HARVARDBUSINESS.ORG

If Private Equity Sized Up Your Business

Key ideas from the Harvard Business Review article By Robert C. Pozen

The Idea in Brief

Private equity funds' outsize returns to shareholders have many public company managers asking, "If they can get that kind of performance out of a company, why can't we?"

Some counter that private equity's enviable returns come from suspect tactics (think collusive deals, excessive leverage, or overpriced IPOs). But Pozen disagrees. Top private equity funds excel, he maintains, because they use rigorous management practices that many public companies don't. For example, private equity funds keep idle cash to a minimum, create operating plans specifically designed to increase shareholder value, and tie executives' compensation to actual increases in value.

Not all private equity practices lend themselves to public companies. But savvy firms are taking the best pages from the private equity playbook. IBM, for instance, saw its share price jump 3.5% on the day it announced it would use its cash plus new borrowings to buy back $15 billion (10%) of its outstanding shares.

The Idea in Practice

Pozen suggests these practices for matching private equity funds' impressive returns:

Keep Idle Cash to a Minimum

Instead of hoarding excess cash, return it to shareholders by raising cash dividends. Companies that did this on average outperformed the market by over 4% in the year the dividends were raised. And firms that started paying cash dividends for the first time on average outperformed the market by over 5% in that initial year.

Take on More Debt

Increasing your company's debt-to-equity ratio can improve financial performance by substantially reducing the cost of capital. To discover the right ratio for your firm, analyze various combinations of debt and equity (including expected returns on equity and interest rates on debt) to identify the lowest after-tax cost of total capital.

Design Value-Enhancing Operating Plans

Develop operating plans designed to increase shareholder value. For example:

- Make astute judgments about where to cut back costs within existing units.
- Look closely at possible sales of non-core businesses.
- Invest to expand revenues; for instance, by opening new stores or increasing production capacity.
- Seek reasonably priced acquisitions that will consolidate your firm's market position or realize economies of scale.

Monitor your operating plan's implementation closely based on appropriate performance indicators. If you fall behind plan, act decisively--by redrawing the plan, changing management, or reconfiguring investments.

Tie Executive Compensation to Shareholder Value

Instead of distributing financial incentives broadly across the employee population, concentrate them on the small group of executives who are proven drivers of company performance. Grant stock options with an exercise price equal to fair market value at the time of grant. That way, you'll ensure that recipients will benefit if the company's share price rises but will not gain if the firm's share price plateaus or declines. Also, place conditions on exercise of options. At Schering Plough, for example, options aren't exercisable unless specific earnings targets are met.

Act Like a Private Equity Board

Public company boards typically spend too little time on their companies' businesses to have optimal impact on performance. Instead, use the private equity model, by having directors spend 3-5 days per month on company business. Also limit their directorships in other organizations. Ensure that directors have extensive experience in your company's industry. Motivate them to create shareholder value by paying them a nominal annual fee but giving them substantial equity in your firm.

- Purchase the full-length Harvard Business Review article here.
- Visit Harvard Business Online.
- See more on Strategy & Execution at HBR Online.

Copyright 2007 Harvard Business School Publishing Corporation. All rights reserved.

Further Reading

Articles

The Strategic Secret of Private Equity

Harvard Business Review

September 2007

by Felix Barber and Michael Goold

The authors identify another strategy contributing to private equity's success: buying undermanaged or undervalued acquisitions with the intention of selling them for maximum return immediately after increasing their value. Public companies, by contrast, tend to dilute their returns by keeping businesses after the growth in their value tapers off. To compete in this space, public firms could copy private equity's model or take a flexible approach, holding businesses for as long as they can add value as owners. This latter strategy would give companies an edge over private equity funds, which must liquidate within a preset time. However, public company managers would need to begin seeing exiting a healthy business as the culmination of a successful transformation, not a strategic error.

Why Not Leverage Your Company to the Hilt?

Harvard Business Review

May 1988

by Amar V. Bhide

Bhide explains how to decide what to do with excess cash and what the right ratio of debt to equity for your company might be. Excess cash and unused debt capacity make up a company's financial inventory. Too little can be crippling. But too much costs money and invites takeovers. To determine the proper balance, CFOs must understand three factors: 1) the costs--implicit and explicit--of maintaining unused debt capacity or excess cash, 2) the risks that cash reserves protect against, such as being unable to raise equity capital when your company needs it, and 3) the potential financial needs that reserves may have to cover, such as covering interest payments and normal operating expenses as well as funding growth opportunities.

New Thinking on How to Link Executive Pay with Performance

Harvard Business Review

March 1999

by Alfred Rappaport

The author provides additional ideas for tying executives' compensation to shareholder value in ways that encourage true corporate performance. Shareholders, he affirms, will applaud any changes in pay schemes that motivate companies to deliver more value. For example, for top managers, replace conventional stock options with options tied to a market or peer index. Below-average performers would not be rewarded under such plans; superior performers could receive even more, depending on the how the plans were structured.

About the Author

Robert C. Pozen (bpozen@mfs.com) is the chairman of MFS Investment Management, a global money management firm. He is based in Boston.

Copyright © 2007 CNET Networks, Inc. All Rights Reserved.