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Plugging into private-equity practices

Applying Learnings From PEs To Limited-Liability Companies Can Create More Value Faster

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Private equity (PE) investments in the country this year have gained significant momentum, with a number of deals being struck across sectors. In the consumer and retail sectors alone, in the first nine months of 2010, about $600 million has been invested. This is a sharp increase from the $150 million invested in 2009 and $450 million invested in 2008.

Also, various PE firms — from the 275-odd PE firms in the country — have exited some of their investments over the last 3-6 months, with very attractive returns delivered to their investors as well as managements and entrepreneurs of the investee companies. Similarly, around the world over the last 15-20 years, leading PE firms have delivered very attractive returns. Some well-known examples of successful turnarounds and value growth include Burger King, Polaroid, Universal Studios and Ducati Motors.

As a result, PE activity in the country is being viewed with increasing interest, especially by entrepreneurial companies. This is not only when these companies are looking to raise capital for growth funding, but to also benefit from the sophisticated techniques PE firms apply with their investee companies to create significant value.

Some years ago, Roberto Mendoza, ex-vice-chairman of the board of JP Morgan, spoke about the PriPub model wherein public company boards can learn from PE models. Extending this further, our belief is that private- and public-limited companies (PLCs) can do to themselves what an external PE would do, without necessitating a divestment.

Most PE firms in the country have so far focused on providing growth capital, implementing more efficient capital structures and have then sat back to watch their investments grow. However, this is now changing, with PE firms playing a more involved role, and a number of them — including Blackstone, KKR, TPG, India Equity Partners and Samara Capital, amongst others — taking on board-operating partners. Five key areas that PE companies work on to create value in their investee companies — and can be adopted by PLCs — include:

Set clear value goals: The starting point is putting down clearly-defined value goals. This is important because, firstly, a number of organisations do not focus on the correct financial metric, i.e., value. Secondly, some organisations, especially public ones, focus on the short term (at worst, focus quarter by quarter or, at best, yearly). Many PE firms' approach to establishing performance goals involves four steps:

- Set aspiration versus peer set of companies (e.g., top 15% among top 20 industry peers).

- Determine shareholder performance goal (e.g., top 15% may require shareholder returns of 26% year-on-year).
- Derive value performance goal (e.g., double company's value every three years).
- Establish return on investment (RoI) and growth performance goals (e.g., RoI of 24%, up from 18%, with annual operational improvements). Translate these to executable metrics such as revenues, profit, asset turns, etc.

Ensure strategic focus on core competencies: Given many opportunities that entrepreneurs and companies see around them in the country today, focus on core competencies and the discipline to not chase every new opportunity that comes along is critical.

To start with, a detailed study of existing business and its units and functions will reveal the strategic fit of each with the overall capabilities and objectives of the company. Thereafter, a strategic assessment — Does each part of the business add to the whole? Do we have the right capabilities to manage it? — can help management focus on core competencies.

Improve operational excellence: This includes objective performance benchmarking of operations through an external and internal lens, differentiating between and identifying 'good' costs and 'bad' costs, stripping out bad costs, and applying the old adage 'what can be measured can be improved'.

Good costs are those that contribute to a profitable advantage. They may represent the cost of achieving a particular advantage relative to peers. They may also represent costs that do not contribute to advantage per se, but that are required to be competitive. Bad costs are those that can be eliminated without reducing profitable advantage or the ability to compete. These may represent money spent in unproductive areas. They may also represent inefficient ways of achieving an advantage. Cost reduction programmes that target a common percentage reduction across businesses or functions are rarely optimal; they need to be focused on the bad costs.

Implement a more efficient capital structure: A more efficient capital structure — typically, more debt — is a key element to a PE firm's strategy. Given the recent liquidity in capital markets, PLCs could leverage and deleverage themselves at lower cost and risk than before. However, more than ever, cash is king today! In today's context, it may be too risky and expensive to lever up, and so we leave this piece for a later discussion.

However, cash management continues to be the key. Singular focus on driving current cash-flow; even freeing up cash in property and intangible assets and applying a six-sigma mindset to every rupee you spend are the areas to focus on.

Align management and owner incentives: Creating the right reward plans for your management is essential for achieving business objectives, and balancing business priorities with owner and shareholder interests. This includes:

- Reorienting the management focus towards value creation, at all senior levels.
- Introducing value creation-based compensation, wherein employees also participate.
- Defining and implementing the compensation matrix across various management roles.

For a number of entrepreneurs in the country, a pertinent question is whether to divest and unlock value now, or stay embedded for the medium and long term, with the expectation that the business will create more value in future than being offered at present. Irrespective of the answer to this question, putting PE into PLC and adopting a private equity mindset can enable CEOs, managing directors and owners to create more value — not just market valuation — faster.