



# STRENGTHENING COMPANIES:

## Operational Improvement Trends

2014 survey:

*Gaining private equity returns from operational improvement in US middle market companies*

April 2014

### About our survey

Executives at private equity firms get an early start looking for operational improvements in targeted companies, and they start planning those efforts quickly, according to the data from our 2014 survey on operational improvement trends.

The survey was fielded electronically via private invitation to senior private equity executives from The Deal's proprietary database during February and March 2014. 120 private equity professionals with an operational focus participated, sharing insights on size of funds being invested; industries and geographies where they invest; at what point in their process they turn the focus to operational improvements; what operational areas of the business they most closely examine; and how often the results of their operational improvement strategies matched their initial assumptions.

Of the 120 respondents, 48.4% said they begin focusing on operational improvements before signing a letter of intent. Only 11.6% said they begin after reaching a definitive agreement, and the same percentage said the process starts after closing. Asked how they plan for operational improvements after closing, 47.5% said they use a 100-day program, while just 16.8% said they use a three- to five-year plan.

The largest number of respondents—32.5%—hold executive management roles at their firms. And they are investing large funds: 36% had more than \$1 billion in assets under management. Most of these pools—51.7%—are larger than the firms' previous funds. The firms are mainly focused on the U.S. and pursuing targets in the industrials (51.7%), consumer/retail (47.5%) and healthcare (45%) sectors. Infrastructure (24%) was the least-targeted sector.

A strong majority said they believe operational improvement is more important now than it was before the financial crisis. Nearly 80% of the respondents either somewhat or strongly agreed with that sentiment. "Investors are still skittish and learned their lessons that poorly run companies will eventually meet their destiny," one respondent explained. Several, though, noted that operational improvement has always been important. "The fallacy was that it wasn't as critical pre-recession and leverage levels (and prices) went through the roof with investors relying on financial engineering in lieu of operational improvement to generate returns," explained one executive.

The respondents also agreed that former CEOs and senior executives are most effective at identifying problematic operational issues at every stage: during due diligence, after a definitive agreement and after one year.

The survey also revealed wide agreement that sales execution has been the most important operational improvement to their investment thesis. Healthcare cost improvement was seen as the least important issue. Not surprisingly, given the focus on sales execution, actual results in that area most closely matched the firms' assumptions.

Clearly the most troublesome problem for private equity firms is finding that senior managers' skills are significantly weaker than originally thought. This issue occurred either frequently or somewhat frequently to 61 of the 88 respondents who answered the question. On the bright side, bribery and fraud by senior managers or groups appears to be rare.

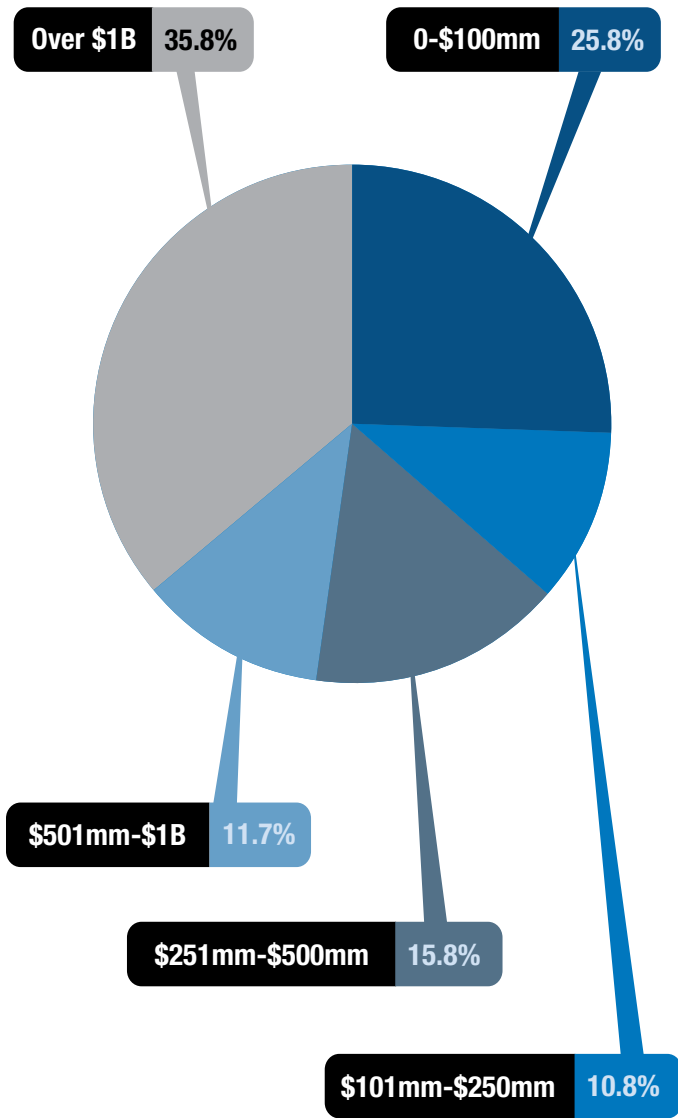
In general, the survey demonstrated the importance of operational improvement and the thought that private equity firms put into the process. As one respondent put it: "Companies require investment to continue improve productivity. The global markets are more competitive and productivity and technology will improve returns on investments."

