In Private Equity, Management's Role, Incentives Are Shifting

Part II of this two-part Knowledge@Wharton podcast on private equity looks at the management structures that are working best for portfolio companies and how incentives are changing. "For a period there was a trend toward incentivizing [with equity] deep into the organization … we are starting to see more firms start to really focus on the top five to six people," notes Michael Rogers, EY's global deputy private equity leader. He and Stephen M. Sammut, a senior fellow and lecturer at Wharton, explore these and related topics below.

An edited transcript of their conversation follows:

Knowledge@Wharton: In this second half of our podcast on private equity [PE] we will look at how approaches to management of portfolio companies have been changing. Some approaches seem to have performed better than others, and we will discuss that with our guests, Steve Sammut, a senior fellow and lecturer at Wharton, and Michael Rogers, EY's global deputy private equity leader.

Some companies seem to focus more on management improvements than others. What does the record show performance-wise? For example, I understand that those that have replaced management more often have had a different experience than those who stuck with the original management.

Michael Rogers: What the PE fund chooses to do with management does have a very serious outcome in terms of results at the end of the hold period. Having the right management team at the start of a deal is one of the factors most strongly correlated with success. In fact, it results in shorter hold periods, higher EBITDA [earnings before interest, taxes, depreciation and amortization] growth, and maybe even higher equity multiples as well.

The firms that kept their initial managers and changed during the hold period experienced slightly overall higher returns, but at the expense of slightly longer hold periods and lower IRRs [internal rates of return] – you could assume that because they held that longer. The firms that brought in new management at the outset – and then, unfortunately, had to replace them down the road – saw the worst outcomes and that is somewhat obvious. They had lower equity multiples and longer hold periods, because it essentially takes 12 months or so to identify and place a new management team and get them up to speed.

In terms of the ways the PE firms are trying to get the right things in place, they are doing a number of things. They are using management teams that they have used before – that have worked in PE. They have sometimes taken the same management teams and used them over multiple deals. Another aspect: They are starting to invest in second-level management, especially if there is a chance that the original team may not be around fulltime. That was something interesting found in this study.

They are also using consultants to assess new management teams at the outset to figure out what pieces need to be added or changed. Lastly, and most importantly, they are changing management immediately when it is clear that they are not up to the task. That's the critical component because – given the time frame of the holds of these deals – you just can't afford to either to go a couple years in a deal, take a year to get a new management team, and then install them and let them run. By that point you have already exhausted the primary part of your change-management period during your value-creation phase. Those are some of the key issues we found from the study.

Stephen M. Sammut: One thing I would speculate on is, what is the necessity of changing the management team if you are a PE fund that has acquired the company from another PE fund? Perhaps in those cases the management team is where you need it to be and there is perhaps less hands-on [needed].

But if you are acquiring something from the open market the emphasis is on pre-deal management assessment and post-transaction performance acceleration, through either bringing in people from the private equity fund itself – in order to help improve management or replacing management – or using other sources of support. These are all very healthy trends. As somebody who teaches this material to students, who are always asking, "What courses do I need to take in order to become a private equity professional?" for years I have been saying do not ignore operations. This is not all financial transactions and now we have some evidence to support that recommendation.

Knowledge@Wharton: Some of the PE firms give top management more autonomy. Others act more as an operational partner. Is there one way that works better or is it all situational?

Rogers: That is a great debate in the PE community these days. Our research showed that just over a majority – 52% – followed what we would describe as a management-centric philosophy. These are folks who say, "Look, we install management and we will monitor. We will be partners. We will look over your shoulder at the numbers, of course, and we will give advice and maybe use our network to fill gaps in your management team. But you are really there to run the business." And then we have others – the other 48% – made up of several different buckets of varying degrees of people that follow more of a model that Steve also alluded to – more of the operating partner model.

In many of these organizations these folks are now even bifurcating their businesses. They have maybe two sides of a business – it might be the deal side and then the operating or management side. In some cases some of the funds call them different names – call them different firms. And the idea here is that they analyze the company when they acquire it. Then they go in and they drop-ship executives into these roles. Many times they work for the fund. Sometimes they are outside consultants. But the idea is to get the best expertise they can on the ground.

Many of these companies are middle market entities – they may not be able to afford the very best supply chain person in the world, but maybe they could afford them quarter-time and maybe they could be dropped in from the fund to add expertise on a transition or something that is going on in the entity.

So, it is an ongoing debate. I think there is a little bit of a leaning towards using more operating partners than bringing in consultants types, but there is clearly still a majority that really lean on management and expect them to drive the operational process.

