Private Equity Firms: Decisions Influenced by Time and the Implications for Value Harvesting

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This paper combines existing theory on approaches to organizational change interventions and links this theory to the price earnings ratio method of valuation. In doing so, this paper introduces levers for value creation that are determined by the appropriate change intervention typology and are influenced by the constraint of time. This paper then takes this new theory and applies it to a case study[1]. As a result, this theoretical paper seeks to showcase the importance of time and the possible implications for the chosen intervention method, which ultimately influence value harvesting for private equity firms.

PROLOGUE

Emery and Trist (1965) were the first to stress the importance of environment or 'context' on organizations. Over time, Clarke (1994) and others (Mirvis, 1988, 1990; Van De Ven & Poole, 1995; Nadler & Tushman, 1999; Pettigrew, Woodman, & Cameron, 2001; Morgan, 2006) have reaffirmed these observations. Weisbord (2004) borrowed the term "permanent whitewater" (p. 185) from Vaill (1996) to depict a world of "accelerated change, growing uncertainty, [and] increasingly unpredictable global connections of economics, technology, and people … producing [relentless and often unfathomable] 'irreversible general change'" (p. 186). Pettigrew, Woodman, and Cameron suggested that our understanding of change is changing, while Morgan posited that the very idea of change as manageable should be questioned. Whatley and Kliewer (2012) asserted that we are only just beginning to appreciate the importance of how we interpret change, suggesting that "change is social construction in flight" (p. 2). In light of this observation — the move toward change being viewed as socially constructed — there are significant implications: firstly, that a sound understanding of the context is even more important; and secondly, that the correct selection of intervention method will be more dependent on an accurate assessment of the context than ever before.

It is against this backdrop that this paper combines Whatley and Kliewer's (2012) *Approaches to change: Consultant use of self in change complexity* model (see Fig. 1) with Doucette's (2011) *Liquidity Time Frame* model (see Fig. 2). As a result, this paper showcases some very important implications for private equity firms (PEFs). Specifically, the paper discusses how a self-determined focus on time may be "leaving money on the table" when it comes time to value harvesting. Firstly, we will introduce our "levers for value creation" and present a typology of change intervention in accordance with these levers for value creation. Secondly, we will discuss the background, or the context, of PEFs. Thirdly, we will highlight the theoretical considerations of time on value harvesting. And, finally, we will describe the contributions to theory and practice and the implications to value harvesting.

