Private Equity and Value Creation in Frontier Markets: The Need for an Operational Approach

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1. Introduction

Nowhere else is the operational value creation approach more in demand than in the Middle East North Africa (MENA) region. Advocating and building operational capabilities requires active investment in business processes, human capital, and a long-term horizon. Developing the capabilities of managers to deliver value from operations will not only result in building capacity for great companies, but will also raise the bar for human talent and organizational capability in the region. In the long term, direct support and nurturing of the new generation of business leaders could have a profound effect on the regional economy, its competitiveness, and overall integration of MENA private equity markets.

A recent study of private equity (PE) in the MENA region reported the results of a survey of the mangers of private equity funds (Balze, Mezias, and Bazian, 2011). The facts portray a stark reality. Most managers responded that they are mid-way through their first fund's investment cycle and are managing between four and nine small- and medium-sized enterprises in their portfolios. At this point in the lifecycle of a fund, the possibilities to exit the investments should begin to unfold. However, it is becoming clear that the prospect of exits for these portfolio companies are less than bright; simply put, the managers of these funds face high hurdles to profitable and timely exits. Another finding from the survey is that large amounts of capital raised during the boom years before 2008 have not yet been invested; the managers of funds holding this so-called "dry powder" are between a rock, (i.e. make bad deals), and a hard place, (i.e. return the unused capital to their investors). Despite this dilemna, managers in the region report that their single highest priority for the future is to raise more capital. While it is understandable that those who manage investment funds would claim that the solution to any problem is more capital, we would suggest a different response to the problems faced by these funds. Specifically, we claim private equity funds in frontier markets like MENA need to take a more operational - as opposed to a financial - approach to growth and returns.

The basic proposition behind private equity (PE) investments is straightforward: limited partners (LPs) provide financial capital to the management teams of PE firms, known as general partners (GPs). The GPs buy ownership stakes in firms with the intention of creating value and eventually capturing value by selling the ownership stakes, earning returns for themselves and the LPs who invested with them. While this clarifies that capturing premiums through ownership transactions is a primary goal for GPs, it does not completely address the question of what GPs need to do to make the stakes more valuable before selling the companies in question. There are many ways that the GPs can manage their investments to increase value, ranging from bringing in functional expertise, e.g., sound financial management, to bringing in specific sector operational expertise, e.g., superior logistics capabilities. Indeed, the expertise required to create value in a given enterprise can be as diverse as the portfolio businesses themselves. Thus, as we introduce a distinction between two approaches to managing PE investments, we admit that it is a great simplification. At the same time, we believe that highlighting this distinction has considerable value in illustrating key points about the PE industry in MENA specifically and frontier markets more generally.

In the industrialized economies, private equity investors often create value by bringing financial or sector-specific operational expertise in to generate greater returns at portfolio companies. This works largely because a majority of the target portfolio companies have an established foundation of corporate governance and basic financial reporting. The managers of the PE firm build on this sound foundation to create additional value using specialized financial approaches or by applying functional knowledge and expertise. In contrast, in frontier markets such as MENA, financial and specialized functional expertise alone are often not sufficient; weak corporate governance and poor financial controls require additional efforts to result in value creation. Failure to recognize and address the lack of sound corporate governance and poor financial reporting practices can result in costly outcomes for private equity investors. In the long run, these expensive lessons for the investors can have a profound effect on the regional economy and other frontier economies in the global financial markets.

To develop recommendations for PE in frontier markets generally, and the MENA region in particular, we begin by distinguishing two approaches to managing PE investments. The first involves the financial approach and focuses almost exclusively on the role of the PE firm in bringing financial expertise to its transactions with target firms. In this approach, the GP relies on cheap money and the use of leverage to amplify the returns that can be obtained with investment capital from LP. Using this larger capital base, the GP searches for deals that offer opportunities to flip stakes quickly in target firms at a good rate of return. Although there are clear cases where this approach has been able to deliver handsome returns for GP and LP, it has become harder in the wake of the financial crisis, which has made debt financing more difficult. In addition, the crisis has greatly circumscribed options for exiting investments, particularly in frontier markets, which means that GP have been forced to retain their ownership stakes in portfolio businesses for longer periods of time (Balze, Mezias, and Bazian, 2011). The net result is that even GP whose approach might arguably be characterized as more financial than operational have been forced to find alternative funding strategies, for example, generating cash from operations to afford improvement programs. The result has been that the relative importance of operational considerations in creating value has increased. Our point is not to laud this development, although we imagine that a case could be made for doing this; rather, we cite these changes to highlight the fact that recent developments in the financial markets as a whole have amplified the value of core operating competencies within the PE sector in MENA and other frontier markets.

