

"I say we should go with plan 'A', sir."

The new hands-on approach to building value in portfolio companies

# Private equity's road map to profits

by Chris Bierly, Graham Elton and Chul-Joon Park

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## The new hands-on approach to building value in portfolio companies

When Thomas H. Lee Partners, Bain Capital and Providence Equity Partners joined with Edgar Bronfman Jr. to acquire the Warner Music Group (WMG) from Time Warner in 2004, the \$2.6 billion buyout looked to some like a triumph of hubris over common sense. Even though WMG had a world-class roster of talent and a legendary catalog, the music business was in the doldrums. Digital piracy was rampant. Consolidation among traditional retailers was squeezing the music industry on one end of the business. Meanwhile, the cost of acquiring and marketing artists squeezed it on the other, as freewheeling competition among record labels had inflated the price of signing breakthrough acts. Against that background, the new owners seemed unlikely to recoup their initial investment, much less reap the high returns private equity deals are expected to generate.

But, within a little less than two years, the skeptics were whistling a different tune. The buyout partners had so transformed WMG, with dramatic increases in cash flow and earnings, that they were able to take the company public again. They paid down debt and, through cash dividends received in the first year, recouped 110% of their original stake. And they did all of this while keeping their equity position intact, so that as WMG's stock price climbed, their gains continued to grow. In fact, a little more than two years after the acquisition, the stock price rose to the point that the buyout firms' remaining stake in the company—combined with the money paid

out to the investor group as dividends—was worth more than three times their initial investment. How did they pull it off?

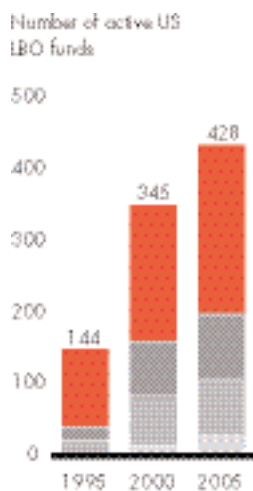
Collaborating closely with management, the new owners moved quickly to pick up the tempo at WMG. After taking inventory of WMG's most attractive markets and business segments, they developed a bold operational plan that challenged the conventional wisdom of the music industry. First, Bronfman (now the CEO) and his team pared down the roster of performers and pruned the product pipeline. They focused on promoting their established stars and new acts that had the greatest long-term potential. They also embraced the new world of digital distribution, making WMG's content more widely available online and on mobile devices. They created premium price digital albums, adding special bonus tracks to entice buyers to download new releases. In the process, Bronfman and his team of private equity backers did something more than turn WMG around. They established a new benchmark for how buyout funds must operate, as the private equity industry is gripped by a fundamental shift. It's a shift that provides lessons—and could have profound consequences—for managers of companies in nearly every corner of the economy.

### Activists needed

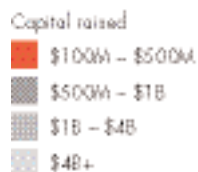
For years, buyout deals followed a familiar script. After months of digging to ferret out the target company's true value, the papers would be signed and the toasts drunk. And what happened next? The target's management would slip back into business as usual, and the new owners would hunker down until market conditions ripened for a sale. For better than a decade, this model was a money machine, outperforming the market indexes.

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Figure 1: More, bigger funds



Note: Active funds are those that have raised capital in the previous five years. Source: Baywin Newsletter, Bain LBO Fund database.



Today, that approach looks more like wishful thinking than a winning formula. Fed by a seemingly bottomless well of investors' money, the number and size of private equity firms have mushroomed. Between 2001 and 2005, more than 425 US-based firms had amassed nearly \$300 billion from limited partners, with multi-billion-dollar rounds of new funding becoming routine. (See Figure 1.)

To put that capital to work, firms are pursuing larger deals. In July 2006, for example, a consortium of private equity investors offered a record \$33 billion for HCA, the hospital chain—eclipsing the storied RJR Nabisco buyout by KKR that first put private equity in the public eye in 1989. In fact, private equity firms are assembling portfolios that make some of them the world's biggest conglomerates. Venerable brand-name companies, including Hertz, Celanese, Neiman-Marcus, Metro-Goldwyn-Mayer and General Motors Acceptance Corporation, have landed in private equity portfolios in the past two years.

