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Value creation tutorial

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What private equity has to teach public companies



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Executive summary



Companies are in business to create value for their stakeholders, and that pursuit occupies countless hours in boardrooms and executive suites around the world. Certain companies are singularly adept at adapting their business to create and sustain value over time, but most are not. It's here that the example of top-tier private equity (PE) firms can be illuminating and useful.

The best of these firms are able to create economic value over and over again, and they do so not only through a tight regimen of cost reduction but also by creating real and sustainable operating and productivity improvements at their portfolio companies.

It's true that private equity firms enjoy a number of natural advantages over public companies when it comes to building efficient, high-growth businesses, including a built-in burning platform for change (that is, an exit within 10 years), tightly aligned ownership and compensation models, and fewer institutional loyalties and competing distractions. Still, there are many private equity lessons that do apply or can be adapted to help public companies develop the same sort of focused, time-sensitive, and action-oriented mind-set. We explore seven in this report.

Key highlights

- *It's all about value.* To attract investment, PE firms must be laser focused on value creation, not just through financial engineering but increasingly through substantive operational improvements.
 - *Cash is king.* Private equity acquisitions are highly leveraged, which instills a focus and sense of urgency in PE firms to liberate and generate cash as expeditiously as possible.
 - *Time is money.* There is a bias for action most vividly demonstrated in the “100 day” program that PE firms invariably impose on portfolio companies during the first few months of ownership.
 - *Use a long-term lens.* While private equity firms act with speed, they do not forsake rigorous analysis and thoughtful debate.
 - *Have the right team in place.* The assessment of management talent begins as soon as due diligence commences on a prospective acquisition and intensifies after closing; once made, the verdict is swiftly executed.
 - *Get skin in the game.* Management has a substantial stake in the performance of the business — on both the upside and the downside.
 - *Select stretch goals.* PE firms quickly identify the few key metrics critical to driving value capture and then track them rigorously.
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Emulating the best of private equity

There are any number of admirable aspirations enshrined in company vision statements, but it is the pursuit of value creation that drives every corporate charter. Companies are in business to create value for their stakeholders, and the pursuit of that value consumes countless hours of contemplation, debate, planning, and review in corporate boardrooms the world over. A number of select companies get it right — they set the correct value creation course and sustain it over time. But many do not. Some companies cannot find the right strategic path; others cannot execute their strategy over time. Still others execute well for a while but then lose their way. And another group of exhausted organizations are so depleted by rounds of business transformation (that is, cost reduction) that they don't have the stamina to search for additional ways to secure and sustain value.

It's here that top-tier private equity firms provide intriguing and powerful lessons. There are reasons that those who can afford the extravagant management fees continue to invest in private equity — the evidence shows that the best of these firms create economic value again and again, and they do so by implementing real and sustainable operating and productivity improvements at their portfolio companies. The fact that they perform this feat within a window of three to 10 years and in many cases after paying a significant premium is remarkable, all the more so when you consider that general partners typically extract 20 percent of any profits and roughly 2 percent of all capital committed/employed.¹

Naturally, not all private equity firms are created equal, but those that underperform the market tend not to survive their next round of raising capital — a particularly unique Darwinian market discipline that keeps PE firms operating at the top of their game.

A public company does not enjoy certain liberties that highly concentrated private ownership affords PE firms, but there are still many lessons that do apply or can be adapted. The private equity framework (see *"The Basics of Private Equity,"* page 8) compels a very focused, time-sensitive, and action-oriented mind-set that public

companies would do well to emulate (*see Exhibit 1, next page*). Specifically, public companies should build a value creation regimen on the following seven private equity principles: It's all about value, cash is king, time is money, use a long-term lens, have the right team in place, get skin in the game, and select stretch goals.

It's all about value

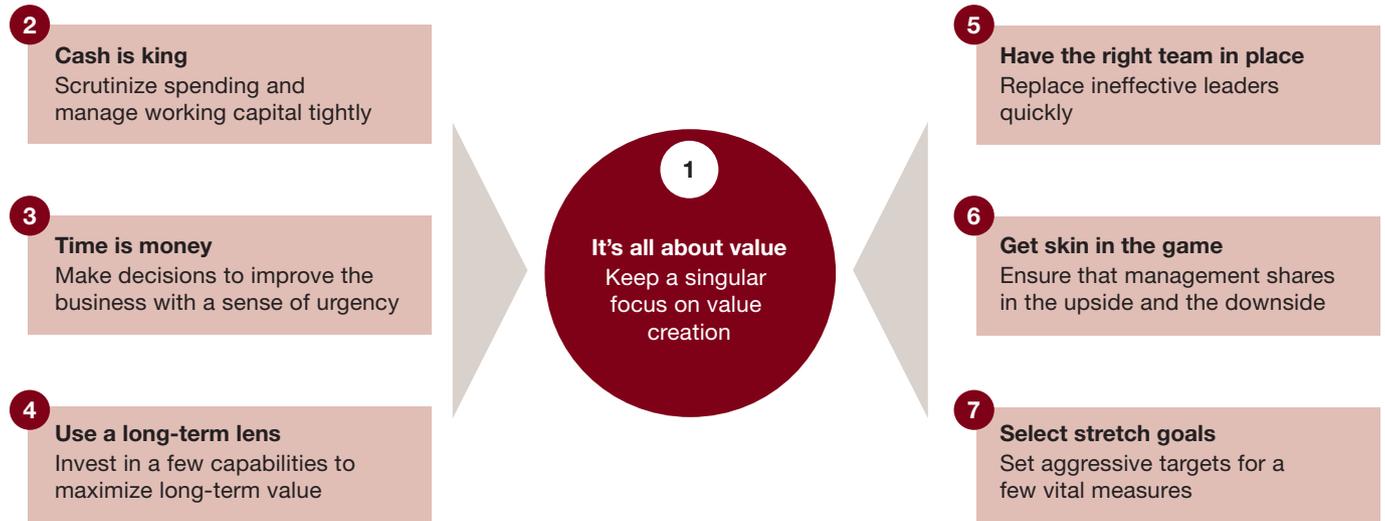
To attract continued investment from limited partners and earn the generous fees for which they are renowned, private equity firms have to be laser-focused on value creation, and that does not mean just financial engineering and severe cost cutting. While it's true that private equity firms have been known to exploit the tax benefits of significant leverage in restructuring portfolio companies, and that cost cutting is often the first step to realizing low-hanging value, more and more PE deals feature substantive operational improvements that result from the application of deep industry and functional expertise. It's no coincidence that former CEOs Lou Gerstner and Jack Welch are now affiliated with the Carlyle Group and Clayton Dubilier & Rice, respectively. Private equity firms are in the trenches at their portfolio companies, investing in core operations as often as they are cutting extraneous costs to build enduring value. Without doing so, they can't hope to cash out at the multiples to which they aspire.

