MANAGING TO PERFECTION

Both papers explore how improvements in management practices can bolster company performance and ultimately add value. But what is actually meant by management practices?

Matthew Serfling: “We are really talking about structured practices around monitoring and incentivisation, whether that is through pay, or hiring and firing. For example, the survey we use, which was devised by Nick [Bloom], considers how many key performance indicators (KPIs) an establishment has. The assumption is that the more KPIs there are, the more structured the management practices will be and therefore the better those practices will be.”

Nicholas Bloom: “Exactly. It’s about whether businesses collect information and act to improve performance based on that information. That’s monitoring. And it’s about whether employees get evaluated. Do good employees get rewarded and promoted? Does something happen to bad employees? Do you try to retrain them or, if you can’t fix them, do you get them out of the company? That is incentivisation or good human resources practice.”

The private equity model is predicated on backing sound management teams to make improvements at portfolio companies. But how much difference do changes to management practices actually make to the performance of portfolio companies? And can strong practices be replicated across buy-and-builds? Two new research papers look at these issues.

Recent academic research by Bloom, Mahajan, McKenzie and Roberts suggests that interventions designed to improve management practices, such as monitoring and incentivisation, can have a long-lasting impact on business performance. Further research by Bai, Jin and Serfling shows that management practices can be a material source of synergy in M&A, as acquirers target undervalued businesses and improve their operations (see box on p23 for more details).

The findings are significant for PE. Not only does the research implicitly endorse the asset class’s own operationally-driven interventions and find them to be a source of persistent value creation, it offers insights into implementing sustainable change. The studies also raise interesting questions about how to integrate and improve the performance of add-on targets in buy-and-build strategies.

Here, we talk to the authors of the research, and to managing partners of buyout firms in Europe and the US, about the role that management best practice plays in PE investment. Chaired by Amy Carroll.

How significant are these management practices as value creation levers for PE investors?

Neil MacDougall: “They are pretty important. If better practices are introduced and if, crucially, you can make them stick, then that is fantastic. After all, our philosophy is to sell a company in a much better state than we originally found it.”

Sean Whelan: “We don’t really talk about management practices per se. We would put these things under the heading of people and talent, which I think are critical. It’s about making sure there is an engaged workforce and a high-performance culture.”

“I THINK IT’S IMPORTANT TO GET THE RIGHT ALIGNMENT BETWEEN OWNERSHIP AND MANAGEMENT FROM THE VERY START”

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The Coller Research Institute is an independent academic research institute that explores the culture, strategy, and impact of private equity.
Some would minimise the importance of management practices, saying that market forces take care of inadequacies. Nick, what would your response be?

Nicholas Bloom: “I have been working in this area for almost 20 years, and for me the big lesson is that management practices play a huge role in shaping performance. Businesses that have more monitoring and HR input grow faster, make more profit, and are more likely to innovate, export and survive.

“And yet, you are right; there is a large swathe of people in economics, and also in government, that doesn’t buy that. I remember talking to a government minister about this, and him saying, ‘Look, there are no badly managed firms, because competition would drive them out of the market.’ There are Nobel Prize-winning economists and influential management thinkers who have argued that there is no bad management: there are differences, sure, but not better or worse. But I think our research shows clearly that there is better and worse management.”

The research shows persistence in management interventions. But how should PE firms in particular go about making sure that changes stick?

Matthew Serfling: “My take is that Nick’s research is interesting to me as a chair of the board. We tend to bring in consultants if there is a very specialised task, such as changing distribution networks or major IT projects where we don’t have the in-house expertise. But we feel we have the skills to provide strategic direction and to implement best management practices.”

Matthew Serfling: “This part of the research was fascinating to me as a PE investor and former consultant. What struck me about Nick’s study was the importance of making sure sufficient management time is applied to monitoring these changes.”

“While it may not be the primary driver for their acquisition, acquirers improve management practices and realise better performance”

Nick’s latest research focuses on the impact of consultant intervention on management practices. As PE investors, when do you think it is appropriate to get consultants involved?

Sean Whelan: “In my experience, the most important thing is to recruit the right people in the first place. There is no point bringing in consultants if you don’t have people in the business who are going to embrace what they say and, ultimately, implement what they suggest. Having been a consultant myself many moons ago, there is nothing worse than going into a business, doing a load of work, and feeling that it is just going to get left on a shelf.

“At our firm, we are unlikely to get specialists involved unless they have a counterparty in the business that is going to pick up the baton. We can help the business along the way, but we are never a substitute for companies doing it themselves. That’s our philosophy across all interventions.”

