DELIVERING RETURNS

Getting the harmony right

The challenge of delivering strong returns is forcing operating partners to take a more hands-on approach towards portolio companies. The key is knowing just how much to get involved, writes Jim Strang, a managing director at Hamilton Lane

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Around the world, investors and managers continue to face a slower global growth environment that has persisted far longer than perhaps many had expected. For managers, the challenges of delivering strong returns in a difficult macro environment with low to no growth and prevailing high asset prices have led to an increased focus on operational involvement in their portfolio companies. GPs and LPs alike enthusiastically debate questions around just how much involvement is the right amount, and when, and how?

Pausing briefly to reflect, the whole notion of portfolio value creation has evolved considerably over the last 10 years. The impact of the global financial crisis was an obvious catalyst, but the basis of this concept goes back considerably farther than that. Historically, a GP's management team identified which areas the fundamental value growth in respective assets would come. The very essence of a management buyout was predicated upon backing a proven management team to deliver a pre-formulated business plan. The GP would help to deliver the original deal, working on M&A as appropriate and helping the business manage its balance sheet through to exit. Typically, the GP didn't get involved in other value creation initiatives, but would often challenge the progress of the business against the plan from a non-executive board position.

This model evolved as GPs increasingly sought to become more proactive in supervising the talent they entrusted to manage the assets they acquired. Many moved to a model that introduced a non-executive chairman of the board, who was independent of the GP, but possessed appropriate industrial know-how to further support the executive team running the business,

as well as to provide a solid sounding board for the GP's non-executive team.

The rise of the IBO – the institutional buyout – triggered the next wave of change, when GPs began taking greater ownership of the value plans. A number of US-based GPs pioneered this model, which was then adopted throughout Europe. This new approach necessitated some different thinking: with an IBO, GPs needed a better way to understand and assess the "full potential" for the asset they were acquiring. As a result, they began adding individuals with more operational or consulting backgrounds to their talent pool, and also leaned

Strang: *GPs now have a large and varied set of tools at their disposal*

Playing the right tune: *to make beautiful music, GPs need to know which instruments to play*

more heavily on "industrial advisors" to help validate and underwrite investment cases.

As this model continued to evolve, in addition to conducting operational analysis, the new operational staff became increasingly involved in actual value creation efforts. They helped with the so-called "100 day plan" and other value creation initiatives, and also developed and often manned the project management office to coordinate and support the business as various value creation initiatives were undertaken.

Today, this engagement model is extremely varied: some GPs employ extensive teams of dedicated resources to deliver on these initiatives, while others maintain smaller dedicated teams and instead leverage external consultants to provide additional resources. There are also other GPs that lean far more on external support to drive value. With the latter, the key premise is that the GP doesn't need to have all the answers so long as they are confident that they have the right questions.

Most recently, there has been a slight change of emphasis on where GPs are looking to drive value: we've seen a shift from the bottom line to the top line. In this low-growth, hyper-competitive deal world, being able to optimise a business from a cost perspective is a necessary, but not sufficient, criteria to deliver strong returns. It will only get you so far. The change of emphasis on the growth side has seen an increasing focus on full revenue potential. Market entry, new product development, loyalty, customer share of wallet maximisation and, perhaps most of all, product pricing strategy have become the new watch words. All of these initiatives represent powerful tools in value creation and, while not trivial to deliver, the rewards can be great.

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GPs now have a large and varied set of tools at their disposal to drive value in portfolio companies, whether those companies are large multi-national businesses or far smaller and simpler entities. Akin to an orchestra, in which there are many instruments and many ways to play them, there exists a multitude of ways to approach portfolio value creation. The challenge GPs face is that, in order to make beautiful music, they need to know which instruments to play, how to play them, when and for how long. Doing so effectively is incredibly challenging to get right, but when done well, the music is powerful indeed. ■

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