



**IE UNIVERSIDAD**

**DOCTORAL DISSERTATION /**

**TESIS DOCTORAL**

**OPERATIONAL VALUE CREATION IN PRIVATE EQUITY:**

**ART OR SCIENCE?**

**CREACIÓN DE VALOR OPERATIVO EN *PRIVATE EQUITY*:**

**¿ARTE O CIENCIA?**

**ANNICK E. DESMECHT**

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## **ABSTRACT**

We examine how executive teams of Private Equity portfolio companies deliver superior returns through their strategic and daily operational decisions and actions. We run a comparative multiple case study of four companies, each of which went through a successful Private Equity (PE) investment cycle, and interview key members of the executive team and board as well as cross-industry experts. Using a qualitative, inductive process methodology, we match patterns between cases to tease out similarities and variance across cases and to develop a typology of actions maximizing the enterprise value at exit of the investment. We structure those actions in four distinct dimensions, which mirror the key stages of an investment, to develop a model for Private Equity operational value creation. Finally, we use dynamic capabilities and agency theories as an interpretive lens to analyze value creation in the specific context of Private Equity portfolio companies.

**KEYWORDS:** agency theory, dynamic capabilities, leveraged buyouts, operational value creation, Private Equity

## **ABSTRACT**

Examinamos la forma en que los equipos ejecutivos de compañías de cartera de private equity ofrecen retornos superiores gracias a sus decisiones y acciones estratégicas y operativas diarias. Llevamos a cabo un caso de estudio comparativo múltiple de cuatro compañías que han acometido exitosamente un ciclo de inversión en *private equity* (PE) y entrevistamos a miembros clave del equipo ejecutivo y la directiva, así como expertos interprofesionales. Recurriendo a una metodología cualitativa de proceso inductivo, comparamos patrones entre casos para establecer similitudes y diferencias entre ellos y desarrollar una tipología de acciones que maximicen el valor de la empresa a la salida de la inversión. Estructuramos esas acciones en cuatro dimensiones distintas que reflejan las etapas cruciales de una inversión a fin de crear un modelo de creación de valor operativo en *private equity*. Por último, utilizamos capacidades dinámicas y teorías de la agencia como un prisma interpretativo que nos permita analizar la creación de valor en el contexto específico de las compañías de cartera del *private equity*.

**KEYWORDS:** teoría de la agencia, capacidades dinámicas, compra apalancada, creación de valor operativo, *private equity*

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## INTRODUCTION

Since the advent of the first Leveraged Buyouts (LBO's) about four decades ago and the development of a new Venture Capital and Private Equity industry, researchers have been keen to benchmark returns of this asset class against the average returns of public companies. A consensus has built amongst academics that Private Equity funds – also called *General Partners* - deliver superior net returns to investors – or *Limited Partners* - versus an S&P 500 benchmark, despite the relatively hefty fees paid to Private Equity fund managers in the process (Groh & Gottschalg, 2006; Acharya, Gottschalg, Hahn, Kehoe, 2013; Higson & Stucke, 2012; Harris, Jenkinson and Kaplan, 2014).

The industry derives superior returns from three main sources: financial engineering, governance engineering and operational engineering within the portfolio companies. Prior literature has focused mostly on financial engineering and governance engineering, which are now well understood and documented (Berg & Gottschalg, 2005). Although researchers have attempted to measure operational engineering (Acharya et al, 2013; Ayat, Schutt, 2016), we still know very little about how operational engineering impacts firms' performance. In fact, it remains unclear whether and how operational engineering may be a source of value creation for Private Equity investments.

This study focuses on how executive teams in Private Equity portfolio companies create superior value through their strategic and daily operational decisions and actions. The relevance of and increasing interest in benchmarking the returns of Private Equity funds with the average returns of public companies calls for in-depth analyses of Private Equity executive teams' managerial actions. Our research extends

the topic from the traditional realm of the Corporate Finance literature to the two streams of dynamic capabilities and agency theory.

Dynamic capabilities (Teece, Pisano and Shuen, 1997) are a key component of the success model of operation in a Private Equity portfolio company. In picking the executive team, Private Equity fund managers ensure strong dynamic managerial capabilities (Adner and Helfat, 2003). They then set structures and processes in place to ensure the dynamic nature of strategy decision making (Eisenhardt and Martin, 2000) and ambidextrous management (O'Reilly and Tushman, 2008; Birkinshaw, Zimmerman and Raisch, 2016).

Agency theory – while originally developed for a public ownership context -, can also be extended to this new context (Gomez-Mejia and Wiseman, 2007) to analyse the principal-agent relationship between the executive team and the Private Equity fund. Private Equity portfolio companies represent unique cases of principal-agent conflicts. As owner-controlled firms, we would expect that corporate performance, rather than size, becomes the primary predictor of CEO and executive pay (Tosi, Werner, Katz and Gomez-Mejia, 2000). Yet, the largest share of CEO pay in such cases is inextricably linked to the exit value of the investment, which does not necessarily reflect traditional performance measures.

With these two interpretive lenses in mind, we address our research question – how executive teams in a Private Equity portfolio company create superior value through their strategic and daily operational decisions and actions – by way of an inductive study based on a cross-case research design with a literal replication logic (Yin, 2003). We studied four cases of private-equity-owned companies, which resulted in proven discontinuous operational performance. Our research design used a literal replication logic in which each case served to confirm or disprove the

inferences drawn from the others. Pattern matching between cases ensured the robustness of our emerging theory. We corroborated our emerging insights with investors and advisors to the industry who used their cross-case experience to comment and refine our learnings.

We used an inductive research approach (Gioia, Corley & Hamilton, 2013) to develop a dynamic operational value creation model. This choice of approach is favoured for two main reasons. First, an exploratory, inductive study is well suited to examine research questions and phenomena that are still unexplored. Second, this type of study is appropriate for this industry, which is inherently private, with no public reporting requirements during the period of Private Equity ownership (“holding period”). Actors creating value in Private Equity portfolio companies rarely share their experience openly in public. While the actual chosen value creation path will necessarily be idiosyncratic in nature to each specific portfolio company, all such value-creating actors share a focus on maximizing their company’s attractiveness – hence, its value - in the market for corporate control at exit of the investment (Manne, 1965).

In a first step, we gather a typology of managerial actions, which are most conducive to the successful build-up of enterprise value within a private equity context. Those first order actions are then ordered into second order themes, which are common to all cases studied. Lastly, we order those themes into aggregate dimensions, which reflect the key stages of a typical Private Equity investment.

Our study offers a deeper understanding of how operational engineering in Private Equity portfolio companies impacts corporate performance, measured as the return received by limited partners after general partners exit the investment and cash in on their own fees (the “net return”). It proposes an operational value creation model,

which gathers key strategies and operational actions most conducive to maximizing the exit value of the company across sectors.

Contributing to extant literature on dynamic capabilities and to agency theory, this study identifies a set of dynamic capabilities developed internally by Private Equity funds in the process of creating enterprise value, which can be replicated throughout the fund's portfolio of investments. Next, our study also examines the principal-agent relationship between the Private Equity fund partners and the portfolio company's CEO and executive team. We highlight the effectiveness of powerful compensation models for executives in owner-controlled firms, which best align their actions with the value creation objectives of the owners. We contrast the nature of these compensation models with the ones mainly referred to in prior literature and which commonly apply in a public ownership context.

The model developed in this research, linking strategies, actions, capabilities and supportive compensation models, provides a useful road map for public market executives who are increasingly at risk of facing the pressure of financial activists to deliver superior performance and returns to shareholders.

## INTRODUCCIÓN

Desde la llegada de las primeras compras apalancadas (LBOs) hace aproximadamente cuatro décadas y el desarrollo de la nueva industria de *venture capital* y *private equity*, los investigadores han buscado referenciar los retornos de esta nueva clase de activos con los retornos medios de las empresas cotizadas. Se ha instaurado un consenso entre los académicos de que los fondos de *private equity* –también llamados socios generales– ofrecen retornos netos superiores a los inversores –o socios limitados– en comparación con una referencia SyP 500, a pesar de las sustanciosas comisiones que se pagan a los fondos de *private equity* en el proceso (Groh y Gottschalg, 2006; Acharya, Gottschalg, Hahn, Kehoe, 2013; Higson y Stucke, 2012; Harris, Jenkinson y Kaplan, 2014).

La industria obtiene retornos superiores a partir de tres fuentes distintas: ingeniería financiera, ingeniería de gobernanza e ingeniería operativa en las compañías de cartera. La literatura anterior se ha centrado principalmente en la ingeniería financiera y la de gobernanza, que ahora se comprenden bien y están muy documentadas (Berg y Gottschalg, 2005). Aunque los investigadores han intentado medir la ingeniería operativa (Acharya et al, 2013; Ayat, Schutt, 2016), seguimos sin saber gran cosa acerca de la forma en que la ingeniería operativa afecta al rendimiento de las empresas. De hecho, no está claro hasta qué punto la ingeniería operativa puede ser una fuente de creación de valor para las inversiones de *private equity*.

El presente estudio se centra en la forma en que los equipos ejecutivos de una compañía de cartera del *private equity* genera un valor superior gracias a sus decisiones y acciones estratégicas y operativas diarias. La importancia y el creciente interés en referenciar los retornos de fondos de *private equity* con los retornos medios

de compañías cotizadas exige análisis detallados de las acciones de gestión de los equipos ejecutivos de PE. Nuestro estudio amplía la cuestión desde el terreno tradicional de la literatura sobre finanzas corporativas hasta los dos cauces de capacidades dinámicas y teoría de la agencia.

Las capacidades dinámicas (Teece, Pisano and Shuen, 1997) son un componente clave del modelo de éxito operativo de una compañía de cartera de *private equity*. Al seleccionar un equipo ejecutivo, los gestores de fondos de *private equity* se garantizan unas sólidas capacidades de gestión dinámicas (Adner and Helfat, 2003). A continuación, establecen las estructuras y los procesos que garanticen la naturaleza dinámica de la toma de decisiones estratégicas (Eisenhardt and Martin, 2000) y gestión ambidiestra (O'Reilly and Tushman, 2008; Birkinshaw, Zimmerman and Raisch, 2016).

La teoría de la agencia, si bien se desarrolló originalmente en el contexto de la propiedad las empresas cotizadas, también se puede ampliar a este nuevo contexto (Gomez-Mejia y Wiseman, 2007) para analizar la relación de agente-principal entre el equipo ejecutivo y el fondo de *private equity*. Las compañías de cartera de *private equity* representan casos de conflictos de agente-principal especialmente marcados. Como empresas controladas por propietarios, cabría esperar que el rendimiento corporativo fuera el principal predictor del salario del CEO y los ejecutivos más que el tamaño (Tosi, Werner, Katz and Gomez-Mejia, 2000). Sin embargo, el grueso del salario del CEO en tales casos se encuentra inextricablemente unido al valor de salida de la inversión, que no refleja necesariamente las mediciones de rendimiento tradicionales.

Teniendo en mente esos dos prismas interpretativos, abordamos la cuestión de nuestra investigación –la forma en que los equipos ejecutivos de una compañía de

cartera de *private equity* crean un valor superior a través de sus decisiones y acciones estratégicas y operativas diarias— por medio de un estudio inductivo basado en un diseño de investigación de casos cruzados con una lógica de replicación literal (Yin, 2003). Hemos estudiado cuatro casos de compañías en manos de *private equity* con el resultado demostrado de un rendimiento operativo discontinuo. El diseño de nuestra investigación ha utilizado una lógica de replicación literal en la que cada caso confirmaba o desmentía las inferencias realizadas a partir de los otros. El cotejo de patrones entre casos garantizaba la solidez de nuestra teoría emergente. Hemos corroborado nuestras percepciones emergentes con inversores y asesores de la industria que emplearon su experiencia en casos cruzados para comentar y refinar nuestros hallazgos.

Hemos usado un enfoque de investigación inductiva (Gioia, Corley y Hamilton, 2013) para crear un modelo de creación de valor operativo dinámico. La elección de este enfoque se ha primado por dos razones principales.

En primer lugar, de índole exploratoria: los estudios inductivos se ajustan bien al examen de áreas de investigación y fenómenos inexplorados. En segundo lugar, este tipo de estudios es apropiado para esta industria, que es de naturaleza intrínsecamente privada y carece de la obligación de llevar a cabo informes públicos durante el tiempo que una compañía esté en cartera. Los actores que generan valor en las compañías de cartera de *private equity* rara vez comparten su experiencia de forma pública y abierta. Si bien el camino de creación de valor elegido será consustancial a cada empresa de cartera concreta, todos los actores implicados en la generación de tal valor comparten el objetivo de maximizar el atractivo de su compañía —de ahí su valor— en el mercado para el control corporativo a la salida de la inversión (Manne, 1965).

En una primera fase, recopilamos una tipología de acciones gestoras con más visos de conducir exitosamente a un aumento del valor de la empresa en un contexto de *private equity*. Esas acciones de primer orden luego se disponen en temas de segundo orden, comunes a todos los casos estudiados. Por último, ordenamos esos temas en dimensiones agregadas que reflejan las principales fases de una inversión de *private equity* típica.

Nuestro estudio permite entender con más claridad la forma en que la ingeniería operativa de las compañías de cartera de *private equity* afecta al rendimiento corporativo, medido como el retorno obtenido por los socios limitados una vez que los socios generales salen de la inversión y capitalizan sus comisiones. Propone un modelo de creación de valor operativo que reúne estrategias fundamentales y acciones operativas con más visos de maximizar el valor de salida de la compañía en diversos sectores.

Contribuyendo a la literatura existente acerca de las capacidades dinámicas y la teoría de la agencia, este estudio identifica un conjunto de capacidades dinámicas desarrolladas internamente por los fondos de *private equity* en el proceso de generación de valor en la empresa que puede replicarse en toda la cartera de inversiones del fondo. A continuación, nuestro estudio examina también la relación agente-principal entre los socios del fondo de *private equity* y el CEO y el equipo ejecutivo de la compañía en cartera. Resaltamos la efectividad de modelos de compensación robustos para los ejecutivos de compañías controladas por propietarios que alineen mejor sus acciones con los objetivos de creación de valor de los propietarios. Comparamos la naturaleza de estos modelos de compensación con aquellos que ha mencionado mayoritariamente la literatura anterior y que suelen aplicarse habitualmente en un contexto de compañías cotizadas.

El modelo desarrollado en esta investigación, que vincula estrategias, acciones, capacidades y modelos de compensación de apoyo, proporciona una útil hoja de ruta para ejecutivos en el mercado cotizado que corren un riesgo creciente de enfrentarse a la presión de los activistas financieros para ofrecer un rendimiento y unos retornos superiores a los accionistas.



## **LITERATURE REVIEW**

Ever since Jensen wrote his seminal article “The eclipse of the public corporation” in 1989, scholars in management and finance have increasingly examined leveraged buyouts (LBOs), with the aim of understanding the actual sources of value creation of a new alternative asset class and comparing its returns to the ones of other mainstream investment options, especially the favoured benchmark investment in the S&P 500 companies.

Jensen argued that the public corporation format was only appropriate for companies in growth industries, which do not lack positive investment opportunities. However, for industries where long-term growth is slow – arguably a large majority of industry sectors in the Western business world today -, the private corporation format was preferable since its tight governance from a limited number of shareholders forced management to either use the free cash flows generated by the business in an efficient and profitable manner or redistribute them to the shareholders for redeployment in more profitable investment opportunities elsewhere.

While Jensen saw the private corporation as an optimal long-lived form of ownership, the Venture Capital and Private Equity industry, which developed from the first wave of LBOs in the 1980’s, built itself on a principle of limited time ownership. This limited time ownership is based on an investment cycle where “limited partners” – mostly institutional investors – entrusted capital to “general partners” to purchase a portfolio of companies, create enterprise value, exit those companies and return a multiple of the original capital, all within 10 years. Figure 1 introduces the model.

Even if Stromberg (2008) showed that 40% of LBOs were actually still in private hands after 10 years, this still meant that the majority of investments had to generate

significant enterprise value creation within the span of just about 5 years, possibly moving to the stage of secondary buyout for another investment cycle after that.

For at least a decade following Jensen's article, most research focused on analysing the financial returns of private equity funds' entire portfolios as benchmarked against public markets. Researchers had to settle for a paucity of transparent data in an industry whose actors are, by essence, private. This narrow empirical focus led to conflicting conclusions depending on the data source used. A first wave of researchers showed the absence of abnormal return within the industry (Kaplan & Schoar, 2005 and Phalippou & Gottschalg, 2009) while others proved it otherwise (Groh & Gottschalg, 2006; Acharya, Gottschalg, Hahn, Kehoe, 2013; Higson & Stucke, 2012; Harris, Jenkinson and Kaplan, 2014).

Eventually, following the release of several new data sets (from Venture Economics to Burgiss, Cambridge Associates or other large LP data sources), a consensus built that LBO's do indeed provide superior returns to investors versus public market investments. In the most comprehensive reviews of US LBOs from the eighties to the noughties, this excess return was quantified in a range between 300 and 450 basis points per year, net of fees (Harris et al, 2014 and Higson et al, 2012) Considering general partners' fees – estimated at \$19 for every \$100 invested for the median private equity fund (Metrick & Yasuda, 2007) -, it became clear that LBOs outperformance versus public companies was substantial.

This proven outperformance of the Private Equity asset class led to its unprecedented development in recent years. Industry assets are currently at an all time high, with US\$ 5 trillion of capital raised since 2012 and US\$ 2 trillion still available to invest – otherwise called *dry powder*. Buyouts represent about 10% of global Mergers and Acquisitions deals. The number of private companies is steadily

increasing and currently stands at about 8000 in the United States against a shrinking 4000 listed companies on the various stock exchanges. After several decades of co-habitation with private markets, it does appear that public markets are indeed shrinking. Jensen's prediction about the attractive nature of private corporations is currently turning into reality.

### **What drives Private Equity's superior performance?**

Whether academics agreed or not with the superior average performance of the whole industry, they all seemed to point at a certain performance persistence by the most experienced players of the industry, which started to suggest distinctive actions (best practices) capable of producing superior LBO returns (Kaplan et al, 2005; Harris, Jenkinson, Kaplan, Stucke, 2013). This opened a new avenue of research into the sources of value creation generated by those top performers.

A first "action" identified by researchers was one of "buying right". Groh & Gottschalg (2006) showed that PE funds tend to select transactions in industries with a low operating risk. Guo, Hotchkiss & Song (2011) estimated that 18% of value created in buyouts post-1990 was due to an increase in the industry multiple at exit, demonstrating the value of a fund' ability to pick winning industries.

A second practice refers to the means to build enterprise value: financial engineering and operational engineering. In the early days of the development of the Private Equity industry, the former was quoted as the primary source of value creation. During the 1980's, significant incremental leverage and the ensuing tax shield could account for up to 40% of the final enterprise value at exit (Kaplan, 1989b). However, such leverage excesses all but disappeared in later decades. While the compensation structure of Private Equity firms continued to provide an incentive to maximize debt,

the actual leverage for buyouts became mostly unrelated to firm-specific factors but rather reflected the prevailing debt market conditions at the time of acquisition (Axelson, Jenkinson, Stromberg and Weisbach, 2008; Kaplan & Stromberg, 2009). In fact, institutional investors started to rely on banks to stop general partners from overleveraging their acquisitions or making ill-conceived acquisitions for the sole purpose of fee maximization (Axelson et al, 2008). Ivashina & Kovner (2008) showed that the best performing PE funds, rather than pushing for higher leverage, were able to negotiate cheaper debt deals and more advantageous covenants to give them an edge over their competitors. Post 1990, Guo et al (2011) estimated that increased leverage was responsible for 29% of total value creation.

### **Operational performance through improved governance**

Over and above financial engineering, Kaplan & Stromberg (2009) split Operational Value Creation into two distinct but interrelated types of activities: Governance Engineering and true Operational Engineering. Together, they are estimated to represent between 23% and 33% of valuation gains for LBOs (Guo et al, 2011; Acharya et al, 2013).

Extant literature has identified three key aspects of governance to explain LBO's superior operational performance versus comparable public companies: 1) board monitoring by representatives of the Private Equity fund or general partner, 2) financial incentives for top executives in the portfolio company and 3) the "debt incentive" or the pressure of higher interest payments, which forces management teams to avoid wasting free cash flows or risk financial distress and possibly bankruptcy.

