PARTNERS CAPITAL

Private Equity: Post Acquisition Operating Value Added Best Demonstrated Practices

March 2023

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US-20231103-3209278

Introduction

Private Equity faces its greatest challenges redoubling the industry's focus on PAOVA

- The essence of private equity investing is to be a better owner than the seller – much of this manifested itself in the early days of PE investing in buying public company corporate orphans.
- The best way to be a better owner is to be more able to grow the long-term earnings of the business.
- We refer to this as Post Acquisition Operating Value Added or PAOVA. This term was inherited from the Bain & Company PE consulting business which is the provenance of the three working founders of Partners Capital.
- We have always had a bias towards those PE firms most focused on this as the reason for owning a given business and who manifested the highest accumulated experience in this area (thinking of Malcolm Gladwell's 10,000 hours).
- For us to be able to perform just adequate due diligence on a private equity firm's ability to add value to their portfolio companies, we must be experts on PAOVA.
- To confirm that we are experts in this area, we continually study, through our ongoing PE manager due diligence, the best practices found inside those firms and funds who have demonstrated the greatest ability to improve company management's own ability to grow earnings. This presentation is a living document which aims to capture what we believe to be PAOVA best demonstrated practices.
- Much of this learning was codified in 2015 and 2016 but we have updated this where we felt there was important learning since.

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Private equity must double down on PAOVA

Private Equity faces its greatest challenges redoubling the industry's focus on PAOVA

- Falling interest rates elevated returns in most asset classes, including buyouts benefiting from high leverage and low borrowing costs, and venture capital and growth equity benefiting from low discount rates inflating back-ended cash flows.
- Record levels of private equity funds raised has left too much capital chasing a reduced set of investment opportunities.
- The top driver of historical returns was multiple expansion, mostly reflecting the inverse relationship valuations have with discount rates.
- In a rising rate environment, we believe earnings growth will emerge as the dominant source of PE value creation, and firms without extraordinary skills in this area will ultimately fail.
- We expect to see a significant shake out in the private equity world as many firms have not built adequate value creation capabilities to justify their high fee levels (in the absence of multiple expansion).
- Competition among PE LPs will be intense as it pivots toward those firms with the greatest skill in adding value to their portfolio companies.
- We believe Partners Capital has an edge over competition given our long historical focus on those firms with the greatest post-acquisition operating value added (PAOVA).
- We cannot be complacent, but rather must forge ever stronger insights into the best practices for PAOVA and use that to build ever stronger relationships with these rare GPs based on our own ability to add value to their organizations.

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Post Acquisition Operating Value Added (PAOVA) -- Sources

Specific input from current or past Operating Executives has primarily come from individuals from the following firms:

- Bain Capital
- CD&R
- Audax
- Arsenal
- Francisco Partners
- HIG
- TPG
- Vista
- Thoma Bravo
- 3G
- L-Catterton
- RallyDay

Additional Input from

- Bain & Company PE Consulting Team
- Academic studies on LBO Corporate Governance

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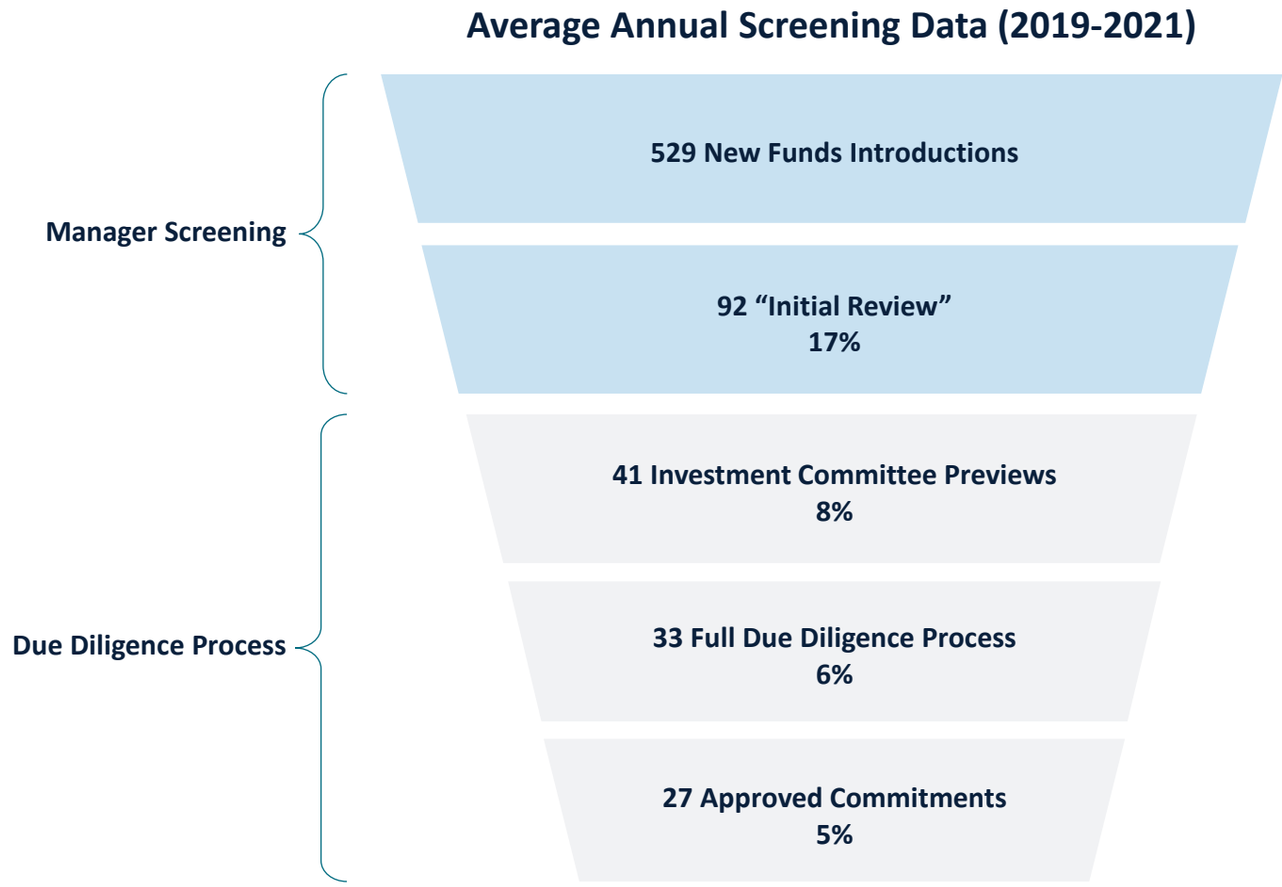
Private Equity Investment Process

Partners Capital PE Investment Screening

Partners Capital maintains a long list of investment opportunities in the private equity space. This is narrowed down to a shortlist for in-depth due diligence based on Partners Capital's 7Ps framework.

Detailed due diligence is performed on the shortlist of funds including numerous meetings with the key principals of the fund, reference calls with other LPs, in-depth analysis of previous deals and investment processes, and operational due diligence ("ODD").



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Agenda

1. PAOVA matters more today than ever
2. Organizational resourcing models for deploying PAOVA
3. Key capabilities required for extraordinary value creation
4. How Partners Capital Adds Value to PE firms in which we invest

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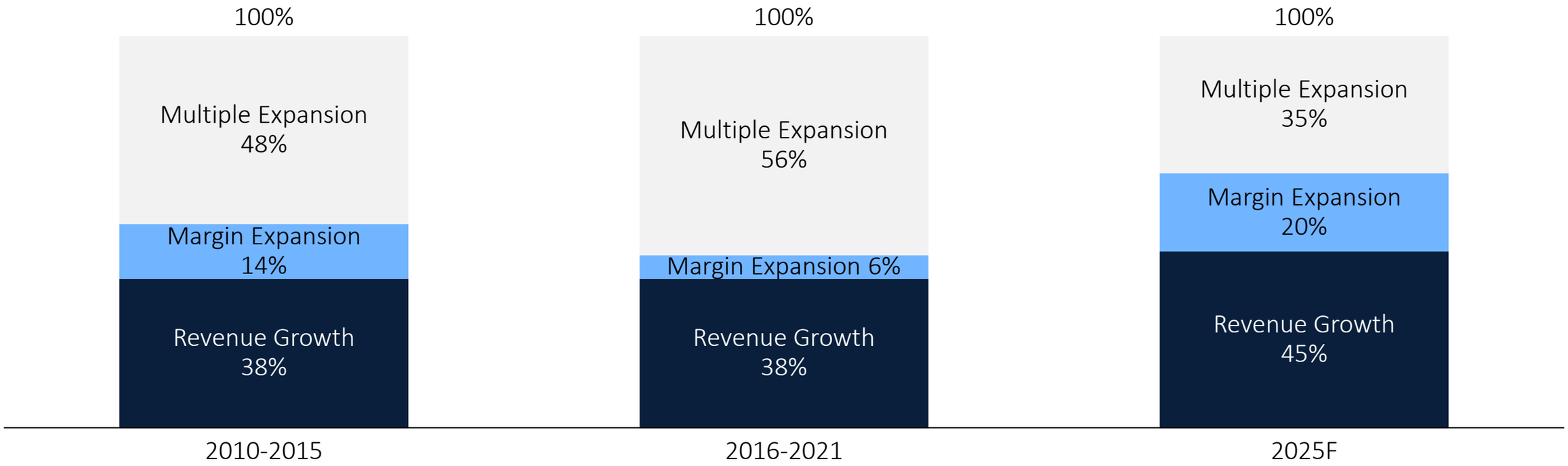
PE Value Creation (Bain)

In a rising rate environment, we believe earnings growth will emerge as the core source of PE value creation

Median PE Total Enterprise Value Creation, by Year of Exit



Notes:

1. Source: CEPRES Market Intelligence; Partners Capital Analysis. Includes fully realized global buyout deals with >$50M in invested capital; excludes deals with missing data as well as real estate and infrastructure deals; 2021 data as of December 14, 2021. Excludes leverage

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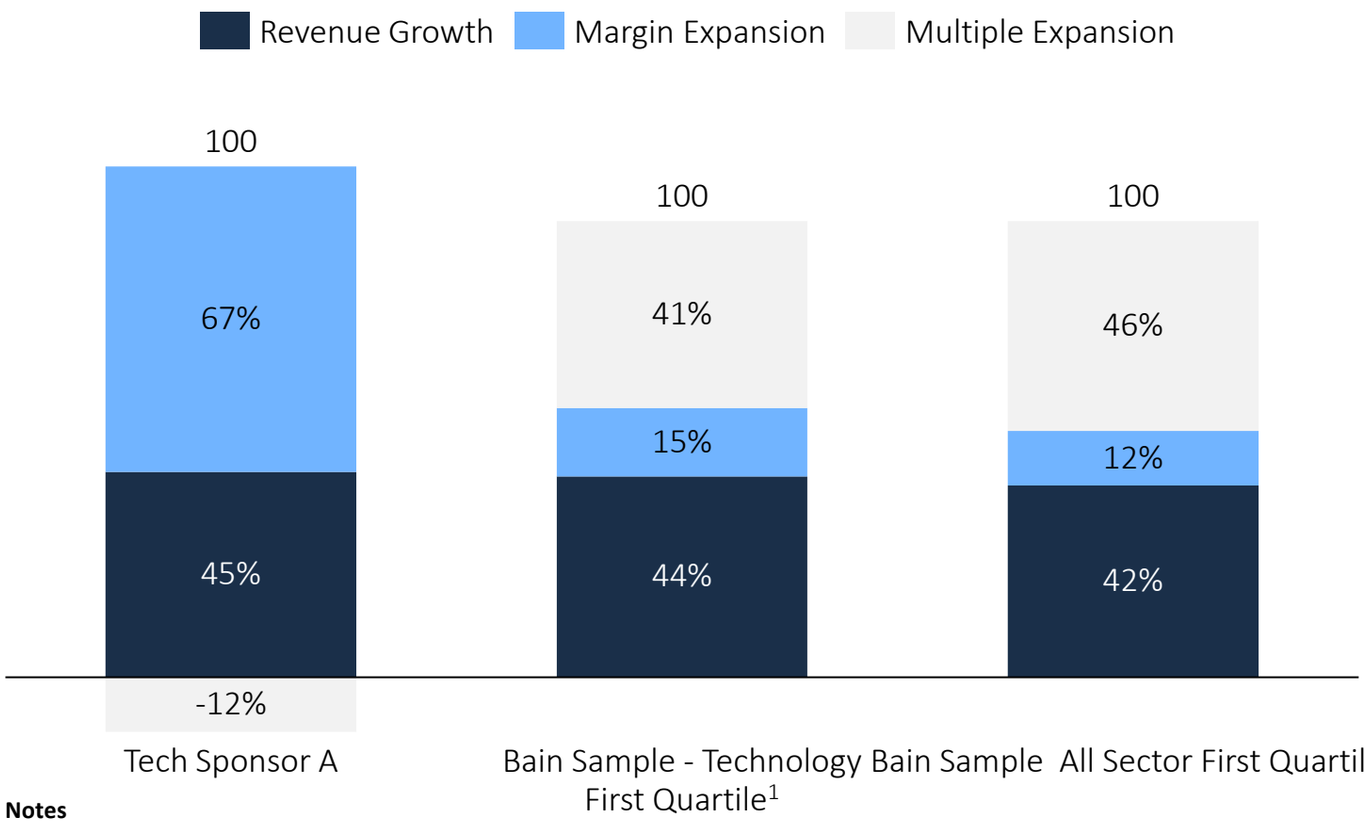
Bain & Co's Value Creation Index (Introduction)

Our approach aligns with Bain & Co's approach that focuses on TEV growth (excluding leverage) and de-emphasizes multiple expansion

Components of Sources of Value Creation – Bain Value Creation Index

Average Percent of Enterprise (Not Equity) Value Creation[1]



- Bain's value creation index measures how sponsors have leveraged revenue growth, margin expansion, and multiple expansion to create value in buyout deals.
- It focuses on enterprise, not equity value creation and is averaged across deals versus weighted by invested capital. Numbers will thus not tie with conventional cumulative equity value bridges. This approach excludes the effect of leverage.
- PCIG believes margin expansion is a key driver of value creation in buyouts. Bain's data supports this view by highlighting that top quartile deals (and funds) have created proportionately more value through margin expansion than the other drivers.
- Existing tech sponsor A (67%) generated >4x more value through margin expansion than even the top quartile tech funds in the Bain sample.(15%)
- Despite challenges in headline performance, this enhanced our conviction in the sponsor's PAOVA playbook, which is spearheaded by a portfolio group.

