

Process: the common denominator of the top quartile

In an environment now marked by massive fund flows into private equity, a focus on identifying which GPs have efficient processes in place can help LPs identify top-quartile returns. Constitution Capital Partners managing partner John Guinee explains.

By all accounts, 2015 was a phenomenal year for private equity. While it may seem unduly nostalgic to reflect upon deal activity now far in the rearview, those who understand the impact of fund flows recognise that the wave of capital that has streamed back to limited partners will continue to shape both deal activity and general partners' fundraising efforts.

Moreover, in an era now marked by periods of convulsive capital inflows, the divide between the haves and the have nots will continue to grow as the capabilities of GPs become either more obvious or more exposed by these punctuated market cycles.

With a capital overhang exceeding \$500 billion, fund flows into private equity not only exacerbate the competitive environment but can also influence the timing and fervour with which sponsors seek to deploy and raise capital. As such, the role of "process" has become a critical factor for limited partners in assessing the opportunities and risks of a particular strategy or team.

Institutional investors, before they make a commitment, need to understand how a GP sources, manages and exits their investments.

If co-investments are an option, GPs should telegraph how they historically work with their equity partners and what roles their co-investors will play in the management and oversight of companies. Gone is the day when a mid-market buyout firm could get by on the skillset or charisma of one or two rainmakers.

What is also left unsaid is that there must be a reason for being. If a GP can't clearly articulate their competitive advantages, be it an industry focus, an operational bent or something else, they had better deliver top-decile performance lest inspire the JAMBOG acronym (just another mid-market buyout group): a classification that evokes a spectre of indifference among both investors and business owners.

The impact of fund flows on the buyout cycle

Private equity returns can generally be attributed to three core factors: multiple expansion, EBITDA growth, and the use of leverage. This is why the bias of most industry observers is to focus on the macro factors influencing activity, be it economic conditions or debt market liquidity. Typically ignored are the behavioural factors, which is where the impact of fund flows can be most evident.

Consider the virtuous cycle that occurs as exit activity grows. As distributions flow back to LPs, LPs are keen to put this capital back to work and will often begin their outreach to GPs of interest whether or not they're actually in the market fundraising.

While no GP would ever admit to accelerating their investment activity to expedite an ensuing fund launch, these periods are often marked by narrower investment cycles. Moreover, the race to deploy capital drives purchase price multiples higher, which only motivates new sellers to bring yet more assets to market, further driving dealflow.

For LPs, the appeal of a clearly articulated investment process is that these efforts are designed to support outperformance and drive consistency in returns for GPs. The far less obvious draw relates back to LPs' healthy paranoia around pacing. If a fund is moving too slowly to either line up or exit investments, something is usually amiss; if capital is being deployed too quickly, LPs will run the risk of being squeezed into a tighter vintage period, leading to over-exposure to a particular two- or three-year window of time. The GPs who closed multiple funds between 2005 and 2007, for instance, left investors in those vehicles with exposure to three of the worst vintage years ever witnessed in private equity.

The importance of identifying GPs with efficient investment processes

When queried by prospective investors, no GP is going to own up to an extemporaneous approach, and the truth is that effective processes differ substantially from firm to firm.

Take sourcing – in the mid-market and below, nearly every sponsor is going to claim to have access to proprietary dealflow. Most probably don't, but those with a process in place will typically have an angle that affords the firm a distinct advantage that serves to tip the scale in their favour in competitive situations. Deal flow that's more reliant on sponsor-to-sponsor transactions on the other hand may betray a tendency to lean on intermediaries or convey a willingness to win auctions on price alone.

A process can be as simple as employing a dedicated team of business development professionals or initiating outbound cold-calling efforts; for some it may be as involved as building out top-down, in-depth sector coverage that maps out in detail a particular industry and all of its related subsectors.

Managing companies and driving growth, meanwhile, has been a focus area for the industry at large since the late 1990s, when efforts began in earnest to shed the image of the corporate raider.

Operating partners have also become a staple at most firms today, though their impact can vary wildly. Some have equated their roles to that of a monkey in a cage, brought out as entertainment for special occasions, whereas others can truly instill a collaborative dynamic and offer insight and guidance that is very impactful in optimising performance within the portfolio. The difference, outwardly, can be difficult to parse, but those firms generating the most value from their operating partner team are increasingly including these partners in the fund's carry, which is a new development in the middle market.

Investors will also find that those GPs utilising a process-oriented approach will simply have an easier time selling assets when the time is right or executing a dividend recap when appropriate, as good companies are in demand in all markets. Strategic buyers, in particular, will pay up for those assets that either pose a real competitive threat or provide entry into a new market or

opportunity.

A focus on investment process is not necessarily new among LPs, but institutional investors are paying more and more attention to these areas. This is particularly true as the on-again, off-again fund flows introduce a behavioural component around investment activity that may not have been recognised or as acute in earlier eras.

A hardwired process for GPs can provide the guardrails that protect against style drift; it can instill discipline that saves firms from getting carried away during hot markets or help uncover undervalued assets in more difficult environments.

Process is particularly critical in the small and mid-market areas less beholden to the ebb and flow of the debt markets, and more reliant on a sponsor's ability to add value post close. A process-orientation will help GPs maintain a rhythm and consistency that keeps LPs at ease, while the rest of the world is trying to squeeze into a window they fear could close at any moment.

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