Private Equity 4.0

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Reinventing Value Creation

Benoît Leleux,
Hans van Swaay
and Esmeralda Megally

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Contents

List of case studies

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Hans van Swaay

Hans van Swaay has a long track record in private equity as Partner of Lyrique, Head of Private Equity at Pictet & Cie, Managing Director of UBS Capital, Managing Director of Merifin and partner of Lowe Finance. His career has taken him through many cycles of the private equity industry. Today with Lyrique he is actively involved in private equity investments for private wealth, like family offices and private banks.

Hans has made direct investments in Switzerland, Germany, France, the United Kingdom and in the Netherlands. As an investor in funds he has been active in the

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Prior to his private equity career Hans van Swaay worked with Shell in the United Kingdom in general and financial positions. He started his career in the construction industry with one of the Netherlands' major construction companies, HBG in the Middle East.

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Esmeralda Megally

Esmeralda Megally started working in the venture capital industry in 2007, when she joined Boston-based venture capital firm Commons Capital as manager to explore—with the Bill and Melinda Gates Foundation—a new business model in venture capital. At Commons Capital, she worked closely with venture-backed portfolio companies to develop and implement growth strategies and was in charge of identifying new investment opportunities globally.

She holds a B.S. and M.S. in Economics from the Université Libre de Bruxelles, Belgium, a Masters degree in Management of Technology from EPFL, Switzerland, and an MBA from the Massachusetts Institute of Technology's Sloan School of Management (MIT Sloan), US. She served as venture advisor to the NextLab at the MIT Next Billion Network and was part of the biotech committee of the MIT Technology Licensing Office, working alongside entrepreneurs, investors and large corporations to devise licensing strategies.

Esmeralda is a co-founder of Xsensio, a spinoff of the EPFL Nanolab in Switzerland which develops nanotechnology-based intelligent stamps. She is also a co-founder and board member of GCS, a Tanzania-based spinoff of the MIT D-Lab that was selected by Forbes' 30 under 30 and Bloomberg Businessweek America's Most Promising Social Entrepreneurs. Her innovations have been awarded the Harvard Catalyst Grant, the EPFL Innogrant, the MIT IDEAS International Technology Award, and the MIT IDEAS Graduate Student Award. Esmeralda is the co-author with Benoit Leleux and Michel Galeazzi of an IMD case study on the IPO of Tumi (EFMD Case Writing 2013 Award, Finance and Banking category).

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Esmeralda Megally

To my parents, with love and gratitude.

Foreword

Private Equity 4.0 is upon us, and with it hopefully enough experience to start drawing inferences about what works and what does not in private equity. Maturity is an expensive and time-consuming proposition sometimes; to paraphrase the infamous quote: good decisions are based mostly on experience, but experience is the cumulative result of many bad decisions... The financial and economic crises of 2007–2009 were very much the last nails in the long-rotting coffin of private equity "as it used to be". There is also a wonderful opportunity to take stock of the developments of the last 70 years in the industry and, with the dust slowly settling, to envision the future of this most original and resourceful industry. There is no doubt in our mind that private equity is here to stay. Its contributions to society and the economies of the world are too large to ignore. But yes, it did stray at times, taking advantage of temporary opportunities created by mismanagement and misguided economic policies. These arbitrage opportunities were low-hanging fruits; it is preposterous to blame private equity investors ex-post for having taken advantage of such blatant economic insanities. But these low-hanging opportunities have, for the most part, been arbitraged away (don't despair though on the creative ability of governments to create new ones…), forcing the private equity industry, against its better judgement, to start considering more sustainable business models, including the ultimate indignity of actually having to create value the hard way, i.e. earning it! Yes, this was said, of course, a bit "tongue in cheek", but the reality we will endeavour to describe in this book is not far removed from this somewhat crude caricature. Private equity post-crisis has indeed been going through its own revolution, one that we believe can finally be taken to maturity as an invaluable component of the world's economic system. New business models have emerged with fundamentally sounder groundings providing robust bases for sustainability.