Notes

1. Source: Bain DealEdge: How Top Quartile Deals Create Value, September 2022; Bain data on deals from 2010-2019
2. Margin Expansion: Represents (Change in EBITDA Margin from acquisition to exit) x (Revenue at exit) x (EV/EBITDA multiple at exit) Revenue growth: Represents (Change Revenue from acquisition to exit) x (EBITDA Margin at acquisition) x (EV/EBITDA multiple at exit); Multiple Expansion: Represents the change in the valuation multiple of trailing EBITDA from initial investment to exit, multiplied by entry EBITDA

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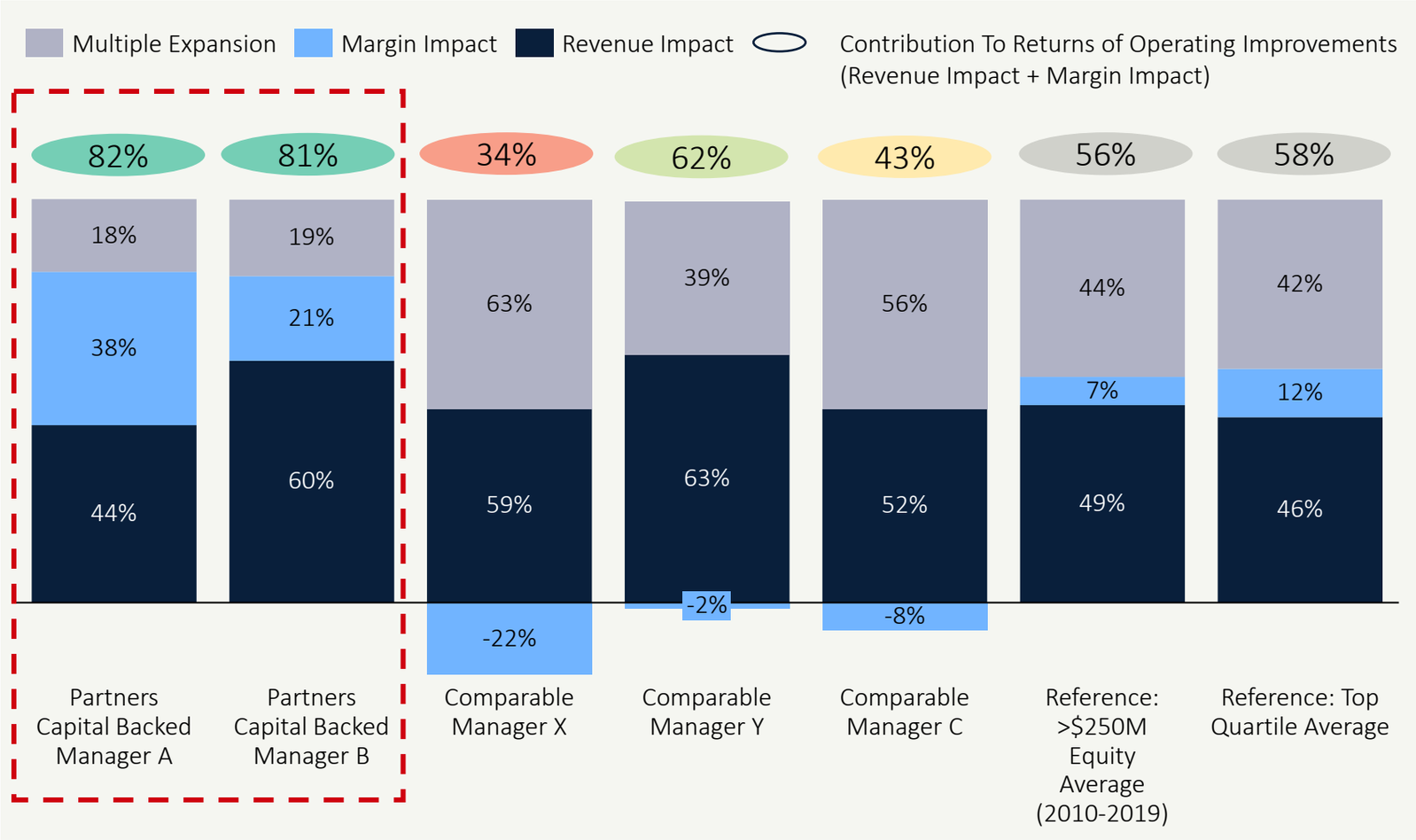
Operating Performance (Average TEV Value Creation)

Proprietary tools to measure *how* funds drive PAOVA to improve manager selection, and identify managers we believe can consistently outperform

Partners Capital is focused on managers than generate post-acquisition value-add through operational improvements, which we believe to be the most consistent driver of outperformance.

We have developed proprietary tools and analyses to decompose the drivers of return for buyout managers. Our recent commitments to two buyout managers demonstrate that focus. These managers have generated 80%+ of their value-add through operational improvements vs. c.50-60% average for the broader private equity market and c.30-60% for other managers we analyzed in their peer group.



Note

1. Analysis includes funds 2006 and on.
2. Excludes all businesses values on multiples of Revenue, Book Value, Average, or other non-EBITDA Multiple as well as debt investments and real estate
3. Performance as of: Manager A (30 June 2022); Manager C (30 June 2022); Manager X (September 30 2020); Manager Y (30 June 2022); Manager B (31 March 2020) Excludes pre-2006 funds.
4. Representative of the change in average TEV of underlying portfolio companies, so excludes any changes in net debt
5. Margin Expansion: Represents (Change in EBITDA Margin from acquisition to exit) x (Revenue at exit) x (EV/EBITDA multiple at exit) Top-Line Growth: Represents (Change Revenue from acquisition to exit) x (EBITDA Margin at acquisition) x (EV/EBITDA multiple at exit); Multiple Expansion: Represents the change in the valuation multiple of trailing EBITDA from initial investment to exit, multiplied by entry EBITDA

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Few firms have adequate PAOVA capabilities

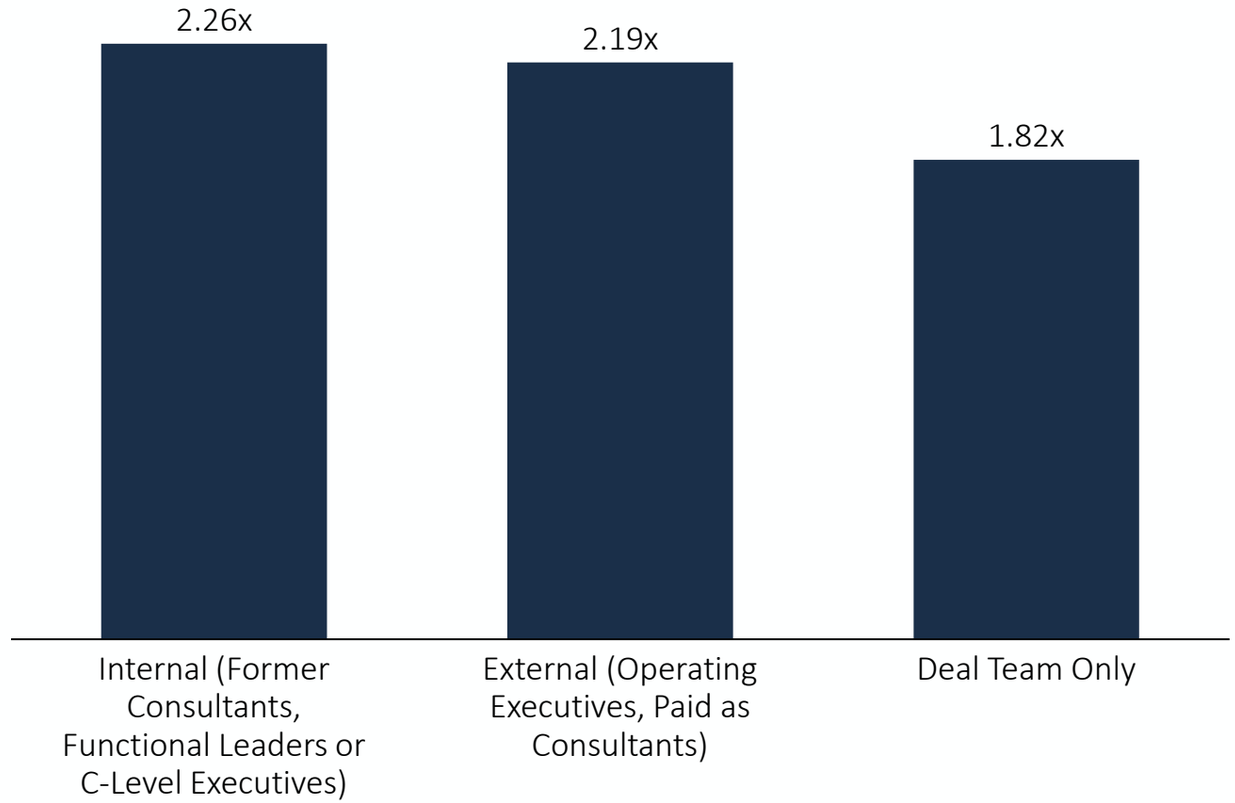
We believe the future winning firms have substantial consulting-based portfolio company operational teams with functional experts

There is already a significant performance edge (c. 0.44x MOIC, which we believe translates to a c. 5% higher net IRR, assuming a five-year deal holding period) between funds with dedicated internal or external operating resources versus those where value creation initiatives are primarily spearheaded by deal team members.

In that same study, the average performance difference across buyout firms that rely on the different types of operational support team structures was small, as long as there is clear involvement from high quality, experienced operating executives.

However, we believe the current macroeconomic environment will drive a paradigm shift that advantages the portfolio group model (internal consultancy or function-based), which represented just 18% of firms in the AlpInvest sample. 27% of firms have no dedicated operating resources at all. 55% of funds have operating partner-driven PAOVA.[1]

Average Gross MOIC of Buyouts Funds by PAOVA Approach



Notes

1. Source: AlpInvest, From Financial to Operational Engineering: Organizational Aspects, November 2021; Sample includes 3,949 deals from 212 buyout and distressed debt funds raised between 2004 and 2015

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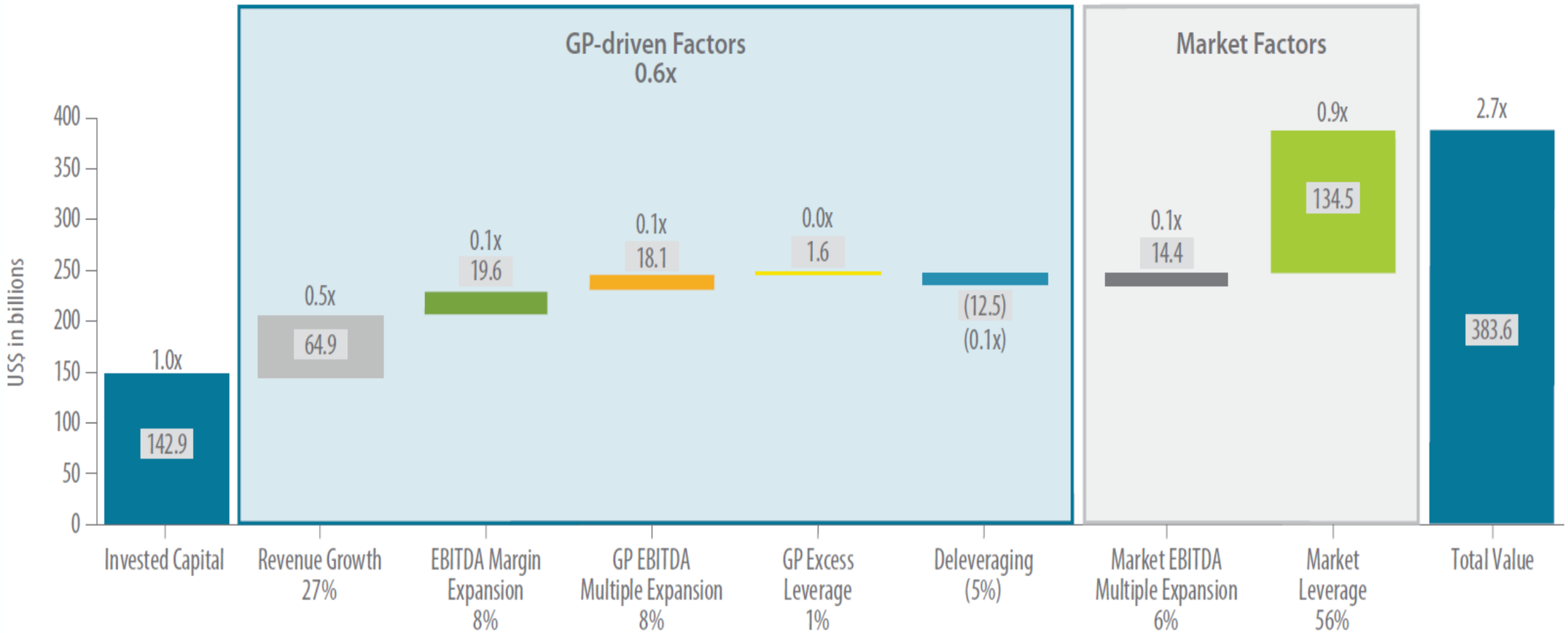
The PE industry is only just starting to measure sources of value creation

Stepstone estimates that market-based factors have been the primary driver of private equity returns. In other words, "leveraged equity beta" has contributed most historic LBO returns.

Private Equity Performance Attribution (Source: Stepstone)



Source: SPI, March 2017.

Notes

1. Source: SPI, March 2017

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Different firms deliver different sources of value creation

LP due diligence is exposing those firms who have been beneficiaries of leveraged beta and not added value ("unique alpha in Duff and Phelps' terminology). LPs are more discerning about the source of past value creation being tied to specific actions by the PE firm to increase the value of their portfolio companies.