This scenario leads directly to the relevance of the second approach, which we call the operational approach; for funds operating under this philosophy, the relationship between the PE firm and the target firm is hands-on, proactive, and focused on operational and strategic issues. The focus of investor involvement with the target firm can range from rectifying minor issues to improving coordination to very complex turnaround management in more difficult cases. In this approach, the GP takes an active role in managing the target firm, engaging in building and transferring knowledge to increase the value of the target firm. In the operational approach, the GP inspects, reviews, and transforms all aspects of the business, as necessary. Consistent with the espoused purpose of PE, the investing firm adopts a longer timeframe in assessing target firms and takes action that are intended to improve value in the long run. Empirical research has shown that PE investment is associated with higher levels of firm growth and more effective investment strategies, particularly with respect to research and development (Davis et al., 2008; Bruining and Wright, 2002; Lerner, Sorensen, and Stromberg, 2008; Cao and Lerner, 2007; Chapman and Klein, 2009; Wilson, Wright, and Scholes, 2011). Despite recent publicity that suggests evidence to the contrary,[1] research has also demonstrated that PE investments increase levels of employment and wages in the long run (Wright et al., 2007; Work Foundation, 2007; Cressy, Munari, and Malipiero, 2007).

Of course, one response might simply be a decision to invest only in developed markets. Given the challenges of investing in frontier markets like MENA, investors might be inclined to not enter them at all. However, there is a strong countervailing force to any desire to avoid the complexities of frontier markets: investors love growth. In recent decades, it has become increasingly clear that the engines of growth in the global economy are the emerging markets, and this trend has only accelerated in the wake of the financial crisis of 2008. Annual consumption in these markets is growing at an unprecedented pace; Atsmon, Child, Dobbs, and Narasimhan (2012: 1) report that it will reach $30 trillion by 2025, calling these markets "… the biggest growth opportunity in the history of capitalism." In this analysis, we focus on those emerging markets with lower market capitalisation and less liquidity, the so-called frontier markets.[2] Our premise is simple: the need for capital to fund private sector growth and generate employment in these economies is acute. Despite the shallow equity markets and constrained liquidity, the low correlation with broader markets and potential for high returns has piqued the interest of investors, particularly PE capital. We focus on PE investment, particularly in the frontier markets of the MENA region, to highlight the need for investors to focus on the creation of value from operations when they buy stakes in local firms. Indeed, we would claim that the creation of value from operations is the key imperative for successful investment in companies in frontier markets, particularly those of the MENA region.

For PE investments in frontier markets, the post recession credit crunch, which has made the financial approach less tenable, has been exacerbated by a series of challenges that make finding deals with good financials and flipping them quickly more difficult. Prime acquisition targets in frontier markets are typically family owned firms; often they have not developed robust corporate governance or a good foundation of effective business practices. One consequence of weak and ineffective corporate governance is that financial and other management reports are less reliable and difficult to obtain. In MENA, as in other frontier markets, the governance issues are compounded by the lack of developed legal institutions for financial transactions, which undermines the enforceability of contracts. In addition, the equity markets for initial public offerings are shallow, which greatly limits the options for exit (Leeds and Sunderland, 2003). The MENA region shares these characteristics of frontier markets and adds two additional challenges for the financial approach: First, the integration of economies in this region with global financial markets, especially in terms of share of foreign direct investment, has remained low, given both the sizes of the populations and the levels of GDP (Khoury and Wagner, 2009). Second, there were huge increases in flows of private equity capital to the region in the years before the financial crisis, causing an overheated market and a spectacular collapse. Potential investors in the region now feel "once bitten"; the "twice shy" response is for investors to lose interest in the region, exacerbating the difficulties of exit. Further, owners of firms in the region, having become accustomed to the inflated prices of the boom, are reluctant to accept the lower valuations that are the inevitable consequence of the collapse. The difficulty of finding suitable investments for all of the funds that flowed to MENA PE firms during the boom that had not yet been invested before the collapse, further reinforces the reluctance of LPs to consider investments in the region (Balze, Mezias, and Bazian, 2011; Mezias and Goutam, forthcoming).