Private equity firms' focus on core value begins with the due diligence conducted before the acquisition. General partners carefully choose each target company and explicitly define in an investment thesis how they will create incremental value and by when. This assessment does not stop after the acquisition — they periodically evaluate the value creation potential of their portfolio companies and quickly exit those that are flagging to free up funds for more remunerative investments. Within a portfolio company, PE firms make it their business to understand how each activity contributes to value creation and diligently cut costs on low-value activities.

That can often mean exiting entire lines of business that are simply not drawing on the company's core strengths and differentiating capabilities. Public companies should try to apply a similarly objective and dispassionate lens to their portfolio of businesses — by assessing first the financial performance of each, and then the degree to which each employs mutually reinforcing capabilities that cross business unit lines and distinguish the enterprise as a whole (*see Exhibit 2, page 9*). For each business, management should ask these questions: Is it core to our company's future value? Does it require capabilities coherent with our company's capabilities system? Does it offer a path to building

Exhibit 1
Private equity principles

Private equity value creation



Source: Strategy&

financial performance that is greater than what investors can earn elsewhere in their equity portfolios?

Private equity firms concentrate on those businesses for which the answer is “yes” to all three questions — and they monetize the rest. All the good opportunities to generate superior value stem from this core; there’s no need to bother with anything else. Private equity firms dispense with also-ran, me-too offerings. They bet the business on the products and services in which the company enjoys a competitive advantage through its capabilities, such as its technology, its cost position, its design and manufacturing skills, its customer relationship management, or its ability to create compelling new products.

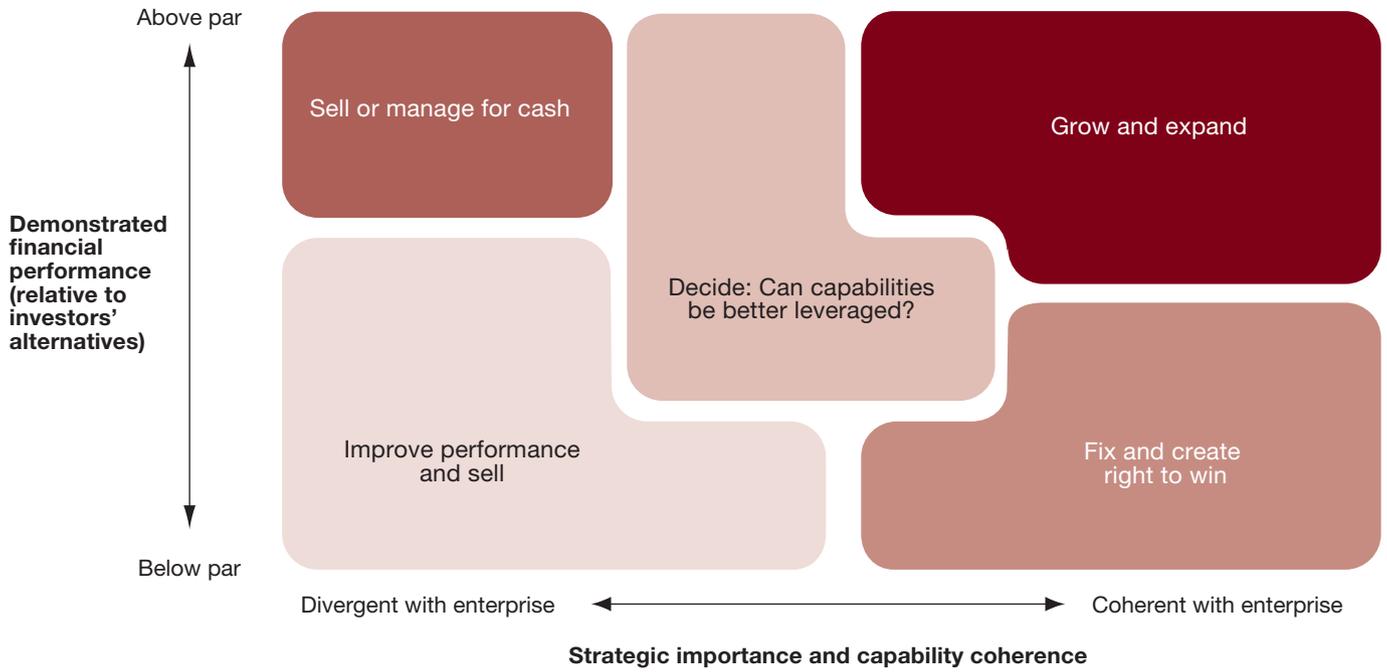
Though public companies are often more institutionally loyal and attached to historical lines of business, they should strive to hold them to an equivalent standard of value creation or find a home for them in a more compatible capabilities system at another company.

