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Private Equity Practice

From pure investor to entrepreneurial owner: How private-equity firms can master the shift

To take their investments from good to great, PE firms need to act more like entrepreneurs: totally engaged and willing to take risks to create value.

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September 2019

Historically, in a buoyant economic environment with ever-growing multiples, active management hasn't always been required for private-equity (PE) firms to make healthy returns. Today, the economic underpinnings of PE deals have changed. There is a palpable sense in the market that deal prices have likely reached their peak. As competition intensifies, secondary and tertiary buyouts have become the norm and value creation for PE investors is less straightforward than it once was.

While for more than a decade PE experts have extoled the virtues of active management, few investors have made strides in building the mind-set or the muscle needed to actively manage their assets. What explains the discrepancy between PE firms' acknowledgement that active management is essential and the fact that so few seem committed to doing it? It might simply be that the industry has essentially been successfully applying the same investment processes for decades and change is hard. It could also stem from the fact that they're unsure of the key roles—both on their assets' management teams and in their own organizations—that will create value. And not enough portfolio companies or PE firms have people with the right backgrounds and skills in those roles.

To create real value, high-performing firms must essentially become more entrepreneurial—that is, they need to take initiative, shape strategy, be willing to assume risks with the promise of bigger rewards, and take the long view on creating value. High-performing firms play an active role in the transformation journey of their assets. They also demonstrate that value-generating activities are not just onetime exercises but part of a larger commitment to improving a company's health and effecting a real transformation. In addition, PE firms that successfully take their investments from good to great also transform themselves by ensuring that the right skills and structures are in place within their own organizations.

Are many PE firms actively involved in creating value?

To gauge the prevalence of an entrepreneurial approach in PE, we analyzed the results of the McKinsey 2018 Private Equity Operating Group Benchmarking Survey, where 45 operating partners across a range of countries described how they support their firms' investment strategies and create alpha in their portfolios. The survey results do support a strategic shift toward active management. The time spent on "driving measurable performance improvement" increased to 49 percent from 40 percent in 2015. In return, the time spent on "monitoring and reporting" decreased to 19 percent from 29 percent.[1]

We found that 59 percent of respondents claim that their PE firm has a well-defined model for value creation. Of those firms, 75 percent (up from 50 percent in 2015) report that the value-creation model is being consistently used across their portfolios.[2] These findings support an emphasis on taking more initiative (exhibit).

However, in our experience, few PE firms are "active performance partners," working closely with management to rapidly and sustainably create value. Rather, most firms collaborate in a less rigorous manner. In fact, nine of 20 operating partners interviewed for a recent McKinsey study reported that they only intervene with management if there is deviation from the value-creation plan for at least three consecutive quarters.

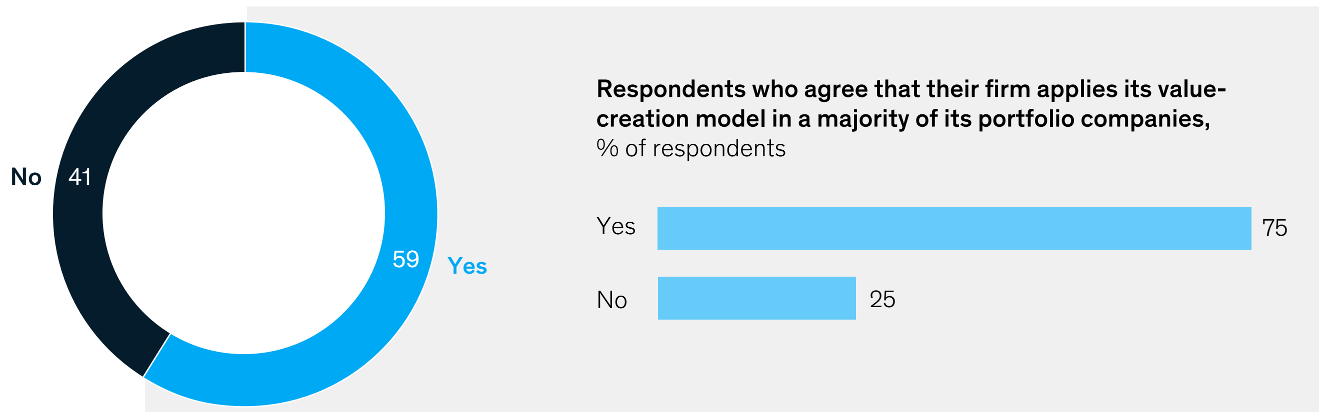
We have seen the most successful PE firms build trust-based relationships with their assets' management teams from the start. They work together with management teams to cocreate a comprehensive and detailed operational plan and, even before closing the acquisition, set priorities for improvements that support both a transformation and exit plan. Then they allocate adequate resources throughout the holding period to deliver real value and continuously work together with management teams.

