# Private Equity Domain

***Private Equity Domain*** *is a periodic Mill Creek Capital Advisors publication, each edition of which focuses on a specific aspect within one of the major sub-segments in private equity – Buyout Funds, Venture Capital, Debt/Credit Funds, Real Estate/Real Asset Funds, and Secondaries.*

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**Building Well Gets Results.** There are many ways for the General Partners (the GP) of buyout funds to build bigger and stronger companies from the underlying private companies that they purchase. The issue is how to distinguish the buyout funds with the greatest odds of repeating their prior successes. We find an emphasis on "Building Well" to be a strong indicator of repeatable success, and we discuss two methods that can be used in tandem for evaluating building capabilities.

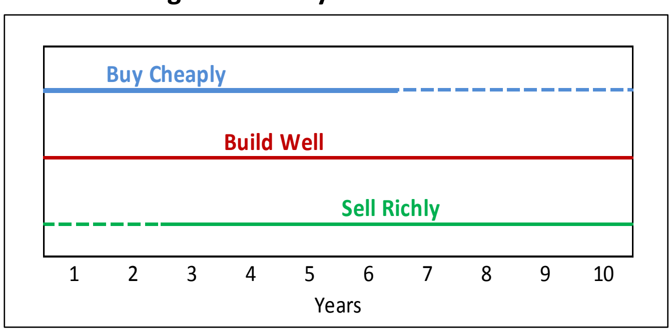
Although our example below is overly simplified, a buyout fund has three ways to make money and generate compelling returns for investors (Diagram 1).

1. **Buy Cheaply** -- Purchase a majority or influential stake in a private company at a sizable discount to the prevailing prices of publicly-traded comparable companies.

2. **Build Well** -- Make changes to the management, financial structure, and/or operational performance of a company in order to create greater value and more resilience across economic cycles.

3. **Sell Richly** -- Sell or exit the underlying buyout-backed company for significantly more money than the GP paid to buy and build that company.

**Diagram 1: Lifecycle of GP Activities**




**Correlations to Public Markets.** In many industry sectors, the largest companies are publicly-traded and they become the standard bearers by which valuations for smaller companies and private companies are valued.

Depending on the business niche, we find private market valuations show a correlation to the public valuations of 20% to 80%. Higher correlations (the 50% to 80% range) tend to be seen when there are many publicly-traded comparable companies, product offerings are more homogenous, and operating margins (profitability per unit) are highly consistent across competitors and the margins are small. Low correlations, in the 20% to 50% range, can be observed when there are few public companies for comparison, product offerings are highly dissimilar between companies, and operating margins vary considerably between companies and are generally high.

Given the correlation between public and private valuations (particularly when valuations are high), it is very hard for GPs of buyout funds to "Buy Cheaply" when public stock markets are fully valued or over-valued. Granted, some GPs will buy more cheaply than others because of superior deal-sourcing capabilities and/or the ability to operate in smaller business niches where there is less competition. It is also difficult for GPs to "Sell Richly" when public stock markets are in a downturn. Again, some GPs will fare better than others because they are better connected to potential buyers and/or they have better insight into what products and services are truly critical to customers. However, broadly speaking, a GP will not have enormous influence over prevailing public market valuations, nor the knock-on effect that these valuations have on private company valuations.

Given the influence exerted by public markets on a GP's ability to "Buy Cheaply" and "Sell Richly", more emphasis needs to be placed on the middle horizontal line in Diagram 1 – Build Well. It is important to focus on those activities over which a GP can exert considerable control -- the actual building, rebuilding, and/or repositioning of a company. There are numerous ways to assess a GP's ability to "Build Well", of which we highlight two methods – functional components and attribution components -- that can be used in tandem to reveal much about a GP's skills and the ability to generate compelling returns

**Functional Components to Building.** Most GPs use a mix of the three components discussed below.

A. **Managerial Shifts**: This involves replacing or enhancing the management teams (the entire C-Suite) and Board members of the underlying companies. It is worth noting when and how the GP makes these shifts.