### ***Role of the fund manager on the board***

Several studies have examined the exact role of Private Equity fund managers joining the board of portfolio companies. It is generally accepted that an active involvement of the fund manager on the board has a positive effect on value creation. Several studies show that managers with smaller portfolio sizes provide improved screening and add greater value to the portfolio companies (Kanniainen & Keuschnigg 2003, 2004, Schmidt 2006, Cumming & Walz 2004 and Cumming 2006).

In fact, funds with a higher number of firms in the portfolio and/or a lower board presence usually compensate this with different governance tools at their disposal: either an increase in the equity given to the CEO (Bernile, Cumming & Lyandres, 2007) or higher leverage and/or tighter debt terms (Cotter & Peck, 2001).

Beyond the level of the fund managers' personal involvement on the board, Acharya et al. (2013) also showed that their background tends to influence the value creation trajectory of the portfolio company: managers with operational or consulting backgrounds usually preside over organic growth plans while managers from a banking or accounting background rather favour an inorganic acquisition strategy. Confirming the impact of the fund managers' background, Cressy, Munari and Calipiero (2007) showed that PE firms with industry or stage specialization deliver better buyout returns.

One last but critical role that fund managers play on the board is the one of vetting the CEO of the portfolio company. Two thirds of CEOs are replaced over the first four years of a private equity acquisition (Acharya & Kehoe, 2008).

### *The CEO and executive team as value creators*

The involvement of a Private Equity Fund representative on the portfolio company's board is considered a first positive element for value creation. In their running of daily operations, the company's CEO and his or her executive team are the next critical agents generating the superior returns typical of Private Equity. Research aimed at determining the relative importance of the CEO's compensation versus specific personality and skills, which would explain the excess returns.

First, the compensation of CEOs in Private Equity differs significantly from this of public company CEOs in one key respect: his or her share of equity. Acharya et al (2008) estimate the average share of equity of Private Equity CEOs at 3% while the executive team gets 15% of the company. According to Kaplan (1989a), this would represent about four times the equity share allocated to public company CEOs. Nikoskelainen and Wright (2007) show that returns are highly dependent on the level of management ownership.

A second success factor for Private Equity investment is the profile of the CEO. Kaplan, Klebanov and Sorensen (2012) identify two key characteristics, which are common to most successful CEO's in Private Equity portfolio companies: first, a "general ability", which means the CEO is comfortable to act across all functions of the firm and second, strong skills of execution, resoluteness and overconfidence, which ensure a relentless drive to create value within a short time frame. Such characteristics are seen as more important for the Private Equity CEO than more typical interpersonal skills, considered as critical to the success of a public company CEO. The latter's responsibilities usually span a much larger number of stakeholders with varying and sometimes conflicting objectives, as compared to the single-minded focus of Private Equity shareholders on value creation at exit.

A third key success factor is the origin of the CEO, whether s/he comes from incumbent management of the acquired company or is appointed from the outside. An incumbent CEO is typically the divisional head in a carve-out of a division from a larger firm. The Centre for Management Buyout and Private Equity Research (CMBOR, an academic research body) reports this form of LBO to be the most common form in recent years: 47% of all UK LBOs during the period of 1982 and 2005 were divestitures (CMBOR, 2006). A change of performance in divestitures/carve-outs usually derives from the resolution of agency conflicts between second tier management and senior management or from the freeing up of corporate constraints in terms of incentive and control systems. (Holstrom, 1989; Francis and Smith, 1995). This usually results in value creation strategies, which are highly focused on topline revenue growth. When the CEO is appointed from the outside however, the focus of value creation strategies rather tends towards cost containment and productivity improvements (Amess & Wright, 2006; Nikoskelainen & Wright, 2007).

Similarly, Gompers, Kovner, Lerner and Scharfstein (2010) showed the value of prior experience as “second time” CEOs in Private Equity benefit from a higher chance of success (30% versus 21 % for first-timers), partly based on skill but also on the *perception* of performance persistence, which allows them to attract better resources to their companies in a subsequent round.

### **Operational performance through improved economic efficiency**

In order to explain the excess returns generated for Private Equity investors, most research focuses primarily on the typical traits of leverage and governance outlined earlier. But researchers also turned their attention to determining the “real returns” (Cumming et al, 2007) - or the actual impact of LBOs on economic efficiency.

This research tried to use standard accounting measurements to determine real returns or productivity improvements in Private Equity portfolio companies. However, these studies suffer from a high risk of accounting manipulation in the data as management teams either underestimate performance prior to the MBO transaction (Wu, 1997) or overestimate performance right before reverse LBOs (Chou et al, 2005). To overcome this hurdle, researchers either focused on measures of productivity for specific sub-units of the company – like individual plants’ productivity – or for other specific company factors.

Despite these challenges in measurement, LBOs were shown as good mechanisms for enhancing economic efficiency. Wright, Wilson and Robbie (1996) demonstrated a higher return on assets in LBO firms versus non-LBO ones. LBOs were also shown to significantly improve plant productivity in manufacturing investments without using obvious cuts in personnel, wages, R&D or capex (Lichtenberg and Siegel, 1990 and Harris, Siegel and Wright, 2005). In fact, empirical evidence demonstrated that LBO employment continued to grow - even if sometimes slower than non-LBO firms (Amess & Wright, 2006; Boucly, Sraer & Thesmar, 2008 and Kaplan & Stromberg, 2009) - with the added benefit of an improved quality of employment as job elimination was higher at low productivity levels and lower at strong productivity levels (Davis, Haltiwanger, Handley, Jarmin, Lerner, Miranda, 2014). Lastly, innovation appeared to be more impactful as the number of patents remained unchanged but the level of citations and focus increased (Lerner, Sorensen & Stromberg, 2011).

## **Operational performance through daily managerial actions**

Most research focused on measuring the return and productivity changes in the portfolio company after an LBO but virtually no research exists to uncover how those changes are generated in the day-to-day management of the company. “We know a lot about how MBOs affect financial and economic performance, but virtually nothing about the impact of such transactions on work-life” (Cummins et al. 2007, p 16).

Some management studies report an improvement in human resources management practices in LBO firms and more specifically a higher level of discretion for employees, particularly at higher levels in the organization (Bruining, Boselie, Wright and Bacon, 2005, Amess, Brown and Thompson, 2006 and Amess and Wright, 2006). But what exactly do managers do with this increased discretion? And if those managers are meaningfully motivated by increased equity ownership versus their public counterparts, what do they do differently in their day-to-day activities to build their equity’s worth at a better rate than their public company counterparts? This is the topic of our research.

Our research question is therefore: how does the executive team in a Private-Equity-owned company create superior operational value in their strategic and day-to-day managerial actions? We want to uncover the day-to-day consequences of aiming for a maximum medium-term enterprise value when Private Equity owners exit the investment. Our focus is on commonalities of behaviour and actions across portfolio companies, which tend to differ versus behaviours and actions to create value in other corporate settings such as public companies.

### *Calculation of Enterprise Value (EV) in Private Equity*

Enterprise value in Private Equity is mostly determined through a very simple equation, based on the firm's earnings before interest, tax, depreciation and amortization (EBITDA):

$$\text{ENTERPRISE VALUE} = \text{EBITDA} \times \text{MULTIPLE}$$

Interestingly, this enterprise value is only calculated at one specific point in time: when investors look to exit the investment, or usually between 3 to 5 years after acquisition.

While the EBITDA in this equation is a fact-based measure, which reflects the profitability impact of past managerial actions, a potential buyer may exercise some discretion in establishing the appropriate multiple. A large part of the multiple tends to reflect the long-term industry trends and the economic climate prevalent at the time of the change of ownership. However, the multiple also partly reflects the perceived value growth potential of the company for the new acquirer. Our current research in the Private Equity industry shows that many investors may have a rather constructivist view of the enterprise value, rather than an objectivist one. Rather than believing in a single independent value, they recognize that enterprise value is also in the eye of the beholder. We expect the best of executive teams to actively construct this perception of future potential during the time of ownership.

As a matter of comparison, value in public companies is made of the cumulative perception of atomized shareholdings and is determined day by day throughout the life of the company. Executives are required to report key metrics – like sales growth and net income – on a quarterly basis, on the basis of which they will have to face competitive benchmarking.

## **Agency Theory as an interpretive lens**

To understand how executive teams in a Private Equity portfolio company create superior value through their strategic and daily operational decisions and actions, we want to use the interpretive lenses of agency theory and dynamic capabilities theory.

While agency theory was developed primarily for a public company context with dispersed ownership, Gomez-Mejia and Wiseman (2007) showed that it is adaptable to a variety of models for examining the different manifestations of conflict of interest. Specifically, Private Equity portfolio companies are one case of owner-controlled firms for which performance is the strongest predictor of CEO pay (Tosi, Werner, Katz and Gomez-Mejia, 2000). This contrasts with the dominant role of firm size in determining CEO pay in public companies. Tosi et al. (2000) recognize that we know very little of the role played by the nature of the performance criteria used to assess CEOs, as moderator of their pay. The specific measurements of performance in Private Equity portfolio companies are usually directly related to the elements of the enterprise value equation and much clearer to the top executives than traditional public company long-term financial incentives.

The distinct compensation model of Private Equity determines the nature of the principal-agent relationship between the portfolio company CEO and his executive team, on the one hand, and the Private Equity fund manager, on the other. This compensation model reflects closely the classical theory of the firm where the entrepreneur's interests are aligned with those of his company. This leads to a reduction of the potential for moral hazard and a direct experience by all participants of the two main assumptions of agency theory – i.e. profit maximization and perfect knowledge.

This “purist” application of agency theory in the Private Equity context, which makes compensation the primary motivator for members of the executive team, is in sharp contrast with the typical motivation factors of public company top executive counterparts, aka. status, power and sense of achievement (Pepper, Gore and Crossman, 2013).

The chosen model of governance between board and CEO – highly inspired by the key tenets of agency theory - has a strong trickle-down effect on the overall work culture inside the portfolio company. Delivering a successful exit is a clear case of a “team production” situation where the end result achieved by a group is greater than the sum of products which could be produced by each group member, yet individual input is difficult to observe and measure (Alchian & Demsetz, 1972). According to agency theory, an increase in the size of the group – or the firm – increases agency costs. However, it need not be so here as individual compensation through multiple layers of the organization is structured so that team members are rewarded for building team effort (Cuevas-Rodriguez et al, 2012): a portion of the team members’ pay is dependent on the collective output represented either by typical annual measures of EBITDA growth and working capital reductions or by the final enterprise value at exit of the investment.

Those specific reward systems tend to complement a preferred leadership style, *“which cultivates trust and increases subordinate collaboration resulting in increased confidence in pursuing organizational goals. This trust releases new possibilities for value creation, which are less accessible to contractual relations built on assumptions of conflict of interest and reduces the number of resources needed to control agency costs inside the organization”* (Cuevas-Rodriguez et al, 2012, p532).

## **Dynamic Capabilities as an interpretive lens**

The theory of Dynamic Capabilities is the second interpretive lens useful to analyse how executive teams in a Private Equity portfolio company create superior value in their strategic and daily operational decisions and actions.

Teece, Pisano and Shuen (1997) define dynamic capabilities as “*the firm’s ability to integrate, build and reconfigure internal and external competences to address rapidly changing environments*” (p516). While not all Private Equity portfolio companies face substantial changes in their competitive market environments during the time of Private Equity ownership, the change of ownership itself and the shift of perspective towards enterprise value creation certainly constitutes a “rapidly changing environment” and requires a significant revision of internal processes and retraining of personnel.

We examine dynamic capabilities at play within private equity portfolio companies along three dimensions identified by Barreto (2010) in his review of the subsequent literature on the subject: the corporate context, the heterogeneity assumptions and the nature of dynamic capabilities used.

First, while Teece et al. (1997) originally conceived their theory for companies operating in rapidly changing environments, Private Equity portfolio companies generally represent “moderately dynamic contexts” (Eisenhardt and Martin, 2000). This is because Private Equity fund managers commonly select investments in industries with lower operating risk (Groh and Gottschalg, 2006).

Second, the Private Equity industry is highly skilled at resolving the “*commonalities paradox*” outlined by Barreto (2010). During the first 100 days following an acquisition, Private Equity fund managers will typically be highly involved with the top executive team as well as relevant external resources like

management consultants, business advisors and investment bankers to develop the “strategic value creation blueprint” to cover the duration of the investment. Since Private Equity fund managers tend to sit on the boards of several portfolio companies at a time, they can easily transfer their experience and capability from one executive team to the other. These practices resonate with the concept of “*dynamic managerial capabilities*” (Adner and Helfat, 2003). These “*dynamic managerial capabilities*” emerge from the combination of three interdependent factors of the firm: managerial human capital – or experience -, managerial social capital – within and outside of the firm - and managerial cognition – or beliefs and mental models underlying a manager’s decisions -. By developing a set of dynamic capabilities shared amongst all their portfolio companies, Private Equity Fund partners combine with the necessary idiosyncratic details necessary to sustain competitive advantage in each individual investment. Similarly, Eisenhardt et al. (2000) identified strategic decision making as a specific dynamic capability “*in which managers pool their various business, functional and personal expertise to make the choices that shape the strategic moves of the firm*” (p1107).

Ambidexterity is another essential dynamic capability for any Private Equity portfolio company aiming to maximize value creation at the point of exit. O’Reilly and Tushman (2008) were the first to integrate the concept of ambidexterity - or the ability of a firm to simultaneously explore and exploit resources to adapt over time - within the context of the dynamic capability literature. They argued that the ability of senior managers to seize opportunities through the orchestration and integration of both new and existing assets was critical to overcome inertia. Birkinshaw, Zimmerman and Raisch (2016) further linked exploration and exploitation to the two key characteristics of dynamic capabilities of “sensing” and “seizing” opportunities as

defined by Teece et al. (1997). Using case studies of large companies having sustained their competitiveness through significant environmental changes, Birkinshaw et al. (2016) equated Teece et al.'s third characteristic of "reconfiguring" resources to the organization structure chosen by those companies to implement both exploration and exploitation activities simultaneously. Of the three structural propositions the authors outlined, one seems to be most relevant to the case of private-equity owned companies. The "behavioural integration" brings the conflicting activities required by ambidexterity together in a single business unit by designing a supportive behavioural context throughout the firm. This reflects well the private equity environment where all managers act like entrepreneurs and are accountable for the consequences of their decisions through their equity stake in the company.

The ambidexterity dilemma comes to the fore in the very equation of enterprise value, which the executives are aiming to build: building EBITDA requires short-term exploitative actions with returns within the investment timeframe of the owners while building the multiple calls for long-term visionary exploration and investment. Executives in private-equity owned companies are the ultimate ambidextrous managers, juggling between exploitation and exploration within a very short time frame and a very tight cash flow environment.



## DATA AND METHODS

We used comparative case data to zoom in on companies' operational decisions and actions and investigate those actions, which are designed to directly influence the enterprise value at exit of the investment.

The case study method is particularly appropriate for our desired research as it is an empirical inquiry that investigates a contemporary phenomenon within a real-life context (Yin, 2003). We deliberately want to cover the contextual conditions of a company acquired by a private equity firm, as this context justifies the relevance of our study phenomenon. Moreover, given the private nature of the value creation process in such companies, which do not face any obligation of reporting, a field study offers unique, fine-grained access to rich data on value creating managerial actions in private equity, which are otherwise unavailable through public data sources (Eisenhardt, 1989).

We chose to run explanatory case studies, since this research design is the most appropriate for "how" and "why" research questions where the investigator is trying to determine whether an event  $x$  led to an event  $y$  (Yin, 2003). We used a comparative, multiple-case, holistic design with a literal replication logic in which each case serves to confirm or disconfirm the inferences drawn from the others to uncover aspects of the phenomenon under analysis. Evidence from multiple cases is often more compelling and the whole study is therefore regarded as more robust (Herriott & Firestone, 1983).

Since our research focuses on the executive team within the portfolio company, we targeted our interviews towards CEOs, COOs, CFOs and other C-Suite executives in actual Private Equity portfolio investments. Our experience in interviews showed us that few C-suite executives had enough exposure to the full process of investment to be able to provide valuable reflection about the value creation in their company. We therefore narrowed down our target interviewees to CEOs and CFOs.

To allow for better generalization, we chose companies of different industries, sizes, geographies and which were owned by Private Equity groups with differing key characteristics. Our subsequent analysis distinguished the actions we found across multiple cases from the ones which were idiosyncratic to a specific industry or type of deal.

In a second phase, we interviewed operating partners within Private Equity funds as well as management consultants with significant experience working with Private Equity portfolio companies. We submitted to them our early conclusions from the first phase of interviews and asked them to comment or extrapolate on those from their experiences across multiple deals and companies. We used the feedback from those informants to contrast the findings emerging from our main interviews as partners from Private Equity Funds or management consultants mostly act at arms' length and make recommendations but they rarely take the actions themselves.

Table 1 gives an overview of the companies, Private Equity Funds and management consultants and other advisors, whom we interviewed. Table 2 details key characteristics of individual informants.

## **Data collection and analysis**

### ***Case selection***

We had originally planned to select all our cases from the largest and most mature Private Equity funds listed by Private Equity International (PEI) in their yearly ranking. Justification for this choice were the learnings from Kaplan & Schoar (2005) who demonstrated that superior returns were concentrated in largest and most mature firms. However, subsequent research challenged that conclusion and Harris and his colleagues (2014) confirmed they found no significant relation between performance and fund size for buyout funds. A few test interviews allowed us to verify that a true “value creation model” existed not only within big PE groups portfolios but across the

board. We therefore reoriented our case selection to show a variety of industries, company sizes and geographies to the exclusion however of new Private Equity Funds without prior successful experience in exiting their Private Equity investments (see Table 1). This variety allowed us to extract the heterogeneity of the corporate actions as well as the impact that industry, size or geography can have on the general model. The variety also ensured we control our findings for specific cultural biases, which could influence the choice of some managerial actions over others.

### *Data*

Our data consists of a mix of interviews and desk research documents. We gathered interview data through semi-structured interviews with individual respondents. We developed the interview protocol through a first series of interviews with professional investors of the Private Equity industry. We then submitted this early protocol to a first respondent to validate its applicability and relevance to the research topic.

From this test interview, we drew a number of conclusions, which were reflected in our final interview protocol shown in Appendix 1. In general, we concluded that the best format for engaging respondents was to limit the protocol to a limited set of very open questions, which allowed them to tell their story. In a second phase of the interview, the interviewer filled the gaps by probing on specific topics, which might not have come up naturally in the earlier conversation.

Importantly, for our case studies, we only reached out to informants who have been personally involved in the daily operations and executive decision-making of our target companies (Table 2). This selection of respondents ensured clear connections between the story-telling by the interviewee and actual strategic actions of the

company. We conducted the interviews in person whenever possible, and, when it was not, over a video connection or, as a last resort, a phone connection. On all occasions we used the interview protocol. Interviews typically lasted between 75 and 100 minutes. Detailed notes were taken during the interviews and were transcribed within 24 hours. To minimize cognitive biases and impressions in retrospective data collection (Huber & Power, 1985), we always asked informants to first recount the actual actions they had taken with the express objective to build enterprise value as well as, if applicable, the strategy decision process. Only after having gathered the facts did we ask them for their opinions.

We also undertook in-depth desk research to collect additional data, from academic but also largely from practitioner-oriented sources and media articles which analysed successful value creation of idiosyncratic investments. We used the desk research data as well as the input from our cross-industry experts' interviews to anchor and contextualize our case study respondents' accounts and opinions and consolidate our emerging theory.

### ***Triangulation***

We triangulated the data gathered through the interviews in three ways (Eisenhardt, 1989; Yin, 2003). First, we relied on multiple respondents per firm, who were interviewed separately. We sought to speak to the CEO and the CFO in each case, plus other key decision makers from the executive team or an investor who played an influential role on the company's board. This allowed us to mitigate potential subject biases and to juxtapose and compare stories and impressions between informants (Miller, Cardinal & Glick, 1997).

Secondly, we double-checked the interview data, using industry experts or advisors. This helped our understanding of actual value-creating actions in the focal company and allowed us to distinguish those from typical actions from any average firm facing a similar context in a similar industry. We used this strategy to mitigate potential subject biases as well as help us tease out variance and similarities across cases.