Notes
1. Source: Duff and Phelps

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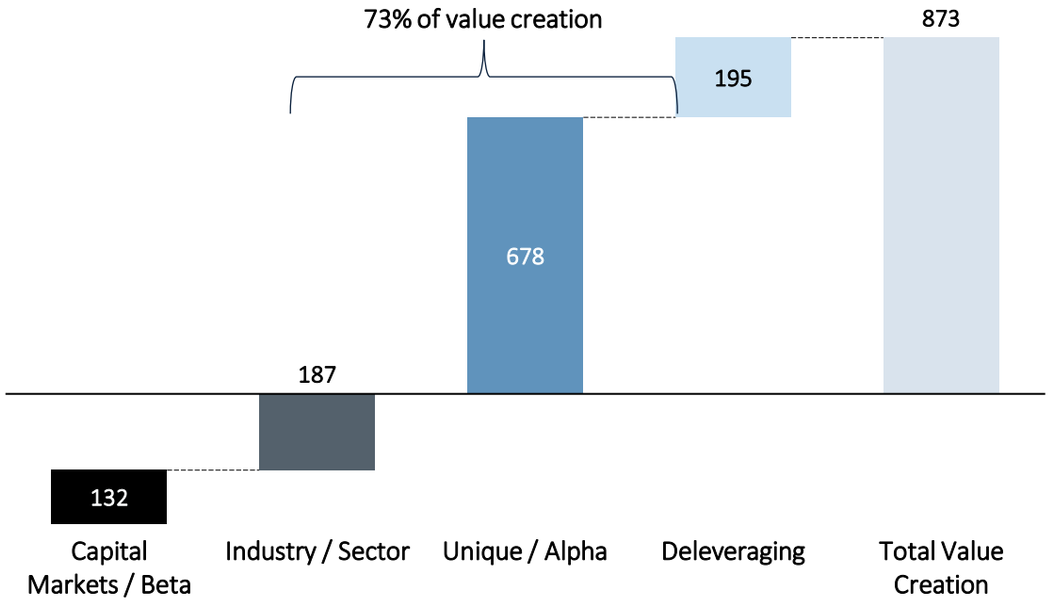
PE firms are hardwiring performance attribution into their processes

Illustration: Manufacturer of refrigeration and food merchandising equipment

Deal Summary	
Investment Date / Exit Date:	Sep 2011 – Apr 2015
Equity Investment:	$194M
Entry Multiple:	7.6x EV/EBITDA
Gross MOIC:	4.7x
Gross IRR:	53.5%



Sourcing:

- Non-core asset of global industrial conglomerate, however was sold through an auction process.
- PE Firm's initial bid was rejected however the highest bidder tried to renegotiate their bid when they had further information on the operational requirements to separate from parent. Seller then re-engaged with PE Firm and proposed a partnership structure .

Thesis:

- Positive secular market trends, including higher standards for energy efficiency and food safety, increased specialization of retail food displays and international and emerging market expansion.
- Market leader in a duopolistic market in which manufacturing scale, footprint and customer relationships provide meaningful barriers to new entry.
- Opportunity for operational improvements as Company had been a non-core business for Parent and was severely undermanaged, underinvested in sales and marketing and lack of product innovation following a period of reduced R&D spending.

Value-Creation:

- The company delivered 115% EBITDA growth throughout PE Firm's hold period with the majority of this from organic growth.
- Completed add-on acquisitions that added significant manufacturing capacity in new and aftermarket doors, strengthened competitive position in Asia Pacific and added a Chinese manufacturing facility.
- Undertook a number of initiatives to improve the culture and re-incentivise the workforce
- Implemented new processes for evaluating and pursuing contract bids with large national accounts to help ensure profitable revenue growth rather than unprofitable market share.
- Redesigned and launched key product line to deliver greater energy efficiency, simplify production process and drive market share improvement.
- Implemented new business plan to develop and expand aftermarket product and related service offering

Exit:

- Sale to Asian Strategic in April 2016.

Source: Attribution analysis conducted by Duff & Phelps. The review was engaged by PE Firm, however Duff & Phelps conducted the analysis independently.

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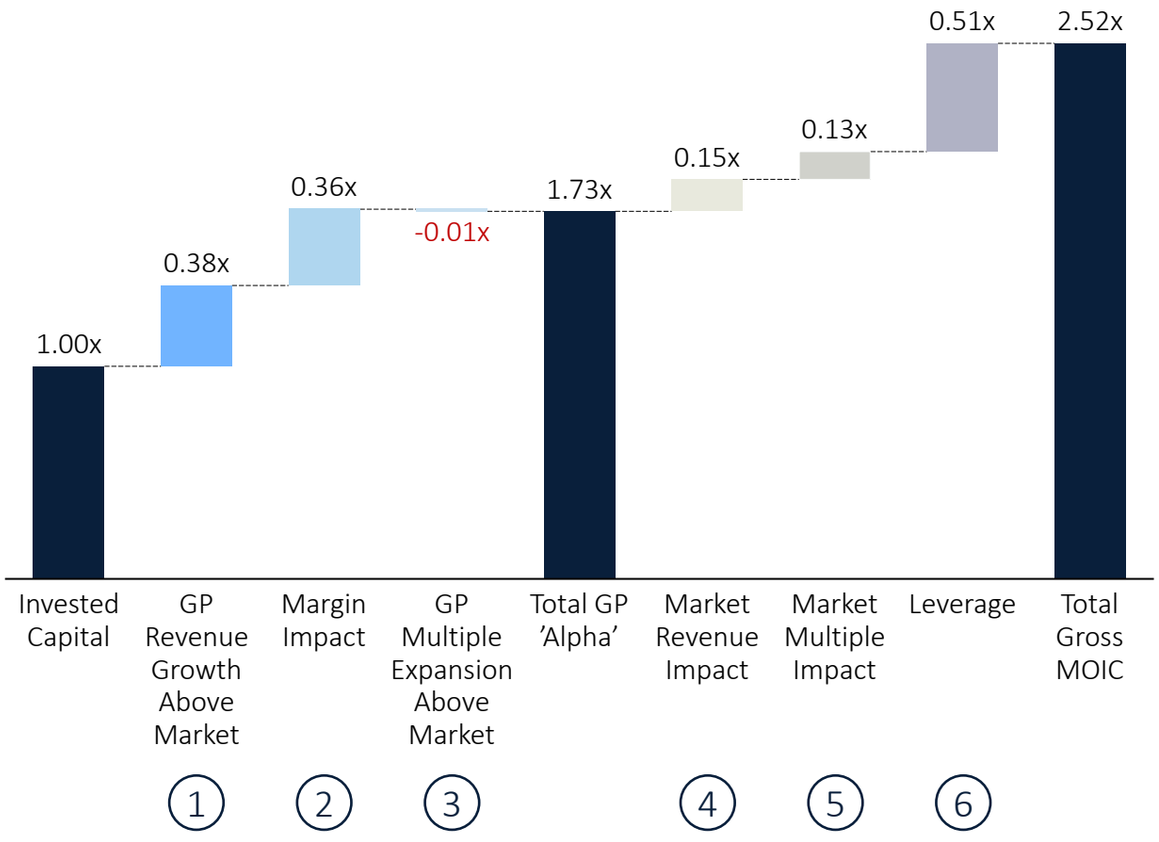
PCIG Gain Decomposition Analysis Tool ("GDA")

PCIG's GDA tool attempts to attribute performance to manager skill versus the effects of sector exposure, market multiple expansion, or leverage

Components of PCIG PAOVA

Average Gross MOIC



We believe there are six key value drivers in an LBO, three we view as 'beta categories' and three as 'alpha categories'. Growth in each category can be compounded by the average deal duration to calculate a per annum return.

'Alpha Categories'

Core PCIG Focus

- **(1) GP Revenue Growth Above Market** – Defined as the fundamental revenue outperformance of an acquired business over their publicly traded peers
- **(2) Margin Impact –** Effect of EBITDA margin expansion on MOIC We see all margin expansion as driven by manager skill
- **(3) GP Multiple Expansion Above Market –** Defined as the effect of EV / EBITDA growth over a hold period above the increase in multiple of publicly traded peers. We more commonly see this as a key driver in the lower middle market, indicative of a 're-rating' of professionalizing smaller companies.

'Beta Categories'

- **(4) Market Revenue Impact and (5) Multiple Impact** – Defined as the average MOIC impact of public market sector performance
  - Revenue Growth – based on revenue growth per share
  - Multiple Impact – based on EV / EBITDA
- **(6) Leverage Effect** – net effect of debt used to acquire an investment

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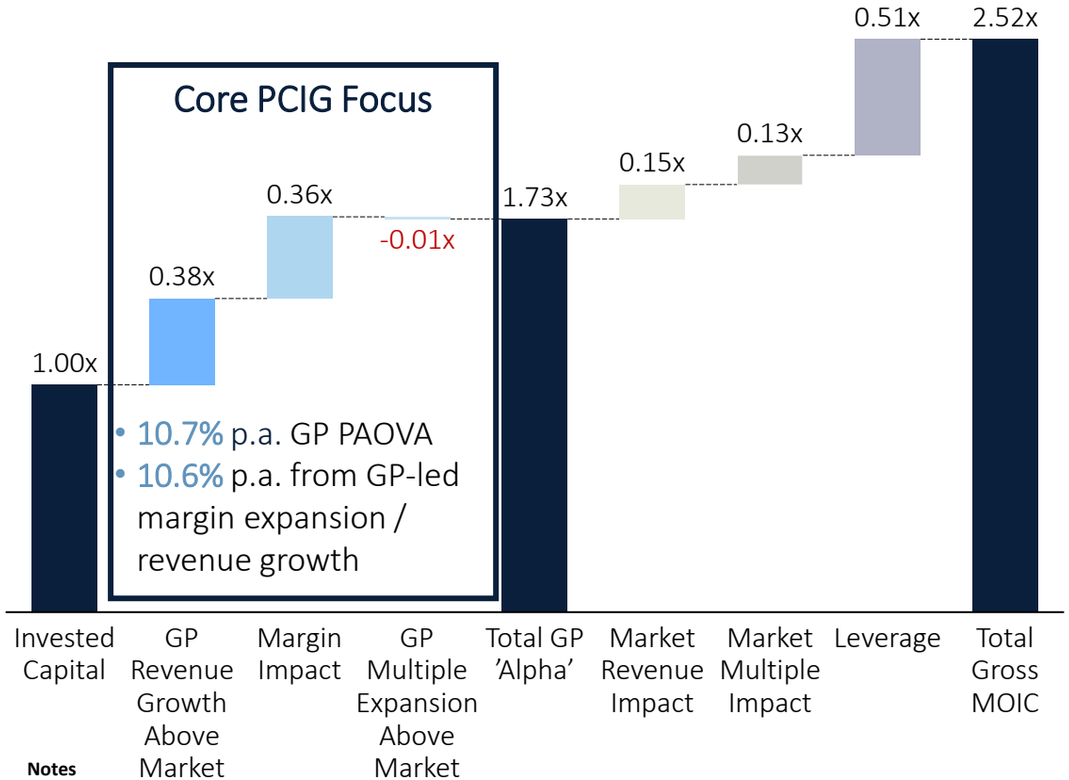
Large Cap – PCIG PAOVA Assessment

Partners Capital chose large cap sponsor A over large cap sponsor B – despite nearly identical headline returns – because we attributed >3% per annum more performance to manager skill. We view above-market revenue growth and margin expansion as the two most repeatable forms of value creation.

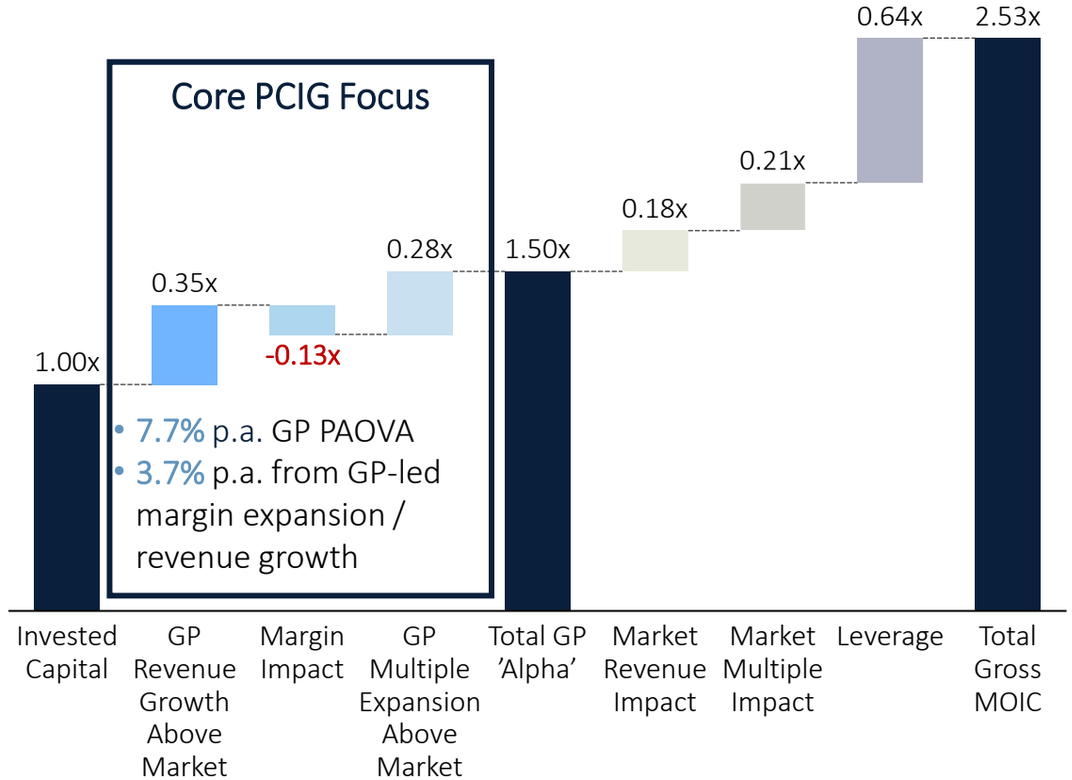
Components of PCIG PAOVA

Average Gross MOIC – Deals with >2 years' maturity

Large Cap Sponsor A – PCIG Invested



Large Cap Sponsor B – PCIG Did Not Invest



Notes

1. Source: Portfolio sheets of two sponsors, both sponsors as of 06/30/22; Bloomberg for public market revenue growth and EBITDA multiple growth by sector. Excludes a number of deals where data is not available on all elements
2. Margin Expansion: Represents (Change in EBITDA Margin from acquisition to exit) x (Revenue at exit) x (EV/EBITDA multiple at exit) Top-Line Growth: Represents (Change Revenue from acquisition to exit) x (EBITDA Margin at acquisition) x (EV/EBITDA multiple at exit); Multiple Expansion: Represents the change in the valuation multiple of trailing EBITDA from initial investment to exit, multiplied by entry EBITDA. Per annum data is compounded by the average duration.

