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Private Equity: Primaries · Secondaries · Co-investment

SL CAPITAL - 10 YEARS OF OPERATIONAL FOCUS

Continuous improvement

Whichever model firms use, it's never been more important to generate real operational improvements at portfolio companies, says SL Capital's Peter McKellar



McKellar: operational experts to the fore

Private equity funds think of their investments in a very different way compared with a decade ago, according to Peter McKellar, chief investment officer at fund of funds manager SL Capital.

“Ten years ago there was an element on the part of many funds of being, to quote the mantra of one fund manager, ‘management’s best friend’”, he explains. “This model was about trying to find proprietary transactions by identifying high quality management teams and, with their support and intrinsic knowledge of the company, buying the business well. During the period of ownership, the reliance was on management to really deliver on their plan, although clearly the fund manager would be an influential board member.”

UPGRADED CAPABILITIES

But these days the relationship is much more involved, he says. High quality assets don’t come cheap, so fund managers have had to work harder to deliver value – which may mean “upgrading the capabilities” of management. “If you look across our managers, they will actively change the CFO in most cases to improve financial reporting and to create a focus on the key performance indicators and will be more aggressive in recruiting a CEO if required.”

That doesn’t mean private equity firms should run businesses – in fact, McKellar says SL would be “concerned if they did”. However, “fund managers have developed the expertise to know in advance what strategic direction they want to take the business, and it may not necessarily be what

the incumbent management team have promoted.”

McKellar says there are three different operational improvement models in existence today. Some firms use a “strong bench of industry non-execs and experts who sit on the company boards to provide guidance and coaching for the management team, while being the fund manager’s second set of eyes”. This is particularly prevalent in the lower and middle market, he says. Other groups work closely with strategy and operational improvement consultants; some of whom may have a specific expertise in, for example, procurement, cash management or logistics.

And finally, there are those firms that have their own internal operating team – an approach that is increasingly prevalent. “Firms have spent significant time and resources building or buying in their own internal consulting groups or operational improvement teams. Their job is to use their experience to lead and co-ordinate the implementation of projects to push [portfolio companies] forward. They help execute the business plan on a micro level.”

The role of these groups has broadened recently, he adds. “Even five years ago, operating teams wouldn’t get involved until they had bought the asset, which somewhat defeats the purpose of the exercise. I think it’s fair to say now that everybody has these guys involved at the outset of due diligence, at the point of identifying opportunities – then certainly in the creation and execution of the hundred day plan, and in ensuring that value is built in the period thereafter.

So it's much more hands-on."

Seeking out managers with a strong operational track record has always been a priority, McKellar says: "What we have always done is to seek out active private equity fund managers – people who are focused on achieving fundamental change within businesses. We believe that private equity has to be more than just buying low, selling high and leveraging up on the way through. What we want to see is the majority of value growth from increases in revenue and profits, combined with improved margins through efficiency gains. And by creating a better business you can enhance exit valuations."

CHANGING WITH THE TIMES

Nonetheless, the evolution of the industry has forced SL to upgrade its own internal capabilities, too. "We have had to build out our own team, staffing the investment side with people that have backgrounds in direct investment, strategy consulting and corporate finance," says McKellar (who himself used to be the CFO of a private equity-backed company). "This gives our team an important understanding of how the private equity model should work."

Going forward, McKellar believes portfolio construction will become an increasingly important issue – because what investors in the asset class want above all is consistent, repeatable returns. "We are doing a lot of good things as an asset class, in terms of adding value and sector specialisation, but we need to get some of the big macro calls right in terms of portfolio construction. I

often joke with our investors that every deal done is a good investment at the time of entry; that's what every fund manager has to believe about his or her deal. So it seems difficult to justify why they put 15 or 20 percent of their fund into one opportunity saying, 'Oh I did that because that was a good investment.' Well, isn't the one that was at 5 percent or 10 percent a good deal as well? There are managers who have put too much into one particular investment."

And what of macroeconomic concerns? "We will continue to focus on bottom-up analysis, finding the best managers and co-investments from the countries and regions we operate in. But you always have to balance this with a top-down view – to understand the macroeconomic and political factors during the time you will invest in that fund or own that asset. We are a long-term investor who takes a long-term view, and we need to have a view on what will happen over that timeframe." That's why the firm has largely been investing in Northern Europe since 2003, for instance. "We just didn't feel that the potential for private equity was as compelling in Southern Europe. So we have avoided a lot of the regional issues that have surfaced."

Either way, McKellar believes that operational improvement is crucial to the industry's ongoing success. "Private equity would not have been able to generate the results it has over the last 10 years without a focus on this type of added value. It has been down to the additional resources deployed by the private equity funds, working with strong management." 🌸

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