**Jeffrey Kanige**

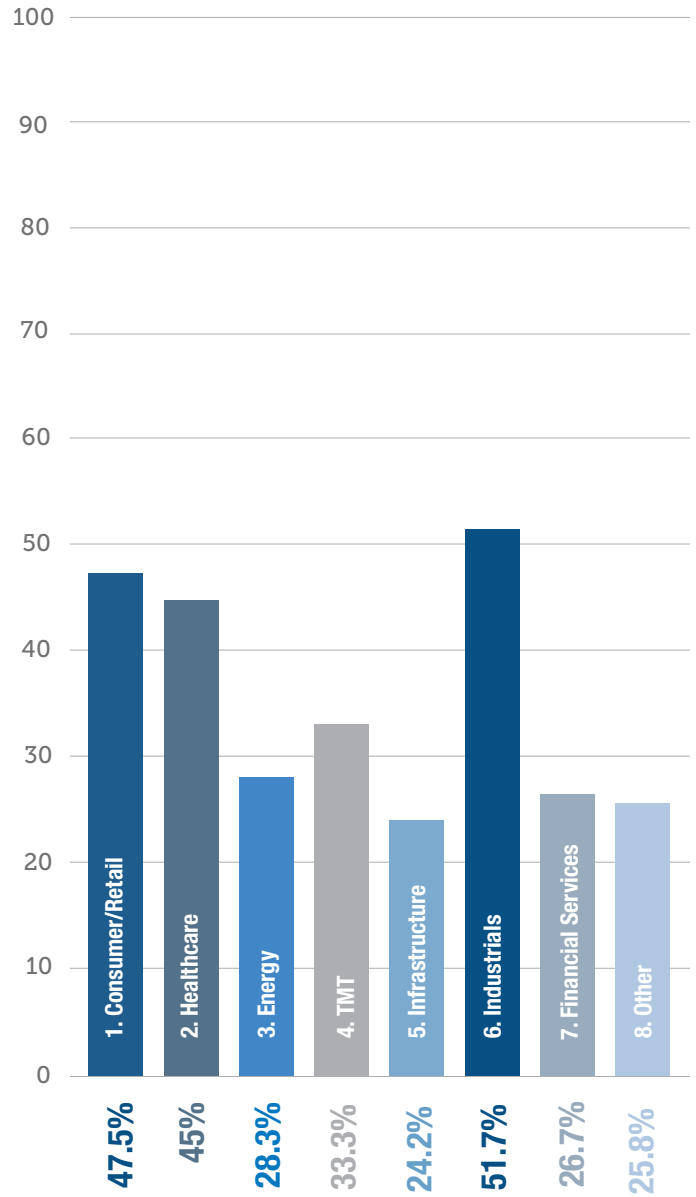
Editor-in-Chief, The Deal



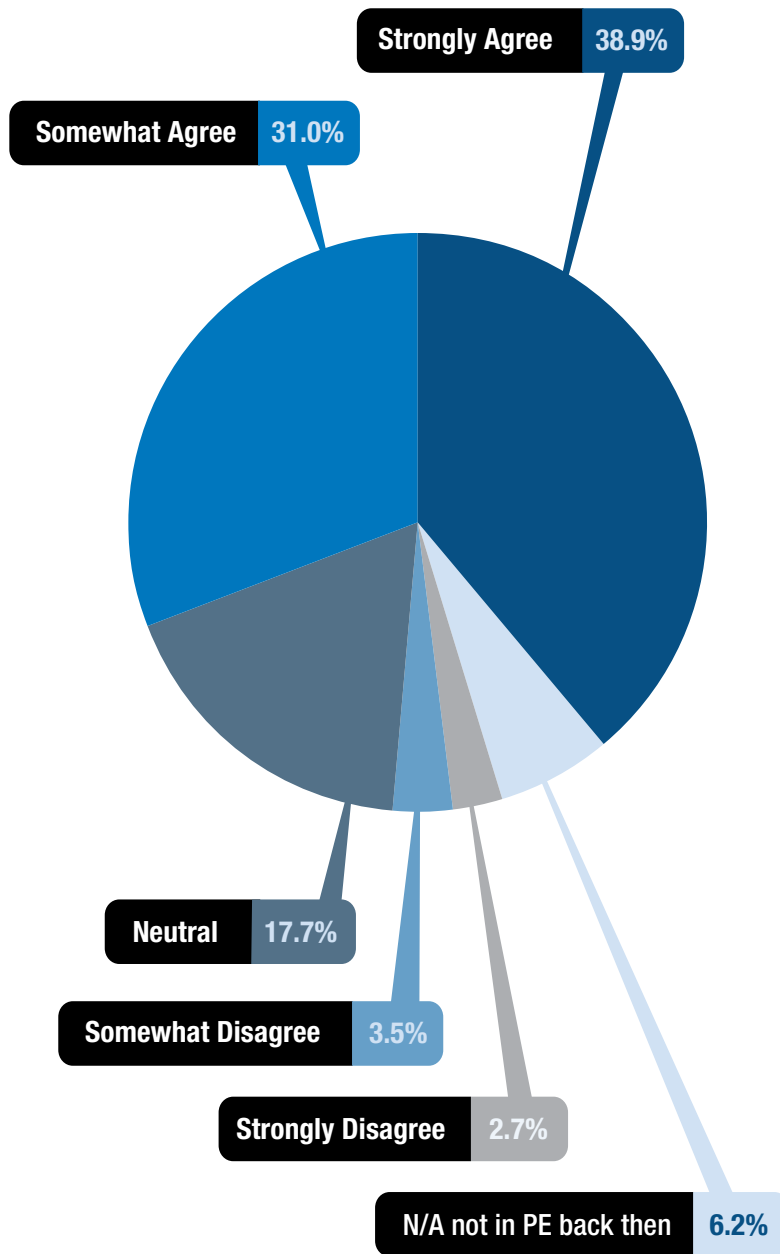
### What are the AUM of the current fund you are investing?



### Which sectors are you currently pursuing transactions in?



## Thinking back to pre-crisis, how strongly do you agree with the following: Operational improvement is more important now than pre-crisis.



### What some respondents said:

*"We now need to play a more active role... thinking creatively about portfolio company synergies, partners, etc., to enable more growth, more cost savings, more quickly."*