To address these current market dynamics, we suggest that MENA GPs should develop in-house operational capabilities and strategic expertise that can be transferred and applied across a number of portfolio businesses. Thus, PE firms in the region can enhance their effectiveness by creating human capital, knowledge systems, and other competencies that permit them to manage their portfolio businesses more effectively. At a minimum, this will involve the capability to implement sound corporate governance and reliable financial reporting systems soon after purchasing a stake in a target firm. Having done this, the possibilities for making portfolio businesses more valuable are greatly enhanced, which can be transformative in its own right. Just as the failure of individual PE investments had negative consequences for the region, we believe that delivering higher returns on PE investments can help to create a flourishing and sustainable MENA private equity industry, with consequent economic benefits for the region. The need for an operational approach is premised on an understanding of several specific and on-going business challenges facing PE in the MENA region.

The first challenge is the need for executive talent in portfolio businesses to execute and deliver ambitious value creation plans. Labor market factors in the MENA region greatly constrain the supply of talented managers, making it prohibitively expensive to hire or poach top talent from other firms. The pool of experienced operations managers is also limited due to the youth of the regional PE industry, which is made worse by the paucity of talented managers emerging from local organizations. Looking beyond the PE arena, free mobility among experienced senior management is not as common as it is in many developed economies. Executives in the major local family conglomerates tend to have deep ties to the firms where they work and their network of businesses; moving to a management position in another firm is often not an option. There is also a problem of supply of educated workers to become junior managers. At the most basic level, there is a fundamental disconnect between how the educational system prepares students and the needs of the economy for skilled managers. In addition, a bloated public sector siphons good people away from the private sector. In the oil-rich Gulf countries, this is exacerbated by issues of cost, productivity, work ethic, and the way that legal systems allocate worker and employer rights (The Economist Intelligence Unit, 2009).

The second challenge is related to the first; specifically, the human capital deficit that leads to a shortage of skilled individuals in MENA economies has corollaries at the levels of organizations. Just as there is a shortage of competent managers, there is also a shortage of organizations with capabilities and competencies vital to growth and successful investment. This problem leads directly to a shortage of viable target firms to create the deal flow that is vital to a vibrant PE sector. Additionally, the lack of competencies and capabilities at organizations constrains the entire ecosystem for PE investments. We use the term ecosystem in a manner very similar to how it is used in biology; we define a PE ecosystem in terms of groups of organizations that provide services to support successful PE investment (Mezias and Goutam, forthcoming), including fund services, special advisers (such as information technology, logistics, and management consulting firms), banking services, and legal services. The number of organizations available to provide services essential to the success of

PE investments is small and in some cases, such organizations are virtually non-existent. This makes it difficult for PE investment to play a role in advancing MENA economic development in a way that is similar to the role that it has played in most industrialized economies.

The lack of organizations in each of these areas creates challenges for PE transactions. A scarcity of fund-services organizations leads to a situation where the most basic aspects of administering a fund must occur at higher cost, from day to day operations to handling the minutiae of doing a deal. The paucity of special advisers in information technology means that integrating systems during an acquisition and using information systems to enhance the value of a target firm will be more difficult. A lack of logistics advisories makes it more difficult to gain advantages from supply chains as well as making supply chain management for an industry or sector more costly. Similarly, difficulty in finding talented local management consultants means that changes in organizational policy and strategy to create value will be more complex and costly. Any deficits in banking services, particularly those most relevant to PE investments, will also create great difficulties. Most notably, this can lead to limited availability of inexpensive debt financing structures, which can intensify the effect of the global credit and liquidity squeezes in the local market. This may make it prohibitively expensive to leverage a portfolio company's assets to finance other activities, such as growth in operations or restructuring programs. Problems arise when a limited amount of debt capital tries to serve both the well-capitalized corporates and the undercapitalized PE portfolio businesses; these issues will be even more acute when knowledge about PE in the local banking sector is underdeveloped. A lack of local law firms familiar with global standards and best practices for PE investments means that managing the legal aspects of PE investments in the local market will be more difficult. Clearly, a lack of depth of organizational competencies across a variety of sectors is likely to have a negative impact on PE firms that do not have these abilities in-house.

Third are the difficulties that PE firms may face due to lack of knowledge about corporate governance standards and state of the art financial reporting systems in MENA economies. This is likely to affect both deal flow and the ability to manage target firms once a deal is consummated. In the MENA region, it is often the case that the firms that might be targets of new investments are led by founding entrepreneurs or their immediate families. Most of these firms have remained small- to medium-sized enterprises and have avoided the need to hire large numbers of outside managers who might have prompted the development of a delegated governance framework. As a result, most of these businesses are dominated by a few related individuals and operate more as personal fiefdoms rather than standardized corporations. Further, the dominant individuals have often exercised autocratic controls and are not accustomed to reporting to anyone. Not surprisingly, they do not often see the need or benefit of investing in financial reporting infrastructure or expertise. This lack of understanding of governance is so widespread that it can make relations with management at target firms much more difficult. At a minimum, PE managers are likely to face resistance in getting managers at target firms to deliver accurate and timely reports about financial and operational results.

