Private-equity operations: Inside the black box

Initiatives to accelerate growth are a priority; cost cutting is seen as a commodity skill.

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As private equity's focus has shifted in recent years from financial engineering to extracting value from operations, a gap has opened in the public understanding of how private firms operate their companies.[1] Many firms have established operating groups, but little is known about exactly how these groups function and how they add value to the operations. Accordingly, in late 2013, we surveyed 30 private-equity firms on three topics[2]:

- the size and composition of the operating group (the number of people, types of roles, and prior experience of team members)
- the scope and mandate of the group (for example, how many companies they interact with, at what stages of the deal cycle, and on what functional topics)
- the group's governance and practices (for instance, its roles in diligence, career progression, participation in investment committees, and compensation)

The survey shed some light on how these firms are managing their portfolios. One finding was that they are placing a strong focus on building revenues (exhibit). Today, operating partners at the firms we surveyed are pursuing initiatives in the service of three goals: to boost sales-force effectiveness, improve pricing, and implement "design to value" principles (whereby products and services are redesigned to enhance margin through either higher prices or lower product costs). In conjunction with these programs, firms we surveyed are also putting an emphasis on capability building; sales and pricing skills may not be as entrenched at their portfolio companies as firms would like. Cost reduction, which in the eyes of many is becoming a commodity skill, is less of a focus.

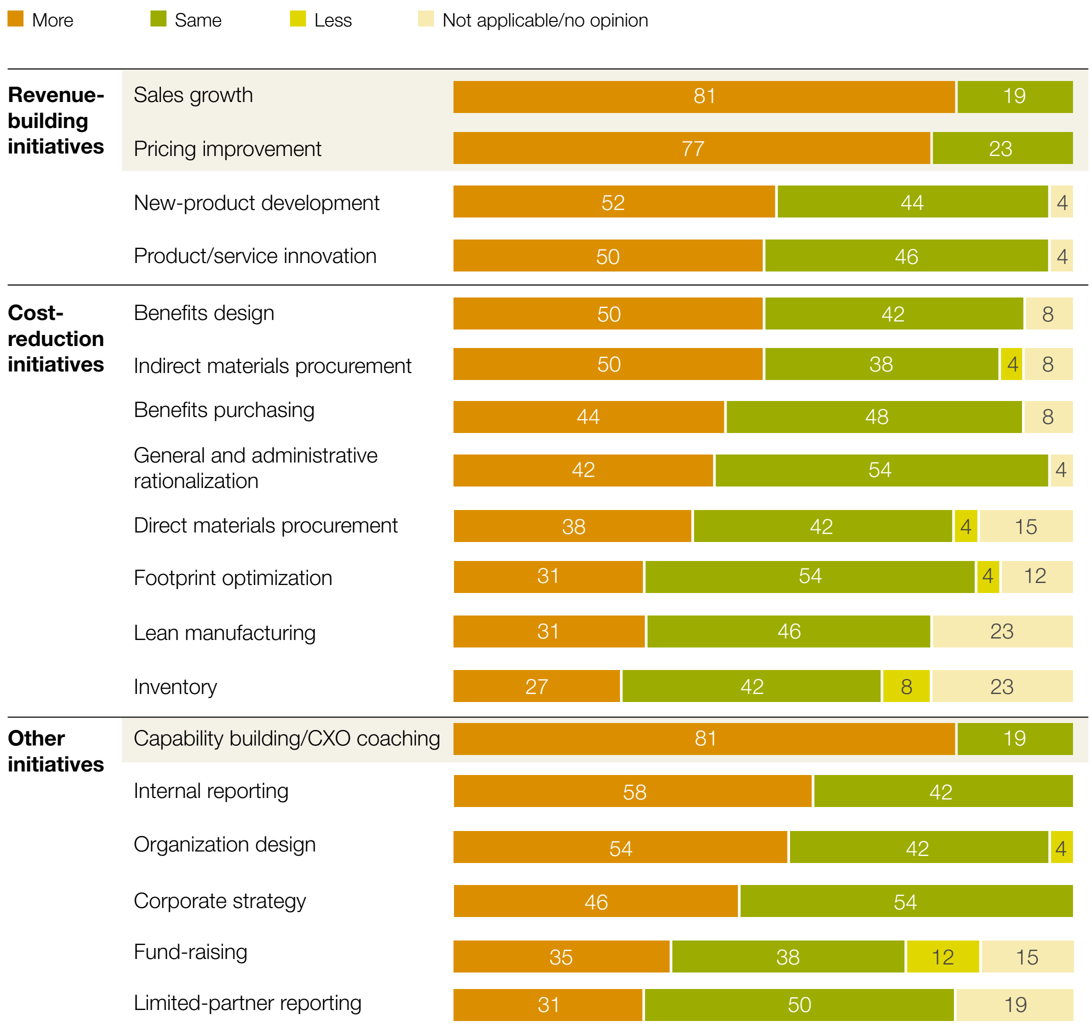
Three other findings also stood out.

The size of the operating group does not matter. Although the sample is not sufficient for statistical analysis, there appears to be no connection

Exhibit

Firms plan to pursue revenue-related initiatives and capability building.

Anticipated company effort over next 2–3 years, by initiative, % of respondents[1]



[1]The survey was in the field from Aug to Nov 2013 and included respondents from 30 private-equity firms. For most questions, 25 or 26 firms provided responses. Figures may not sum to 100%, because of rounding.

Source: McKinsey analysis

between the size of the firm and that of its operating group. In both small and large firms, it is most common for the operating group to include three or four people.

A 'set it and forget it' operating model is common.

At the firms we surveyed, managers spend a lot of time with their investments early in the process of acquiring them and assuming ownership. After the first 100 days, most of them fall back to monthly communications. One factor here might be resources. Operating groups tend to take on a broad range of responsibilities; we counted 25 discrete activities at one firm, and most have at least a dozen tasks. With a small team trying to accomplish a lot across many companies, the frequency and depth of interactions with any one of them is probably limited.

A standardized playbook is still elusive for some.

While some surveyed firms have managed to develop a standardized approach to most core processes across their portfolio companies, many others say they want to find ways to standardize even further. Most reported that their operating groups continue to rely on custom programs and metrics for each of the companies in their portfolio.

[1] McKinsey first visited this topic nearly a decade ago; see Joachim Heel and Conor Kehoe, "Why some private equity firms do better than others," *McKinsey Quarterly*, February 2005, mckinsey.com. In *Corporate Governance and Value Creation: Evidence from Private Equity*, 2008, stern.nyu.edu, Kehoe and coauthors found that general partners with an operational background generate significantly higher outperformance than those with other backgrounds, at least in certain deal types. For another perspective, see Coralie Hemptinne and Veronique Hoflack, *The value of in-house operations teams in private equity firms*, INSEAD, 2009, insead.edu.

[2] The survey was in the field from August 2013 to November 2013. Participating firms ranged from those with less than $1 billion under management to those with more than $70 billion and are based in all major regions of the world.

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