

# Gotham Consulting Partners 4th Annual Private Equity Survey: Operating Value Creation In Private Equity

2008 Survey Results Summary And 3-Year Trends

March 2009

## GOTHAM CONSULTING PARTNERS

*Operating Value Creation In Private Equity*

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# PE Survey Purpose And Response Profile Overview

## Annual PE Survey Purpose

Conduct an annual survey of PE firms to track and better understand:

- Overall industry trends and changes
- The role of and approach to portfolio operating value creation
- Insights into successful operating value creation

## Response Profile Overview

- 278 responses from 189 PE firms
- Bulk of respondents functioning on the deal side (versus the operating/portfolio management side)
- Diverse representation in terms of:
  - Size (capital under management)
  - Industry investment focus
  - Position within the firm, with about two-thirds at the Managing Director/Partner or Vice President/Principal levels

**See Appendix for Response Profile  
Details**

# Summary



# 2008 PE Survey Results Summary

## Key Survey Questions

### General Industry And Market

#### A. Value creation levers

- Importance for next 5 years
- Increased in importance since last 5 years (multiple responses allowed)

#### B. Impact of current market conditions on:

- Deal flow (multiple responses allowed)
- Deal valuations (multiple responses allowed)
- Deal financing (multiple responses allowed)

#### C. Impact of current market conditions on portfolio companies (multiple responses allowed)

Response to the change in market conditions

#### D. Expectation of improvement in:

- General economic conditions
- Credit markets

#### E. Differentiation factor for your firm (multiple responses allowed)

## Survey Result/Highlights

- 77% cite “**Operating Value Improvement**” as *most important lever*
- 64% cite “**Financial Leverage**” as *least important*
- 54% say “Operating Value Improvement” has become *more important*
- 66% say “**Fewer Deals**”
- 42% say “**Increased Distressed/Lower Quality Deals**”
- 82% say “**Valuations Going Down**”
- 77% say “**Less Favorable Terms**”
- 74% say “**More Equity Participation**”
- 71% say “**EBITDA Below Plan**”
- 69% say “**Revenue Below Target**”
- 46% say companies “**Approaching Covenant Thresholds**”
- 77% “**Increasing Involvement In Company Management**”
- 60% “**Extending Exit Timeline**”
- 68% expect *economic conditions to improve in 2010*
- 48% expect *credit markets to improve in 2<sup>nd</sup> half of 2009*
- 40% expect *credit markets to improve in 2010*
- 69% differentiate themselves through “**Operational Expertise**”
- 55% differentiate themselves through “**Industry Expertise**”

# 2008 PE Survey Results Summary (Cont.)

## Key Survey Questions

### Approach To Operating Value Creation

#### 1. Due diligence

- % time spent

- Quality

#### 2. Operational due diligence

- Evaluation team (multiple responses allowed)

- Change in approach due to changed current market (multiple responses allowed)

#### 3. Time spent post-acquisition

#### 4. Success in identifying operating value opportunities

## Survey Result/Highlights

- On average
  - 24% of time is spent on “**Accounting/Financial**”
  - 24% on “**Strategic**” issues
  - 19% on “**Operations**”
  - 16%, 11%, and 6% respectively on “**Assessment of Management**”, “**Risk Management**”, and “**IT Systems**”
- Average quality **rating of operational due diligence** is 7.4 (scale of 1-10)
- Average quality **ratings of accounting, strategy, and assessment of management** are 8.2, 8.0, and 7.6, respectively
- 59% use “**Operating Partners**” to perform operational due diligence
- 44% “**Consulting Firms**”
- 40% “**Executive Advisors/Industry Specialists**”
- Two most commonly cited:
  - 73% adopting “**More Conservative Assumptions in Investment Thesis**”
  - 46% adopting “**More Rigorous Approach**”
- On average, highest (22%) time spent on “**Operational Initiatives**”
- Average **success rating** of 7.7 (scale of 1-10)
- >40% **rate success** at 7 or below

# 2008 PE Survey Results Summary (Cont.)

## Key Survey Questions

### Approach To Operating Value Creation (Cont.)

5. Approach to capturing operating improvements (multiple responses allowed)

- For firms with an internal operations team, role of team
- For firms with no internal operations team, the plan for developing one

6. Operations opportunity at portfolio companies

- Applicable opportunity levers
- Success in capturing opportunity levers

7. Mechanisms used for portfolio management (multiple responses allowed)

8. Overall performance rating of your portfolio

## Survey Result/Highlights

- 70% **“Rely On Existing Management”**
- 52% **“Use Internal Operating Partners”**
- 41% **“Use Executive Advisors/Industry Specialists”**
- 35% **“Install New Management”**
- 31% **“Utilize Consulting Firms”**
- 75% use internal operations team as **“Operations Initiative Champion”**
- 74% use the team for **“Strategic Planning/Reviews”**
- 45% for **“Interim Executive Role”**
- Of the 42% of respondents without an internal operations team, 87% **do not plan on developing one**
- **“Top-Line Growth”** most often cited
- Although **“Top-Line Growth”** rated highest in opportunity potential, it only garners a 6.7 average rating for **success** in capturing opportunity (scale of 1-10)
- All the **other operational opportunities** deliver greater-than-expected results
- 93% of respondents cite **“Standard Financial Reporting”**
- 83% cite **“Standard Operation Performance Reporting”**
- More active portfolio management mechanisms not widely used
  - 42% use **“Dedicated Resources To Manage/Assess Portfolio Companies”**
  - 38% use **“CEO Get-Together To Share Best Practices”**
  - 25% use **“Cross-Portfolio Leveraging Of Purchasing Scale”**
- Average **rating of 6.5 given to portfolio performance** (scale of 1-10)
- Only **11% rate as 9 or 10**
- ~50% rank portfolio performance **6 or below**

# Not Surprisingly, Survey Results Indicated 2008 Was A Challenging Economic And Credit Environment For PE Firms...

## Deals

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- Mixed situation with the **deal flow** – number and quality of deals are decreasing but valuations are also going down
- **Credit environment** remains tough – less favorable financing terms, increased equity participation, longer time to secure financing, and 25% indicating that credit is not available
- **Recovery** not in sight – most expect credit markets to improve in late 2009 or 2010 and economic conditions in 2010
- Overall **due diligence** approach the same as prior years with some nuanced changes – more conservative assumptions in investment thesis and greater rigor in due diligence

