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Introduction

Operational approaches: The limited partner perspective

By Jay Bartlett, Parthenon-EY

In today’s market, private equity investors (GPs) need tools beyond financial engineering to create value within their portfolio. Many firms are touting their approach to operational resources as the key differentiator in a challenging market. This chapter examines how limited partners (LPs) view these resources.

While much has been written about operating partners, there is little meaningful work published about how LPs think about them or specific operating approaches. Given the important and influential role LPs play in the private equity ecosystem, Parthenon-EY sought out LPs who invest in middle-market private equity firms and asked them what they thought about operating resources, if anything at all. The interviews involved four key questions:

1. What is the LPs’ level of awareness and understanding of operating resources?
2. What operating models are available and how prominent are the various types?
3. Do LPs believe there is a superior approach to leveraging operating resources?
4. How do LPs react to the different characteristics of operating resources models?

Parthenon interviewed approximately 25 LPs during the summer of 2014. Key takeaways from this research are:

- LPs are very knowledgeable of how operating resources are deployed within the private equity ecosystem, and they are generally supportive of this trend. LPs clearly articulated the range of models being used and indicated that operating resources have become a much more visible presence.
- No operating resource model was viewed as superior. Rather, LPs want GPs to clearly articulate and provide evidence of added value as to how their investment strategy is supported by their operating strategy.
- LPs demand transparency regarding how operating resources are paid for. They show a surprising level of flexibility in this area but warn GPs against making fees or reimbursements opaque.

The evolution of private equity has dramatically increased the importance of operational improvements to create value. As a result, operational resources at private equity firms have become nearly ubiquitous. All of the LPs interviewed observed an increase in the presence of operating resources at private equity firms in the past three to five years. Specifically, LPs noted an increase in operating partner presentations at
annual meetings, involvement during fundraising and references in quarterly investment updates. According to one LP:

“It used to be that during fundraising in the 1980s and 1990s every GP talked about having ‘proprietary deal flow’; now everyone is talking about their operating partner. Operating partners are part of the value proposition now.”

LPs recognise that GPs can no longer ‘make in on the buy’ and are increasingly turning their attention to understanding the value-creation potential of the operating resources. While the use of operating resources has waxed and waned over time, LPs believe the current focus on operations is a more permanent shift. It is difficult for a private equity firm to differentiate solely on financial acumen, and thus operating resources are often a critical part of a vision that drives and executes superior returns. As such, LPs take a more critical look at how operating resources are deployed and how they fit into the fabric of the firm. As one LP noted, “Operating partners are no longer ‘window dressing’.”

LPs also noted that these operating resources are relevant across the board, not only in larger firms that can ‘afford’ resources of this type. In fact, LPs suggested that operating resources are highly relevant for lower middle-market private equity firms. Because larger portfolio companies tend to have more seasoned management teams or in-house consulting resources, they may have less to learn from operating resources. However, in the lower middle market, experienced operating resources may bring significant experience and insights that help create value. Lower middle-market firms may claim they cannot afford these resources, but their use provides the potential to make a significant and positive impact on portfolio company performance.

LPs also acknowledged the variety of operating resource models across firms and they spoke about the different flavours of operating resources they encounter. There are limitless ways to approach the structure of operating resources and nearly every firm has a slightly different model. One of the LPs put it this way, “We really have to dig in to understand how they are being used, because every approach is so different”.

While LPs may see limitless ways to structure operating resources, we wanted to frame the options to gauge how common each approach was. To do this, we analysed the operating partner resources at a sample of more than 150 middle-market private equity firms. Our findings are summarised in Figure 2.1.

Private equity firms’ deployments of operating resources fall along a continuum from ‘focus on financing’ to ‘operators first’, and almost everywhere in between. However, we do see three branches of philosophy.

The most traditional model utilises operating resources on a periodic or as needed basis. These resources can be board members or a loose network of industry executives
(board resources) or consultants deployed against specific initiatives (focus on financing). Overall, this model is characterised by the private equity firm conducting financial oversight of portfolio companies but not engaging in the week-to-week operating initiatives and decisions that must be made. In this model, it is common to see little to no operating experience resident within the firm’s partnership.

At the other end of the continuum, there are private equity firms driven by (and possibly founded by) operators, either alone (operators first) or in collaboration with senior personnel from the finance world (joint leadership). In these firms, operating resources are making investment decisions and are typically much more involved with their portfolio companies on a day-to-day basis. With this level of operational experience, these firms often pursue investments that more financially oriented funds shy away from, such as carve-outs or turnarounds.

