As the private equity industry has matured, it has become harder for private equity firms, big and small, to generate the outsized returns their limited partner investors have come to expect.

According to Cambridge Associates, the rolling 10-year returns of the U.S. Private Equity Index last peaked in 2013 and have been downhill ever since. Most recently, the index returned 11.3% annually from 2006 to 2015, well below its long-term return and approaching the long-term return from public markets. In an effort to combat decreasing returns, most private equity firms are placing greater emphasis on their value creation process. That said, private equity is not a one-size-fits-all type of industry, and neither is how private equity firms go about creating value at the portfolio level.

Perhaps the most visible value creation models are the ones built by megafirms such as Vista Equity Partners and KKR & Co. Industry veterans certainly know about the Vista playbook, a how-to of sorts for Vista Equity’s portfolio companies, and KKR’s Capstone division, a captive consulting arm of KKR, which works extremely closely with KKR dealmakers to create value post-acquisition. These models clearly work well. Vista Equity Partners has a track record of delivering 30%-plus shareholder returns, according to various media interviews.

It’s clear that these firms have been successful at creating value in the companies they buy. Look no further than KKR’s exit of Alliance Tire Group in early 2016. In one of the largest exits by private equity in India, KKR sold its 90% stake in Alliance Tire Group to the Japanese strategic buyer Yokohama Rubber Co. for $1.2 billion, making over a twofold return on its April 2013 investment. There are many deals to point to, including the firm’s extremely successful purchases and exits of Dollar General and PRA Health Sciences.
What’s the right value creation model?

KKR Capstone is a big part of the reason KKR is able to create value at the portfolio level globally and in return create big exit opportunities. Founded in 2000 on two key principles — to help KKR build better companies and to drive returns — the KKR Capstone team, which boasts 50 full-time operations executives, works hand in hand with the KKR deal team as well as portfolio company management teams. They support the entire life cycle of an asset — from asset selection and helping assess the management teams to creating customized 100-day plans and executing on the value creation process.

“We assist in figuring out what’s important and what’s not, and we support management teams in execution,” says Derick Prelle, a managing partner and head of KKR Capstone Americas. The KKR Capstone team partners with management on what is needed at a particular portfolio company to create value, often helping to design performance metrics accordingly.

“We can do the hard, roll-up-your-sleeves work. We aren’t limited to any particular job, and we expect to support our deal teams and our management teams as needed. Together, our ultimate goal is to build better companies,” says Prelle.

Capstone is organized in three general pools of professionals. Pool one is a group of industry-specific operational professionals who are integrated with the KKR deal teams. Pool two is composed of senior executives with deep functional subject matter expertise who are available to support the portfolio companies. Lastly, there is a pool of experienced operating executives who can be deployed to work hand in hand with KKR companies. KKR relies on these groups as a resource for portfolio companies to provide a strong shot at growing and thus creating sustainable value.

“We are very proud of the level of integration between KKR, KKR Capstone and the management teams at the portfolio companies. We keep priorities in line and stay on the same page,” says Prelle. That said, it’s important to note that contrary to what many believe, KKR Capstone will seek outside help when necessary.

Many private equity firms want to emulate the captive consulting model. Comvest Partners, a middle-market private equity fund that raised $893 million in late 2015, spent much of 2016 developing an operations team, the Operating Advisory Group (OAG). The team has four people today and expects to grow to six or seven over the next 12 months.

“We were given an opportunity that was even better than a blank sheet of paper. The firm’s culture of teamwork and creativity provided the perfect environment to build a strong operating group,” says Shahriyar Rahmati, a managing director who leads the OAG, an adviser to the Comvest portfolio. “Deal teams have limited — and very precious — time. Having your deal team spend a significant amount of time on operating issues post-close is challenging on many fronts, and can affect the scalability of the firm. How much time can an investment professional spend working with portfolio companies? If there’s a performance hiccup, which happens despite the best-drawn plans, or the portfolio company is trying to execute on a major initiative, management needs a focused partner to get into the details with them while simultaneously keeping in mind the big picture,” says Rahmati.

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Derick Prelle, a managing partner and head of KKR Capstone Americas
What’s the right value creation model?

