The Operating Partner: an Industrial Approach to Private Equity Investment

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All private equity firms seek to maximize the value of their investments. However, there are many different models or routes to this end. What shall be referred to as the "industrial approach" in this chapter is a distinctive model which is based on acquiring businesses that are underperforming relative to their potential and then working closely with the management to improve long-term profitability. Operating improvement, rather than multiple expansion or excessive going-in leverage, and its translation into increased enterprise value can produce superior risk adjusted investment returns.

Private equity firms that build the companies they acquire into stronger, more competitive and more profitable enterprises will create better exit options, irrespective of capital market conditions. In some cases, portfolio companies that have been materially transformed under active ownership, a hands-on style distinguished from traditional private equity portfolio management, are well positioned to select between multiple attractive exit alternatives. To execute the industrial private equity strategy requires a combination of financial and executive management skills within the private equity firm.

Firms that integrate an "industrial mindset" into their investment process also will have a competitive advantage in globally sourcing and generating superior returns from these investments; investments that almost invariably require deep day-to-day management expertise. In today's market, where quality assets are in high demand and sale processes are increasingly competitive, private equity firms relying solely on financial engineering skills (as important as they are) risk being left behind. Firms demonstrating more than financial prowess will build trust-based relationships with corporate sellers. For example, in both the Hertz and Rexel transactions completed in 2005, it was Clayton, Dubilier & Rice ("CD&R") that persuaded The Ford Motor Company and the French conglomerate PPR, respectively, to pursue private sales largely based on the firm's operating insights and credibility established over thirty years of building companies it has owned into more competitive enterprises.

GLOBAL RESTRUCTURING IS INFLUENCING TRANSACTION SUPPLY

Current market dynamics for deploying private equity funds, together with trends in the corporate landscape, (e.g., global divestiture transactions and large corporate transformations), favor what can be described as an industrial oriented investment strategy. The essence of this strategy is to leverage operating expertise to drive above-market investment returns as it applies across the entire lifecycle of an investment, from sourcing through structuring, managing and ultimately exiting the investment. An industrial approach to private equity is predicated on the belief that effective governance, active involvement and, if necessary, timely intervention, are essential elements in the value building process. As corporations confront unprecedented levels of cost, complexity and competition, the need to focus on core businesses and clear up balance sheets becomes ever more compelling. Meeting this need is the large emerging supply of private capital seeking attractive investment opportunities, which increasingly demand strategic, hands-on operating support, as well as additional capital.

The supply of potential transactions is being influenced by a number of trends that align well with industrial oriented investment strategies focusing on acquiring underperforming, non-core corporate divisions. Some of these trends are explored in more detail:

First, there is a definitive link between the pace of corporate divestitures and corporate leadership changes. CEO tenure in mean years has declined precipitously and is today a little over six years. The number of CEO dismissals has tripled in the last decade, largely reflecting unrelenting pressure from investors and global competition. At the start of 2006, eight of the thirty companies making up the Dow Jones Industrials had new CEOs, including HP, Boeing and Walt Disney. New CEOs often embrace new strategic priorities. They buy and sell assets, often large quality businesses that are considered non-strategic. Over time, as corporate M&A rises, so too does the supply of divestiture candidates.

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Second, the emergence of activist hedge funds and other pressures related to corporate underperformance create a rich source of corporate divestiture opportunities. There is little doubt that Ford's financial challenges in the car and truck business influenced the company's decision to divest Hertz. In a period of stress when corporations confront similar financial restructuring issues, as well as an unprecedented degree of new costs, there will be many attractive investment opportunities for private equity firms possessing "hands on" management capabilities.

Third, the pipeline of large transactions is likely to continue as multinational companies redefine their core competencies and business models. Nearly $200 billion of disclosed PE-backed capital was put to work in 2005, and large company buyouts accounted for a substantial portion of the transaction dollar volume. The 50 deals that closed in 2005 with disclosed price tags of at least $1 billion represented more than two-thirds of the year-end total. These large, complex businesses have enormous profitability and capital efficiency improvement potential that can be unlocked by firms with operating capabilities.