Adam Suttin: “Our operating partners play a key role in investments, typically as chair of the board. We tend to bring in consultants if there is a very specialised task, such as changing distribution networks or major IT projects where we don’t have the in-house expertise. But we feel we have the skills to provide strategic direction and to implement best management practices.”

Although the research focuses on consultants, PE is of course another external force for change. What can the fund managers take from the study in terms of PE’s role in management intervention?

Nicholas Bloom: “I see this research as extremely pro-PE. Boston Consulting Group folklore says that two-thirds of interventions collapse in five years. We didn’t find that. We found these changes to be surprisingly persistent. I think that creates the optimistic message that external interventions can pay returns for many years afterwards.

“The second message is that these management interventions, which are the bread and butter of operationally-driven PE, can lead to huge improvements in the company’s performance and growth rate. It is a kaiser-type system that puts the business on a higher trajectory.”

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Matthew Serfling: “My take is that Nick’s research clearly shows that maintaining these practices takes effort. Good management practices are not something that a business and its top team can set and forget. If managers want to keep maintaining good management practices and realise the most benefits from them, they need to work at it.”

Some management changes were discontinued in Nick’s study. One reason cited was lack of management oversight, as Neil mentioned, another was poor buy-in among management. As an external force for change yourselves, how should PE firms mitigate this risk?

Sean Whelan: “You have to have leadership from the top. The chief executive of the portfolio company is the most important element when it comes to making changes stick. Change then cascades through the organisation. It starts with a clear, shared vision and purpose. A set of values then filters through, to create a culture in terms of how people work. Get those things right and you see the impact in HR metrics such as staff turnover and employee engagement, and ultimately in business metrics such as productivity and profit growth. It’s all interlinked.”

Neil MacDougall: “I agree. If change is not sponsored by senior management, then guess what? A report gets written, put in a drawer and nothing happens. As Nick’s research shows, these things take time. They also require a budget. You need to persuade even the sceptics, through instruction or insistence, that the changes are in their interest and that they might just be surprised.”

Matthew Serfling: “This isn’t specific to PE. It is about the conditions required for groups of people to change the way they operate; to do something differently, and hopefully do it better. It’s about changing human behaviour.”

Nicholas Bloom: “Interestingly, the interventions that did stick were in areas such as quality control, which had an immediate impact on output, and therefore on profits. What didn’t stick were things like standard operating procedures. I think the issue was that these things were too advanced, too complicated, and didn’t get the buy-in.”

That would certainly prove valuable for PE firms, in terms of understanding where they should dedicate their time and effort.

Nicholas Bloom: “Yes, and the other big question that the research raises is whether these interventions are complementary to existing practices or substitutes for them. We work together to develop a strategy and then hold ourselves and management accountable for compliance with that strategy.”

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Matthew Serfling: “It’s also interesting how this relates to our research into the impact of management practices on value creation in M&A. Its insights could help potential acquirers identify the most undervalued businesses, by focusing on those that rate low on the specific management practices found to provide the most benefit – in other words those that tend not to get dropped.”

Just to summarise, Matthew, your research finds that businesses with better management practices tend to acquire those with weaker ones. The latter are subsequently improved, leading to higher productivity and therefore value creation. What do you think is going on there?

Matthew Serfling: “The way we interpret the findings is that the target business has a lower operational efficiency than the acquirer. Profit and productivity could be boosted by improving management practices, but for whatever reason it doesn’t happen. Managers may be stuck in the status quo, or there could be additional costs involved and they simply don’t want to adjust practices. While it may not be the primary driver for their acquisition, acquirers improve management practices and realise better performance.”

Could it be that there is something about the rigour of the acquisition and integration process itself that facilitates the uplift in the target company’s management practices?

Matthew Serfling: “We haven’t looked at exactly how the transfer in management practice happens. It could end up being as simple as the acquirer coming in and installing its own management team, which leads to the target company inevitably adopting the acquirer’s practices. Our findings certainly show not only an improvement in management practices but a convergence with those of the buyer.”

Neil MacDougall: “I’m not convinced by this. I think acquirers often mistakenly assume they are the better business, with better practices, but that’s not necessarily true. When an organisation goes into an acquisition thinking that it is buying something mismanaged and that it is going to add a lot of value by introducing its own better way of doing things, it is often settling itself up for a fall.”

“I’ve seen too many acquisitions fail because people don’t give the acquired company the respect it is owed. Companies are about people, and if people don’t feel they have been treated in the right way, more often than not they will quit and then you’ve lost what you were looking to buy in the first place.”

Does the research not provide a good case for buy-and-build strategies, though? Get management practice right in the platform company, buy up poorly managed businesses, and benefit from multiple uplifts as convergence takes place?

