Morgan Stanley

INVESTMENT MANAGEMENT

Sharpening an Innovative Edge in Private Equity

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Private equity investing has evolved beyond the days of buy low and sell high. Now the focus is on transforming portfolio companies into category-leading platforms.

Private equity investment managers have typically sought to generate returns without the short-term uncertainties and market cycles that propel public markets. Ideally, the ability to identify promising companies, provide guidance to execute strategic plans and improve operations gives private equity investors a greater degree of control over investment outcomes.

“It’s not about stock-watching. It’s about investing in promising businesses that require capital for transformation,” says Aaron Sack, head of Morgan Stanley Capital Partners. “Every year, thousands of middle-market businesses in the U.S. are seeking investors—many growing well in excess of GDP.”

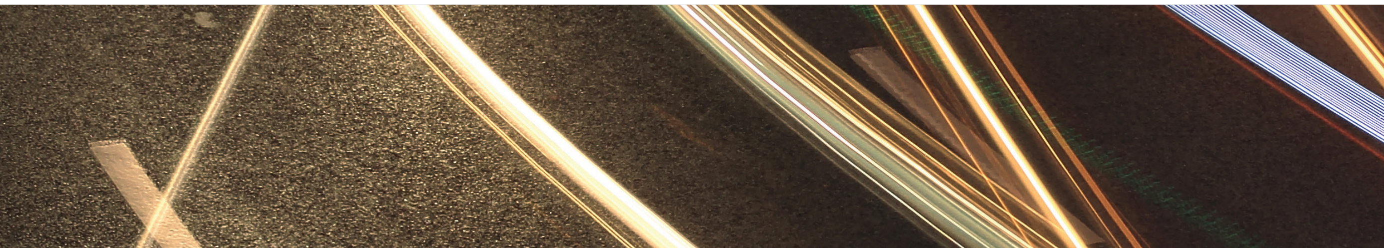
However, the private equity landscape is changing. Amid high valuations and increasing competition in the middle-market arena, investment managers need to go beyond the traditional private equity playbook of buying low and selling high, or making minor operational changes that amount to a fresh coat of paint.

Instead, Sack says, the newest iteration of private equity means seeking to improve company quality by combining operational precision with strategic vision—then building value through acquisition.

Taking Operations into the Weeds

There was a time when private equity firms plied their trade buying companies at a discount and flipping them for a profit. That approach has evolved considerably over the past decade, as more firms have embraced an increasingly hands-on approach—the operating model—though to varying degrees.

Adapted from the presentation “An Innovative Approach to Value Creation.” For more information, ask your Morgan Stanley representative or visit www.morganstanley.com/im/capitalpartners



Typically, the old approach meant appointing industry experts to the board to provide big-picture advice. However, it came with limitations, particularly for small and midsized companies. “Founders and management teams at middle-market companies are focused on running the day-to-day business,” says Sack, “They often don’t have the bandwidth to execute a new strategy, let alone identify possible acquisitions or strategic partners along the way.”

As such, the next generation of private equity must drive operational change at many levels and from many angles. One method of accomplishing this change—which is becoming increasingly prevalent in the industry and which Morgan Stanley Capital Partners helped pioneer—is by including operating partners with industry-specific expertise to actively advise the senior team. These professionals take the lead on mapping out and giving advice that is critical to the execution of strategic plans for portfolio companies in their respective areas.

“At the earliest stages of each investment, we work with management to guide the development of a value creation plan focused on the handful of initiatives we believe will be most impactful,” says Sack. “We ensure we’re aligned on the Key Performance Indicators (KPIs) for each,” he adds, “and then meticulously track these to assess progress toward specific goals.”

Yet, a great strategy does little good if it’s diluted or derailed by poor execution. Recognizing this, Morgan Stanley Capital Partners is taking the operational model to the company level, with team members who work alongside company management and leverage their business experience to advise on implementing the highly bespoke strategic plans.

“These professionals, whom we call ‘accelerators,’ play a critical role in guiding a value creation plan through and, just as importantly, identifying ways to potentially improve it or modify it to reflect changes, challenges or opportunities that come up along the way, and sharing those with senior management,” says Sack. “We think our ‘accelerator’ program is unique, in the way that it reinforces the operational vision led by management and our operating partners but empowers management to accomplish these objectives with on-the-ground resources not previously available to them.”

Whereas traditional private equity firms often look to buy out owners and replace top management, this model strives to be collaborative, incentivizing founders and key employees to work toward a common goal.

Unlocking Untapped Potential

Sack believes this operating model is particularly powerful when applied to middle-market companies, which represent a large, diverse and undercapitalized segment. “The middle-market universe is wide-ranging and can offer greater opportunities to add value,” Sack says. “And in many cases, these companies are seeking institutional capital for the first time.”

While these companies tend to have proven track records in their respective industries, they can offer a good deal of upside. Even small enhancements to their operations and strategy can profoundly improve their profitability and growth. “There are so many opportunities to transform businesses of this size,” he adds, “and you can work to do this independent of what’s happening in the broader economy.”

Turning Success into a Platform

There are many ways for private equity teams to potentially achieve strong results with individual, stand-alone acquisitions. Yet, arguably, the real potential for generating alpha comes from building on the success of one company to create a platform for add-on deals.

“When we pursue opportunities to add to these thriving businesses, each acquisition brings the potential to further reduce costs and drive new revenue streams,” says Sack. Having accelerators actively advising the company, he adds, is key for identifying, vetting and integrating acquisitions.

Whatever the industry, a platform approach opens doors to acquire smaller firms—potentially at attractive valuations—and apply a cohesive strategy that drives earnings growth and lowers average acquisition costs.

“Success in private equity isn’t just about finding the right companies, refining operations or finding accretive acquisitions, it’s about bringing together all of those components so that whole is greater than the sum of the parts,” says Sack. “That is the real difference in creating value versus simply looking for it.”

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