, PE firms can't underperform for very long, because their track records directly affect their ability to tap into capital markets.

Yet a number of prominent private-equity firms have succeeded for decades, earning healthy returns for investors and founders alike. So it's not surprising that some public-company managers would look in that direction for new models to address their own myriad challenges—around aspects of governance, operations, and active ownership, among other things.¹ The way private-equity firms manage strategic planning, for example, offers lessons that might help public companies adapt to an environment marked by heightened shareholder pressure for performance and a fast-paced business cycle.

In our experience, successful private-equity firms excel at some practices that public companies should—but often don't. These include detaching themselves from the tyranny of quarterly-earnings guidance, deploying highly disciplined business-unit strategies, and developing a competitive advantage in M&A. We believe many public companies would benefit from applying a private equity–like approach more aggressively in these areas, even by going to lengths that might seem unorthodox.

Don't be tyrannized by the short term

Private equity's most powerful advantage may simply be that it is private. These firms can restructure and invest for the future while avoiding the glare of quarterly analysts' calls and the business media. They can also communicate more intimately with a much smaller investment community, so they don't broadcast their strategies and growth advantages to competitors. Our research shows that public-company managers can also gain shareholder support for long-term programs by communicating convincingly and making the right progress metrics clear to the investment community.

In the first 100 days after an acquisition, some successful PE firms explicitly collaborate with the new portfolio company during an intensive planning process. Over this period, management and the board develop a five- to seven-year plan, agreeing on new markets, channels, or products; assessing the capital needed to execute these initiatives; and developing an explicit set of new metrics and corresponding management incentives. In addition, they identify tactical near-term moves to build positive momentum from the deal's most readily apparent benefits.

Such efforts require a highly disciplined, rigorous emphasis on metrics that reflect longer-term

value, like cash flow, rather than short-term ones, like earnings per share (EPS). Many private-equity firms separate the financing of a business from its operating performance, which they get management teams to focus on by using cash flow–based measures, such as earnings before interest, taxes, depreciation, and amortization (EBITDA) and free cash flow. EPS reflects nonoperating factors (such as interest and tax expenses) that rely on a deal's structure, but EBITDA depends more on operating performance. Free cash flow also takes into account the capital expenditures and additional working capital required to generate profits; EPS does not.

During the 100-day planning process, private-equity firms are more active than public companies in considering the furthest horizons of strategic planning. Public companies often focus on nearer-term objectives, including existing baseline products and emerging product lines, though longer-term bets can help to create significant longer-term value. Typically, private-equity firms more actively identify and emphasize strategic planning's third horizon—including new markets and products—and diligently make tactical bets on it. For example, when PE firm Clayton Dubilier & Rice (CD&R) acquired PharMEDium for \$900 million, in 2014, it hadn't previously invested in out-patient care. But managers identified this as a major growth opportunity and made a calculated bet that paid off handsomely. CD&R ultimately sold the business for \$2.6 billion.

Public companies could emulate much of this. Quarterly earnings can't be ignored, but long-term shareholder value depends heavily on the generation of free cash and on the third horizon of future growth trajectories. Public companies should also explore the intensive 100-day planning process PE firms put in place after acquisitions, whether every other year or after the transition to a new leadership team.

Private-equity firms develop, monitor, and act upon performance metrics built around an investment thesis.

Create disciplined business-unit strategies

A multibusiness company is the sum of its parts: if strategies for the underlying units aren't focused and robust, neither will the overall picture. Success requires picking winners and backing them fully—something that often eludes public companies looking for the next new thing. Indeed, most of them pass only three out of ten tests of business-unit strategy.² Although financial theory suggests that capital should always be available for attractive investments, public companies that are constrained, for example, by their EPS commitments to Wall Street or by planned dividends often face intense competition for internal resources. Too often, they spread those resources thinly across business units. The right strategy means little if it isn't fully resourced.

Private-equity firms don't plan strategy around business units, but their investment theses for portfolio companies amount to the same thing. They're a plan for investing across a portfolio of businesses, basing the allocation of capital on ROIC relative to risk, and explicit plans for creating incremental value in each business. PE firms do focus less than public ones on the strategic fit of companies in their portfolios—a tech company in a portfolio of heavy-industry businesses wouldn't be a concern because they're managed separately. But the portfolio-management objectives and disciplines ought to be similar. Both public companies and PE firms should evaluate a similar set of expansion options to assess market context, potential returns, and potential risks.

PE firms develop, monitor, and act upon performance metrics built around an investment thesis. That's in sharp contrast with the one-size-fits-all metrics public companies often use to evaluate diverse business units—an approach that overlooks differences among them resulting from their position in the investment cycle, their prospective roles in the overall portfolio, and the different market and competitive contexts in which they operate. Although tailoring metrics to reflect these differences is hard work, it gives corporate management a much clearer picture of each unit's progress.

Public companies could go further. Unlike PE firms, for example, they traditionally manage the balance sheets of a business unit against the needs of the enterprise as a whole. But should they always do so? Instead of divesting a slow-growing but cash-generating legacy business unit, should they have it issue its own nonrecourse debt? This would save the tax and transaction costs of divestiture, and potentially preserve additional upside. Would it make sense to bring outside capital into a high-risk emerging business unit—as Google X (now known as X) did for some of its nascent healthcare ventures? This approach would help investors to see the long-term value of such units, which would be more directly exposed to the discipline of the capital markets.

