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How we did it: Implementing a private-equity strategic vision

A private-equity veteran describes his approach to strategy.

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Established organizations are mostly structured to do yesterday's work. To meet the changing needs of today's and tomorrow's customers, businesses must constantly reinvent their structure, human capital, processes, and technology.

In my experience, private-equity (PE) firms do this—and create value—by focusing on the medium and long term, as well as on the short term. Among the best of them, this emphasis on the classic three horizons of growth shows up in their vision, investment, governance, operations, talent, and capitalization. Over my career, I've worked to incorporate that basic mind-set into the culture at both Aetna and Clayton, Dubilier & Rice (CD&R). Here's how we did it.

Vision: Clearly articulate the five- to seven-year vision and plan for the company.

A successful long-term strategy requires historical or baseline products, emerging product lines, and future growth trajectories. Public companies often focus on the first two, but the third is the hardest—even though it often has the biggest impact on long-term value creation. Private-equity firms more actively explore this third horizon and are diligent about identifying and making tactical bets against it.

I served as chairman at PharMEDium, a leader in customized pharmacy sterile compounding, after it was acquired by CD&R. We identified it as a major growth opportunity, and after extensive due diligence, we developed an investment thesis. The thesis focused on enhancing penetration of current customers, launching new products, and ramping up to serve a new customer segment: the outpatient market. Our thesis was well executed by an excellent CEO in 2013. Our $900 million investment paid off to the tune of $2.6 billion when we sold it just two years later, much sooner than expected. Public companies could make similar decisions, but managers there are often hesitant to take the short-term hit to their earnings-per-share (EPS) ratio. That limits their long-term growth investments to things they can offset by cutting costs. The lesson here for public executives is to consider making a set of focused, tactical bets on the long term, and then clearly communicate the value story to the market.

We took a similar approach during my tenure as CEO of Aetna, where we made long-term vision and the innovation cycle a key focus for our management team. This was partly because of industry regulation, which required that we write down every new product we created and file it with public agencies. That eventually allowed competitors to launch copycat products, so we had to innovate constantly to stay ahead of our peers. As a result, we emphasized a three-year planning horizon, devoting significant management attention to "white space" brainstorming on the likely evolution of the industry and ways to leverage technology to create new services and capabilities. Aetna's market cap over the period grew to $15.3 billion, from $4.7 billion.

Investment: Determine the significant capital and operating investments required to achieve the vision, independent of impact on near-term earnings. Making substantial investments in growth over the long term can be hard for a public-company CEO. Given that the average tenure of a Fortune 500 CEO is under five years, the returns on long-term investments can easily accrue outside the EPS timeline as CEO.

Managers of PE-backed companies are much more likely to invest in change early, particularly within the first one or two years of acquiring a portfolio company, if it will increase earnings or change the trajectory of the business at the time of exit. The new expenses of PharMEDium's investment in the outpatient market did not have to be covered by cuts elsewhere, as they might have in an EPS environment. Instead, the board and management agreed on the costs and benefits of investment and were comfortable sacrificing short-term earnings to a tactical bet that it would drive long-term value.

Governance: Ensure alignment and cooperation in the strategic-planning process among the chairman, board, CEO, and executive team. Public boards tend to focus on key strategic and compliance questions, such as risk management, and often come from a range of industries and backgrounds. A private-equity board, by contrast, will usually be filled with a combination of private-equity professionals and experienced former executives from the industry in which the company operates. A board chair may meet with a CEO several times a week, offering counsel on how to achieve the strategic plan, helping to assess and sponsor growth opportunities, and supervising key operational challenges. This level of board involvement and relevant experience makes it easier to reach alignment on vision, horizons, and investments.

Envision Healthcare is one good example of this. Soon after CD&R acquired Envision in 2011, the board and I approved the rollout of an ambitious revenue-growth expansion plan. Under the implementation of CEO Bill Sanger, the company eventually almost doubled its revenue to $5.45 billion, from $2.90 billion. Because of this successful growth, CD&R took Envision public two years later, in 2013. Board alignment has allowed the expansion plan to continue, with CD&R

returning a fivefold multiple of capital on its investment.

Operational improvement: Assess restructuring needs with a fresh eye.

The quarterly timing of earnings that matters so much in a public company doesn't matter in private equity, as long as earnings at exit meet or exceed the original investment. As a result, PE-backed companies are much more willing to take a restructuring charge in the near term or to weather midterm earnings volatility. This, along with different approaches to governance, also allows PE-backed companies to recover more quickly than public companies during periods of distress.

Restructuring a company in the public market is still feasible if managers clearly articulate a plan and the pathway to long-term value, similar to private equity's approach. For example, at Aetna in 2002, Jack Rowe and I set out to transform the business and improve performance. Knowing that would take time, we made the decision to withdraw EPS guidance. This, we believed, would minimize distraction and focus the market on the turnaround story. I then did a listening tour with all of our customers to understand their preferences and unmet needs. Those conversations led to the most fundamental component of the restructuring: refocusing the business on all fronts—from product development to sales and finance—to serve customers vertically, by industry segment, rather than horizontally, by geography. This required a significant redesign and streamlining of the organization, as well as extensive value-chain analysis to break apart each segment and assess potential profit pools. It was also crucial to the long-term growth that followed, as Aetna focused on developing new products, services, and capabilities for each customer segment. In addition, it formed the basis of a compelling value-creation story for our investors.

Talent management and incentives: Tie management-performance incentives to long-term shareholder equity returns, focusing on value at exit rather than near-term liquidity.

Public companies often tie executive compensation to shares or options. Executives receive grants annually that vest at a given level of performance or length of time—usually a year. Not surprisingly, this can encourage a focus on near-term earnings.

In contrast, private equity typically ties executive compensation to a five- to seven-year view. The entire executive team and board receive the standard cash compensation, but their incentives have little connection to near-term liquidity. They do receive one-time equity grants at the outset of a deal, but must usually hold them for the duration of the holding of the company. That compensation structure enables them to focus on

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investing in and building toward value at the eventual sale or exit from a business. That, in turn, is a key element of private-equity success, because it encourages managers to act as owners, with a focus on cost efficiency, cash flow, and long-term value.

Public management teams should explore tying compensation to longer-term performance metrics and liquidity milestones. Aetna, for example, made several key changes to its compensation structure. First, the company created profit-and-loss statements for each of the end-to-end customer segments. Then it tied incentives not just to running the day-to-day business but also to a specific set of innovation metrics around expanding the products, services, and interactions with that customer segment.

Capitalization: Optimize the capital structure of the business, basing debt load on interest coverage and enterprise value rather than on EPS impact.
In contrast to the public market's focus on post-interest EPS and retaining an investment-grade credit rating, private-equity firms often choose to utilize more leverage. This gives them increased flexibility with respect to, for example, more earnings potential for acquisitions, without equity dilution.

In fact, as McKinsey research shows, almost a third of the value created by private equity comes from the appreciation of market or sector value, plus financial leverage independent of company outperformance. For instance, CD&R purchased Envision Healthcare in 2011 for $3.2 billion, with $915 million of equity. In addition to the company's significant operational outperformance, its use of leverage multiplied its equity return. Today, Envision Healthcare has an enterprise value of $6.7 billion, with $3.8 billion of equity. ■

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