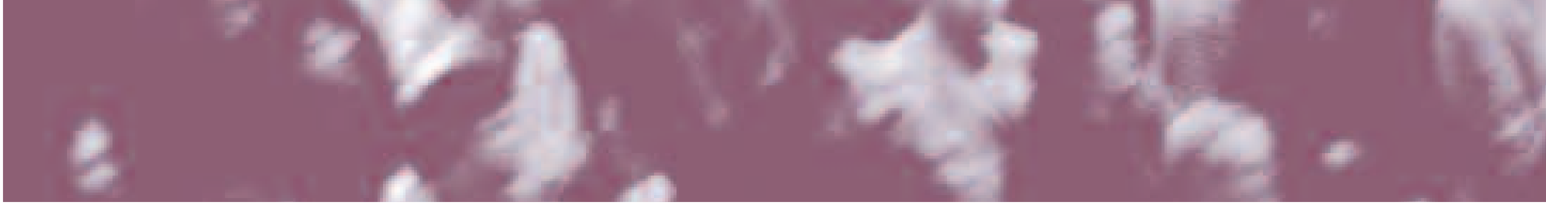

Why People Matter: the LP Perspective

Nicole Brandes and Katharina Lichtner, Capital Dynamics

Everybody knows that the key resource in a private equity firm is top talent – people with an above average vocation in creating value. They are the key differentiator in creating alpha. This holds true for both limited partners (LPs) and general partners (GPs). So at Capital Dynamics the belief is that the often stated slogan 'people are our greatest asset' is actually true.

COMMON SENSE BEFORE SCIENTIFIC CLAIM

The idea to write about human capital from the LP perspective seems an obvious one: the issue of human capital is ubiquitously present. A vast number of books have been written given the increasing awareness of the importance of human capital in the economic world, but few are specific to private equity. According to our experience a systematic approach to human capital is still not used by all GPs. However a proxy for the rising importance of human capital is the rapid increase in salary top performers can demand, and the good margins executive search companies can achieve helping private equity firms to find such talent. The following lines are not a scientific article, but they go beyond the mere discussion of alignment of interests as driver of performance. Below are highlighted some of what are believed to be the fundamentals which drive our daily business.

THE STATUS QUO IS HISTORY

'Change' is probably the buzzword of our times. Pick up any newspaper, magazine or book which deals with business, and sooner or later one comes across that 'c' word again. It has become a convenient label for nearly every aspect of today's life: economically, technologically, politically, legally, environmentally and sociologically. This is no different in private equity. With the development of the traditional financial markets, private equity has become recognised as a sophisticated asset class. The industry has shifted from being a niche player to one of wielding great influence both in terms of geography and financial power. A wider range of investors from all around the world are attracted to and investing in private equity. Larger sizes of capital commitments flow into the industry. New markets, such as Asia and Eastern Europe, are garnering more interests. New GP teams emerge. Even the reputation of PE firms has shifted: rather than being job killers, PE firms are more and more recognized as job providers.

The change of paradigms impacts business as a whole. It requires a significant mind shift from all involved. Yes, the potentially high returns and diversification of risk are still the main focus of both, LPs and GPs. Performance undoubtedly is still the core target. But in the end, what drives performance? True, there are several elements which need to come together in order to achieve a high return, like finding the right deal, favourable markets, a stable or growing economic environment, etc. However, while performance is driven by many external factors, it does not take away the fact that human capital is the underlying and primary internal driver in ensuring success.

MOVING WITHIN A COMPLEX ENVIRONMENT

Globalization has reinvented the nature of competition and drastically increased the complexity of the industry. It places a huge onus on identifying capable, experienced human capital at the GP level. Why do LPs invest with GPs? Put simply, because an LP believes and trusts the skill set of the GPs. Top GPs are knowledgeable and skilled about how value can be generated. They can read and interpret the trends within their target markets. They can quickly implement the right investment approach. They have the networks and the contacts. And they have the intuition. It is the intuition that marks out talent. In a world caught up in tight expediency, the courage to trust one's intuition is one of the key catalysts.

