Talent Blueprint for Private Equity Portfolio Operations

Lancor

Introduction

Over the past few years, there have been some excellent articles on the genesis and structure of portfolio operations groups housed within private equity funds. As an executive search firm, we have set out to study and document the realities of building and retaining an effective portfolio operations team. We believe there are some worthwhile lessons to be shared with regard to the right and wrong way to implement this type of group.

During the upswing of the last economic cycle, which saw global funds under management soar to $2.5 trillion, “best practice” in private equity embraced the concept of bolstering investment teams by hiring senior executives from the business world into portfolio operations groups. What began as a novel, sporadically deployed idea a decade ago has evolved to be an accepted feature of a contemporary firm’s toolkit. The thesis is that financial engineering alone does not maximize return, and that operational transformation across a fund’s portfolio companies is essential to success. Further, with an influx of professional business managers to oversee existing portfolio companies, the deal teams could therefore be freed up to focus on what they do best: buying and selling. Moreover, limited partners (LPs) are now very aware of which LBO funds have constructed substantial portfolio operations teams. One managing director at a well-known pension fund told us, “We don’t have religion about what type of PortOps philosophy works best, but we do expect funds to have a story.”

The operating partner role is relatively new, and as such, there is no one best practice as it relates to the management, continuity, and scalability of this function. Unfortunately, just as the operating partner started to become a recognized career path, the recent global economic events caused many funds to downsize costs and thin their ranks. Now, with some stability (hopefully) returning to the markets, debating how to properly staff and maintain portfolio operations is topical.

This tiny population of professionals—our sources estimate that the total number of full-time operating partners tally 500 or less—generates ongoing discussion. In our opinion the role is broadly understood in concept, but only a few funds have executed on the true potential of portfolio operations. This overview looks at the practical human-capital considerations and includes some facts and analysis, as well as a number of hypotheses and anecdotes. We hope to demystify what the term “operating partner” actually means.

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Methodology

As an executive search firm focused on this sector of the market, we have examined the data collected from several portfolio operations searches we have conducted over time. To that, we have added analysis from numerous recent interviews where we surveyed senior-deal professionals, past and current operating partners, portfolio company CEOs, and LPs. Our methodology and research was based on the largest 250 private equity funds in North America, and focused on full-time operating partners. Our target audience for this piece is senior investment professionals at funds (the clients who retain us) and executives considering in-house portfolio operations as a career move (our prospective candidates).

For sake of ease, we have used "portfolio operations" as a generic title for a broad range of naming schemes, including: asset management group, portfolio support group, resources group, portfolio strategic services, as well as simply, operations. Likewise, we refer to the vernacular "operating partners" for job titles that range from the specific and descriptive, such as global head of portfolio transformation, to the typical paygrades used by banks and corporations.

Acknowledgements

We thank all friends of the firm who participated in this survey. In particular, we appreciate the input from industry luminaries with tenure in these operating partner roles.

THE PERSON

Operating Partners—Defining the Role

Most job titles are clear and straightforward. What is expected of a CEO or a CFO or an audit committee chair does not really change from one industry sector to another. Of course there are differences in scale and experience between a Fortune 50 executive and his or her counterpart by title at a venture-backed start-up, but their general mandates are essentially the same. By contrast, operating partner is a role that can mean different things to different people.

The first task of any fund creating or rebuilding its portfolio operations team is to corral the thinking, biases, and strong opinions on this topic into one place. Nominate a "PortOps" taskforce and identify a senior investment professional at the fund to chair it. The ideal chairperson should be a partner or managing director with a propensity for decision-making. We recommend a set period (100 days or less) of introspection and market-based discovery. The product should be a succinct "acid test" defining the role, the preferred candidate profile, and the acceptable compensation range.

As a firm goes through the discovery process, it can take meetings with third-party consulting firms who have exposure to the function as well as speaking directly with operating partners at other funds. Collection of this external data is important, but in actuality, it is the head of the fund/investment committee that will define the role and the metrics for success. So we say, "Focus on the corner office." Experience dictates that unless the head of the fund is enthused about the value of portfolio operations then it will probably fail. Funds that take eons debating whether to move forward with the creation of a group probably have some internal cultural issues that are insurmountable. In the long run it is better to be firmly against the concept, and to save the money and hassle, than to toy with the idea just to appease LPs.

Most discussions on defining the role will start out listing the obvious, explicit responsibilities expected from the ops team. Asking how a given operating partner should be spending his or her time is a good way to get the conversation moving in the right direction. Of course, no two funds are the same. However, based on our survey, and as a point of calibration, the bullets below and graphic above illustrate how respondents told us they spend their time day-to-day. [See Figure 1]

- **Helping portfolio companies.** This will include turnaround or restructuring projects, interim executive roles, assisting with recruiting and interviewing candidates, strategy setting, CEO mentoring, and deciding when to engage third-party professional services firms. A key aspect is readying a given company for an exit—whether IPO or sale to a "strategic."
- **Deal due diligence.** The operating partners work with the deal teams as they evaluate new investments and roll ups. They assist in preparing tailored 100-day plans, spend time onsite at the company, assess the leadership team, and start to determine who is a "keeper" and where and when upgrades will need to occur. As appropriate, they will select and manage service providers (i.e., lawyers, headhunters, accountants, consulting firms, and bankers).
- **Investor relations to LPs.** Some funds like their operations team "front and center" and in direct contact with LPs, while others do not. Independent PE funds (versus merchant banks/internal sponsor groups) will expend time and effort raising capital and sometimes the quality and impact of the portfolio operations team has a bearing on the outcome. Marquee operating partners will be expected to be a sounding board for investment hypotheses and give a real-world perspective on market trends and competitive analysis.

