

FROM THE EDITOR



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The Source Of Great Returns

How many ways are there left to squeeze returns from a leveraged buyout?

Leverage? Just about dried up. Rising multiples? Let me check my 401(K) and get back to you. Selling off assets? I'm still on that 401(K) run. Multiple arbitrage? Sure, but add-on deals can command high prices, and mergers are notoriously hard to pull off.

That leaves only one significant method—cranking up EBITDA at portfolio companies, by generating higher revenue, cutting costs, or some combination of the two. I've never really gotten a handle on just what portion of buyout-fund returns derive from performance improvement versus other methods. One recent study puts the figure at 20 percent to 25 percent. Regardless, I'd wager that firms that perform consistently well over many years place more emphasis on operations than their rivals. Why would I bet that? It's arguably the only factor that buyout firms can reasonably control in both good times and bad.

Fortunately, just how the best firms inspire better performance in their portfolio companies has never been better understood. This year alone has seen the publication of several good studies and books on the subject.

Hugh MacArthur, leader of consulting firm Bain & Co.'s Global Private Equity Practice, is co-author of one of them, along with Bain Chairman **Orit Gadiesh**: "Lessons From Private Equity Any Company Can Use." **Geoff Smart** and **Randy Street**, with management consulting firm ghSmart, recently wrote a book titled "Who," which analyzes how successful buyout shops pick top-flight management teams. And London Business School Professor of Finance **Viral V. Acharya** has teamed up with a McKinsey & Co. consultant, **Conor Kehoe**, to produce a draft paper titled "Corporate Governance and Value Creation: Evidence From Private Equity." They plan to submit the paper, based on a study of 66 U.K. buyouts from 1996 to 2004, for publication in a finance journal by the end of the fall. Here are some of the top tips I gleaned from the three:

"Who"

- * Do your best to hire "A" players, defined as managers who have "at least a 90 percent chance of achieving a set of outcomes that only the top 10 percent of possible candidates could achieve";

- * Find managers that you'd like to hire before you actually need them; that way you can avoid a pressurized rush to fill a key position when it does open;

- * Create a scorecard for the person you'd like to hire that focuses less on the responsibilities of the position and more on the goals you'd like the candidate to achieve and the qualities needed to achieve them; not "manage sales team" but "triple EBITDA over three years by signing highly profitable new contracts";

"Lessons From Private Equity..."

- * Define clearly how much you want your equity to grow in value in a company, and over what holding period, and make that a goal for your management team;

- * Pursue no more than three to five key initiatives (in most cases) to grow cash flow; any more than that and you could wind up spreading your resources too thin;

- * Make sure your management team understands that, with a leveraged business, managing cash is more important than managing earnings, and that often means learning how to lower working capital requirements;

"Corporate Governance and Value Creation..."

- * Don't hesitate to show management the door, and quickly; a hallmark of many of the best-performing deals is top management turnover in the early phase of a deal;

- * Get engaged. The authors found that buyout firms generate higher returns when either they themselves provide strong direction to management teams, or when they bring in consultants to do so.

Sincerely,