Third, in as many cases as possible, we contacted respondents again at the end of the study to share our interpretation of the events and the conclusions we have drawn (Locke & Velamuri, 2008), in order to collect their reaction and feedback about our data and interpretations.

### *Coding*

We summarized and coded the notes and transcripts from the interviews and developed analytical tables to navigate through the data (Eisenhardt, 1989; Miles & Huberman, 1994). The coding procedure started building on the macro-categories which we had developed for the interview protocol i.e. the likely typology of drivers of value creation in Private Equity portfolio companies (e.g. Strategic Setting, Incentives, Board governance, etc) but were subsequently adapted based on the input received from informants. Following the Gioia methodology, we gathered first order concepts, which were those strategies and actions derived directly from our data analysis and were consistent with our respondents' phraseology. We then included them into second order themes, which came out consistently from all our interviews. Finally, we grouped those into aggregate dimensions, which we ordered according to the typical chronology of a Private Equity investment. Figure 2 outlines our data reduction process.

Through this data reduction process, we collated similar instances and noted patterns and variance in the emerging sub-categories (Miles & Huberman, 1994; Coffey & Atkinson, 1996). This process was highly iterative between data and the emerging theoretical hypotheses while we pushed our understanding of the value creation phenomenon.

To increase the validity and reliability of this research (Lincoln & Guba, 1985), we asked other researchers who are expert on our subject of interest to review our findings independently in order to form their own views of our subsequent operational value creation model.

## **FINDINGS**

The objective of our research to uncover the daily operational decisions and actions which supported the value creation in a Private Equity portfolio company was like opening a “black box”. Most researchers so far gave little credit to the executive team in this process, implying the Private Equity Fund managers on the board of the portfolio company were the ones truly responsible for the operational value creation. Our first finding was that only a small number of executives in any investment were truly aware of the full value creation plan and related actions. Board members would usually only have a helicopter view as their interest relied mostly on seeing the key performance indicators (KPIs) being met every month, while functional heads in the C-Suite could talk about actions within their own area of focus but very little about the total picture of value creation. We found that two to three executives only in each portfolio company would usually give us the full value creation picture: the CEO, the CFO and possibly one other multi-skilled executive who could bear various titles like COO (Chief Operating Officer), CRO (Chief Restructuring Officer), etc.

The pulling together of the findings of our interviews provided us with a long list of strategies and actions, which executive teams typically use in a Private Equity portfolio company to create superior operational value during the time of the investment (Table 3).

Working iteratively and following the Gioia methodology (Gioia et al, 2013), we were able to segment those strategies and actions into eight second order themes, which inform the executives’ behaviour.

We finally ordered those themes in four distinct phases, which any typical Private Equity portfolio company goes through from the time of closing the deal to the final exit.

Figure 2 illustrates the process of data reduction, while Figure 3 gives us an idea of how those aggregate phases pan out across the typical 5 to 7 years investment cycle of a Private Equity portfolio investment.

### **Phase 1: Acquisition and structuring the investment**

This first phase in value creation covers a period which starts with the due diligence work done by the investment partners of the Private Equity Fund before bidding for the business and extends over the actual acquisition of the asset and the establishment of the rules of engagement between investors and the executive team. This period can last up to six months following the deal closure.

Value creative actions taken during this phase can be segmented in three distinct themes. The first theme focuses on building the right executive team for the investment ahead. In parallel, a number of actions are taken to set up an appropriate Top Team Incentive Program. Finally, both parties will establish clear rules of governance.

Most early research on buyouts has assumed that value generation in the portfolio companies was mostly “front-loaded” during this phase, as “*much of the value is created at the time of the deal*” (Baker and Montgomery, 1994:20). This would mean all operational value created would be the product of the right governance and incentives set out at the outset of the investment – a single-minded agency perspective. Latest research however recognized the impact of the daily decisions and actions of the executive team in creating the operational value and presented the buyout as a vehicle for a distinct type of entrepreneurship (Berg et al, 2005).

The best Private Equity Funds develop a proprietary systematic approach to restructuring companies for efficiency and value creation. This ability then becomes a routine across their entire portfolio, so that it starts resembling a reorganizing “technology” representing a source of competitive advantage. (Wruck, 2008)

However, this ability of the Private Equity Fund to “govern” its portfolio companies, does not necessarily translate into an ability to “manage” them. Even Funds which decide to upgrade their in-house capability with an “operating” group – mostly formed with experienced corporate managers -, generally recognize it cannot be a substitute for effective management and reorganization at the portfolio company level.

While this first phase of “structuring the investment” will see heavy involvement of partners from the Private Equity Fund, the portfolio company executives will build on the investors’ lead and start laying down their first actions aimed at maximizing value creation, as outlined below.

### ***Building the right executive teams***

Traditionally, Private Equity Funds do not choose the whole management team but only the CEO, and sometimes the CFO. They only have a relatively small window to do so: from the start of the due diligence to the end of the “First 100 days” following the execution of the deal (Informant 13).

In the first wave of Private Equity buyouts in the 1980’s – when most buyouts would take the form of “carve-outs” of business units out of large diversified conglomerates -, the initial assumption was almost always that, while companies could be improved, existing managers, with the proper incentives in place, should be able to do the job. (Baker & Smith, 1998). It was hard to forecast though how well

managers would adjust to the changes in culture and behaviour required by the stringent discipline of debt and the relentless pressure to create enterprise value. Former division heads from traditional conglomerates in particular, would need to take responsibility overnight for corporate reporting, tax and treasury functions and internal control systems, previously out of their personal job scope. As Informant 12, an operating partner and former senior corporate executive, stated:

*“CEO’s of Private Equity portfolio companies have an additional requirement to a public company executive: they need to understand how to manage cash. In a public company, Treasury takes care of that.”*

From the 1990’s onwards, buyouts started to take various forms, from conglomerate carve-outs – which were then named more specifically “management buyouts” - to public-to-private deals, private-to-private secondary buyouts or purchases of family firms. It became more common for the Private Equity Fund to select a potential CEO for the deal from the due diligence phase, irrespective of the management already in place in the target company. The industry would later name this type of deal “management buy-ins”.

While this initial choice of the CEO by the Private Equity Fund partners is recognized by all industry participants as a key success factor to maximize enterprise value in the portfolio company, it is clear that the Fund partners’ opinion about their chosen CEO can often change over the time of the investment. In fact, two thirds of CEOs are replaced by the board of directors over the first four years of a private equity acquisition (Acharya et al, 2008).

This tendency to change CEOs seems to depend partly on individual Private Equity Fund cultures, as well as on the nature and location of the investment. As Informant 8 – an experienced Private Equity portfolio company CEO – told us:

*“I prefer working with European Private Equity firms. With US firms, the CEO is too much of an expendable resource. In Europe, there is much less labour mobility than in the US and a lot more of cultural specificity, which means that sending a Frenchman to run a business in the UK can be risky and Private Equity houses try as much as possible to minimize risks.”*

Once the Private Equity Fund chooses the CEO, it is the latter’s responsibility to form the executive team reporting directly to him, with the Fund partners’ role being limited to – in certain cases – giving the nod to the CEO’s choice. This is when the CEO will use very similar criteria to the ones used to appoint him in his role to select his close team of collaborators.

### ***Incentivizing the Top Team***

The central objective behind the compensation of the Private Equity portfolio company’s top executives is to align their interests as closely as possible with the ones of the Private Equity Fund – usually the majority shareholder of the company - and to reduce agency conflict after the buyout.

The CEO compensation will be the object of negotiation between the individual and the Private Equity Fund partners at the outset of the investment. Such negotiation might also occur with the CFO or any other executive which the Private Equity Fund considers as critical to the success of the investment. As Informant 14 noted:

*“My concern is the compensation of the top three, typically CEO, CFO and CTO as we focus on technology companies. Below that, it is the executive team’s responsibility. I expect the top 3 to invest their own money in successive financing rounds to show commitment.”*

Partners of the Private Equity Fund want to make the CEO an owner of the business and expect him to put his own “skin in the game” by investing a share of his personal wealth in the company he wants to lead. The size of this personal investment

has to be balanced: *“the downside has to hurt, but not too much or the executive could become too conservative; the upside though, has to be sweet”* (Baker & Smith, 1998, p132).

General partners will tailor the expected equity contribution and the overall compensation package of the CEO based on the individual’s financial and personal circumstances as well as on the profile of the invested company.

Private Equity Funds expect any incumbent CEO to invest a significant share of proceeds he would have received from the sale of pre-buyout stock. Should this not be sufficient to get the CEO to a target level of ownership, the Private Equity Fund partners either ask the CEO to increase his personal investment or decide to award him stocks or options, usually on a five-year vesting schedule.

The total value of the package is highly dependent on the size of the portfolio company and the enterprise value expected by the end of the investment period.

Informant 13 commented:

*“Incentives depend on the scale of the business. For SME’s, the package will not be as motivating as gains at exit are not that great. Hence, it is much harder to attract stellar talent. With larger companies, you can afford the best talent and give them great incentives.”*

By making the CEO co-owner of the business, partners of the Private Equity Fund establish a mechanism of “carrot” and “stick” to align the CEO’s interests with their own. The equity participation represents an attractive incentive as it gives the CEO a greater stake in any value-increasing actions and is structured by the Private Equity Fund to lead to better operating and investment decisions, in line with the dual objective of maximizing enterprise value (Easterwood, Seth & Singer, 1989). At the same time, the personal investment functions as the stick, as it increases the personal cost of inefficiency and reduces the incentive to shirk (Berg & Gottschalg, 2005).

Also, the CEO sees his own human capital and a substantial undiversifiable equity investment locked in the company until exit.

Once compensation negotiations are over and the CEO is in place, it is his turn to design the incentive program for his executive team and beyond. In order to attract or retain the desired type of talent, the CEO needs to decide how much equity he wants to distribute, to whom and in what form.

Depending on the corporate size, he can dispose of a total equity representing between 2% and 25% of the company to distribute to the key company executives, including himself. It is customary for the CEO to receive between 5 and 10 times the equity provided to each of his direct subordinates. The CEO will most often limit equity awards to his direct reporting team, with the possible addition of a few key “rainmakers” identified lower down the line. Informant 8 explains the thinking behind the equity program he designed:

*“I personally do not believe in giving EV (enterprise value) related incentives to more than 10 to 20 people in the company. If you have more, you have a problem as it means you cannot pick who really are the core people who will deliver the expected results. These people are not always the ones at the top: you can identify critical people at lower levels and ensure they get the right incentive plan.*

*At the end of the day, the management never gets more than 20% of the company in my sector and the more you split it, the more you dilute the final benefit.”*

The equity incentive for top executives can take different forms, be it stocks, options or phantom equity. The actual choice of specific incentive format depends a lot on the local country culture and/or the local tax legislation. For example, this format might depend on the location of the portfolio company headquarters, as incentives are eventually paid in the country where executives are resident. And it is not always possible to move the headquarters and put it in a beneficial jurisdiction. Informant 8 explains:

*“In the US, stock options are more commonplace: people pay nothing to get them, they also get nothing if they end up below price. In continental Europe, it is more common to ask to put your own skin in the game by buying stocks and you then earn or lose depending on the value at which the stock is sold.”*

The equity incentive – which is directly linked to the exit of the investment by the owners - is only one element of the compensation package designed by the CEO for his executives. Another key element of success is the link between personal performance of key managers and their annual pay. This performance-based pay depends on a revised set of corporate metrics – agreed with the Private Equity Fund partners – which we will come back to later on.

In designing his incentive program, the CEO will want to ensure that it is seen by the recipients as fair – in regards to an individual’s expected gain compared to the CEO himself and the individual’s peers – and highly motivating. Informant 9, as COO of his Private Equity portfolio company, shares his experience:

*“I always had a good understanding of the potential financial outcome at exit. The owners gave the key leaders a model to calculate our net proceeds. This was very motivating.”*

### ***Setting Up Value Driven Governance***

In their effort to minimize agency conflict and align the executives’ performance with the shareholder interests, private equity owners go beyond providing stock ownership and also redesign the governance structure of the portfolio company. Their primary objective is to have a close monitoring and control over the portfolio company management.

The typical buyout leads to a high concentration of equity in the hands of only a handful of investors, making it relatively easy to form a board which represents more than 50% of the company’s equity. The Private Equity portfolio company’s

board is normally composed of a small number of members compared to a standard public company board – usually five to eight members. It tends to comprise one or two representatives of the Private Equity Fund, the CEO as the single executive (with sometimes the addition of the CFO) and a few action-oriented non-executive directors with relevant experience to support the value creation plan of the company. The board is usually chaired by a non-executive member. Finally, all non-executive directors receive equity-based incentives to strengthen the alignment of interests between board and executive team (Wruck, 2008).

The mission of the buyout board is to ensure the creation of long-term value for the company as crystallized on the day of exit of the investment. To do so, members usually adopt a more active governance style characterized by fast decision-making, access to fast-track capital when needed and the option to take back control of the company in case of underperformance. The role of the board will not limit itself to monitoring though: the presence of experienced industry experts will mean the board is also used by the CEO as a useful consulting body to debate business building ideas.

The high involvement of the board will usually be focused during the early years of the investment when the debt burden is the most severe and when the opportunities for, and risks of, managerial difficulties are greatest, leading to a potential risk of bankruptcy. After this initial period of three years or so, board members will usually concentrate their attention primarily around key financial strategies (like a dividend payback to limited partners) and M&A activity.

In practical terms, board oversight will start with a request from the members to get direct access to confidential company information, which allows them to oversee ongoing operations. This will usually take the form of detailed monthly

reports sent by the portfolio company executives to all board members, which provide a close follow up of key predictive measures as agreed between the CEO and the Private Equity Fund when working out the value creation blueprint at the outset of the investment.

In some portfolio investments, this step of achieving adequate reporting of predictive measures can run well beyond our first phase of structuring the investment. Indeed, it is recurrent for the acquired company not to have the adequate reporting systems in place to aggregate those measures and having to make a significant investment upfront to develop this capability. Informant 9, in his role as COO, recalls:

*“As our company moved from Venture Capital to Private Equity, we saw an overnight step up in expertise. The governance, the compliance, the reporting expectations were significantly higher. We had to dramatically improve the quality of our board meetings, our reporting packs and all other deliverables in general. Private Equity is obsessed with data and analysis, with a longer decision making, which is used to mitigate the risks. PE also works a lot with consultants. Overall, it has professionalized our business.”*

Once the new structure of governance is in place, formal board meetings become less frequent and important. The majority of the oversight and control happens during day-to-day interactions between the CEO and a single high-level Private Equity Fund partner. Both parties having aligned interests, their interaction does not usually raise serious tensions. The Private Equity Fund partner usually sees his role as one to examine, question and even debate management decisions but rarely overrule them. At the same time, he expects from the CEO ongoing candid, informal and fluid communications to allow the owners to grasp the changing realities of their holdings whenever those occur.

The quality of such interactions does depend on the Private Equity Fund's style as well as its internal structure.

As Informant 14 tells us, some owners prefer a more “robust” type of interaction:

*“The CEO is an agent for the owner and is supposed to execute the plan. The real work is not done in board meetings but more on a one-on-one basis with executives. We will talk openly behind closed doors and exchanges can become rough. Executives will have the right to one yellow card but no more. If the CEO is looking for a friend, he should get a dog. You have to keep them on their toes and challenge them. They are well compensated for it.”*

In contrast, CEO Informant 8, comments on the differences between working for a Private Equity Fund with or without an operating partner or an operating group on board:

*“The Private Equity owners are not really more involved than in a public context except that they have the freedom to be. Again, it depends on style. The funds who have decided, for reasons of their own marketing to their investors, to hire an operating partner and an operating team, will be more involved. My preference is clearly to work for a PE partner which does not have any operating partner as I can then better get on with things.”*

From the above verbatims, we understand that the CEO and the executive team of the portfolio company need to adapt during this first phase to a new governance model. We list typical elements of this model in Table 3 with the evidence we found across our case studies.

## **Phase 2: Holding period**

Once the deal is closed and the investment has been properly structured in Phase 1, staffed with a high talent executive team, which benefits from an attractive incentive program and is monitored by a highly focused and active board, the work of creating value truly begins.

## **Phase 2A: Cleaning up the Corporate Act**

### ***Crafting the value creation blueprint***

The first step is to finalize a clear action plan, which will serve as blueprint for value creation for all parties involved. Such action plan has likely been drafted by the PE partners during due diligence prior to the closing of the deal. However, it will now need to be confronted to the reality of the investment and be endorsed and put into action by the executive team and all levels of management throughout the company.

One can see a clear evolution in the content of value creation blueprints over the short history of the Private Equity Industry.

In the beginning of the development of leveraged buyouts in the 1980's, value creation was most often the result of financial engineering, with relatively low impact on the actual operations of the portfolio companies themselves. This was the time of a widespread disaffection for large diversified conglomerates, which had sprung up in the American economy over the previous decades. Leveraged buyouts were mostly carve-outs from those conglomerates. Value creation in such instances amounted often to the exploitation of the conglomerate discount, which states that a multi-unit company can be less valuable as a whole than divided into pieces. A core question at the heart of a Private Equity-led reorganization would then be "which assets should remain in the organization?" (Wruck, 2008). The new owners would therefore mostly focus on redesigning and optimizing the corporate scope (Magowan, 1989) while also using the benefit of existing tax laws, which allowed them to step up the book value of their newly acquired assets, leading to an accelerated depreciation and ensuing tax benefit for the portfolio company.

By the early 2000's however, most large conglomerates feeling the pressure from their shareholders had restructured and refocused their operations and tax

reforms in many countries had removed the accelerated depreciation benefit (Berg & Gottschalg, 2005).

When the markets matured and became increasingly competitive, buyout firms started to acknowledge the need for them to focus on adding value by helping portfolio firms with their operations and strategy (Lerner, Indahl and Zinterhofer, 1998).

This need has made this phase of working out the value creation blueprint all the more critical for more recent deals. It usually happens during the “first 100 days” period following the closing of the deal.

Private Equity owners start working with the CEO and executive team to assess the true current reality of the company – hardly feasible at the time of due diligence when bidders only get access to a limited “data room” about the company. From there, with or without the one-off support of external consultants, they will evaluate their strategic options to create value, choose a strategic course and design an action plan and adequate measures to monitor the delivery of this action plan.

When compared to the traditional strategic plan developed in a public company context, the Private Equity blueprint is a lot more focused on just a few big initiatives. It is also a lot more action-oriented, specifying how the company intends to deliver the value via a detailed roadmap.

Paramount in this phase for the Private Equity owners is the alignment on what will constitute the “equity story” that the owners and the executive team seek to sell to future buyers at the time of exit. Partners of the Private Equity Fund often start the construction of this equity story before they invest in the portfolio company as it can be the basis upon which they calculate the value of their bid. Creativity in designing the equity story can be critical in uncovering value to future investors.

Various Private Equity Funds have different views as to the extent to which they will develop the equity story at this stage. This can depend on various factors like the Private Equity fund style of investment or the industry where the fund invests. Some will go as far as identifying at this early stage the potential acquirer of the business and provide an answer to the question of “*what can the next investor do with this company?*”. It is not uncommon at this stage that the fund partners or the CEO invite M&A advisors to contribute to this exercise as the latter are well known for their expertise in spinning attractive equity stories for their clients.

The content of the value creation blueprint will invariably focus on creating a step-changed delivery of two measures: EBITDA and Cash.

A first step will often be to evaluate the incremental enterprise value which can be created without relying on revenue growth of the business. Until recently, some Private Equity Funds still marketed themselves as being able to create incremental value with efficiency gains alone, without the need of any revenue growth in the portfolio companies they invested in. In a number of cases, still today, revenue growth might not appear in the key metrics against which the executive team’s performance will be evaluated and compensated, revenue growth being seen only as one of the levers available to deliver a successful EBITDA growth plan.

This arms-length rapport of investors with revenue growth constitutes a significant difference in the way the executive team will be able to make decisions in a PE context compared to the context of public corporations. Here is what Informant 12, a senior actor in both public and private equity contexts, has to say:

*“The benefit of Private Equity is that you can sometimes decrease the top line for a while because you have no analysts to report to quarterly. Therefore, in PE, you can do the right thing. In public companies, you may always end up needing to do the wrong thing to show the necessary quarterly results.”*

Typical actions in this step will be ones which represent “low hanging fruits” or others which aim at “sweating the assets”.

