With competition increasing and prices high, PE firms are relying on value creation more than ever. In this edition, we examine the continuing evolution of the models that firms are using to maximize the impact of their operating resources.

Operational value creation is keenly important amid high price environment

It’s no secret that private equity (PE) firms are in the midst of one of the most challenging environments for capital deployment on record. High valuations, continued competition from corporate acquirers and record levels of dry powder have sent average acquisition multiples well north of 10 times earnings before interest, taxes, depreciation and amortization. With limited potential for multiple expansion, driving returns through operational improvements is now front and center for PE firms. As one participant at the recent Harvard PE/VC conference said, “The current PE model is to overpay for an asset, and earn it back through value creation.”

As a result, the role of operating resources has become an increasingly important part of firms’ strategies for driving returns. In a series of interviews conducted between September 2014 and April 2017, EY documented the evolving role of the operations teams at PE firms, seeking to more fully understand the changing ways that groups are structured, how they’re deployed, how they’re compensated, how firms use them to maximum effect and the ways they’re measured.

The last 10-15 years have seen the role of the operating partner evolve from a “nice to have” to a critical component that is valued by limited partnerships (LPs), management teams and general partnerships (GPs). Indeed, what started as a handful of shops employing senior industry executives to work side-by-side with management teams to lend their experience, connections and knowledge has since developed into a wide range of models spanning various seniority levels, skill sets, backgrounds and objectives.
Variations on the operating resource model

<table>
<thead>
<tr>
<th>Level</th>
<th>Type</th>
<th>Skill set</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Retired CEO</td>
<td>• Advisor</td>
<td>• Generalists</td>
</tr>
<tr>
<td>• Peer-level resource</td>
<td>• Partner</td>
<td>• Industry professionals</td>
</tr>
<tr>
<td>• Junior analyst</td>
<td>• “Arms and legs”</td>
<td>• Functional professionals</td>
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<td>• Advisor</td>
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<td>• Functional professionals</td>
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<table>
<thead>
<tr>
<th>Background</th>
<th>Working style</th>
<th>Purpose</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Operator</td>
<td>• Mentor</td>
<td>• Strategic</td>
</tr>
<tr>
<td>• Consultant</td>
<td>• Doer</td>
<td>• Tactical</td>
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</tbody>
</table>

Overall growth rates are slowing, but smaller firms are catching up

Currently, the industry has approximately one-third more operating resources than it had just four years ago. Much of this growth is occurring at smaller and mid-market firms. Where perhaps a decade ago, operating resources were concentrated at larger shops with the scale and deal sizes to make them more cost effective, mid-market firms are increasingly catching up – driven by necessity, as intermediated deals and high valuations permeate increasingly deeper into the middle market.

And while the overall rate of operating resources in the industry is growing, there is anecdotal evidence that the rate of growth might be slowing, especially at some larger firms that may have overbuilt in recent years.

Three key trends define ‘operating resources 2.0’

A number of developments is defining the next phase of the model’s evolution. First, operating resources are increasingly sourcing new deals and being involved earlier in the deal cycle to help assess targets and identify value creation opportunities. Second, firms are increasingly using specialized operating resources to add increased value across the portfolio in a range of functional areas. Third, many firms are moving away from keeping operating resources on staff as they move toward a contract-based model.

1. Firms are involving operating resources earlier in the deal cycle

Traditionally, operating resources have focused on adding value during the hold period, with resources brought in post-close. However, many firms are now involving operating resources earlier in the process. As targets are identified, teams are being brought in during the diligence phase to help build the investment thesis and flag opportunities for value creation. Given their deep sector or functional experience, operating professionals are often able to uncover opportunities that deal teams might miss. This can help make a case for higher valuation, allowing them to win a deal. Early involvement also allows them to begin building relationships with management teams and get a head start on the planning process; the sooner teams are brought in during diligence, the more quickly they can initiate action. And as sourcing becomes increasingly competitive, many firms are looking to their more senior operating partners to help uncover new opportunities. With their wide networks, they’re often able to open doors that might have otherwise been shut.