The basics of private equity

Private equity firms are specialized investment boutiques that raise large, typically closed-end funds to purchase majority stakes or full ownership in a portfolio of existing, often mature companies. The general partners in a PE firm provide the seed capital and manage the fund, but the bulk of the money comes from investors, or limited partners — generally corporate and public pension funds, endowments, insurance companies, and wealthy individuals. Companies acquired by private equity firms run the gamut — their one common characteristic is that the firm’s general partners believe they can create substantial incremental value in three to 10 years.

Private equity funds have a finite life — most often 10 years, which can be extended by as long as three years. General partners normally have five years in which to invest the capital and then an additional five to eight years in which to return that capital plus “carried interest” to investors, typically by exiting portfolio companies through sale or sometimes an IPO. For their efforts, general partners earn an annual management fee (1 to 2 percent of capital invested/employed) and a share in the returns from exiting portfolio companies.²

Exhibit 2
Focus on core value and capability coherence



Source: Strategy&

Cash is king

To paraphrase Samuel Johnson, nothing focuses the mind like an imminent interest payment. Private equity firms, formerly known as leveraged buyout firms, typically finance 60 to 80 percent of an acquisition with debt.³ This high-leverage model instills a focus and sense of urgency in PE firms to liberate and generate cash as expeditiously as possible. Since portfolio companies carry such high levels of debt, they pay scrupulous attention to cash flow, closely monitoring spending levels, debt repayment schedules, and real-time financial metrics. To improve cash flow, PE firms tightly manage their receivables and payables, reduce their inventories, and scrutinize discretionary expenses. To preserve cash, they delay, or altogether cancel, lower-value discretionary projects or expenses, investing only in those initiatives and resources (including human) that contribute significant value.

This is all part of the investment thesis that private equity firms put together when assessing a potential target and then refine after acquisition. Public companies can take a page from the PE playbook and develop a similar performance improvement plan for their own businesses. Though the specifics will vary from company to company, any such plan will focus on two principal value creation levers — increase profits and improve capital efficiency (see *Exhibit 3, next page*).

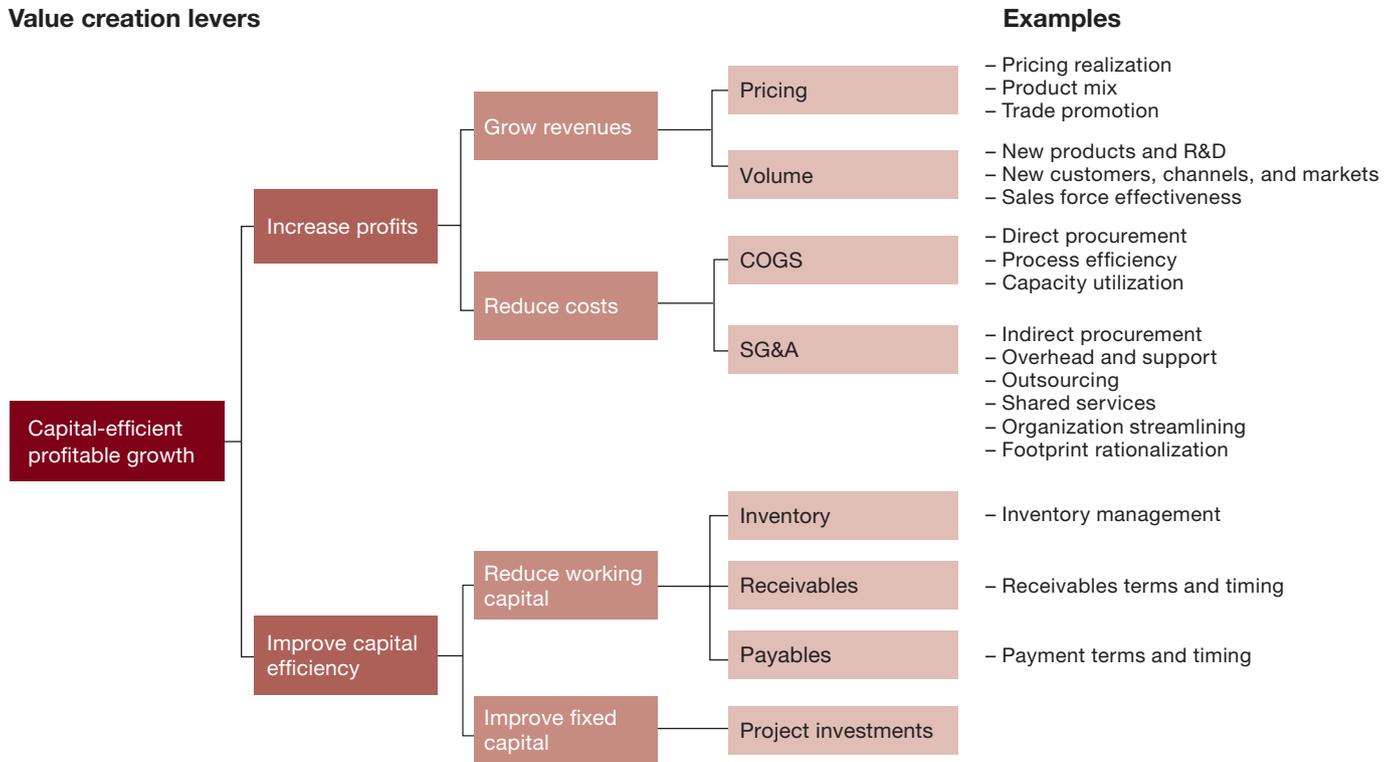
Private equity firms take a particularly sharp-penciled approach to releasing cash flow, but public companies can still learn a lot from their example. We have helped many corporate clients pursue a PE-like agenda to enable capital-efficient, profitable growth. The key is to start with a blank slate and then objectively and systematically rebuild the company's cost structure, justifying every expense and resource. We call this a “parking lot” exercise — we advise clients to, in effect, remove every resource and expense from the building, place it in the parking lot, and then determine whether it deserves to be let back in (see *“PE Lessons Save Automotive Supplier,” page 12*). There are three basic steps:

1) Review what work is performed for what purpose

Management must assess every activity the company performs and put it in one of these categories:

- “Must have” work, which directly fulfills a legal, regulatory, or fiduciary requirement, or is required to “keep the lights on” and run the ongoing operations of the company

Exhibit 3
Value creation levers



Source: Strategy&

- “Smart to have” work, which directly provides differentiating service to end customers, informs critical business decisions, or enhances employee performance, ultimately strengthening critical capabilities that allow the company to outperform its competitors
- “Nice to have” work, which describes all remaining expenses; in the pursuit of quick cash and sustained value creation, these activities should be viewed as discretionary and dialed down aggressively

2) Eliminate low-value, discretionary work

In our experience, “must have” work accounts for as little as 15 percent of total expenditures, while “nice to have” work constitutes about a third.

PE lessons save automotive supplier

The example of a prominent supplier in the automotive industry illustrates how applying a private equity–like restructuring agenda can help resurrect a company’s fortunes. As the North American auto market cratered along with the economy, this supplier’s stock price fell more than 40 percent in six months. Faced with a sharp drop in sales and a predominantly fixed cost structure, the company was hemorrhaging cash and looking at imminent bankruptcy.

Fortunately, this supplier acted quickly to stop the bleeding. It divested three subscale businesses, shut down unprofitable programs, deferred planned capital expenditures, and liquidated inventories, among other immediate measures.

Having averted bankruptcy, it then took a “parking lot” approach to cost reduction to conserve cash. Senior management figuratively removed all expenses, including head count, and put them in the parking lot; these costs had to earn their way back into the building based on their necessity and value to the business. Only “must have” resources were retained; most “smart to have” and all “nice to have” resources were left in the lot. Through this severe approach, coupled with various operational improvements and short-term cash flow savings, the company achieved US\$60 million in run rate savings in the first quarter alone and \$130 million after three more quarters (*see Exhibit A, next page*).

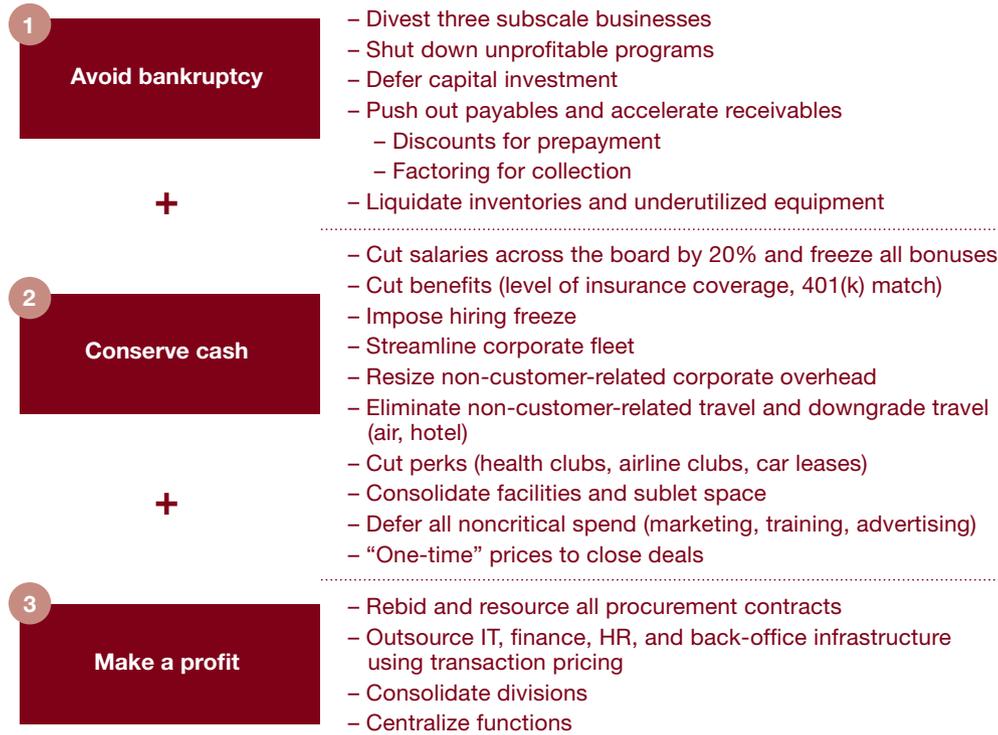
With its cost base rationalized, the company was able to make the gains permanent by consolidating and variabilizing remaining costs. It rebid and re-sourced all procurement contracts; outsourced IT, finance, human resources, and back-office infrastructure services; and streamlined headquarters operations — all while maintaining critical union relationships.