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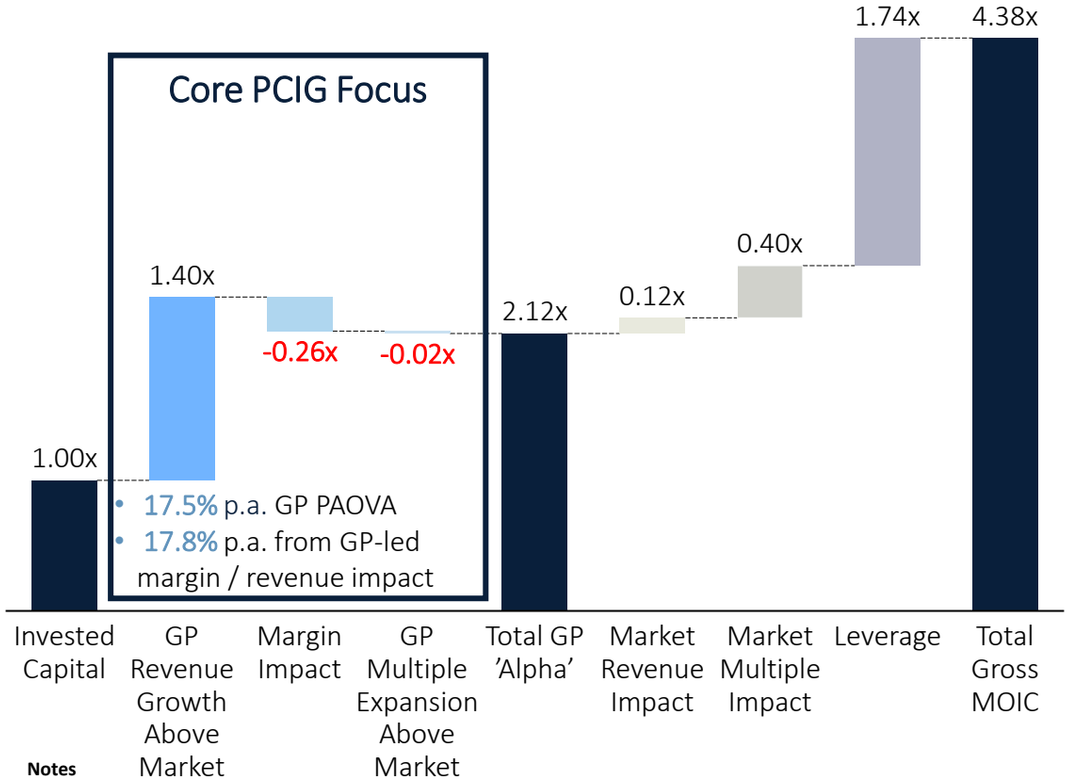
Middle Market – PCIG PAOVA Assessment

Partners Capital chose Middle Market Complex Situations sponsor A over LMM Complex Situations sponsor B (a spinout of Sponsor A) because it generated c. 4% more GP alpha, despite investing at larger deal sizes where PAOVA is often more challenging. In both cases, returns were primarily driven by outsized revenue growth funded with debt.

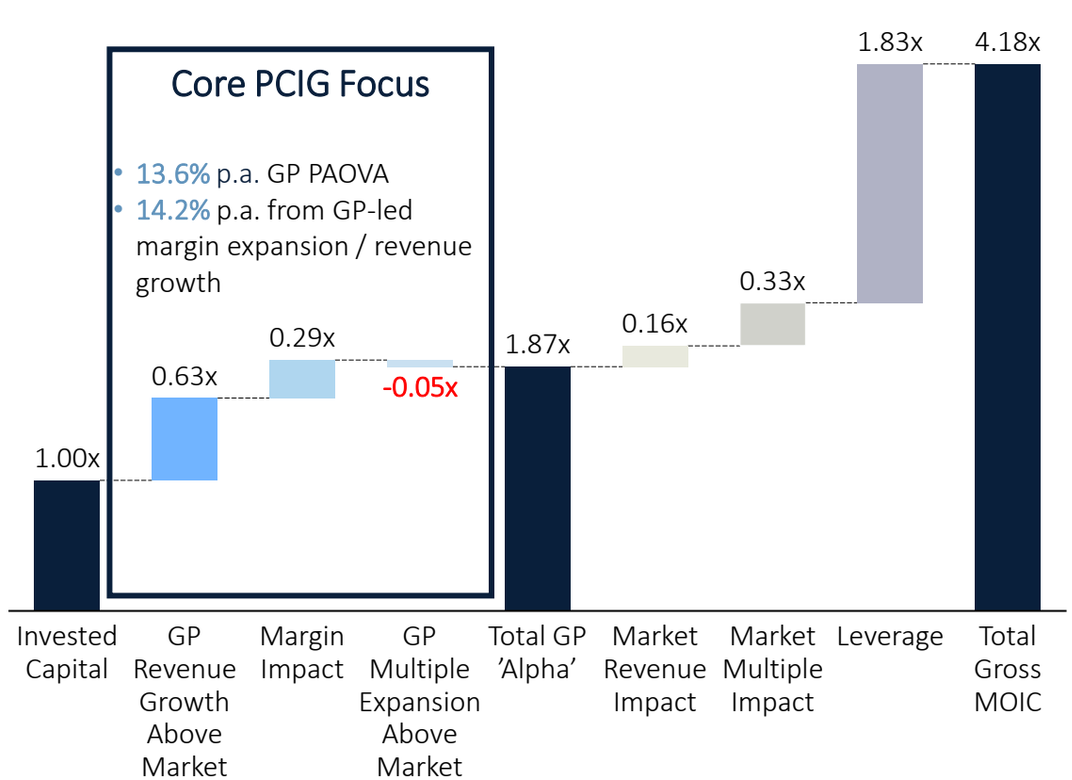
Components of PCIG PAOVA

Average Gross MOIC – Deals with >2 years' maturity

Middle Market Sponsor A – PCIG Invested



Middle Market Sponsor B – PCIG Did Not Invest



Notes

1. Source: Portfolio sheets of two sponsors, Sponsor A as of 12/31/21; Sponsor B as of 06/30/22; Bloomberg for public market revenue growth and EBITDA multiple growth by sector
2. Margin Expansion: Represents (Change in EBITDA Margin from acquisition to exit) x (Revenue at exit) x (EV/EBITDA multiple at exit) Top-Line Growth: Represents (Change Revenue from acquisition to exit) x (EBITDA Margin at acquisition) x (EV/EBITDA multiple at exit); Multiple Expansion: Represents the change in the valuation multiple of trailing EBITDA from initial investment to exit, multiplied by entry EBITDA. Per annum data is compounded by the average duration

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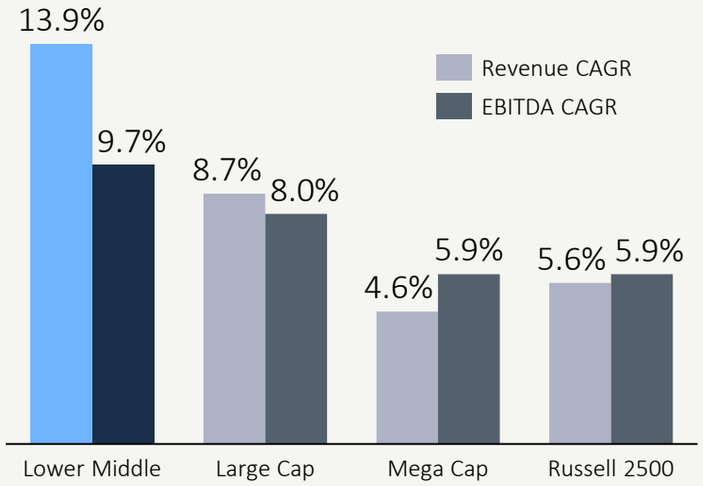
Lower Middle Market / Middle Market Buyout Opportunity

Faster earnings growth, lower leverage, more dispersion

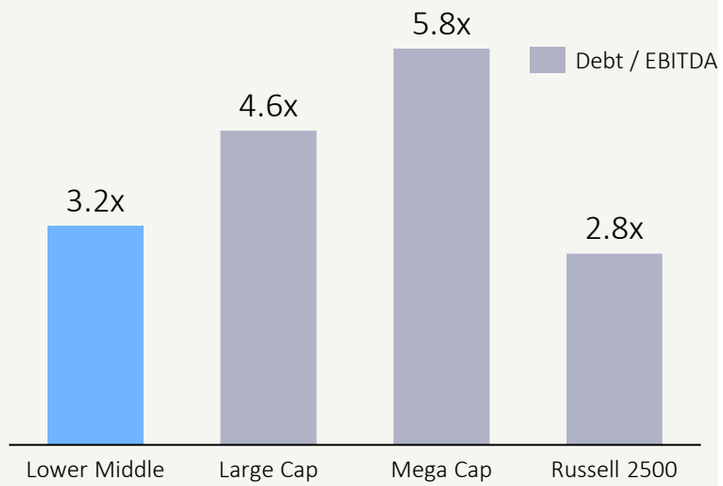
LMM / MM buyouts have c. 4% higher per annum EBITDA growth than Mega Cap deals or public markets…

Avg. Annual Rev. and EBITDA Growth, 2008-2020



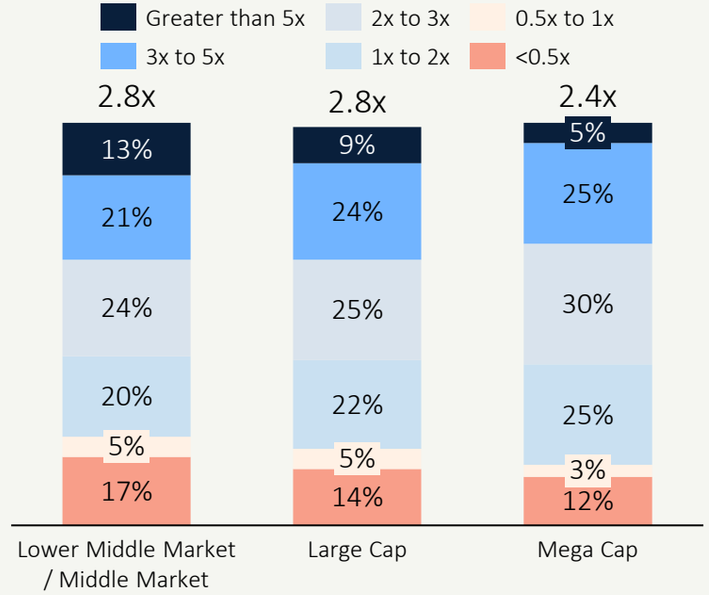
…With lower leverage levels than larger PE deals

Average Leverage Multiple, 2000-2020



…And stronger <u>hypothetical</u> potential for outsized performance by deal size

Average Gross Cash Multiple by Company Size, March 2022



Notes

1. Source: Cambridge Associates, US Private Equity Looking Back, Looking Forward: Ten Years of CA Operating Metrics, November 2022. Company sized based on enterprise value at acquisition: Lower Middle Market / Middle Market defined as <$250M of EV, Large Cap defined as $250M-1B EV, Mega Cap defined as deals with >$1B EV; includes sample of c. 1,600 deals

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Private Equity Return Expectations (updated January 2023)

Illustrative Leveraged Buyout (LBO) modelled market returns which highlights the critical role of earnings growth to investor returns

Model Assumption	Large Cap / Mega Cap Buyout Transaction	Lower Middle Market / Middle Market Buyout Transaction	Lower Middle Market / Middle Market Buyout Co-Investment
Entry Multiples	13.8x	9.7x	9.7x
Exit Multiples	13.8x	9.7x	9.7x
Debt / EBITDA Multiple and Cost of Debt	6.4x	4.5x	4.5x
Cost of Senior and Sub-debt	10.0%	12.0%	12.0%
EBITDA CAGR over 5-year hold period	7.0%	9.7%	9.7%
Fund Fees: Management / Performance	1.5% / 20%	2% / 20%	0% / 0%
Net Cash Multiple	1.7x	2.0x	2.4x
Net Cash IRR	10.1%	14.1%	19.6%

Notes

1. Other assumptions in the model not shown above: EBIT % of EBITDA = 70% for MM and 80% for Large Cap; Tax Rate = 21%; 5 year holding period.
2. Entry multiples: Average purchase multiple for large cap US buyouts from Preqin Asset-Level Benchmarks (via Colman Research) for deals with $1-5B of entry TEV in 2022; and Middle Market buyouts from GF Data May 2022.
3. Assumes buyout multiples remain constant throughout the hold period.
4. Debt/EBITDA Multiple and Cost of Debt: Average purchase multiple for large cap US buyouts from Preqin Asset-Level Benchmarks (via Colman Research) for deals with $1-5B of entry TEV in 2022; Average US debt / EBITDA level for $100-250M EV deals from GF data (May 2022)
5. Cost of debt for MM is 10% and Cost of Large Cap debt is 12% based on recent data from a Partners Capital leveraged lender in the US (November 2022).
6. EBITDA CAGR over 5-year hold period: Based on 2008-2020 average by equity investment size from Cambridge Associates; US Private Equity Looking Back, Looking Forward: Ten Years of CA Operating Metrics, November 2022. Lower middle market / middle market is defined as <$250M TEV (Cambridge's small cap cohort), large cap / mega cap is the average of $250M-$1B and >$1B (Cambridge's mid cap and large cap cohorts)
7. Private Equity Fund Fees: Based on fee rates seen in recent fundraises.

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Private Equity Value Creation – Which Approach is Best?

	Deal Team Driven / Advisor Network Model		Operating Partner Model		Internal Portfolio Group Model	
Model	No Advisors	Advisors	Generalist	Functional	Functional	Consulting-Based
Description	• Similar to public equity investing "security selection" – relies on a set of insights about the investment, with any improvements driven by the deal-team	• External network of senior advisors that assist in sourcing and usually take a board seat • Incentives could incorporate having the advisor invest in the fund or a small equity incentive in the company	• Single layer of executives on the PE firm's payroll with generalist expertise • Involves heavy monitoring against KPIs and milestones	• Single layer of executives on the PE firm's payroll with functional expertise • Typically paid consulting-type fees and have project-based involvement across many portcos	• Similar to Operating Partner Functional model but executives may receive meaningful carry and have a deeper level of alignment and experience with the PE firm	• Multilevel group of operating professionals on PE firm's payroll • Heavy involvement throughout the life of the investment
Resource Type	• Limited – relies on the strength of the investments	• Former CEOs and CFOs	• Former senior executives	• Former executives and consultants with functional expertise	• Former executives and consultants with functional expertise	• Large operating team of consultants with comparable compensation to deal team
PCIG Conviction in Model						
Percent of Market[1]	27%		55%		14%	4%
PCIG Commitments	11% (8% with one sponsor)		15%		46%	27%
Illustrative Firms		H.I.G., Golden Gate, Carlyle	Thoma Bravo, CD&R	American Securities, Apax, Tenzing, Center Rock	Audax, Francisco Partners, L Catterton, Rallyday	Bain, Vista, Gemspring, Platinum

Notes:
1. Source: AlpInvest, From Financial to Operational Engineering: Organizational Aspects, November 2021; Sample includes 3,949 deals from 212 buyout and distressed debt funds raised between 2004 and 2015:

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Resourcing for operational value creation
Various models applied at our highest convictions managers

- It is not clear that one model wins out over another. Our highest conviction PE partners have very different models. We do have a bias toward the Vista model where sector expertise creates the opportunity for more in-house operating expertise.