[1] For more on the survey, see Jason Phillips and Dhruv Vatsal, "Private equity groups and the pursuit of 'portfolio alpha,'" November 2018, McKinsey.com.
[2] Phillips and Vatsal, "Private equity groups and the pursuit of 'portfolio alpha,'" November 2018.

Exhibit

More than half of PE firms have a well-defined model for creating value, though they may not apply it consistently.

Does your firm have a well-defined model for creating value in portfolio companies?
% of respondents



Source: Jason Phillips and Dhruv Vatsal, "Private equity operating groups and the pursuit of 'portfolio alpha,'" November 2018, McKinsey.com

Creating value: An entrepreneurial approach

Of course, investors need to concern themselves with the day-to-day-business of their assets. Occasionally firms will acquire assets that are in obvious and desperate need of transformation. But in our experience, even in cases where assets are performing well, it is crucially important for PE investors to have a transformational mind-set from the start. Those who take ownership and think like entrepreneurs are much more likely to create real value. In addition to installing a transformation function to head the change,[3] our work shows three key factors that support successful value creation in PE-owned assets.

Creating early trust-based relationships with the asset's management

For a PE firm to be prepared for fast course changes, it pays off to invest in understanding the asset's operations and its management team early on. In our experience, rapid decision making and execution are closely linked to the level of trust among key stakeholders in an organization. Therefore, creating strong, trust-based relationships is critical for successful value creation.

This trust is typically achieved when investors become considerably more involved and learn all that they can about their potential new assets. For example, the head of operations of one European-based fund accompanied their deal team to visit all seven of an asset's production sites, including those overseas, prior to closing a deal. They brought along experts on equipment effectiveness and lean manufacturing, among others, to advise them on the details of all the processes and fuel a meaningful conversation with management about operational improvements in production.

At this stage of the process, such a hands-on approach requires more resources than what have

[3] For more, see Olivier Gorter, Richard Hudson, and Jesse Scott, "The role of the chief transformation officer," November 2016, McKinsey.com.

been typically allocated in the past. While many PE firms are willing to invest in upgrading the digital capabilities of their assets, they might balk at heightened resource requirements in other areas, particularly those related to HR such as talent, change management, and organizational health. In our experience, however, we have found these to be worthy investments.

Another way to foster trust with a management team is to ensure clear alignment on the cornerstones of the asset's strategy, priorities, and timing—even when everyone doesn't see eye-to-eye. Take the case of one PE firm that invested in an automotive supplier of components for light vehicles and heavy trucks. The ambitious growth plan of the management team required large investments into the company's asset base. While both the PE investor and management were in full agreement on that growth plan, the investor had a different view of how to create the most value for shareholders: separating the light vehicle and heavy truck businesses to give both divisions a clearer strategic profile.

At first, the management team resisted the idea of separating the business. Through an early alignment on corporate strategy and full underwriting of an extensive capital-expenditure plan, both sides built a trusted relationship. All along, however, the investor persisted in expressing the notion that a separation of the business should be considered later. After two years of working together extensively, the management team had fully bought into the separation, executed on it flawlessly, and sold the heavy truck components business to a strategic buyer that operated only in that market segment. The light vehicle business continued to grow on the back of its investment program and was sold two years later to a Chinese investor.