The first set of actions are those which allow to reduce rapidly the existing cost base of the company and can therefore give a one-off boost to the EBITDA. Executives look here at all manners of one-off fixed cost reductions, product reengineering, headquarters restructurings, divestitures, etc. They might also look at a review of pricing policies, designing for example differentiated pricing strategies for various segments of the clientele and rolling this plan out in one effort early on in the investment cycle.

At the same time, both Private Equity Fund partners and executives search for creative actions to extract maximum value from existing assets in the company. A very common course of action for example is to review the real estate assets owned by the portfolio company and evaluate sale and leaseback options or straight divestitures when applicable. This is often the case of investments which include a large retail base, whether supermarkets, pubs, restaurants, etc. A great example of this is how Texas Pacific Group (TPG), one of the largest Private Equity investment firms in the world, used this technique successfully to win a bid for the pubs business of Allied Domecq against the typical trade buyer Whitbread in the United Kingdom. In an effort to lower the interest costs after acquisition, TPG thought of securitizing their portfolio company pub assets. TPG was able to package the rents it earned from the pub assets into real estate investment securities, which could then be sold to investors. In doing so, it was able to afford a lower leverage capital structure.

The next step in building up the value creation blueprint is to design an action plan for revenue growth. We identified three main types of actions to do so.

First, executives focus on expanding the client base, whether by reaching out to new segments of clients in existing markets, expanding the geographic footprint of the business internationally or launching new product lines.

Second, executives – often supported here by the Private Equity Fund partners – will evaluate a “Buy and Build” strategy to grow the business through related acquisitions. This strategy is usually favoured by Private Equity Fund partners who come from a financial background. Having no experience in growing businesses organically, they prefer to rely on M&A, which has the distinct advantage to create “instant” growth at the closing of the deal. Acquisition targets will then be screened on whether or not they are immediately “Gross Margin Accretive”. In view of the limited time executives have to create value before an exit, Private Equity owners will prefer to leave synergistic benefits as a growth opportunity for the next investor, rather than counting on them into their own value creation blueprint.

Finally, the third type of actions will hover around capturing more of the value chain. This can take several forms. A common form has been for consumer businesses to take back control of distribution of their products in geographies where this capability was in the hands of local third-party distributors. In Samsonite, when owned by Bain Capital, executives chose to gain back control of distribution in both Russia – by buying out the Russian distributor – and in Japan, by bypassing the existing distributor and going direct. Informant 14 offered another example:

*“We bought a company offering software project solutions to banks. The executive team evolved their service offering from project to pre-configured software. They acquired software distributors in other markets also offering IT services and maintenance and ended up running the whole IT backbone of banks. The company grew to 1200 people and became a bit like SAP: once hooked to the services, banks would pay recurring fees year after year.”*

Beyond those actions aimed at maximizing EBITDA and cash, we uncovered a clear debate amongst our various respondents as to whether one should include within the value creation blueprint early actions aimed at influencing the multiple of the final enterprise value at exit. We will come back to such discussion in our next value creation phase focusing on building a bright future for the portfolio company.

This process of strategic setting and value creation blueprint development in a Private Equity context involves far fewer stakeholders than a comparable exercise in a public company. Sometimes, it can be an exercise involving solely the CEO and his Private Equity partner counterpart. This, together with the limited time horizon of the Private Equity Fund of five to seven years to achieve the expected return, makes that the resulting strategic blueprint is usually very simple and narrow in focus.

As for preparing for the delivery of this blueprint, the CEO and his executives decide on the best structure to ensure that expected results are achieved. It is not uncommon for the top team to form a “Program Office” made out of the key staff members whose role at various levels of the organization is critical in delivering the blueprint. Members of this Program Office will report on a regular basis to the executive team on the progress made. Those staff members, identified by the CEO as the “rainmakers”, will often be given equity incentives, reflecting those awarded to the executive team.

While the blueprint will be made very clear to all staff of the portfolio company and all actions will be geared towards its delivery, executives will stay very alert to dynamic changes in the market, which could lead them to evolve the equity story during the course of investment. Informant 14 gave us this example:

*“One of our portfolio companies had decided to pursue an aggressive international expansion plan focused on the United*

*States. In doing so – quite successfully -, they started effectively stepping on the main US competitor’s toes. We eventually decided to adapt our “equity story” to entice this US competitor to buy the company so as to remove the source of their pain. This is exactly what the US competitor did.”*

In this phase of cleaning up the corporate act, the executive team is hard at work figuring out the best possible value creation blueprint to maximize the enterprise value of the investment at exit. The outcome of this first period of working with the new Private Equity owners is a refocusing of the company’s activities on a clear, narrowly focused and action-oriented plan. Typical strategies and actions developed by executives at this stage are delineated in Table 3, together with the evidence from our interviews.

### ***Managing Investors/Debt holders***

In the first couple of years following the investment and the alignment between Private Equity owners and the executive team about the value creation blueprint, focused attention will be given to please both debt and equity investors via a combination of debt reduction and dividend payment.

Next to stock ownership and board monitoring, the high leverage of buyout transactions serves as a third lever of alignment between the portfolio company executives’ and the shareholders’ interests.

At the start of the investment, high leverage may constitute a type of additional outsourced governance over and above the role of the portfolio company board, as covenants and repayment schedules of the debt imposed by banks serve as a sort of operating budget for the buyout company (Baker & Montgomery, 1994).

The pressure of interests and capital repayments – also called the “discipline of debt” – clearly limits managerial discretion, minimizes waste of free cash flow and

helps to eliminate non value maximizing behaviour. It requires an ironclad budgetary discipline from the executive team, allowing no slack, no surprises and no deviance. Above all, in case of issues, it requires complete transparency and candour from the management.

The discipline of debt is therefore considered as a positive element of performance governance. Yet, it needs to be properly calibrated as too high a leverage may lead to risk aversion on the part of the executive team, which could alter its investment decisions to decrease the risk of default and, by doing so, forego opportunities for further enterprise value creation.

In the early days of the Private Equity industry, banks used to structure their debt offerings and covenants as to include a rapid paydown of debt, especially shorter-term senior debt, in the first two years following a buyout, making the executive team focus primarily on developing all actions necessary to please the debt investors.

Since then however, as the Private Equity industry has seen an ever-growing availability of cash for both equity and debt injections, the best Private Equity Funds have been able to minimize bank covenants and favour a focus on an early dividend payment to the limited partners. Indeed, Private Equity Funds' ability to raise follow on funds with limited partners is highly dependant on the single measure of the Internal Rate of Return (IRR) they have been able to deliver on prior funds. The IRR, calculated as the return over equity invested, can be boosted by reducing its denominator via a dividend payment early on in the life of the investment.

Hence, various Private Equity Funds will have different degrees of priority in terms of debt or equity repayments. Informant 12, as operating partner, confirms the clear views of his Private Equity Fund when saying:

*“The focus on cash flow is with three priorities in this order: 1) Pay dividend, 2) Reduce Debt and 3) Invest in the Business”.*

On the other hand, Informant 15 represents the views of a new type of “evergreen” Private Equity Funds, which is currently developing in the industry. Those evergreen funds have a longer investment horizon than the standard 10 years’ commitment of capital which is traditionally agreed with limited partners. He tells us:

*“When we enter the business, we spend the first 18 months to look at increasing cash and earnings. Similar to traditional PE firms, we look to deleverage but not to pay out a dividend to investors, rather to make the company stronger for growth. We do not cut marketing and R&D. Those investments only pay after 18 months”.*

Whether their objective is to reimburse debt or equity, executives in the portfolio company show, in this phase, a razor-sharp focus on cash generation and reduction of working capital requirements in the business. This will include all the “low hanging fruit” decisions outlined earlier as well as all the efforts to “sweat the existing assets”, converting those into alternative sources of financing, if possible, through sell and leasebacks, divestitures, asset sales, etc.

Short-term cash generation is not always a quick process. This phase may already require that the portfolio company changes its mindset and measurements to be implemented successfully. A good example is the investment of KKR, another large global Private Equity Fund, in Safeway supermarkets in the United States. Accounting practices at the outset of the investment did not allow to measure returns on a division-by-division basis and executives admitted to be making large capital investments in stores without knowing whether each individual operation was viable for the long term. To identify underperforming divisions, top executives started to measure the “Return on Market Value” (ROMV) for each store and division, calculating cash flows from each store divided by the expected market value of its

assets. In essence, they were probing whether each store or division would be profitable as a stand-alone, with cash flows being worth more than the expected sale value of the unit. This accounting exercise applied to thousands of stores led the company to shed 1000 of its lowest performing stores in the first two years after acquisition and to use the capital to pay down part of the original debt.

This phase also usually includes an improved process of decision-making for capital expenditures with a revision of levels of discretion, which are usually elevated all the way up to the executive team. One popular way in Private Equity circles of engaging all levels of the organization in thinking about the opportunity cost of the capital employed in any project has been to request a measure of any investment in terms of “economic value added” (EVA). In effect, EVA subtracts a cost of capital to the net income of any project, so that executives start to account for the value of the capital they use to generate income. Executives’ performance can then be measured by the Private Equity Fund not just on the profits they generate but also on how well they make use of the capital under their control. This technique of efficient asset utilization was used very successfully by KKR after their acquisition of Duracell in the 1990’s, for example.

Finally, the executive team will review all elements of working capital, aiming to minimize the inventory value necessary to the good running of the business, extend the term of payables to suppliers while shortening the term of receivables. Informant 1 explains how this latter working capital strategy was applied to the extreme in his company:

*“As a clear leader in our industry, we pushed our suppliers very hard to accept payment terms at no less than 90 days and refused to supply any client which would not accept and abide by our stringent 30 days payment terms. The idea clearly was to use our strong position in the market to aim for running pretty much as a bank: we wanted to get the money from our sales in, before we had to pay out*

*to our outside suppliers. This allowed us to drastically reduce our working capital requirements and helped in achieving our desired interim dividend payment two years after investment.”*

Whatever actions are undertaken by the executives to meet the stringent cash requirements in this period, this discipline represents a good “finishing school” for managers, as it does demand competencies which are often untested, especially with executives coming from a public company context who have rarely had to deal with the balance sheet of their company. Typical actions and evidence from this period are summarized in Table 3.

### **Phase 2B: Building a High Value Future**

Once executives have established the right organization, developed a compelling value-creation blueprint and sorted out all short-term actions to settle the portfolio company on sound foundations, comes the work to create long-term value. This new phase, which can start very early after investment and run parallel to the prior phase, typically gets a lot more attention after the first year or two. Overall, this phase will mean the establishment of a new work culture throughout the company and focused efforts on building promising investment prospects for the next owner of the business.

#### ***Changing Work Culture***

The Private Equity model clearly influences what executives do – their decisions – but also how they do it – their behaviours. Informant 12 explains the foundation of the new work culture in the portfolio company:

*“The interest of the Private Equity model – with its focus on dividends, debt and enterprise value creation – is different to the one of a public firm which focuses on growth, buying, investing, changing and not caring about debt. The latter is taken care of by*

*Treasury and the normal leader does not get involved. This difference between the two models leads to totally different decisions and behaviours.”*

The justification behind executive decisions can be traced back to one fundamental principle, which we started touching upon earlier: a Private Equity portfolio company is managed for Cash Flow, not for Profit (Magowan, 1989). The primary concern is to provide sufficient cashflow to pay down the debt or pay out a dividend as soon as possible. Profit is seen as only one element of cash flow. A corollary to this first principle is that the Private Equity portfolio company is therefore managed for efficiency, not for growth.

The first effect of those two principles is that executives are asked to focus on unfamiliar measures of performance, like the often used “Return on Market Value” and “Free Cash Flow”, and not on Earnings per share, Earnings growth or Price/Earnings ratio, which are all prevalent in a public company context (Baker & Smith, 1998). CEOs most often build their pay for performance program on a very limited number of measures – most often EBITDA and Cash-Flow –, which are part of the standard jargon of the Private Equity industry itself and are therefore critical to communicate success in value creation at the time of an exit. Supplementing this, CEOs will also add a number of idiosyncratic measures which are predictive of those primary desired outcomes. Informant 8, who heads a fast-growing technology company, comments:

*“I defined our core KPIs (Key Performance Indicators) as revenues and cash, reflecting the fact that, in the technology sector, enterprise value is built on a revenue multiple, rather than an EBITDA multiple. I then looked at adding KPI’s which are a proxy for the revenue trend: pipeline, conversion rate, pipeline of hiring of sales managers, etc.”*

Informant 9 shares his own experience as an executive in the C-suite of his portfolio company. He relates how, after a new Private Equity Fund acquired the company, the new owner worked with the executive team to identify the metrics which directly impacted the business model of the company. As a result, the number of metrics which the executive team had to report to the board increased significantly.

The focus on efficiency and a reduction of capital requirements often leads to a significant reconfiguration of the company's resources (Berg & Gottschalg, 2005). Executives see no virtue in sustaining people or assets in inefficient or underproductive uses. In an effort to reduce production costs, increase plant productivity and eventually improve margins, manufacturing executives therefore look at plant closures, de-localizations, outsourcing, reduction of overheads, etc. This is where the benefit of being a private company – therefore avoiding the possible public backlash of some of these drastic measures – can be significant.

Any subsequent resource allocation in the company prioritizes projects which are essential either to creating short-term returns – hence influencing the EBITDA – or to maintaining or enhancing competitive advantage – influencing the multiple.

In parallel to the usual reconfiguration of resources, executives strive to make existing corporate assets more efficient via rationalizing corporate operations, improving the management of working capital and capital expenditures, improving inventory control and tightening accounts receivable management while lengthening accounts payable lead times.

Another typical strategy which is used to improve overall margins is to remove any existing cross-subsidies between product lines, distribution outlets, etc (Liebeskind et al, 1992). In order to achieve such a laudable objective, companies often need to develop a new capability of activity-based costing. This step alone can

take more than a year to be established, often delaying the expected savings to the second half of the investment cycle. Informant 1 comments:

*“When we were acquired by our new Private Equity owners, we did not have the internal capability to cost individual product lines. We used to apply an average cost, add our desired margin to it and sell most of our products around the same price points to consumers. Our new owners insisted on us developing this capability, which eventually led to a significant review of our product portfolio and a complete revision of our pricing policies per product line.”*

The portfolio company’s focus on Cash Flow and Efficiency does lead to different decisions about how to manage the business day-to-day. At the same time, Private Equity Ownership also leads to very different behaviours and a very different culture of how to achieve results. Wruck (2008) notes that buyouts are often followed by dramatic changes in decision-making authority. In an ideal scenario, Private Equity owners prefer a minimum of day-to-day interference in the company, as long as financial targets are met. This usually releases executives from the type of corporate bureaucracy which they might have been accustomed to in other contexts.

To note, Private Equity Funds do not wish to create any overarching headquarters bureaucracy or common corporate culture between companies in their portfolio. All they usually wish to transfer are learnings they gathered on financial techniques, accounting and control systems. They will also expect a common level of communication, a minimum common language which, for example, can serve as well for a supermarket as for a manufacturer (Baker & Smith, 1998).

Beyond this sharing of financial best practices, Private Equity Fund partners encourage their executives to act as entrepreneurs, to take independent decisions from the board and to become true owners of the results of their decisions.

This sudden freedom provided to top executives will regularly result in *“very energized and highly motivated executive teams who would be willing to take nearly*

*any action to make their buyout a success”* (Berg et al, 2005, p32), a phenomenon sometimes called “LBO Fever” or “LBO Adrenalin”. This will usually translate in executives setting very aspirational targets and stretch budgets, requiring all staff to work harder or risk losing their jobs in the process.

To counter-balance this increased job pressure, the pay-for-performance program offered to the executive team is regularly broadened to a larger number of employees. Buyouts may introduce new motivational systems like employee share ownership plans or other shareholdings schemes and change employee contracts in a way that motivates to achieve key tasks through changes in their evaluation and compensation. Not all employees however are enrolled in those additional incentives while they all feel the pressure on delivering the expected results.

Informant 9 shares his personal experience of the new culture in his company after a Private Equity Fund took ownership of it:

*“Delivering on the Private Equity plan requires a huge commitment, working a lot of hours. I know I cannot work like this flat out forever. Once we go through exit, it is unlikely I would take another senior operational role in a regular organization. I am more thinking about doing part time consulting and advisory.”*

The new work culture, which usually results from a move of a company to Private Equity ownership, translates into various new characteristics reported in Table 3, together with the evidence we found during our research.

### ***Building Future Investment Prospects***

Most efforts to create value which we have reviewed so far focus primarily on cutting costs where appropriate or moving resources from lower to higher productivity units, so as to satisfy debt holders and current owners with free cash flow redemptions. However, times when buyouts could be viewed as solely emphasizing

downside efficiencies are over (Wright et al, 2001a). Organizational changes mentioned above need to be such that they do not negatively affect the company's ability to compete in the marketplace (Easterwood et al, 1989). Resource allocation should ideally prioritize projects which enhance competitive advantage.

Executives need to invest and build where the prospects of value creation are good, paying attention to preserving the right balance between projects which offer a reasonable chance of return in the short and medium terms (EBITDA-enhancing) and projects which promise the opportunity for value creation further into the future or post-exit (Multiple-enhancing) (Lerner, Sorensen, Stromberg, 2011).

This is a phase when owners and executives start to crystallize their views on the target buyer for the business and might even tailor their actions to ensure they add value to the target buyer's existing business.

An exit through a trade sale or an Initial Public Offering (IPO) – usually the preferred routes for Private Equity funds – often requires a history of strong growth (Butler, 2001). Executives in portfolio companies will often strive for a “hockey stick” growth curve, showing minimum growth during the first phase of cleaning up the corporate act and a subsequent acceleration of growth during this new phase, which slowly prepares the company for an exit.

Executives in the portfolio company will tend to push for internal, organic growth strategies when they can see the potential of promising internal innovations or innovative strategies. In the absence of those organic opportunities, they will strive for external growth. This can take the form of acquisitions of new lines of businesses or new competencies, which strengthen the company's competitive edge. It can also be an expansion of business scope like geographic expansion (Wiersema and Liebeskind, 1995). As Informant 13 comments, the timing of such activities is critical:

*“For any penny invested in the business, you need time to get a return. Any major transformational acquisition needs to happen in Year 1 to 3, rather than Year 4 or 5. The scale achieved through acquisitions has the potential to influence the multiple at exit. So does relevant diversification, especially in “sexy areas”.*

We found in our research contradicting opinions as to whether or not executives should include in their value creation plan actions aimed at influencing the exit multiple, over and beyond those actions meant to maximize EBITDA. Individual points of view were either a matter of chosen policy or of industry dynamics faced by the portfolio company. Informant 6 shared his experience:

*“Our owners – who were specialized in turnarounds of companies from bankruptcy – focused their attention on a positive EBITDA delivery and a proven increasing efficiency in our manufacturing. They did not include revenue growth in our performance metrics and did not show interest in discussing actions we could have taken to improve our multiple. As far as they were concerned, the multiple was solely in the hands of the market at the time of exit.”*

Informant 12 on the other hand, as an operating partner for a different Fund, had a different view, showing that he might even expect a higher value contribution from an increase in multiple than one in EBITDA over their investment cycle:

*“We believe in influencing the multiple. Yes, it is partly set by the market at the time of exit but within a range. Our objective in our latest investment is to get from a multiple of 10 to 14 by investing in Asia and growing EBITDA from US\$ 70 to 100 MM.”*

Our respondents in the world of technology had a nuanced view on the question of multiple. They agreed that, in most other industries, future EBITDA would bring less money home than historical EBITDA. However, they saw the digital and technology industry working with different value dynamics. Typically, technology investors spend money on the future, not the past. In such high growth environment, EBITDA can be minimal or even negative and companies focus on

revenue and gross margin while aiming to sell on a revenue multiple, rather than an EBITDA multiple. This multiple can vary significantly – by a factor of two or three – depending on who else is playing in the same activity segment at the time of a desired exit. However, they did see one factor in their control, which could significantly influence the exit multiple: how they could prove the scalability of their model.

Whether executives believe more in future building actions with a net EBITDA impact prior to exit or a proven “growth option” to present to potential future investors, they all embrace the idea of implementing “discontinuous” actions, which would justify a superior value creation during the investment cycle, compared to the prior history of their company. Typical actions taken by the management team in this phase are summarized in Table 3, together with the evidence provided by our informants.