Where we are seeing significant innovation, even experimentation, is in the middle part of the continuum. Here, financial and operational resources work together throughout the investment life cycle. It is these firms that are building operating or resource groups. Right in the middle of this continuum are some firms with a network of operating experts. These resources are marshalled as needed, which we term ‘active advisers’. However, there are also firms with dedicated internal resources, or ‘operating support services’. These groups are being built both vertically (that is, with industry focus) and horizontally (that is, with functional focus), as well as hybrids of the two. LPs

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**Figure 2.1: Continuum of private equity firm structure and integration of operating resources**

<table>
<thead>
<tr>
<th>Integration of operational expertise</th>
<th>Percentage of partnership acting as operating partners</th>
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</thead>
<tbody>
<tr>
<td>~15%</td>
<td>~15%</td>
</tr>
<tr>
<td>Investors consult operators</td>
<td>Investors team with operators</td>
</tr>
</tbody>
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**Focus on financing**
- These private equity firms prefer to allow their portfolio companies to operate independently, generally only getting involved when necessary.

**Board resources**
- Firms maintain networks of senior executives to both provide ad hoc guidance to company leadership and support fundraising efforts.

**Part-time | Full-time**
- Active advisers

**Internal | External**
- Operating support services

**Joint leadership**
- Investment and operating professionals are two distinct groups; operating support is provided by dedicated internal resources or hired as needed by ops team.

**Operators first**
- Deal teams are composed of both financiers and operators who often invest around operational improvement potential. Industry specialisation is common.

**Fund leadership**
- Comprised mostly of former executives who invest in known industries with investment theses around operational improvement.

Source: Parthenon analysis of PE firm organisation structure, n=192.
acknowledge the rationale of both models and are focused on how these resources align with the firms’ investment strategies.

All of these models are prominent today, as shown in Figure 2.2. The most common model adopted by private equity firms are active advisers, which supports the assertion that firms are trending towards teaming with operators to create as much value as possible within an investment.

With so many different approaches, one wonders whether LPs believe there is one superior model. The LPs we interviewed answered with a resounding no. It is not just that the LP community as a whole does not see a ‘best’ model, but 95 percent of the LPs indicated that one model is not better than the other - “There is not one model that works better; it depends on alignment and how the pieces of the puzzle fit together.”

We then asked LPs how they assess whether a model is working or not. They admitted that it is difficult to ‘prove’ that operating resources are driving higher returns and to clearly articulate how operating resources support the strategy imperative. What emerged was a more holistic approach to understanding not only how the operating resources are structured, but also how they are aligned with the fund’s investment strategy. As one LP put it, “It’s not a question of what model works best - they all can work - it is a question of how it fits with the firm’s approach and strategy and how the firm integrates the resources.”
The relationship between a firm’s operating resource structure and its investment strategy is key. The investment strategy will inform the chosen structure for the operating resources group, and the operating resources group will in turn support the firm’s investment strategy. For example, a firm that invests in highly complex engineering companies should have an organisational structure that can support the resulting portfolio companies, specifically a model with operating partners who have functional expertise in engineering. Another example would be a firm that invests in only consumer products companies. This firm should have operating resources that have specific line expertise in consumer products, which can be translated directly into value creation at the portfolio company. As one LP summarised:

“If I am looking at a fund that invests in oil, I don’t want the operating partner to have a degree from Princeton, I want him to have a degree from Texas Tech. I want to believe the operating resources have direct experience that can drive value within the companies.”

Figure 2.3 provides some examples of how strategy can link to the operating structure.

Knowing that the relationship to a firm’s investment strategy is most important, we assessed five levers that private equity firms can utilise to align their operating resources to their investment strategy. LPs were asked what they thought about the models along each of these continuums. Figure 2.4 outlines these five levers. While there is not one right model, some LPs do have opinions on the various levers that can be pulled.

1. **Expertise.** For the most part, LPs had no preference between operating resources that were generalists or those that had more functional expertise. Most important was that whatever the approach, it was closely integrated with the investment thesis. If a
firm is focused on one sector, the resources should have experience operating businesses in that sector. If it is a generalist firm with limited operating resources, a generalist could diagnose issues and then the right functional expertise is brought in.

LP comment: “I don’t think one is superior... tell me why they chose that route and give me examples of how it works.”

2. **Staffing.** LPs were less enthusiastic about a big name CEO sitting on the bench, but they could see its merits in specific cases. More frequently, they preferred the full-time employee who was fully engaged and committed to the success of the overall fund.

LP comment: “I question the level of commitment of bench players, so I like full-time employees.”

3. **Compensation.** The overwhelming majority of LPs interviewed want operating resources to be compensated in a way that is aligned with LP incentives – at the fund level, rather than deal level. If the operating resources are compensated based on fund performance, he/she will deploy resources at the most valuable place in that fund. However, if the economics are deal specific, the operating resources will focus on those deals only. That said, when operating partners are bench players, it can make sense to have them compensated at the deal level.

LP comment: “I like when their incentives are aligned with those of the LP... although specific deal co-investment makes sense for the bench players who are just working on individual deals.”