## Portfolio

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- Economic environment driving significant drop in **portfolio company performance** – ~70% cite EBITDA and revenue to be below target and 46% indicate companies approaching covenant thresholds
- **Responses to performance drops** varied – significant majority increasing involvement in company management (primarily focused on capital structure, lender negotiations, and recession planning) and extending exit timelines
- **Operating value creation** still the top value creation lever and remains underleveraged – no discernable change in approach to portfolio management, even with proven benefits of active portfolio management
- Recent trend of adding **operating partners** to PE firm appears to have topped out – 1 in 2 firms with operating staff and these operating partners primarily focused on being operations initiative champions and driving strategic plan/reviews

# ...Underscoring The Need For More Robust And Creative Approaches To Due Diligence And Portfolio Company Management In 2009

## Deals: Stress Test The Investment Thesis And Target Business Model/ Operations To Find Winners

- Develop rigorous **market models** that can accurately pin down the target market behavior in scenarios involving significant ups and down in economy
- Gain a solid understanding of **company positioning** to find winners that will survive this downturn and emerge stronger as weaker competitors go away
- Perform a **robust due diligence** of target's operations and cost structure to ensure that the company can rapidly adjust the cost structure in downward scenarios and is prepared to take advantage of unexpected upturn
- Ensure that the **management** team can execute in these challenging times and is nimble enough to take advantage of unplanned opportunities

## Portfolio: Find And Act On Immediate EBITDA/Working Capital Opportunities And Create Flexibility For Rapid Response/ Proactive Strategies In Fast-Changing Market Environment

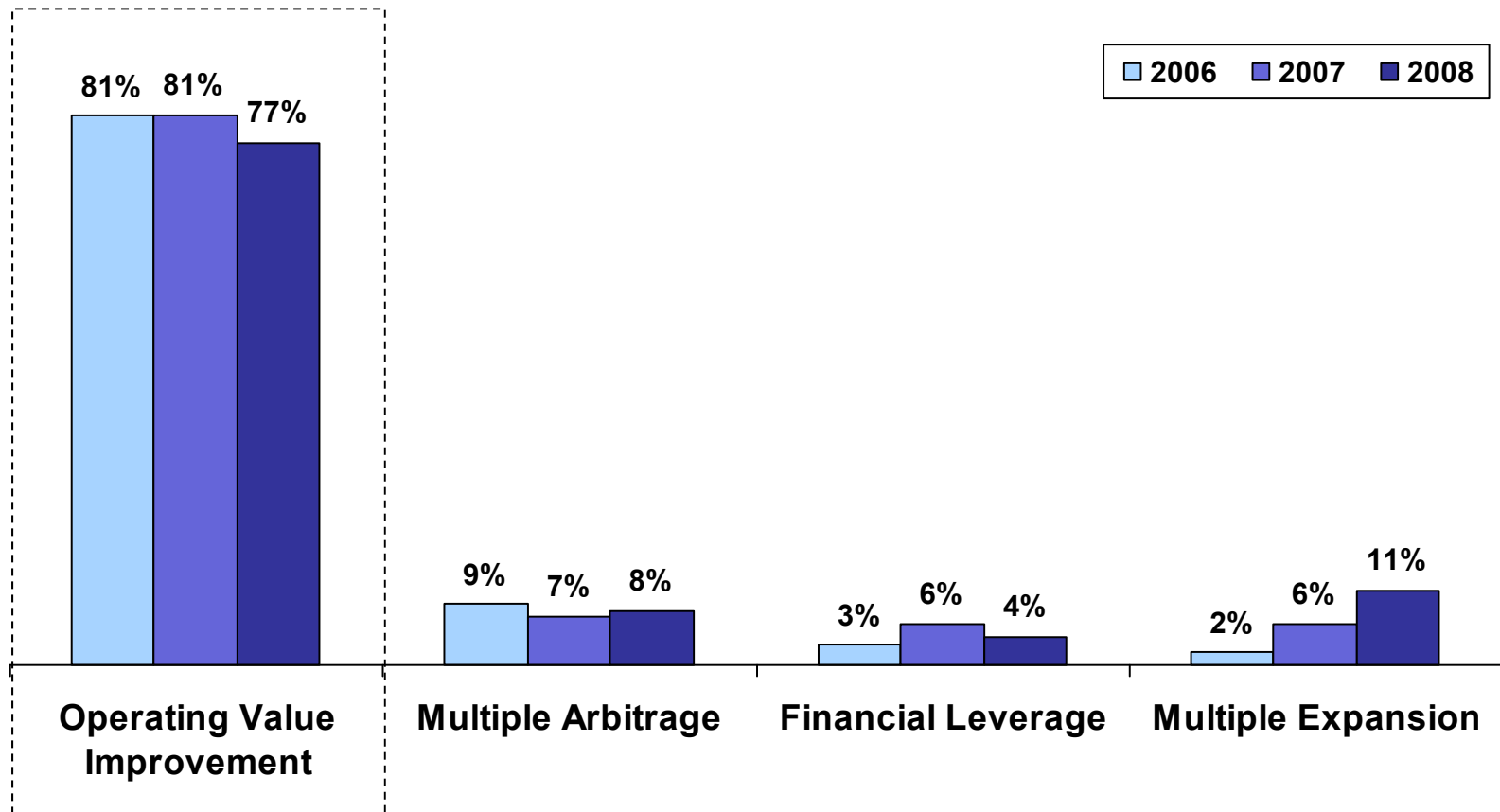
- Be bold and creative in finding savings opportunities that **add immediately to the bottom-line**:
  - Be innovative in reducing **personnel** costs while protecting talent/experience, e.g., rotating layoffs, reduction in hours
  - Squeeze **purchasing** costs as recent commodity price fluctuations create claw-back opportunities and suppliers are willing to cut deals with companies with cash
  - Try new approaches to generate **process-related** savings (labor productivity, material waste, etc.) as it is easier to overcome cultural barriers in this environment
  - Capture **freight** cost savings through better rates, improved freight efficiency, and network optimization
  - Don't just cut prices but leverage customer and product segmentation to find **price increase** opportunities
  - Monetize cash tied up in **inventory** as conventional inventory management approaches are likely creating excess inventory in this environment
- Go after **next-generation operating value creation levers** as original investment thesis unlikely to generate desired returns in an extended ownership period

## **3-Year Trends**

# 3-Year Trends: Operating Value Improvement Has Unanimously Been The Most Important Value Creation Lever For The Past 3 Years, But Is Down Somewhat In 2008, Likely Due To Market Conditions