Finally, the operating pressures on corporations globally are unprecedented and increasing. The emergence of new information technologies, for example, has enhanced the productivity of many business functions, but it has also increased IT budgets and facilitated more competitive markets and tighter supply chains that erode margins. Industry leaders like Wal-Mart, Dell and Southwest Airlines are forcing far-reaching industry changes. Similarly, shifts in the global economy are creating sweeping changes across all industries. Cost advantages are shifting to China for manufacturing and to India for software development. Indirect labor costs like pensions and health care are drastically altering corporate economics. Collectively, these operating challenges are causing large corporations to set new priorities and to restructure continuously for competitive advantage. These non-core businesses often will represent a strategic channel for the selling parent company, which, as a result, will prefer that the business not fall into the hands of a competitor. Furthermore, these businesses may be difficult to sell in a broad auction or take public as independent entities because of the complex nature of the carve-out from the parent, or a lack of corporate infrastructure.

AN INDUSTRIAL INVESTMENT STRATEGY

While the pipeline of private equity transactions is attractive globally, the competition among buyout firms for these assets is intense. The market for pricing assets is efficient, particularly for well-managed businesses, and multiple arbitrage is no longer a reliable source of investment returns. General economic growth cannot be relied on either, given the increasingly competitive macroeconomic environment. The only sustainable source of out performance in buyout investing is the operational improvement of companies.

In today's private equity market, forming a differentiated view of business performance improvement potential is vital to success in highly competitve sales processes. An industrial investment strategy is best suited for making these types of assessments.

In some cases, a business will be sold through an auction, but complexities or uncertainties around the asset may cause a significant number of competitors to drop from the process. Operational capabilities enable a firm to sift through the wreckage of such broken auctions to find "diamonds in the rough."

In other instances, such as when most of a senior management team returns to the corporate parent after the sale, an operationally focused firm can avoid auctions altogether, or successfully position itself to be the winner of limited auctions. A private equity firm's management capabilities can be significant factors in winning these auctions, even if they are not the highest bidder.

Private equity investment activity aimed at acquiring businesses performing below their full potential often requires the significant hands on engagement of the private equity firm. Typically, these types of businesses have not been managed with a clear focus on value maximization. Among the factors that lead to such underperformance are a lack of management attention or capital resources within a diversified organization, a narrow strategic view relative to a wider market opportunity, or a historical mandate to serve exclusively the narrower interests of a corporate parent. By redefining business strategy and bringing new ideas, increased urgency, additional managerial talent and an uncompromising commitment to operational excellence, proactive private equity owners can serve as catalysts for significant value creation.

The industrial investment approach has been particularly effective in transforming non-core divisions of large corporations into strong and profitable free-standing enterprises. These transactions require experience managing deli-

cate employee, customer and supplier issues, as well as the many complexities associated with corporate carve-outs (e.g., commingled assets, incomplete management teams, shared distribution channels and ongoing supply agreements). This experience is quite useful when working collaboratively with large multinational corporations to facilitate their restructuring strategies.

In many transactions, the structure and organization of the business being acquired is complex. In other transactions, the financial structure of an acquisition can be complex. In some cases, both the deal and business structures will be complex. A firm with the capacity to handle both will find opportunities in complex situations where other financial or strategic buyers may only see downside risk. Minimizing competition in this manner will allow assets to be acquired at more attractive valuations, providing an opportunity for more comprehensive due diligence and structural acquisition agreements, and, post-acquisition, allows the firm to create significant incremental value by implementing strategies to reduce complexity.

THE OPERATING PARTNER'S PROFILE AND ROLE

There is no single operating partner template that will fit every private equity firm. Within the context of the industrial investment model, operating partners should be proven business leaders with the credibility, established track records of success and professional experiences to successfully lead portfolio companies forward. In addition to unquestioned professional integrity, ethics and personal values, the qualities that CD&R has looked for in the senior corporate executives the firm has recruited include most of the following:

- An accomplished, CEO-ready executive with a proven record of achieving sustained growth while running a diverse, global, multi-billion dollar company. For example:

– Currently at the CEO or COO level with responsibility for a global organization of significant scale; possibly a former CEO who successfully ran a company.
– Alternatively, a "best athlete" with experience running large, diverse businesses in a company known for growing top talent (i.e., General Electric, Emerson Electric).