Finally, this automotive supplier applied a PE-like discipline and focus to its business model going forward. It replaced half of its top 30 managers and ranked those that remained on a bell curve. It rewired the compensation system to emphasize EBITDA and cash flow. It invested in “big bets” viewed as pivotal to driving growth; for instance, it established a number of joint ventures in India and China to become more competitive in winning global platforms being developed by large original equipment manufacturers. And it institutionalized “economic value added” as its key corporate metric.

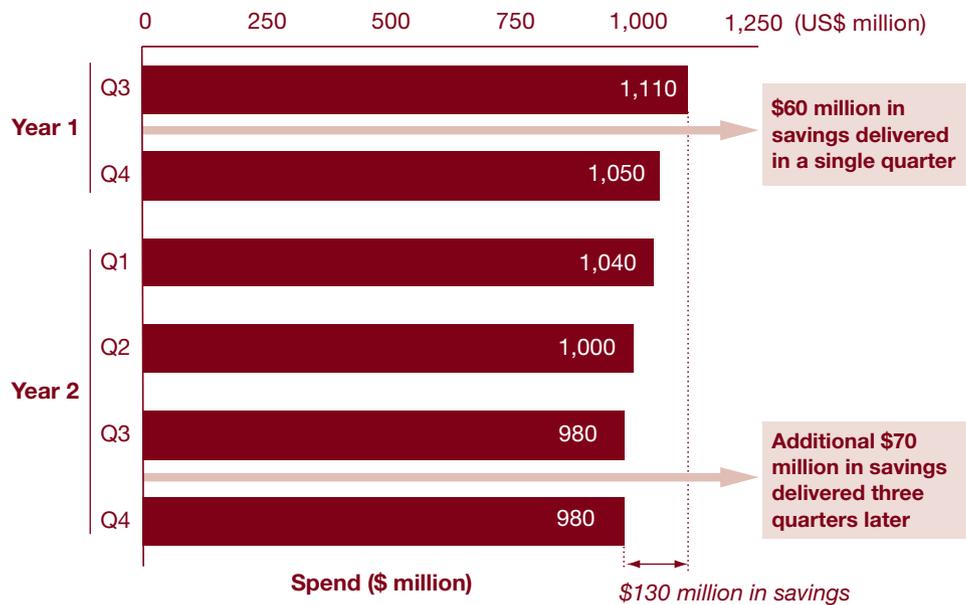
By taking this private equity approach to value creation, the automotive supplier was generating EBIT margins in the high teens within two years of being on the brink of bankruptcy. As other competitors courted disaster and even became insolvent, this company emerged as one of the most reliable prime suppliers to the automotive industry worldwide and has safeguarded sustainable profitable growth for years to come.

Exhibit A

Distressed auto supplier applies private equity lessons



Savings run rate exiting each quarter



Source: Strategy& analysis

Private equity firms take a fairly draconian approach to eliminating discretionary “nice to have” work and even reduce “smart to have” work in some cases, based on stringent value creation criteria. At a minimum, public companies should take a hard look at “nice to have” expenses and reduce them substantially, if necessary by executive fiat: “We will stop doing this work.”

3) Optimize remaining high-value or mandatory work

Many management teams make the mistake of declaring victory once discretionary costs have been identified and eliminated, but the “must have” and “smart to have” expenses still need to be streamlined and optimized. Once these activities have been carted back into the building, management should assess their efficiency and effectiveness and improve them through various means, from automation and process improvement to consolidation and even outsourcing.

Time is money

Consistent with the imperative to generate cash quickly to pay down debt is the constant reminder among private equity firms that time is money. There is a bias for action captured most vividly in the “100 day” program that PE firms invariably impose on portfolio companies during the first few months of ownership. There is little appetite for the socialization and consensus building common at many large public companies — private equity firms and their management teams feel the “burning platform” and make decisions to change rapidly.

It helps that the management team is heavily invested in the company — compensation of portfolio company managers is heavily weighted toward equity and performance-based bonuses, so their interests are fully aligned with those of the PE general partners. Also, portfolio company executives are extraordinarily empowered and have close working relationships with their actively involved boards. They do not need to navigate or appease layers of oversight and external stakeholders. Still, public company executives could learn a lot from the private equity firm’s sense of urgency. There is an opportunity cost to waiting that too many public companies inadvertently and unfortunately pay.

Use a long-term lens

The fact that private equity firms act with speed does not mean they forsake rigorous analysis and thoughtful debate. Quite the opposite. PE firms and their portfolio companies are able to apply a considered,

Private equity firms and their management teams feel the “burning platform” and make decisions to change rapidly.

long-term lens to major strategic issues. It's an interesting and very productive dichotomy. On the one hand, PE firms are seized with a sense of accelerated urgency in executing their strategic plans for portfolio companies; on the other, they can afford to be very deliberate and analytic in crafting that strategy.