### **Phase 3: Exiting the investment or realizing the value**

Owners and executives start preparing for an exit about 12 to 18 months ahead of their target date. This process is usually triggered by the Private Equity owner when the business has achieved or is close to achieve some key milestones. Upon these results, the owners may consider that they can extract substantial incremental value from their investment while building an “equity story” for the next buyer, which attracts high level bids.

Once executives enter into “selling mode”, they start changing their decision making to focus on the exit event. Of paramount importance is to show in the year preceding the exit a maximum EBITDA as this is the basis, which interested bidders can use to present their final bid value. At this point, executives scrutinize costs,

trying to reduce any fixed costs or replace them with variable elements. Informant 14 comments:

*“Since we invest in smaller firms, growing the top line is key. In earlier years, we invest a lot in R&D or international expansion depending on what the value creation plan entails. After 3 to 5 years of top line focus, we turn the switch to the bottom line to get a positive EBITDA.”*

The CEO and his executives often take a number of short-term decisions to boost EBITDA. They have to pay attention not to compromise resources, which would be seen by the target buyer as critical for the future success of the company. Yet, this period can be one where executives cut into critical but less visible resources or try to push resources which are fixed into variable contracts of even one-off “extraordinary” costs, in order to “polish” the long-term EBITDA base of the business.

The selling process itself starts with the preparation of the final most compelling and forward-looking “equity story”. We saw that a number of actors in this industry start building up the equity story as early as during due diligence prior to investing and certainly, in the first phase of structuring the investment, when owners and executives build up their value creation blueprint. However, a number of factors can change during the course of the investment, that requires to review and sharpen the equity story. This is the moment to evaluate whether a blueprint, which would have included, for example, the repositioning of the company to a new target industry or new industry segment with higher multiple, can indeed be credibly exposed to potential buyers.

Having identified target buyers and while building the equity story internally, executives also start, whenever possible, to market the company to their potential investor audience. Informant 6 comments:

*“We had decided to pursue a “dual track” exit process, which could either result in an IPO or a secondary buyout. Once this was decided, we started a global campaign of corporate marketing to get our future investors more familiar with the company before they would have to decide whether to invest in it or not. We invited financial analysts to visit the company and meet key managers, so they could start to cover the company in their analyses, despite it still being private.”*

In larger buyouts, the Private Equity Fund partners and the CEO enrol investment bankers to work with the owners and executive team in putting together the exit equity story. Bankers bring in external industry validation with numerous industry-wide metrics to bring justification to the expected value requested by the current owners. They also inform management and owners alike of the state of the market and the expected “appetite” which they expect for this particular investment. Appetite depends on different factors related to the preferred route for exit.

For an IPO, bankers first assess how attractive public markets see the company and its industry and, as a result, how much of the company they think the market is ready to absorb – in such a route, owners usually sell only a share of the company. Bankers then assemble a list of comparable companies involved in recent liquidity transactions and the valuations they achieved. This can help them determine the appropriate price range to market the company at.

In the case of a trade sale or secondary buyout – selling to another company or another Private Equity Fund -, investment bankers look at the state of the economy, the state of the debt market, the amount of “gunpowder” available to potential bidders, the closeness of “fit” of the investment to specific target buyers and the success of recent transactions. These elements help bankers to advise the Private Equity owners on expectations of EBITDA multiple at exit.

Investment bankers, owners and executives also often discuss about the most appropriate geography where they want to market the company.

The choice of geography for marketing a portfolio company can be informed by the industry – technology companies are often marketed in the US market, for example, where they tend to reach higher valuations due to a higher understanding and risk appetite of investors for technology in that region. Informant 14 explains:

*“The preferred exit route can be different per continent due to differences in the structure of the capital markets. For our investments in technology companies, we will prefer a listing on the Nasdaq for US companies while in Europe, we favour strategic trade buyers.”*

But the choice of geography can also depend on the future growth prospects of the company, which the sellers want to highlight in their “equity story”, or on the number and quality of other companies being marketed to investors at the same time in a particular region, which can have a positive halo effect. Informant 3 elaborates:

*“When we started preparing for our IPO, we saw that our biggest achievements in terms of EBITDA growth were coming from our Asian business while our most promising forward growth opportunities also came from that region. At the time of our preparation, bankers informed us of plans from very attractive and potential comparable companies to list of the Hong-Kong stock exchange. We therefore decided to follow suit and we had an amazing success with Asian investors. In retrospect, we learned that the Hong-Kong Stock Exchange had surpassed both the New York and the London ones in terms of total value of transactions that year.”*

Exit preparation also entails a review of the existing governance in the company. While the board composition tends to remain relatively stable during the period of ownership – with, however, the possible change of CEO as mentioned earlier -, it is clear that the Private Equity Fund does not see this board structure as permanent. When approaching the occurrence of a “liquidity event”, the owners will reassess the validity of this board composition depending on the chosen route for exit. When an IPO is chosen as the preferred route, the Private Equity owners will assemble what they consider to be the most “selling” board. They might consider

sometimes that the board lacks “a sense of historical legitimacy” because of its size or the new direction taken by the business and want to appoint a prestigious director, ideally with significant experience in the running or governing of public companies (Johnson et al, 1996). Potential investors in the IPO, not always familiar with the industry or business model, are reassured of the bright business prospects of the firm by the “celebrity value” of the newly appointed independent board chairman.

This new board then becomes one of the selling points used in the ensuing IPO Investment Memorandum. Informant 10 remembers:

*“A professional IPO board was formed right before our IPO. The chosen board chairman was the outgoing CEO of a large industry player, a true industry veteran. He was flanked by a former FTSE 100 CEO and another former CEO of a major healthcare corporation. Our Private Equity owners were clearly able to attract a great board, which was eventually made of 5 independent directors and 2 Private Equity members, so our Fund found itself in the minority for the first time.”*

Finally comes the time to actually market the portfolio company to key target investors. Owners will enrol a limited number of key executives – usually three or four at a maximum, including the CEO and the CFO – to go on a roadshow and produce some “theatre” in front of potential buyers. The presentation will include a three years value creation plan – a follow-on to the plan just delivered in this investment cycle -, a perspective on the value to be built after the current exit. The equity story, repeatedly rehearsed before the roadshow and then repeated multiple times to investors will aim to show a value creation plan of which only the first half has been delivered, trying to convince the future investor that the keys to further growth lie already within the hands and minds of the executive team. This is where the value of any “growth options”, which the executives took care to develop – proof

of concepts for new businesses, new geographies for example – will play a critical role to build confidence in future growth prospects.

The roadshow is also an opportunity for future investors to meet key members of the company's management as the investor usually buys as much a team as they buy a business. The performance of key executives during the roadshow is therefore of great importance for the success of the sale. Informant 10 remembers:

*“As CEO, CFO and COO, we got together to develop the pitch. We then embarked on the IPO roadshow making no less than 80 presentations in total to Fidelity, Blackrock, etc., trying, for each, to present the most compelling story possible. This was one of the most gruelling experiences of my career”.*

While key executives are presenting the company during the roadshow, the Private Equity partners are usually keeping any bidding conversations confidential, so as not to demotivate the team for further presentations. When owners approach a final bid, they do however usually check back with the CEO as he needs to be happy to play his role for the deal to be successful.

Once the Private Equity Fund provisionally accepts a bid, current and future owners enter into a number of discussions with key executives to ensure their continued support in creating further value after the sale. Future owners usually expect from key executives that they reinvest part of their proceeds from their equity sale into the new venture and commit to stay on for at least a minimum “lock in” period – often at least a year – after the new deal is closed. If some of the top executives do not wish to stay on during the next cycle of investment, a succession plan will be ready to be presented to potential bidders.

Of course, not all liquidity events do happen according to the type of orderly exit outlined above. First, an exit might happen a lot sooner than expected - after two years for example - as the result of an unsolicited bid. The Private Equity Fund –

which is usually a majority shareholder in typical LBOs – has the final say. The partner sitting on the portfolio company’s board will however liaise with the CEO and, if the CEO is against the sale, the owner might start discussions of additional compensation to ensure his supportive involvement in the process.

Second, in cases where the ownership of the portfolio company is split amongst several major shareholders – as can happen when several Private Equity Funds invest together as a consortium or when a Private Equity Fund invites one of his limited partners to co-invest directly in a portfolio company, shareholders might not agree whether accept a buyers’ bid or not. The role of the CEO can be critical in such situations, as an arbitrator helping the board to reach a final decision.

Finally, even after the executive team have delivered positive value creation, the market might not show enough appetite for purchasing the portfolio company or bids might come in but be considered too low by the owners. This can happen in times of economic uncertainty or when the prospects of the industry where the company operates does not look promising enough for the buyer to be confident in creating and – most importantly – realizing its own incremental value. Private Equity owners are then left with a last exit option, which is to milk the business through dividends to recover their investment and, hopefully, collect incremental value.

Throughout this last exit phase, when owners finally realize the value of their investment, the role of the top executives of the company remains critical to fully materialize the value created during the cycle. The executive team is usually seen by the new buyer as a critical element of the package he buys into.

Typical actions gathered from our research at that crucial time are summarized in Table 3.



## **THEORETICAL MODEL**

Our research has enabled us to develop a theoretical model which outlines the mechanisms through which Private Equity investors and portfolio company executives deliver superior returns in their strategic and daily operational decisions and actions. The model is shown in Figure 4.

We distinguish three primary value creation mechanisms, which occur mostly chronologically during the investment cycle.

The first mechanism to deliver superior value is one of making the decision makers inside the portfolio company – those executives who have a direct impact on the company’s operations - as personally interested in the financial value created than the shareholders themselves.

Private Equity investors achieve this alignment of interests in the first phase of structuring the investment by first, picking the right executives who show a high motivation in making significant money from their daily efforts; second, by structuring the incentives of those executives in a manner which clearly links their final pay out with the exit value obtained when the portfolio company is sold and third, by establishing a close, personal and relatively informal governance model to constantly check the adequation between the shareholders’ interests and the motivation and actions of the top executives.

This mechanism of interests’ alignment is of a different nature and magnitude to a similar mechanism which is often put in place in public companies. Most top executives of public companies also benefit from a share of their compensation tied up to the measure of corporate value, i.e. the company’s stock price on public markets. Yet, this share is usually less significant when compared to the other elements of compensation like base salary and bonus schemes.

Beyond the size of the corporate value incentive, public company executives are often viewing their role as serving a varied set of stakeholders – staff, unions, public bodies and authorities, the public at large – making shareholders only one of the “beneficiaries” of their daily decisions and actions. This is most evident in instances when public company executives hesitate to take shareholder value enhancing decisions which could create a public backlash against the company and could eventually result in a drop in the stock price of the company.

In the structuring of a typical Private Equity investment, top executives are selected and incentivized, so that they understand shareholders – a group to which they belong - are the only stakeholders they truly need to care for. The private ownership of the equity provides the executives with the necessary immunization to allow for the implementation of critical – but possibly unpopular – decisions like plant closures, de-localisations, divestitures, etc.

This first mechanism leading to superior value creation in Private Equity portfolio companies leads us to craft a first proposition (Figure 3):

*Proposition 1: In the context of Private Equity, the structuring of the relationship between top executives and shareholders – in terms of both incentives and governance – leads to a better resolution of agency conflicts than in a public market context.*

The second mechanism contributing to building superior value in a Private Equity investment is one which focuses on freeing up all unexploited value lying hidden inside the portfolio company at the time of purchase by the new Private Equity investors.

This mechanism aims to eliminate any waste and make the organization the leanest, yet fittest for the purpose of building a business of maximum value for future potential acquirers. Private Equity investors demand from their top executives to

either maximally exploit the intrinsic value lying within their company or free it up to either boost EBITDA or return the value immediately to shareholders who can then redeploy it to more productive uses elsewhere.

Pent-up value is extracted from existing company assets (real estate sale and lease-back), from inventory, from bloated working capital spending, from non-essential staff, from manufacturing inefficiencies, from non-performing subsidiaries (through divestitures), from unused pricing power, from sourcing scale efficiencies, etc.

As we have seen from the first mechanism, company executives are acutely aware of their role in serving the single Private Equity stakeholder who owns their company in full. Being spared the critical eye of the public market, they can more easily implement all those actions which free up intrinsic value and which might otherwise be quite unpopular with other stakeholders in different contexts.

This second mechanism of maximizing value extraction from the Private Equity portfolio company leads us to venture a second proposition (Figure 3):

*Proposition 2: In a Private Equity Context, CEOs have more freedom to focus the whole organization on significant value creation and take all necessary actions to do so.*

In the first decades of the Private Equity industry – in the 1980's and 1990's – the two mechanisms above were mostly sufficient in explaining operational value creation in a portfolio company. These, coupled with financial engineering, which played on the levers of the company's debt structure and the related tax shield, were sufficient for the Private Equity Fund to deliver significant returns to their limited partners.

As opportunities to create value from creative financial engineering and improved operations efficiency diminished, Private Equity Funds understood the

necessity to develop their skills at a third mechanism, which aims at creating – and partly delivering – promising future growth prospects for the portfolio company. Creating discontinuous growth – past and future – would not only impact the EBITDA part of the Private Equity value equation but also the multiple. Any potential buyer would tend to bid higher for a business where his own opportunity for value creation was clearly articulated, tried and tested.

Unlocking multiple opportunities for growth would not only be achieved during the definition of the value creation blueprint by investors and top executives at the outset of the investment, but would also become part of the new corporate culture permeating all levels of the organization.

This outlook for growth would build on the other key aspect of culture, which we mentioned earlier, aiming at maximizing efficiency and extracting all pent-up value from the existing business. The resulting culture of Private Equity value creation and its translation in daily operational decisions and actions is unique to the industry and a vital component of its success. It inspires us to formulate our third proposition (Figure 3):

*Proposition 3: In a Private Equity Context, the culture of the organization plays a stronger role in value creation than in a public market.*

One could argue that the search for growth is not the preserve of Private Equity portfolio companies. Yet, once more, the nature and profile of growth would differ from a more traditional public market context. Public markets reward continuous incremental growth year on year. Top executives constantly communicate their future “planned growth” with the company’s stock price adjusting accordingly. They tend to put all their efforts in delivering the planned growth, avoiding at all costs the sudden one-off jumps, which would be difficult to anniversary the following year,

causing the stock price to rise on the positive news, only to collapse, possibly drastically, when it would not be repeated the year after.

The year-by-year growth curve profile of a Private Equity portfolio company does not matter as much to the final determination of enterprise value at exit. It is not uncommon for portfolio companies to even experience a dip in revenues during the first phase of maximizing the efficiency of all assets.

Two elements have the most significant impact on the value creation at the time of exit of the Private Equity investment. The first one is the profitable growth already delivered at that point – which has translated into an increase in EBITDA alongside the increase generated through improved efficiency. The second one is the expected growth opportunity for the business which, – especially if it can be illustrated with a proof of concept on a small scale -, will favourably impact the multiple.

Delivering both discontinuous profitable growth by the time of exit and the proofs of concept for future growth opportunities represent the third mechanism, through which executive teams in Private Equity portfolio companies deliver superior value to their shareholders. This mechanism inspires us a last proposition (Figure 3):

*Proposition 4: In a Private Equity Context, long-term strategic thinking can be as valuable, if not more valuable, than in a public market context.*

To a lesser extent, one can also highlight the value creation mechanism at play during the last phase of the investment, when the Private Equity owners realize the value. While we said that the exit value results from a calculation of the equation of EBITDA x Multiple, this latter element can be influenced by the aspirational vision for future growth which the top executives and the Private Equity owners present to potential suitors. This investment story - often crafted by the Private Equity Fund at

the very start of the investment, if not before the original bidding - will be polished based on actual operational results achieved during the time of ownership and the availability of “proofs of concept” of future growth opportunities.

Coupled with the quality of the investment story is the marketing of the asset to the largest pool possible of potential acquirers. While the Private Equity industry has historically been primarily active in the Western markets, the recent development of multiple sources of capital from all geographies, especially Asian markets and notably China, has opened new avenues to elicit a larger number of bids from a larger number of suitors. Top executives can impact the value creation in this last phase of the investment by thinking from the outset of the investment about how to raise the awareness and attractiveness of their business to potential acquirers in other areas of the world than their own.

## DISCUSSION

### Operational value creation and agency theory

This research about operational value creation in Private Equity portfolio companies exposes an alternative model of alignment between agents and principals to the typical public corporation model which represents the heart of agency theory (Table 4).

When announcing the eclipse of the public corporation, Jensen (1989) introduced the new Private Equity model as “*resolving the central weakness of the public corporation – the conflict between owners and managers over the control and use of corporate resources*” (p61).

The weakness mentioned by Jensen is the core focus of agency theory, which aims to identify the most efficient contract for aligning the interests of an agent with those of a principal (Jensen & Meckling, 1976, Fama & Jensen, 1983). The theory was developed in the context of large public corporations with the disperse nature of their stock ownership. In a typical public corporation, the agent – the CEO -, is assumed to be risk-averse, since his employment security and income is inextricably tied to one firm (Wiseman & Gomez-Mejia, 1998). This CEO makes important decisions without bearing a substantial share of the wealth effect of those decisions. The essence of agency theory becomes therefore to resolve the trade-off faced by residual risk claimants – the shareholders - between a) the cost of measuring the agent’s behaviour and 2) the cost of measuring outcomes and transferring risk to the agent (Eisenhardt, 1989).

Our research highlights the characteristics of an alternative model of relationship between agent and principal in the Private Equity context, which successfully minimizes the conflict of interest between the two parties.

To start with, every Private Equity investment is structured with the objective to align the risk appetite of both agents and principals. To achieve this, Private Equity investors start by picking the right profile for the CEO, preferring candidates with an increasingly lower risk aversion. We have seen in our case studies how top executives are being asked to invest some of their own funds when they are appointed, sending a clear signal that risks are being shared and forcing a self-selection amongst executive candidates. CEOs of portfolio companies are typically seasoned executives, having created some wealth for themselves prior to joining the portfolio company.

Whenever possible, Private Equity Funds will prefer to pick their CEO from a pool of “seasoned Private Equity executives”, as executives having tasted the rewards of a first successful Private Equity exit are likely to be less risk averse in a second round. All CEOs in our case studies were part of such a pool. A similar mindset is behind the request by Private Equity Funds who purchased a portfolio company in a secondary buyout for the top executives to reinvest part of their gains from the first exit into the second round of investment with new owners.

Having picked agents with a lower risk aversion, Private Equity investors incentivizes them further by aligning their wealth effects to their own with outcome-based contracts. They transfer a significant share of the equity to the executive team, in proportions clearly unheard of in a public context. This reflects the principle of the positive agency theory, which suggests the alignment of interests between agents and principals by making a portion of the agent’s pay contingent on achieving outcomes which are important to the principal and therefore, transferring risk to the agent (Fama et al, 1983, Eisenhardt, 1989). The illiquid nature of the equity ownership for the portfolio company executives prior to an exit – as opposed to the staged liquidity of

stock option grants in a public context - exacerbates the alignment of interests between the parties.

The prevalence of outcome-based contracts helps to lighten up the burden of control on the owners, reflected in their chosen governance model. All informants in our research confirmed a common governance mechanism amongst all Private Equity Funds of improved information systems and increased data sharing with the board of directors. Informants also confirmed that the richness of board information was enhanced via frequent board meetings, both formal and informal (Eisenhardt, 1989), a direct and simple communication style between the board chairman and the CEO (Fama et al, 1983) and a trust-based relationship (Cuevas-Rodriguez, Gomez-Mejia and Wiseman, 2012) – at least at the outset of the investment.

In order to ensure maximum efficiency of their chosen governance and minimize the costs associated with it, we learned from our informants that Private Equity owners do not limit the role of board directors solely to decision control, as is often the case for a public board of directors. They insist on forming a board which will be actively playing the additional roles of service and resource dependence (Johnson, Daily and Ellstrand, 1996). To that effect, they surround themselves with a few non-executive directors (NEDs) who they usually select for their experience in the industry and their extended network of relevant contacts. NEDs will advise the executive team from the stage of the build-up of the value creation blueprint to the creation of “growth options”, those future projects which often involve the expansion to new customer bases, testing of new business models or new acquisitions.