But with so much capital to deploy, buyout firms find themselves pitted against one another in high-stakes auctions that drive up acquisition prices. Look at the business headlines and it's clear that almost all large deals involve private equity firms competing against each other or trade buyers.

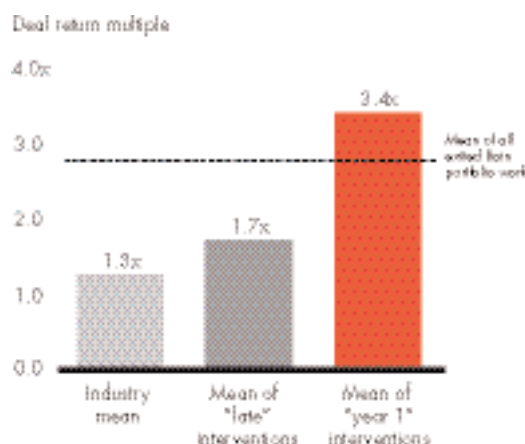
The new masters of the universe will soon confront other new challenges. With interest rates low and abundant credit available for borrowers, the debt markets have been exceptionally benign in recent years. But even with the wind at their backs, buyout firms generated returns exceeding three times their original investment—a common benchmark for success—on just over one-third of all deals. Forty percent failed to return their acquisition cost.

It's going to be a lot tougher going forward as credit markets turn less favorable and

private equity funds will no longer be able to rely on the magic of leverage to deliver outsized gains. For example, a hypothetical investment made under prevailing conditions in 2000 and sold in 2005 would have turned in a smart three times its original cost. But as lending conditions tighten and borrowing costs rise, exit multiples are likely to tumble such that a similar acquisition made at today's high costs would barely return its original investment.

To succeed in this new environment, private equity funds need a radically different formula. They must replace passive stewardship with a hands-on approach to building value in their portfolio companies. Shifting gears immediately once a deal is completed, the new activist funds follow a five-step process for spotting, staging, leading, measuring and profiting from breakthrough operational improvements. Our experience shows that deal makers who in the first year actively plan and launch initiatives this way outperform the industry average by a better than two-and-a-half-to-one margin, measured on cash returns. (See Figure 2.)

Figure 2: Early activism drives success



Note: Includes all exited deals supported (excl); analysis completed January 2006 with return data as of end2005; industry mean based on 1998-2002 funds. Source: Bain analysis.

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**Private equity's road map to profits****Flesh out the investment thesis**

Private equity investors do a better job than most acquirers in developing a clear understanding of how a potential target makes money and why they'd want to own it. But activist investors don't mistake an investment thesis for a detailed strategy. A thesis simply posits why there is an opportunity for a buyer to extract value from an acquisition. It doesn't identify operational priorities or draw a road map to accomplish them. And inevitably, as with any plan hammered out with incomplete information in an arm's length negotiation, the investment thesis is bound to get some things wrong.

That's why, once in control, the activist owners quickly engage with management and put meat on the bare bones of the investment thesis. Working intensively over several months, they identify the most attractive opportunities, gather data and information to test their viability, and develop strategic objectives and financial targets.

The experience of the investment group led by Bain Capital and Charlesbank Capital Partners following their purchase of Sealy Corporation in 1997 reveals how a thorough reexamination and ongoing analysis of changing events surrounding an acquired company can energize growth. With a 23% share of the \$4 billion mattress market, Sealy held an industry leadership position that appeared to warrant the partners' aggressive \$830 million acquisition price. Before the sale, Sealy's management team had mapped out a promising plan to increase revenues through a number of approaches, including boosting the sales of the company's midpriced mattresses. And by stripping complexity out of manufacturing, the senior managers projected, they'd increase profit margins, provide additional benefit to their customers and consumers and reduce working capital.

The new owners gave management a green light and waited for results. But the results were less than expected, owing to changing market conditions and increased competition. The private equity firms sprung into action. Together, with Sealy management, they assembled a team to launch a 100-day appraisal of the company's competitive position, prioritize opportunities to improve performance and develop a detailed road map to guide implementation.

The team probed every corner of Sealy's business—from product development and manufacturing to pricing and sales-channel management—and challenged every assumption. They scrutinized each option's potential effect on revenues and costs, and the financial resources and organizational capabilities needed to achieve it.