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It requires time, accurate systematics, persistence and the feel and sense for knowing where to look. Several hundred funds approach Capital Dynamics every year. Probably about 200 of them have meetings with us. Detailed due diligence to its final completion is done only on those funds that are believed to have a good chance of making it through the due diligence. Every time a new investment opportunity is looked at, all the fundamentals are also looked at, even if the team is already well known to the firm. For managers that are well known and where investments have previously been made by us, this is done in the course of the post investment monitoring in anticipation of their next fundraising. Due diligence at Capital Dynamics is a sophisticated and detailed qualitative and quantitative process that starts with the collection of basic information. There is no catch all formula. The matter is too complex to be approached formalistically. As a result a process has been developed at Capital Dynamics that aims at looking behind the usually well crafted marketing stories and dissects what is really happening. Overall, there are several main factors that are believed to be vital:

1. Team: Here the focus is on understanding the team dynamics, their stability and complementary skill sets. The belief at Capital Dynamics is that historic turnover as well as a proper salary structure and long-term incentivization are valid proxies, amongst others, to assess team stability. Biographies are thoroughly reviewed to identify complementary skills sets in the team; and extensive reference checking is undertaken to understand who contributed what to an investment. At Capital Dynamics there is the assumption that today's requirements to achieve a successful investment are too complex as to one individual being able to do it all. Here is a selection of issues that are addressed:

- Ability to identify interesting markets and to think them through strategically with a first hand experience in a set of industries
- Have a sufficiently deep network effectively to source transactions
- Successfully run competitive auctions
- Identify good management teams or have the ability to attract high quality management teams in a buy-in situation
- Use state of the art financing techniques
- Formulate effective post investment strategies for the acquired companies and execute them
- Demonstrate ability to successfully exit portfolio companies

2. Strategy and market: Here an assessment is made of the market that is targeted and the overall strategy. For Capital Dynamics, the strategy needs to be appropriate – for the GP team and the market. Also assessed is how concise a manager is able to formulate this strategy and if the team has a common understanding of this strategy. Consistency of that strategy is sought from fund to fund. On the other hand, at Capital Dynamics there is the awareness that the markets change all the time, and there is an understanding that certain adjustments to a fund's strategy may be needed even during the lifetime of a fund. Capital Dynamics has an openness to what the GPs want to do and change is supported as long as it is done for good reasons and within boundaries.

3. Track record: Much of the work is done on analysing the track record. While in the earlier days the focus was on the net performance and the benchmarking of this performance as a proxy for success, at Capital Dynamics the analysis has been augmented by emphasising the understanding of how the return was actually generated. Taking the analysis of a buyout track record as an example (for venture funds different proxies are used), Capital Dynamics has developed models that enable an understanding for each portfolio company whether the value was created through financial engineering, operational enhancement (i.e. improvement of the operating margin), expansion of sales or multiple arbitrage. Capital Dynamics seeks management teams that are able to generate value by fundamentally changing operations of a company or are able to grow them. Such improvements are expected in a number of successful portfolio companies and it would be viewed as less favourable if overall performance would be driven by a single 'home run' investment. Capital Dynamics believes that such value creation is sustainable, whereas this is less true for financial engineering and multiple-arbitrage as value generators. Financial engineering is becoming a commodity and is impacting value generation less and less, while multiple arbitrage is either a result of a successful

growth/operational improvement or driven by a favourable market. Positive multiple arbitrage in the absence of clear growth or operational improvements are not sustainable, as it would imply that a manager can systematically time the markets.

All these assessments are summarised in the investment recommendation, which is supported by a file that measures several inches! However, whilst the ideal GP manager is easy to define, he/she is hard to find and the most vigorous process is no guarantee for tracking down top performers. At the end of the process the decision is driven by carefully weighing the strength of a team against identified risks – and, by intuition. Like the GP the LP depends on this.

Thus as for GPs, LPs are similarly in need of top talent, albeit with different skills. This need is intensified by the fact that LPs are confronted with an increasingly complex environment, e.g.