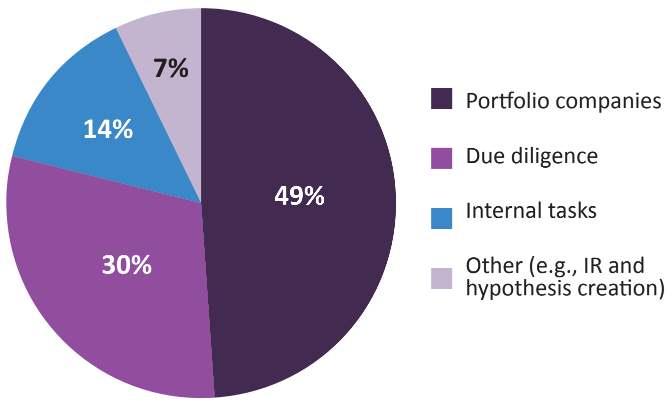

Figure 1: How Operating Partners Spend Time

Subtle Ways Operating Partners Can Contribute

As noted in Figure 1, investors can expect operating partners to spend the majority of their time on existing portfolio companies and on new deals. That said, there are many other ways a senior operating partner can bring real value to his or her firm.

- **Silverback in the room.** Having an operating partner who can represent the firm and handle any aspect of a business discussion is often viewed as an invaluable asset. Most firms have only a handful of senior partners in their ranks—by that we mean the founders of the firm and the decision-makers on the investment committee. The senior team is spread thin and travelling a lot. Having a seasoned operating partner can provide a level of polish to the broader team that can shore up junior investment professionals when they need to take a meeting with a potential seller. Operating partners we surveyed told stories of junior team members asking rookie questions and showing their ignorance or—worse—trying to go toe-to-toe on spreadsheets and getting into petty minutia with senior, corporate management team members from a target investment. A properly positioned operating partner can engender trust with the corporate CEOs and CFOs who are critical to a PE firm's success.
- **Managing board relations.** A top-level, effective operating partner should have the credibility to act as a trusted conduit between the portfolio company executive team and the investors and (for a club deal) between the investors themselves. Over the past couple of years, due to the distressed economic climate, PE investors and their portfolio company leadership were often faced with making very stressful choices to maintain a businesses' value. An operating partner should be an ally for the executive team and should assist in the efficiency of the communication between firm and company. In other cases, the chemistry among board members from different PE firms can become toxic. One well-known operating partner referred to his primary role as "Cutting the Gordian knot" when a club deal with three senior investors from three different funds all stopped speaking with each other. Having a professional in the form of an operating partner on the board can help to smooth over differences and/or insulate the CEO and CFO from the investor discord.
- **Recruiting the C-suite.** Just about every fund places a premium on recruiting world-class talent–especially CEOs and CFOs. The right operating partner can be your fund's best closer when it comes to CEO and CFO hiring. A competent search firm will identify and attract talent to take an exploratory first interview. A successful operating partner will have built teams, run a P&L, and know how to probe at interviews. Beyond bringing an informed assessment on a given candidate's competency for the job in question, they can build trust and empathy with the finalist. If it is a seamless process from a candidate's first interview to getting them on-boarded, it significantly increases the chances for a positive short-term impact. Again, the deal team alone may not have the time or gravitas to do this well.

> The models for operations groups are varied, ranging from structured and intensely managed to loosely affiliated.

- **Internal fund management.** This can be an emotional topic, but our research indicates that many senior operating partners act as internal coaches and culture builders at their firms. The running and management of funds varies enormously in our experience. Some are flat and others are autocratic. Some managing partners are hands-on and involved in the details. Others rely heavily on COOs, CFOs, and chief administrative officers. As talented leaders, the investment team often congregate around top-notch operating partners. Some managing partners even go so far as having their operating partners lead 360-degree review processes on themselves. Over time, the management and culture of the firm can be part of the operating partner's remit. Sometimes there are difficult politics to navigate. Interestingly, most operating partners list "internal" tasks as a negligible amount of how they spend their time. However, perhaps their greatest value to a founder or managing partner is helping the fund maintain stability and ongoing clear direction.

Where Do They Fit On the Org Chart?

Once the expectations are set and the operating partner role is defined, the next consideration is where to position portfolio operations on the organization chart. Our findings indicate there is no set rule. We have seen it reporting into the managing partner/head of fund, to the investment committee (matrixes), to a dedicated partner/managing director, or alternatively to a rotating partner/managing director who will take on its management for a couple of years. Larger funds have more infrastructure, such as a chief administrative officer who may take ownership.

- **One size does not fit all.** There are both similarities and anomalies between funds. As expected, we have found a correlation between the number of asset management professionals and the size of the funds themselves. [See Figure 2] Even so, the models for operations groups are varied, ranging from structured and intensely managed to those that are loosely affiliated. Further, the size of a fund does not correlate to its number of portfolio companies. For example, Silver Lake Partners (SLP) is a top-20 fund by size, yet it has 12 current portfolio companies. In contrast, Warburg Pincus (Warburg) may be similar in size, but has 110+ current investments. Every investor in the private equity community knows that SLP and Warburg have different investment mandates. Yet to the untrained eye, especially those from the corporate world who are new to private equity, both funds look like they have a general focus on high-tech and business services with about the same amount of capital to invest. There are also some differences between how publicly listed funds operate (like Blackstone and Fortress and sponsor groups within banks) versus the majority of PE funds, which are privately held.