The road to sustainability: from arbitrage to operational value creation

Private equity, in its original incarnation, was very much (ad)venture capital, born out of the industrial and technological advances brought about by World War II. Georges Doriot and his early fund, American Research and Development (ARD), wrote some of the fundamental rules of the game, most notably the fund and incentive structures. The model was picked up later on by buyout funds, which soon outgrew their venture capital brethren and came to dominate, size-wise, the industry. As such, private equity has often become synonymous with buyouts, even though technically buyouts are only a major segment of the private equity industry.

Since the creation of ARD in 1946, private equity adopted and capitalized on a series of business models, replacing them when new opportunities to create value emerged. **Private Equity 1.0** capitalized on the organizational inefficiencies of large diversified conglomerates, splitting them apart with the financial helping hand of the junk bond markets of the 1980s. The cycle came to a screeching end with the indictments of the junk bond kings and their patrons. The 1990s were around the corner, and with them a glorious period of GDP growth, multiple expansion and ultimately a technology bubble of epic dimensions, in which **Private Equity 2.0** bloomed under the guise of new technology and growth. The internet crash of April 2000 brought the club back to earth. As no good deed goes unpunished, central bankers came to the rescue of the faltering economies that followed the 2000–2001 correction, opening the floodgate of a liquidity surge private equity quickly took advantage of in its **3.0** iteration. As for all previous irrational exuberance episodes, the party had to come to an end when realities intruded on the collective hallucination, taking with it the cheap leverage dreams. The credit bubble was over: it was time to find a new model for value creation that would not be as dependent on financial engineering or the availability of cheap credit. Welcome to **Private Equity 4.0**, a model that spells the return to the sources of private equity: value creation through operational improvements and the enabling of growth, rather than on pure financial engineering. In other words, earning money the hard way...

In a sense, this is a most welcome development for the industry as the first real opportunity to make it sustainable. This is the age of maturity, the chance to capitalize on 50-odd years of deal making in a wide array of economic environments. Private equity has shown its mettle and its uncanny ability to re-create itself in the face of wildly changing circumstances. With some of the brightest minds involved, and backed by some of the smartest money available, private equity demonstrated the resilience expected of an industry whose impact goes far beyond the deals it actually engineers. Private equity for many has become the standard for corporate performance, the benchmark against which managers of all stripes are measured. Its simple existence and presence disciplines many economic actors to unleash upon themselves many of the measures private equity investors would have forced upon them. The total impact of private equity on economies is thus impossible to measure, but it is fair to assume that it is probably orders of magnitude larger than the deals it actually gets involved with or the value it generates in those transactions.

Instead of being thanked for the impact they had on whole economies, private equity players have been portrayed as barbarians, locusts, asset strippers and worse. How could such a small group of individuals reap such humongous profits if not by devious means? Were the convoluted tax structures used by the funds and their general partners not the proof of some malfeasance at play? Were the millions earned not unfairly taken away from employees and managers left in the cold? Private equity was the all-too-visible hand that proved markets were not anywhere close to efficient. Its very existence and survival proved that corporate governance systems were inappropriate at best, deeply flawed at worst. Unsurprisingly, this flew in the face of common wisdom. Private equity exposed the limitations of the system, and as such was a convenient scapegoat for its ills. And the privacy it likes to shroud itself in was further proof, if needed, of its Machiavellian intents.

Gaining perspective: The road ahead

With the perspective offered by three full cycles at least, it seemed appropriate to try to draw some pragmatic lessons for would-be investors and practitioners alike: What are the best strategies to invest in private equity? How best to select fund managers? What is the best time to commit money to funds? What are red flags in fund prospectuses? How is value really created in private equity transactions?