The OAG is involved with the firm’s portfolio companies over the full life cycle of the ownership period. One of the advantages of an operating team focused on the portfolio is the benefit of pattern recognition — the ability to quickly reach into the past to help management through certain challenges. In addition to its operating team, third-party consultants also play an important role.

Like Capstone, Comvest uses third-party consultants when necessary. “We value our relationships with third parties, and by keeping continuity and developing a standard way of working together, we get out of the blocks fast, know how each group will approach diligence at various stages, and develop ‘flex capacity’ for periods when activity swells,” says Rahmati.

There is no question that these firms create value, but having a captive consulting arm is not the only way to create value. In fact, some firms would argue that having a captive consulting team can be too costly and may force a private equity firm to pair an operator with a portfolio company even if it’s not the best fit. “The in-house approach has its merit, but the problem is a team is often imposed on the portfolio company. The idea is, ‘Here are the experts you will work with.’ We don’t want to do that. We want to find great teams and boost them up. That said, it’s clear that [the] in-house model works,” says one private equity professional.

The Riverside Company is actually moving away from the captive operating model approach. First, having consultants (1,099 employees) billing for their services makes it easier for Riverside to track how operating resources are spending their time. Second, a broad pool of consultants allows Riverside to dedicate the best operator possible to a portfolio company based on needs and capabilities.

The consultant model is extremely effective, says Ron Sansom, a global executive operating partner and a managing partner with Riverside. “Sectors like health care and technology can be very specialized. You want to be sure you are giving the portfolio team the best help possible,” says Sansom. “Using consultants allows us to deliver the right capabilities every time, because you aren’t sure exactly what you are going to buy.”

The consultant model also allows Riverside the flexibility to give its consultants the right amount of work, whether that’s with one portfolio company or three, and they can ensure a perfect match between companies and operators. “This model allows us to dedicate the right resources to the right companies, pairing experts in particular sectors with portfolio companies that benefit most from their knowledge,” says Sansom.
What's the right value creation model?

One upper-middle-market private equity firm that has typically not used in-house operating partners or an internal consulting team hasn’t been hurt by it at all. This firm has more than doubled the capital it has managed since its inception, and it delivered 4.5 times its invested capital at the end of 2015 on a gross basis.

Additionally, this firm is one of the few that will still allow itself to be called a generalist firm, although it has industry verticals it focuses on. “We bring people in with sector expertise to work with our portfolio companies or, if we are planning to do add-on acquisitions to a portfolio company, we may partner with an operator who has experience in the sector to be the de facto CEO, which is the person who can create value,” says a managing director with the firm, which wanted to remain anonymous for this article.

Additionally, while many firms spend their time talking about all the people they hire to create value, this professional says the majority of the firm’s deal partners have operating and investment banking backgrounds as well as practical expertise. “We back management, and sometimes we will hire consultants to help them. Other times, we will bring someone in at the board level, and sometimes we bring people in to help the CEO. It really depends on the company and its needs,” says the professional. “There’s no one answer for us. It’s not like the Vista playbook, but we do have best practices in place and they work for us and our portfolio.”

While the consultant model seems to be more popular, there are pros and cons to everything. “The positive of having an in-house staff is you know the people you have there can do a great job. But it’s very costly and you may try to pair an operator with the wrong company because it’s a close match, but not a perfect one. That can hurt the portfolio company growth,” says the professional.

While the Carlyle Group doesn’t have a consulting arm per se, it has what’s called the Carlyle Edge. Their value creation model focuses on four things: a global network of 700 investment professionals, deep industry knowledge, a stable of 30 C-level consultants, and market and sector data gathered from a global portfolio. “Taken together, they can create real value on the deal,” says Carlyle Managing Director Chris Ullman. The first thing Carlyle does is assign the portfolio management company an adviser, a so-called operating executive who has been in the portfolio company’s industry for 30-plus years. This operating executive is a paid consultant. While in-house executives run the company day to day, Carlyle takes board seats and helps with strategy, executive recruitment and M&A, among other value-add activities. For example, Carlyle will set up the portfolio company with its international teams if necessary, or partner the portfolio company with sector teams in the U.S. when it makes sense. “If it’s a health care deal, we will bring that team in. If they need help overseas, we will get that team involved,” says Ullman.