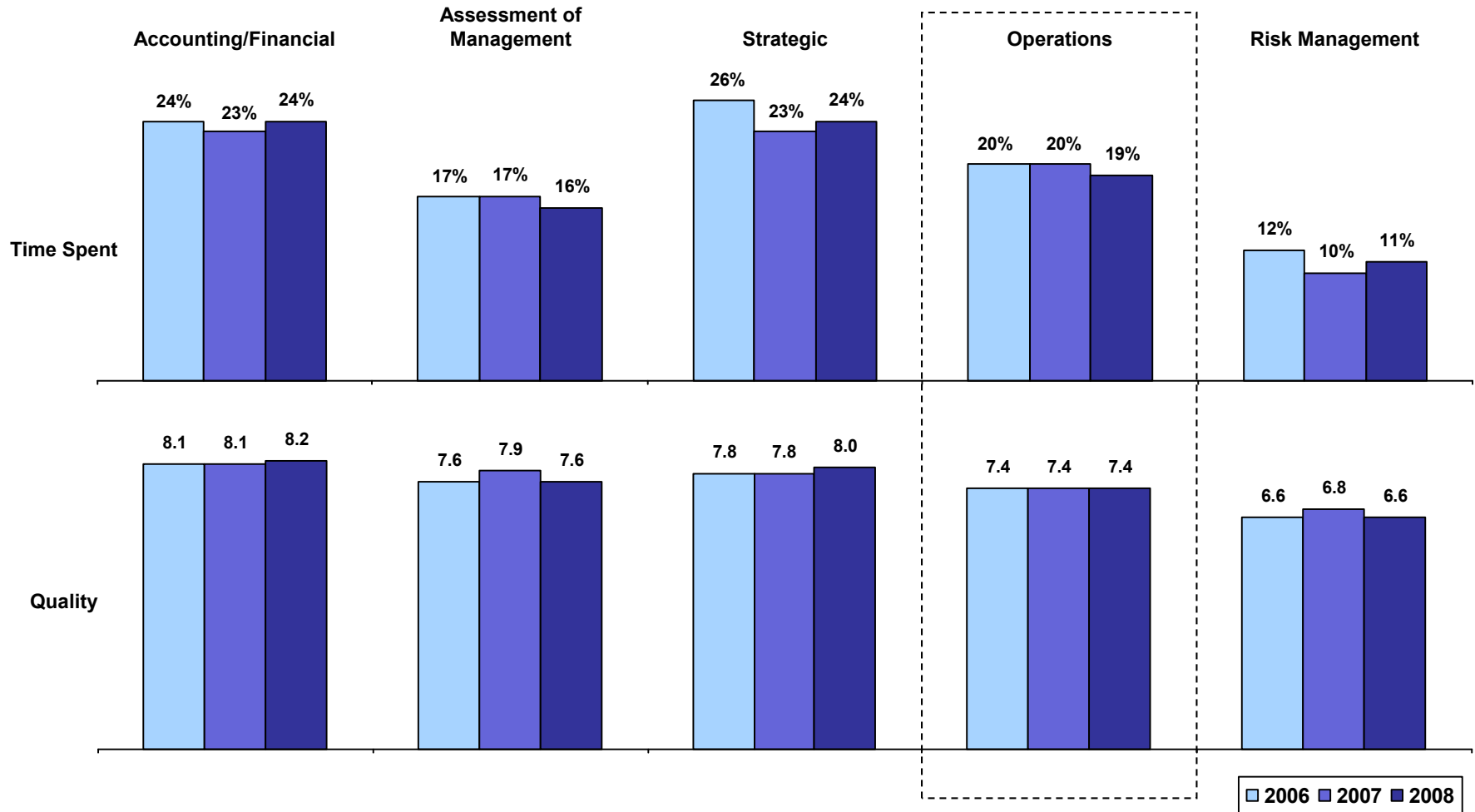
## The Importance Of The Value Creation Levers: Historical Trend

(% of Respondents, Multiple Responses Allowed)



# 3-Year Trends: The Average Time Spent On And Quality Rankings Of Operations During Due Diligence Efforts Have Remained Stable Over The Past 3 Years...

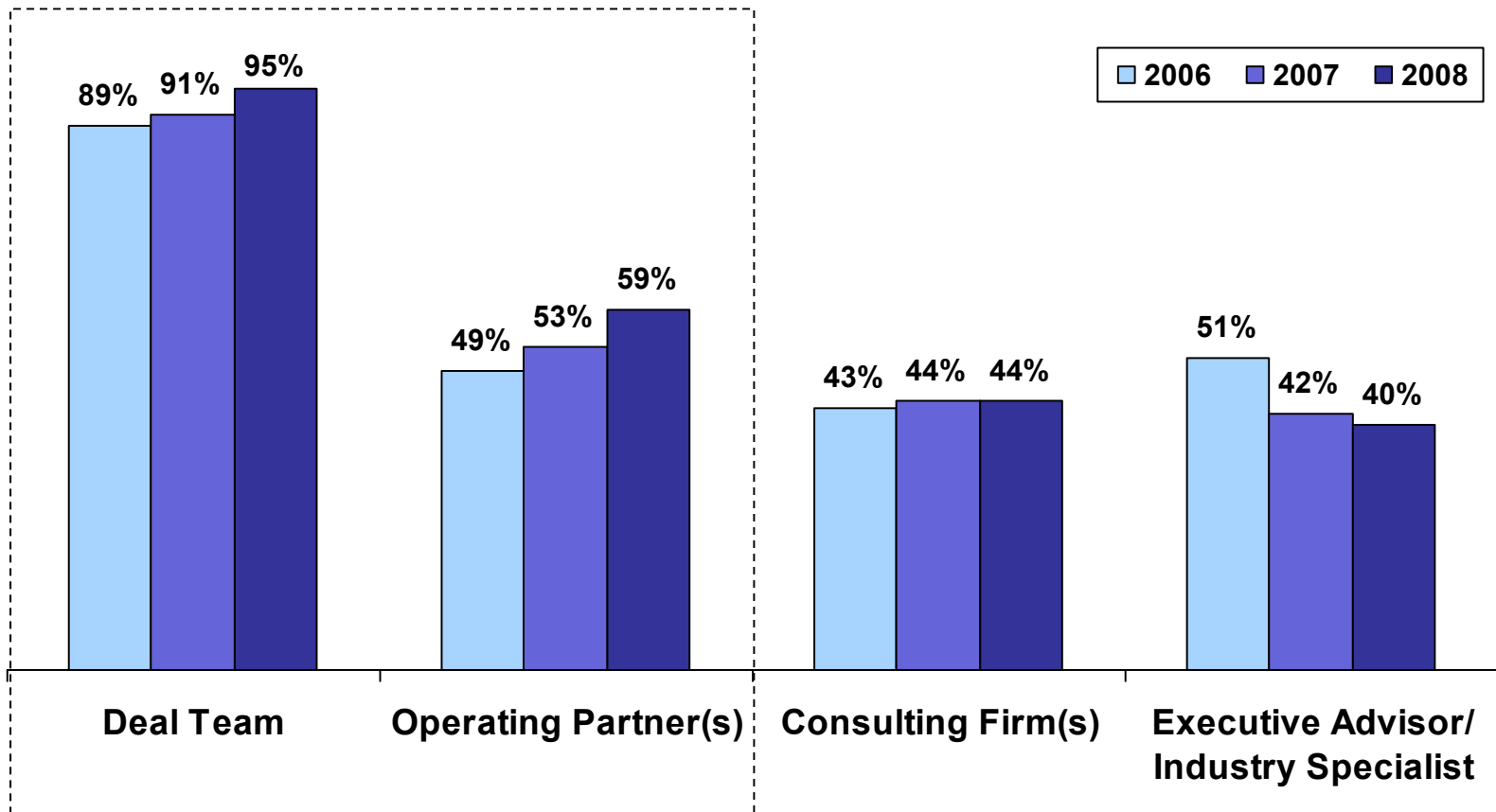
## Average Time Spent During And Quality Of Due Diligence: Historical Trend (% of Time)



