Holding PE to its Word – A True Measure of Value Creation

Deal selection and leverage are no longer core differentiators for PE fund managers, as investors are increasingly looking for replicable operational expertise

Over the last 15 years, the private equity (PE) fund model has become a mainstay in the portfolios of the world's largest institutional investors. As PE assets under management increased five-fold during that time, the industry has rapidly matured and prospered through a series of business cycles and extreme market dislocations. Although the illiquidity of PE investment often restricts fund allocations to single-digit percentages, repeated findings in academic and for-profit research citing the industry's outperformance relative to public equity markets underscores its importance in a balanced portfolio.

But what has produced this outperformance? And, more broadly, how do successful PE fund managers (general partners, or GPs) consistently and repeatedly generate value for investors (limited partners, or LPs) over time? Sceptics have long pointed to a combination of job cuts and "financial engineering" – i.e. the aggressive use of leverage – as private equity's secret sauce. GPs, on the other hand, have increasingly of late pointed to operating teams and operational value creation as the key driver of value creation in PE.

With an expanding universe of opportunities in both primary and secondary PE markets, LPs need tools to separate true operating capability from the claims made in fund pitch documents. In our recent report, **Value Creation 2.0**, we argue that existing metrics are an inadequate gauge of GPs' ability to create value, and present an execution-ready solution to identify value creation talent.

Where is the Gap?

The ambiguity around value creation lies partly in the simplistic measures applied by PE firms to show the sources of investment returns at the portfolio company level. Historically, they have pointed to the following three drivers:

· Change in annual operating cash flow, typically using EBITDA as a proxy

· Change in valuation multiple, typically the EBITDA multiple, and

· Change in net debt, a catch-all category representing cash generation during the holding period

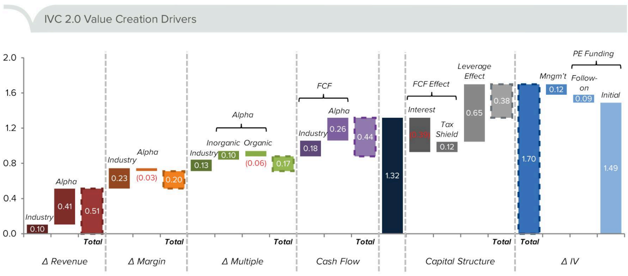
This approach neither provides insight into the drivers of operational change realised under PE ownership, nor benchmarks the performance of a PE-backed company to that realised by its peers.

Academic studies addressing the question of value creation suffer from a different set of limitations.

While several studies have uncovered specific drivers of outperformance in PE-backed companies – for example, superior margin and efficiency improvements relative to their peers – most leave large residual values unaccounted for and rely on simplifying assumptions to assess large datasets and populate incomplete transaction data. Studies that take a holistic view and isolate PE outperformance or "Alpha", typically do so by comparing performance to public equity markets, and again provide no insight into the source of underlying operating improvement.

A New Way

Over the past six months, INSEAD's **Global Private Equity Initiative** (GPEI) has developed a framework that brings clarity to the value creation debate, and applied it to investments made in developed and emerging markets. The framework – IVC 2.0 – both defines the crucial financial and operational drivers underpinning value creation in PE and provides a robust methodology with which to assess them. The exhibit below presents IVC 2.0 output from one such application, our analysis of a U.S. midmarket leveraged buyout.



Extending advanced frameworks developed by Capital Dynamics and Duff & Phelps, IVC 2.0 deconstructs an investment's return into five categories of value creation. Value created in four of these categories – change in Revenue, change in Margin, change in Multiple, and Cash Flow – is attributed to either industry performance or company-specific performance (which we also dub "Alpha"). In our example, for instance, the value created through change in revenue (0.51) was predominantly accounted for by company-specific operating improvements (80%, or 0.41/0.51) relative to industry performance (20%, or 0.10/0.51).

What's more, IVC 2.0 explicitly breaks down the impact of incremental leverage on investment returns in a fifth value creation category, Capital Structure. Increasing leverage (debt financing) reduces the amount of fund capital required to finance an investment, and thus increases the return realised by the PE fund; IVC 2.0 captures this dynamic in the "leverage effect." Increasing leverage reduces a company's annual free cash flow due to additional interest expense, which is partially offset by an increase in a company's tax-shield; IVC 2.0 captures this dynamic in the "free cash flow" effect.

In a final step, IVC 2.0 allocates the return generated by the investment – Δ IV in our Exhibit – to different sources of funding, according to ownership group (PE and management in this case) and round of investment (initial and follow-on funding). An in-depth review of IVC 2.0 methodology can be found in our paper here.

Show Me the Money

Real operating capability provides a tangible means to generate value in LPs' PE portfolios irrespective of economic and market cycles. The complexity surrounding this topic has grown exponentially in recent years, as GPs have developed a range of techniques – at varying degrees of maturity – to engage with portfolio companies during the holding period. IVC 2.0 provides LPs with a means to determine those investments and GPs that create value, and those that don't.

*INSEAD's GPEI is looking for additional partners with which to explore the concept of value creation across a set of investments and thereby help LPs or GPs better understand the sources of Alpha in their investments. Interested parties can contact us **here**.*

*Bowen White is the Associate Director of INSEAD's **Global Private Equity Initiative** (GPEI).*

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