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Walking The Tightrope

The New Path to Success in Middle Market Private Equity

By Michael Fisch and Glenn Kaufman

As the large number of middle market private equity firms create a blur in the minds of industry participants and as rising purchase multiples cause "base case" investment returns to move steadily downward, there is a growing feeling that the industry as a whole may not satisfy investor expectations.

Call it a wave of consolidation. Call it a weeding out. Call it, as one of our investors, Harvard Professor Michael Porter might, the natural evolution of a competitive landscape. The result is that attributes that were once sufficient for success-broad deal-sourcing networks, detailed financial analysis, careful due diligence and good investment judgment-are now necessary but not sufficient. The bar has been raised and the new threshold requires something more. Middle market private equity firms must help stimulate meaningful post-investment value-creation through improved operations and resultant financial performance. There seems to be a strong consensus that not all such firms will survive the coming industry shake-up. The ability to deliver on this metric will be a huge determinant of who does.

This view of course is not new. It has been a growing belief among many students of this market for many years. And it has advanced to become expected marketing pabulum does any firm not present themselves as a value-added partner to management teams? However, the actions in the marketplace have yet to match the broad understanding or the marketing.

What Is Holding Firms Back?

So why have firms been so slow to do what so many seem to realize needs to be done?

First, the most obvious reason: Private equity participants have historically come from the world of finance, and as a result have gravitated toward focusing on the financial and "deal making" aspects of the business. Even those who believe they should be broadening the focus of their firm have a difficult time doing so. For many it is simply not in their genes.

And moving this way is made even more difficult because a private equity firm having a value-added orientation is often distrusted. And ironically, that distrust from the CEOs and executives of companies-the very people whom private equity firms seek (and need!) to be partners-is a product of the way our industry has taught these individuals to think about us.

To understand this, reflect back to what most people view as the dawn of the institutional private equity market the early 1980's - and the subsequent decade of activities. With most industry participants having pure financial backgrounds and viewing their time best spent finding the next opportunity, CEOs came to view their private equity partners as largely absentee owners. They looked at monthly results, attended occasional board meetings (often held at the private equity firm's offices or by phone) and handled requests for major capital needs such as acquisitions. Outside those activities they were generally heard from primarily when and if results were not as expected, and then only to ask "why”.

Of course, there were occasions when the private equity firms would get more deeply involved, but those were generally related to times of trouble. And when the investment firms got involved they generally got deeply involved in many instances replacing management teams or coming in themselves to "run" the operations. In short, firms were either very hands-off or intensely hands-on. And in a world of those options it is certainly understandable that virtually any CEO would choose a hands-off environment to the alternative of having a deeply involved, micromanaging investor.

So CEOs learned from private equity firms a simple lesson-things are best when the private equity firms are not around, and any sign that a firm was getting involved was indicative of brewing trouble. And so not surprisingly CEOs favored partners that were going to keep their distance and that had a history of doing so. And firms, not wanting to alienate management partners nor risk developing any reputation for being micromanagers, found it easy to do that while living in their own comfort zone of hands-off financial oversight and antiseptic telephone board meetings. Except, that is, when something was really wrong and all of the drastic micromanaging had to occur.

How To Move Forward

So it is with this background that middle market private equity firms face the challenge of adjusting their approach. And it is because of this history and those dynamics that what seems so obvious has proven so slow to occur. While everyone is happy to mouth the words, very few firms want to run risks with existing management, or more importantly run the reputational risk in the marketplace, of taking actions associated with stepping up to a true value added partner role.

But how should firms adapt and how should they act to provide the value-added they must without threatening their attractiveness to the management teams that everyone is so focused on winning over? We believe that to succeed they must commit themselves 100% to developing their ability to add value and to building an organization and a culture that can continually walk the tightrope between the twin villains of absenteeism and micromanagement. They must change who they are, how they prioritize, what they value, and the basis of their relationships with management. And they must invest in new people with different skills and in outside resources where they have not previously focused.

There are tremendous challenges, beginning with private equity professionals working extra diligently to understand (and stay knowledgeable about) both the portfolio companies and their people as no busy CEO enjoys dialoging with someone who constantly has to be brought up the curve and is devoid of insight and ideas. Then it requires the same professionals to take time away from finding the next deal to deepen their relationships with managers in order to bring about a greater level of mutual respect and trust. Only then can suggestions be heard by managers constructively, and can CEOs make requests or seek input knowing it will be perceived not as weakness but in the spirit of partnership.