- Experience in a multi-faceted company. Industry characteristics include global, capital-intensive, manufacturing/technology and business-to-business experience.

- Global view; significant international experience; track record of growing businesses across worldwide markets; ability to relate to business and government leaders on a global basis.

- Immediate credibility with the financial community; a record of building shareholder value.

- Ability to balance strategy and execution; a skilled operating leader who has and will improve a company's execution capabilities and cost competitiveness; a willingness to make tough decisions and create an environment where people exceed expectations.

- A competitive spirit; strong marketing and sales skills; someone who is effective at interacting with customers; the ability to see emerging needs and opportunities through the eyes of customers.

- Proven track record building high-performance teams; encouraging partnership across a complex business and ensuring that proper talent development and succession planning has been conducted.

- Experience running a business during a restructuring or one that is in transition, reinforcing integrity, esprit de corps and transforming public and investor attitudes toward the business.

As a group, CD&R's operating partners have spent more than 200 years in senior management positions at over 50 companies (including General Electric, IBM, BBA, BTR, Emerson, Ecolab and Reliance Electric, among others) across a wide range of industry sectors. They are full partners with an equal share of the firm's economics. Other private equity firms have employed individuals with operating experience on a part time basis as consultants or advisors.

The role of the operating partner within the industrial investment model spans the private equity investment cycle from sourcing to post acquisition value building and ultimately navigating the exit window. But the most important role is managing the investment throughout its various phases. CD&R's investment in Kinko's is a good example of the range of challenges confronted as the transformation unfolded.
Today, Kinko's is the leading document management company that serves many of the Fortune 500. That was far from being the case when CD&R acquired the company in 1996. The transformation took place over seven years and occurred in three phases, each requiring distinct managerial skills.

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The most important due diligence question then becomes: "Can the operating performance of the business be materially improved?"

Phase one required integration skills and involved rolling up 127 sub-chapter S corporations and partnerships into one unified corporate entity; easier said than done. This meant wrestling with 127 independent minded founders of Kinko's. The business grew up without a strategic plan in mind. For example, Kinko's did not even have a common point of sales system. The machines throughout the 1,100 store network were all different. There was no single system of general ledgers, office staffing, sales forces and the like. It was hardly a true business.

Phase two required strong cost management skills as we turned our attention to efficiencies and scale. The cost structure was rationalized by removing approximately 1,300 copy machines, aggressively pursuing new sourcing opportunities, implementing best practices across the 1,100 location branch network and streamlining corporate overhead. In this phase the EBITDA margins doubled from 6 percent to 12 percent .

Phase three required the ability to ignite top line growth by building a highly differentiated value proposition and a world class sales force that targeted large commercial accounts. In less than two years, corporate accounts grew to approximately 20 percent of Kinko's approximately $2 billion in revenues and were growing at double-digit rates on exit. It was Kinko's increasing penetration of the attractive corporate market, which ultimately caught the attention of FedEx.

The Kinko's case study illustrates the range of managerial skills required for a successful corporate transformation. In the final analysis, however, it is the portfolio company management that needs to execute. To be effective, an operating partner's interactions with the portfolio company management team should never undermine autonomy and authority, but rather support a culture directed toward accelerated change and to increasing operating profit and revenue growth as happened at Kinko's.

LEVERAGING OPERATING CAPABILITIES IN INVESTMENT DECISION-MAKING

The industrial oriented private equity investor does not depend on mechanical financial modeling or the views of management consultants, as valuable as these are, in making investment judgments. An operational assessment of the business is also a key part of the evaluation process, which means conducting due diligence and contract negotiations more as a corporate or strategic buyer. The most important due diligence question then becomes: "Can the operating performance of the business be materially improved?"

The subsequent line of inquiry reflects the unique perspective of someone with hands on operating experience over a long period of time in a variety of industries and economic climates, not simply the analysis of a management consultant.

