



Kevin Curry

Why some private equity firms **do better** than others

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Investments don't govern themselves; active ownership is the answer.

Private equity firms have long promoted the virtue of active ownership—the hands-on style that distinguishes them from traditional portfolio investors. But what does active ownership mean, and does it really lead to superior performance?

systematic way that would increase the returns from an active-ownership approach.

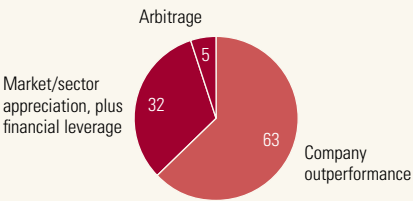
Eleven leading private equity firms, all boasting better-than-average track records, made up our sample. Each of them submitted five or six deals from which they had exited. The deals represented a range of returns from average to very good. To calculate the value generated by active ownership, we built a model to isolate the source of each deal's value: overall stock market appreciation, sector appreciation, the effect of extra financial leverage on those market or sector gains, arbitrage (a below-market purchase price), or company outperformance.

EXHIBIT 1

Leading the pack

Primary source of value creation, %

100% = 60 deals from 11 leading private equity firms



Recent McKinsey research reveals a strong correlation between five steps that private equity firms can take to direct a company in which they invest and outperformance by that company—in other words, performance better than that of its industry peers. Many private equity firms have embraced these steps and execute them well, yet surprisingly few do so in the consistent and

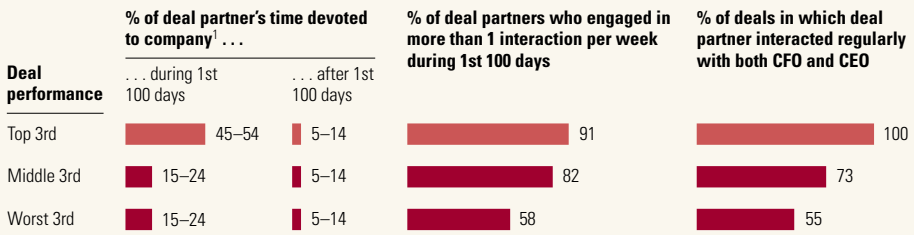
The main source of value in nearly two-thirds of the deals in our sample was company outperformance. Market or sector increases accounted for the rest (Exhibit 1).¹ Outperformance, which generated a risk-adjusted return twice that of market or sector growth, was the least variable source of value.

These results show that outperformance by companies is clearly the heart of the way private equity firms create value. How do top investors make this happen? Interviews with deal partners and with the CEOs of

EXHIBIT 2

Time well spent

Deals in which company outperformance was main source of value (n = 38 deals)



¹Median time of deal partners in sample.

Source: Interviews with deal partners and CEOs of exited investments; McKinsey analysis

target companies—and the correlation of the results with cash-in/cash-out multiples²—identified five common features that could constitute a code of leading-edge practice. The first two concern traditional private equity competencies, the other three a more engaged form of corporate governance that we describe as true active ownership.

First, successful deal partners seek out expertise before committing themselves. In 83 percent of the best deals, the initial step for investors was to secure privileged knowledge: insights from the board, management, or a trusted external source. In the worst third of deals, expertise was sought less than half of the time. Second, successful deal partners institute substantial and focused performance incentives—usually a system of rewards equaling 15 to 20 percent of the total equity. Such incentives heavily target a company's leading officers as well as a handful of others who report directly to the chief executive. In addition, best-practice deal partners require CEOs to invest personally in these ventures. There is no standard formula, but the most successful arrangements call for a significant commitment by CEOs while ensuring that the potential rewards don't make them too risk averse. Formulas

that failed to account for the individual circumstances of a company's officers or that spread incentives too widely proved less effective.

Next, successful deal partners craft better value creation plans and execute them more effectively. Naturally, management's plan is a part of the process, but the best new owners view it skeptically and develop their own well-researched viewpoint that they use to challenge it. Once developed, the plan is subject to nearly continual review and revision, and an appropriate set of key performance indicators is developed to ensure that it remains on track. Firms implemented such a performance-management system in 92 percent of the best-performing deals and only half as often in the worst.

Fourth, the most effective deal partners simply devote more hours to the initial stages of deals. In the best-performing ones, the partners spent more than half of their time on the company during the first 100 days and met almost daily with top executives. These meetings are critical in helping key players reach a consensus on the company's strategic priorities: relationships are built and personal responsibilities detailed. A deal partner may use the meetings to challenge

management's assumptions and to unearth the company's real sources of value. By contrast, lower-performing deals typically took up only 20 percent of the investors' time during this crucial period (Exhibit 2).

Last, if leading deal partners want to change a company's management, they do so early in the investment. In 83 percent of the best deals—but only 33 percent of the worst—firms strengthened the management team before the closing. Later in the deal's life, the more successful deal partners are likelier to use external support to complement management than are the less successful deal partners.

These research findings pinpoint the practices that distinguish great deals from good ones. The five steps are, in the main, uncontroversial. They are applied inconsistently, however, and their implementation seems to depend on the individual partner's beliefs and skills. A standard active-ownership process that applies and develops best practices is the next step for the private equity industry.

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¹ In 3 of the 60 deals, value was created primarily through arbitrage. Since these deals are relatively rare, and interviews indicated that they are difficult to find, we excluded them from our analysis.

² Calculated by dividing the cash realized from a deal by the cash invested.