FIGURE 1
APPROACHES TO CHANGE: CONSULTANT USE OF SELF IN CHANGE COMPLEXITY

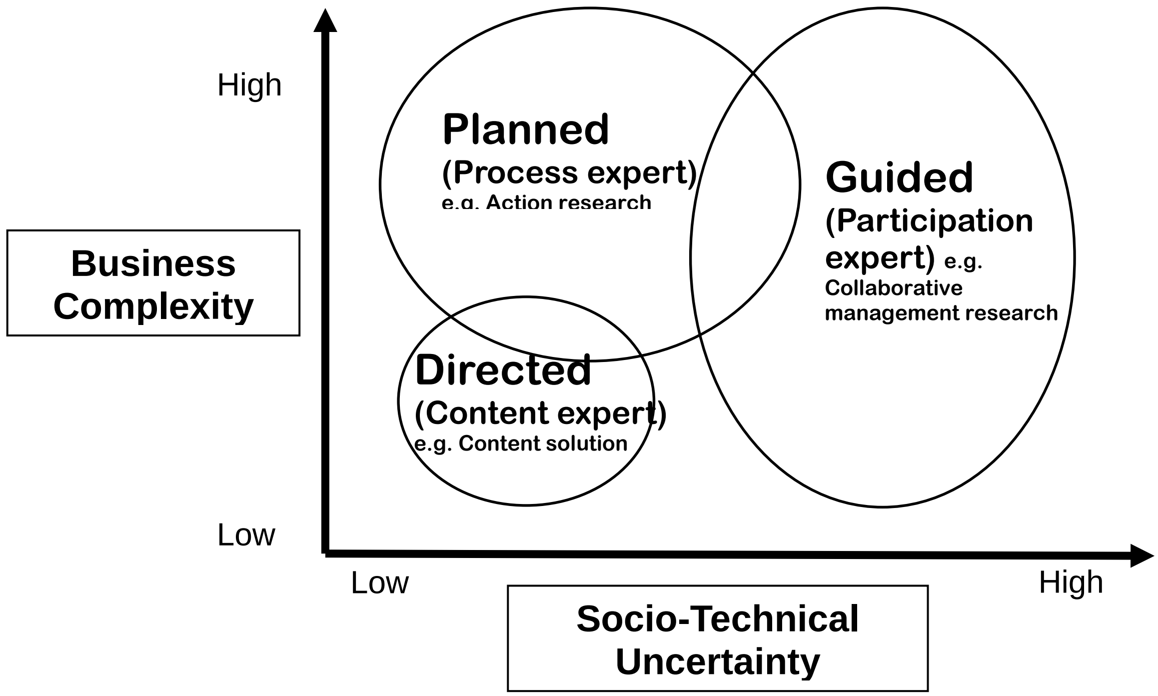
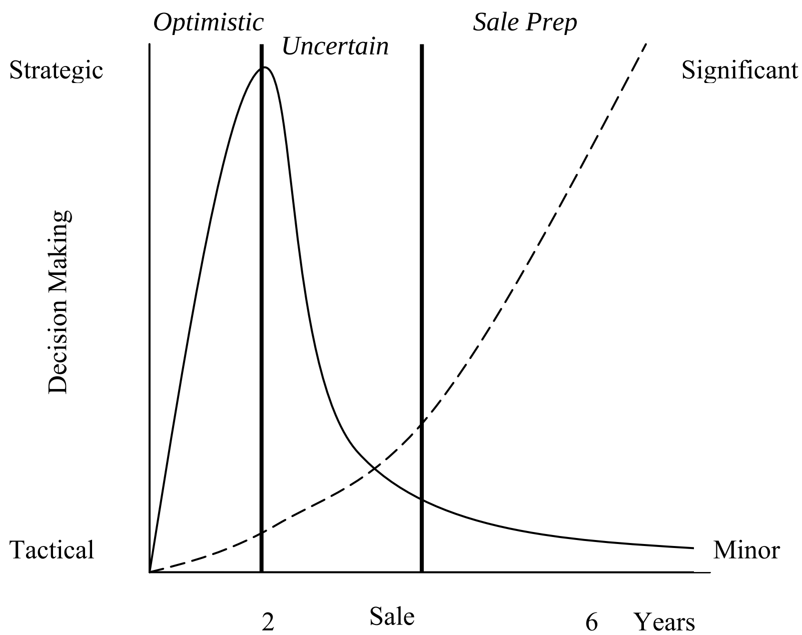


FIGURE 2
LIQUIDITY TIME FRAME



LEVERS FOR VALUE CREATION

Firm value is always a topic of much discussion and debate, and there are many alternative methods for determining value, such as goodwill based methods, cash flow discounting, and breakup value, to name a few (Fernandez, 2002/2007). One of the most commonly used methods is the income approach method often referred to as the Price Earnings Ratio (PER). Under this method, firm value or Equity Value is calculated as PER x Earnings. This simple formula is powerful because of its ease of use and its clarity of focus around the importance of the firms' earnings. Additionally this method is important as it highlights one fundamental truth for value creation — the foundational purpose of all change efforts — that there are essentially two ways to create value: firstly, by increasing or stabilizing earnings, which is often represented by the specific income statement item EBITDA (earnings before interest, tax, depreciation and, amortization); and secondly, by increasing the multiple itself, which is a more subjective number representing factors such as management's ability, talent pool, the firm's market position, etc. Unless the change intervention is designed to do one of these two things then any improvement in value may be occurring due to other unmanageable aspects and thus considered chance. In this paper we have classified change efforts by identifying which element of the PER equation we are attempting to improve and our classification results in a typology of change intervention based on the lever of value creation.