A fund's resources for managing and transforming its portfolio are not neatly housed within a standalone PortOps division. Overall financial performance of a fund's portfolio will always be tracked and analyzed by the investment teams.

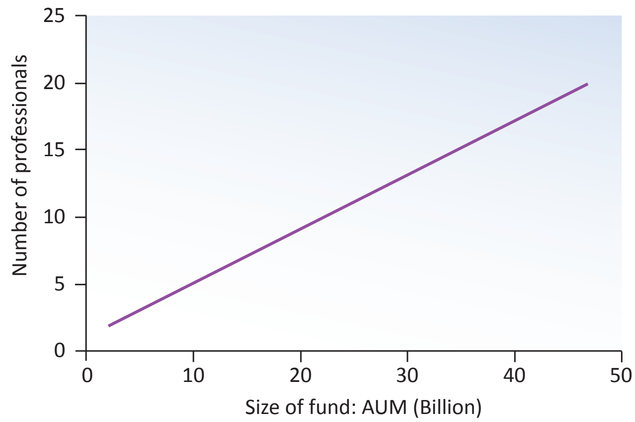

Figure 2: Operating Professionals Scale With Fund Size. On Y AXIS: Number of Professionals

THE MODELS

Three Models for Operations Groups: A Synopsis

In the following pages, we have identified three prominent models that exist today.

- **Centralized and Core to the Firm**

  This is the most highly evolved model, where the PE firm believes passionately in driving portfolio transformation. They believe the benefits of a sophisticated operations team outweigh the fixed cost. [See Figure 3]

  This philosophy is more typically seen inside larger LBO firms ($10+ billion in assets—with substantial management fees to deploy), but is also present in smaller platforms epitomized by Platinum Equity, Sun Capital, and Gores Technology Group. The thematic is that these funds take majority or complete ownership ("control" positions), and believe that they can find new ways to cut costs and drive EBITDA. One of the drivers for investing in these new multi-disciplined teams is the sheer scale and complexity of overseeing and coordinating a large portfolio. The six biggest PE funds each have 500,000 people or more on their payrolls worldwide, for example. In Figure 4 (see page 6), for context and to benchmark against the corporate world, five funds have more employees in their portfolio than GE, PepsiCo, and Apple combined.

  Every portfolio company is assigned one or several operations experts. Their philosophy is that there is always more to do. Change is constant. No human being is perfect; therefore, no system, culture, or process is left unmonitored. Very rarely does a private equity firm own the overall market-leading company in a particular category; therefore, sponsors are consistently trying to steal slivers of market share from the dominant blue chips. They are always playing catch up, and believe active, hands-on management is necessary. Most centralized models have a strong and homogenous culture, and there is a house-style with an agreed-upon methodology. The best-run operations teams

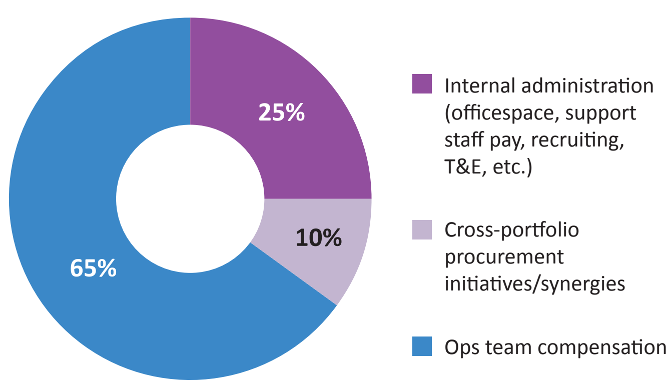

Figure 3: Ops Team Budget Allocation

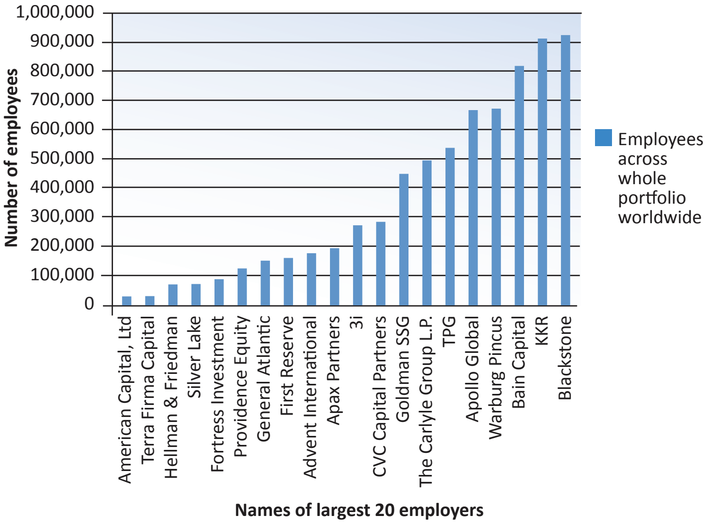

Figure 4: Employees Across All Portfolios Worldwide
Notes: Research conducted by Lancor via public sources including Cap IQ. Through syndication, there is inevitably double-counting as funds calculate number of employees across the companies they own.

work closely and effectively with portfolio CEOs. Their interests are aligned and tasks that would normally take a corporation a year (due to bureaucracy, politics, and less motivated/talented executives) can get accomplished in weeks by a world-class PortOps SWAT team.

Large funds will hire a head of portfolio operations and formalize the management structure of its operations group. Examples of firms that have functioning heads of operations include TPG, Blackstone Bain Capital, and KKR's Capstone[1].