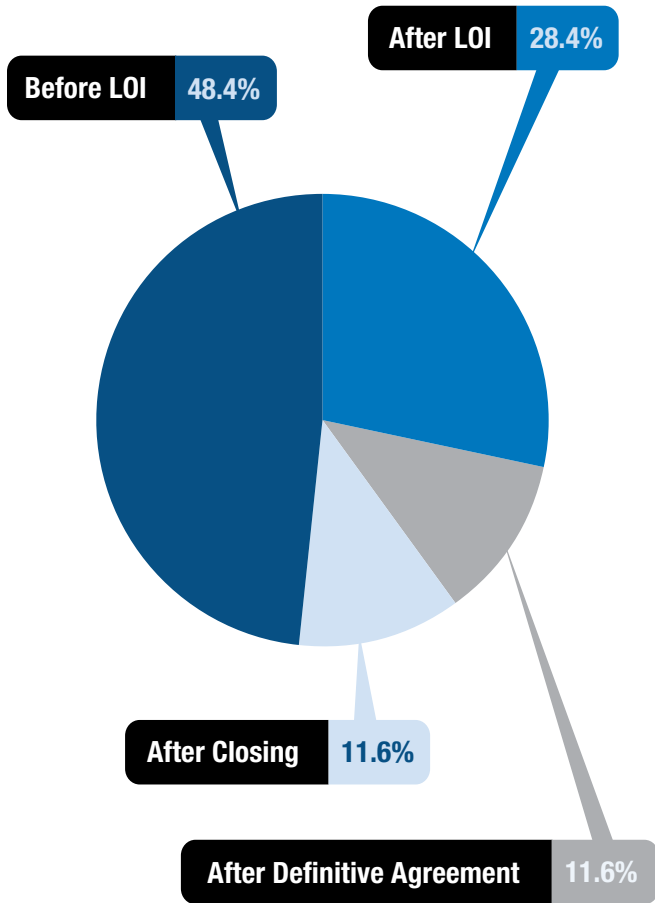
*"Financial arbitrage is dead."*

*"LPs are insisting that GPs have operational capacity in house."*

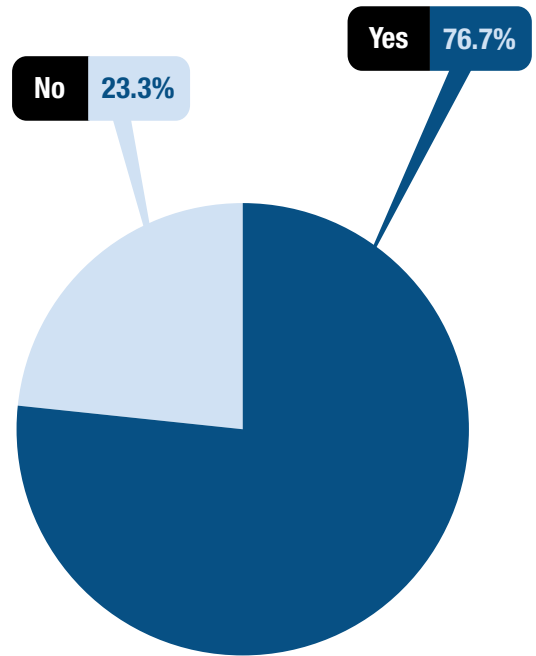
*"Operations side is a very important aspect in every successful business, especially one that is closely monitored by the SEC."*

*"Exits have proven more difficult for companies that have not been 'operationally upgraded'."*

