What public companies can learn from **private equity**

Public companies will need to raise their governance game if they are to compete with private firms.

Andreas Beroutsos, Andrew Freeman, and Conor F. Kehoe

Web exclusive, January 2007

The more successful private equity becomes, the more scrutiny it attracts. In November 2006, the United Kingdom's Financial Services Authority warned of the growing risk to the industry as private equity firms set their sights on ever bigger targets, in the process taking on ever higher debt. Elsewhere, the high fees and dividends that some firms are extracting within months of closing deals suggest that the clubby industry may have entered a period of excess. Some firms may well find that they have bitten off more than they can chew. But it would be wrong to assume that the challenge private equity firms pose to the public equity model is about to ease.

True, McKinsey research shows that three-quarters of private equity firms perform no better than the stock market over time. Even so, the top 25 percent of private equity firms do outperform the relevant stock market indexes. Moreover, they do so by a considerable margin—and persistently.

More important still is the source of their success. Top performance does not, as many imagine, come from unusual financial acumen. In our observation of private-sector deals worth more than $100 million, very few of the successes came about because firms paid less than prevailing market prices for similar assets. Markets are reasonably efficient, and most important assets sold to private equity firms undergo a relatively wide auction. Indeed, if anything, the risk is that private equity firms overpay for their assets as they compete against strategic public buyers. Nor do private equity firms obtain the bulk of their returns by profiting from a rising market or an even more quickly rising sector within the market. Their real—and often overlooked—source of success is the governance model they apply to the companies they own. This is an advantage that public companies find hard to emulate.

Active ownership in private equity

To find out what the private equity advantage entails, we examined the data behind 60 deals completed by 12 top-half private equity firms and interviewed individual deal partners (the firm representatives in each company in our portfolio). We asked these partners how much time they spent on their respective companies, what resources they had, and to what end—and corroborated their input by interviewing CEOs. We then correlated the reported behavior with the amount of value created in excess of what an equivalent investment in similar quoted equities would generate. Our analysis was skewed toward the better deals by the better firms. It suggests some lessons for public-company executives who might wish to emulate their performance.

We found that private equity firms at the top of their game exert ownership control over management and in this way create levels of sustainable above-average performance that set them apart from public companies, as well as from their rivals in the private equity industry itself. All these firms conduct deep research into their target companies prior to acquisition. Once an acquisition is completed, the contrast in governance style between the good and the great can be striking. It's even more striking when measured against the practices of traditional public companies, which typically diffuse shareholder bases, powerful CEOs, and nonexecutive directors (who have no research staff, no budgets to hire external support, and access only to data that management supplies).

Top private equity firms seem more committed to effective oversight of their investments. True, they use high levels of compensation to align managers' interests with their own. But in addition they not only commit their own time to make the board more effective but also conduct research to develop personal views about the direction a company should take, using their block vote to speed up decision making. Among the 60 deals we reviewed in depth, active private equity partners devoted half of their time to the company (usually at its premises) during the first three months after the deal. Less active and less successful deal partners spent only about 15 percent of their time in this way.

Similarly, active deal partners had teams of analysts working with them; less active partners worked alone. Active partners build up their own viewpoint about how a company could create value, verifying or modifying hypotheses they had developed during the due-diligence phase of

the deal. Less active partners typically reviewed and commented on plans drawn up by management. Active partners became familiar with management, sometimes long in advance of a deal, and made any replacements quickly. Less active partners made replacements too, but usually much later. Finally, active partners measured performance using operational indicators (usually linked to the value creation plan), whereas less active partners tended to rely on standard financial measures.

In our view, this active assertion of ownership is the crucial difference between the best private equity firms' concept of good governance and the one put into practice by public companies and less successful private equity firms. Intriguingly, private equity firms have longer time horizons—a five-year holding pattern is the norm—than the quarterly earnings treadmill of public markets.

In effect, today's successful private equity firms exploit what might be called "governance arbitrage" rather than the financial engineering or price arbitrage that proved profitable when the industry was less mature. The best private equity firms can find and successfully realign businesses whose governing structures (owners and managers) are misaligned. So big is the opportunity for this type of transaction, we believe, that private equity is likely to maintain, and perhaps to expand, its presence as a parallel system to established public markets. It would revert to marginal status only if the governance of public companies improved dramatically.