Big LBO funds can afford to align their industry-specific deal teams with former top executives from the dominant companies within that sector. The collective expertise can be impressive. If a firm's portfolio is big enough, it may employ a two-tiered system which will include a centralized operating partner group (described above) as well as a group of alternate ops professionals not as formally tied to the fund. These "field-based" consultants are generally executives located across the world who have a specific expertise in one functional area and can be deployed in several industries. This structure can be advantageous because these field-based professionals are cheaper for the PE firm in that their time is billed back to the portfolio company (versus the tax inefficiency of paying directly out of the fund's 2% management fees). They also do not have any carry component to their compensation.

One trend that seems to be gaining momentum is to organize operations into sub-teams of functional experts. Blackstone and Cerberus are known for this specialized approach, for example. Reviewing the large buy-out funds we found domain experts spanning:

- Lean/Six Sigma/SCM
- Pricing
- Procurement, especially employee health and benefits (which is getting a lot of attention)
- Salesforce effectiveness
- Web/eCommerce strategy
- Merchandising
- Bankruptcy and workouts
- Human capital management

Often firms bifurcate between "growth" experts and cost-cutting/efficiency gurus.

- **Virtual Individual Contributors—Ops Lite**

In this context, a firm will hire one, perhaps two, senior operating executives who serve as the "quarterbacks" to a team of more junior ops team members. They manage through influence and matrices, either in coordination with a given portfolio CEO (using the company's resources) or by engaging strategy consulting firms. This model resembles the centralized model (discussed above), but instead of staffing across all disciplines and functions, the talent to support the portfolio is "rented" via external consultants. This role is lightly staffed in contrast with the centralized model, whereas there are no "armies of analysts and associates" in this model.

Many middle-market funds appoint a head of portfolio operations. This individual's role is primarily to ensure that portfolio CEOs are given a day-to-day sounding board as challenges arise. If a portfolio company is underperforming then they will be expected to provide an informed opinion on whether the cause is justifiable (and being fixed) or whether the CEO is ill-qualified for the role and needs to be replaced. The role is more hands-off and primarily about hiring and coaching CEOs, procuring the right service providers, and holding CEOs accountable to performance metrics.

[1] Capstone is the name of KKR's captive consulting team that provides advisory services exclusively for KKR's investors and the leadership teams at its portfolio companies. Unlike a traditional strategy consulting firm, Capstone is never in conflict amongst clients as it only works for KKR. Also, its consultants focus on project execution rather than selling the next engagement. The pitch to prospective Capstone consultants is that there is no selling; thus, there is less political maneuvering and more focus on the content of work. KKR argues that Capstone can be a more expert cost-effective resource for the portfolio companies versus a traditional strategy consultant.

- **Soft Affiliation With Senior Advisors**

  This model is the most common as it is easy to institute and does not necessitate much monetary investment by the deal partners. Generally, a firm will invite an executive with whom it has some history to affiliate and enter into a quid-pro-quo set up.

  In this model, the advisors are traditionally seasoned and at a later stage in their career—and are often the biggest marquee names and storied CEOs. Their roles are routinely to serve on the boards of the companies in the PE firm's portfolio, with traditional board director responsibilities: They will work to make sure the company has the right CEO in place; they will then assist that CEO on strategic issues; they will also leverage their rolodex for the benefit of the company. They typically do not take an active role in operating the business. It would be unusual for them to spend significant time in-person at the company.

Our own opinion is that there are fine examples of pure consultants and pure line managers, but having a career that spans both allows for flexibility in any setting.

  Like the models listed above, the advisors assist the investment partners on deal due diligence, and they will lend their industry and functional expertise to help the deal teams make smarter decisions. They will also leverage their domain knowledge for purposes of reference checking and talent scouting.

  In return, in addition to receiving traditional board director compensation and benefits, the advisors will have the opportunity to invest as an LP in the PE firm's funds, and can also invest personally in the individual portfolio companies (alongside the PE firm).

  These seasoned executives bring a career of operating experience to "income statement" issues (revenue and cost). They are often silent on capital markets, capital structure, or credit-agreement issues, and are generally not expected to be the exclusive representative of the owner on issues like timing of exit.

  While easy to institute and cheap to maintain, these types of relationships can feel detached to the senior advisor unless there is a specific program for keeping that person engaged and interested in what is happening inside the PE firm on a timely basis.

Hiring Templates

We have seen a few predominant philosophies in terms of what makes for a credible operating partner. By definition, operating partners need to be financially and operationally astute, and bring immediate credibility and value-add to a given situation. Rightly or wrongly, most funds have their own lens when it comes to defining excellence. Following are four of the most prevalent hiring templates:

- **Process-oriented general managers.** Invariably, private equity investors want to see cost containment and heightened efficiency. A world-class GM trained in procurement, SCM, Six Sigma, and operational excellence will be able to drive up EBITDA and create value. Culturally, many investors like GMs with this penny-pinching attitude and expertise. These funds put more value on operational process and line management. The best of this talent, for example, may come through academy companies like General Electric, Honeywell, Pepsi, and Danaher, to name a few.
- **Former strategy consultants.** Some funds believe that the analytical and modeling skills gained from the leading consulting firms are invaluable and almost a prerequisite to be effective within private equity. Unsurprisingly perhaps, seasoned GMs with tenured line-management experience are sometimes more skeptical of this value. These are funds that put a premium on a strategy consulting pedigree (Bain & Co, McKinsey, BCG, Booz, and their boutique offshoots like Parthenon). PE firms use consulting firms extensively and so having one of their alumnus on staff means that they know how to select the right service provider and have enough of an internal network to cross-reference the abilities of specific engagement partners and the team. Adjacent and sometimes competitive to the "classic" strategy firms is a burgeoning group of restructuring experts such as Alvarez & Marsal, FTI, and Alix Partners. We see some special situations funds preferring to hire for specific turnaround and distressed expertise.
- **The all-rounder.** Our experience is that many funds want both skill sets. The typical career history sequence is sufficient strategy consulting experience coupled with successful C-level roles at blue chips. Our own opinion is that there are fine examples of pure consultants and pure line managers, but having a career that spans both allows for flexibility in any setting. It also helps avoid stereotypical pre-conceptions: The consultant who talks but has never run a P&L; the GE-type who gives clinics on Six Sigma but cannot think outside of that paradigm.

