The Five Tools of Private Equity – Part Four: Portfolio Management

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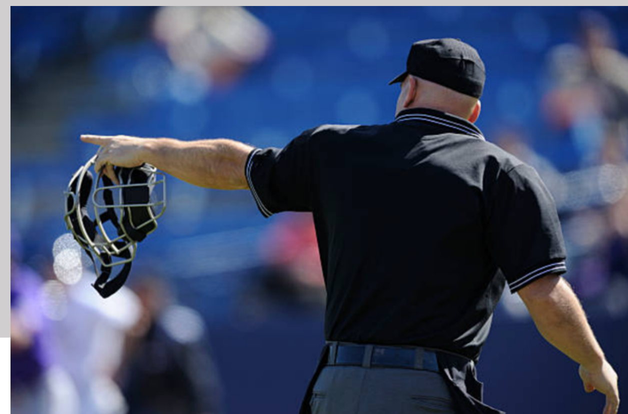
When you reach the mountaintop, you can see more mountains.



Congratulations, readers! By this point in our series, you've followed along with an investor's progress, having sourced, evaluated, and executed an investment. It's a long, difficult, stressful process, and one would not excuse an investor at this stage for wanting a deep breath and a good night's sleep.

Cue the pained chuckles from the experienced investors in the audience. They know that the closing dinner represents the end of the initial stage of the investment, but also kicks off the next several years of struggle to convert "spreadsheet returns" into real returns. Where theory becomes action, and strategy begets execution. Where the rubber meets the road and the metaphors emerge from their chrysalises. This is the stage of an investment where the **portfolio management** tool shines.

Portfolio management encompasses an enormous collection of activities. For our purposes, we'll define it as all of the activities an investor might undertake during a hold period to assist its portfolio company in creating value. While the degree of involvement an investor takes in a portfolio company lies on a continuous spectrum, we'll split that spectrum into two halves for simplicity: "active" and "passive" approaches to portfolio management. We'll then examine how these approaches might be executed, and look at how both can be successful for different investor types.

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Additionally, as in previous installments, we'll contextualize portfolio management as a value creation "tool" and compare it to the others.

Portfolio Management: Adding Value as an Owner

Ideally, the lengthy conversations between investor and company during the transaction process would at some point touch upon what everyone's expected role will look like post-close. Sure, the investor is there to "add value," but what does that actually mean? What does an owner do?

Faithful readers know what's coming next: it depends. Some investors truly do nothing post-close and seek only to do no harm at this stage. That's not bad, per se—it just means those investors provide value (to their capital, if not to the business) from the other investor tools. On the other end of the spectrum are entrepreneurs or search fund operators, who become the day-to-day CEOs of their investments immediately post-close. Nobody gets deeper in the weeds than these investor/operators, and for some of them, it's not unfair to say that their entire value comes from their hard work post-close.

Most investors fall between these two extremes, and for the sake of discussion, we'll organize them into two seemingly

arbitrary groups: **"active"** investors and **"passive"** investors. We'll try to keep the definitions broad and inclusive, in an effort to offend every investor equally.

"Board members who tinker and meddle, and start requesting additional reporting without purpose, or request one-off scenario analyses, or direct activities of executives in parallel with the CEO's directions, are well-meaning but value-dilutive."

In our nomenclature, passive investors interact with the business at the board level only, while active investors add on some duties or projects at or beneath the CEO level. "Advising at a board level takes active effort," some private equity principals are no doubt muttering to themselves, indignantly. Don't worry, my Patagonia-vested friends: you'll quickly see the rationale for this framework.

Passive Investor Strategies

Being a valuable board member is challenging. Anyone who's coached a sport knows the helpless feeling of being responsible for an outcome, but unable to take part in the actual game. Guiding a company at a board level can elicit a similar disconnection. Investors comfortable with a passive portfolio management strategy have broken through this challenge and developed techniques for adding value in limited time.

At its core, monitoring a company means having to perpetually decide if the company needs to adjust its course. For well-managed companies, this can make board meetings boring (and yet satisfying, at the same time). But a board member should never request or consume information about the company without framing that information in a way that helps them answer if additional action is needed or not.

Passive investors have a limited number of additional action levers they can pull to effect change in a business, and good passive investors know exactly what their levers are and have a heightened awareness for when to pull them. These levers are usually spelled out in the operating agreement, but the levers are big ones: hire and fire executive management, approve budgets, approve major strategic shifts, approve recapitalization, or acquisition events.

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Some boards take this philosophy to the extreme and hold one lever: hire and fire the CEO. This is the "back 'em or sack 'em" strategy, which leaves incredible autonomy in the hands of the CEO and severely limits the board's capacity to make minor course corrections.