Establishing a comprehensive and granular operational plan that leads toward the targeted exit

Alignment with an asset's management team is also critical when it comes to exit planning. It is paramount for management and PE owners to jointly formulate future plans that are designed with the exit scenario and the required timeline in mind.

The most successful plans share two common characteristics. First, they are fully comprehensive: our experience suggests that, regardless of the circumstances, real transformation happens only when a leadership team embraces the idea of comprehensive change in how the business operates—tackling all the factors that create value for an organization, including top line, bottom line, capital expenditures, and working capital, as well as the business model and the overall strategy. Second, they are granular: detailed milestones, rigorous meeting cadence, and clear responsibilities enable tight management of the progress and drive execution.

A telecommunications company in the United Kingdom, for example, undertook a thorough back-office benchmarking exercise and identified cost-reduction opportunities—its savings plans were included in their general and administrative expense targets. But a couple of months in, they were not making any progress. The chief transformation officer determined the reasons why: the initiatives were too high level, with insufficient information on approach, timeline, milestones, and underlying key performance indicators to be addressed. For example, most initiatives—such as "Reduce headcount by 10 percent"—were focused only on output, with no further detail on how that should be achieved.

The potential was thoroughly quantified but the initiative was simply not actionable. Rather, the analysis should have been coupled with tangible changes such as new processes or automation tools that would free up the targeted headcount and deliver the full potential.

Remembering that the standard rules of transformation apply

Of course, best practices for organizational transformation also apply to PE firms looking to transform their portfolio companies and are often even more important in the PE context. Unlike strategic investors, PE firms have holding periods of between four and seven years and a shorter time frame to materialize an ambitious, full-potential plan. Hence, PE firms must rely on well-proven and fast transformational practices to beat the odds of

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successful transformation that McKinsey research estimates at only 26 percent.[4]

PE teams need to think about value drivers in waves. They must consider the right timing for implementation and when they need to show evidence for an EBITDA-uplift (which may be considerably later than the implementation, particularly for digitization initiatives). Certain tools, while promising, may eventually be deferred into the holding period of the next owner.

Moreover, as with any transformation, organizational health and talent are key.[5] McKinsey research shows that organizations with top-quartile health achieve 3.0 times higher returns compared with those in the bottom quartile and that health programs can result in tangible performance gains after as little as six months.[6] Talent is equally important for performance. McKinsey research shows that organizations that align talent with their value agenda are more than 2.0 times more likely to outperform their peers and achieve 2.5 times the ROI in their first year.[7]

PE investor, become an entrepreneurial owner

Some PE firms have indeed experienced success in applying this more hands-on, entrepreneurial attitude to their portfolio companies. But those firms that sustain their ability to create value by leading their portfolio companies through transformations repeatedly and consistently share three key traits: these firms have the right resources in place to truly be active, entrepreneurial owners. They focus on securing the right skills for the job, which include deep financial acumen and operational and change-management skills. And lastly, they set up internal structures to facilitate value creation. Primarily, this involves ensuring that the deal team and the operating partners work well together from the early stages of the investment.

Allocate enough resources to create value

When value creation becomes a material part of a firms' investment thesis, additional in-house resources are necessary to drive operational improvements. Back when multiples were lower, investment professionals used to be deeply involved

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[4] For more, see "The T-word," *McKinsey Quarterly Five Fifty*, McKinsey.com.

[5] Organizational health is broadly defined as a group's ability to agree on and achieve strategic goals. For more, see Lili Duan, Rajesh Krishnan, and Brooke Weddle, "The yin and yang of organizational health," *McKinsey Quarterly*, November 2017, McKinsey.com.

[6] For more, see Chris Gagnon, Elizabeth John, and Rob Theunissen, "Organizational health: A fast track to performance improvement," *McKinsey Quarterly,* September 2017, McKinsey.com.

