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Private Equity

Lessons from Private Equity Any Company Can Use

by Orit Gadiesh & Hugh MacArthur

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In good times and bad, the top private equity firms have outperformed most businesses over the past forty years–even during down cycles. Clearly, PE firms have had to adjust their deal flow but the way that leading players operate their portfolio companies serves as a model for public firms, especially during an economic squeeze. That's why watching how these firms respond to the recent global credit crunch is especially instructive.

Now more than ever, PE funds are sticking with a time-tested approach that generates big returns from dramatic improvements in operations. The results speak for themselves: the top 25 percent of U.S. private equity funds raised between 1969 and 2006 have earned internal rates of return of 36 percent on average, through good times and bad. That's close to 10 points higher than the equivalent S&P 500 top quartile.

Private equity masters follow a set of disciplines that senior executives can employ for similar results. In fact, public companies have boosted their own performance in just this way–by adapting the PE model. Some of these lessons will sound familiar. Some may even appear obvious. However, in times of increasing economic uncertainty, these proven techniques are especially relevant.

In the coming weeks, we'll be writing in more depth on each of the six private equity lessons, but briefly, the lessons are:

Define full potential: Top PE firms generate high returns primarily by creating operating value. They start by building an objective fact base. They scrutinize demand, customers, competition, environmental trends, and the details of how money is actually made. Only then do they pursue a few core initiatives to reach full potential.

Develop the blueprint: PE blueprints are about action. They turn the few core initiatives into results, choreographing actions from standing start to the finish line.

Accelerate performance: Top PE firms mold the organization to the blueprint, use a rigorous program, and monitor a few key metrics.

Harness talent: Top PE firms create the right incentives for employees to act like owners, and they assemble decisive and efficient boards.

Make equity sweat: Top PE firms embrace leverage. This is perhaps one of the toughest PE disciplines to adopt, and one that CEOs and their boards should consider carefully, especially when credit is tightening. Scarce cash compels managers to manage working capital aggressively, discipline capital expenditures, and work the balance sheet hard.

Foster a results-oriented mind-set: This lesson is about creating repeatable processes that spur performance improvements again and again.

One way that PE firms systematically create value is that they often operate in a turnaround mode, one that starts with a hardheaded assessment of the full potential of the base business.

When Bain Capital and Charlesbank Capital Partners bought Sealy Corporation, for example, they aimed both big and realistically: seeking to increase the value of their original equity investment fivefold in just a few years. They knew they could after probing every corner of Sealy's business. Their main finding was that the complexity of its product line was not the primary margin problem–differentiation was.

Sealy had been making a costly, two-sided design that allowed mattress owners to do something most don't actually do: flip mattresses. The company shifted to a "no-flip" mattress design whose technology improved Sealy's margins and leapfrogged its rivals' technology. What Sealy did not do was go ahead with former plans to boost the volume of its mid-price mattresses, concentrating instead on higher price points. Result: the new mattress design improved EBITDA by 22 percent. And in 2004, the group sold the company for more than five times its investment. This example illustrates the first PE lesson, define full potential. In the coming weeks, we'll explain the remaining five lessons.

Individually, PE's six lessons are clear and compelling. Together, they can reliably produce superior results. Particularly now as the economy slows, public as well as private companies should consider that larger lesson as they seek to find gold under the mattress.

Orit Gadiesh. chairman, Bain & Company, is a partner in Bain's Paris office. Hugh MacArthur, director, Bain's Global Private Equity Practice, is a Bain partner in Boston.

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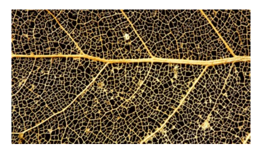

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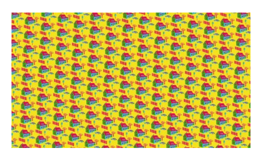

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