**When, in your transaction process, do you typically focus your attention on operational improvements?**



**Is this the same time you begin incurring expenses against assessing those operational improvements?**

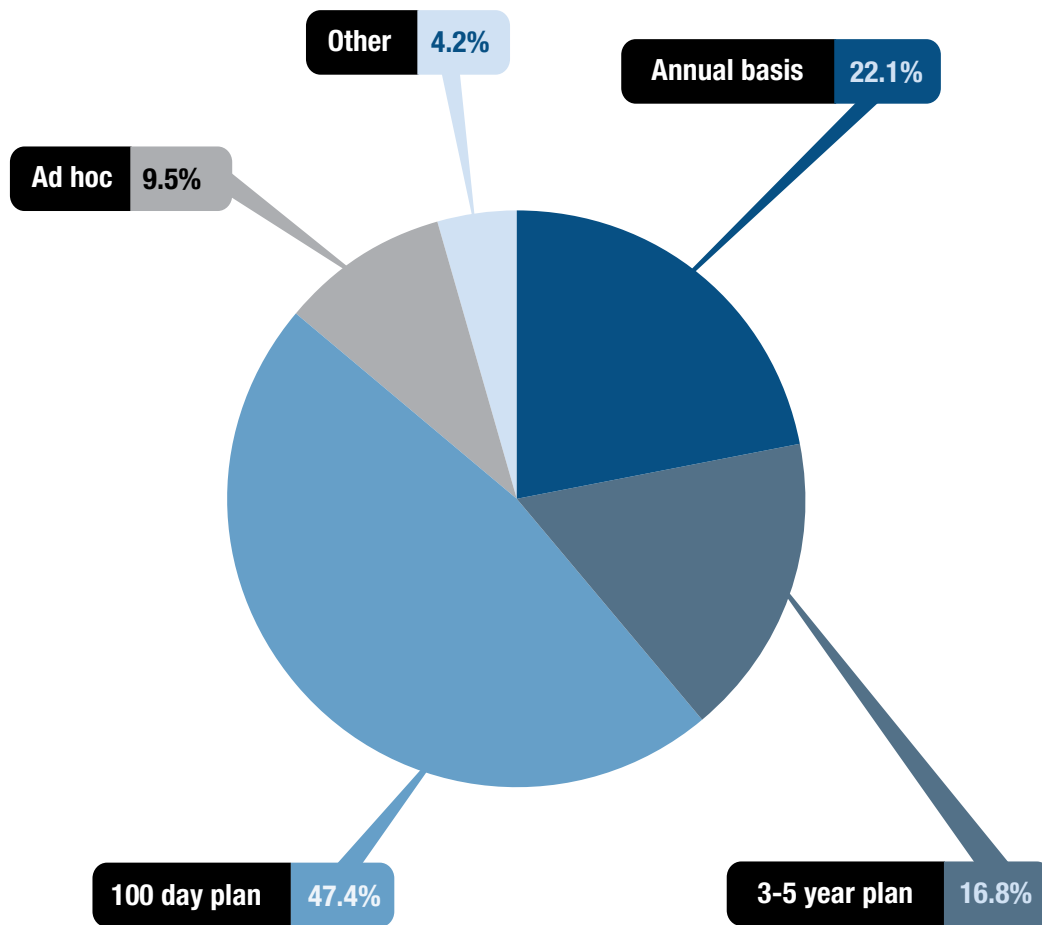


**What some respondents said:**

*“Our team of executive partners layout initial cost containments and revenue opportunities during diligence. Further vetted by LOI. Plan in place by closing.”*