FIGURE 3
CHANGE INTERVENTION TYPOLOGIES AS LEVERS OF VALUE CREATION

Lever one: Increasing or stabilizing earnings — improving ‘efficiency’ or ‘effectiveness’

- Lean production, TQM,
- Outsourcing
- Cost saving measures
- Process consultation and reengineering

Lever two: Improving the multiple – improving ‘organizational capacity’

- Systems change, organizational assessments
- Structural change, work design or flow
- Strategic planning implementation
- Appreciative inquiry
- Organizational cultural intervention
- Relational intervention
- Life coaching and mentoring

As a result of this classification we have identified two distinct types of change levers. Firstly, the “efficiency and effectiveness levers” — tactical in nature — are designed to improve the current operations. These levers are interventions that are designed essentially around the idea the organization needs to continue doing what it is doing but needs to do it faster or better. These levers have a shorter implementation time horizon (one to two years), and would be more characterized as a hard systems change intervention by Senior and Swailes (2010). Secondly, the “organizational capacity levers” — strategic in nature — are essentially designed around the idea that the organization needs to build future skills and capacity within the organization to: 1) consistently replicate desired outcomes (meaning it may be able to accomplish these outcomes occasionally but it needs to be able to repeat them consistently), or 2) achieve a particular goal for which it currently does not have the necessary skills. We assert that these organizational capacity levers have longer time horizons (three to five years), and would be characterized as soft systems change interventions by Senior and Swailes (2010). All of these distinctions can be seen in Fig 3.

PRIVATE EQUITY FIRMS (PEFS) AND THEIR REOCCURRING THEMES

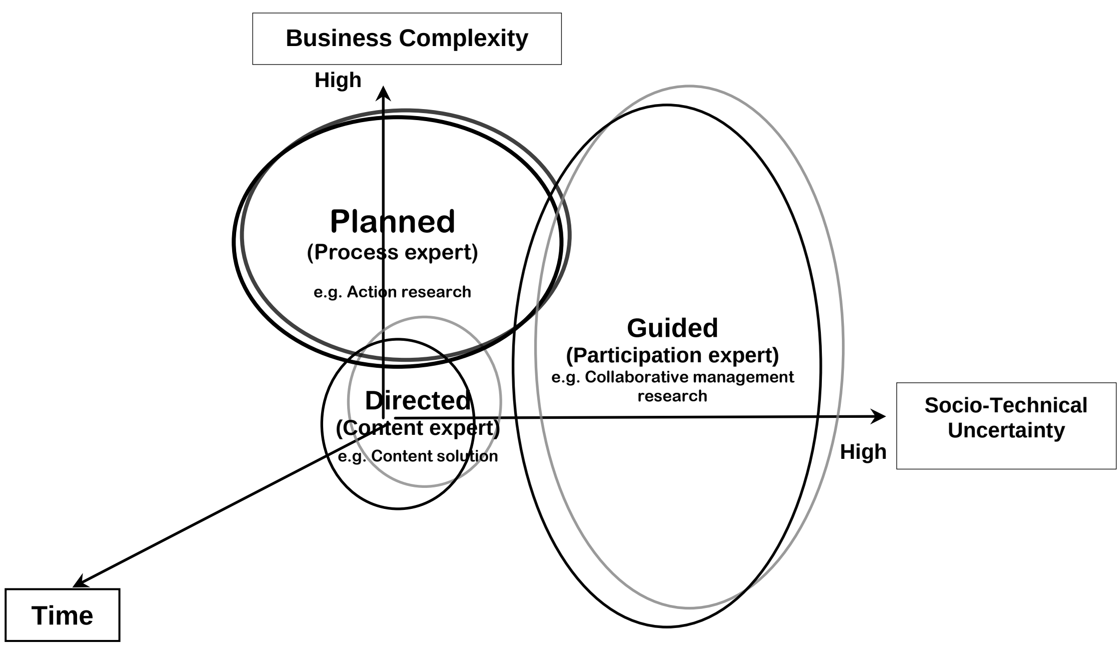
Private Equity Funds are designed as an alternative for investors seeking to obtain a higher long-term return than other traditional investments such as stock market index funds (Cendrowski, Martin, Petro, & Wadecki, 2008, p. 63; Kaplan & Schoar, 2005). Between 1970 and 2007 there were more than 21,000 transactions with an estimated transaction value of $3.6 trillion, out of which 40% or $2.7 trillion was associated with deals after 2000 (Strömberg, 2008, pp. 3-4). The British Venture Capital Association and the European Venture Capital Association suggest that the private equity business model is an increasingly dynamic and efficient component of the capital market that has the capability to deliver substantial reward to fund investors, partners and management (Clark, 2009, p. 2033). However, in light of the levers of value creation, we assert that this has to be questioned as there are only limited levers being used under this investment vehicle (see further discussion below).