Private equity firms typically have three to five years to invest their fund, so they have time to carefully assess potential targets and develop an investment thesis. They then have a window of about 10 years to exit these deals and return the proceeds to investors. Despite the occasional claim to the contrary, PE firms do not tend to “flip” investments — the median holding period is six years, and only 12 percent of deals are exited within two years.⁴

The limited partners in a private equity fund are effectively silent partners — they have little say in how the general partners deploy the capital, so general partners are not beholden to vocal shareholders or quarterly reporting expectations. After realizing the short-term cost benefit of eliminating low-value activities, the general partners can afford to invest in the long-term value creation potential of the companies they acquire. In fact, that is the only way they will secure the returns they desire upon exit — by convincing a buyer that they have positioned the company for future growth and profitability.

The best private equity firms not only cut costs but also invest in the highest-potential ideas for creating core value, and this is a lesson that public companies can learn — the art and science of making these judicious choices. Because private equity firms are often cash-constrained, they cannot fund every superficially attractive initiative — they must rigorously focus on those that promise the best return and are consistent with the investment thesis for that company. Public companies that have fallen into the trap of committing capital to every interesting proposal that crosses the boardroom transom should take note of the way private equity firms approach capital investment (see *Exhibit 4, next page*). First they take a rigorous view of costs, collapsing “nice to have” expenses and optimizing those that remain. Then they take the cash released through this exercise and invest in the most differentiating “smart to have” capabilities based on careful screening.

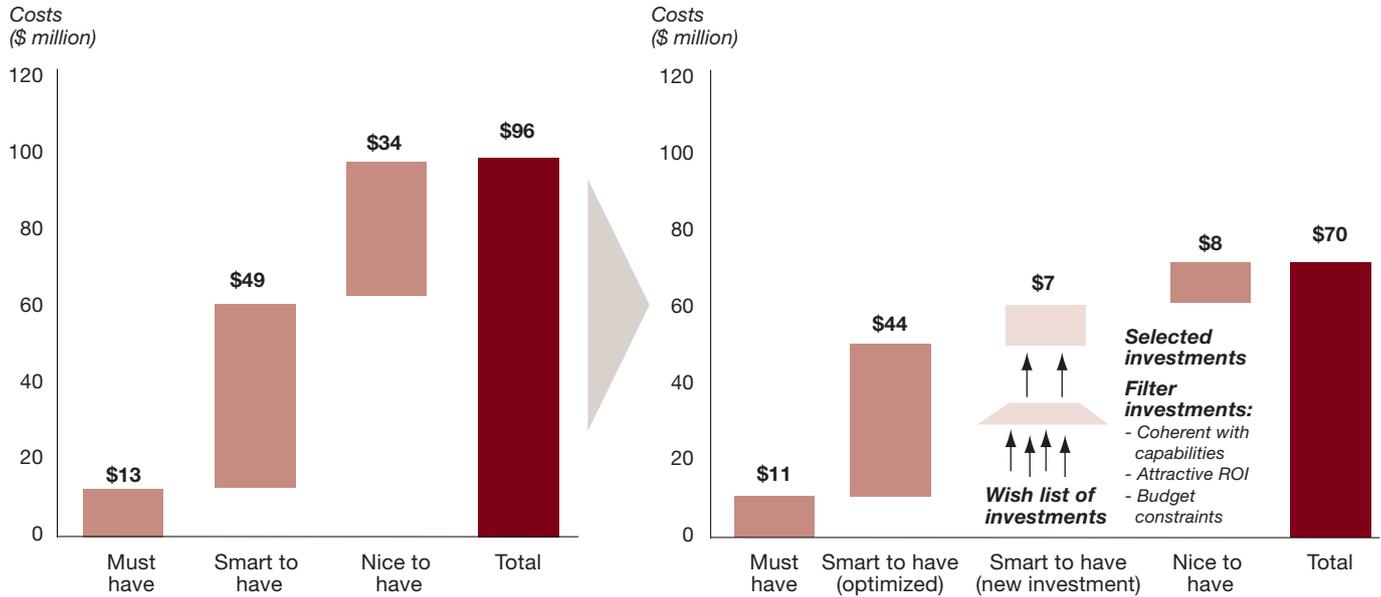
Have the right team in place

Private equity investors waste no time getting the right team in place after an acquisition, but once that team is established, they delegate to it a great deal of authority and accountability. PE general partners intuitively understand that strong, effective leadership is critical to the success of their investment — in fact, they often invest in a

The best private equity firms not only cut costs but also invest in the highest-potential ideas for creating core value.

Exhibit 4
Making judicious choices with limited investment

Minimize “nice to have” costs and invest in differentiating capabilities



Source: Strategy& analysis

company based on the strength of its existing management talent. The assessment of talent begins as soon as due diligence commences and intensifies after closing, and once made, the verdict is swiftly executed. A third of portfolio company CEOs exit in the first 100 days, and two-thirds are replaced during the first four years.⁵

A private equity firm will act assertively to put the right CEO and management team in place, but it does not get involved in the day-to-day management of portfolio companies. Instead, PE general partners give their managers aggressive but achievable targets, incentivize them to generate long-term value, and hold them accountable for making progress toward their exit strategy. They put in place formal governance processes, such as monthly business reviews, through which the PE board interacts with a portfolio company's management team and influences its direction.