# 3-Year Trends: ...While Involvement Of Internal Resources In Operations Due Diligence Has Been On The Increase

## Who Evaluates Operations During Due Diligence: Historical Trend

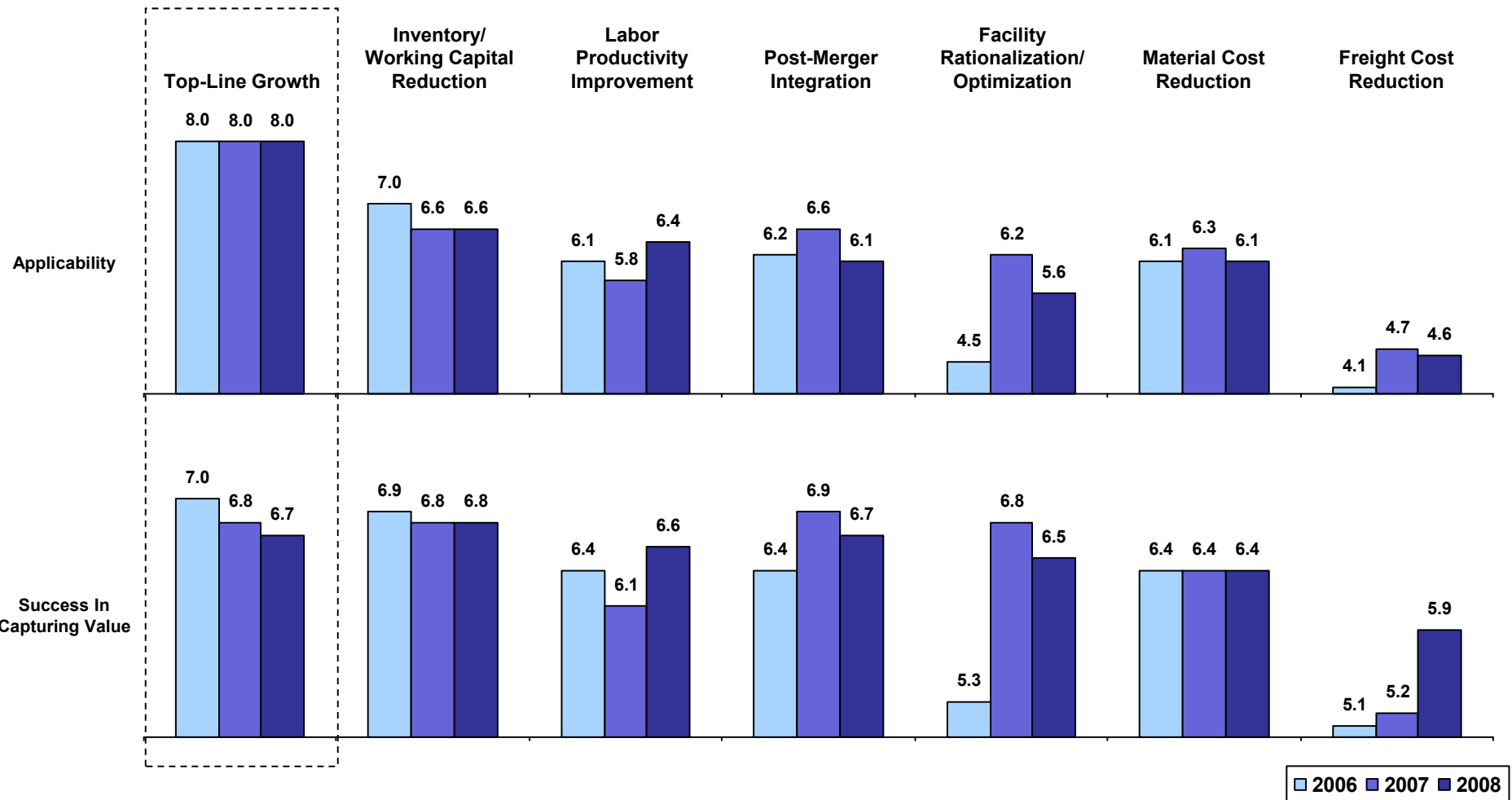
(% of Respondents, Multiple Responses Allowed)



# 3-Year Trends: While The Presumed Applicability Of Top-Line Growth Remains High, Its Capture Success Has Declined, While Other Types Of Operations Opportunities Continue To Deliver Greater-Than-Anticipated Results