Nonexecutives seldom **enjoy great financial gains** if a company is successful, but they do stand to lose if there are lapses in compliance; lawsuits may ensue

Of course, the private equity system is not perfect, even though it provides for well-supported, motivated, and professional governance. The management fee in large funds may now be so great that it will blunt the hunger to create returns; large private equity funds may be generating annual revenues of $1 million to $2 million per professional from fees alone. As funds grow in size, they may outstrip the abilities of private equity firms: a $40 billion company may require governance skills that are different from those needed to run a $400 million company (though not so long ago, a $400 million deal was considered large). Some private equity firms, eager to avoid endless fund-raising visits, are seeking "evergreen capital" from stock market issuance, but this approach might reduce their attention to the investors' needs. Finally, although only the top 25 percent of funds create significant value for investors, the other 75 percent manage to win financing, usually on the same terms as the better performers. Their weakness could threaten the industry's long-term sustainability.

Nevertheless, public equity markets currently face a real challenge from private equity—though not from its technocratic excellence, let alone its sometimes giddy use of financial leverage. Rather, the challenge comes from private equity's ability to align owners and managers far more effectively. The people who run public companies will need to raise their game if they want to better what the best private equity firms can offer.

Active ownership in public companies

Some might argue that governance has greatly improved in public markets, notably since the cleanups that followed recent high-profile corporate scandals. But this is to misunderstand what has been happening. If you ask nonexecutive directors of public companies, you will find that they overwhelmingly direct their efforts not at value-creating governance but at compliance—the need to ensure that none of the growing number of codes and regulations is breached.

This problem is reinforced by the structure of incentives: nonexecutives seldom enjoy great financial gains if a company is successful, but they do stand to lose if there are lapses in compliance; lawsuits may ensue. Further, nonexecutives are often drawn from the ranks of professional managers, so they may naturally empathize more with management than with owner-shareholders. Also, they have little share-voting power and few staff resources to support their contributions to board deliberations.

Furthermore, nonexecutive directors of public companies may simply lack the necessary information. Those McKinsey polled in 2005 complained that they wanted to spend more time on strategy and on selecting and developing management talent—and less time on audit and compensation issues. But only about 10 percent of these directors felt that the board had a complete understanding of their company's strategy and long-term objectives or of the key initiatives designed to achieve them (the rough equivalent of the value creation plan for private equity).[1] Indeed, when asked to describe the extent of the board's understanding of the long-term objectives, more than half of our respondents answered "limited" or "none." Over a quarter felt the same about the board's understanding of corporate strategy. Most felt starved of operational and strategic information; more than 70 percent wanted more of it, while only a minority wanted more financial information.

The survey suggests that public companies would benefit from much greater engagement between managers and nonexecutives, including much more sharing of relevant nonfinancial information, as well as a greater commitment from nonexecutives to develop their understanding of the business and the industry context. The wishes of nonexecutives serving on the boards of public companies are likely, however, to arouse hostility or ambivalence similar to the feelings expressed by managers in private equity-owned companies. Without the incentives, resources, and voting power of private equity nonexecutives, the public-market cadre faces an uphill struggle.

Transferring private equity DNA

Many of the managerial approaches that the best private equity firms use, however, could be reproduced in publicly owned companies. There is scope to do so at the board level as well as in the way the CEO and CFO interact with the units of a multibusiness company. Several practices offer the greatest potential.

A more intensive and externally focused strategy process

Private equity firms conduct an intensive strategic assessment of businesses they buy. This assessment, which takes place during due diligence and the first 100 days of a private equity deal, identifies costs to slash, new markets and profit pools to pursue, and portfolio changes to make. Its outcome is a value creation plan that—because of the intensity of preparation—is believable to all involved (including management) and delivers a good sense of the major risks and further opportunities. Publicly held companies conduct similar activities in their own strategic-planning processes, but they typically lack the same intensity.

The process has some critical elements. One is external benchmarking through a range of key performance indicators (KPIs) and processes (for example, overhead costs, the utilization of assets, cost per unit produced, purchasing processes, and manufacturing processes), which may identify best practices to emulate. External benchmarking should extend beyond industry best practice to that of the leading-edge industry for the activity in question. The process should also provide independent verification of key assumptions about the business, such as the outlook for the industry (volumes, prices, input costs) and the competitive position of the target company.