The logic is that private equity funds are formed by inviting like-minded investors who combine their capital to increase their purchasing power in the marketplace (Cendrowski, et al., 2008, p. 5). Private equity funds raise investment funds based on the premise investors will be provided with a certain level of return and the opportunity to liquidate their investment after a specified period of time. Private equity funds buy companies to sell them which is different than corporations or standard firms who tend to keep them for long term strategic reasons (Barber & Goold, 2007). The typical investment structure for private equity funds is a limited partnership. The investors in private equity funds are considered "limited partners" since they do not have active control or influence over the investments (De Clercq, Fried, Lehtonen, & Sapienza, 2006, p. 91). Private equity funds then serve as the 'general partner' and are in control of the fund, investments, and typically serve on the boards of portfolio companies. Institutional investors and individuals invest capital in private equity funds to diversify their investments and seek better than market returns over a set period of time (Cendrowski, et al., 2008, p. 63). Essentially agreement between the private equity fund and the investors enables the private equity fund to invest the investors' capital for a specified period of time (usually 10-12 years). This commitment to "time" places an additional burden/stress on the contextual elements experienced by the PEF that other investments vehicles do not experience. Thus, the important difference from other investment vehicles is the closed and finite nature of the fund. The pivotal question or focus of this paper is to explore exactly how this reoccurring theme — the constraint of time — impacts the decisions of those involved, if at all, and how it could lead to higher value.

THE THEORETICAL CONSIDERATIONS OF TIME ON VALUE HARVESTING

In this section we introduce the implications of time on decision making within PEFs by combining Whatley and Kliewer's (2012) *Approaches to change: Consultant use of self in change complexity* model and the concept of time (see Fig. 4).

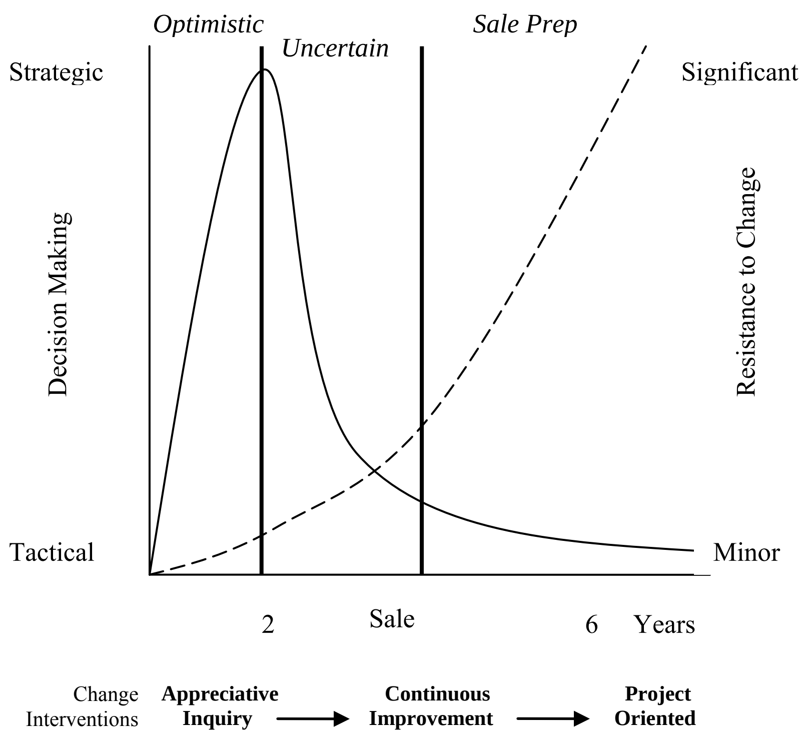
FIGURE 4
CONSULTANT USE OF SELF IN CHANGE COMPLEXITY MODEL AND THE CONCEPT OF TIME