## Applicability Of And Success In Capturing Specific Operations Opportunities: Historical Trend

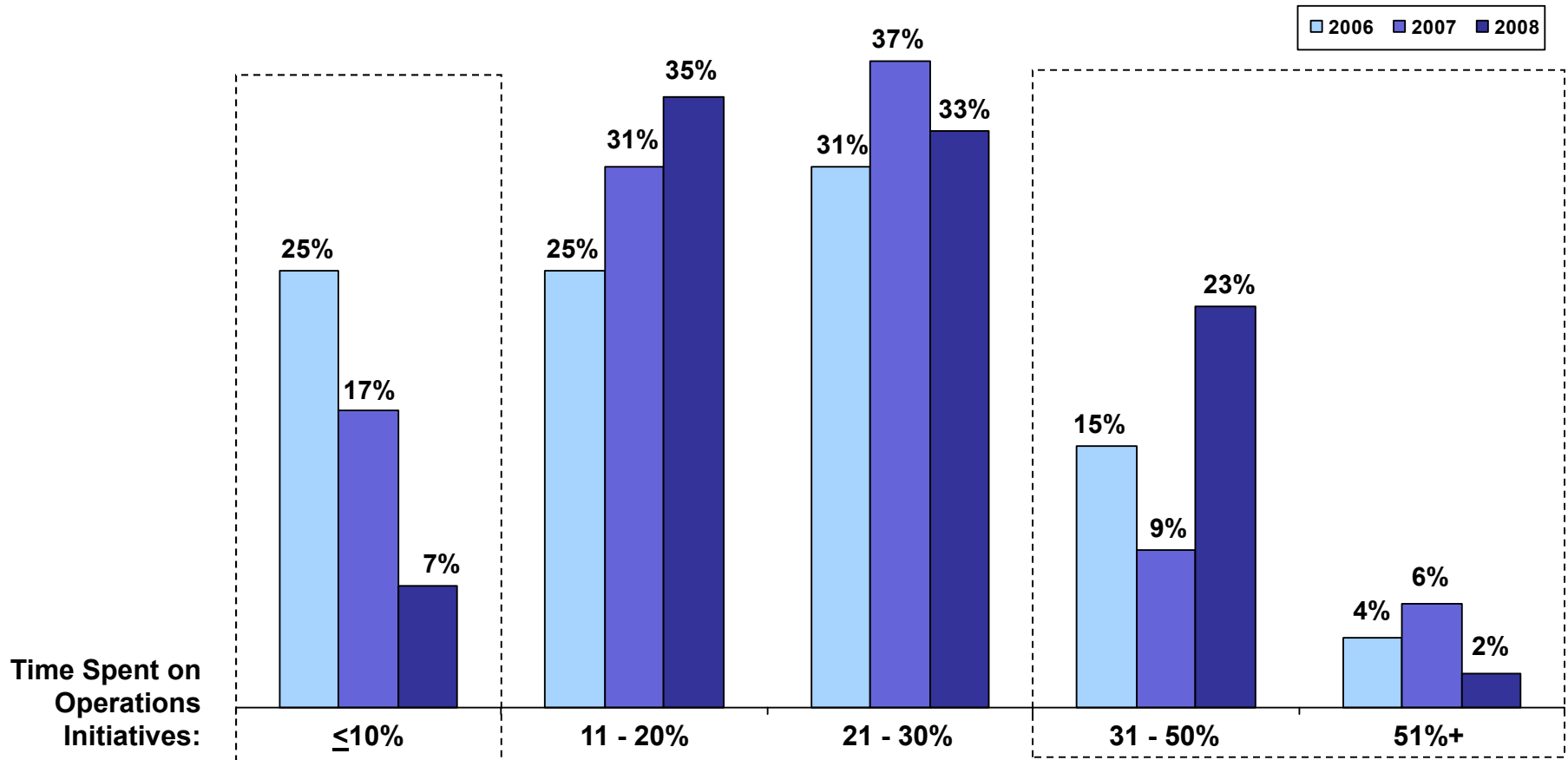
(Self-Rating on a Scale of 1-10; Some respondents indicated multiple techniques)



# 3-Year Trends: The Percent Of Respondents Spending Minimal Time On Operational Initiatives Is Trending Way Down, With 25% Of Respondents Now Spending Over 30% Of Their Time On Operations...

## Profile Of Time Spent On Operations Post-Acquisition: Historical Trend

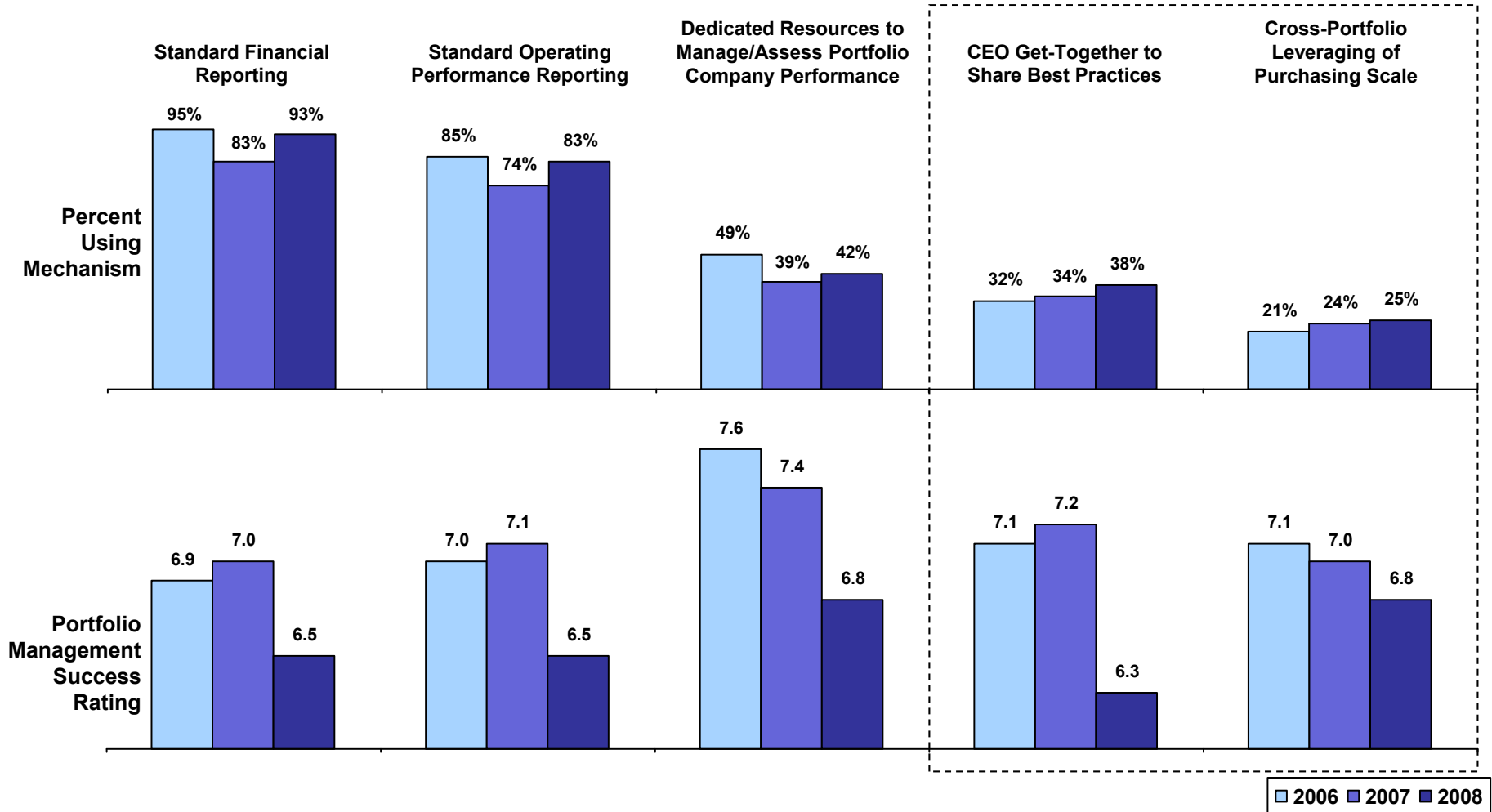
(% of Respondents)