  Unsurprisingly, there is a premium on operating partners who have a proven track record and prior life as a successful CEO. Bear in mind that operating partners are often working offsite at one of the companies and stuck in different timezones. The individual needs to possess a comprehensive skill set—especially if they are expected to engage the CEO in a strategic discussion. The all-round "athlete" is, therefore, relevant and additive in most situations and conversant in most topics. The operating partner that has broad expertise will have universal appeal and therefore a high utilization rate. However, these elite executives come with a commensurate price tag and expectations as to their status within the fund. A fund needs to place huge value on the benefits of portfolio improvement programs to be able to attract, remunerate, and retain a full-time A player with this level of credibility.

- **The CFO Czar.** Private equity investors manage by the numbers and thrive off financial data. Another tried and accepted model is to appoint a world-class, seasoned CFO as part of portfolio operations. CFOs are—by definition—both experienced at managing business operations and also deciphering trends. A number of funds operate a performance dashboard and run analytics based on financial reporting across the portfolio. Portfolio CFOs therefore report directly to their CEO but have dotted-line accountability into the fund, or as one CFO put it, "mother ship." These CFOs are viewed as strategic thinkers and often have strategy consulting or investment banking backgrounds earlier in their careers.

THE ISSUES

Why Operating Partners Quit

To understand the tactics for minimizing potential turnover, we examined some reasons why an ops team might experience frustration in the role. Unsurprisingly, perhaps, we believe the primary cause for "organ rejection" is a failure to create a realistically defined role and therefore mis-set expectations.

However, even self-aware managing partners should accept that there will be some attrition over time. The life of an operating partner is busy with extensive travel [See Figure 5]; little direct authority; convoluted, internal relationships; and a wide array of external stakeholders to satisfy. The combination of these overall factors can make even the most dedicated professional experience fatigue.

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Keep in mind that many of these operating partners made their reputation either as the best portfolio company CEO a deal team had ever hired, or as a strong performer at a household name Fortune 100 public company earlier in their career. They are generally accustomed to running large organizations where they call the shots and their orders are faithfully executed. Of course, as soon as they take on the operating partner role, the "Office of the CEO" mentality must be shelved in favor of what sometimes feels more like a mission to support, massage, and cajole the less talented.

Moreover, a fund's best-laid plans can unravel easily because the same pedigree, smarts, and people skills that result in a given operating partner being initially hired indicate that they will also be a magnet for other opportunities. Paradoxically, the fact that they are now working at a world-class private equity fund may make them an even more alluring target to outsiders.

Wide Range on Compensation

Because the term "operating partner" is hard to define and probably misunderstood, we are asked about compensation levels frequently. We have found that, typically, the larger the fund, the broader range in total compensation and the amount of carry. On the other end of the spectrum, our research indicates that coming up with a simple answer is not as easy as it would seem. [See Figure 6]

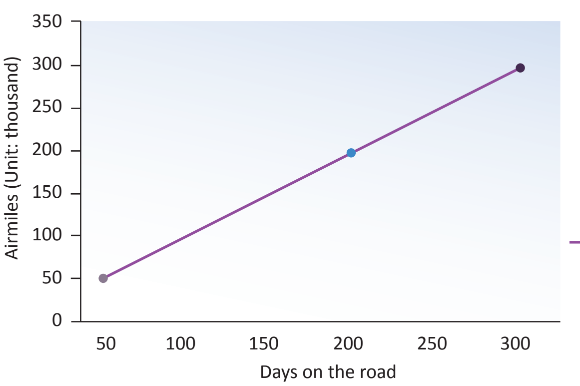

Figure 5: Life of Travel for Operating Partners

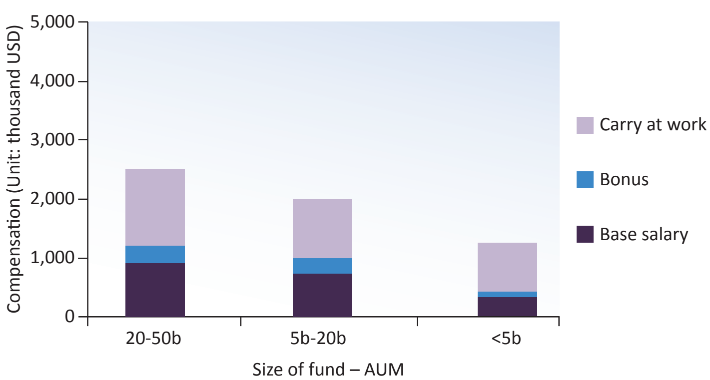

Figure 6: Compensation Ranges

Following are general themes that we have learned:

- Operating partners at firms based in New York City and San Francisco generally earn more. In many cases, we have seen partners in these two locations earn two to three times more versus other geographies. While some of the delta is due to differences in fund sizes, the "fund size-to-compensation" metric does not necessarily follow a linear path. Further, as laid out earlier, their compensation is a metaphor for "perceived value-add" by the senior partners at the fund. If the culture is heavily in favor of portfolio operations then there is an upward spike in pay compared to funds of a similar size that do not see the same strategic upside. For example, unsurprisingly, Bain Capital (born out of Bain & Company), has been using operating partners for more than 15 years and views them as integral to success and intrinsically valuable. Likewise, KKR's Capstone was founded by a couple of senior partners from BCG who had worked closely with the fund.