Bain Capital

- Senior Operating Advisors
- Operating Partners
- Primarily In-House Consultants augmented with Functional Experts
- External Consultants / Functional Expertise

Deal Team

Vista

- Senior Operating Advisors
- Operating Partners (Have OP type resources but they operate out of internal consulting group)
- In-house consultants/Functional Experts (100+ people)
- External Consultants/Functional Experts (only on as needed basis)

Deal Team (arguably less critical / differentiated contributions compared to internal consulting group)

CD&R

- Senior Operating Advisors (part-time but important role advising and monitoring management teams)
- Operating Partners (heavily relied on both at investment evaluation and deal management stages. Role has near-equal weight to investment partners)
- In-House Consultants / Functional Experts
- External Consultants/Functional Experts (only on as needed basis)

Deal Team (co-sharing of responsibilities with operating team)

Notes

1. Source: PCIG analysis

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PE firm relationship with management as core driver of PAOVA

The relationship between management and the private equity firms operating partners is key to successful PAOVA and unlocking value

Everything starts with a shared vision	One of our key buyout funds starts every relationship with a newly acquired portfolio company's management team with an exercise focused on revisiting the company's ""purpose" which may or may not have moved on from the founder's original purpose or the previous owner's view. Purpose moves to vision and mission and on to strategy. If you aren't on the same page on all of these from the outset, then progress will be disappointing.
All LBOs are highly complex situations. No exceptions.	Business entities of the size and history of a typical private equity buyout are complex organisms with tremendous management challenges in steady state, and the management challenge is only exacerbated when undergoing transformational change. External interference from a third party who is not an integrated component of the leadership structure can push the complexity and challenge into the realm of the impossible.
Management Empathy	On day one of the transaction, management has new owners with tremendous ambition for the company which are here to help but are outsiders. Managements' starting assumption is often that this won't work. Empathy for this mindset from theGP is the key to success in the early days of the relationship.
Replacing Management.	Success comes from two viable strategies with many variants of each in between the two extremes. One strategy is to replace incumbent management with known management teams who understand the drill and process of working with the PE firm. This is the "Vista" model in the software buyout space. The greatest cost to this strategy is the disruption to the business of new management unfamiliar with customers, products, regulation, manufacturing, distribution, culture and much more. This is a big risk. However, many firms have made this work, but they are in the minority. The universe of available deals for this strategy is limited to those businesses which can survive the complete "plug and play" replacement of management.
Retaining Management	The other successful approach is to retain incumbent management but create a shared vision of full potential in the courtship phase which can be a matter of years before the deal is consummated. In many ways the PE firm is buying the team first and the company next. Savvy PE firms with the "keep management" strategy must be much more selective of the companies they buy and be as certain as they can be that they can work with a management team they have never worked with before. The universe of "good" acquisitions for the keep management strategy is limited to those where the marriage of two firms can last the life of the full potential plan. Thoma Bravo is an example of successful firm pursuing this strategy.
Most firms are in the Middle	Most PE firms play in between these two extremes, and one could argue that the most successful have both playbooks and an infinite set of permutations in between. Replacing just one or two senior executives is far less risky than the full "replace management" model. The ambidextrous PE firm has a much larger universe of companies available to acquire. But few firms have managed to be fully flexible, in part, because the PE firm skill set and cultures vary at the two ends of the spectrum.

Notes

1. Source: PCIG analysis

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Lessons Learned about resourcing for POAVA Activities

There must be a clear change agent and sufficient quality resources with the right specialist attributes focused on the biggest drivers of value.

1. There must be a clear Change Agent	• This is the individual who owns the transformative process and has sufficient influence to effect change. This could be a "Chief of Staff" or Project Management Office (PMO). This role can be filled by different people i.e., a CEO, operating partner, or even financial partner. However, it is unlikely to be someone previously involved with the company before the transaction.
2. Quantity of resources	• In theory full potential can be realized through (upgraded) management and hiring the right teams underneath them. However, large teams of GP-side resources can be deployed to accelerate the change process. These people are highly aligned and have no learning curve, seamless communication with the GP and can reach deep into portfolio company organizations. • Logically, there is a minimum efficient scale to internal operating teams which favors large PE firms. However, it is still unclear whether the lower hanging fruit in smaller buyouts allows for smaller PE firms to match (or even exceed) the PAOVA of larger firms even with low levels of operating resources.
3. Quality of resources	• Operating team members favor prior industry backgrounds, experience in a PE environment, and an ability to reuse the same people across portfolio companies. Industry veterans with previous consulting backgrounds are ideal. • GPs find it easier to find good specialists for specific tasks than good all-around executives ("athletes").
4. Specialist Capabilities	• For senior external advisors, ex-CEOs of companies in the same industry sector or with transferrable skills (e.g., a retail executive on board of a dental practice rollout) have been most effective. • A focused strategy plays to more operating value added. E.g., having deals that present consistently the same business problems that need to be solved helps immensely in terms of allowing for a well-aligned operations team. Specialization along this dimension is much more important than focus on a specific industry sector.
5. Resources should be focused on the biggest multiple impact	• Most GPs focus on fixing companies in trouble and trying not to lose capital ("a no donuts policy") i.e., operating teams are distracted and drawn to troubled companies where the opportunity cost of those resources is very high. • An alternative philosophy is to focus resources on where the fund value can be most effected; i.e., resources should be focused on larger portfolio companies which can be moved from a 2.5x MOIC to a 4x ahead of a smaller one that can be moved from 0.5x back to 1.0x. GPs should direct resources behind potential homeruns and do what you can on obvious losers without distracting valuable resources. Think about the opportunity cost of the operating team.

Notes

1. Source: PCIG analysis

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Portfolio company business models that have greatest PAOVA potential

Companies with similar fixable issues, where frequent iterative improvements can be made, and in fragmented markets

Understand which portfolio company business models allow for *rapid-cycle iterative* improvements

- E.g., unit-based businesses where it is possible to fully optimize the model before wider roll-out and where systematic A/B testing across customer base is possible.
- At the other end, avoid models with long sales/customer cycles where it's going to take too long to figure out whether something is working or not. Avoid investments based solely on slow burn trends (e.g., embedded replacement demand) as these tend to disappoint.

Fragmented and highly decentralized business models accommodate "buy and build" strategies

- This makes aggressive roll-ups strategies possible with low integration issues. Most businesses can't grow fast enough to be true "homerun" investments purely on an organic basis and so add-ons are as close to structural returns as one can get in PE.
- This also makes it possible to sell a portfolio company and "do it again" right-away.

Industries where companies share similar fixable issues for "repeatable PAOVA"

- E.g., product-centric, founder-led businesses that don't know how to run sales properly
- E.g., industrial companies that neglect highly profitable aftermarket sales opportunity
- E.g., software company where staff can be moved to lower cost geographies

Notes

1. Source: PCIG analysis

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The six key capabilities for PE value creation

Smaller firms cannot afford to build this capability entirely internally and often outsource parts of their value creation capabilities

- For the most operationally focused buyout firms, we see their value added coming from outsized involvement working with portfolio company management on one or more of the six areas below.
- We believe no firm excels at all these activities, but the top firms have demonstrated skills in at least three. Whilst numbers 1, 3 and 5 are becoming common PAOVA features ("hygiene factors"), we believe the value adding outliers excel at numbers 2, 4 and 6.

	Source of value added	What can be outsourced
1.	Pre-acquisition business plan development (in due diligence)	Consultants such as Bain or their sector specific equivalents can produce high quality business plans as part of pre-acquisition due diligence studies.
2.	Expectation setting process	Not outsourceable
3.	Governance, board and monitoring	Not outsourceable
4.	Assessing, recruiting and building a great management teams	Executive recruiting firms have developed private equity portfolio company assessment practices and specialist human capital consulting firms are armed with psychological testing approaches that have proven effective
5.	Full potential development plans and execution (including strategic acquisitions)	Consultants such as Bain or their sector specific equivalents are often hired after acquisition to work with the PE firm and company management to develop full potential plans.
6.	Functional expertise injection - focus is on improving the existing operations	Specialist consultants exist in most areas of functional expertise including supply chain management, Asian sourcing, digital transformation, etc.

Notes

1. Source: PCIG analysis

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Agenda

1. PAOVA matters more today than ever
2. Organizational resourcing models for deploying PAOVA
3. **Key capabilities required for extraordinary value creation**
4. How Partners Capital Adds Value to PE firms in which we invest

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The six key capabilities for PE value creation – *One page summary*

For the most operationally focused buyout firms, we see their value added coming from outsized involvement with portfolio company management on one or more of the 6 areas described below. We believe no firm excels at all of these activities, but the top have demonstrated skills in at least three. While #s 1, 3 and 5 are becoming common PAOVA features, we believe the top PAOVA outliers excel at #'s 2, 4 and 6.

1. Pre-acquisition business plan development (in due diligence): Deal due diligence needs to be driven toward the development of as comprehensive a five-year business plan as possible. While this leads to the creation of plan for the first 100 days, the impact on total value creation is driven mostly from the strategic insights gleaned from due diligence. Past PE firm experience in the sector, third party experts, operating partners and company management will define the company's full potential. The main differentiator between firms is the insight and value creation levers developed early in due diligence that allow the team to move faster and with higher conviction.
2. Expectation setting process: After a change of ownership, the level of management uncertainty skyrockets and it is critical to engage in extraordinary levels of communication around company vision, strategy, interim targets, deadlines and management changes. A symbiotic relationship between buyout firm and management requires full alignment on objectives, critical deadlines and milestones to achieving operating targets with clearly defined roles and responsibilities.
3. Governance, board and monitoring: Achieving a company's full potential is often blocked by poor corporate governance, especially where founders are still involved or by short-term earning focus in the case of previously public companies. Best practices generally involve smaller boards, clarification of senior management and board member roles and milestone driven board monitoring of strategic projects.
4. Assessing, recruiting and building great management teams: Value added is driven from the combination of more successfully assessing management, upgrading management and making them more effective through strong governance. Different PE firms have different strategies as policy or track record of replacing management can affect the success of winning a given transaction. Employing specialist internal talent assessment and management specialists, with particular skills in assessing management during the diligence phase (psychological tests, etc) can deliver more value added in the long term. Changes to the incentive systems is the rule rather than the exception, tying remuneration to milestones.
5. Full potential development plans and execution (including strategic acquisitions): Buyout firms see much greater potential in the LBO than their previous owners and this is where the best firms turn that vision into results. They understand from competitors and specific analysis what the full value can be and most commonly realize that full potential through their assistance in major strategic projects (breakups, spinouts, roll-ups), turnaround programs (factory shutdowns, layoffs), and expansion initiatives (adjacent product lines, new markets). The buyout firm brings the catalyst, expertise, capital and confidence.
6. Functional expertise injection - focus is on improving the existing operations. The most value-added buyout firms provide their portfolio companies with a combination of in-house and third-party functional specialists including talent/HR, sales and marketing, product development, pricing, IT, purchasing/supply chain management, working capital management, manufacturing optimization, brand building, international expansion, etc.

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1. Pre-Acquisition Full Potential Business Plan Development

Deal due diligence needs to be driven toward the development of as comprehensive a 5-year full potential business plan as possible. While this leads to the creation of plan for the first 100 days, the impact on total value creation is driven mostly from the strategic insights gleaned from due diligence. Past PE firm experience in the sector, third party experts, operating partners and company management will define the company's full potential. The main differentiator between PE firms is the insight and value creation levers identified early in due diligence that allow the team to move faster and with higher conviction in the company sales process than the competing bidders.

Best Practices	
1	Detailed sector opportunity analysis (usually performed prior to proprietary approach or immediately upon auction invite)
2	The deal must fit neatly in the PE firm's "wheelhouse" in terms of what they describe as their target deal in terms of size, sector, degree of turnaround, etc.
3	Integrated due diligence with senior operating resources and external consultants with specialty experience when necessary focused on business full-potential assessment covering growth, efficiency, M&A, management, financial restructuring, etc.
4	Prepare draft 3-5 year full potential business plan with supporting value creation analysis
5	Developing detailed plans for 2-4 "mission critical" strategic or M&A and operating initiatives
6	Develop 100-day Plan focused on management changes, governance, reporting and key strategy project planning

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100 day plans

In our experience, the first 100 days after a private equity firm takes ownership of a company are critical to long-term value creation as they set the tone and pace of expected change. A 100-day plan outlines the most urgent value-creation steps that firms can take as soon as the deal closes. The objective is to identify key value drivers and create a roadmap to make improvements in those areas.

Primary 100-day plan objectives	
1	Define a clear strategic direction for the company. Value creation always comes back to strategy. Where, exactly, does the firm want to take its newly acquired business, and how does it plan to get there? Answering these questions helps focus everyone's vision, from the private equity firm executives and its staff, to the CEO and employees of the portfolio company.
2	Build an organization that will help realize the defined strategy. The only way the strategy can be implemented properly is if the right people, structures, and processes are in place. Everyone should be working toward the same goal and know their roles.
3	Put in place the most effective corporate governance. A new board including two or more PE firm GPs/Operating Partners is established usually on day 1 with the confirmed executive management members to follow. Roles should be made clear and the governance process's cadence should be communicated. Most governance will happen outside of and in-between formal board meetings.
4	Move Company Financial Reporting onto PE firm system. For smaller companies, this may involve wholesale move to the PE firm reporting package, but for larger companies, this generally involves consolidating existing system output into the PE firms' reporting package.
5	Translate Strategy into a 3-5 year Business Plan and revise current year budget to fit year one. Management and PE firm board members take the pre-deal draft 3-5 year plan and validate assumptions, make necessary revisions and get the board to approve it.
6	Identify a series of initiatives for short-term cash generation. Growing the business may be the long-term goal, but how do you fund the journey? While you do not want to sacrifice long-term opportunity for short-term gains, you do want to start making a return on investment sooner rather than later. Carefully assess the business, and identify places where it can achieve some immediate returns.
7	Identify and prioritize opportunities to improve operational performance. What are the value creation drivers that will help the company grow in the medium-term (e.g., improving the supply chain, greasing the R&D pipeline, or overhauling sales and marketing programs)?
8	Build a process to ensure successful implementation. None of this can be done without a detailed process that everyone can follow for setting deadlines, allocating resources and monitoring progress. Private equity firms should clearly define measures and targets so that the portfolio firm's CEO, staff, and others have something concrete toward which to work

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2. Expectations-setting Process (1 of 2)

After a change of ownership, the level of management uncertainty skyrockets and it is critical to engage in extraordinary levels of communication around company vision, strategy, interim targets, deadlines and management changes. A symbiotic relationship between buyout firm and management requires full alignment on objectives, critical deadlines and milestones to achieving operating targets with clearly defined roles and responsibilities. This is a critical output of the 100-day plan.