This book is anything but a blind endorsement of the industry. It is always incisive, and at times critical if not cynical. Some practices in the industry deserve to be criticized and attacked to the extent they hide or even harm the true contributions made. Like all industries it has its black sheep, and exposing those dubious practices only reinforces the credibility of the industry as a whole. The authors can best be described as "critical believers": they are convinced that private equity embodies and leverages some of the most effective tools of capitalism. But because of this, it also "packs a wallop", and as such its potential for misuse is great. Nobody ever said making money was easy... In this book, we offer insights into the industry deals and rules of engagement with a view to discovering the most effective ways to reap benefits from them. The recipes are not simple; but, like a good cooking book, the rewards can be most satisfying...

Introduction

Private equity at the crossroads

The economic crisis of 2008–2009 will stay in the annals of private equity as *Anni Horribili*, the years in which the bill was passed for all the prior misdeeds of an industry that had come to believe it could "walk on water". The downgrade to "villain" status was at the same time painful and immensely illuminating. This time, the very fundamental *modus operandi* of the industry was put under the limelight and seriously questioned. Was private equity really contributing to the strength of an economy? Were the various actors of the industry properly rewarded for their actions? Were the incentive structures properly aligning the various interests at play? Was it appropriate to let this important component of economic activity continue to operate with minimal levels of disclosure and regulation? Did it truly deserve the favourable tax treatment it had been able to engineer? And finally, was private equity truly delivering returns over the long term?

With private equity at a crossroads, the timing could not have been better to investigate its inner workings and provide some much needed direction for investors and industry watchers. The recent financial and economic crises have stopped private equity investments in their tracks, and forced a critical re-examination of the various business models and governance structures. Out of this extraordinary boom-to-bust cycle emerges a new understanding of the drivers of performance in the industry, laying the ground for stronger governance and incentive structures.

An historical perspective to gain insights for the future

If the attention focused on private equity is new, the principles behind it are not. For most of history, there has been a need to link capital from wealthy families or institutions with worthy enterprises or endeavours. Academic studies have traced adventurous relationships between investors and entrepreneurs as far back as King Hammurabi, who reigned over the Babylonian Empire from 1792 BC until 1750 BC.[1] A closer example of private equity activity is the financing of Christopher Columbus' adventures, who had, by the 1480s, developed a plan to travel to the Indies by sailing

[1] Gompers, P. A. and Lerner, J., "The Venture Capital Cycle", MIT Press; Cambridge, Mass, 1999.

west across the Atlantic Ocean. He tried to secure financing from King John II of Portugal and King Henry VII of England but it was Ferdinand II of Aragon and Isabella I of Castile who finally agreed to put resources into the venture, together with private investors. The agreement stipulated that Columbus would be made "Admiral of the Seas", and be given 10% of all revenues from the new lands.[2] Upon his return, Columbus never received what he was promised, Spain citing a breach in the contract.

The entrepreneurial nature of the adventure, Columbus' persistence to achieve his goal, the financing and reward structures and the sheer magnitude of profits (Spain's imperial power can largely be attributed to the venture), lie behind what many see as a beguiling comparison with today's private equity industry. In private equity speak, this first-time fund was raised with as much difficulty as new groups encounter today.

This book has been conceived as a timeless, unbiased investigation of the ways and means of the private equity industry. As authors, we clearly believe the private equity industry has a good story to tell; for many reasons, internal and external, it has not made the case powerfully so far. To a large extent, we see private equity as potentially the ultimate embodiment of effective capitalism, or what we sometimes colloquially refer to as "capitalism on steroids". The basic premises, i.e. detailed due diligence, efficient financial structuring, close and active support of management, alignment of interests throughout the entire value chain, and a rigorous focus on creating and realizing value are difficult to argue with. But the lack of transparency and the complexity of some business models have created suspicion and mistrust. Underneath the surface lie a number of myths and half-truths that in the end discredit the industry as a whole. To understand private equity as an asset class, it is thus essential to dive into its inner workings and hopefully make sense of those finer realities.