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Anonymous managing director
What’s the right value creation model?

Even with all these resources at the portfolio company’s fingertips, there are many times when additional consultants are brought in for various reasons. “It can’t be a cookie-cutter approach. Our people do sector-specific deals, however there are times when we need more specialized consultants, like if there is an environmental issue or a specific legal issue. We want to be sure we are getting the right people in place so the portfolio company can manage and grow,” says Ullman.

Carlyle’s value creation process varies greatly deal to deal, but one thing remains constant: Carlyle has an in-house economist who researches sectors and geographies to help all its portfolio companies, deal teams and operation resources understand the macroeconomic trends that may affect a company.

“Having this data readily available helps feed the decision-making process. It’s often real-time, actionable data that can impact the company’s decisions,” says Ullman.

Although most firms approach value creation differently, it’s important to note that all strive to create a somewhat repeatable process so it doesn’t require reinventing the wheel every time a firm makes an acquisition. Additionally, most agree that while there are some commonalities among portfolio companies, sector knowledge has become a much more pervasive way to create value.

“Sector focus is all you hear about. And the emphasis on having a plan and a means of executing is much more intense than it was 15 years ago when buying at the right price and using cash flow to pay down the debt was common,” says Ullman. “But prices weren’t as high and competition wasn’t as fierce.”

Indeed, today any auction process of a certain size will see KKR, Blackstone and Carlyle going head to head. Firms need an edge to win and their value creation process can be that edge. Look no further than Carlyle’s $1.35 billion investment in Axalta Coating Systems, a carve-out from DuPont, in 2013. The company was the focus of a hotly contested auction process. Carlyle paid the most, won the deal and was trashed by the media and its peers for overpaying. But Carlyle previously created value at a similar company and differentiated itself with its carve-out know-how in that space. The deal turned out to be Carlyle’s second-best deal ever, despite the high price it paid. In 2016, Carlyle sold Axalta for $5.8 billion, quadrupling its investment in the company.

Riverside also aligns itself by industry verticals, which Sansom says gives it an edge in today’s hypercompetitive market. “Today, you are competing with 100 different firms for a deal. In order to make yourself a winner, you need to show why selling to you is the best option. Oftentimes, it is industry experience and operating experience in those industries that separates us from the pack,” says Sansom.

Limited partners (LPs) are also playing a role in the increased focus on the value creation process. “KKR Capstone has been an evolution. We developed this function because it was one of the best ways to create value for limited partners,” says Prelle.

And some say the consultant model works best with LPs. “There’s fee pressure from the LPs. They want to know where expenses are being generated. With the consultant model, it’s all disclosed in the LP agreements. It’s hard to justify having someone on staff who isn’t working to capacity because there are no deals in their particular sector, and you don’t want to place them with a portfolio company where they don’t have the right expertise,” says one GP.
Grant Thornton’s perspective:
The value creation process in the middle market

The value creation process has become increasingly important as private equity firms look for ways to drive returns for their investors. Sal Fira, partner and practice leader in the Transaction Advisory Services group at Grant Thornton LLP, and Brian Pitera, principal and operations leader in the Transaction Advisory Services group at Grant Thornton, have observed how middle-market firms are responding to the added pressure of maximizing returns and creating strong value creation processes. Fira and Pitera have been working with private equity firms for more than 30 years combined. Below is an excerpt of a conversation with them about the value creation process in the middle market and what’s on the horizon.

Q: Is value creation really more important than ever before?

Fira: Value creation is a concept we have all talked about and heard about for years. When I started working in the industry, it was a buzzword, but when you look at most private equity firms — even 10 or 15 years ago — they didn’t really have a value creation model. The professionals were smart, but they weren’t operators and they weren’t able to really create value outside of financial engineering. Today, the value creation process has become more institutionalized. Firms like KKR and Comvest have set up captive consulting arms to help with the value creation process. It’s really a testament to how far the private equity industry has come. Most private equity firms have figured out their core skill set is doing the deal. They have then split out the origination process and value creation process, which is a smart strategy.