We assert that low social-technical uncertainty when combined with low business complexity only requires a small time horizon (1-2 years) for a change intervention and would only contribute to improving or stabilizing earnings — lever one of the levers for value creation. While medium social-technical uncertainty when combined with medium business complexity produces the need for a medium time horizon (2-3 years) and would only contribute to improving or stabilizing earnings — lever one of the levers for value creation. Finally, a high social-technical uncertainty when combined with high business complexity produces a need for a long time horizon (3 to 5 years) — lever two of the levers for value creation. Thus we assert that lever two change interventions, the most impactful, are only possible and likely successful when the time horizon is greater than three years.

We then introduce Doucette's (2011) *Liquidity Time Frame* model and match it against the typologies and their related lever for value creation (see Fig. 5). In doing this we can see that it is not possible for PEFs to make consistent substantive returns since they are only ever able or choose (avoiding risk) to implement level one levers for value creation. Unless PEFs are purchasing undervalued assets in the first place, the important question is whether the purpose of the private equity fund is to aid the increase in portfolio company value or is it to simply identify undervalued firms.

FIGURE 5
LIQUIDITY TIME FRAME AND INTERVENTION TYPOLOGY



ONE PARTICULAR PLAY

Scene One v Case Background

The original PEF that founded CFGC never intended to hold it for very long and this is evident in that it was formed in 1996 and publically traded by 1998. For all intents and purposes it was what is referred as a classic 'roll-up and sell strategy'. While at the same time, the U.S. insulation industry was a highly fragmented $25 billion industry with a few major corporations at the top. Most of the industry was made up of local or regional players who benefited from the booming U.S. economy, strong building sector and available credit. CFGC focused on acquiring as many businesses as possible so that it could be eventually sold to a competitor or other interested investor for a large multiple of EBITDA. At the time, if you owned an insulation business, were interested in selling, and your organization fit into the metrics of CFGC, it was likely you would be offered a competitive deal (usually in cash) to sell your business to CFGC. Beyond the cash, the seller was told they would be able to run their business as they had in the past with little interference from CFGC. Over an eighteen-month period CFGC had acquired some forty businesses.

In light of the events of September 11, 2001, there was a subsequent downturn in the economy that impacted many businesses and the insulation industry was no exception. As a result, CFGC and its competitors began to see a significant drop in business. Similar to other industries, those firms without the burden of debt would fare better than others, however CFGC had significant amounts of debt. Additionally, CFGC was a loosely held group of individual companies with no ability or commitment by 'legacy owners' (original owners) to seek leverage of possible synergies. The premise of selling to CFGC was that the acquired firm could run the business the way they always did with little interference. This is evidence that the entire management process at CFGC was purely lever one intervention as CFGC really only represented the attempt to consolidate EBITDA. At the onset, there was no attempt to stabilize earnings (otherwise causing less debt) or to enter into lever two interventions. This was further compounded when the economy softened and the firm lacked the 'organization capacity' to change. Lever two change interventions can build organizational capacity and, as result, CFGC was heading towards a financial hurricane with clear signs of financial distress.

The pressure to 'run' the business was placed on a PEF not prepared or interested with this type of challenge. Specifically, the CEO at that time was a considered a relationship builder focused on 'making deals', not on running a $600 million company during turbulent economic times. After a series of events, the confidence in the CEO by the Board eroded and he was removed. CEO #2 was hired in September 2002 to 'turn around the business'. As part of the turnaround, CFGC voluntarily filed for a pre-arranged Chapter 11 bankruptcy in June 2003. As a result of the bankruptcy, the previous stockholders were essentially removed and the bondholders were given control of the company. The plan was to emerge quickly once the debt was restructured and the courts approved the reorganization plan. In August 2003, CEO #2 left CFGC to pursue other interests. Enter CEO #3 or, more specifically, a 'Chief Restructuring Officer' (CRO). He and his firm were hired to oversee CFGC during the restructuring process until a "permanent" CEO could be found. In February 2004, CFGC successfully emerged from bankruptcy with a plan to repay vendors 100% within eighteen months. The search for CEO #4 was completed in June 2004 and a new era had begun for CFGC. Jimmy C who recently left a major ice cream provider as their Chief Operating Officer was anxious to assume his first CEO role.