As owners and management worked together on the reassessment, candor, trust and collaboration between the two groups grew. And a different vision of Sealy's future emerged. The previous strategy was scrapped, as deeper investigation indicated that market forces, the changing retail environment and competitive attacks would make it untenable. The investigation also revealed that concentrating on the premium end of the market, not on midpriced products, would raise profitability and reward its retailers and other stakeholders most. And rather than focus solely on stripping complexity out of manufacturing, the analysis showed that by redesigning its core mattress, Sealy could simultaneously reinvigorate its product line, streamline its production and its supply chain, and hit even more ambitious cost-reduction goals.

The new approach proved a winner. Within three years, the combination of growth initiatives and cost cutting increased Sealy's earnings before interest payments, taxes,

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Private equity funds will no longer be able to rely on the magic of leverage to deliver outsized gains.

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depreciation and amortization from \$112 million to nearly \$168 million. The company was sold to KKR in 2004, netting a better than fivefold return on equity.

**Draw up a blueprint for action**

The investment thesis lays out a broad picture of what's possible. But it takes an explicit plan—an operational blueprint—to prescribe what gets done, in what order and by whom. The process begins with the company's management team conducting a rigorous, fact-based assessment of how the business makes money and where it has the best opportunities to increase its value. Blueprinting is not about generating a laundry list of nice-to-haves that typically fill strategic planning binders and end up on a bookshelf. Instead, the team identifies the most promising near-term initiatives and longer-term strategic opportunities, and fine-tunes the road map to establish time lines with milestones and calibrate the resources needed to meet them. The owner-activists' goal: to help strong management teams increase the company's value under their ownership more than they could have achieved if bought by the next highest bidder.

Blueprinting comes in many different flavors, as the experiences at a company we'll call Home Wares shows. When a private equity consortium purchased the home products company in 2002, Home Wares was experiencing renewed growth, having pulled itself out of a market slide and performed an operational turnaround several years earlier. But the company still faced challenges: For one thing, competitors were outselling Home Wares in mass discount retailers like Target and Wal-Mart, where volume sales had shifted. The new owners realized that to profit from

their investment, they'd need to keep the momentum going. They had to quickly sort through the company's myriad growth opportunities and zero in on those with the highest potential impact. For instance, should they expand into a new line of outdoor furnishings, develop brands for the discounters, or invest in repositioning and expanding the company's small network of stores?

A two-day workshop, which built on a solid preliminary plan and market analysis the private equity firms had done during due diligence, helped Home Wares set its priorities. In the end, the team decided to concentrate energy and resources in three areas: rapidly penetrating the mass-market channel, winning more business from its cornerstone accounts and ratcheting up the supply chain's capabilities to world-class levels, to serve customers better.

With the private equity owners helping to refine the focus and set the pace of change, project teams developed a schedule with a sequenced series of steps for accomplishing the new initiatives, and anticipated where bottlenecks needed to be broken. For example, the process reaffirmed the company's plan to increase its use of cost-effective off-shore manufacturers, mostly in Asia, to lift their share of Home Wares' total output from 10% to 80% within five years. But doing so would further strain an already underperforming supply chain and make it difficult for Home Wares to meet the stringent delivery demands of Wal-Mart. It was likely to worsen the company's ability to shorten delivery lead times and manufacture products to real demand. The solution: developing a short-term sourcing strategy while Home Wares recruited new supply chain managers with the expertise needed to serve the mass chan-

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nels. Then, with fresh talent in place, the company focused on finding and attacking sources of shipping shortages and inventory excesses. Home Wares was able, within a year, to squeeze some 30 days out of the nearly six-month-long order cycle, as it doubled the proportion of goods produced to order to approximately 60%.

To get more business from its best retail customers, Home Wares also redesigned its account planning process for its top seven accounts. It renegotiated floor space with the big-box discounters. Because research showed little overlap between sales to full-price retailers and the big boxes, the company decided to introduce a new wholesale brand line for Wal-Mart. The team also invested in new packaging to help strengthen the brand image.

By 2004, Home Ware's sales of dedicated lines to mass merchandisers had risen to \$94 million, a more than 20-fold increase since 2001. That year the company went public in an IPO, at a value four times greater than what the private equity investors had originally paid. (See sidebar, "Blueprints Work for New CEOs, Too," page 7.)

### **Support strong managers**

Too often, traditional buyout firms hold the executive teams at their portfolio companies at arm's length, insisting on calling the shots and parachuting in experts to impose change. In stark contrast, value-building activist funds cultivate a consultative style. But they don't stand passively aside waiting for management to get things done, either. Instead, they quickly win over company management and demonstrate how they can help to increase the value of the business.