In general, the relationship between the board and management at a private equity portfolio company is far more direct and accountable than at many corporations. While a public company director might pre-sent a concern indirectly in the form of CEO coaching, a private equity director will likely pick up the phone and convey an idea directly: "I think we can do this a little bit better. Let me know if you need any help analyzing this approach."

If there are gaps in the management talent, a PE firm may well draw on its own in-house experts or external network. PE firms have been known to parachute trusted leaders into new or struggling investments. Many elite private equity firms keep celebrated former CEOs on retainer to advise on operational matters and intervene as needed in portfolio company affairs.

Talent management continues beyond the first few months after the acquisition and extends well beyond the C-suite. Pressured to do more with less as the margin for error narrows, PE firms must continually reassess individuals in middle as well as top management positions and separate low performers quickly.

The private equity firm's role in the management of its portfolio companies can be likened to the role of the corporate center or "headquarters" at a public company, and the lesson here is to keep it lean. Public company corporate centers tend to expand and morph over time as their responsibilities shift more toward administration and overhead. Believing that they are consolidating to create scale economies, some start accumulating staff resources that, in turn, foist their services on the business units to justify their existence.

Private equity firms keep it clean — their role is to create long-term value by identifying and executing investment opportunities. PE firms see themselves as active shareholders committed to putting capital to best use with complete objectivity. They will swiftly exit a portfolio company if a better opportunity knocks or if improving its performance consumes too many resources.

Given this dispassionate, clear, and narrow role, PE firms are very lean — they comprise investment professionals who identify attractive deals and professional staffers who provide basic governance and fiduciary support. As mentioned above, some large PE firms also maintain a bench of internal consultants and senior advisors.

Get skin in the game

The CEO and senior managers at a private equity portfolio company are deeply invested in the performance of their individual business — their fortunes soar when the business succeeds and suffer when it fails to achieve objectives, and that is a very deliberate and widely recognized part of the private equity business model. Management has a substantial stake (equity and bonus) in the performance of the business.

PE firms pay modest base salaries to their portfolio company managers, but add in highly variable and rich annual bonuses based on company and individual performance, plus a long-term incentive compensation package tied to the returns realized upon exit. This package typically takes the form of stock and options, which can be quite generous, especially for CEOs. One recent study of 43 leveraged buyouts pegged the median CEO's stake in the equity upside at 5.4 percent, while the management team collectively received 16 percent.⁶

Top managers receive their annual performance bonus only if they achieve a handful of aggressive but realistic performance targets. This bonus is a “real” bonus — it is paid only if it is earned, unlike the bonuses at public companies, which have become a reliable part of overall compensation. PE firms will reduce or even eliminate bonus payments if an operating company fails to achieve its targets.

Not only does management participate in the upside in a private equity operating company, it also shares in the potential downside. CEOs and select direct reports have real “skin in the game” in the form of a meaningful equity investment in the acquired company. As this equity is essentially illiquid until the PE firm sells the company, it reinforces the alignment between top management's agenda and that of the PE shareholders, reducing any temptation to manipulate short-term performance.

The CEO and senior managers at a PE portfolio company are deeply invested in the performance of their individual business.

Some public companies have tried to create similar equity-based incentives for their business unit heads; however, without that big payday looming on the horizon when the business is sold, the upside potential is simply not the same. Moreover, the equity awarded is stock or options to buy stock in the parent company, not the individual unit. Since the company stock is not unduly influenced by the performance of one particular unit, these equity grants don't usually inspire the same sense of ownership among line managers.

Though public companies may not be able to match the rich equity-based rewards of a successful PE venture, they can create a tighter link between management pay and performance, particularly over the long term. Companies can stimulate a “high-performance culture” by strengthening their individual performance measures and incentives to align them with true value creation (*see “How to Pay for Performance the PE Way,” next page*). The first step is to reform the performance review process so that it truly distinguishes and rewards star talent. All too often, public companies reward mediocre performance with satisfactory appraisals and bonuses that are only slightly lower than top-tier bonuses. Poor performers are not shown the door but rather shuffled around the organization. These seemingly good intentions on the part of an employer de-motivate its best employees and breed a culture of lackluster performance — the opposite of the private equity environment.

To better align pay with performance, public companies need to “publish” company-wide metrics and cascade them down to the individual level, at least three levels down from the top of the organization. For each metric, an aggressive but achievable target should be set to measure progress against value creation. Individual performance reviews should be as robust and fact-based as possible and evaluate an individual's progress toward these value creation targets. Incentive compensation should constitute a large portion of the total pay package and be tied as clearly as possible to individual and business unit performance, as well as long-term company value creation.

Perhaps most important, companies need to identify those stars who will thrive in a high-performance culture and those laggards who will not. Low performers need to be transitioned out of the organization to unleash the true value creation potential of those who remain.

Select stretch goals

As discussed, top private equity firms manage their portfolio companies by developing and paying rigorous attention to a select set of key and customized metrics. PE general partners quickly assess what matters in

How to pay for performance the PE way

- Define the behaviors that will drive value creation (for example, motivating managers to act like owners).
 - Balance the total compensation package — fixed vs. variable, short-term vs. long-term.
 - Encourage a long-term view with a focus on longer vesting periods and multiyear performance targets.
 - Make bonuses extraordinary rather than ordinary. Award variable pay based on individual and team achievement of stated goals.
 - Match rewards to strategy and investment time lines.
 - Design equity-based compensation to reward relative performance against peers rather than stock market windfalls.
 - Reward executives for performance against metrics they can actually influence.
 - Reward value creation through effective use of capital rather than just earnings and cash flow.
 - Put some portion of executives' wealth creation at risk by having them participate in the downside as well as the upside.
 - Make the system transparent so that investors, the board, executives, and employees have a clear line of sight on what it takes to drive individual wealth creation.
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driving the success of an acquired company and then isolate these few measures and track them. Private equity firms believe that a broad set of measures complicates management discussions and impedes action. They set clear, aggressive targets in a few critical areas and tie management compensation directly to those targets.