2. Firms are increasingly using specialized operating resources

When operating resources first started becoming commonplace, deploying generalists was typical. CEOs value generalists for their ability to think holistically about the business, for their insights from working across a range of industries and issues, and for the perspective of someone who has walked in their shoes. Indeed, the experience and insights that strong, well-aligned generalists can bring are often not otherwise accessible or available in the market. As such, they remain an important part of the playbook. In interviews EY conducted with CEOs of portfolio companies last year, 75% said they preferred generalists.
However, firms are increasingly involving specialist resources for a number of compelling reasons:

- They’re typically able to work across an entire portfolio.
- They offer insights that are differentiated from the deal teams and management.
- They tend to be cheaper than heavyweight generalist operating partners, and aren’t as reliant on “chemistry” with the CEO.
- They’re often able to deliver a faster and more quantifiable return on investment than a generalist, whose impact can sometimes be widely seen but hard to measure.

In our interviews, two-thirds of PE firms’ operations teams had some level of sector specialization and two-thirds had functional specialization.

And while PE firms are utilizing specialists across a wide range of disciplines, a handful of areas is receiving particular attention from GPs. Finance was the most commonly cited; more than 70% of GPs either have resources in place or are planning to add them. Human capital is another area where firms are focused. Having to replace key members of the management team midway through the hold period can add years to an exit and have a dramatic impact on returns; specialists can increase the chances of getting the management team right at the outset. In addition, procurement and IT are other areas of focus where firms are often able to leverage the breadth of their portfolios to achieve efficiencies.

### Breakdown of functional specialties across the PE firms we interviewed – either existing or planned

<table>
<thead>
<tr>
<th>Function</th>
<th>Contractor</th>
<th>Hybrid</th>
<th>Employee</th>
</tr>
</thead>
<tbody>
<tr>
<td>Finance</td>
<td>73%</td>
<td>50%</td>
<td>45%</td>
</tr>
<tr>
<td>Talent</td>
<td>73%</td>
<td>50%</td>
<td>45%</td>
</tr>
<tr>
<td>Procurement</td>
<td>36%</td>
<td>36%</td>
<td>36%</td>
</tr>
<tr>
<td>Sales and marketing</td>
<td>36%</td>
<td>36%</td>
<td>36%</td>
</tr>
<tr>
<td>Strategy and M&amp;A</td>
<td>18%</td>
<td>18%</td>
<td>8%</td>
</tr>
<tr>
<td>Operations</td>
<td>77%</td>
<td>77%</td>
<td>77%</td>
</tr>
<tr>
<td>Digital/commerce</td>
<td>18%</td>
<td>18%</td>
<td>18%</td>
</tr>
<tr>
<td>Pricing</td>
<td>9%</td>
<td>9%</td>
<td>9%</td>
</tr>
</tbody>
</table>

3. Firms are increasingly using 1099 contractors – either in addition to or in place of full-time employees

Parallel with the increasing prevalence of specialists is a significant change in the way that PE firms populate their operating teams. Two years ago, most operating resources were comprised of full-time employees of the GP; today, many firms are now increasingly using contractors in their place, or sometimes using hybrid models that utilize both. In our interviews, 45% of firms used a contractor model; another 30% used a hybrid internal/external model.

While full-time operating resources can provide better alignment with GPs and management teams, and are often better positioned to generate and harness institutional knowledge for the firm, it can often be hard to find the right people with exactly the right skill sets. The contractor model can allow firms access to a wider range of specialized operators, making it easier to bring best-in-class resources to bear, while allowing firms to variabilize their costs. Moreover, contractors are most commonly compensated by the portfolio company itself, which reduces firm-level outlays and simplifies regulatory compliance and disclosure.

### Employment status of operating resources within PE firms we interviewed
No ‘one-size-fits-all’ solution

It’s important to note that there’s no one-size-fits-all solution. For every model, there’s a firm out there that’s using it successfully. As such, the question isn’t “what’s the right value creation model?” It’s “what’s the right model for your firm, for your strategy and for this particular portfolio company?”

What’s keenly important is that the model aligns with or complements a firm’s strategy, competencies and key differentiators.

Firms need to consider a number of questions to determine the approach that’s right for them:

• How are we going to add value and generate return?
• What resources are required to execute against our thesis?
• What’s the most effective and efficient way to get these resources?
• How do we recruit, motivate, compensate and retain our talent?

Careful consideration of these elements, and indeed of all aspects of the operating resource model, can help maximize the impact of these increasingly essential resources.

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