Finally, we heard from our informants about the importance of the relationship between agent and principal – between the Private Equity Fund and the CEO – during the negotiations for an exit. Private Equity owners are acutely aware of the

“managerial welfare hypothesis”, which asserts that managers place their fiduciary responsibilities to shareholders second to their own welfare and will decide to resist or embrace an offer based on their expected personal wealth changes (Walkling & Long, 1984). While the equity portion of their compensation plan is meant to provide incentives for top executives to go along with any offer which is judged positive by the Private Equity owners, this can sometimes be insufficient to elicit the executive team’s support, like in cases of a very early offer – when the executive team believes they can create a lot more value for themselves in holding on to the investment. While not the final decision makers, key members of the executive team are often a key part of the “sale package” which Private Equity owners offer to transfer to the buyer. In such cases, we heard that Private Equity owners do not hesitate to use golden parachutes – mostly with the CEO -, as an alternative outcome-based contract to the executive stock ownership (Singh and Harianto, 1989).

One additional aspect of governance, which is often overlooked as not directly in the control of shareholders, is the market for executives. It is a very valuable tool to discipline agents into behaving consistently with the preferences of principals (Fama, 1980). In a public company, the stock market serves as an external monitoring device of performance for top executives with the stock price representing a visible signal that summarizes the implications of internal decisions for current and future cash flows (Fama et al, 1983).

Several of our informant CEOs voluntarily brought up the “freedom” they felt in moving from the external monitoring of the stock market to the monitoring of the market for takeovers, and only at the time of an exit. The absence of the daily yardstick of the public stock market, combined with the trust from the very limited number of shareholders forming the board, allowed CEOs to take the drastic actions

which are sometimes necessary to (re)structure the portfolio company on a sound footing for future value growth. Our expert informants confirmed how, in the case of public to private deals – when a public company is taken private by a Private Equity Group –, a significant part of the value creation blueprint is often based on the ability to implement those necessary drastic actions out of the public scrutiny. While this might be the cause of the poor public opinion suffered by the Private Equity Industry, it does not bear any negative impact on the value that these kinds of actions create in the eyes of future buyers, even in the case of an IPO exit when the company eventually gets sold to individual private investors.

### **Operational value creation and dynamic capabilities**

As originators of the dynamic capabilities view, Teece, Pisano and Shuen (1997) determined the first definition of dynamic capabilities as “*the firm’s ability to integrate, build and reconfigure internal and external competences to address rapidly changing environments*” (p516). The theory was developed primarily for use in large multinational companies and highly changeable competitive environments. Barreto insisted on the importance to identify new types of firms for which dynamic capabilities are an important concept (2010, p277).

Our research confirms the value of dynamic capabilities created in the context of an internal change of ownership towards Private Equity (Table 5). The change of ownership, while independent from the company’s market dynamics, constitutes in itself a rapidly changing environment, characterised by a changing performance objective which becomes dependant on the dynamics of the market for takeovers and a sense of urgency related to the finite time horizon of the Private Equity investment.

More recent definitions of dynamic capabilities seemed to us more appropriate for the type of capabilities we witnessed within Private Equity portfolio companies in this research.

We found a number of other linkages between our informants' input and alternative definitions of dynamic capabilities in the literature. First, we noted Zollo & Winter's definition of dynamic capabilities as "*a learned and stable pattern of collective activity through which the organization systematically generates and modifies its operating routines in pursuit of improved effectiveness.*" (2002, p340). We note here that the authors consider dynamic capabilities as "higher level" capabilities, which operate to change ordinary capabilities and operating routines.

Amongst our informants, those who were incumbent executives in portfolio companies were most vocal about the new capabilities brought in by the Private Equity Fund and the CEO, if he was new. The primary objective of those new capabilities in the first half of the investment cycle was an improvement of effectiveness, for the purpose of freeing up cash from the company as quickly as possible, usually to pay down debt or pay out an interim dividend to shareholders. Our research shows however that the dynamic capabilities of value creation did not stop at making the company operations as efficient as possible. We find therefore Zollo and Winter's definition to stop short of describing the full extent of the impact brought by the New Private Equity dynamic capabilities on the portfolio company.

Barreto (2010) views dynamic capabilities as structured and persistent to systematically resolve problems. We do find in our research a structured and systematic process across Private Equity Funds as well as across individual Private Equity Fund portfolios of transforming the acquired companies to refocus them on value creation for an exit in the market for takeovers. What we did not find is a

persistence of the value creation capabilities taught by the Private Equity Fund after an exit with a non-Private Equity buyer.

Finally, Zahra et her colleagues (2006) define dynamic capabilities as *“abilities to reconfigure a firm’s resources and routines in the manner envisioned and deemed appropriate by its principal decision maker(s)”* (p918). We do fully agree here that the distinct dynamic capabilities established within the portfolio companies are single-mindedly meant to serve the objective of value maximization of the Private Equity fund owners and no other stakeholder.

Dynamic capabilities are often disaggregated into three distinct activities of 1) sensing and shaping opportunities and threats, 2) seizing opportunities and 3) reconfiguring business assets to maintain competitiveness (Teece, 2007).

We could find expressions of these distinct activities in every one of our case studies.

The first activity of sensing and shaping opportunities represents a key element of the bidding process prior to a Private Equity investment and of the first phase of laying out the value creation blueprint, once the deal is consummated. As Makadok (2001) argues, potential investors will first clarify that their target investment possesses the resources on which the dynamic capabilities of value creation can act. Discussions at the Private Equity Fund level then centre around the Private Equity Fund partners’ sensing of an opportunity to create value in the target company as well as possibly shaping this opportunity through creative financing or unconventional operational ideas. In a bidding situation, the winner will often be the Private Equity Fund which shows the most creativity in this step of the process.

The second activity of seizing of opportunities fully falls under the responsibility of the portfolio company’s executive team. Our informant Private

Equity Fund partners who are sitting on a portfolio company board, are happy to recognize that they do not have the intent, and most often nor the ability or the experience to make the value creation blueprint become reality.

Finally, as we have shown on multiple occasions in our findings earlier, the focusing of the portfolio company on the maximization of enterprise value, as calculated as EBITDA times a multiple, leads, in most instances, to a significant reconfiguring of existing company resources, led by the executive team.

As research confirmed the high prevalence of sensing, seizing and reconfiguring in a typical Private Equity portfolio company investment cycle, our case study in the energy sector was a clear manifestation of the additional dynamic capability of continuous morphing, when the strategic flexibility of the firm to change organizational form is used as a strategic tool (Rindova & Kotha, 2001). Form is understood here as *“those characteristics of an organization that identify it as a distinct entity and at the same time, classify it as a member of a group of similar organizations”*. (Romanelli, 1991, p81).

The most notable examples of value creation blueprints in the industry often involve carve-outs, buy-and-build platforms, outsourcing, moving from a product to a service, sell and leaseback, divestitures, etc. The objective of this continuous morphing in the industry is single-mindedly to extract the maximum enterprise value from future acquirers in whatever corporate form is most attractive at the time of exit. Our case study in the energy industry showed us how the ideal form at exit can vary during the course of a single investment cycle – impacted in that case by contextual changes in industry regulations -, confirming the dynamic nature of this valuable capability.

We note a last type of dynamic capability, which comes out as very relevant in the context of a Private Equity investment: the ability for the executive team to extract “*interest alignment rents*” from their organization (Gottschalg and Zollo, 2007). The authors define those as “*the improvement in organizational performance due to changes in employee behaviour obtained through increased interest alignment that accrues to the organization, net the costs required to establish interest alignment*” (p419).

Jensen (1989) highlighted the important role that interest alignment between managers and owners played in determining buyout success. Gottshalg et al. (2007) focus their attention on the role of this capability within the buyout organization itself, linking employee behaviour to the combination of *extrinsic motivation* – driven by the goal of obtaining extrinsic work rewards or outcomes – and *hedonic intrinsic motivation* – driven by the goal of being engaged in enjoyable, self-determined and competence enhancing behaviour (p420).

As our case studies confirmed, buyouts boost extrinsic motivation through equity ownership for top management and key employees and pay-for-performance compensation packages (Anders, 1992). Interest alignment is also enhanced via intrinsic motivational factors like enhanced autonomy as many Private Equity Fund managers reduce their interference with daily operations as long as financial targets are met and CEOs tend to follow on the same path with their own subordinates (Bruining et al, 2005 and Wright et al, 2001a).

Beyond its positive impact on daily buyout performance, interest alignment is also a key advantage in a dynamic setting like the buyout investment cycle when, as mentioned earlier, strategic requirements can change swiftly and require significant adaptation throughout the organization (Gottschalg et al, 2007). Our case study in the

world of technology was the best example of this need to swiftly adapt to changing market and competitive conditions and keep the executive team focused on the end prize of the exit throughout.

This latter dynamic capability highlights the importance of moving from a “capabilities – enabled executive team” at the start of the investment to a “capabilities-based organization”. Stalk, Evans and Shulman (1992) evoke the four steps to achieve this, each of which was demonstrated clearly within our case studies.

First, the CEO – in alignment with the new owners - shifts the strategic vision of the firm to aim for aggressive goals. Very often, employees of a newly acquired portfolio company are incredulous when presented with the value creation plan imagined by the new owners. It is up to the CEO to show his confidence in leading the organization on this new path.

Second, the CEO re-organizes around the new capabilities necessary to ensure the delivery of the blueprint and ensures that his employees benefit from all skills and resources to achieve the new vision.

Next, the CEO brings measurements and rewards into alignment and make progress visible. The usual focus of a Private Equity portfolio organization on a limited number of common measures creates a common language of success across the organization and makes it easier for every employee to internalize progress.

Last, the CEO remains the visible leader of the transformation throughout. His close contacts with board members from the Private Equity Fund openly establish him as the leader of the movement.

The CEO and his executive team, creating interest alignment throughout a “capabilities-based organization” can then claim to have achieved “dynamic fitness”, which is about making the right investments at the right time, lining up the necessary

complements in the process and succeeding in either positioning the organization advantageously in its environment or even reshaping the environment to do so.

(Helfat et al, 2007).



## **CONCLUSION AND AVENUE FOR FUTURE RESEARCH**

In this research, we have endeavoured to uncover how executive teams in a private-equity-owned company create superior value in their strategic and daily operational decisions and actions.

Choosing an induction method best suited given the private nature of the value creation process in such companies, which do not face any obligation of reporting, we ran a comparative, multiple-case, holistic design with a literal replication logic in which each case serves to confirm or disconfirm the inferences drawn from the others to uncover aspects of the phenomenon under analysis.

Compiling our interviews findings, we worked iteratively, using the Gioia methodology, to sort all executive strategic and day-to-day actions in eight second order themes, themselves aggregated in four distinct phases of the investment cycle of Private Equity investors. This allowed us to develop an operational value creation model for portfolio companies owned by Private Equity Funds, aiming to maximize their enterprise value at exit.

Finally, we corroborated this operational value creation model with extant literature and expert opinions, which confirmed the replicability of this model in a large segment of Private Equity investments.

Taking a step back, we analysed our findings through the theoretical lenses of Agency Theory and Dynamic Capabilities. We first confirmed the essential agency nature – in one of its purest forms - of the investors' relationship with their top executives in a Private Equity investment. We then confirmed the existence of distinct dynamic capabilities used by the executives to transform portfolio companies and make them most attractive to future buyers, maximizing buyers' valuation appetite in

the process. We discussed the process through which board members and top executives were spreading the necessary dynamic capabilities across managerial ranks to effectively transform the whole organization's mindset. In doing so, we eventually answered our original question: operational value creation in Private Equity represents an actual science – which can be transmitted -, not just an art gifted to a few remarkable individuals.

Throughout our analysis, we made a number of comparisons between strategies and day-to-day actions taken by top executives in a Private Equity portfolio company and those which were typically taken in similar situations but in a public company context. Our overall conclusion has been that the mindset developed by executives who focus on maximizing the private equity equation of “EBITDA x multiple” leads to different decisions than the mindset of executives aiming to steadily grow the stock price of their company in public markets.

Our analysis revealed however a developing trend in the public markets to emulate key elements of our Private Equity operational value creation model. This trend seems to have coincided with the development of financial activism.

Financial activism traces its roots to the rise of agency theory as the dominant perspective on corporate control from the 1980's forward (Goranova & Ryan, 2014, p1231). This activism developed in concert with the increase of ownership of public companies by institutional investors. In the past five decades, ownership of US equities by institutional investors developed from a mere 10% to an estimated 70% to date (Gillan & Starks, 2007). At first, institutional investors applied their will for improved performance in corporations they invested in mostly through “quiet diplomacy”, focusing primarily on reforming corporate governance. They were very careful to only attempt to influence companies on matters of principle, staying shy of

intervening in firm strategy, in which influence attempts would mean the financial institution was trying to second guess management in its own field of expertise (Brandes, Goranova & Hall, 2008). When they stepped up their interventions using the proxy process, their vote was still mostly advisory with no obligation for executives in the company to implement their recommendations.

However, over time, institutional investors started to become ever more familiar with the Private Equity operational value creation model. First, they witnessed the development of the Private Equity asset class, which they agreed to invest a minority share of their assets in, and learned about its apparent superior long-term returns – at least amongst the biggest and most experienced players – with a total asset risk which seemed to have been mitigated despite a clear cyclicity of returns. Next, they started to witness first hand the private equity governance model as a number of the takeover artists from the 1980's started assuming board seats in major public companies and applied their familiar oversight model in this new context. (Anders, 1992).

As the Private Equity model started to sift through the mainstream of public markets, top executives started to feel the impact of this change of mood in governance. A first consequence of a closer scrutiny of the CEO by board members has been the dramatic reduction in the average CEO tenure in public companies. While in 1992, the average CEO tenure was still at 6.5 years with most CEOs reasonably expecting to reach their 10 years tenure before retiring (Anders, 1992), the average tenure has dropped to date to just 3 years. A second consequence has been the considerable push to split the roles of CEO and Chairman in US public companies.

Other influences have been a tightening control of corporate spending and a refocusing of many companies on core businesses through the sale of peripheral

operations (Anders, 1992), this latter move feeding the pipeline of Private Equity Funds on the look-out for those numerous carve-outs which could command a higher enterprise value once transformed into a viable stand-alone operation.

The pressure from financial activism got stepped up another big notch in recent years with the entry of hedge funds in the ownership of major public companies. Hedge fund activists of today are much more likely to seek direct influence on strategy and managerial actions (Goranova et al, 2014).

Their adherence to the operational value creation model created in private equity and outlined in this research has become more and more evident from their choice of targets and their key objectives for activism. First, they will more likely target companies with low managerial ownership, pushing for an increase in the top executives' ownership, coupled with the deployment of pay-for-performance compensation programs at the top but also across the managerial ranks. Their attention will also be drawn to companies with high cash holdings, favouring a return of free cash flows to shareholders (Goranova et al, 2014). They are also very likely to challenge the “contentment” of many public top executives with regular earnings growth under the pretext that “Wall street won't reward greater growth”. (Anders, 1992).

While hedge fund activism only targets a limited number of public companies, their influence is spreading as institutional investors keep tabs of activism directed at peer firms.

Corporate managers may react to these new trends of shareholder activism in a very reactive manner – putting their own job at risk. They can also take a more proactive stance by pre-emptively engaging their organization to understand the PE operational value creation model as outlined in this research and starting to integrate it

into their day-to-day practices (Goranova et al, 2014). Major public corporations like Nestle or Unilever have done this very publicly.

While the Private Equity operational value creation model is spreading to companies in different contexts, its positive impact on long-term performance in such contexts has not been proven. Linking the full model or some of its distinct elements to actual performance represents an interesting area for further research.



## CONCLUSIÓN Y CAUCE PARA FUTURAS INVESTIGACIONES

En esta investigación hemos procurado revelar la forma en que los equipos ejecutivos de una empresa propiedad de un *private equity* crean un valor superior con sus decisiones y acciones estratégicas y operativas diarias.

Tras elegir un método inductivo que encajaba mejor con la naturaleza privada del proceso de creación de valor en tales compañías, que no están obligadas a emitir informes sobre su actividad, aplicamos un diseño comparativo, multicaso y holístico con una lógica de replicación literal en la que cada caso sirve para confirmar o desmentir las inferencias establecidas a partir de los otros a fin de revelar aspectos del fenómeno analizado.

En cuanto a la recopilación de los hallazgos realizados en las entrevistas, hemos trabajado de forma iterativa, utilizando la metodología Gioia, a fin de clasificar todas las acciones estratégicas y diarias ejecutivas en ocho temas de segundo orden, agregados a su vez en cuatro fases diferenciadas del ciclo de inversión de los inversores del *private equity*. Esto nos ha permitido desarrollar un modelo de creación de valor operativo para compañías de cartera propiedad de fondos de *private equity*, al objeto de maximizar el valor de su empresa a la salida.

Por último, hemos corroborado este modelo de creación de valor operativo con la literatura existente y las opiniones de expertos, lo que ha confirmado que se trata de un modelo replicable en una gran porción de las inversiones de *private equity*.

Tomando algo de distancia, hemos analizado nuestros hallazgos a través de los prismas teóricos de la teoría de la agencia y las capacidades dinámicas. Hemos confirmado, en primer lugar, la naturaleza esencial de agencia –en una de sus manifestaciones más puras– de la relación de los inversores con sus principales

ejecutivos en una inversión de *private equity*. Luego hemos confirmado la existencia de capacidades dinámicas diferenciadas que los ejecutivos utilizan para transformar las compañías de cartera y hacerlas más atractivas para los futuros compradores, lo que maximiza el apetito de los compradores en su valoración. Hemos analizado el proceso a través del cual los miembros de la directiva y los principales ejecutivos extendían las capacidades dinámicas necesarias a través de todo el escalafón gestor a fin de transformar eficazmente la mentalidad de toda la organización. Al hacerlo, hemos dado respuesta a nuestra pregunta original: la creación de valor operativo en *private equity* es una verdadera ciencia –transmisibile– y no solo un arte del que estén dotados un puñado de individuos fuera de lo común.

A lo largo de nuestro análisis, hemos realizado una serie de comparaciones entre estrategias y acciones diarias llevadas a cabo por los principales ejecutivos de una compañía de cartera de un *private equity* y aquellas que se suelen acometer habitualmente en situaciones similares, aunque en un contexto de empresa cotizada. Nuestra conclusión general ha sido que la mentalidad desarrollada por los ejecutivos que se centran en maximizar la ecuación de *private equity* “EBITDA x múltiplo” conduce a decisiones distintas a las derivadas de la mentalidad de los ejecutivos que buscan incrementar de forma sostenida el valor en bolsa de sus compañías en los mercados.

Nuestro análisis revela, no obstante, una tendencia creciente entre las empresas cotizadas a emular elementos clave de nuestro modelo de creación de valor operativo de *private equity*. Esta tendencia parece haber coincidido con el desarrollo del activismo financiero.

Las raíces del activismo financiero se remontan al auge de la teoría de la agencia como la perspectiva dominante en el control corporativo desde los años 80

del siglo XX en adelante (Goranova y Ryan, 2014). Este activismo se desarrolló de la mano del creciente número de empresas cotizadas propiedad de inversores institucionales. En las últimas cinco décadas, la propiedad de acciones en EE. UU. por parte de inversores institucionales ha pasado de un mero 10 % a un 70 % aproximadamente en la actualidad (Gillan y Starks, 2007). En un primer momento, los inversores institucionales manifestaron su voluntad de un rendimiento mejorado por parte de las compañías en las que invertían recurriendo a una “diplomacia silenciosa”, que se centraba en la reforma de la gobernanza corporativa. Procuraban limitarse a influir exclusivamente en cuestiones de principios, rehuyendo intervenir en la estrategia de la empresa, ya que tal intento de influir podía significar que la institución financiera pretendía superar al equipo gestor en su propio campo de especialización (Brandes, Goranova y Hall, 2008). Cuando reforzaron sus intervenciones por medio de un proceso vicario, su voto siguió siendo principalmente de orden consultivo, sin que los ejecutivos de la compañía estuviesen obligados a aplicar sus recomendaciones.