  Depending on the fund, the general partnership may allow operating partners to co-invest and participate in the promotion on specific deals. Some operating partners are more equal than others. The overall head of operations may be a full partner at the fund and command significant carry. One of the largest funds pegs carry dollars for partners and principals in portfolio operations at 50-75% of their counterparts (by title) in the deal teams. The other rule of thumb is to keep compensation at or above whatever that individual would be earning in a conventional C-suite role. The top-billing strategy consultants (directors at McKinsey & Company and senior partners at BCG, for example) are earning $2 million+ (some as high as $5 million annually), and so even the biggest funds regard that price tag as prohibitive.
- Some firms default to the investment banking model of compensation for operating partners. They pay a low base salary and give the ops team members significant cash bonus upside if certain goals are reached. Critics of this model say it is flawed for two reasons: (1) generally the best people for an operating partner role are not coming from investment banking, and therefore find this compensation model odd and unsatisfactory; and (2) many top firms in PE have abandoned this idea and compensate their operating partners in line with what they would receive if they were a portfolio company CEO. Thus, firms that stick to the i-banking set-up risk losing good operating partners to more evolved situations. That said, some large and accomplished funds have built strong portfolio asset management teams using large annual bonuses like a Wall Street bank. We see no drop off in quality or ability at say Goldman Sachs versus standalone funds. However, funds that view operating partner as a career path and use long-term incentives like carry have less staff turnover, in our experience.

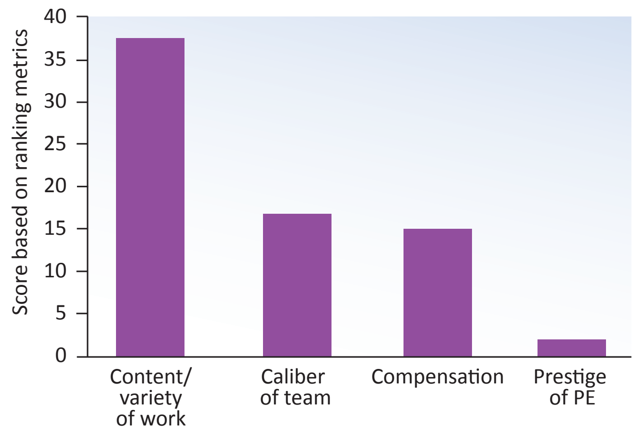

Figure 7: Motivations of Operating Partners

Retaining Top Talent in Portfolio Operations

We believe there are some clues to retention and longevity. PE investors are commercial and rate compensation high on their list of career needs. Operating partners are less coin-driven and primarily care about the working environment. As one partner candidly tells us, "It's like being a consultant again. It's about influence and persuasion. I am a band of one so they either listen or they don't. At least this time around, I have some conviction when giving advice." They are most keenly interested in the variety and challenge of the work, and working with a team of high-caliber professionals. [See Figure 7]

We recommend four considerations when PE firms are ready and interested to bring on—and retain—a seasoned operating partner to the fund:

- **Ensure the candidate's readiness for the role.** Ensure that the finalist candidate you are considering wants to be part of a fund and is committed to a career change versus treading water waiting for the right CEO or CFO role. Several funds have recruited operating partners and kept them somewhat occupied helping portfolio companies. However, they are really executives-in-residence (EIRs) in a holding tank hoping that the fund acquires a company they can run. It is a high-risk approach because their retention is dependent on being able to close an appropriate deal. As a result, some operating partners give up waiting, quit, and return to C-suite jobs elsewhere. Another dimension that requires careful management, and is typically a show-stopper, is when an operating partner candidate harbors an ambition to become an investor. Last year TPG promoted an exceptional performer from portfolio operations to the deal team. However, we cannot think of any other examples, although they may exist.
- **On-boarding and expectation setting.** Even the best-paid and most influential operating partners within PE funds need to manage through influence, nuance, and dotted-line structures. It is hard for

many former senior line managers to adapt to a de facto staff role—especially after they have led thousands of employees in a past life. Support the operating partner by teaming with that person in presenting ideas to the portfolio CEO. Get them off on the right foot and show the commitment of the deal team. Be unequivocal, or risk flight by the operating partner who will complain that the deal team never supported his or her efforts and never laid out a clear mandate to all the constituencies.

- **Show-horse versus plow-horse.** Some funds hire marquee names from industry and politics. These visible candidates have high-level relationships and access to policy-making. As rain-makers they tend to be seasoned and experienced, but only work part-time. They look wonderful on a firm's website and they garner positive PR for the firm. The plow-horse, on the other hand, tends to be mid-career and 100% integrated into the fabric of the PE firm. They are less visible externally. They spend their time getting their hands dirty solving real business problems inside the portfolio. Again, a PE deal team must be clear about what kind of contribution they are expecting.
- **On compensation, don't just set it and forget it.** We touch on the inevitable topic of compensation at several junctures in this paper. Our opinion is that the process of setting and reviewing compensation is sometimes underestimated and mishandled. Deal teams should be thinking about the cost to the portfolio of losing a valuable operations team professional and periodically evaluate compensation to make sure it is in line with industry norms. The best way to create value in a portfolio is to have an ops team that the portfolio company CEOs clamor over. Protect your franchise and lay out an attractive compensation plan to keep people happy. The challenge ("elephant in the room" as a managing director at a $4 billion fund put it) is the disparity between pay levels. No matter how valuable and talented the operating partner, the lion's share of the carry is distributed to the founders and senior deal team, and we do not expect this condition to change anytime soon.