- Private equity is expanding beyond the regions of the US and EU, where it was previously concentrated;
- There are many more players in the market than ten years ago;
- The specialization of funds, i.e. emergence of sector funds, is growing and LPs need to understand these industries in more depth to effectively evaluate a manager;
- Some established players are experiencing succession problems and their future performance is questionable;
- Emerging managers have to be identified to ensure a high quality portfolio in the long run;
- It is getting more and more difficult for LPs to access top performing funds;
- The fund raising cycles are becoming shorter leaving less time for detailed due diligence.

LPs have to respond to these challenges in order to stay on top. Whereas in the past private equity investing was mainly relationship driven, the analytical component has gained increased importance. These challenges can only be met by teams formed of skilled individuals that have complementary talents. And something else becomes vital. These teams have to be stable too. Looking after and retaining top talent has therefore become critical in the LP industry. Good investment acumen is not developed in a year. It requires many years of experience and an environment where individuals trust each other's judgement. In addition top quality GPs are increasingly in the position to choose their LPs and this is where long standing functional relationships become key. While these relationships used to be between organizations they shift increasingly to the individual. Thus an LP that is not able to retain their key senior investment managers, risks losing access to top performing GPs, as their staff take these relationships to the next employer. This is best illustrated by a quote from a meeting Capital Dynamics had with a a core GP:

"For us an existing investor is not an organization anymore but an individual that we know and that knows us well, trusts us and understands how we operate. We are tired of going through the same due diligence ordeal answering the same questions fund after fund, because the person involved in the last due diligence has left the organization."

THE GP–LP RELATIONSHIP – A TWO-WAY STREET

Whilst the GP-LP relationship is a business relationship, this does not take away the fact that actively nurturing the relationship and communicating in the right way is vital for any long-term success. Of course, there is the internet, conference phones and video links. There is no doubt that technology has reshaped the fabric of culture and the ways of communicating. Just look at the way it has changed business. But the real connection is not supplied by technology. What has that got to do with human capital in the PE world? A lot. The standard relationship between an LP and a GP probably lasts longer than the average marriage – one good reason to make sure the relationship is sustainable over the long term. And that goes both ways. It is definitely fair and appropriate for an LP to request proper information and documentation to do their work and to demand terms that keep a fair balance between the interests of LPs and GPs. However access is getting more difficult now, with more potential investors trying to get into the best performing funds. At Capital Dynamicss the view is that, as an investor, there is the need to be a credible, long-term partner and as mentioned above, long-term

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When PE capital becomes a scarce resource again (as in 2001- 2004) those GPs that survive will be the ones that not only have good performance but also managed to maintain a good relationship with their LPs. And this means catering to the needs of their LPs even in boom times

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relationships are key to avoiding these access issues. Top quality GPs are increasingly in the position to choose their LPs. And in some unfortunate instances this comes with a deterioration of how they treat their investors. However the cycle will swing again. When PE capital becomes a scarce resource again (as in 2001- 2004) those GPs that survive will be the ones that not only have good performance but also managed to maintain a good relationship with their LPs. And this means catering to the needs of their LPs even in boom times.

So, fostering relationships, in which both parties trust each other and enjoy doing business together, are a two-way street and are not established over electronic media only. These are longstanding personal relationships between individuals that share a common understanding of how private equity works, and understand that ultimately long-term success performance can only be generated if LPs and GPs work towards this common goal.

SUMMARY

Top talent in private equity is all about assessing, managing, retaining the right people and establishing, enhancing and keeping relationships. In the end, it always comes down to the people - talented people that have skills, creativity, experience and the intuition. Strangely enough, this is not a new observation. Lao Tzu wrote three thousand years ago in his classic book, Tao Te Ching:

'Evolved individuals know that people who are not intuitive can be dangerous to work with, since they are guided solely by the current appearance of things that are, in reality, changing. Evolved individuals seek out others who have intuition and vision – a form of intelligence that comes from cultivating the instincts, observing the direction of change, and apprehending the evolution of ideas.' ■

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