The types of questions that are investigated include: What kind of business is it to manage? What are the inherent strengths or underutilized assets? What are the customer opportunities or attractive segments that require greater focus? Can the financial performance be altered through management action or will the business be overwhelmed by industry and market conditions? What can be done to manage the strengths and weaknesses in each element of the business system, (e.g., research and development, manufacturing, distribution, marketing, sales, service)? Can distribution patterns change? Can the product lines be repositioned to meet shifting customer needs? What can be done to commercialize relevant technologies more rapidly? Can the restructuring process be accelerated?

As these questions suggest, determining value for an industrial investor is not so much a matter of discounted cash flow or EBITDA multiples or balance sheet ratios — although these are certainly important — as much as it is a function of the operating partner's assessment of the operational risks and earnings potential of acquisition candidates. During the course of due diligence, the role of the operating partner is to challenge the fundamental assumptions about how an acquisition target should conduct its business and what should be changed. This level of scrutiny, even before a transaction closes, can accelerate the transition of an acquired company to an independent, standalone business.

CD&R's investment in Rexel, the global wholesale distributor of electrical products with revenues in 2005 of approximately €7 billion, is a good illustration of the early value creation that results from including an operating viewpoint during due diligence. CD&R led an investor group in acquiring Rexel from luxury goods maker Penult Printemps Redoute. Electrical products distribution is an industry segment the firm knows intimately – and one in which it has enjoyed considerable success over the years. CD&R owned for nearly five years WESCO Distribution, a highly regarded electrical wholesale distribution business that

trades on the New York Stock Exchange and which generated a gain of 6x on the original investment. CD&R also spent about 12 months of due diligence on a bid to acquire Hagemeyer, a €6 billion in sales global electrical products distributor headquartered in the Netherlands. The firm was unable to complete this deal, but the process gave us further depth of insight into this industry and conviction about its attractive dynamics.

Rexel's attractive spread of risk characteristics in terms of its fragmented customer base, broad geographic diversity, and global scale, fit well with CD&R's extensive experience in distribution businesses. Rexel had survived a very difficult industry downturn prior to our investment. While the company was both stable and profitable, it was strongly believed that there was more opportunity than reflected in Rexel management's business plan. There was the potential to: exploit further operational improvements; continue the reshaping of the company's worldwide footprint; and, transform the company through both organic and acquisition-led growth.

The Rexel management team embraced the CD&R investment case enthusiastically, and during the first year of ownership the company aggressively pursued operating improvement initiatives – some big, some small – covering a range of issues, including sales growth, purchasing optimization, product mix enhancements, private label roll-out, operating expense actions, and working capital management improvements. The company also executed a series of earnings accretive acquisitions, including the $750 million purchase of GE Supply, making Rexel the market leader globally and in the U.S. the world's fastest growing electrical distribution market.

A NOTE OF CAUTION ABOUT PRIVATE EQUITY TRANSFORMATIONS

The culture of transformation is in full sway with private equity firms promoting the virtue of active ownership. But does this culture lead always to superior performance? Empirical and anecdotal evidence suggest not. Management consultant A. T. Kearney, for example, estimates that two-thirds of corporate change projects actually fail.

The pressure for corporate change has led not only to the increasing turnover of CEOs and other senior managers, but also to second thoughts about the pace and costs of business transformation itself. John Pepper, retired CEO of Procter & Gamble, aptly captured the essence of this reconsideration when he observed: "We undertook too much change too fast…We clearly took on more than we were able to execute."

Private equity firms that follow an industrial investment approach need to be sensitive to the powerful paradox of change. Perhaps the most significant value that an operating executive can bring to the typically impatient private equity asset class is the clear understanding that first-rate execution takes time, whereas second-rate execution will almost always be disruptive, costly and chaotic. This theme is likely to be heard increasingly in the next few years as more private equity firms attempt to incorporate some level of operational content into their investment models.