Q: Many larger private equity firms have institutionalized the value creation process, but have middle-market firms done the same?

Fira: Value creation is key to everything middle-market firms do. Most can’t hire in-house consultants, but what they can do is construct 100-day plans and build teams of people with the help of outside consultants to validate the transaction and uncover the value. Many middle-market firms are taking this approach. You are seeing firms such as Riverside Company work within this type of model and have tremendous success.

Pitera: What we are seeing today is more emphasis on the value creation process. One way some private equity firms are able to create value is by acquiring add-ons to existing holdings or acquiring for vertical integrations, making them extremely knowledgeable in their selected sectors. This is a good strategy to create values as they grow the size of a business through multiple acquisitions. At Grant Thornton, 50% of our group is comprised of industry/sector executives while the other half are really smart MBA graduates. The bottom line is you need both to be successful today. Many private equity firms are aligning themselves this way, and it makes sense.

Being an industry specialist, I have been in 500 different plants throughout my career, and I have seen success achieved many different ways. Firms gain that knowledge when they work with executives who have experience in that field. I am not smarter than anyone, but I have worked with many different businesses and I have that insight I can share. Whether private equity firms use experts who are in-house or they outsource, it’s important they remain agile so they can find the best solutions.
What's the right value creation model?

**Q** Will private equity firms continue to differentiate themselves based on sector? And does this lead to value creation?

**A** Fira: Industry experts typically know the value drivers and the levers to pull to create that value. The common thread between all the firms that we talked to about value creation is that they are all open to using outside expertise in addition to their in-house experts, which translates into them being open to using various ways to create value, which is beneficial to the portfolio company, private equity firm, and ultimately, the investors. While many people think that because a private equity firm has captive consultants they will only use them, that is not the case. Smart private equity firms will work to find the right people to help them create value, whether that’s in-house or not. KKR is a perfect example of this as they will frequently hire outside consultants to help them achieve their growth goals at the portfolio level.

**A** Pitera: It’s interesting. In the past, funds had winners and losers, and the private equity firms invested like a fund manager to pick more winners than losers, but they rode an average with a drag from those lower-than-expected assets. However, competition and the maturation of the market has changed the way private equity firms think about their portfolio composition. Today, there is no room for lower return losers; now they all have to be winners. The use of a more repeatable value creation process is definitely a result of private equity firms’ need to have more winners today. Also, there is usually more money to be made through improvements and growth vs. cost-cutting.

**Q** What role do the LPs play?

**A** Fira: The reality is that private equity firms live and die by their returns. They have realized what they are good at, which is mostly deal execution, and they are getting the help they need with the value creation process. Value creation is fundamental to what they need to do and it’s more important than ever to institutions. You will continue to see all kinds of value creation models used, but all firms will work toward institutionalizing the process.

**A** Pitera: With more add-ons and tuck-ins happening today, you will continue to see an institutionalization of the value creation process. Firms like Carlyle and Riverside say their LPs are demanding it. As a result, the private equity firms are more honest than ever before about their exit thesis when they are going into the deal, and they are saying, “Let’s formulate the best plan to get there with the right process so we can achieve the best returns for our investors.”
Ultimately, all strong private equity firms strive to achieve a balance between outsourcing and keeping things in-house, and all agree that what’s most important is creating real value at the portfolio level with the expectation of delivering outsized returns to their limited partners. “Our goals are to provide portfolio company management teams and Comvest with consistent, attentive and collaborative coverage of the highest-priority issues, both in terms of risk management and value capture. What we spend our time on often comes down to prioritizing and de-risking activities,” says Rahmati.

What’s also clear is no two processes will be the same — now or ever. “You will always have differences, and all the models can be successful. All portfolio companies need something different, and it’s our job to decipher what that is so they can grow and generate strong returns upon exit,” says Sansom.

The takeaway is that there will continue to be more emphasis on the value creation model, but private equity firms will continue to create value differently. It will be interesting to see how the different variations of value creation models manifest themselves in the middle market. While most middle-market firms do not have the bandwidth or resources to do what KKR or Carlyle can, most are thinking about how they will create value, and in some way, shape or form look to emulate the larger players in the market.