Selling to Private Equity

Once Jimmy arrived, the direction of the reluctant bondholders turned owners through bankruptcy was to sell the company. Generally, bondholders do not want to be shareholders and the CFGC bondholders wanted to exit the business quickly with a reasonable return. As a result, CFGC was entering a 1-2 year period of little change related to people and process (low social-technical uncertainty) and a very specific financial target and timing (low business complexity). The chosen focus was earnings or EBITDA growth in order to improve the eventual sale price — lever one focus appears again. There was no significant time or resources given by the bondholders to focus on building organizational skills or capacity (organizational capacity levers or lever two) in an attempt to affect a multiple of EBITDA. In a rating agency presentation immediately after Jimmy's arrival, the 2004 Strategic and Operational Initiatives included such initiatives as: branch profit management; insulation fleet optimization through capital expenditures and aggressive preventative maintenance plans; continued critical analysis to drive revenue and cost containment; and a focus on internal growth (vs. acquisition). The topics of discussion throughout the first two years were lever one, tactical decisions designed to improve or stabilize EBITDA.

Beginning in the fall of 2005, CFGC was involved in a marketing process to sell the company. The presentation to potential buyers emphasized investment highlights such as: favorable industry growth trends; strong operating performance and momentum; strong cash flows and insulation equipment values; experienced management team; diversified geographical footprint; standardized operating procedures; and cash benefit from NOL carry forward. The investment highlights genuinely reflected the accomplishments of the organization's work since Jimmy's arrival in June 2004. Certainly, there was a marketing flare to the presentation, but the target audience was the financially minded professional looking for an investment with potential. Unlike the bondholders turned stockholders, the next owners of CFGC would presumably have a longer runway to focus not only on earnings stability and growth but a larger EBITDA multiple based on improved organization capability. In July 2006, CFGC was successfully sold to a private equity firm called TGP. With the purchase of the company by a PEF, the 5-7 year liquidity time frame was underway.

In May 2006, a letter of intent was signed and CFGC began to respond to TGP due diligence requests. The focus of the due diligence requests were mainly financial and regulatory in nature. For example, TGP did not conduct deep human capital inquires, cultural assessments, or management team interviews. TGP relied on informal interactions with CFGC's top management team (TMT) to gain comfort with the human capital aspects of the business. Further, TGP had no in-depth discussions with CFGC's TMT regarding planned organizational capability changes. The only exception was some initial direction by TGP to shed two non-related divisions in order to harvest additional cash and pay down debt. The pre-assessment stage was financially thorough (lever one) but hardly investigated how CFGC's TMT would build organization capability (lever two) in order to improve the EBITDA drive multiple. Even though CFGC's TMT had a vision regarding how to grow organization capability, TGP did not conduct a deep inquiry into this area. Given the estimated liquidity time frame, the opportunity to implement large-scale and capability driven organizational changes was beginning to slip away from TGP investors.

The first several years of TGP ownership focused on the sale of two major divisions of the CFGC. One division was sold at a premium and the proceeds used to make a sizeable reduction in debt. The sale of the second division was a move to exit a low margin, highly volatile, people intensive (as opposed to capital) business unlike the core insulation business. Even though the second division was sold for a very low price, the divestiture freed a large portion of the TMTs energy and redirected it to the more profitable core business. The sales of these divisions were important to a long-term strategy of becoming attractive to a strategic buyer. CFGC did not want to have a non-core or low margin business that might detract strategic buyers. Despite the longer strategy play, the transaction was designed around efficiency and effectiveness (lever one). Lever one value creation efforts continued at the start of 2008 with familiar organizational goals such as: safety; improving the operating performance and increasing the EBITDA margins; refining the rate disciplines and pricing strategies to profitably grow the business; continuing training of the outside sales force and implementing training of the operating managers and inside sales force; balancing the insulation fleet to optimize CAPEX spending; implementing cost reductions in alignment with core operations; improving customer satisfaction; and strengthening employee morale. Although some of the 2008 goals hint of improving organizational capability (lever two) the reality was that many initiatives were tactical in nature. After two years, CFGC had successfully executed the divestitures, but had not added value to the business nor created a compelling reason for potential buyers to pay a higher multiple.

