Opportunities for Action in Corporate Finance and Strategy

What Public Companies Can Learn from Private Equity

THE BOSTON CONSULTING GROUP

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The rapid growth of private equity and its increasingly important role in driving mergers and acquisitions have led many executives at large public companies to ask a fundamental question: Is the recent rush to go private simply the sign of a bubble? Or is it, rather, the result of certain structural advantages that make private financing a better vehicle for value creation than the public capital markets?

The numbers are eye-catching: in the past decade, the value of private-equity deals worldwide grew at roughly 20 percent per year, as funds from institutional investors flowed into private equity on the expectation that it would deliver superior returns. In 2005 the total value of such deals worldwide reached $84 billion. There is some $200 billion in private-equity funding available for investment in the United States, with an additional €40 billion available in Europe. What's more, new private-equity funds currently being raised are likely to increase these amounts substantially.

Given the increasingly large size of such funds, it seems clear that private equity represents a long-term trend that is fundamentally changing the market for corporate control—even for companies with market caps greater than $10 billion. One reason investors expect higher returns from private equity is that it enjoys a lower cost of capital owing to higher leverage and the easy availability of debt. But a second key reason is that private equity offers a distinctive governance model. In many respects, that model is superior to the one found at most public companies because it allows private-equity firms to drive changes in a company's fundamental value-creation performance.

The good news for public managers is that a public company doesn't necessarily have to sell out to a private-equity firm in order to benefit from this superior governance model. It's possible to adapt at least some of the model's most important features to the realities and constraints that public companies face.

In effect, public companies and private companies are engaged in a competition for value creation. The asset class that offers superior returns to shareholders will not only attract a growing share of capital from institutional and individual investors; it will also attract the best managerial talent. There are five things, in particular, that public companies can learn from private equity: they can benefit from sophisticated investors, build an engaged and effective board, create value through growth, develop a healthy sense of urgency, and get managers to act like owners. If they learn to do these things, they will level the playing field and make the competition more equal.

Benefiting from Sophisticated Investors

Private-equity firms tend to be highly sophisticated and extremely well-informed investors. As a result, the process of crafting the strategy and establishing the operational priorities at privately held companies is built on deep transparency between owners and managers. Because of the high hurdle rate for returns required by private-equity firms, shareholders and management align around a focused and explicit drive to create equity value on the basis of rigorous outside-in analysis and an agreed-upon set of metrics. At many public companies, by contrast, the fact that shares are bought and sold in public capital markets can mean that the management team's strategy is diffused among a wider—and sometimes contradictory—range of objectives and interests.

A public company will always have a diverse group of owners whose makeup fluctuates as shares are traded, and that can be a serious constraint on the long-term execution of its strategy. What's more, fair-disclosure requirements may limit the information that management can divulge. Still, there are many opportunities for executives to engage in an active dialogue with investors, to take advantage of their insight about a company's competitive strategy, and to create alignment around long-term value creation.

For example, most companies have a dominant type of investor, and it is possible for management to develop a strategic dialogue with a few leading investors who represent that type.[1] The best public companies don't leave this dialogue to the investor relations (IR) department; rather, they treat it as a critical task of senior management. They engage directly and nondefensively in a continual dialogue. Senior managers—and not just the CEO or the IR staff—take the time to personally understand investors' attitudes and requirements.

The advantage of developing a rich understanding of investors' views is that it can be a source of valuable insight about strategic tradeoffs facing the company. Investors often have information and perspectives that managers lack. They meet regularly with management teams across a wide range of similar companies. And the most sophisticated develop powerful models to explain what drives the valuation of their investments.

Building an Engaged and Effective Board

For the same reason that most privately held companies have more focused and knowledgeable investors,

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1. See "Treating Investors Like Customers," BCG Perspectives, June 2002.

they also have more engaged and effective boards. Board members are almost always outsiders to the company who are either investing their own capital or representing specific investors with major amounts of capital at risk. This fact creates alignment among board members around the steps needed to create medium-to-long-term capital appreciation (as opposed to simply improving near-term earnings).

Often, board members are explicitly selected by the private-equity fund for their industry or functional expertise, and they bring considerable hands-on experience and know-how. This means that they aren't captive to management's agenda. At the same time, the depth of their engagement and expertise makes them a far more effective resource for the management team.

Having a highly engaged and knowledgeable board should be an important goal for any public company, and it does not have to be driven by shareholders. Board behavior is something companies can address directly: by carefully defining the board's mission; by determining its size, leadership model, and committees; by selecting, developing, and adequately compensating its members; and by building a challenging but supportive culture explicitly focused on value creation.

For example, instead of considering just current or former CEOs (the typical approach at many public companies), a company can recruit board members who fill specific slots or functions—some with in-depth financial expertise, others with operating experience in areas of major environmental or financial risk, and still others with deep knowledge about specific challenges to the company's main businesses. A company can also structure its board meetings to minimize formal presentations and maximize hands-on engagement with the substantive issues affecting the business. For example, something as simple as a requirement that business unit heads, not the CEO, report on financial results can significantly improve interactions between the board and the broader management team.[2]

Creating Value Through Growth

One of the common beliefs about private equity is that private owners use debt to buy a company and then ruthlessly focus on cutting costs in order to boost short-term profits to pay down the debt. The reality is more complicated. Although some acquisitions by private-equity firms are based on driving down costs to pay off debt, in our experience, more and more deals are tied to creating long-term value through new sources of growth.