  As important as the actual economics is the review process. Nearly every operations professional has been trained in a highly structured organization where pay-for-performance is measured. They are accustomed to being reviewed by Fortune 100 CEOs and/or an independent board of directors; hence, we would advise putting aside the appropriate time to do so. As the pace of private equity is hard-driving and frenetic at times, funds need to be self-aware of the competing external/internal factors and put in place a system that avoids clumsy mismanagement. Brilliant investors are not necessarily capable people managers.
- **Rotation between assignments.** It may seem like a nuance, but monotony can set in if an engagement drags on. We know of one fund where members of the PortOps team were commuting to the same engagement for three years. The company in question is based in rural Montana—pretty but not exactly convenient from Park Avenue. The board recognized the risk of burn out, but with no exit likely in the near term it poses a dilemma. Where possible, best practice is to put in place internal knowledge transfer programs and succession plans so that there is never too much reliance on an individual. Most of the professionals we have interviewed in this field like to work on an eclectic set of projects.

The Contrarian View

A general theme has arisen in PE to adopt these models; however, there are some notable hold-outs against operating partner programs. This report would be unbalanced if we did not point to several successful funds who disagree with the concept of operating partners altogether.

Funds like CD&R and Carlyle have a general bias towards hiring investors who are themselves seasoned operators with past career backgrounds in industry. They argue (not without merit—just look at their track records) that getting hands-on and into the operational details is an intrinsic part of the job of a board director. Paraphrased, how can one be a competent investor unless one has run a real business?

Poignantly, one managing partner remarked that his fund typically pairs up CEOs with a strong chairman. He believes that it is the role of the chairman of the board to coach the CEO, brainstorm on strategy, and drive through changes. For 1% or 2% equity in the company he can attract a stellar chairman who is hand-picked for that specific assignment—a cheaper and more precise way to augment the CEO's skill set. Amusingly, he went on to say: "Operating partners are like the Euro as far as I can tell. Created by idealists and abused by investors."

Others simply do not want to second-guess their CEOs and insert an additional layer of communication. "Three is a crowd," said one partner, adding that he would "prefer to pay more and get an even better CEO in the chair rather than building up portfolio operations teams."

Another objection is that operating partners can actually hinder productivity. One middle-market fund told us that some of their executives historically lost focus because they spend more time communicating and writing reports versus simply getting results. Other CEOs were paranoid that the only reason an operating partner was getting assigned was because they were about to get fired or moved aside. "I don't like my guys having to look over their shoulders," said a seasoned investor. This fund has since changed its approach and tells us that the trust factor is now higher.

In addition, contrarians think that the management of portfolio operations is a drain on the managing partner's time and energy. On this criticism, time will tell. Probably, funds that perform well will be given free rein to manage themselves as they see fit. Any that falter or fall behind their competitors will feel pressure from LPs to make changes and add operations capabilities. LPs are very aware of which funds take an active approach to portfolio management.

Over time, many CEOs have weighed in about their personal experience with operating partners. Our estimate is that the majority of CEOs value the operating partner's insights and the extra resource. Other CEOs are neutral and feel they get the same value for the same cost from advisors and consultants. One CEO in particular had a unique vantage point. He was running a company owned by three different firms in syndication. One firm was dogmatic about ops partners, another forced consultants into the situation, and the third was hands-off. Guess whose style he, as a seasoned, repeat CEO valued the most? Not surprisingly, the hands-off approach was the clear favorite in his mind.

Sometimes the dynamic between an operating partner and a CEO can become strained. Nothing raises tempers faster than issues of power and control, job security and money. One CEO reminisced that he was "fit-to-be-tied" after meeting a new member of a fund's ops group at an offsite. Between expletives, this CEO described how he had a 12-year working relationship with this sponsor and considered the lead investor "a close ally," adding "we have made a ton of money together over three different transactions." Evidently, a VP in the fund's operations group had shown the lead investor a growth thesis that he had co-written back from his consulting days for a public company in an adjacent sector. What was probably intended as eagerness by a rookie in the PortOps role was clearly misinterpreted. The CEO felt circumvented and blind-sided. Whether the VP's findings were right or wrong, the VP distracted the CEO from his day-job over-seeing a $1.1 billion company and several hundred million dollars of the fund's capital. Did the CEO overreact? Probably. However, the consequences of trust erosion with a valued CEO are considerable. Repackaged appropriately and delivered more diplomatically, the very same content may have delighted that CEO.

There is a delicate balance that must be struck in order to ensure a smooth relationship. We recommend the following types of questions to be considered and discussed openly by the leadership of the fund as you consider the practicalities of who does what:

- Should the operating partner, when it comes to successful ideas, attribute all credit to the CEO as a matter of course?
- What information gets reported back to the board?
- Can the CEO say no to a suggestion?
- Can a CEO fire the operating partner and request a replacement?
- A CEO may perceive that one of their executives is invaluable whereas the operating partner may be nonplussed by that person's performance as they observe it. Who makes that judgment call when it comes to upgrading executive team members?
- Who controls when to sell? Judging the timing, price, and conditions for exit is a complicated equation. The answer generally depends on whether that PortOps professional does or does not occupy a board seat (i.e., who has a vote). This begs the question: Does the head of your fund encourage operating partners to sit on boards?