*“We are made up of an operating team that can assess personnel, bottlenecks (both artificial and real)...and have our three trading company partners bid the raw materials. Reduces risk and determines if we can save money and costs which should go right to the bottom line.”*

## Post-closing, how do you typically plan for operational improvements?



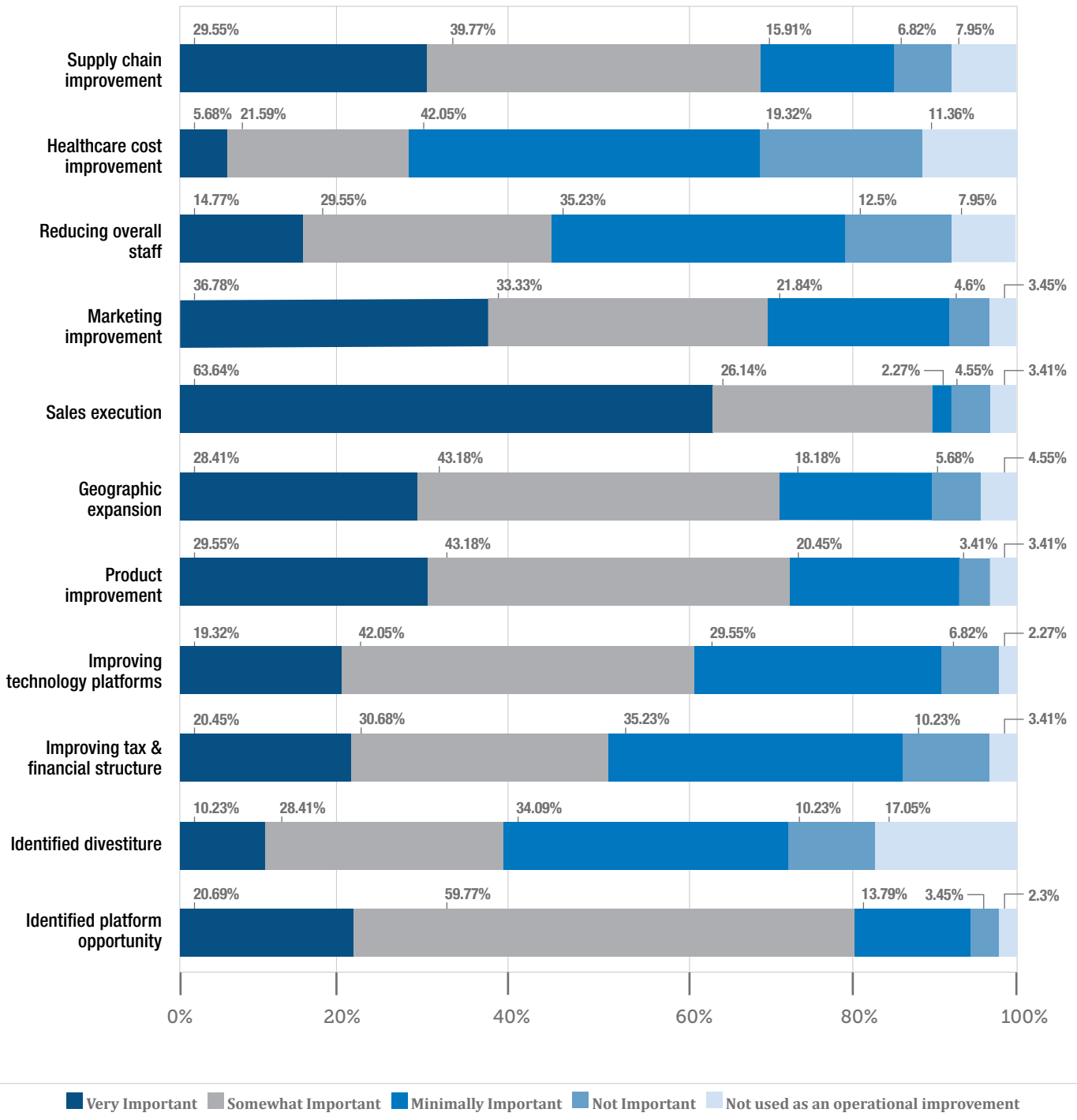
### What some respondents said:

*"Always done before closing and budgets and plans are put in place for a 24 month program."*

*"Within 100 day plan period develop 3-5 year value creation plan with very detailed action plan and budget for year one which is then reviewed annually and updated."*

*"Depends on situation."*

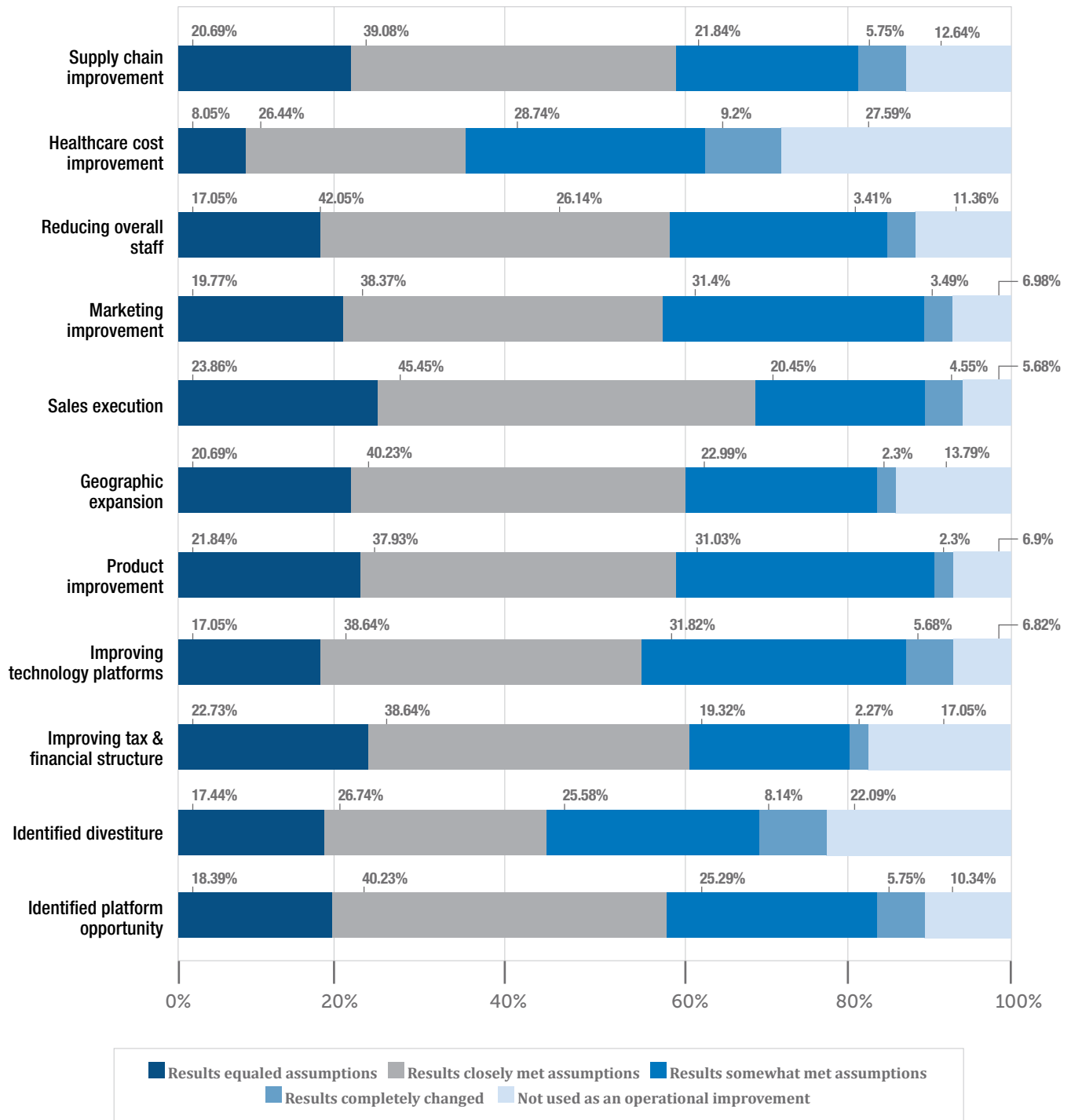
## During due diligence, please rate how important each operational improvement has been to your investment thesis.