[7] For more, see "Winning with your talent-management strategy," August 2018, McKinsey.com and Mike Barriere, Miriam Owens, and Sarah Pobereskin, "Linking talent to value," *McKinsey Quarterly*, April 2018, McKinsey.com.

only in the three to 12 months leading up to a deal closing, and again shortly before the exit. But entrepreneurial owners need to allocate resources throughout the entire holding period.

For example, a midmarket fund acquired an Italy-based IT systems integrator. Before the acquisition, the Italian company had already conducted multiple acquisitions and established a process that integrated one company after the other over the course of several months. The fund's plans for the company involved ambitious growth through a buy-and-build strategy, a plan that the management team could not fully execute with existing resources. So, to complement its strategy and management skill set, six months after acquiring the base company the fund hired a team to serve a new function: postmerger integration and corporate development. This team consisted of a postmerger integration expert and other dedicated resources with a background in M&A and postmerger management consulting. The team spent the first months getting up to speed on the situation and existing integration strategy before defining a new strategy that prioritized generating the highest-value synergies—all while maintaining the business momentum.

From the pre-acquisition phase until the integration was complete, the team was deeply involved in assessing every potential new acquisition. Within a short time, they acquired and successfully integrated 12 companies, doubling revenues to almost €500 million from 2017 to 2019. The team sees the clear potential to double revenues again to €1 billion by 2022. During this time frame the company also expects to generate EBITDA synergies of €15 million or 3 percent of combined sales by systematically integrating processes and product portfolios of the acquisitions and realizing economies of scale. Since the arrival of the new manager and his postmerger integration team, the company has developed the ability to integrate several acquisitions in parallel and at a much faster pace than before. By dedicating resources to a new role and filling it with the right expertise, the company effectively became a well-oiled integration machine.

Secure the right skills for the job

While investment professionals need to be equipped with deep financial acumen, a focus on value creation also requires a more diverse set of operational and change-management skills. PE firms might consider hiring people from more diverse professional backgrounds. COOs of their assets' competitors, industry advisers, and company founders, for example, might all have more valuable hands-on experience than the usual hiring targets for PE firms.

Also, it is essential for those PE professionals who are driving the value-creation program to have strong interpersonal skills. Specifically, they need the ability to influence others both to have an impact on portfolio companies and to convince the right people to join the assets in the first place. Particularly when PE professionals tend to be ten to 20 years younger than those on the management teams of portfolio companies, it is critical that they take the time to understand and be empathetic, respectful, and thoughtful about how to build good working relationships.

Ensure that internal structures facilitate value creation

In our work, we have seen two distinct models that allow PE firms to focus more strongly on value creation. The first is the extended deal team. Smaller firms tend to favor this model, where they hire professionals with financial expertise but also backgrounds in operational and strategic functions. This background allows them to assess potential acquisition targets, determine what resources are needed for the implementation, and then oversee that implementation.

The second is a model where the dedicated operating team takes on a more meaningful role after an acquisition is completed. Larger firms tend to favor this model, where a dedicated operating partner supports the deal phase, and a larger operating team fully takes over post-acquisition. The key is for this team to work closely with the company's management and take on a more active role in implementing value-creation initiatives.

More so than what model they choose, the degree of interaction among all those involved throughout the investment period is critical for creating value. In our experience, close collaboration between all PE professionals—from due diligence to exit—is key to executing a defined goal successfully. Specifically, conflicts tend to arise in models with a dedicated team of operating partners, due to different compensation models or strict distinctions of responsibilities across the different stages of the investment cycle. These potential conflicts need to be considered and actively managed. Close cooperation among fund managers and management teams from the early stages of a deal onward, coupled with harmonized incentive schemes, should help.

To some degree, PE professionals sense a change in the air. That change might not have arrived for all investors—some continue to cling to the old ways of focusing almost solely on finding deals, closing them, and then beginning their search for the next deal. But in the coming months, as multiples have likely reached their peak, those firms will indeed find it increasingly difficult to extract value from their investments. Investors who take an early lead on the path toward entrepreneurial ownership can boost their ROIs as well as their firm's reputation.

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