Organizational Strategies for Competing Through Specialization: Three Growing Trends Affecting Private Equity

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There is no doubt that the private equity industry is benefiting from improved cash-on-cash returns that will result in attractive gains and better prospects for capital raising across the board in 2004.

Improved return expectations and potentially shorter fund-raising cycles will allow many firms to step back and carefully assess staffing levels and organizational structures with the goal of determining the best approaches to access top quality investments in an increasingly competitive environment.

At the same time, the private equity industry continues to mature and it also continues to attract top talent from a variety of backgrounds. The attraction is based on the opportunity to create and grow companies while sharing in the financial gain that results from building a solid, well-managed portfolio.

Near term, there will be more funds raising incremental capital from traditional private equity sources. At the same time, a number of hedge funds are eyeing the private equity arena as an opportunity to expand their reach and apply their industry expertise. As a result, a number of private equity firms are evaluating their organizational structures to ensure that they are positioned to source the largest number of high quality proprietary investments, successfully manage portfolio investments to achieve maximum returns and monitor financial performance of their portfolios to identify issues and address them in a timely fashion.

The creation of a role for proprietary-deal sourcers is the first trend we're seeing come to light. These individuals are responsible for working directly with operators and intermediaries to source proprietary investment opportunities across an array industries. They also broaden the firm's market reach and profile such that deal making partners can choose from the widest array of investment opportunities related to their areas of expertise. Individuals filling these positions are often investment bankers with sizeable networks of industry contacts. Their mandate is to pursue opportunities that fit their firm's specific investment criteria and industry goals. Individuals attracted to these positions usually enjoy working as part of a broader team and are motivated by compensation packages that feature a combination of cash and carried interest.

A second area of focus for private equity firms today is portfolio management and portfolio administration, with an eye toward improving operations. A number of firms have established teams that are responsible for monitoring portfolio company performance and growth and for centrally sourcing products and services for portfolio companies at prices that are more competitive than the companies would pay if they negotiated independently. Products and services sourced can include telephony, insurance, package transport, computer software and hardware and raw materials used by multiple portfolio companies. Individuals in these roles can help to reduce a portfolio company's costs by 10 percent to 20 percent, thus contributing significantly to an improved overall return on the portfolio. These individuals typically report to a chief financial officer or chief operating officer and are compensated with a combination of both cash and a share of carried interest.

A third area of recruiting focus is on operating partners who can add value to a portfolio company by assessing the quality of operating systems and controls, implementing consistent performance monitoring techniques, improving operating efficiencies and helping out on turnarounds. More firms are integrating experienced operating professionals into their teams to address the aforementioned issues and to help companies grow organically by identifying new revenue opportunities while controlling costs.