**DATA HIGHLIGHTS:** When considering operational improvements pre-close, our respondents report that sales execution, geographic expansion and product improvement rank as the three most important to their investment thesis. Equally important is identifying the platform opportunity.

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**Please rate for each improvement how closely your actual results compared to your pre-close assumptions.**

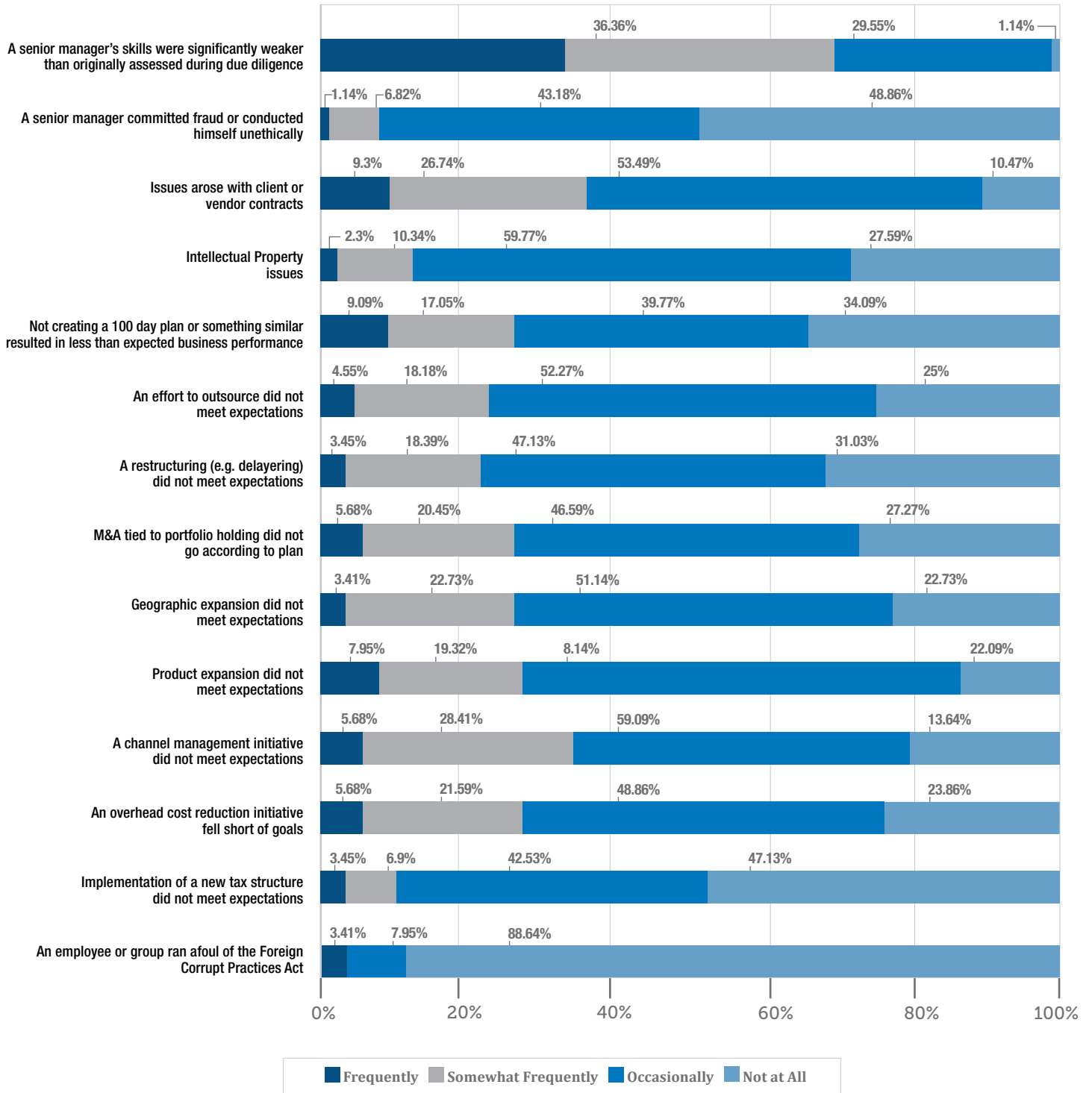


**DATA HIGHLIGHTS:** When looking at actual results of operation improvements compared to pre-close assumptions, results were closely met or fully met in the areas of financial & tax structure; geographic expansion; and sales execution. The areas where results most often completely changed from initial assumptions were healthcare cost improvement and identification of divestitures.

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## In looking at your prior portfolio holdings, please rate how frequently the following operational challenges occurred over the life of those holdings:



**DATA HIGHLIGHTS:** The three most frequent operational challenges when looking at prior portfolio holdings included senior management skills that were weaker than originally assessed; lack of 100 day plan or something similar; and issues that arose with client or vendor contracts.

## About Pepper Hamilton LLP

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Pepper Hamilton was founded in 1890.

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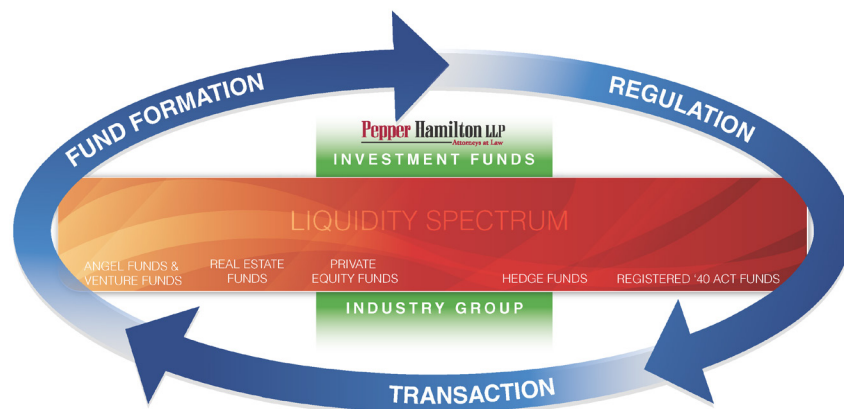
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## Pepper Hamilton's Investment Funds Industry Group

Attorneys in Pepper Hamilton LLP's Investment Funds Industry Group (IFIG) assist private equity, venture funds, real estate funds, hedge funds or registered investment funds throughout their entire life-cycle, including

- formation
- operation
- regulatory compliance, and