One large European private-equity firm, for example, analyzed the sources of total shareholder return (TSR) at a sample of companies it had recently sold. (See the exhibit "At One Private-Equity Firm, Growth Has Been the Main Source of Total Shareholder Return.") The firm compared the market value of the businesses in question at the time they were purchased with the value realized upon exit and quantified the relative contribution of key value drivers. A full 50 percent of the value created was attributable to growth, and only 18 percent of the increase in value was the result of margin improvement (for example, through cost cutting). On top of this fundamental value creation, another 37 percent of TSR was due to an increase in valuation multiples caused by improved growth prospects at the time of exit. Change in lever-

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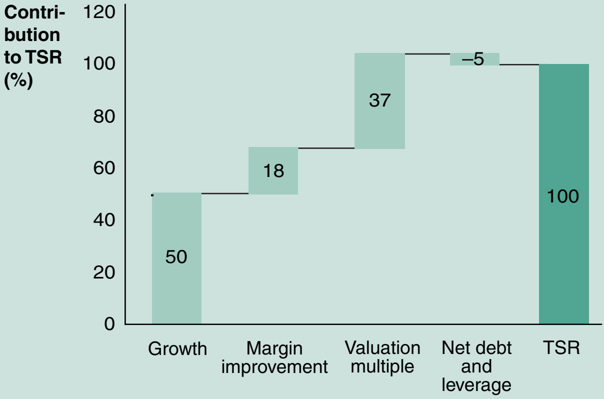
2. See "Making Sure *Independent* Doesn't Mean *Ignorant*," BCG Perspectives, October 2002.

At One Private-Equity Firm, Growth Has Been the Main Source of Total Shareholder Return



SOURCE: Company analysis.

NOTE: This analysis compares market value at the time of purchase with value realized upon exit for a selected sample of private-equity investments.

age was a relatively unimportant factor in the companies' TSR performance; during the holding period, increases in debt were responsible for a 5 percent reduction in TSR.

There is no reason why a public company could not likewise focus on creating value through growth. But over time, many public companies develop internal barriers to growth that hinder their ability to build new businesses. Some examples include overly "democratic" capital allocation, too-frequent rotation of line managers, and short-term incentives that encourage managers to milk their businesses.[3] These barriers can be addressed systematically.

3. See "Managing Through the Lean Years," BCG Perspectives, February 2003.

Developing a Healthy Sense of Urgency

Private-equity firms have a laserlike focus on creating value within a three-to-five-year time frame. Managers of public companies often criticize this time frame as “too short term.” And yet it is far longer than the time frame one finds at many public companies, where management is prisoner to next quarter’s results. On the one hand, private equity’s focus on the medium term frees managers from the “short termism” of analysts and capital markets, giving them more room to maneuver. On the other, private equity’s relentless commitment to exit forces managers to develop a healthy sense of urgency about creating value.

Another way that private equity creates a sense of urgency is through a consistent focus on competitive advantage. After a private-equity firm buys a business, it is common for the new owners to institute a “100 day” program. The program focuses both on how the business can create competitive advantage, given the trends and landscape of its industry, and on what kind of operational changes are necessary in order to deliver on the private-equity firm’s financial targets.

Obviously, the arrival of a new owner is an ideal time to revisit these critical issues. But a public company doesn’t have to go private to institute such a program. It can start immediately.[4]

Getting Managers to Act Like Owners

One of the big themes in corporate finance over the past decade has been the imperative of getting man-

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4. See “Assuming Leadership: The First 100 Days,” BCG Perspectives, January 2003.

agers of public companies to act more like owners. Many companies have implemented elaborate incentive-compensation programs, complete with stock options and other benefits designed to achieve this goal. And yet, despite all this effort, the relationship between pay and performance at most public companies remains weak.

Private-equity owners, by contrast, have found a way to create a much tighter connection between pay and performance. They force managers to put significant skin in the game—and then reward them handsomely when they succeed. A Boston Consulting Group benchmarking study found that managers at companies bought by private equity have the equivalent of as much as one to two years of salary invested in the business—and receive 8 to 12 times the amount invested upon exit.

At first glance, this more entrepreneurial compensation structure may be the most difficult part of the private-equity model for public companies to replicate. In some parts of the world, there continues to be substantial public resistance to the idea of managers earning millions of dollars when their companies perform well. Still, public companies could institute at least some of the features of the management participation programs found at most private companies. For example, there is no reason why public companies can't also require their senior executives to invest significant sums of their own capital.

Unless public companies find a way to unleash the entrepreneurial energies of their senior executives and allow managers to participate in the upside of the business, they risk losing their best people to privately held companies. As noted above, public companies and private equity are not just in a race for capital; they are also in a race for the best managerial talent.

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If executives at public companies can learn the five lessons described above, they will go a long way toward recreating the best features of the private-equity model in their own organizations. When they do, they will find that they are well-equipped to take part in the competition for value creation.

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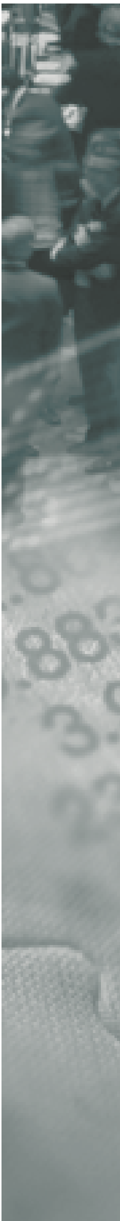

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