Leading buyout firms, like The Blackstone Group, provide an arsenal of resources and capabilities that let their portfolio companies take advantage of scale economies they couldn't achieve alone. As the number, size and complexity of their holdings grew, the deal makers at Blackstone decided to hire a senior managing director to focus exclusively on improving operational performance across their portfolio companies. In 2004, they brought in James Quella, a merchant banker and former senior strategy consultant to fill that role.

In addition to the overall company performance monitoring and management activities, Quella set up a buying cooperative to purchase office equipment, insurance, utilities and other noncore supplies. Portfolio companies that opted in achieved savings of as much as 40% on these overhead outlays. And because the purchasing group was set up as a consortium independent of Blackstone, the companies could continue to reap savings by using it even after Blackstone sold off its stake in the group.

Blackstone is now moving to harness even bigger cross-portfolio opportunities by looking to create shared service centers, outsourcing operations and expertise for such functions as sales force productivity, pricing, human resources processing, information technology, lean manufacturing and supply chain management. By recruiting seasoned former C-suite executives and outside technical experts to work on portfolio-wide projects in these areas, the firm makes available A-team talent that would normally be out of the portfolio companies' reach. Blackstone estimates that this new hands-on approach will generate \$100 million in savings from purchasing alone, improve its companies' performance and boost the internal rate of return it delivers to its co-investors.

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## Private equity's road map to profits

The new performance measures made transparent for the first time how much revenue per customer every dollar invested in the sales effort yielded. They gave a powerful signal to investors that the new sales force strategy was working.

### Measure what matters

All private equity firms obsessively watch measures of financial performance like cash flow, working capital and return on equity. Activist buyout firms, however, track measurements that help them monitor progress toward operational goals before it shows up in the financial results. Experienced activists don't get blinded by data blizzards. Instead, they focus on a few key measures—an operational “dashboard”—that can be understood throughout the organization. A program office overseen by the company's senior executives watches the data dials, synchronizes initiatives and intervenes quickly when targets are missed.

Getting the metrics right was a cornerstone of the strategy developed by CVC Asia Pacific and CCMP Capital Asia (formerly JP Morgan Partners Asia) to turn around Singapore Yellow Pages (SYP). The two firms led a consortium that purchased the telephone directory publisher from SingTel, the local telecommunications company, in June 2003. The first order of business for the new owners: creating a sense of urgency in an organization that had grown complacent and stale. Despite an 87% market share and no serious rival to challenge its dominance, SYP saw revenues slide from \$104 million (in Singapore dollars) in 1999 to just \$62 million in 2003, while profit margins deteriorated. Advertisers were defecting and so, too, was SYP's sales force, with the annual turnover rate among demoralized sales reps topping 50%.

The new owners and SYP management developed a blueprint that called for a major overhaul of advertising sales. The plan set concrete revenue and profit growth targets for each of a dozen clusters of high-priority customers. It revamped the sales prospecting

process, replacing the overlapping, uncoordinated efforts of telephone customer-service reps and individual account managers with a process in which sales teams set priorities by determining advertisers' current and potential value to the company. To keep the sales teams focused, management ratcheted up the number of accounts each sales rep served and established guidelines for the number of calls or visits needed to close a sale. They benchmarked the company's sales and marketing performance against the industry's best practices and established an incentive-heavy compensation scheme to reward top performers.

The new performance measures also provided a regular report card on whether the SYP turnaround was on track. They made transparent for the first time how much revenue per customer every dollar invested in the sales effort yielded. The clear metrics helped give a powerful signal to other potential investors that the new sales force strategy was working. A little more than a year after making the acquisition, the private equity partners floated an initial public offering of SYP shares, reaping \$213 million (in Singapore dollars), locking in a gain of 2.6 times their initial investment while still retaining shares worth another \$50 million.

### Plant the seeds for a successful sale

By understanding how their portfolio company makes money at each stage of the business cycle and engineering performance improvements, activist firms create a brighter future for the company and position themselves for a more profitable exit. Indeed, activist owners defy a common rap against private equity investors: that they're focused only on stripping value out of their holdings and priming them for sale. Instead, activist owners cultivate new opportunities for the next set of owners



### Blueprints work for new CEOs, too

New corporate CEOs face many of the same challenges as private equity activists. With tenures typically about equal to the three-to-five-year holding period of a private equity acquirer, chief executives who want to build a lasting legacy have little time to waste. And even when promoted from within, new CEOs also have to win over skeptics quickly.