Sammut: One of the key lessons – and this was pointed out in the EY report – is that one size does not fit all. That is, firms are going to have to make a case-by-case determination as to just how much intervention is needed. Once you build your in-house infrastructure to support operations, your bias is going to be toward finding opportunities that will utilize that capability. So we may end up seeing, two or three years from now, that this is neatly divided – or there has been a schism between these two philosophies – and some firms are exclusively operationally focused and others are perhaps more traditional in their approach to financial engineering.

Knowledge@Wharton: What is happening around top management incentives?

Rogers: There are big changes in this aspect. Obviously, one of the key tenants of PE is alignment of interests. That is really what drives their model. Getting the GPs, the LPs, and management teams all on one page – the idea is if one makes money everyone is supposed to make money as well.

We're seeing now a shift in the way that PE firms are paying people. For a period there was a trend toward incentivizing deep into the organization. While the aggregate amount of equity remains essentially the same, we are starting to see more firms start to really focus on the top five to six people.

What we heard anecdotally when we did the interviews with a lot of the PE funds is that you do not want to pay people in a currency that they may not value. We think this is a trend we will probably see become more pronounced as time goes on.

If you think through it – if you have got a young professional in your organization that is more concerned with real life current time cash challenges – maybe raising a family or building a house or whatever – they may not put as much value on that equity as somebody at a little bit different stage in their career. So we are seeing a lot of the management teams looking through this and saying "where can we place our bets with five or six folks that can directionally change this business" as opposed to a little bit more of a spreading the peanut butter on the bread [evenly] kind of approach.

It seems to really be taking hold in a number of funds. They are starting to think, let's really super incentivize the folks who we know that can turn the dials and make this business run better. And let's appropriately award, but maybe through other mechanisms – through cash or bonus or restricted stock or something different – the folks that may not value the currency as much.

Sammut: This is a very important point because many of us find the allure of the Silicon Valley model of giving stock options all the way down to the pizza delivery guy as the way of incentivizing an organization. And while that may be true in the binary outcomes – either extraordinarily successful or complete loss is in venture capital – in PE, generally speaking, the currency, as Michael puts it, is seen very differently.

For top management, yes, it may be incentivization worth millions or many, many millions. But for the rank-and-file of the corporation, it is hardly life-changing at all. And people in operating companies come from a different culture. Current compensation is more the driver. So companies have to assess this very carefully and in those instances – where only the senior managers and the people who can make a difference are incentivized with ownership – that does put a burden on still creating a very participative culture among all employees. Because when you are making major changes in operating strategy and expectations, you still have to find ways of keeping people engaged. And sometimes that means just a better bonus structure as opposed to ownership and incentivization.

Rogers: What we are hearing from the funds is they are experimenting with a lot of different models, including compensation plans that are somewhat time-based – or clearly performance-based. [They might look at] liquidity options – even going so far as creating tracking stocks or other mechanisms to reward people that may not cause out-of-pocket equity dilution from the fund itself. So there is lot of creativity in this space and it seems to be a big trend.

Knowledge@Wharton: The study mentions that private equity is still delivering better results than public markets.

Rogers: We have found that over the now eight-year period that we have been doing these studies, we have been able to figure out that PE-backed companies have grown EBITDA at an annualized rate of about 14%; the public companies that we looking at grow at a rate of about 4.3%.

In particular, in the last three years or so the EBITDA growth of our study candidates has been about 13% versus about 6% for public companies. So we do see that there is value being added by PE. I think that that is the premise of the study – trying to understand that, not only is it there, and we concur that it is there, and then, secondarily, what are some of the value drivers that they are really focused on to create the additional value.

We have definitely seen that the model has survived through this downturn and in some ways may thrive. It may look a little different and will probably have to act a little bit differently in the coming years. As we have chatted about, the multiples being paid for some businesses these days are really rich in many cases, and there are strategic players stepping in and paying some very stout multiples.

That may limit private equity's field of play in that space. But what we do see them doing is looking around, being a little bit more creative – maybe looking at bundles of assets or maybe looking at opportunities where they can go in and add the value that we have talked about in the value creation phase. What we are encouraged about; the exit market seems to be holding up – there is a very robust equity market right now and the IPO markets are there. The funds are trading amongst themselves in many cases, but what I think will really heat up the market is when the corporates get back in, in a big way. We think that is a trend that is just breaking out as well. That is our sense for the second half of the year here.

Sammut: And this can bring us full circle back to the IPO issue. One of the ways of monitoring the success at improving earnings in these companies is to watch the after-market or secondary market for the companies that are publicly traded. If they falter in terms of operational performance, the market will most likely punish these issues. On the other hand, if they maintain this level of growth as compared to other publically traded companies, they will enjoy continued value improvements and market capitalization. So there is a hallway monitor in all of this and that is in fact the public markets. ■