Keeping a perspective is always difficult when the storm has just passed and left few players unharmed. It is at this critical juncture of the industry's existence that this balanced perspective is most important, giving it a chance to re-establish itself for the future.

This book is grounded in interviews with some of the world's leading investors, case studies of successful and less successful deals, extensive research and the more than 50 years' combined experience of its authors, as academics, investors and practitioners. It seeks to explain how private equity actually functions, who the key players are, and examine the different segments of this rapidly maturing market. The objective is to develop a "How To" guide for potential investors and industry observers, providing a realistic "deep dive" into the inner workings of this most intriguing, often opaque and definitely deeply misunderstood industry, with guidelines about ways to invest and errors to avoid.

To discover the inner workings of private equity, we offer to take you down its most interesting alleyways, in search of its true *modus operandi* and value

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[2] Demaria, C., "An Introduction to Private Equity", Wiley, 2010.

creation potential. Chapter 1 provides an assessment of where the industry stands today. Chapter 2 investigates the industry's dominant business models. Chapter 3 analyzes how financial and economic value are created in the industry. Chapter 4 details how value creation comes to be measured in the industry and examines the return characteristics and fund performances by industry segments. Chapter 5 gives an overview of the main characters in the industry, i.e. the successful firms in each of the industry segments and their "representative" deals, while Chapter 6 provides insights into what we refer to as the "supporting cast", i.e. the ecosystem of advisors, gatekeepers and professionals gravitating around private equity funds. Chapter 7 takes a fund investment perspective, trying to provide guidelines for the selection of funds to invest in. We conclude with Chapter 8, where we attempt to provide a map to the future of the industry, highlighting the issues at stake in an increasingly challenging environment and suggesting ways to improve the contribution of the industry. Throughout the chapters, case studies of successful deals are used as illustration.

Private equity: all about people

As often, headlines in the popular press tend to paint a rather biased picture of a situation or individual, and the more so the more secretive the target. Why bother with actual data when one can simply create them? Private equity in that sense has all the attributes to become the ultimate scapegoat for politicians and journalists alike: it caters to high net worth investors only (i.e. the privileged ones), involves a small number of professionals only (hence attacks on them do not disturb the voting base much…), keeps its practices suspiciously discreet, uses a colourful array of tax-optimized vehicles, enjoys a way-too-cozy relationship with the powers-that-be (from bankers to politicians), seems to lack all form of social or environmental responsibility credentials and, to make matters worse, seems to earn oversized salaries and bonuses not in line with the performance they generate. In other words, the ultimate form of leech: private equity lives off society's weaker elements without a trace of ethics or concerns for the very society that harbours it. In short, the ultimate abuse of capitalism...

But could this all be misplaced? Could this be the result of undue focus on some deviant behaviours within an otherwise perfectly healthy industry, or simply the upheavals of natural selection in a maturing industry? Are we throwing the baby out with the bath water? In this book, we make both a passionate plea for the contributions the industry makes to society and investors' portfolios, and mercilessly point out the weaknesses in its business models. In other words, while we can be described as "true believers" in private equity, we are certainly the most critical (and at times cynical…) observers of that very same industry. This critical sense is essential in analyzing the facts and developing a cohesive set of principles to make private equity work for you as an asset class. In other words, we have not sold our soul to private equity: as investors in our own right, we are attempting in this book to share some of the hard learned lessons about how to "do it right". As we will show you later, this is both one of the most exciting, creative and ultimately value generating segments of the world of finance and one of the most difficult to make sense of, or even to accommodate in a portfolio. Ultimately, it is one that relies more heavily than any other on people, managers at funds and at portfolio companies. People are the most difficult elements to assess and at times to motivate. But when properly supported and incentivized, they can be the most incredibly resourceful asset… Private equity is about people: incredibly sophisticated, passionate and focused people. And human nature remains one of the most elusive characters to capture…

The best capitalism has to offer? The conceptual groundings

In theory, private equity uniquely combines elements that could create one of the most sophisticated "economic animals" on earth, the ultimate embodiment of the powers of competitive markets, unfettered creativity and rapid adaptation. Of course, as Einstein once put it, "in theory there is no difference between theory and practice, but in practice there is". And the translation of these concepts and theories into practices has been a convoluted process at times polluted by raw opportunism. But what are the conceptual groundings of private equity? Why would we assume they would ever lead to superior performance?