The next iteration involves the private equity firm gathering the resources to ratchet up the value-add it can deliver and requires the integration of those resources into an organization that has likely, until this time, operated largely as a series of semi-permanent deal silos. It requires developing the ability to work with portfolio company executives to implement ideas and improvements in a value-enhancing, non-threatening manner. And it requires shifting the mindset of deal professionals to take time and think about how these resources and capabilities can be used to assist companies in moving the operational and financial performance needles. And while all this may not sound like a heroic shift, having worked at it for more than ten years we would submit that it is very hard to truly accomplish.

But if and when a private equity firm does in fact develop the organization, culture and resources to follow the value-added model, it must still cross the precipice with managers. Private equity firms must learn to speak to managers convincingly about their ability to deliver on a promise. And in a marketplace of executives with an understandable fear of micromanagement, this is a hard step to take at any point and is particularly difficult until a firm has done it sufficiently to have references who can vouch for their abilities. And since having those references generally means having stepped up to the plate numerous times, a leap of faith exists for those willing to move forward.

To Walk The Partnership Tightrope

So what if a private equity firm was committed to make such an effort, what would this shift look like? To best understand what it means to walk the tightrope of true value-added partnership we looked to those who would understand the notion best some of our own portfolio company CEOs. Although an unscientific sample to be sure, the feedback was instructive. Among things mentioned:

Showing up. Perhaps the most surprising finding was how positive CEOs felt about having their investment partners' visit. Even more than for themselves, CEOs felt that it was highly beneficial for other members of management and for employees to see "ownership" involved and caring about their enterprise. Many CEOs felt that this element of attention elevated the game of their team.

Communicating frequently. Many CEOs cited the ability to have regular dialog with the lead professional on the transaction as very helpful. In particular, CEOs mentioned the value of having an outside but knowledgeable senior-level sounding board. In opposition to the long held view, our CEOs seemed to be comfortable talking both in good and bad times and some mentioned that they appreciated a balance between getting calls and making them.

Providing resources. CEOs cited the availability (although, importantly without a requirement to make use) of corporate services and expertise that they did not have in-house. Areas such as strategic planning, organizational effectiveness and operational project management were all cited as examples of resources, which did at times help companies move beyond where they otherwise would have been.

Developing mutual respect. CEOs cited the positive experience of being treated as a partner by senior members of the private equity firm. A number contrasted the partnership dynamic highly favorably to working as a group vice-president and reporting "up" to the corporate decision makers or to young kids in their 20s "filling in" for senior private equity professionals.

Bringing best practices. Despite the sometimes held view that private equity firms who specialize only in one area can add more value, CEOs cited just the opposite. Specifically they indicated an appreciation for having generalists who could act as thinkers without the limitations imposed by having lived exclusively in an industry. Indeed some seemed to feel it balanced their own deep industry expertise. And they found that certain of the outside-the-industry best practice ideas were helpful in expanding the thinking and creating value.

Cross Pollinating. Consistent with the idea that CEOs are often limited in their opportunity to share thinking, ideas and experiences with others of their level, many of our CEOs were very positive about interacting with other portfolio company CEOs.

Clearly, in the maturing industry in which we operate, a growing number of CEOs understand the traditional private equity models and understand their weaknesses. They see how they can gain assistance from an active and knowledgeable outside investor willing to invest time and provide resources. And they can appreciate the benefit of highly interested partners whose knowledge rests mostly in areas different from theirs. Perhaps most importantly they have the self-confidence to appreciate outside participation without feeling that such involvement means they will not be able to "run their business."

Conclusion

Whether anyone likes it or not, the environment in which middle market private equity firms participate has changed-and in a way that will not reverse. The tools that have brought success are proving increasingly uncertain of creating comparable returns in today's environment.

Moving to a true value-added partnership model is not an easy shift for organizations that grew up doing business a different way. In fact it is not easy for most people given the complexity of the hard and soft skills involved. But anyone who has been to the circus knows that walking a tightrope is not without challenge. For those who want to move their portfolio companies and their firms forward in today's marketplace, it is a challenge that must be met.

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