PE firms watch cash more closely than earnings as a true barometer of financial performance and prefer to calculate return on invested capital (ROIC), which indicates actual returns on the money invested in a portfolio company, rather than fuzzier measures such as return on capital employed.

Many public companies are already following the private equity example in developing “dashboards” that track the key measures of business performance and longer-term value creation. Taking to heart the adage “What gets measured gets done,” they are developing the right set of metrics to convert strategy into action plans. Moreover, they are aligning individual performance and incentives with company goals.

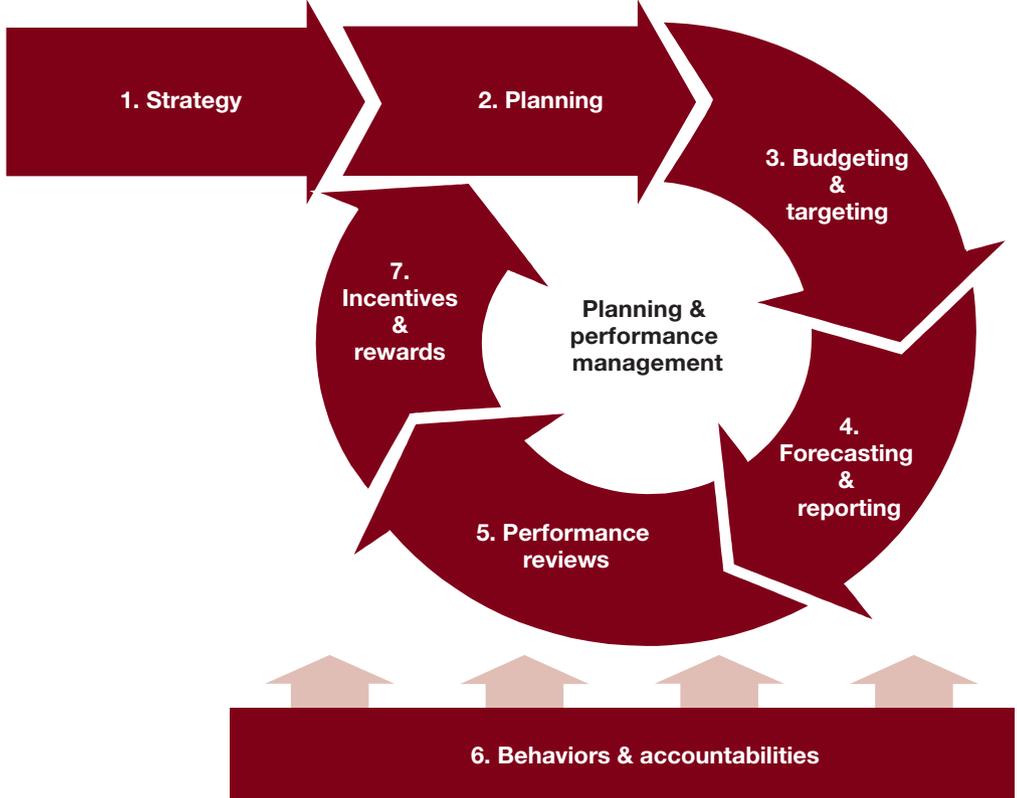
Ideally, companies want to create a virtuous cycle of performance measurement and management (*see Exhibit 5, next page*). The vision and long-term strategy should drive a set of specific initiatives. These initiatives and their financial implications should, in turn, drive annual plans and budgets and the development of aggressive but achievable targets. These targets should measure progress against these initiatives and, ultimately, the strategy.

The metrics should be explicitly reviewed at regular intervals (for example, monthly). During these reviews, management should ask three questions:

- 1) Are we doing what we agreed to do?
- 2) Are we getting the results we expected?
- 3) If results are lagging, how can we rectify? If results are exceeding plans, how can we build on this success?

Exhibit 5
Virtuous cycle of planning and performance management

Planning and performance management cycle



Source: Strategy&

Private equity points the way

Private equity firms enjoy a number of natural advantages when it comes to building efficient, high-growth businesses, including a built-in burning platform for change (an exit within 10 years), their tightly aligned ownership and compensation models, and fewer institutional loyalties and competing distractions. Public companies will not be free anytime soon from quarterly reporting requirements, governance rules meant to drive accountability and transparency, or the demands of a vastly larger and more vocal group of stakeholders. Still, the boards and executives of public companies can learn from the better practices of PE firms and adapt them to the realities and constraints of their own business model to create additional and lasting value.

Endnotes

¹ “Leveraged Buyouts and Private Equity,” by Steven N. Kaplan and Per Strömberg (*Journal of Economic Perspectives*, Winter 2009). pubs.aeaweb.org/doi/pdfplus/10.1257/jep.23.1.121

² Ibid, 123–124.

³ Ibid, 124.

⁴ Ibid, 129.

⁵ Ibid, 135.

⁶ Ibid, 131.

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