Public companies can and should undertake similar intensive and externally focused assessments. However, since these assessments are time consuming and expensive, and because market outlooks and opportunities do not change very quickly for public companies, they need not undertake the more intensive process annually. In our experience, an assessment is necessary only following a major deal in the sector, a change in the industry structure, or major changes in input costs, such as raw-materials prices. Otherwise, every three to four years should be adequate. In off years, the normal strategic-planning process ought to suffice—and could involve no more than a cursory update of a few key assumptions.

Tough but realistic targets linked to significant incentives

For private equity players, the first element of performance management is to forge a close link between the KPIs used to evaluate management and the value creation plan developed during due diligence and the 100-day phase. Private equity firms expend a lot of effort to design KPIs that are focused and comprehensive and to ensure that they cascade down the organization. In this respect, private equity players resemble good performance managers in public companies; the difference is the way private equity firms create incentives, based on the KPIs, and use them to manage acquisitions.

At companies governed by private equity firms, managers have significant incentives in the form of equity stakes, coinvestment opportunities, and bonus payouts for meeting key objectives. In the private equity deals we reviewed, top managers typically owned 5 to 19 percent of the equity and had invested a substantial amount of their own net worth to obtain it. In addition to this participation in the upside, the high leverage of private equity deals imposes its own discipline and motives to perform. Incentives at private equity-owned companies often are significantly better than those at publicly listed ones, especially in mature industries; management, with its own wealth invested, bears greater risk. This incentive structure is also better designed to align the interests of the owners and the managers. While the incentives that publicly listed companies can offer are sometimes constrained (for example, by executives' fear of being labeled as "fat cats"), many of them actually can offer greater incentives that are better aligned with the shareholders' interests.

Finally, performance-management conversations in private equity-owned companies are frequent, fact based, and hard edged. When their performance suffers, private equity players are quick to act, spending more time with management, replacing underperforming teams, and hiring external experts. While many publicly held companies have similar conversations, few are as

rigorously implemented and as focused on value creation as those at private equity firms. In this vein, public companies should review these conversations to ensure that the performance challenge is robust, fact based, and transparently linked to value creation initiatives.

Evaluation of key managers and an ongoing search for talent

One of the most important yet challenging aspects of conducting a private equity-style program in a public company is forming a management team that is fully ready for radical change. In the case of multibusiness companies, corporate senior executives must stand 100 percent behind the business-unit-management teams they are backing and be ready to make changes to meet their goals. The senior executives must therefore get to know the team's strengths and weaknesses, identify who must be replaced and which new roles must be filled, and have enough knowledge to supplement the team with external support that plugs any remaining gaps. To do all this, they need to spend enough time on site; the private equity best practice is 50 percent of a partner's time for the first three months. Finally, they should assess whether the management team is a credible agent of change: a team that has been happy with the status quo for a long time may find that it cannot generate the "followership" needed for a radical program, no matter how strong its desire to do so. In these circumstances, the solution is to rotate in new teams to manage the business unit.

The challenge for public companies is not so much securing the skills to undertake the tasks described here but rather developing the will to undertake these tasks without the incentives, powerful and well-supported board members, and an exit time frame that the private equity system provides. Public companies also face the challenge of finding the time for senior management and the board to undertake these value-creating tasks while dealing with the growing demands of compliance. The alternative, of course, is to go private.

Private equity, as a governance system, will no doubt suffer its own ups and downs, particularly if the industry's performance falters. However, if private equity continues to offer superior governance in a range of circumstances, we believe that it could rival the public market system in size. That scenario presents a clear challenge to public companies and their boards: they simply must raise their governance game.

About the Authors

Andreas Beroutsos is a partner in McKinsey's New York office. **Andrew Freeman** is an adviser based in the London office, where **Conor Kehoe** is a partner.

The authors would like to thank Braam Verster for his contributions to this article.

This article was first published in the Winter 2007 issue of *McKinsey on Finance*. Visit McKinsey's corporate finance site to view the full issue.

Notes

1 "What directors know about their companies: A McKinsey Survey," *The McKinsey Quarterly*, Web exclusive, March 2006; and Robert F. Felton and Pamela Keenan Fritz, "The view from the boardroom," *The McKinsey Quarterly*, 2005 special edition: Value and performance, pp. 48–61.