Best Practices	
1	Day 1 meeting (before or after official close) to assemble the right group of top managers to introduce PE firm Operating Partners team and board directors. Main topic is respective role clarification including that of PE firm appointed Chairman (if applicable). Ample social time so both side get to know each other well.
2	Announce to management what is known and what is not known, and how the initial process will work with a focus on frequent meetings in the first 100 days. Be clear on who does what with clear signal that management is in the drivers seat and the PE firm role is value added activist shareholders with valuable additional resources to catalyse progress on strategic projects.
3	Conduct an employee survey and town hall meeting with portfolio company employees early after closing
4	Line up management to meet and talk to other PE firm portfolio company management teams about the process and what process works best; helps to establish trust.
5	Pick up with management where you left off pre-deal on the strategic plan development – clear vision and goals. Management drives this with heavy input from PE Deal Team and Operating Partners (Board members). See step 5: Full Potential Plan Development.
6	Hold multiple away-days with management teams until strategy is translated into strategic initiatives and those projects are on autopilot with clear resources and deadlines. Be clear on process for project tracking.
7	Financial Reporting: introduce portfolio company financial reporting package and process; how links to in-house systems. CFO matrix into PE firm finance team.

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2. Expectations-setting Process (2 of 2)

A symbiotic relationship between buyout firm and management requires full alignment on objectives and clear critical milestones to achieving operating targets with clearly defined roles and responsibilities.

PE Team Member	Role and Facts to be clarified (expectation setting)

Deal Team Partner	• Involvement post acquisition:
	  ○ Board Director?
	  ○ Strategic Value add role? E.g., M&A?

Operating Partner(s)	• Board Role • Mentor model • Specific expertise and value to be added • How incentivised?
Chairman of the Board	• Executive/ non-executive and what this actually means. Full time? • What other boards, responsibilities? • How active? • Responsible for all aspects of good governance • Role on Strategic Projects, Recruiting • Term • Form of incentives
In-house or external consultants	• Who is their client? • Specific project scope and timing • Cost to portfolio company • How results will be assessed?
Senior Advisors	• Who are they mapped onto inside the Company? • Be clear on what their specific contribution is expected to be • Management should know what defines success for the advisor and how incentivised • Be clear who is paying them (is this free advice to management?)

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3. Governance– lessons from 4 decades of LBO case studies

- Governance generally, and the board specifically must be fit for purpose for any company. In the case of private equity portfolio companies, the role of the board is to deliver the incremental value from being the best owner vs the previous owner. PE is very high-cost ownership for the ultimate owners (LPs). The PE firm's existential proposition is that they are the best owner for the Company by virtue of the value that they can help create.
- Therefore, the relationship between the PE shareholders and management is to be a major source of shareholder value creation. If management is 99% of the value creation and the owner is 1%, then PE firms should not own the asset.
- This shareholder–management relationship is a hands-on day to day relationship that lives mostly outside of the board room. The monthly or quarterly board meetings are mostly about milestone reviews against the full-potential plan. The board members are present between meetings where most of the action takes place.
- The thesis underpinning LBOs is often all about the change in governance as managers become owners and time frames shift from short term to long term (the latter in the case of public to private ownership).
- Achieving a company's full potential is often blocked by poor corporate governance, especially where founders are still involved or by short-term earning focus in the case of previously public companies.
- Best practices generally involve smaller boards, clarification of senior management and board member roles and milestone driven board monitoring of strategic projects.
- Boards of PE portfolio companies can often times systematically take a coleader role with the CEO on important topics; engaged directors not only help set strategy and manage performance but also master the details needed to stress-test, reset, and dramatically improve the business.
- The learning from past successful LBOs related to corporate governance changes after the buyout depends on whether it was a public to private acquisitions, corporate orphan, secondary purchase or purchase from the founding entrepreneur or a multi-generational family business. We try to define below the end point governance structure regardless of from where it started.
- Where the CEO is changed, the changes to the board must compensate for a CEO who has less familiarity with the business.
- CEO and management team equity holding average between 15 to 20%.

Good governance in private equity is about striking the right balance between more formal governance approaches and the need to move quickly and focus on value-creating activities

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3. Governance - Board Size and Composition

- While there is no uniform board size or composition, the boards of PE portfolio companies usually include five to seven board members including the Chairman, CEO, CFO, the PE owner "mid-career deal partner," one other member of the PE firm and, optionally, one or two specialist independent directors. The composition is typically 100% "value-adders." There is typically an independent chair, who is frequently an ex-CEO, often from a much larger company than the portfolio company in question, but from the same industry. The other non-executive directors (NEDs are experienced external nonexecutive directors with specific know-how in the company's core sector or in a functional topic, such as digital transformation or a new product/market extension that is key to the company's future.

- Moving from either a public company or private founder owned company, the board size typically decreases on average by 15% and the presence of outside directors is drastically reduced, as they are replaced by individuals employed by the private equity sponsors.

- PE portfolio company boards are generally younger and smaller than public-company boards, thereby increasing each individual's engagement. This engagement and PE company board members' bias toward active ownership are what drive much of the "alpha"—outperformance relative to quoted peers—in any deal.

- Private equity sponsors are more present on the boards of the more difficult deals, presumably because these deals need more expertise, monitoring and advice. More difficult cases coincide more often in the situations where the CEO is changed at the point of acquisition. These may be the forced CEO change cases where a large overhaul of the company has been necessary due to unsatisfactory performance of the management, or the voluntary CEO change cases where losing the CEO who is very familiar with the business constitutes a significant challenge to a successful restructuring of the company.

- Greater involvement of private equity sponsors after the deal closes tends to reduce CEO turnover. This is explained by the fact that the private equity owner is more likely to look into and understand the reasons for financial underperformance and not fire CEOs for factors outside their control (with public boards evidencing the opposite).

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Private Equity Portfolio Company Board Size and Composition

Independent Chairman

- Usually a former CEO of a larger company in the same sector as portfolio company

Management	Owners	Independent Specialist *
CEO	PE Sponsor Deal Exec	NED #1 – e.g. Digital Transformation Specialist
CFO	PE "Operating Partner"	NED #2 – e.g. International Sales and Marketing

⇧

Active "value adders" in areas of greatest strategic importance

*Usually from PE firm network of "Operating Partners" (external to PE firm), on retainer, usually paid with equity + cash

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3. Governance, Board and Monitoring (2 of 2)

The thesis underpinning LBOs is often all about the change in governance as managers become owners and time frames shift from short term to long term (the latter in the case of public to private ownership). Achieving a company's full potential is often blocked by poor corporate governance, especially where founders are still involved or by short-term earning focus in the case of previously public companies. Best practices generally involve smaller boards, clarification of senior management and board member roles and milestone driven board monitoring of strategic projects.

Best Practices	
1	Interview senior management to understand the current roles of all key executives and board members and to hear what was working and not working under previous ownership in terms of effective decision-making.
2	Review a subset of past board (or divisional management) reports and minutes to gain insight into how complete the business information sets were and how formally board and management meetings were run.
3	Review overall organizational design to assess whether it has outgrown the original matrix of geographic market and business unit and functional unit. Think about the right number of layers and about moving to a "Team of Teams" structure (McChrystal). Identify any desired changes and implications for key management positions and roles.
4	Create new board of directors from a "clean sheet of paper" seeking a small effective group of executives and non-executives (PE firm GPs and Advisors). Appoint independent Chairman (see step 4: Building Great Management Teams). Create subcommittees to be responsible for decisions where full board is not needed.
5	Board approves 5-year plan, key strategic projects and is accountable for seeing that resources are in place and milestones are met for each strategic project.
6	Ensure strict adherence to regular board meeting attendance (even though many of the key decisions are made outside of formal board meetings). 12 meetings a year are not unusual with frequent meetings in between.
7	Ensure management has significant economic upside and downside in the business succeeding with CEOs having between 3-5% of the equity of the business (less in large transactions). Ideally, the management team will have invested personal capital in the business that is theirs to lose.
8	Deploy RAID - like decision making responsibility allocation without complicating decision making. Embrace all good governance policies with a bias toward leaving decision-making close to the facts and embrace single-point accountability.
9	Make changes in the CEO on a timely basis. The most common learning we hear from PE GPs is that "we didn't change the CEO soon enough."

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4. Assessing, Recruiting and Building Great Management Teams

Value added is driven from the combination of more successfully assessing management, upgrading management and making them more effective through strong governance. Different PE firms have different approaches and the track record of replacing management which can affect the success of winning a given transaction. Employing specialist internal talent management specialists, with particular skills in assessing management during the diligence phase (psychological tests, etc.) can deliver more value added in the long term. Changes to the incentive systems is the rule rather than the exception, tying remuneration to milestones.

Actions	
1	Start with the CEO: DD will have determined the keep or replace decision and made significant progress on finding a replacement before deal close. The best firms have a "bench" of proven management from previous deals to source new team members. Ensure CEO and Chair are the right fit (see Chair role in Governance section).
2	Commence top management assessment process with CEO and Chairman driving together, involving comprehensive set of interviews with second tier management (about the top tier). Employ best-in-class management assessment (Top Grading, psychological testing or similar). Heavy referencing via third party service. Make well evaluated but quick keep/replace decisions for top 4-6 posts. Build a team with optimal diversity of perspectives/approaches, complementarity of styles but with a common set of values. ("brakes and accelerators")
3	Sector focused recruiting process using PE firm network, again with bias to recycle past management teams in data base or on retainer. Build strategic relationships with core executive search firms
4	Commit to the new management team: Draw a line separating assessment period from "Day 1" kick-off for the chosen new management team, having been "rehired". They have to know they are "it" That being said, Chairman and Operating partners continue to monitor management, particularly legacy management at the onset of a new deal. Identify quickly who will make it and who won't, which people will support change and help implement the plan and which ones are resisting.
5	Be aggressive in making changes. A common lesson we hear is that PE GPs waited too long to replace the "question marks" or weak contributors. Performance issues are quickly addressed. Missed targets cannot go without consequences for management.
6	Management incentives fully aligned with shareholders'. PE Firm should draw on its in-house framework for matching the right incentive system to the business and management team.. Incentives are often tied directly to defined outcomes from strategic initiatives. (see next page)
7	Provide ongoing proactive talent management advice to full portfolio company management team, not just HR Director of portfolios company. (See Step 6 on Injecting functional expertise)
8	Install best practice internal performance review system at all levels of the company. Performance evaluations informed by 360 feedback and balanced against financial and strategic objectives. External culture studies are invaluable (e.g., Denison Consulting)
9	Have documented succession plan for unexpected departures, with named internal or external candidates. Plan B management team.

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4. Assessing, Recruiting and Building Great Management Teams
Anecdotes on Management Selection from our PE GPs

1	**Having right CEO/management is widely cited by GPs as most important success/failure factor** • Most common cites lesson from PE GPs is that "we didn't change management soon enough." • There is a reduced need for operating partners if management selection goes right
2	**Seek to work with management teams one has invested behind previously** • Requires a narrowly focused specialist model as outside of CFOs most other functions are difficult to port across industries.
3	**Second best is to have a very comprehensive management selection process** • Knowing how to pick management is a vitally important PE GP skill, and one that needs to be worked on over time. Many veteran PE GPs feel that skill in this area is elusive even after decades in the business. • Some larger firms are adding dedicated HR professionals (it is too early to point to quantitative results from such additions) • Increasingly, PE firms are using cutting edge evaluation processes (behavioral interviews, pre-identified key traits, psychological testing, day on the job, top-grading, etc.) • Match the management to the circumstances: e.g., find management with most past experience with key value-drivers and major strategic projects (points to hiring within industry sectors and not risking talented serial CEO to a new sector)
4	**Seek to work with management teams one has invested behind previously** • Have long term goals tied to short term measurable outcomes and tasks (e.g., Hoshin Kanri type methods) • Pick up signs (leading indicators) of underperformance before it shows up in the financials • Watch for "excuse-making" regarding short-term underperformance • Be quick to pull the plug if there is evidence current team isn't working. Have a bench/Plan B for management at all times.

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4. Great Management Teams have great incentive systems

Each buyout firm will have refined their incentives playbook on aligning management down to a few permutations of best practices below

Best Practices	
1	Find the right depth to take management equity. Top 4 - 5 in some cases. Top 20 - 30 in others. Focus on incentivizing 1) exactly as many managers as you need to drive the rest of the company while the GP is not there and 2) key resources the company can't afford to lose. Equity is often "wasted" on lower levels as the amounts per person are not material enough or the people who receive it are actually not in positions to influence outcomes.
2	Sweet equity should be structured to only be in the money if the GP makes at least a minimum hurdle return.
3	Structure ratchets tied to upside outcomes carefully, to avoid outcomes where management team get disproportionate and unjustified payouts from a "lucky" exit that wasn't due to their stewardship of the company. (e.g., peer group performance measures)
4	Pay equity as part of annual incentives with retention (vesting) features. 2x - 3x cash comp is typical.
5	Key individuals involved in strategic projects should have rewards tied to meeting milestones.
6	Ultimately the money can only help to have management feel good about working hard. That work ethic should be there without the incentives. Having the right plan, keeping it simple, communicating it clearly and ensuring the management believe in it are even more important to success.

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5. Full Potential Plan Development and Implementation

Buyout firms see much greater potential in the LBO than their previous owners and this is where the best firms turn that vision into results. They understand from competitors and specific analysis what the full value can be and most commonly realize that full potential through their assistance in major strategic projects (breakups, spinouts, roll-ups), turnaround programs (factory shutdowns, layoffs), and expansion initiatives (adjacent product lines, new markets). The buyout firm brings the catalyst, expertise, capital and confidence.