- acquisition, investment, financing and other transactional matters.

All IFIG attorneys focus their practice on one of these areas, to ensure that clients obtain the most current thinking on market conditions and cutting-edge trends, while working seamlessly with other practitioners to ensure that the full experience of the firm is deployed to address the entire liquidity spectrum, as well as the varying degrees of fund regulatory oversight, ranging from venture capital funds to mutual funds. Because of this coordinated and integrated approach, we fully understand the interrelationships among these functions, and we are well equipped to help optimize our clients' performance across all of them.



IFIG's client-oriented, deep bench of more than 60 lawyers, aligned nationwide across three of the firm's practice spheres – fund formation, fund transactions, and fund regulatory – with wide experience in various areas vital to the success of funds, also can seamlessly draw upon the knowledge and experience of many more Pepper colleagues, in areas such as private equity, investment management, finance and banking, life sciences, tax, employee benefits, intellectual property, labor and employment, real estate, antitrust, and environmental matters.

For more information about this survey, including questions not highlighted here, contact Bruce K. Fenton, partner and chair of the Private Equity Practice Group and Investment Funds Industry Group for Pepper Hamilton LLP.

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# Atypically



A table surrounded by winners can be a wonderful thing. In structuring a deal, it means collaboration without capitulation. It also means having a law firm that sees and solves problems that exist without generating solutions to problems that don't. All of which makes us more than a business partner; it makes us an ally. It's not typical. But neither are we.

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