# 3-Year Trends: ...And Less-Widely-Embraced Active Portfolio Management Mechanisms Starting To Gain Some Traction...

## Mechanisms For Overall Portfolio Management: Historical Trend

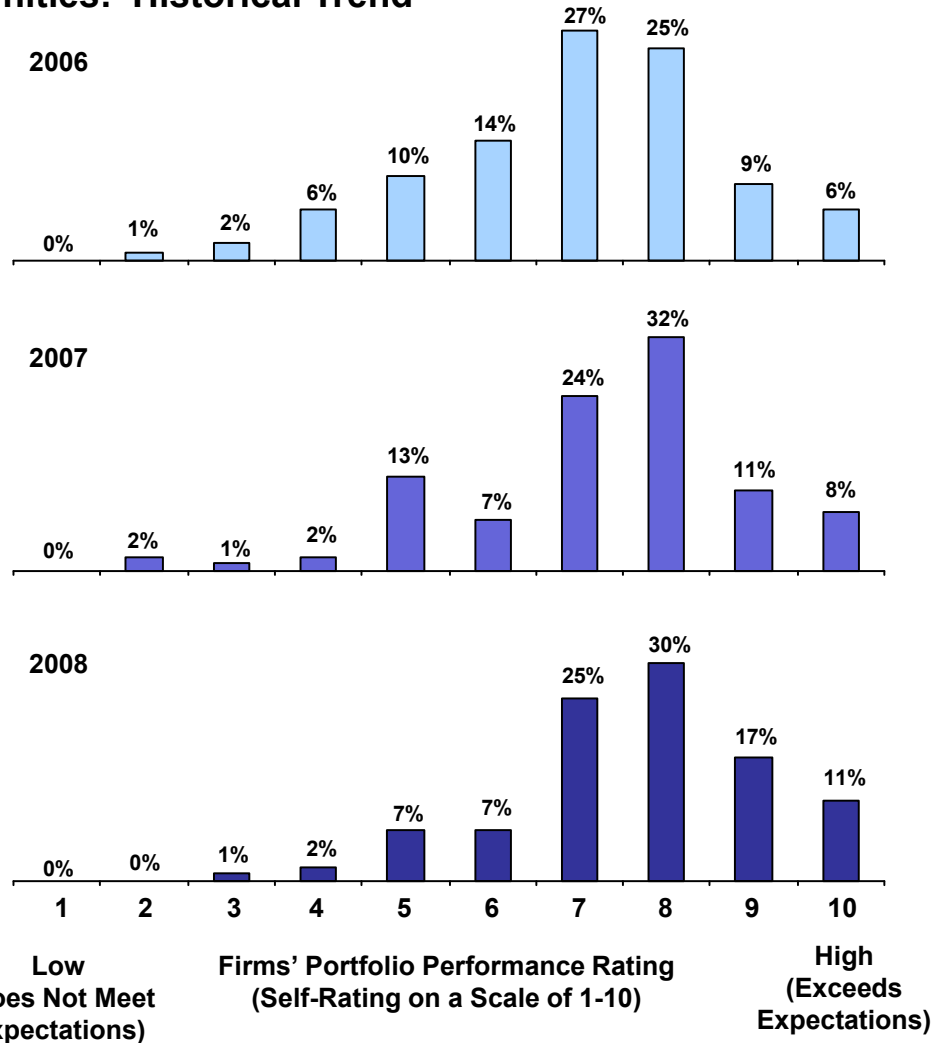
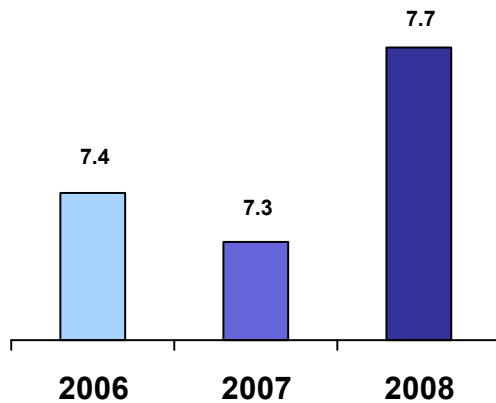
(% of Respondents, Multiple Responses Allowed)



# 3-Year Trends: ...Leading To Increased Success In Identifying Operating Value Opportunities

## Success In Identifying Operating Value Opportunities: Historical Trend

(% of Respondents)



# **Appendix: Response Profile Details**

# Survey Respondent Profile

## Survey Statistics

- Number of respondents 278
- Firms identified in survey 189
- Firms with multiple responses 49
- Anonymous responses 3