Passive investors start to subtract value when they start to expand their scope. Many successful businesspeople fall guilty to the "involvement fallacy," that any situation can be made better by adding their attention and input. Board members who tinker and meddle, and start requesting additional reporting without purpose, or request one-off scenario analyses, or direct activities of executives in parallel with the CEO's directions, are well-meaning but value-dilutive. Young private equity employees can be especially guilty of this effect, in their efforts to prove their value to their own managers by way of brute force activity. Some readers are right now remembering specific people encountered in their careers who have done exactly this; a select few readers are remembering this author as that specific person.

Active Management Strategies

In addition to board responsibilities, active portfolio management can be thought of as providing additional services to the company, either by the investor individually or by the investor's organization. This can be as an ongoing role, like in the case of the search fund investor, who becomes the CEO post-close and runs daily operations. It could be an interim role, such as CFO or head of sales until a replacement is found. For larger private equity firms, it can be a shared service across all portfolio companies; it's not uncommon for large funds to have their own internal staffing or executive search functions, or payroll and accounting support, or corporate development teams focused solely on tuck-in acquisitions. An investor might also

get involved in portfolio company operations in specific ad-hoc consulting-style projects, like a new ERP system implementation, or a digital transformation initiative.

There are differing models for how all this activity gets paid for. Some amount of activity is usually expected as the normal course of an investor's involvement in managing an investment, from which the investor charges a portfolio management fee anyways. But additional services aren't necessarily "bundled" and can be charged separately, just like an independent service provider might charge "a la carte." These can be a source of conflict between the investor, the portfolio company, and the capital base if the investor wants to charge an additional fee for a service understood by the others to be part of the package—but open and up-front communication (and a written record of what's expected of each participant) goes a long way to eliminating later frustration.

The degree of expertise an investor can bring to the table in active management has enormous implications for the entire investment lifecycle.Think of it this way: if a real estate investor has an incredible ability to efficiently redesign and rebuild kitchens, transforming the horrible into the beautiful, then that ability directly influences the type of home that investor seeks and the price that investor can justify.

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He's not going to buy a generic, broadly appealing house that lots of other people are interested in; he's going to buy the weird house with a deeply unappealing kitchen, for a bargain price, because that's the avenue where he faces the least competition and can add the most value in order to maximize the return on his time.

The same holds true for investors with an involved active management thesis. The type of expertise the investor can bring to the table during the ownership stage of the investment directly dictates the profile of the investment target, which then informs the sourcing strategy and evaluation process for developing that specific kind of opportunity.

Which Approach is Better?

Neither approach is best for all situations—it depends on both the investor and the necessities of the deal. Sometimes an investor doesn't get to decide an approach, because the structure of the deal chooses; a minority investor with little in the way of governance rights may believe he has much to bring to the table but does not have the ability to exercise those strengths in a crowded boardroom.

For some investors, the switch from thesis-building and deal-making to operating and managing is painful; for others, it's a relief, a return to comfort. This dichotomy speaks volumes about where that investor should focus time in an investment lifecycle, where the investment return is most likely to be generated, and the style of portfolio management to be enacted after closing the investment.

Portfolio Management in Relation to Other Tools

Returning to our potentially disgruntled private equity readers, the reason we chose this specific segmentation for how to think about portfolio management is to give a better answer to this question. The truth is that an investor's portfolio management approach is either the most or least relatively valuable tool among the five, depending on how active or passive the investor is, respectively.

An investor with an outstanding ability and approach to active portfolio management probably features a skillset that is both valuable and unique. The entire rest of the investment life cycle can build off of that singular foundation: that investor can attract quality investment opportunities, evaluate them through the lens of the unique expertise, gut through the transaction process with the help of a lawyer and outsourced support, and attract capital on acceptable terms, all to focus energy on applying that skillset during the hold period. This strategy is how most industry veterans dip a toe into private equity, and has been executed to fantastic success.

An investor with a purely passive portfolio management approach, on the other hand, derives little to no value from this particular tool, and must rely on their abilities in the other tools to generate returns. We aren't saying that boards don't provide value—they absolutely do—but it's not enough value to carry the entire return creation function for the investor. Causality might be bidirectional here—an investor with excellent skills in the other tools may be better off focusing on the investment process and leaving company management to the executive team (or to a junior associate with oversight), more usefully spending their available time on the next opportunity.

We're on the home stretch, with one tool to go. Next up in the Five Tools of Private Equity series, we will investigate the lifeblood of all investing: fundraising.

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