Empowering and incentivizing: partnering for mutual success

What private equity masters more than any other investment form is the power of incentives to get the best out of people. Private equity deals are mostly about people: therefore, strong incentives have to be put in place to attract, retain and reward the best of them for performance. Not the incremental or marginal type of incentives found in many corporate environments, bonuses tied to vague corporate targets. Private equity builds into its relationships with key personnel the strongest forms of incentives, i.e. oversized and painstakingly handcrafted to match targets individuals have control over. This is probably the single most important driver of private equity deal performance, and one the industry rarely gets praise for. Granted, it tends to benefit a relatively small number of key executives (even though quite often a generous bonus pool is often created for other employees in the acquired firms). But private equity understood before any other industry the kind of ferocious talent war that was going on in the corporate world, and did something about it.

Competent people with the skills to really make a difference at a company level are rare, very rare, and they have multiple career opportunities. Why would they elect to get into the high pressure world of corporate value creation? Because you offer them what they aspire most to: freedom of action and oversized financial rewards. To be "in charge" and directly benefit handsomely from one's actions is the most emotionally rewarding situation, one in which most individuals would go to incredible lengths to ensure success. In a way, private equity investors understood before anybody else that you can only succeed **with** management teams, not against them. Hence their model is really one of "partnering for mutual success". This strong empowering and incentivization of managers is the foundation on which every other element of the private equity recipe is built. And this base is rock solid and will survive the taming of the wild leverage markets. Debt just comes in to leverage and complement the impact of the incentives: it was never the key driver of performance. Let there be no doubt that the horse that draws the cart is empowerment and strong performance incentives, and those are sustainable drivers of performance.

Focus, focus, focus

The second key building block in the private equity recipe is the obsessive focus on single transactions. Private equity is not about diversification within a portfolio: it is about building a collection of positions, each of which standing on its own and actively managed to create value. Asset managers for their part are mostly punting on assets, trying to assess them the best they can and then counting on the power of diversification to generate interesting results. For a private equity manager, diversification is a non-starter: they bet the house on each and every deal, and will dedicate the resources to make them shine. Yes, there will be losses, and when a deal has clearly reached a point of no return, private equity managers will turn into merciless cullers. They will not lose another dollar or another hour of their precious time trying to salvage what is clearly a "goner". This discipline of the deal is fundamental to the success of the recipe. By bringing to bear the full power of incentives and empowerment onto a single deal, they demonstrate that "dilution" (of incentives, perspective, focus, etc.) is the curse of the corporate world. Private equity portfolios are not portfolios by any stretch of the mind: they are collections of individual assets that are managed as such. And there lies another key to their success.

Strategy is cheap; operationalizing is key

The third key building block is the realization that value is created not out of some grand strategy but instead in the meticulous implementation of an internally consistent operational plan. Private equity managers often have backgrounds in strategy consulting, because being able to identify a strategy to leverage assets is a good starting point. But that's all it is: a starting point. To a large extent, a strategy is about as good as any other, or put in other words, having **a** strategy is definitely better than not having one. What matters in a strategy is not the strategy itself, i.e. the macro plan, but the internal consistency of its operational components. The strategy consultants that managed a successful move to private equity (many did not succeed…) are those who believed and enjoyed putting the plans into action. Consulting can be the most frustrating professional experience since you rarely get to implement, i.e. you do not really get to live the impact of the recommendations. Private equity puts its money where its strategy mouth is. For some of consulting brightest minds, the attraction of