The next three years (2008-2010) were occupied by a brief taste of success and then desperate actions to survive. The economy began to falter at the latter end of 2008 and CFGC immediately felt the decline in business. EBITDA declined from $135 million in 2008 to $70 in 2010. With an almost 50% decline in EBITDA, reductions in force, pay freezes, deferral of capital expenditures, and an increase in the sale of insulation equipment were necessary to stay solvent. Years three through five were exclusively focused on survival using lever one initiatives. The planning horizon went from 12 to 24 months down to six months and in some cases monthly adjustments were made by the TMT. Clearly this time period was about protecting the core business with the hope of a comeback when the economy recovered. Yet again, tactical initiatives designed to address the moment replaced strategic growth and capability initiatives focused on increasing organizational value.

The last two years (2011-2012) has seen a more positive turn in the economy and financial stability for CFGC. Slowly, CFGC has begun to emerge from a deep recession and will likely see EBITDA of around a $100 million in 2012. TGP will have owned CFGC for six years in July 2012. As results continue to improve, it is likely TGP will be open to selling the company in the next 12-24 months assuming the offer is conducive to covering debt and providing a reasonable return. What remains difficult to grasp is the lost value creation based on TGP and CFGC's TMT focus on efficiency and effectiveness. Throughout the past six years under TGP ownership, there has been little time spent on capability building. Maybe TGP and CFGC TMT had no other options except to focus on lever one activities. In the end, TGP will sell CFGC and most likely do so at a reasonable return because of improved and growing EBITDA. However, if lever two value creation initiatives were introduced early would the multiple (based on organization capability) of EBITDA have been higher?

CONTRIBUTIONS TO THEORY AND PRACTICE AND THE IMPLICATIONS TO VALUE HARVESTING

This paper has logically developed the theory that value creation within firms is provided via two key levers: lever one — the efficiency and effectiveness levers — involve an improvement in earnings or an improvement in the stability of earnings; and lever two — the organizational capacity levers — involve building skills and capacity. The theory then links these levers to the appropriate change invention method by a contextually constant factor— that is, time. In doing so, several observations can be made for PEFs, private equity investors, and the managers of pooled funds, and, without question, private equity firms are "leaving money on the table" at the time of value harvesting.

Firstly, we assert that there needs to be a clearer understanding of the overall objective of the private equity fund. Perhaps it is to acquire undervalued companies with the intention of holding for a few years and then selling, or perhaps it is to acquire companies with specific change interventions in mind. In either event, this paper stresses that a pre-assessment stage, which is prior to "due diligence", would be the most critical aspect of a private equity fund's acquisitions, and, although this concept is not new to theory, the linkages to specific types of change interventions moving forward and a reduction in the type of change interventions recommended due to time constraints, are contributions to theory.

The second significant assertion of this paper is that the time horizon significantly reduces the intervention methods available/recommended for all firms and this is particularly evident within PEFs. And, as a result, there are no "organizational capacity levers" — type two — available within PEFs that have a preference for short holding periods (7 years or less).

The third contribution is that the longer a portfolio company is held by the private equity fund the less likely that long-term value is being created. The private equity fund partners are so concerned and oriented to not adversely impacting earnings that all level two value creation levers are rarely considered.

Finally, in light of the fact there are only two ways in which value is created, this paper contends that much of the activity within private equity funds is not actually adding underlying value to the portfolio company and, as such, the underlying philosophy of private equity funds is perhaps questionable given the inability to develop a long term 'development' plan.

POSTLUDE

This paper has stressed the importance of the levers of value creation. Additionally this paper has linked the levers of value creation to various change intervention typologies and contextual influence of time. In doing so, this paper suggests that appropriate intervention methods are influenced by time horizons and, in the case of PEFs, this is the most prevalent contextual concern. Finally, this paper has shown that because of the time constraint private equity firms are not considering significant value harvesting opportunities, and are, thus, leaving money on the table when it comes time to sell.

ENDNOTE

1. The names of the firms, the principle actors, and the industry specifics have been changed for the purposes of confidentiality.

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