In addition, public companies could emulate the governance of private-equity firms at the business-unit level, where each portfolio company has its own board of directors. These boards are generally

controlled at the firm level, but they are often supplemented by knowledgeable and senior outsiders with a meaningful equity stake. Since board activities focus on only one business unit, they can effectively surface, grasp, and debate the critical strategic, organizational, and operational issues it faces. While creating true governance boards for business units isn't a realistic option for a public company, nothing prevents it from appointing advisory boards, with incentives based on the creation of value at the specific business units they oversee. In fact, freedom from formal governance responsibilities may make such boards more effective, allowing them to spend significant amounts of time on strategy and on developing management.

Finally, public companies could do more to compensate business-unit managers based on their own results. Compensation for private-equity fund managers typically reflects the results of the fund as a whole, but the pay of management teams at portfolio companies strictly reflects their own company's value creation. This means that portfolio company executives in a lagging business can't hope to be carried along by strong results at the fund level. It also means that executives in high-performing portfolio companies won't be affected by the poor performance of entities over which they have no influence. This is a powerful motivator in both directions.

Could it make sense, for example, for multibusiness public companies to link incentive compensation for business-unit managers not to traditional stock options but rather to "phantom" stocks³ that reflect changes in the intrinsic value of their business units? That would be counterproductive where businesses are highly interdependent, but in many cases at least some parts of a company operate more independently. And such an approach could generate the kind of entrepreneurial focus

on value that private-equity firms get from the management teams of their portfolio companies. In the 1980s, Genzyme, for example, pioneered many tracking stocks for specific business units, and John Malone used them recently for those of conglomerate Liberty Media.

Develop M&A capabilities as a competitive advantage

Among public, nonbanking companies, those that routinely acquire and integrate clearly outperform their peers.⁴ That fact should make unearthing, closing, and extracting value from attractive acquisitions a functional skill—like the effectiveness of the sales force, manufacturing, or R&D. Many public companies don't treat it that way, but the best private-equity firms do, building and institutionalizing M&A skills as a competitive advantage.

Public companies that do behave like successful PE firms engage in M&A around a handful of explicit themes, supported by both organic and acquired assets to meet specific objectives. Achieving this competitive advantage calls for proactively identifying attractive strategic targets, often outside banker-led deal processes. It calls for managing a reputation as a bold, focused acquirer that can offer real mentorship and distinctive capabilities. And it calls for effective commercial and financial diligence based on the detailed information available to acquirers after signing letters of intent. Other requirements include reassessing synergy targets, adjusting them as appropriate to provide a margin of safety, and being highly disciplined about the price paid for acquisitions, to ensure accretion.⁵ Most public companies seek to develop these skills, but many don't dedicate enough time or resources.

Making M&A a competitive advantage isn't limited to acquiring. Private-equity firms, like the most

capable M&A teams at public companies, recognize that they are not permanently the best owners of particular assets. In fact, as empirical research finds, the largest 1,000 global companies that actively acquire and divest generate shareholder returns as much as 1.5 to 4.7 percentage points higher than those of companies focused primarily on acquisitions.⁶ These high performers not only seek the best owner for an asset when the time is right but also actively manage their portfolio companies to make them an even more compelling fit with identified prospective buyers.

Public companies could adopt still more of a private-equity mind-set—for example, identifying and capitalizing more on the flexibility of options-based investing. Owning a portfolio company creates a plethora of options for PE firms. In addition to selling at a time of their own choosing, they can refinance, pay a special dividend, spin out or sell part of a company, or make bolt-on acquisitions. Private-equity firms identify these options and remain open to (and act on) them when appropriate. A traditional public company could encourage this mind-set through its annual strategic-planning process.



These strategic-planning principles are easier to articulate than to execute. Evolving their application to changing conditions is even more of a challenge. Yet private-equity firms that have sustained their success over decades built their businesses by both executing and evolving. Although public companies may find these principles provocative or even foreign, they may offer valuable lessons in how to boost performance in an environment of fast-paced change. ■

¹ See Viral Acharya, Conor Kehoe, and Michael Reyner, “The voice of experience: Public versus private equity,” December 2008, McKinsey.com; Andrew Mullin and Alex Panas, “Private-equity operations: Inside the black box,” December 2014, McKinsey.com; and Andreas Beroutsos, Andrew Freeman, and Conor F. Kehoe, “What public companies can learn from private equity,” January 2007, McKinsey.com.

² Chris Bradley, Martin Hirt, and Sven Smit, “Have you tested your strategy lately?,” *McKinsey Quarterly*, January 2011, McKinsey.com.

³ Phantom stock is a form of compensation in which a company agrees to compensate employees in proportion to the market value of an equivalent number of shares in that company’s actual stock.

⁴ Werner Rehm, Robert Uhlman, and Andy West, “Taking a longer-term look at M&A value creation,” January 2012, McKinsey.com.

⁵ Cristina Ferrer, Robert Uhlman, and Andy West, “M&A as competitive advantage,” August 2013, McKinsey.com.

⁶ Sean O’Connell, Michael Park, and Jannick Thomsen, “Divestitures: How to invest for success,” August 2015, McKinsey.com.

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