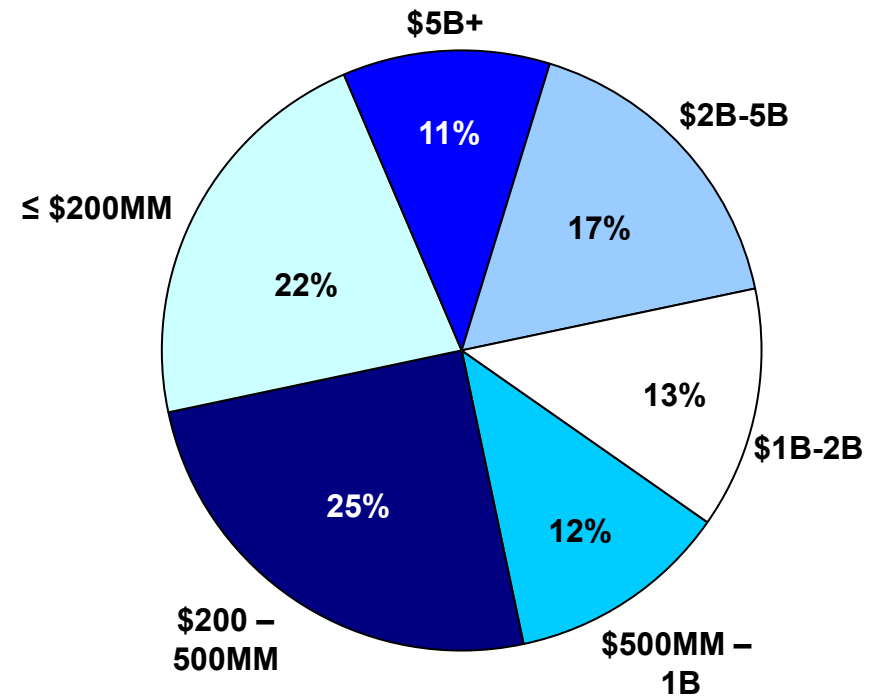
## Area Of Focus Of Respondents

- Deal 77%
- Operating/Portfolio Mgmt. 23%

## Profile Of Respondents' Role In The Firm

- Managing Director/Partner 31%
- Vice President/Principal 31%
- Associate/Analyst 35%
- Other 3%

## Respondents' Capital Under Management (Firm Size)



## Survey Respondent Profile (Cont.)

### Title By Firm Size

(% of Respondents, Total Respondents = 276)

	<u>≤ \$200MM</u>	<u>\$200 - 500MM</u>	<u>\$500MM - 1B</u>	<u>\$1 - 2B</u>	<u>\$2 - 5B</u>	<u>\$5B +</u>
Managing Director/Partner	10%	8%	3%	4%	3%	3%
Vice President/Principal	6%	7%	3%	5%	7%	3%
Associate/Analyst	5%	9%	6%	5%	6%	4%
Other	1%	1%	--	--	--	1%

### Company Focus By Firm Size

(% of Respondents, Total Respondents = 272)

	<u>≤ \$200MM</u>	<u>\$200 - 500MM</u>	<u>\$500MM - 1B</u>	<u>\$1 - 2B</u>	<u>\$2 - 5B</u>	<u>\$5B +</u>
Deal	15%	19%	10%	12%	13%	8%
Operating	7%	6%	2%	2%	3%	3%

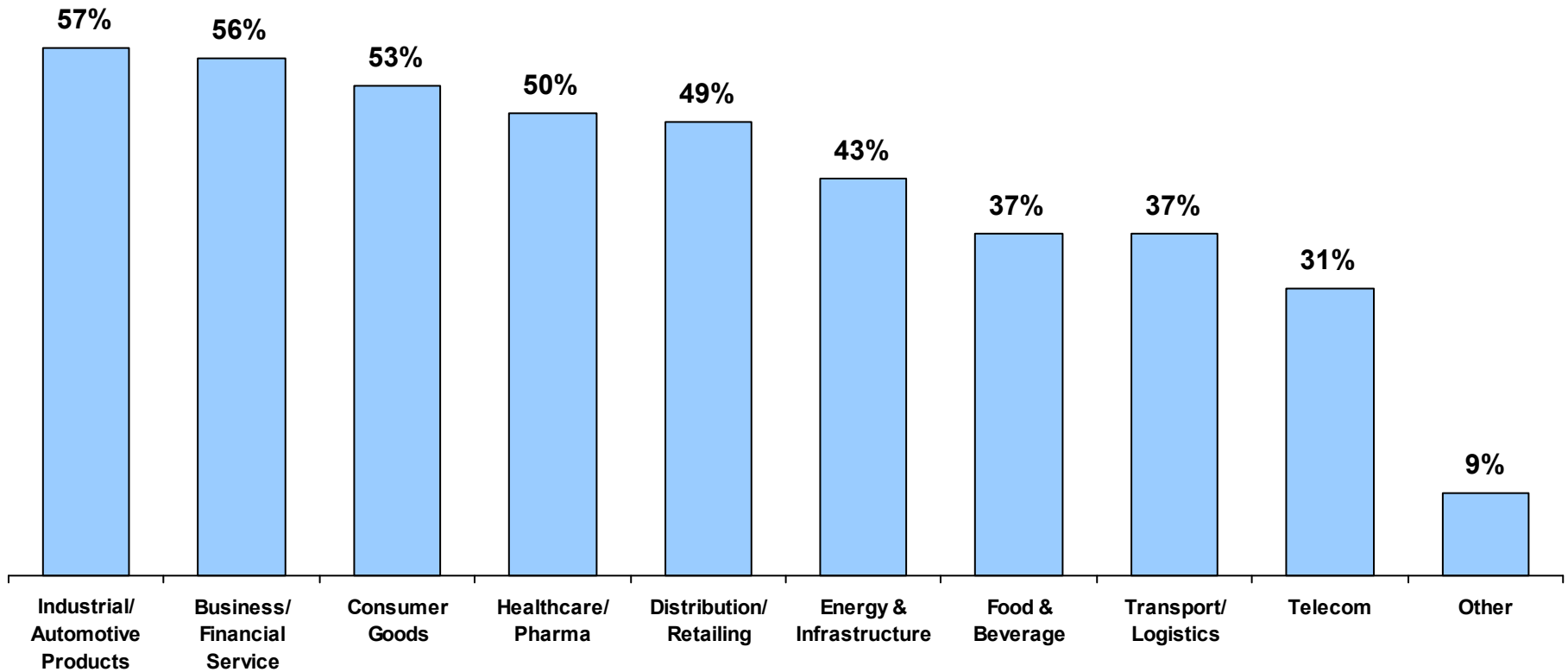
### Title By Company Focus

(% of Respondents, Total Respondents = 274)