B. **Financial Changes:** This requires adjusting the capital structure (the proportion of debt and equity) to better suit the needs of a growing company.

C. **Operational Fixes:** This is a broad mandate encompassing changes in product lines, supply chains, and distribution channels. It also includes acquisitions and dispositions, licensing and joint ventures, internal R&D, cost controls, marketing, branding, and outsourcing decisions.

Most GPs rely more heavily on one of the three functional components listed above. However, in times of stress, a GP may have to rapidly employ another functional component in order to stabilize an underlying company, so the GP needs to possess all of these functional skills and be able to use them effectively. Note that the largest buyout firms have individual teams to deploy in all three functional components, but that does not guarantee successful deployment. An in-depth review of past deals is required to evaluate the functional skills of a GP and determine if these skills were used efficiently and effectively across the economic cycle. For example:

- Was a less capable Head of Sales replaced in a timely fashion?
- Did the increase in the debt load add flexibility or merely increase risks?
- Was the underlying company able to properly digest its recent add-on acquisitions or not?

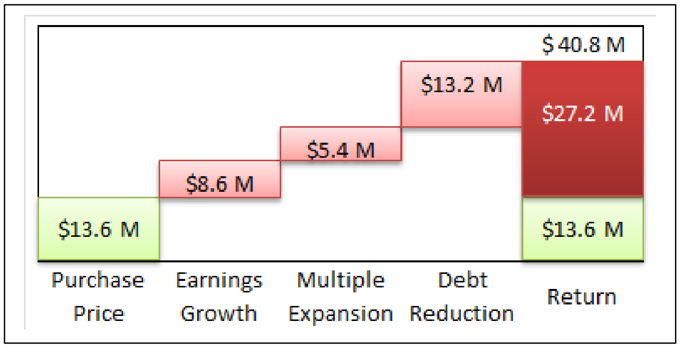
**Attribution Components to Building.** This is a different way to review a GP's track record, by adding and subtracting specific values from the sale price (Diagram 2). We applaud the many European buyout funds that routinely report this information, as required by the European Venture Capital Association. US firms rarely report this data, leaving investors trying to anecdotally back-into the relevant information.

A. **Earnings Growth:** This includes a very wide range of actions from hiring practices to inventory controls to rebranding. However, it is most heavily weighted toward operational improvements, while also encompassing the managerial changes that facilitated the operational improvements.

B. **Multiple Expansion:** This relates to a GP's ability to sell the underlying company for a gain because the company is now larger, better managed, and more resilient. Whether the company is sold through a corporate acquisition, a sale to another private equity firm, or there is an IPO, the buyer(s) should be willing to pay more for a bigger and stronger company, relative to what the GP paid for it.

C. **Debt Reduction:** This aspect rewards the GP for reducing a company's debt and punishes the GP for an increase in the debt load.

**Diagram 2: GP Attribution for Hypothetical Company**




In the example above, the GP produced a 3x return of capital ($13.6 X 3 = $40.8). The Multiple Expansion is determined by subtracting out the Earnings Growth and Debt Reduction from the sale/exit price achieved by the GP. Finding the Multiple Expansion (a greater than 30% uplift from the original price of $13.6M in this example) allows investors to judge whether the GP has been able to achieve market level multiple expansions consistently or not. This analysis also sheds light on the role of earnings growth and debt leverage in generating a return. The attribution gives investors valuable insight into the GP's strategy and style, whether the GP's prior success is repeatable, and how resilient the strategy might be across cycles.

**Conclusion.** There are many variables that influence the sizes of the gains generated from buyout activities. The GP of a buyout fund has only a modest ability to influence the prices being demanded by company owners when purchasing deals and, similarly, the GP has limited input on the prevailing prices buyers are willing to pay for bigger and stronger companies when the GP is ready to sell companies. However, the GP can impact how much bigger and how much stronger the underlying company becomes during its ownership time. Thus, while a GP has three important ways to make money (Diagram 1), we think an emphasis on "Build Well" is warranted. "Build Well" relies more on the internal talents of a GP and less on external market forces, revealing important details about a GP's ability to repeat past successes.