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**Figure 2.4: The five levers private equity firms use to align operating resources**

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<thead>
<tr>
<th>Generalist</th>
<th>Expertise</th>
<th>Specialist (industry or function)</th>
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<tbody>
<tr>
<td>Full-time employee</td>
<td>Staffing</td>
<td>Bench players</td>
</tr>
<tr>
<td>Salary</td>
<td>Compensation</td>
<td>Carry and co-investment</td>
</tr>
<tr>
<td>Sourcing</td>
<td>Deployment</td>
<td>Post acquisition</td>
</tr>
<tr>
<td>Internal resources</td>
<td>Resources</td>
<td>External resources</td>
</tr>
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Source: Parthenon LP interviews, n=25.
4. **Deployment.** Most LPs have observed operating resources getting involved earlier in the life of the deal. In addition to participating in due diligence, operating partners are helping to source deals in industries where they have deep experience. Generally, LPs agree that it is a good idea to deploy operating resources earlier, rather than waiting to engage post-acquisition. This avoids dilution of responsibility and accountability. The operators cannot blame the deal guys for doing a bad deal if they are involved in the due diligence. Further, as the investment becomes more nuanced (around growth or other value creation), having operators involved in early discussions can raise issues and opportunities that the deal team may not have identified.

<table>
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<th>LP comment: “These are the guys who can identify the value-creation plan - so get them in for diligence so they can hit the ground running day one of ownership.”</th>
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5. **Resources.** LPs believe the choice between whether to use internal resources (large team) or external resources (small internal team that marshals external resources) depends on the needs of the portfolio. The LPs interviewed do not have a strong preference about which approach is used.

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<th>LP comment: “Internal resources can be limiting… it is hard to have the toolkit for all the portfolio companies, but it can work. An external model has the advantage of being able to bring best-in-class resources for every situation.”</th>
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When it comes to paying for operating resources, LPs are again flexible. Given a range of options, which include funding the operating resources out of management fees, the portfolio company or additional LP fees, LPs are largely indifferent but they do want 100 percent transparency. LPs realise that if a portfolio company hires a consulting firm, EBITDA takes a hit; therefore, they are willing to have a GP charge the company for operating partner time. LPs model their own net returns after various fees, and so as long as there is transparency, they can model those returns accurately, regardless of where the funding comes from. On the other hand, if they found that a GP tried to hide something, it would be a grave error.

<table>
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<th>LP comment: “Either approach is fine, as long as we know what they are doing.”</th>
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Parthenon-EY pressed LPs on how firms can best tell their story to convey the message that operating resources are appropriately structured and well positioned to drive value creation. We gleaned a few key takeaways that GPs should consider when it comes to operating resources:

- Have operating partners take an active role in fundraising, such as at the annual meeting and during portfolio reviews.
- Make sure the operating strategy is clearly laid out and clearly articulate how it supports the investment strategy of the firm.
• Provide specific details about how the operating resources are spending their time.
• Show proof that the operating model is making a difference with specific examples. Do not hesitate to highlight challenges and how operating resources alleviated the problem.

Operating resources are critical to success in private equity. LPs are savvy when it comes to understanding and evaluating these resources at private equity firms. There are multiple ways to structure operating resources; one is not necessarily better than the other. Rather, what LPs want to see is a model that supports the investment strategy of the firm. It is thus important for GPs to take the time to succinctly explain how the operating resources are being leveraged to drive value creation. And while the jury is still out on how to exactly measure ‘value creation’, the jury has decided that operating resources are a step in the right direction.

Jay Bartlett is a Managing Director and Co-head of the Private Equity practice of Parthenon-EY. More than a decade ago he joined Parthenon, which became part of EY upon their combination in August 2014. He has led hundreds of due diligence and strategy assignments in a broad variety of sectors including consumer and retail products, publishing, education, health care, industrial and business services. Prior to joining Parthenon, Jay was the Director of Business Development for the Salt Lake Olympic Committee and Olympics.com and was a consultant with Bain & Company. Jay received his BA in Economics, magna cum laude, from the University of Vermont, and he completed his MBA at the Tuck School of Business at Dartmouth, New Hampshire where he was elected an Edward Tuck Scholar.

About Parthenon-EY
Parthenon joined Ernst & Young LLP on 29 August 2014. Parthenon-EY is a strategy consultancy, committed to bringing unconventional yet pragmatic thinking together with our clients’ smarts to deliver actionable strategies for real impact in today’s complex business landscape. Innovation has become a necessary ingredient for sustained success. Critical to unlocking opportunities is Parthenon-EY’s ideal balance of strengths - specialized experience with broad executional capabilities - to help you optimize your portfolio of businesses, uncover industry insights to make investment decisions, find effective paths for strategic growth opportunities and make acquisitions more rewarding. Our proven methodologies along with a progressive spirit can deliver intelligent services for our clients, amplify the impact of our strategies and make us the global advisor of choice for business leaders.