Key Conclusions

- **Set a strategy and stick to it.** Only invest in a full-time operations team if you perceive that they will bring significant value in every stage of the economic cycle. Otherwise, it is cheaper to "rent" consultants and part-time advisors, and maintain a flexible workforce. Quantify the value of portfolio operations for your specific situation, and model out the anticipated return on investment. Build a PortOps team that is the correct size for your fund and the way you manage or want to manage your portfolio companies.
- **Choose the right model.** There are enough benchmarks to draw intelligent points of comparison. Whatever the fund, location, or industry, it is possible to apply some analysis to this burgeoning pattern of overlaying deal teams with portfolio operations. It is important to pick relevant examples rather than emulating funds which may be impressive but are actually quite different in the way they are run.
- **Define the role when hiring.** We have tried to explain that this operating partner role is hard to define. In our opinion, time spent up front defining a search strategy (i.e., where to look) and acid test (i.e., what "good" looks like) requires careful discussion and direct, unequivocal input from the leadership of the fund.
- **No surprises.** Rolling out a communication program that explains to every stakeholder what to expect of their interaction with portfolio operations sets expectations and defines clear boundaries.
- **Define success versus failure.** Unless their progress is actively measured against predetermined goals, you are setting up your portfolio operations team for an impossible task. Even a small fund —say $1 billion or less—will have several portfolio companies culminating in thousands of employees. Goal setting by way of sought-after improvements will be routine in almost every PE firm. You must communicate those to the PortOps team and give them a clear mandate to drive toward. Your portfolio operations team can

affect change, but a fund needs to prioritize efforts and consequently deploy resources accordingly. Lastly, it is also wise to link their compensation to specific metrics.

- **Analyze deal dynamics.** Funds that place a premium on "transformation" have built models that predict outcomes based on different operational strategies. Just like a hedge fund collates data and runs algorithms for public equities, sophisticated operating partners extrapolate trends from the companies they oversee. PE investors are expert at macro due diligence and market comparisons pouring over a target asset. However, the "micro" (meaning a granular understanding of that specific business) may be just as important. Established funds will have historical data on past and present portfolio companies that can be used for competitive advantage during a new potential deal. This intellectual property is one factor that determines how a deal team will behave—such as their level of aggression during a bid, plus what terms they would seek (and covenants they would endure) negotiating with the banks and securing debt financing. There is always subjectivity when assessing any transaction. There is also educated guesswork around human factors like the personalities on a board of directors or whether an executive team is fit-for-purpose. However, we see the best operating partners finding ways to add value through hard math, selecting the right inputs and running models for every scenario. A stellar operating partner should be able to assess risks and "the difficulty factor" upfront, helping qualify that diamond in the rough or whether a "value" buy is more like trying to catch a falling knife.
- **Bedside manner.** On candidate selection, charisma and charm matter. One only has to look back at the 2008 United States Presidential Election to see that personality and a likable demeanor can trump decades of more relevant experience. The successful operating partners we know are smooth and politically astute. Political navigation is a stark reality of this role. They tread softly but carry a big stick. Make sure that whomever you hire into portfolio operations has the ability to connect with people quickly and size up a situation. As one prestigious fund puts it, "It's EQ and not just IQ that we care about." The caliber of the head of the group—like any leadership role—will set the tone. We recommend that you aim high and pay aggressively. The right leader will execute on your mandate and deliver the ROI you have forecasted.

What defines an outstanding versus mediocre operating partner? To quote a seasoned PortOps partner, this four-step guide essentially nails the point.

1. **Wearing an "investor's hat":** Operating partners often think about priorities and issues with a mindset into perpetuity instead of thinking about what creates value for the PE firm in the medium-term. An example would be a situation where an underperforming portfolio company wanted to spend a minimal amount of money for a pilot project on a huge cost-savings initiative. The operating partner was strongly against it, since it was discretionary capex and the business was behind budget. My reaction was exactly the opposite—it was the only meaningful opportunity to dramatically improve margins during our hold period and it was worth the risk.
2. **Prioritizing key issues:** This seems obvious, but operating partners can sometimes forget the organizational limitations of PE-owned businesses, and can take a "let's do everything" approach.
3. **Working with "B" managers:** Maybe not true for mega-buyouts, but mid-market businesses often have to tolerate B players at some positions. Some senior managers can ride those guys in board meetings and forget that in difficult geographies with moderate pay packages it might be very difficult to recruit (versus their prior experience where they have a much deeper pool of talent from which to draw).
4. **Keeping their role in mind:** I find it is sometimes difficult for operating partners to stop themselves from running the business. In addition, many struggle with working in partnership with the PE firm. A collaborative style is required as well as an ability to forcefully make one's opinion known while recognizing they may get overruled sometimes.

- **Considering a career as an operating partner?** We have laid out the caveats already, so we will finish on an optimistic note. Designed properly, this operating partner role can be stimulating and rewarding. One of our placed candidates told us two years into his assignment with a large, prestigious fund: "I love the speed of decision-making, and every day I feel I am inner-circle in helping to solve real problems. Everyone is smart and I love the variety of projects. Some days I am Jerry McGuire; some days I feel I just landed on a beach in Normandy. It is never boring."

A decade or more into its formation, this in-house function continues to evolve. There are many schools of thought on best practice. We predict that the operating partner is here to stay.

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