The new landscape, where a more hands-on ownership and management is applied, also will likely affect investment holding periods in certain instances. It should be recognized that it takes time for initiatives relating to salesforce productivity, product quality, distribution efficiencies, mix management, selling, general and administrative expenses, branch profitability, manufacturing, sourcing, private label strategies, or any number of other operating initiatives that form the basis of an industrial investment to gain traction. As a result, it is an investment style that comes with a health warning, particularly for private equity firms with more of a marketable securities investment time horizon.

CD&R, which has specialized in sponsoring and investing in business transformations across four decades, has encountered the problem of "too much change, too soon" in many investments. Lessons learnt may be useful to private equity firms confronting difficult choices about portfolio company transformations. The question of how fast or evolutionary to proceed is ultimately a judgment call. The answer is often shrouded in dense fog, but here are some factors that any operating partner should be prepared to address:

First, *being able to distinguish between false signals of temporary distress and real problems.* Keep in mind that rarely is a significant organizational decision undertaken without some form of crisis or severe shock resulting from it. In the short term, there will be many unpleasant issues about costs, employee morale, new product introductions, customer dissatisfaction and management turnover. The difficulty is to determine whether these hiccups reflect the normal disruptions associated with a business transformation, or a truly dysfunctional strategy and portfolio company management team.

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If the operating partner concludes that it is necessary to pull the plug on a portfolio company CEO, there must be a reasonably developed plan for new leadership and a new strategy

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This difficulty was encountered in the early years of many investments, such as Lexmark and Kinko's. At both companies, the discomfort level was extremely high as CD&R operating partners helped to install new business practices and more disciplined performance cultures.

Second, *recognize that an informed perspective requires a granular understanding of the details and progress of the transformation program*. Operating partners with experience in managing big corporate transformation programs — and who are deeply involved with the portfolio company — are best placed to evaluate what is really going on, including whether the transformation is on an appropriate schedule. Private equity firms that rely on quarterly board updates in "show and tell" formats will never have enough of the gritty details to make informed assessments about their investments.

Third, in pursuing portfolio company transformation strategies, the operating partner may have to take the lead in convincing others to *accept at least one more year of disappointing financial results.* Changing strategies and people, not to mention products, technologies, channel strategies and marketing programs, takes time. A transformation can not be produced by popping it in a microwave oven. Lexmark, Kinko's and other highly successful CD&R investments struggled in early years and were not truly profitable growth companies until their transformations had been under way for at least three years.

Finally, if the operating partner concludes that it is necessary to pull the plug on a portfolio company CEO, there must be *a reasonably developed plan for new leadership and a new strategy*. It is one thing to be dissatisfied with business performance. It is quite another to have a new CEO in the wings ready to implement a revised strategy.

CONCLUSION

In a brutally competitive private equity environment, the capacity to execute portfolio company transformation will increasingly be the primary driver of investment returns. Without a strong industrial investment philosophy and deep operating capabilities, however, it will be difficult for most private equity firms to judge whether their portfolio companies are adapting to change reasonably and quickly enough, or whether they are moving too fast. In the final analysis, to make a critical judgment call like this requires not only a hands-on operating partner who is close enough to the portfolio business to know the difference, but an operating partner with sufficient experience and battle scars to keep in mind Machiavelli's insight that "there is nothing more difficult to carry out, nor more doubtful of success, nor more dangerous to handle, than to initiate a new order of things". ■

Mr. Quarta joined CD&R in 2001 and is based in Europe. He is currently Chairman of Italtel, which he has helped transform from a manufacturer of telecom equipment to a leading global provider of network integration products and services. Mr. Quarta is the lead operating partner responsible for Rexel SA and serves as Chairman of the Board. Prior to joining CD&R, he had served since 1993 as Chief Executive Officer of BBA Group plc and is credited with successfully restructuring and reorganizing the $2.5-billion-in-sales aviation services and materials technology company, which operates in 14 countries. He continues to serve BBA as Chairman and is a non-executive Director of BAE Systems plc and Azure Dynamic Corp. Mr. Quarta graduated from the College of the Holy Cross, where he serves as a trustee. He is fluent in Italian, French, Spanish and English.