Best Practices	
1	First 100 day plan. This is about setting the pace and momentum for change and dealing with management and company-wide uncertainty and anxiety which follows an acquisition by a PE firm. It rarely embeds a clear view of the vision and optimal strategy for the company. This plan is holding the company together, putting management in place and driving the process of defining the long term strategy.
2	Create the joint management team/PE firm operating partner strategy development team. Pick up with pre-deal strategy and business plan and take a big step back to revisit the business model and the key drivers of value in the industry. With this in hand, re-evaluate the vision and strategy for the firm thinking very much in terms of what the full potential can be for the entity.
3	Define the vision and strategy for the business to get to full potential (aka "5-Year Plan"). Translate the gap between the value today vs the full potential value into priority strategic projects, quantifying what portion of the value accretion is expected from each strategic initiative. Narrow the list of strategic projects to what management resources can practically achieve, sequencing them to build management confidence. For each surviving project, define clear ultimate measures of success, interim milestones, resources, and management accountability. Define most likely causes of failure and build in safety valves and fall-back plans.
4	Resource strategic initiatives with a bias to line management driving and staffing. Engage PE firm operating partner and consultants in heavy doses on project which clearly would distract and handicap management from running the business day to day. Inject functional expertise from PE firm or outside supplier (see step 6: Injecting Functional Expertise). Consider need for Project Management Office or Chief of Staff to manage all projects.
5	Monitor progress against plan for each strategic initiative in formal systematic process. Identify weaknesses on team or insufficient resources and address. Persist in the face of what seems to be insurmountable obstacles, but know when to pull the plug or redirect. Seek input from full GP partner group for most challenging initiatives.
6	Celebrate milestone achievements and ultimate success.
7	Revisit the Strategy annually and don't be afraid to change course. Accept mistakes in the analysis, revisit and correct course. Use failures to get the benefit of learning to improve odds of success going forward. Craft the story for the next investor 12-24 months before planned exit. Think about action implications of this story.

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5. Key Success Factors in building the exceptional Full Potential Plan

Five key factors to map your action points

1	Have a clear view on what is easy vs. hard to fix
2	Focus on two-to-three key things to get right to make investment a success • Go deep on these in terms of DD and operational planning pre-closing, then relentlessly pursue them post-closing.
3	Think big with a vision for how a deal gets to 4x - 5x+ returns • Top quartile funds typically require several home runs deals – just going after singles doesn't get it done. • Need to start looking for the upside scenario in DD and be willing to go after them day one. • Most GPs are too risk adverse about reaching for upsides
4	Involve Operating Partners during due diligence • This helps instill a sense of ownership of the value creation plan
5	Speed and initial momentum is extremely important • In-depth diagnostics phase right after signing (pre-closing) to verify/draw out earlier due diligence findings (sometimes on proprietary situations this can be done during due diligence) • Work backwards from where company needs to be in a year, determine steps that need to happen along the way, sequencing, necessary resources, etc. and build a detailed 100-day / 365-day plan. • Find out ASAP who among management team will 1) embrace change 2) stay neutral 3) actively fight change. Get rid of 3rd group quickly.

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6. Functional Expertise Injection

The most value-added buyout firms provide their portfolio companies with a combination of in-house and third-party functional specialists including talent/HR, sales and marketing, product development, pricing, IT, purchasing/supply chain management, working capital management, manufacturing optimization, brand building, international expansion, etc.

Best Practices	
1	Each PE firm must think hard about where the largest functional gaps are for them to fill and whether these should be filled from management hires, PE-firm in-house experts or external consultants. Functional expertise can be injected in all three ways or any mix. • Smaller and generalist PE firms can rarely justify in-house expertise other than favoring individuals on the deal team or generalist operating partners who have more experience with specific functional value added than others (e.g., salesforce management, Asian sourcing, working capital management, etc.) • Larger firms and sector specialists will find it more natural to add internal functional experts and have the scale of opportunity across their portfolio companies to build out more substantial functional expertise. For example, software investors often have functional experts in converting to SAAS models, pricing, salesforce management and product development.
2	All PE firms are grappling with digital transformations, making sure their portfolio companies are the disruptors rather than the disruptors. Again, specialist firms may build this as an in-house functional expertise, but most generalist should turn to the most capable third-party IT talent for hire to deploy with their portfolio companies.
3	Use the full network of portfolio companies to bring together as an additional source of functional expertise –e.g., through " Councils" of portfolio company management on specific functions.
4	Over the longer term holding period, seek to hire, train and develop functional expertise inside the portfolio company as a core competitive advantage (part of the exit story).

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6. Functional Expertise Injection: long list of typical areas of expertise

Areas of broadly defined functional expertise vary widely depending on PE firm strategy, types of deals (e.g., turnarounds, distressed), sectors and geographic markets. The expertise can be sourced from PE firm internal experts or external experts.

Traditional Business Functions	Strategic Functions	Geographic Expansion
Supply Chain Management	Financial Structure	International expansion
Sales Force Management	Acquisitions, buy & build, acquisition integration	China as a functional expertise: sourcing, local market entry, joint ventures
Marketing and Brand Development	Digital Strategy / IT	Outsourcing
Pricing	Regulatory or government lobbying	Transfer pricing
New Product Development	Strategy Development	IP protection
Talent Management / HR	Business Turnarounds / Restructuring	
Manufacturing		
Working Capital management		

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Agenda

1. PAOVA matters more today than ever
2. Organizational resourcing models for deploying PAOVA
3. Key capabilities required for extraordinary value creation
4. How Partners Capital Adds Value to PE firms in which we invest

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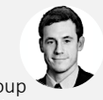
Private Equity / Private Equity Real Estate Team
20 Investment Professionals

Investment Committee

John Beil
Head of Private Equity, Managing Director

- University of California
- World Bank Group
- GW MBA, Tulane BA

Parker Lattin
Senior Principal

- Capital Formation Group
- Western New England College BA

Alex Band
Co-Chief Investment Officer, Partner

- Bain Capital
- Bain & Co.
- Harvard MBA, BA

Adam Spence
Head of Direct Investments, Partner

- American Capital
- TPG
- NY State Governor's office
- Harvard University BA

Euan Finlay
Partner

- Goldman Sachs
- Cambridge University

Private Equity / Private Equity Real Estate Investment Team

Jeff McDonnell
Senior Principal

- Davy Group
- University College Dublin

Daniel Leder
Principal

- L.E.K. Consulting
- Dartmouth College

Vasishta Dasari
Principal

- Barclays
- London School of Economics

Teng Kai Loh
Principal

- Just Jio, OCBC Bank, Standard Chartered
- Singapore Management University

Taylor Hickson
Principal

- Citi
- Wake Forest University BA

Rachel Goldstein
Senior Associate

- Goldman Sachs
- Cornell University BA

Clarissa Caputo
Senior Associate

- Brown Brothers Harriman
- Brown University BA

Rob McGeachie
Senior Associate

- Aon Investment Consulti
- University of Warwick

Andrew Weston
Senior Associate

- RSM UK
- UBS
- Bristol University

Ben Newman
Senior Associate

- Mizuho
- University of Chicago BA

Moritz Flick
Associate

- Agathon AG
- REDI PAY & CLICK
- IESE Business School
- King's College London

Ethan Frederick
Associate

- The Connable Office
- Creighton University BA

Jamie Yu
Associate

- JP Morgan
- Sun Yat-sen University

George Sabatakakis
Analyst

- Yale University BA

Europe Asia North America

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Making Tangible Contributions to PE GP's Businesses

Partners Capital Framework for Value Addition to PE GP Business (where we may be able to help)

Quantitative Performance Assessment – Understanding Absolute and Relative Historical Performance

1. Deal by deal historical value creation attribution to multiple expansion, leverage, revenue growth and margin improvement (vs industry).
2. Return on invested capital (ROIC) analysis: Attribution across sourcing, entry/exit pricing, operational value add, financial engineering (Deal by deal and aggregate).
3. PME and Beta Replication model: Quantifying alpha and its persistence from historical performance through simple beta-adjusted PME return analysis.
4. Deal by deal return decomposition: Looking into market beta, sector beta, purchase/exit price, leverage, post-acquisition operating value add.
5. Batting Average and Slugging Ratio analysis: Distribution of returns. Looking for a high number of high return outliers, positive asymmetry and low loss ratios.
6. Peer Group Rankings on IRR and MOIC by vintage (Rosetta): Confidentiality protected.

Investment Strategy – Likelihood of Future Repeatable Outperformance

1. Competitive Edge: Clear and credible statement of how the firm differentiates itself from peers in terms of source of value creation and skills/edge over others. Clear articulation of team's core competence.
2. Focus: Investment scope is black and white. Clear what deals will not be pursued. Clear on why this focus in terms of structurally attractive and inefficient market.
3. Sector Expertise: That translates into sourcing, winning, operating value add and exits.
4. Operational Value added (PAOVA): Demonstrates capability to enact strategic and operational change with management teams. M&A, buy and build/integration skills.
5. Optimal fund size: To maximise return and take advantage of most attractive fund size.
6. Portfolio construction: Optimal deal sizing and diversification/concentration across geographies, sectors, and themes.
7. Technology: Used fully to leverage competitive edge across investment process.

Team Assessment – Talent Acquisition & Retention

1. Are the leaders clear on firm values and culture?
2. Assess fit with culture, psychological profile, and work habits
3. Cumulative deal leading experience – where are the gaps?
4. Clear responsibilities, reporting relationships, areas of expertise
5. Optimal team size and structure
6. Carry sharing and team incentivization
7. Career management and succession planning
8. Learning and training processes
9. Recruiting process
10. Personal investing practices and policies / conflict policies

Investment Process – Risk Management

1. Proprietary sourcing network, techniques and approaches (databases).
2. Screening efficiency – ensuring resources spent on highest priority ideas.
3. Due diligence – standards set for deep fundamental in-house research.
4. Investment Committee composition and decision-making process.
5. Post-acquisition value added – operations team model vs BDP
6. Selling discipline, exit preparation and timing.
7. Portfolio construction (% home runs vs singles); Risk management process.
8. Energy Transition investment framework.
9. Technology insights regarding portfolio company or sector digital transformation.

Mix and Caliber of Investors – LP Alignment with Manager

1. Quality and re-investment record.
2. Strategic – value added?
3. Degree of diversification / skew to true long term investors.

Terms – Manager Alignment with LPs

1. Optimal fee structure and level by size of LP
2. Co-investment policy for larger LPs
3. Key person provisions
4. Overall alignment with investors' interests

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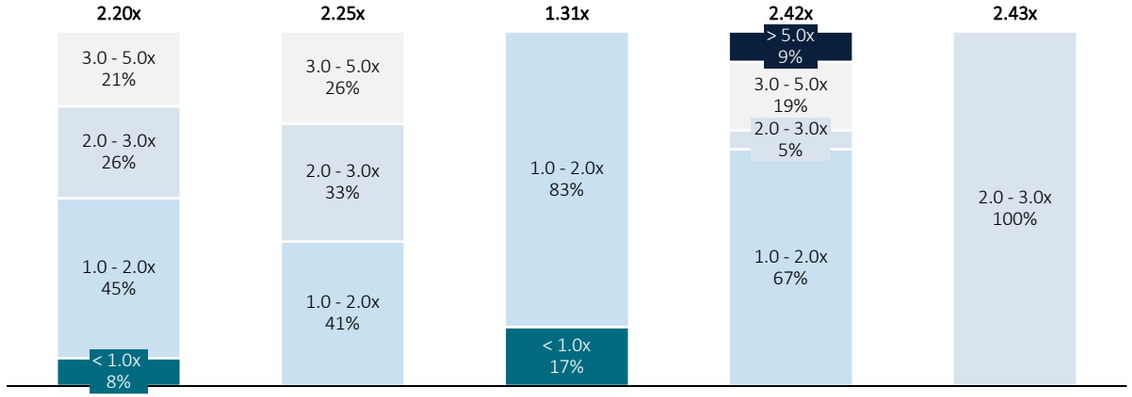
Partners Capital Private Equity Portfolio Assessment Tools

Partners Capital has built a proprietary set of portfolio assessment tools to assess PE fund return drivers

Sample Analyses

Return Distribution

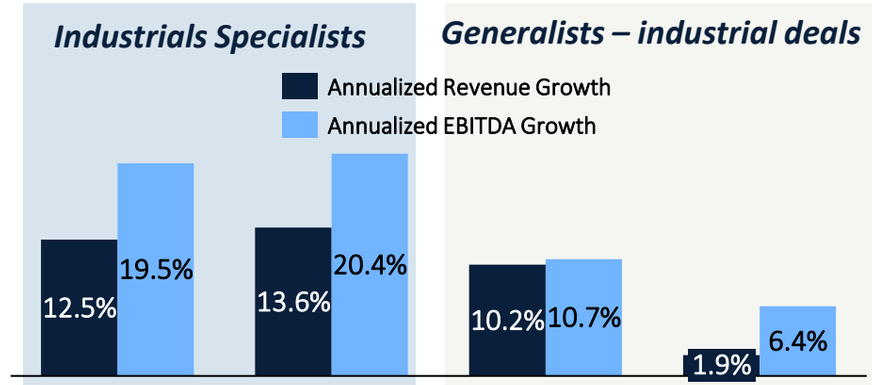
Plot the range of outcomes across funds, industry, geography, and other metrics



	Industrials	Business Services	Technology	Consumer	Financials
Number of Deals	23	15	10	8	3
Total Cost ($M)	7,540	3,290	2,786	2,340	800
Weighted Duration (years)	3.2	3.9	2.3	4.0	6.5
Annualized NAV Growth	28.0%	23.4%	12.4%	24.5%	14.6%
Loss Ratio ($)	0.5%	-	9.3%	-	-

Value creation

Break down deal returns between revenue growth, EBITDA margins, multiple expansion, debt pay down and other drivers



	Manager A	Manager B
Gross MOIC	2.5x	1.8x
NAV growth / annum	40%	23%
Number of Deals	98	28
Total Cost ($M)	$14,305M	$15,371M
Leverage (LTV)	37%	56%
Realized Loss Ratio	-4.4%	-4.7%
Total Loss Ratio	-8.7%	-4.7%

Manager X	Manager Y
2.2x	3.2x
21%	43%
9	8
$3,100M	$799M
68%	69%
-	-
-1.4%	-5.6%

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Your Limited Partners: Optimal Diversification

A diversified limited partner based is of paramount importance for the stability of your business

Our Clients: Partners Capital's client base represents endowments, foundations, family offices, individuals and corporate pensions who take a long-term approach to their private equity program.

Our Network: We can make introductions to the most sophisticated investors across the LP universe.

Our Reach: Our client base and network spans across North America, Europe, Asia and Australia, and we are familiar with the regulatory challenges internationally.

In Europe, the Alternative Investment Fund Manager Directives restricts the ability of a manager to market or fundraise. Partners Capital can be the vehicle through which U.S. firms satisfy the requirements of AIFMD. Partners Capital manages portfolios for all EEA clients on a discretionary basis.

