

Secrets for success from the top 10

James Mawson

Investors have searched for the secrets to long-term investment success for as long as there has been risk capital need to back businesses but the answer is easy: not missing your evening train, writes James Mawson.

As the head of one top 10 private equity firm in the Gottschalg-HEC 2009 ranking said: "For me, the secret is making sure I catch the 6pm train, otherwise I become very grumpy."

More seriously, he added: "Private equity has been around in one form or another for at least 500 years and I think it is well recognized that businesses change hands and management are legitimate buyers of them.

"However, managers often do not have the capital to do so and so those with the money can help them. This means a few relatively bright people with coherent views and highly considered convictions can find a business to back."

Separate to venture capital firms that start up or build nascent businesses, therefore, private equity groups try to add value to investors through the different stages of a deal's life that it is involved with – buying, running and selling a company.

The first part is finding the companies using market knowledge or tips and building a reputation for decency.

Xavier Moreno, chairman and co-founder of Astorg Partners in France, said: "The first point among our success factors is access to a very large dealflow through our deep roots in the French business community as it offers

World's top 10 buyout firms

Rank	Firm	Score
1	Leonard Green & Partners	2.89
2	Nordic Capital	2.12
3	Astorg Partners	2.10
4	Charterhouse Capital Partners	2.07
5	Gilde Buy Out Partners	1.73
6	Linsalata Capital Partners	1.48
7	Berkshire Partners	1.43
8	CVC Capital Partners	1.31
9	AXA Private Equity	0.87
10	Brockway Moran & Partners	0.79

Source: PERACS CN

the possibility of being very selective in our investment policy.

"Many people do the deal they can do, we do the deals we want to and there is never any pressure to make the next investment. We focus on primary transactions [those not previously owned by a private equity firm] where price is not key to the seller and often the vendor reinvests.

"We know it is a difficult decision to sell and give up control so we act like a future son in law trying to marry the owner's daughter by treating employees well and not selling to just anybody. Once you are established as a reliable partner word of mouth brings other opportunities."

Once the targets have been identified and a price agreed, appropriately

leveraging the equity depending on the company's stability of earnings and cashflow magnifies returns.

More controversially, some of the top 10 firms said there was a natural size of deal that gave better chances of success as it offered greater stability of earnings without becoming so big it limited exit opportunities. And many of the top 10 had remained consistent in their size or region rather than try and expand too quickly.

Koos Tuele, investor relations officer at Netherlands-based Gilde Buy Out Partners, said: "We have always covered the same geography of the Benelux and German and French-speaking countries in Europe targeting growing companies in the mid-market."

But once the deal has been agreed,

the hard work of operational improvement is started. Michael Smith, chairman of CVC, said: "Private equity is not perfect but if implemented correctly can be a very effective form of ownership and governance. We invest in companies and try to improve them in a continuous process."

Outsized returns are often delivered by targeting a company in a sector with growth and a positive macro-economic climate and then helping it outperform its peers through a competitive strategy.

Eric Bacon and Stephen Perry, the two senior managing directors at Ohio-based Linsalata Capital Partners, said: "Our senior partners have true operating experience across big and mid-sized companies and this brings empathy and understanding with what our portfolio companies go through and improvise our offering as a partner to them in say judging talent.

Between 1996 and 2005, there was a good economy overall but everyone else had that too and so the difference between Linsalata and others is our operating experience allowed us to mitigate our losses and act fast.

Frank Linsalata, our chairman, smells a downturn earlier and takes action faster than anyone we have known. When we look at a company we make fewer mistakes, such as leveraging a balance sheet in a bad environment or buying a hyper-cyclical company because we do not market time the economy."

The ability for private equity managers to show both tactical speed of decision-making and alignment with managers to drive returns with a long-term will to overcome problems can help overcome the agency problem of aloof and distant shareholders from listed businesses.

Dominique Senequier, executive chairman of AXA Private Equity, said: "We have performed well over the long term by the quality of our company management selection in the beginning, which comes through focusing on sectors we know well, and the capability of the AXA Private Equity team to follow and support the company through different steps, including cash management, build-up acquisitions and restructuring to downsize and helping them with a global strategy."

The final part of the process is timing

an exit, whether through a flotation or sale to a trade or private equity peer, or when to return capital through a dividend recapitalisation. To generate the best returns involves buying low and selling for a high multiple of earnings, which have grown under a firm's ownership, and this requires showing growth is left in the business.

Senequier said: "We are very good at investing during market turbulence and exiting at market tops. AXA sold a lot of cyclical companies in retail and construction business between 2006 and 2007 and now are doing the reverse, such as buying HSE 24 from German retailer Arcandor in just four weeks."

However, as important is to avoid selling a portfolio company too early as a quick flip of an asset can just generates a high annual performance rate without necessarily giving investors the highest cash return as a multiple of the equity invested.

Despite widely different investment strategies and geographies, the top 10 firms also showed similar organizational structures to better make the judgement calls of when to buy, sell and how best to help companies operationally.

A small partnership independently run where decisions are taken democratically by people not motivated by money were common links across all the groups.

Robert Andreen, co-founder with Morgan Olsson of Sweden-based Nordic Capital and its senior chairman, said: "Being focused on the Nordic markets, we have a different management style with a democratic and flat organization where all partners are involved."

The only one of the top 10 superficially different was AXA Private Equity as it is owned by a French insurer, although Senequier said as a independent subsidiary it had no interference and the parent had only ever been one investor among others in its fundraising.

The partnership structure allowed individuals to take responsibility for their actions and evolution of control to younger members without losing the culture built by the founders who often remained important within the firm.

Kevin Callaghan and Bradley Bloom, both managing directors at Berkshire Partners in Boston, said: "A small number of decisions influences private equity performance and over our 25 years more of these have gone right

and we have dodged a few bullets because of the nature of the team and its consistency. As a group we have been together 25 years with virtually no turnover at senior levels but make decisions collaboratively to make more thoughtful outcomes.

"We have a consistent strategy and while we started with firms that now manage more dollars we like the mid-market and think this is where we can invest our own dollars – which makes up 8% to 10% of our funds – best."

Through interviews, time and again similar qualities came through the top 10 of intellectual and personal confidence, insight, luck, speed of thought and decision-making as well as a questioning, restless attitude and humility but experience, too, was consistently rated highly by those interviewed. Most of the top 10 firms were formed a few years before the 1996 to 2005 period in the review and so were often in a sweet spot for their returns.

The senior founders had often considerable operational or takeover experience before that and the early years provided the lessons for dealing with investment timing and operational improvement that have remained embedded in the group.

Andreen said: "Nordic Capital was founded in 1989, at a time when the market was very immature. We were one of the pioneers doing private equity investments in the Nordic region and we were also very early to focus on the health care sector."

"One of our trade marks has always been structuring and handling complex deals, but at the same time as we're also considered to have a very honest appearance and a friendly, Nordic deal-making approach."

"We sometimes hear that Nordic Capital is regarded by the business communities in which we operate as the most cautious investor. Well, they are right: we are more cautious when investing.

"We learnt a lot in those early deals. Our very first deal was a public-to-private, and only one year into the investment, Sweden entered into a severe financial crisis that caused a lot of trouble, but eight years later that deal had generated eight times our money at a 46% IRR [the internal rate of return used as an annual performance measurement]."