Adam Suttin: “We don’t go out of the way to look for management challenges with our buy-and-builds, but we also don’t avoid pursuing them if we have strong management capabilities in the platform company.”

Sean Whelan: “I certainly don’t think it’s a given, though, that the company being acquired will have inferior management practices. There are situations where that is the case, but there are others where, quite frankly, we can learn a lot from the culture of the businesses we buy.”

Matthew Serfling: “The results of the research may depend on the sector that it is based on. It might be different if you are talking about buying a manufacturing plant as part of a buy-and-build, and putting in plant managers that can implement best practice from the acquiring company. But with a service-based business, it is really important to retain the management practices that have made that business successful.

“While this is an interesting piece of work, it does jar with me to an extent. I think creating sustainable operational change is more subtle than putting in your own management and rolling out a playbook.

“If we are pursuing an acquisition strategy, what we try to do is buy a company and integrate the best bits of its management practice and culture so that the sum of the parts is greater than the whole.”

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Neil MacDougall: “I’d agree with that. If you take your management team and put them into all the key positions, then what did you just buy? You may have bought a customer list, but you haven’t bought any customer relationships. I used to work at Bain & Co. and it was clear that a lot of corporate acquisitions turned out to be absolute disasters, often for that reason.”

Adam Suttin: “I’d say there is a balance to be struck. In an acquisition, if you eliminate all the things that made that company successful, then you increase risk. We prefer to see a blend between the platform company’s capabilities and those of the target. We certainly don’t come in with an edict that says everything of the target did before was wrong. It’s not just some option programme they can walk away from. It is real money on the table. One company I was involved in years ago did 50 acquisitions and brought members of the management teams into the equity of the business all the way through.”

Nicholas Bloom: “This is a question of anecdote meets big data. Of course, there is plenty of variation. But, on average, the research shows that well-run firms buy badly run firms and make those badly run firms improve their practices. I would assume those well-run firms are able to do that because they are shipping over a bunch of their practices. Do they fit perfectly? Probably not. You probably only see partial adoption. But as academics, we don’t try to explain everything.”

“PE does it better by identifying key management talent and giving them the opportunity to invest in the equity of the platform company, so they are integrated not only into the management but also into the ownership structure. It’s not just some option programme they can walk away from. It is real money on the table.”

But it also depends on the relative size and sophistication of the companies. If the target company is 20-50% of the size of the platform, then the two will probably end up blending strategies. If the target is less than 20% of the platform’s size, it will probably end up being folded in.”

THE RESEARCH

Do Management Interventions Last? Evidence from India uses research based on 17 Indian weaving companies to explore the persistence of improvements in management practices brought about by the use of consultants.

The research explores two schools of thought. The first is that by improving management practices, consultants create a virtuous circle, with systems put in place that make it easier and cheaper to pursue further improvements. The second is that maintaining good management practice is difficult, and that change initiated externally may be even harder to keep going.

This paper, authored by Nicholas Bloom and John Roberts (both of Stanford University), Aprajit Mahajan (University of California, Berkeley) and David McKenzie (The World Bank), focuses on monitoring and incentivisation practices. It attempts to quantify the persistence of improvements in management practices and subsequent business performance following extensive consultant intervention, relative to a control group that received only basic support from consultants.

The research finds that, although around half of all management practice improvements initiated by the external advisors had been dropped within eight years, a large and significant gap in practices persisted relative to the control group. Productivity, meanwhile, remained 35% higher for those businesses that had experienced extended intervention.

The research also explored the reasons why management process improvements were dropped. The most commonly cited explanations were management turnover and a lack of leadership, resulting from the distraction of chief executives and finance directors. The other reason given was that management believed changes were inappropriate for their businesses. These findings highlight the importance of key employees, as well as buy-in among management.

Management Practices and Mergers and Acquisitions, meanwhile, explores whether improved management practices are a source of value creation in the M&A process.

The research attempts to evaluate the role played by changes in management practice in post-merger value uplift, as opposed to the contributions of better-understood synergies such as improved cash flow, better resource allocation and cost savings resulting from economies in capital expenditure.

Authors John Bai (Northeastern University), Wang Jin (MIT) and Matthew Serfling (The University of Tennessee), mapped the Management and Organisational Practices Survey, created by Bloom in 2010, against a data-set of establishment-level management practices from the US Census Bureau, to analyse 30,000 US manufacturers.

The research finds that better-managed companies tend to buy companies with poorer management and that the practices of the acquired company subsequently improve, converging with those of the acquirer. Improvements in management practice are also followed by stronger performance, including improvements in productivity, profitability, growth and longevity. The conclusion is that the “spillover” of good management practice is an important source of M&A synergy and value creation.