	<u>Deal</u>	<u>Operating</u>
Managing Director/Partner	19%	12%
Vice President/Principal	24%	7%
Associate/Analyst	32%	3%
Other	2%	1%

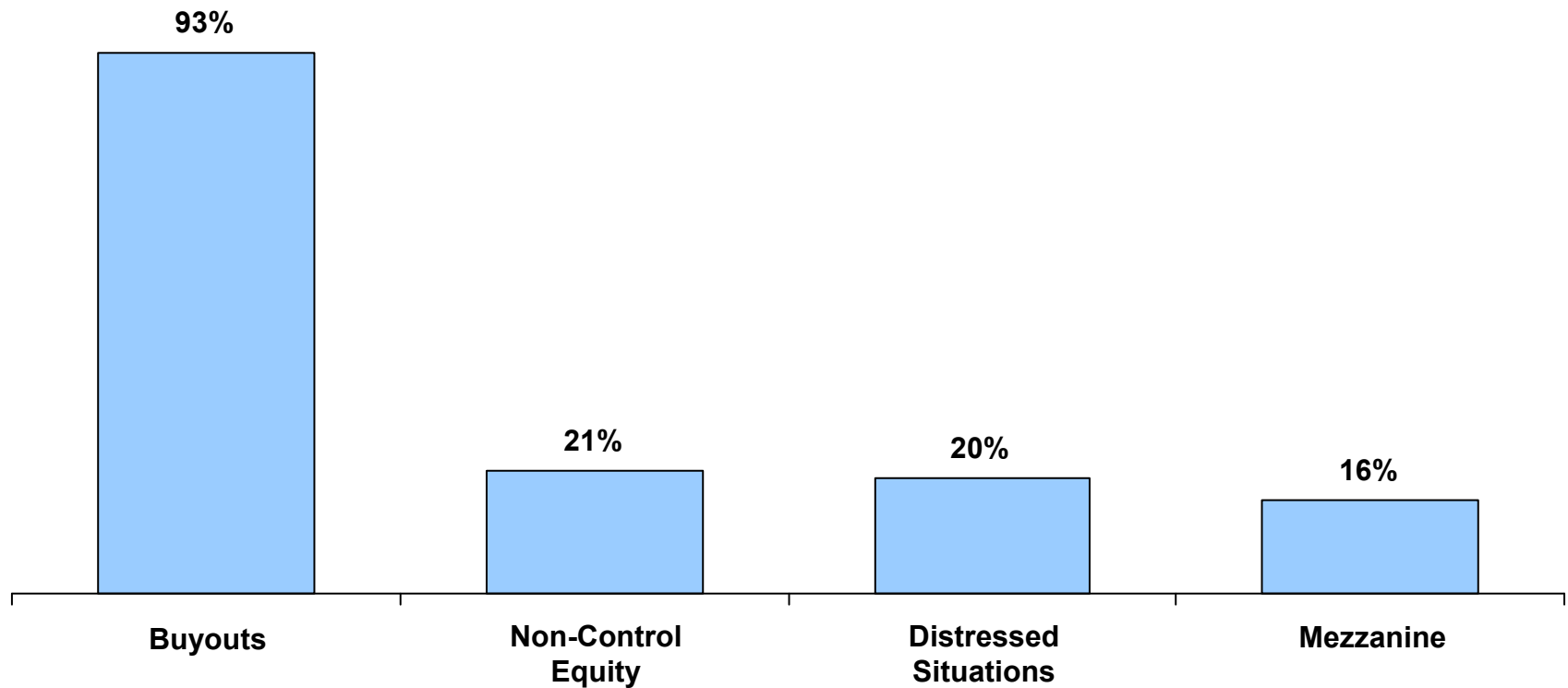
# Survey Respondent Investment Focus: Industry Focus

(% of Respondents; Respondents Typically Indicated Multiple Industries, Total Respondents = 277)



# Survey Respondent Investment Focus: Situational Focus

(% of Respondents; Respondents Typically Indicated Multiple Situations, Total Respondents = 274)



# **About Gotham Consulting Partners**

# Gotham Works Throughout The Investment Lifecycle To Quickly Deliver High Quality, Financially Beneficial Information And Results

## *For Private Equity Firms*

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### ➤ **Due Diligence**

- We stress test the investment thesis by:
  - Validating the target's market positioning and growth potential under various economic scenarios, based on market models (structure, size, growth rates), customer interviews, and competitive dynamics/benchmarks
  - Validating operational assumptions in the PE firm's valuation model and delve deep into operations to identify risks, overall savings opportunity, and the magnitude and rapidity of potential cost structure adjustments
  - Assessing the management team's capabilities

### ➤ **Proactive Investment Strategy**

- We identify and evaluate attractive industry niches based on the PE firm's investment criteria and capabilities

## *For Portfolio Companies*

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### ➤ **Operations Improvement**

- We quickly uncover, value, and prioritize the full spectrum of potentially impactful opportunities and fill capability gaps required for capture while building those same capabilities at the portfolio company, enabling smart decision-making, immediate EBIDTA/working capital benefits, and flexibility moving forward

### ➤ **Growth Strategy**

- We identify product and market niches that complement and augment the company's current market position and will deliver growth whether organically or through add-on acquisitions

# Gotham's Proven Operating Value Creation Model Delivers High Quality Results In A Very Expeditious And Affordable Manner

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- **Exclusive Focus On Private Equity:** Our consultants are attuned to the needs of private equity ownership, and we ensure our recommendations align with the private equity value proposition
- **Broad And Deep Knowledge/Experience Base:** We work in many different industries, tackling the variety of operational challenges/opportunities that arise in today's constantly changing landscape
- **Pragmatic And Fact-Based Approach And Insights:** We assess and prioritize value creation opportunities in a strategic and pragmatic context and get the “right facts”, whether that means filling in missing facts when the company is “information-poor” or distilling out critical facts when the company is “information-rich” but “knowledge-poor” – all decision making is robust and maximum value is created during our client's investment timeframe
- **Financial Results-Oriented Implementation Expertise:** We retain our objectivity while working in partnership with the management teams (from senior executives down to floor personnel) – substantive results are captured rapidly

## Contact Information

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For additional information on the survey results or to learn more about Gotham Consulting Partners, please contact:

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