Blueprints can help new CEOs draw a bright starting line. Launching the initiative within the first 100 days of his or her tenure enables the new leader to light a controlled fire under the organization, as well as cement relationships with other key executives and the board, spot talent deep within the organization and mobilize the company around a common vision.

A blueprint helped the new CEO of a major European retailer reverse the erosion of its industry leadership position. Shortly after taking the company's reins, the new boss asked his top management team to diagnose why revenue growth had stalled and the company's market share had begun to lag. He challenged the team to identify priorities for action within three months and deliver a coordinated three-year program to fundamentally change the company's trajectory.

The diagnosis surfaced key issues at the core of the retailer's slumping performance—from diminishing price competitiveness and an overly complex IT infrastructure to an inefficient supply chain and loss of customer focus. First the team laid out a program to increase average store size to restore organic growth in the core business of housewares and expand into adjacent areas of fashion, pharmacy and healthcare. The target: to boost top-line growth by some \$4 billion over the three years. On the cost side, the blueprinting team identified some \$700 million in potential savings by integrating its information technology organization in house, sharply reducing stock losses, simplifying its logistics by sourcing from fewer suppliers and merchandising more private-label wares.

Unified by a common vision and clear about the way forward, the retailer attacked its "to-do" list with impressive results. With the program office closely monitoring implementation, management delivered \$1.2 billion toward its targeted overall sales gain in the plan's first year. Same-store sales have risen steadily over the past six quarters to a 6% annual pace, and pretax profits from continuing operations are up smartly by better than 12%.

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to harvest. As part of the process, the activists look for ways to jump-start future growth. They don't hesitate to invest in research and development projects, new product lines, new technology, acquisitions or expansions into new markets—even if they may bear fruit only years after the sale.

A veteran of more than a score of management buyouts since the late 1990s, a top European private equity firm we'll call Capital Group Investors has learned a thing or two about the rewards of foresight. The firm and its consortium partners had their exit strategy in mind when they purchased Trade Winds, an Asian marketer of consumer soft goods, in late 2001. Long buried as a division of a conglomerate that manufactured everything from auto parts to sporting goods, Trade Winds had generated good cash flow, but its profit margins were eroding and its market share was shrinking by the time of the buyout.

Guided by a sharp management team, the new owners soon came to learn that restoring the luster to Trade Winds' faded product lines of casual wear and recreational gear required rebuilding the company's marketing muscle. The management team and private-equity directors fixed on a three-phase strategy: raising the company's profile for the quality and value of its basic goods; becoming more responsive to retailers through improved delivery, flexibility, distribution and inventory management; and making selective acquisitions to increase revenues.

By the spring of 2004, the company's sales and profits were on the rise, and it had completed the integration of two modest-sized acquisitions. With the equity markets in an upswing, the private equity owners decided

to relaunch Trade Winds as a public company. But the ultimate success of the initial public offering didn't hinge simply on the changes the private equity firms and their managers had accomplished. Just as important to prospective investors were the ongoing longer-range projects to reconfigure the company's supply chain and build a new distribution infrastructure. When complete, these will give the company new efficiencies it can capitalize on for years to come. In the end the longer-term vision of the private equity owners paid off in a record IPO that netted \$1.25 billion and was 2.3 times oversubscribed. Capital Group and its partners earned more than five times their initial \$235 million cash investment, resulting in a 107% internal rate of return.

The success of deals like Warner Music, Sealy, Home Wares, Singapore Yellow Pages and Trade Winds has leading-edge private equity firms looking to implant the techniques of activist ownership into the core of how they do business. They know that as they compete to attract ever-larger pools of capital, their investors will judge them not just by their ability to spot attractive targets but by their proven track records for building value across their portfolios. That's why activist firms have gone from applying the discipline of adding value to companies on a case-by-case basis to turning it into a repeatable process. From the use of investment theses and probing due diligence to guide their acquisition strategies, to the development of creative new capital structures, private equity pioneers have blazed trails that have become standard practice across the economic landscape. One way or another, private equity's new script for making money looks sure to show up in public-company corporate boardrooms near you. 

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