No obstante, con el paso del tiempo, los inversores institucionales comenzaron a familiarizarse con el modelo de creación de valor operativo de *private equity*. Primero asistieron al desarrollo de la clase de activos de *private equity*, en el que aceptaron llevar a cabo una inversión de participación minoritaria con sus activos, y luego descubrieron sus retornos aparentemente superiores a largo plazo, –al menos entre los jugadores más importantes y experimentados– con un riesgo total de activos que parecía mitigado a pesar de la naturaleza claramente cíclica de los retornos. A continuación, comenzaron a presenciar de primera mano el modelo de gobernanza de *private equity* a medida que, a partir de los años 80, un número de artistas de las absorciones empezaron a ocupar puestos en la directiva de grandes empresas

cotizadas y aplicaban en este nuevo contexto un modelo de supervisión con el que ya estaban familiarizados (Anders, 1992).

A medida que el modelo de *private equity* iba infiltrándose en el mercado cotizado general, los ejecutivos principales empezaron a sentir el impacto de este cambio de actitud en la gobernanza. Una de las primeras consecuencias de la fiscalización más directa del CEO por parte de los miembros de la directiva ha sido la dramática disminución de la duración media de los CEOs en las empresas cotizadas. Mientras que en 1992 la permanencia media del CEO se encontraba en los 6,5 años y la mayoría de los CEOs confiaban razonablemente en alcanzar los 10 años antes de retirarse (Anders, 1992), en la actualidad la duración media del cargo ha disminuido a tan solo 3 años. Una segunda consecuencia ha sido la presión para separar las funciones del CEO y el presidente en las empresas cotizadas estadounidenses. Otra de las influencias ha sido un control más estricto del gasto corporativo y la reorientación de muchas compañías hacia su negocio principal por medio de la venta de operaciones periféricas (Anders, 1992). Este movimiento, a su vez, ha alimentado la cartera de los fondos de *private equity* en busca de esas numerosas escisiones que pueden generar un mayor valor corporativo una vez transformadas en una operación independiente viable.

La presión del activismo financiero ha dado otra vuelta de tuerca considerable en los últimos años con la entrada de fondos de inversión libre en grandes empresas cotizadas. Los activistas de fondos de inversión libre actuales son mucho más proclives a intentar ejercer una influencia en la estrategia y las acciones de gestión (Goranova et al, 2014).

Su adhesión al modelo de creación de valor operativo creado en el *private equity* y descrito en esta investigación se ha hecho cada vez más evidente en la

elección de sus objetivos y sus prioridades activistas. En primer lugar, buscarán más probablemente compañías con menos propiedad entre los gestores, presionando para incrementar la propiedad entre los ejecutivos principales, junto con la implantación de programas de compensación de pago por rendimiento en la parte superior del escalafón, pero también entre los demás rangos de gestión. También se sentirán atraídos por compañías con grandes reservas de efectivo que favorezcan un retorno de libre flujo de capital a los accionistas (Goranova et al, 2014). Además, es muy probable que cuestionen el “contentamiento” de muchos ejecutivos principales de empresas cotizadas con un crecimiento lineal de las ganancias bajo el pretexto de que “Wall Street no recompensa un mayor crecimiento” (Anders, 1992).

Si bien el activismo de los fondos de inversión libre se centra en un número limitado de empresas cotizadas, su influencia se está extendiendo a medida que los inversores institucionales vigilan de cerca con su activismo a los competidores de su sector.

Los gestores corporativos pueden reaccionar a estas nuevas tendencias de activismo accionarial muy a la defensiva, poniendo en peligro su propio puesto de trabajo. También pueden adoptar una postura más proactiva implicando a su organización preventivamente en la comprensión del modelo de creación de valor operativo del PE tal como se describe en esta investigación y empezando a integrarlo en sus prácticas cotidianas (Goranova et al, 2014). Grandes corporaciones cotizadas como Nestlé o Unilever lo han hecho de manera pública y manifiesta.

Si bien el modelo de creación de valor operativo de *private equity* se está extendiendo a compañías en diversos contextos, no se ha demostrado su impacto positivo en el rendimiento a largo plazo en tales contextos. Vincular el modelo

completo o algunos de sus elementos distintivos al rendimiento real representa un área de interés que merecería investigación adicional.

**TABLES AND FIGURES**

**Table 1:** Description of Firms, Funds and Advisors interviewed.

<b>Private Equity Owned Companies</b>				
Company Names	A	B	C	D
Informants	1,2,3,4	5,6,7	8,9	10
Rationale	Large buyout Best-in-Class owners for Operational Value Creation Growth-Oriented Value Creation Exit through Secondary Buyout	Mid-market buyout Bankruptcy Turnaround Story Restructuring Focused Value Creation Exit through Trade Buyer	Smaller Size Investment High Growth Technology Sector Closer to Venture Capital	Long Investment Cycle Volatile Energy Industry Context Multiple IPO exits
<b>Private Equity Funds – Operating Team</b>				
Fund Reference	Ax	Bx	Cx	Dx
Informants	11	12	13,14	15
Rationale	Large and Long Standing Buyout Fund Best in Class for Operational Support	Mid-Market Industrial Focused New to Operational Support Operational Team with vast Public Company Experience	Smaller Fund Structure Growth orientation Closer to Venture Capital	Evergreen PE Fund Large Transactions Closest to former 1980's conglomerates
<b>Private Equity Advisers</b>				
Advisor Type	Management Consultants			Investment Bankers
Informants	16			17
Rationale	Views of a cross-section of PE Fund players with varying degrees of operational oversight. Ability to benchmark.			Views of a cross-section of PE investments at exit around value generated from operational improvements. Witness to buyer sentiment about operational story.

**Table 2: Characteristics of Individual Informants**

<u>Informant</u>	<u>Country</u>	<u>PE Experience</u>	<u>Other experience</u>	<u>Current Position</u>	<u>Company Size</u> (US \$)	<u># Interviews</u>
Informant 1 Comp A	U.S.	C-Suite Functional	Multiple PE- Public	Public NED	3 bn	1
Informant 2 Comp A	U.K	C-Suite Functional	Multiple PE - Public	Mgt Consultant	3 bn	1
Informant 3 Comp A	Hong-Kong	CEO	Multiple PE - Public	CEO	3 bn	1
Informant 4 Comp A	France	C-1	Multiple PE - Public	Divisional President	3 bn	1
Informant 5 Comp B	U.K./Indonesia	C-Suite Functional	Public C-Suite	CEO - non-PE	500MM	1
Informant 6 Comp B	U.K	C-Suite Functional	Public/ PE C-Suite	Mgt Consultant	500 MM	1
Informant 7 Comp B	U.K	CFO	Multiple PE CFO	COO	500 MM	1
Informant 8 Comp C	Sweden/U.K	CEO/Oper. Partner/Board	Public C-Suite	CEO	100MM	1
Informant 9 Comp C	Sweden	COO	VC	COO	100 MM	1
Informant 10 Comp D	U.K	CEO/Operating Executive	PE Fund	Non-PE Investor	150MM	2
Informant 11 Fund A	U.K	Operating Partner	Mgt Consulting	Operating Partner	1-5 bn	1
Informant 12 Fund B	Switzerland	Operating Partner	Public CEO	Operating Partner	500MM - 2bn	1
Informant 13 Fund C	U.K	Operating Partner	HR Consulting Partner	Board Non-Exec	50MM	1
Informant 14 Fund C	Germany	Operating Partner	Management Consultant	Operating Partner	25MM	1
Informant 15 Fund D	Luxemburg	CFO/Operating Partner	Public CFO	Operating Partner	50 bn	1
Informant 16 Adv MC	France	PE Mgt Consultant		Mgt Consultant	500MM	1
Informant 17 Adv IB	U.K.	Investment Banker		Investment Advisor		1

**Table 3: Summary of Strategies and Actions at each stage of the operational value creation model and evidence from interviews**

Type of Activity: Strategies and Actions	Evidence found in Case Studies				Evidence confirmed by PE experts	
	Comp A	Comp B	Comp C	Comp D	Operation Partners	External Advisors
<b>PHASE 1: Structuring the Investment</b>						
<u><i>Building the right executive team</i></u>						
• Favour executives from the same or a similar industry,	✓	✓	✓			
• Look for prior experience in a larger corporate context, able to imagine what success for the investment will look like,	✓		✓	✓		
• Prefer executives with an entrepreneurial spirit, who are hungry for success and relishing change	✓		✓	✓	✓	
• Favour individuals with a sense of urgency, resoluteness, decisiveness, a dose of overconfidence, of resilience and a team-builder	✓		✓		✓	
• Pick executives who are ready to put their own financial upside at risk	✓		✓		✓	✓
<u><i>Incentivizing the Top Team</i></u>						
• Make his top team true owners of the company with stock grants, stock options and/or phantom equity	✓	✓	✓		✓	
• Ask his chosen top executives to put their own skin in the game via co-investment	✓		✓		✓	
• Design the annual executive compensation program to be tightly tied to delivery of few key blueprint KPI targets	✓	✓	✓		✓	
• Communicate the large pay out awarded to executives for strong investment performance which results in a successful exit	✓		✓			
<u><i>Setting Up Value Driven Governance</i></u>						
• CEO develops a singular day-to-day working relationship with a top level PE partner		✓	✓	✓	✓	
• CEO develops a candid, informal and fluid communication style with the owners.		✓	✓	✓	✓	
• Executives learn to use the board as a consultant body, to be challenged and debate their proposed actions, yet take responsibility for the final decisions	✓			✓		
• CFO and other relevant executives establish the right systems for providing the requested monthly reporting of cash and key predictive metrics.	✓	✓	✓	✓	✓	✓
• CFO works with the PE fund board members on all financial strategies and M&A activity during the course of the investment.	✓	✓	✓		✓	✓
<b>Phase 2A: Cleaning up the corporate act</b>						
<u><i>Crafting the Value Creation Blueprint</i></u>						
• Building an attractive “equity story”, sometimes identifying target acquirer	✓				✓	
• Developing and communicating action plan based on the value creation blueprint			✓		✓	
• Extreme Focus on 1) EBITDA and 2) Free Cash Flow Maximization	✓	✓			✓	
• Setting up the adequate structure to deliver, sometimes with an ad hoc “Program Office”		✓	✓			✓
• “Sweating existing assets”: differentiated pricing, revised distribution footprint, sale and leaseback		✓			✓	✓
• Low Hanging Fruit One Off Cost Cutting	✓	✓			✓	✓
• Planning for “Gross Margin Accretive” M&A with post-integration synergy costs left as earnings growth option for next owner	✓					
<u><i>Managing Investors/Debt Holders</i></u>						
• Reducing working capital requirements: inventory reductions, better receivables/payables ratio	✓	✓			✓	
• Establish new process and rules for capital expenditures spending	✓	✓	✓		✓	
• Review all functional budget projections starting from a zero base		✓				
• Convert fixed assets into sources of financing: divesting, sell and leaseback						
• Use any cash release for deleveraging or paying interim dividend	✓	✓			✓	

**Table 3 (continued) : Summary of Strategies and Actions at each stage of the operational value creation model and evidence from interviews**

Type of Activity: Strategies and Actions	Evidence found in Case Studies				Evidence confirmed by PE experts	
	Comp A	Comp B	Comp C	Comp D	Operation Partners	External Advisors
<b>Phase 2B: Building a High Value Future</b>						
<u>Changing Work Culture</u>						
<ul style="list-style-type: none"> <li>Sense of urgency, anxiety and expectation after the PE purchase which automatically fosters change</li> </ul>	✓		✓	✓	✓	✓
<ul style="list-style-type: none"> <li>Cash seen as a scarce resource: top executive oversight on all capital expenditures and other working capital needs</li> </ul>	✓	✓	✓	✓	✓	
<ul style="list-style-type: none"> <li>Focus on improving gross margin: product reengineering, (de)standardization, delocalizations, etc.</li> </ul>	✓	✓			✓	✓
<ul style="list-style-type: none"> <li>Ambidextrous Management: executives working on short and medium term projects simultaneously</li> </ul>		✓	✓	✓	✓	
<ul style="list-style-type: none"> <li>High intensity work culture, top executives working harder to reach their compensation targets</li> </ul>	✓	✓	✓	✓	✓	✓
<ul style="list-style-type: none"> <li>Executives see a direct link between meeting KPI targets, the enterprise value they create and their direct pay out</li> </ul>			✓	✓	✓	
<u>Building Future Investment Prospects</u>						
<ul style="list-style-type: none"> <li>Looking for discontinuous and permanent top and bottom line results: factory closures, delocalizations, outsourcing, restructurings</li> </ul>		✓		✓	✓	✓
<ul style="list-style-type: none"> <li>Build value creating scale through a buy-and-build strategy: the portfolio company is a platform for further related acquisitions and integrations</li> </ul>			✓	✓	✓	
<ul style="list-style-type: none"> <li>Aggressive market expansion – often geographic -, a very prevalent strategy for European buyouts</li> </ul>	✓		✓		✓	
<ul style="list-style-type: none"> <li>Developing organic growth projects with a direct impact on the outer half of the investment cycle, creating the “hockey stick” curve</li> </ul>	✓	✓		✓		
<ul style="list-style-type: none"> <li>Developing “Growth Options” with growth potential after exit: proof of concept for geographic expansion, for new businesses</li> </ul>	✓	✓	✓	✓	✓	✓
<b>Phase 3: Realizing the Value</b>						
<u>Exiting the Investment</u>						
<ul style="list-style-type: none"> <li>Boosting EBITDA to the maximum in the last year prior to exit, by actioning all “dispensable” short term cost cuts.</li> </ul>	✓	✓	✓	✓	✓	
<ul style="list-style-type: none"> <li>Finalize the delivery of “growth options” to present to future investors</li> </ul>	✓			✓		
<ul style="list-style-type: none"> <li>Building a most compelling and forward-looking equity story : writing the investment memorandum, preparing the “data room” available to future bidders to inform their own due diligence.</li> </ul>	✓		✓	✓	✓	✓
<ul style="list-style-type: none"> <li>Develop plans to market the company to future investors, ahead of actual bidding, meeting with analysts, etc.</li> </ul>	✓			✓		✓
<ul style="list-style-type: none"> <li>Building Investor Confidence in the future: Succession Planning, Re-investment negotiations</li> </ul>	✓	✓				✓

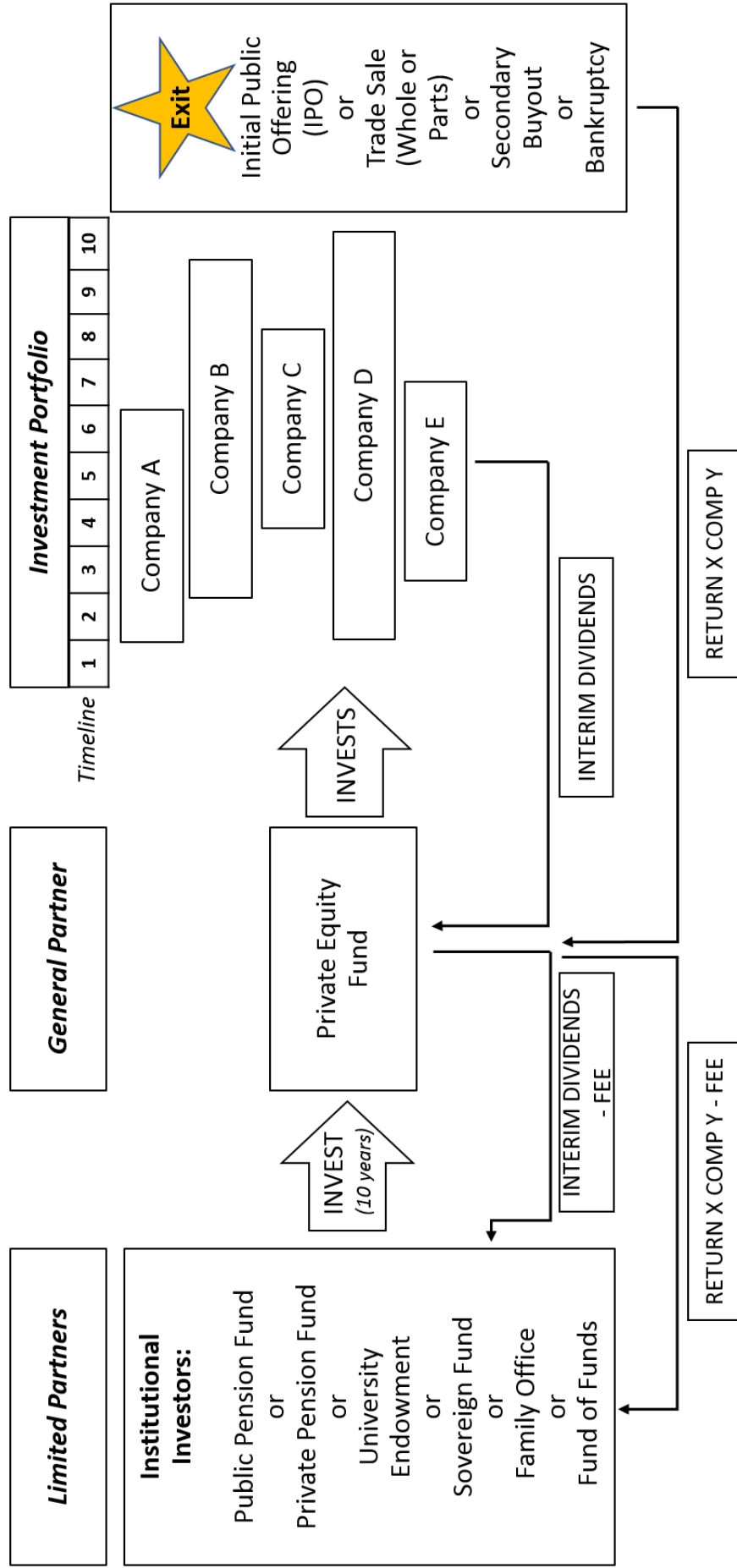
**Table 4: Research Findings and Interpretative Lens of Agency Theory**

What the Literature Says	Findings from this research	Contributions to advancing PE knowledge
The Agency Theory aims to identify the most efficient contract between a risk averse agent - the CEO - with the principal in the context of the public corporations. (Jensen & Meckling, 1976, Fama & Jensen, 1983)	CEOs in a Private Equity portfolio company self-select and show a similar risk profile to the shareholder. This is thanks to a contract that significantly binds both parties to the exit outcome of the investment.	In this research, we offer an alternative contractual relationship in a PE context between a risk-taking CEO and shareholders where the CEO bears a significant wealth effect of his actions. This leads for a lower risk of shirking and a lower cost of monitoring.
The role of the board of directors in a public company is primarily one of decision control. (Johnson, Daily, Ellstrand, 1996)	We find that, provided the value creation blueprint is being delivered, the board of a PE portfolio company prefers to give relative freedom of decision to the CEO and will rather focus on helping the executive team with contacts, networks	We show that the cost of decision control for the board is lower in a PE context and the two other roles of the Board - service and resource dependence - are far more prominent than in a public context.
According to the "managerial welfare Hypothesis" (Walkling and Long, 1984), CEOs always place their fiduciary duty to shareholders second to their own welfare. Their motivation lies primarily in status, power and sense of achievement (Pepper, Gore, Crossman, 2013)	Our research shows CEOs in PE portfolio companies are solely motivated by their wealth sharing with principals. They often accept to lead smaller and less prestigious firms in exchange for their outcome-based contract in PE. Their welfare and the principal's are very similar.	Shareholders in a PE context aim to sort out the managerial welfare hypothesis by clearly aligning the CEO welfare with their own at every step of the investment.
In public companies, the stock market serves as a daily external monitoring for performance (Fama et al, 1983)	CEOs in a PE context do not have to care about daily stock prices and focus single-mindedly on creating the maximum value at exit. They appreciate the opportunity to take bold decisions out of the public eye to deliver the value.	This research shows how performance is not a universal concept but is dependant on the final objective of shareholders. PE shareholders measure performance at the time of exit only and through the lens of a valuation on the market for takeovers.