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Your Future Business: Brainstorming with Partners Capital

Partners Capital aims to invest with managers across multiple funds and fund cycles. There are few investment strategy expansion paths we have not experienced with our asset managers.

Value-Add Investor

Product Extensions

Private Equity into Private Debt

✓ Example: a U.S. middle market manager looking to start a mezzanine and senior lending fund

Private Equity into Public Equity

✓ Example: a U.S. upper middle market manager starting a fund to take a long-term approach to public securities

Market Expansion

New Strategies

✓ Example: Identified opportunity to acquire property in second-tier UK cities. Approached existing manager on the opportunity and helped design a new vehicle, including help with investment strategy and fund terms

New Geographies

✓ Example: Introduced a U.S. consumer fund to a leading private investor in Asia to facilitate growth in global deal flow

Deal Introductions

- Global internet growth equity firm: financial technology company
- U.S. growth-oriented small cap manager: organic consumer products company
- Global upper middle market manager: portfolio company add-on
- U.S. operationally-focused middle market manager: Midwest industrials company

Long-Term Investor

Pooled Vehicle Manager Re-Ups

Invested in 331 funds across 156 firms =
The largest 20 relationships represent 61% of fund investments

Partners Capital concentrates with the best managers and builds long-term relationships.

PE LPAC Participation Examples (Not exhaustive)

5am Opportunities Fund I	Center Rock II	Harbour Group Fund VI
5am Opportunities Fund II	Charger I	Hollyport Fund V
8VC Opps II	DPE Fund III	Hollyport Fund VI
AlpInvest Co-invest Fund II	Dunes Point Fund II and III	Hollyport Fund VII
Audax Origins I	EMK I	Jeneration Fund II
Audax V	EMK II	Pacific Avenue I
Audax VI	Gemspring Fund I	Rallyday Fund I
Audax VII	Gemspring Fund II	Recognize I
Avesi Fund I	Gemspring Fund III	Riverside Microcap IV
Centre Lane Fund V	Gemspring Growth Solutions I	Vertica Fund I
Center Rock I	Great Point Partners II	Vista Foundation Fund IV

Note: Pooled vehicle commitments include Private Equity, Private Equity Real Estate, and Distressed managers. Excludes Private Debt. Deal introductions did not always lead to closed deals.

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Attributes of "Great Investors"
Partners Capital Whitepaper: Cracking the Code

These three elements are the common thread for the highest quality investment managers

Attributes of the Individual	Investment Strategy	Decision Making Process
1. A "force of nature"	1. Security selection dominates sources of alpha (vs. risk timing, and asset allocation to geography , sector, factor)	1. Concentrate decision-making authority with the right person or small group. Avoid consensus decision-making
2. Able to assimilate and synthesise huge quantities of data	2. Long term investment horizon	2. Decision making responsibility is clear and rigorously adhered to
3. Highly competitive and passionate investor	3. Value bias – focused on margin of safety	3. Individual accountability for results over long time horizons
4. Intellectually curious	4. Contrarian – differentiated insights	4. Highly transparent process that all understand
5. Accumulated experience (Gladwell's 10,000 reps)	5. Deep bottom-up fundamental analysis – seeks to know what others do not	5. Process is agnostic to business risk / redemption risk (100% forward looking)
6. Odds-maker by nature	6. Competitive advantage – identifiable "circle of competence"	6. Won't be "cornered" in positions (only face saving way out is to hold and hope)
7. Believer in the value of a rigorous investment process	7. Analysts trained in industries and companies in addition to markets	7. "Trading around positions" (i.e., up and down position sizing decisions) is meaningful contributor to outperformance
8. Confident in their ability, but not arrogant (always learning)	8. Proper application of the proper tools	8. Ongoing portfolio stress testing prepares team to react quickly in market dislocations
9. Honest. High integrity	9. Concentrated high conviction investments	9. Knows when to sell (no love affair with positions)
10. Provenance. Training from the most successful investors	10. Know their "wheelhouse" and stay in it.	
11. Organisational culture that learns from its mistakes	11. Focused on asymmetric returns	
12. Visceral alignment with their investors (cares hugely about "the clients' money")	12. Information Ratio optimizers (highest alpha per unit of alpha vol)	
13. Team builder: by virtue of reputation, skill or charisma, is able to recruit and retain highest quality staff		
14. Long term thinker about their own business – aim to leave a lasting legacy		

Source: Partners Capital Cracking the Code Whitepaper (March 2016)

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PAOVA Appendix

- Corporate Governance Module

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3. Governance– lessons from 4 decades of LBO case studies

- Governance generally, and the board specifically must be fit for purpose for any company. In the case of private equity portfolio companies, the role of the board is to deliver the incremental value from being the best owner vs the previous owner. PE is very high-cost ownership for the ultimate owners (LPs). The PE firm's existential proposition is that they are the best owner for the Company by virtue of the value that they can help create.
- Therefore, the relationship between the PE shareholders and management is to be a major source of shareholder value creation. If management is 99% of the value creation and the owner is 1%, then PE firms should not own the asset.
- This shareholder–management relationship is a hands-on day to day relationship that lives mostly outside of the board room. The monthly or quarterly board meetings are mostly about milestone reviews against the full-potential plan. The board members are present between meetings where most of the action takes place.
- The thesis underpinning LBOs is often all about the change in governance as managers become owners and time frames shift from short term to long term (the latter in the case of public to private ownership).
- Achieving a company's full potential is often blocked by poor corporate governance, especially where founders are still involved or by short-term earning focus in the case of previously public companies.
- Best practices generally involve smaller boards, clarification of senior management and board member roles and milestone driven board monitoring of strategic projects.
- Boards of PE portfolio companies can often times systematically take a coleader role with the CEO on important topics; engaged directors not only help set strategy and manage performance but also master the details needed to stress-test, reset, and dramatically improve the business.
- The learning from past successful LBOs related to corporate governance changes after the buyout depends on whether it was a public to private acquisitions, corporate orphan, secondary purchase or purchase from the founding entrepreneur or a multi-generational family business. We try to define below the end point governance structure regardless of from where it started.
- Where the CEO is changed, the changes to the board must compensate for a CEO who has less familiarity with the business.
- CEO and management team equity holding average between 15 to 20%.

Good governance in private equity is about striking the right balance between more formal governance approaches and the need to move quickly and focus on value-creating activities

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3. Governance - Board Size and Composition

- While there is no uniform board size or composition, the boards of PE portfolio companies usually include five to seven board members including the Chairman, CEO, CFO, the PE owner "mid-career deal partner," one other member of the PE firm and, optionally, one or two specialist independent directors. The composition is typically 100% "value-adders." There is typically an independent chair, who is frequently an ex-CEO, often from a much larger company than the portfolio company in question, but from the same industry. The other non-executive directors (NEDs are experienced external nonexecutive directors with specific know-how in the company's core sector or in a functional topic, such as digital transformation or a new product/market extension that is key to the company's future.

- Moving from either a public company or private founder owned company, the board size typically decreases on average by 15% and the presence of outside directors is drastically reduced, as they are replaced by individuals employed by the private equity sponsors.

- PE portfolio company boards are generally younger and smaller than public-company boards, thereby increasing each individual's engagement. This engagement and PE company board members' bias toward active ownership are what drive much of the "alpha"—outperformance relative to quoted peers—in any deal.

- Private equity sponsors are more present on the boards of the more difficult deals, presumably because these deals need more expertise, monitoring and advice. More difficult cases coincide more often in the situations where the CEO is changed at the point of acquisition. These may be the forced CEO change cases where a large overhaul of the company has been necessary due to unsatisfactory performance of the management, or the voluntary CEO change cases where losing the CEO who is very familiar with the business constitutes a significant challenge to a successful restructuring of the company.

- Greater involvement of private equity sponsors after the deal closes tends to reduce CEO turnover. This is explained by the fact that the private equity owner is more likely to look into and understand the reasons for financial underperformance and not fire CEOs for factors outside their control (with public boards evidencing the opposite).

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Private Equity Portfolio Company Board Size and Composition

Independent Chairman

- Usually a former CEO of a larger company in the same sector as portfolio company

Management	Owners	Independent Specialist *
CEO	PE Sponsor Deal Exec	NED #1 – e.g. Digital Transformation Specialist
CFO	PE "Operating Partner"	NED #2 – e.g. International Sales and Marketing

⇧

Active "value adders" in areas of greatest strategic importance

*Usually from PE firm network of "Operating Partners" (external to PE firm), on retainer, usually paid with equity + cash

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PE Portfolio Company Governance – Chair Difference between public and private

- The difference between chair and a CEO is best understood in the context of the relationship between the board and the management – the management are there to run the company, the board is there to make sure the company is well run. The CEO leads the management, the chair leads the board. The two have to work hand-in-hand.

- While the CEO is primarily concerned with the operational aspects of the company, the board is a step back, overseeing the company as a whole, and the chair is the appointed leader of the board.

- In general, the board is able to overrule the CEO, however the chair of the board - who is considered a peer to the directors - cannot overrule the board. Indeed, the chairperson in private equity companies is typically reliant on influence and their powers of persuasion, rather than any mandated authority.

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PE Portfolio Company Governance - Chairman Role

The goals and operations of a private equity company differ significantly from those of traditional private and public companies and therefore the role of a chair of the board is also very distinct. At the heart of a successful chairmanship is the ability to deal with and understand the needs of a private equity investor.

A good private equity chair will:

1. be an important source of industry specific expertise both ahead of the investment and during it.

2. play an important role ensuring the incentive plan is appropriately structured and distributed. At the same time, they will ensure it does not become an all-consuming distraction.

3. play an important role developing, implementing and monitoring full-potential plan and engaging board members to contribute where their greatest value addition lies (as articulates in their engagement).

4. will help to drive the sense of urgency and time commitment upfront.

5. will play an important role in identifying weak management and ensuring their removal does not disrupt the remaining team, as well as spotting and hiring for gaps in the executive team.

6. Create the most effective working relationship between shareholders and management - mediation role where necessary

7. CEO coaching and mentoring

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PE Portfolio Company Governance - Chairman Responsibilities

Chair of the board responsibilities in private equity companies are not set in stone. The role of the chair will vary by both geography and investor. In all cases, duties of the chair should be discussed and clearly agreed upon upfront, together with clear quantitative and qualitative objectives that might include:

1. Managing board meetings
2. Leading discussions on proposals
3. Setting/sustaining company agenda
4. Effective communication with shareholders
1. Ensuring that the board is capable of achieving the established goals
5. Ensuring board members are informed and up-to-date
6. Encouraging active engagement from all board members
7. Mediating between investor and management
8. Initiating change
9. Nurturing development of all directors
10. Establishing the induction programme for new directors
11. Creating and maintaining a balanced and representative team

The hallmark of someone mastering the role of chair is ensuring that his or her board is forward-looking. Many boards get stuck in the details of corporate control and fiduciary responsibilities, but private equity chair cannot allow this to happen.

Source: Nurole

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Governance, Board and Monitoring - Independent Directors

Identify independent directors early

- These individuals often start their involvement during due diligence as outside advisers, helping assess the specific asset as well as its value-creation opportunity and the competitive landscape within the given industry. These activities may include assessing the strength of the management team, validating the existing business model, developing transformation plans, evaluating key commercial and operational risks, and helping to justify the price being paid.
- In many instances, advisers will be hands-on in creating specific action plans to drive immediate value post close. Among other things, these plans may involve the consolidation of IT platforms, footprint rationalization and organizational redesigns, and supply chain optimization programs.
- Throughout the diligence process, both sponsors and advisers alike think ahead to the immediate business needs, and how to ensure the infrastructure will be in place to begin addressing these needs on day one.
- “It’s a much more proactive endeavor today,” said Paul Peterson, managing director at Wind Point Partners. "There's much more thought put in very early into a deal. We like to identify directors early so they have some ability to weigh in on the opportunity, and so we think about the makeup of the board throughout the deal process, from the beginning.”
- Leading PE sponsors leverage their advisory networks during deal processes to test alignment around strategic thinking and work styles and to get a better sense for those they want to ask to serve as independent board directors post-close. Similarly, the advisers have the opportunity to get a better sense for the culture and values of the sponsor and for the merits of the transaction, enabling them to do their own diligence before accepting a more formal board appointment.
- While adding additional independent board directors also occurs later in the investment cycle, waiting to find initial directors may cost the deal or valuable time in refining the investment thesis and operating agenda.

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Portfolio Company Governance- Adopting more Institutional Board Structures

The PE industry is seeing boards become more in line with the type of boards that the corporate governance literature would identify as exhibiting better corporate governance, but with significant differences.

Private equity firms recognize the value of establishing board structures to increase accountability and build good governance habits early, especially when a public offering is anticipated. Good governance in private equity is about striking the right balance between more formal governance approaches and the need to move quickly and focus on value-creating activities but should not try to re-create the extensive "governance bureaucracy" and reporting requirements of public companies. We are seeing a few emerging trends in portfolio company board governance, including:

1. **Board committees, especially audit and compensation committees, often with independent directors as the committee chair.** Historically, committees were shunned as unnecessary bureaucracy and work against the principle of rapid decision-making and implementation. But with larger companies, committee structures are introduced.

2. **Board leadership.** Some firms regularly appoint a non-executive director as the board chair to serve as a conduit and point person between the PE shareholders and management. The independent chair can help protect the CEO while conveying the expectations and demands of the owner, preserving the relationship between management and the sponsor. Firms frequently look to the chair to serve as a mentor to the CEO, especially if the company is public and the CEO doesn't have public-company experience, or even in cases where a CEO is new to private equity, new to the sector or simply a first-time CEO.

3. **Executive sessions and board evaluations.** Creating opportunities for the board to have candid conversations about their own performance is an increasingly utilized tactic in helping private equity firms improve board effectiveness.

4. **New director onboarding.** Having a thoughtful onboarding program can help new independent directors integrate by immersing them into the board dynamic and operating culture. A strong onboarding program is frequently a symptom of healthy board processes and structures.

5. **Compensation.** Portfolio company director compensation has always been focused on equity, giving directors skin in the game and aligning their incentives with those of the shareholders. However, cash compensation has become an increasingly common component of board remuneration, particularly as boards grow in size and become more diverse. In some cases, cash compensation has equaled what public company peer groups offer. However, in such instances, the larger equity upside is also normalized to public company standards. In almost all instances, independent directors have the additional opportunity to invest their own capital into the deal, providing the chance to maximize their return through an otherwise inaccessible vehicle.

Source: Spencer Stuart

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