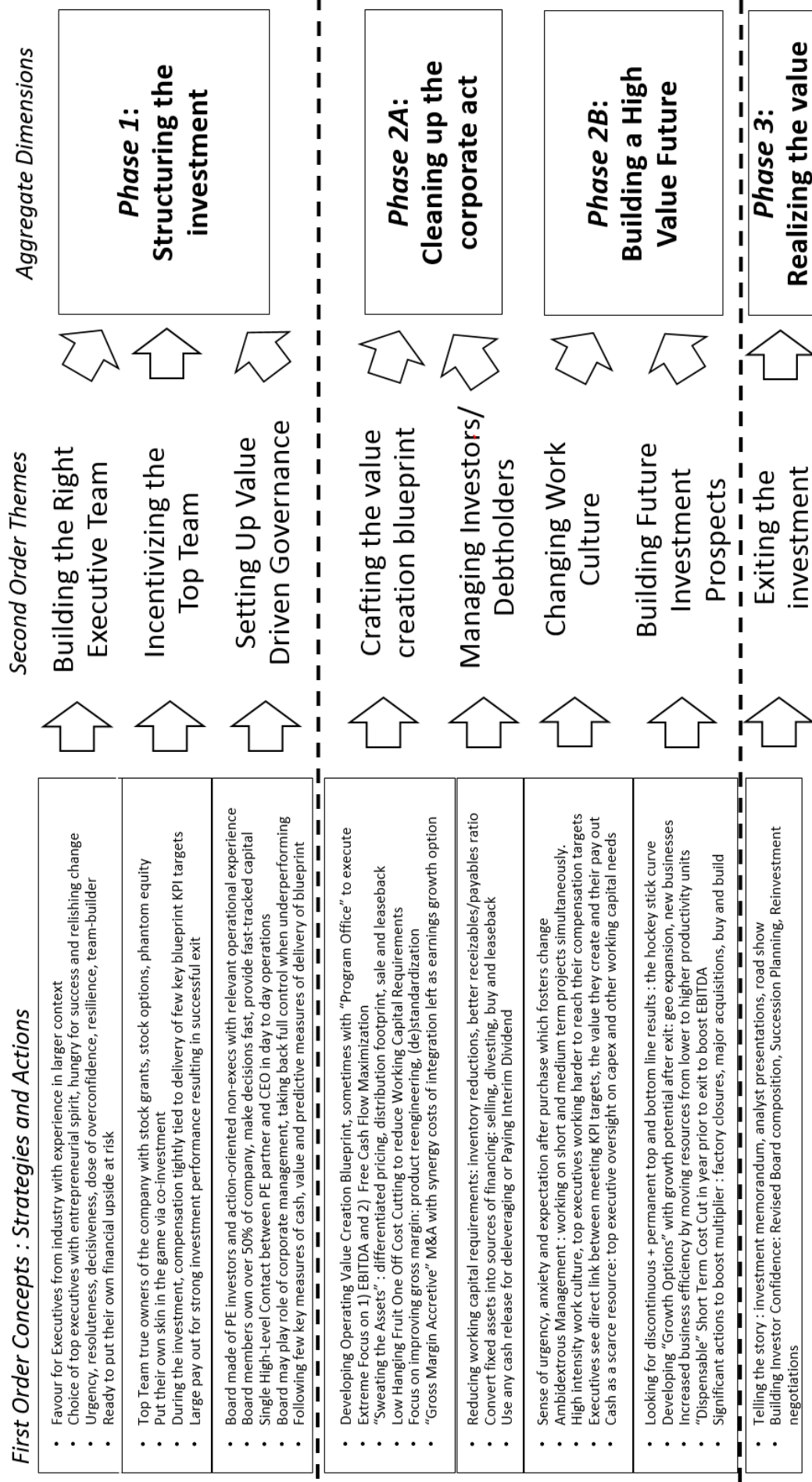
**Table 5: Research Findings and Interpretative Lens of Dynamic Capabilities**

What the Literature Says	Findings from this research	Contributions to advancing PE knowledge
Dynamic Capabilities are mostly relevant in "rapidly changing environments" (Teece et al, 1997)	Private Equity Funds prefer to invest - whenever possible - in companies with a low operating risk. Yet, the change of ownership to a Private Equity deal is seen by the executives of the portfolio company as a drastic change of the internal environment of their firm.  The changing environment which is relevant to the development of dynamic capabilities in PE is the dynamic of the equity markets around the globe.	We extend the concept of dynamic capabilities from those developed within a single industry to develop a competitive advantage to the context of Private Equity where the Dynamic Capabilities are developed cross-industry and cross-portfolios as PE funds compete for best returns and highest investment from limited partners.  The concept of corporate value in public markets is highly dependant on the competitive position of a company within its own industry. Once a company is purchased by PE, corporate value is redefined in relation to the dynamics of the market for corporate control. Performance is redefined.
Dynamic Capabilities is a stable pattern of collective activity in pursuit of improved effectiveness (Zollo & Winter, 2002)	Our findings show a stable pattern of value creation across companies in the hands of PE Funds. The objective is twofold: improving effectiveness (EBITDA-enhancing) and improving future business prospects (both EBITDA and Multiple Enhancing)	Improved Effectiveness is but one of the objectives of PE Funds when they roll out their dynamic capabilities for value creation. How the capability is implemented in each portfolio company might not follow a rigorously stable pattern.
a Dynamic Capability is structured and persistent to systematically solve problems (Barreto, 2010)	PE Funds aim to systematically apply their dynamic capability at creating enterprise value across their entire portfolio of investments and persistently over time, to the benefit of their limited partners who invested in their fund. However, the capabilities installed in their portfolio company might not survive after an exit, especially if the company is sold to a trade buyer who will integrate it into its own ways of doing business and its own capabilities.	The dynamic capability of value creation in an individual PE portfolio company might not survive after a change of ownership through an exit, especially of this exit is not through another PE player. The persistency of the value creation dynamic capabilities is across a PE Fund portfolio and over the life of the Private Equity Fund, not over the life of individual portfolio companies.
Dynamic Capabilities are specific and identifiable processes (Eisenhardt & Martin, 2000)	We observe the nature of the dynamic capabilities which are critical to value creation in PE and are transferable across a private equity portfolio and find three main types. Those are strategic decision making, dynamic managerial capabilities and an acute form of ambidexterity.	The dynamic capability of value creation in PE is less the result of common defined processes amongst firms than the result of a common objective: sell at the highest possible value at exit. PE Funds gain experience in maximizing exit value and ensure their portfolio executive teams deliver this. The actual path to delivery is however left to the entrepreneurial spirit of the executive team.
Dynamic capabilities are abilities to reconfigure a firm's resources and routines in the manner envisioned and deemed appropriate by its principal decision makers (Zahra et al, 2006)	The specific dynamic capabilities which we identified across our various case studies are single-mindedly directed at the owners' objective of value maximization at exit.	Our research highlights the differences in objectives between public market and private equity owners and how they translate into differences in the value of specific dynamic capabilities in both contexts.
Dynamic Capabilities group three distinct activities of 1) sensing opportunities, 2) seizing opportunities and 3) reconfiguring the resource base. (Barreto, 2010) Dynamic Capabilities imply continuous morphing or the strategic flexibility to change the organizational form (Rindova & Kotha, 2001)	Private Equity owners use their financial creativity to sense, seize and reconfigure with the single-minded objective of maximizing the exit value of their investment.	In a public context, success for a CEO in establishing the sensing, seizing and reconfiguring activities ensure the perennity and continuous performance of the organization and the resulting growth of its stock price. In PE, those sensing, seizing and reconfiguring are aimed to value maximization at the point of exit only, even if this means dismantling the firm, changing its scope, reconfiguring the industry through a buy&build strategy, etc.
Dynamic capability of continuous morphing, when the strategic flexibility of the firm to change organizational form is used as a strategic tool (Rindova & Kotha 2001)	Our case study in energy shows a change in the scope of the portfolio company several times over the course of the investment cycle, depending on the evolution of regulations in the field.	Our research shows a much stronger role of creative strategic morphing in the Private Equity context where the perennity of the organization does not have value per se in the minds of shareholders.
The executive team can build "dynamic fitness" from creating interest alignment throughout a "capabilities-based organization" (Gottschalg et al, 2007 and Helfat et al, 2007).	Our informants mention the great value of tight interest alignment in the portfolio company which helps to expand the value creation best practices to all levels of the organization.	The concept of dynamic fitness is a good proxy for the change of behaviour and culture which is brought to a portfolio company when it is jolted out of its "business as usual" outlook by the PE investment.

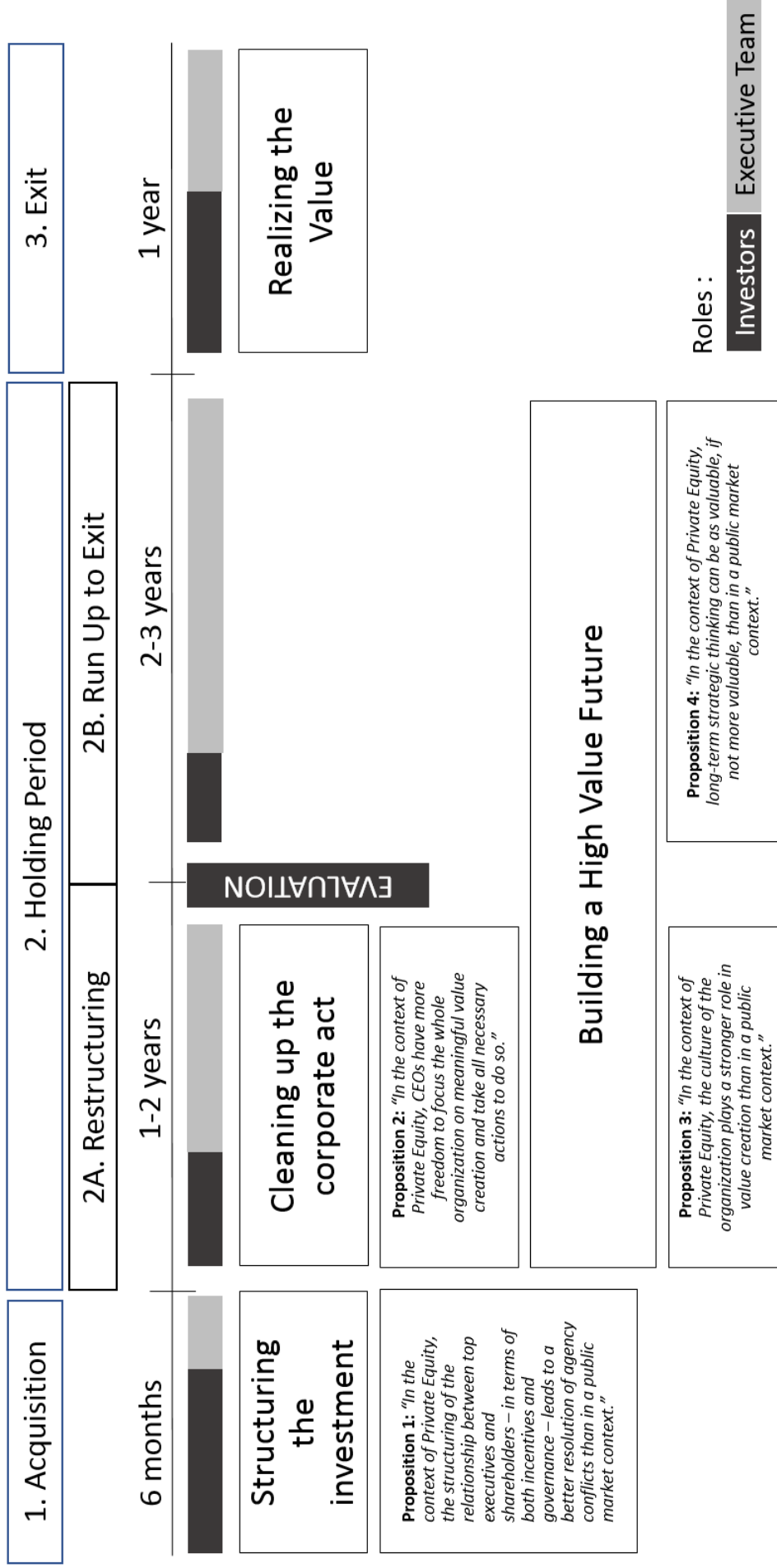
**Figure 1: Private Equity Investment Model**



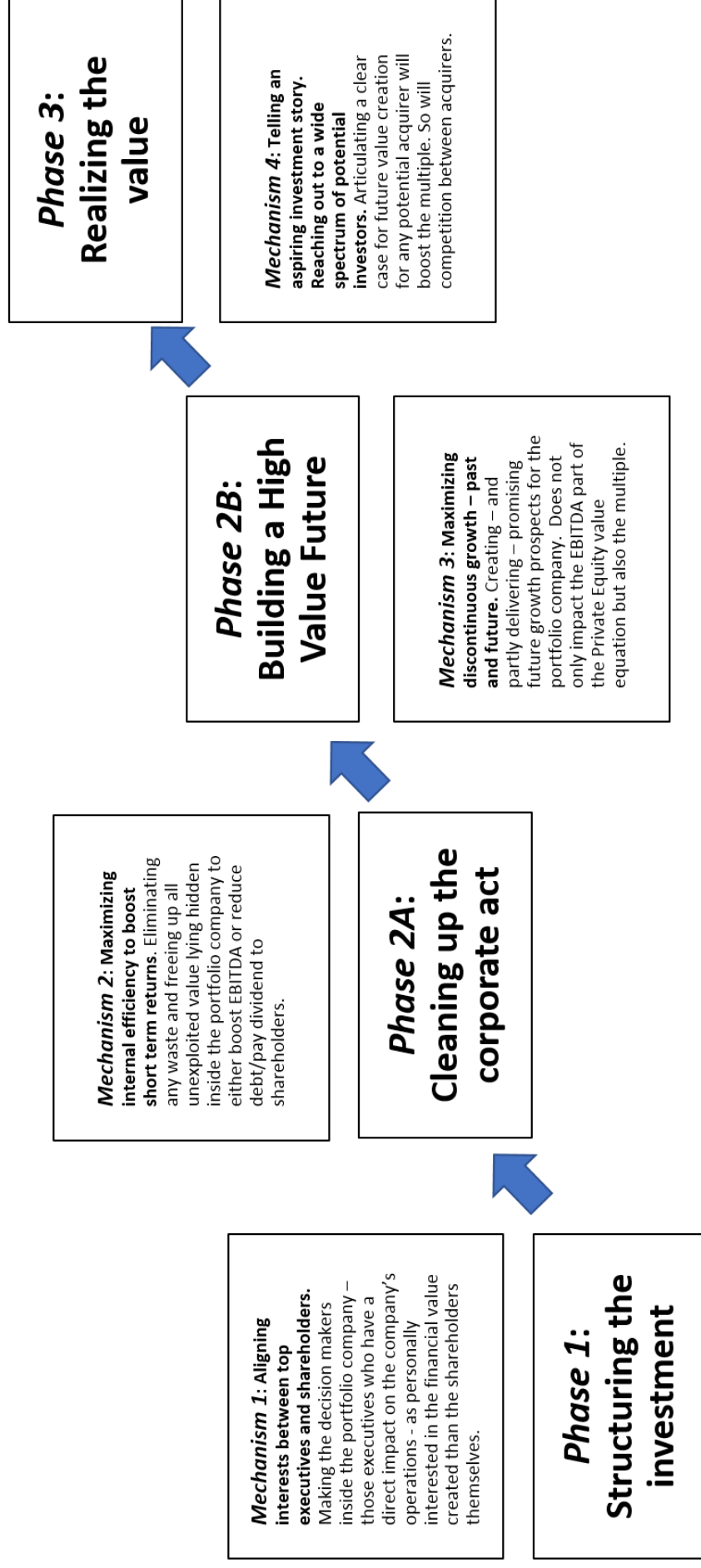
**Figure 2: Data Reduction Process & Operational Value Creation Model**



**Figure 3: Process Model**



**Figure 4: Theoretical Model**



## APPENDIX

### INTERVIEW PROTOCOL

Respondent: \_\_\_\_\_  
Date and time: \_\_\_\_\_  
Place: \_\_\_\_\_  
Interviewer and recording: \_\_\_\_\_

#### JOB DESCRIPTION

- What is your job now?
- What was your job in the MBO/MBI/turnaround?
- What is your prior career history?

#### MBO STRATEGIC SETTING

- **Blueprint**
- Tell me about the creation of the strategic action plan which the executive team committed to the board at the outset of the investment.
- Probe on:
  - Owner's involvement?
  - Executive team participation?
  - Strategic versus Tactical Nature?
  - Time Horizon?
- How could you compare this process to former experiences in other corporate contexts?
- **Measures**
- Tell me about the processes and measures which the investors used to assess the executive team on their performance towards the agreed objectives.
- Probe on:
  - Metrics used
  - System changes to deliver the measures
  - Strength of the PE discipline
  - Nature of the PE investors follow up of the measures?
- How do the measurements compare to those you experienced in other corporate contexts?

#### TOP THREE VALUE CREATION OBJECTIVES

- Please list what you think were the top three value creation objectives of this LBO. How similar/different were they compared to the ones you experienced in other corporate settings?

- **EBITDA**
- Tell me how you embarked on raising the EBITDA
- Probe on:
  - Key elements of EBITDA as primary focus
  - Chronology of actions
  - Specificity of Actions to PE setting: what and/or how
  - Dilemmas arising from EBITDA focus
- How would you compare the executive team's behavior and decisions due to the focus on EBITDA to behaviors and decisions you experienced in other corporate settings?
- Did you engage in: *(list ten specific actions which other firms have taken to grow EBITDA in a PE context)?*
  
- **Growth**
- Tell me about the role that growth played in delivering your value creation plan.
- Probe on:
  - How did your PE owners talk about growth?
  - Share of value created through growth
  - Actions geared to step change the company's growth curve
  - Growth trend after LBO versus before LBO
- How would you characterize your focus on growth versus other corporate settings you know?
- Did you engage in: *(list ten specific actions which other firms have taken to step change growth in PE settings)?*
  
- **Cash Flow**
- Tell me about actions the executive team took to increase free cash flow
- Probe on:
  - Debt profile of the LBO and impact of interest repayments
  - Interim dividend payment to PE investors
- How would you characterize the focus on cash flows and actions taken to your experience in other corporate settings?
- Did you engage in: *(list the specific actions which other firms have taken to step change cash flow generation in PE settings)?*

- **Multiple**
- Tell me about your evaluation and consideration of the exit multiple during the course of the investment as well as any action taken to influence it.
- Probe on:
  - Multiple view: set by market conditions at the time of exit or influenceable through corporate actions?
  - Levers to drive exit multiple
  - Timing of evaluation of likely buyers

### EXIT PROCESS

- Explain how the strategy agreed in the first 100 days evolved over the time of the investment, especially when nearing the exit.
- Tell me about the process of exiting the investment and the type of exit chosen (IPO, Trade Sale, Secondary Sale).
- Probe on:
  - When/How was timing planned?
  - How were potential buyers identified?
  - Executive team involvement in process
  - Advisors involved and their role
  - Length of process – planned and actual
- How much of a success do you rate this exit and the value creation exercise?

### ORGANIZATION ENGAGEMENT & CULTURE

- Tell me about how the executive team engaged the organization in the value creation objectives of the LBO and how the organization adapted to the new model and culture.
- Probe on:
  - How deep did financial incentives go? Did you have a say?
  - How strong was the culture shock to move to an LBO?
  - Positives and negatives of PE setting for staff
- How would you compare the culture and staff engagement versus other corporate settings you worked in?

### GOVERNANCE & INCENTIVES

- Tell me about your relationship to the board of directors or certain members of it and their day-to-day involvement in the business. What about other members of the

executive team?

- Please compare the PE board's ways of working with boards in other company settings.
- Please tell me how your incentives changed with Private Equity owners. What did you discuss at the time of you joining (if applicable)?
- How did PE incentives change your ways of working? Made you work harder/differently?
- Did you and your management team benefit from a mid-cycle dividend distribution, if any?
- How did the illiquidity of the incentives affect your and your management team's behaviour?
- Tell me about the thinking process to stay on board or not after exit. What role did incentives play at that moment, if any?

#### PERSONAL OUTLOOK

- How would you rate the status of this LBO role versus other roles you held in prior organizations?
- How has this period under PE ownership affected your career / life plan?
- What is your future career outlook? Does it include PE and why?

#### FINAL EVALUATION

- Why do you think PE portfolio companies deliver stronger operational results than other corporate settings?
- What are the Pros and Cons of public versus private PE culture? For yourself? For other executives/employees?
- Can you summarize what you see as the top three advantages and top three drawbacks of your experience leading a PE investment?
- If you could choose your ideal PE partner in the future, what would be its characteristics? Size? Specialization? Location?
- What type of owners would you be weary of and why?

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