Fourth, in terms of volume of transactions relative to GDP and integration with global financial markets, most equity markets in the MENA region are not very well developed (Mezias and Goutam, forthcoming). The controversy when index compiler MSCI Inc. refused to 'promote' the equity markets in Qatar and the UAE from frontier to emerging status[3] is a recent indicator of the general view of MENA equity markets. As a result, there is a shortage of equity or bridge funding available from shareholders. Since LPs are very conservative, often because they are managing pension fund assets, they generally regard any PE investment allocation as very risky. Asking them to select a fund that invests in MENA is an uphill struggle. The infancy of PE industry in the region, the limited track record of successful exits, the uncertain political climate, and the consequent challenges to economic growth conspire to push institutional investors away from funds that operate in the frontier markets.

Finally, the large amounts of capital under management with relatively short time horizons left in the contracted times to liquidation of these funds are another nail in the coffin of the flow of additional PE capital to the region. The majority of the MENA PE funds are in their final five years of the fund cycle. Under normal conditions, they should be preparing for portfolio business exits within the next two to three years. However, the lack lustre capital markets limit the options, and fund managers struggle to identify strategic exits. This means that buyers who will evaluate the quality of its human capital and the operational processes of target firms carefully have become the only viable option.

Considering all of the above, we do not believe that raising new funds should be the principal objective of GPs in the MENA region over the next five years. Instead, we would suggest that the top priority for GPs in the MENA region should be to build operational capacity. This will require a continuous focus on growth and profitability of portfolio businesses. As the prior discussion suggests, this will not be easy. Where can GPs find experienced managers with the requisite operational, technological, and logistical expertise to grow or turn these businesses around? At a minimum, GPs must engage intensively with the portfolio company management teams, and this will take considerable time, energy, and attention. It is not easy to act and behave like a full-time dedicated owner of all the portfolio businesses while simultaneously being responsible for sourcing new deals, managing comprehensive due diligence processes, and keeping the LPs fully informed of all aspects of the fund's monthly and quarterly performance.

2. Not a formula but a philosophy

Every PE firm that has implemented an active operations management model will have its own approach and specific philosophy. We believe that there is no strict recipe for building an in-house operations capability, but there is a set of principles that revolves around constantly reviewing the strategy and proactively managing the operations of portfolio businesses. The first recommendation is for GPs to stay as close to the business as possible. This is more easily said than done, since investment bankers tend to dominate the founding teams of many PE firms. These founders are highly motivated and talented in sourcing deals, buying undervalued companies, and fund raising, but are rarely best suited to working proactively with the portfolio management teams on operational tasks. Once they have closed the deal, however, things change; it is in this post-acquisition phase that the need for senior operational experience becomes apparent. Thus, implementing this recommendation begins with the appointment of an in-house operations manager with the requisite experience, skills, and knowledge to serve as either a non-executive board member or a special advisor to the portfolio business. To take this recommendation further, we would suggest that no GP should close a deal to buy equity in a firm without having identified the person who will be the operations manager after the deal closes. The parent PE firm should expect that the operations manager would spend in excess of 70% of his/her time at the new portfolio business in the first few weeks following an acquisition. This exhaustive interaction helps build credibility and trust as well as set transparent delivery expectations. More importantly, it is an excellent opportunity to assess the capability of the current management team; based on this information the operations manager must decide quickly whether to rely on the existing management team, to complement them with external consultants and support services, or even to replace them.

The second recommendation is to have clear, executable performance improvement plans that will create value in both the short and long term for each of the portfolio businesses. Initially developed by the GP, the operations manager must ensure that the management team at the portfolio company will validate and own the plan after the acquisition. Though many management teams, even in frontier markets, have some experience with improvement programs, not many have had experience managing profit and loss, preserving cash, and reducing costs simultaneously in the context of a hard-nosed value creation plan. The first few quarters, indeed through the first two years, can be highly stressful period for portfolio management teams. Over and over, the operations manager must revisit the same question with the CEO/CFO of a portfolio business: What do they need in order to deliver on specific difficult targets for the coming quarter or year? The answer to this question will almost invariably be followed by the tougher question of why the results cannot be delivered even sooner. Although part of the purpose is to push the team to achieve better results, there should also be a clear information flow back to the GP to ensure that the portfolio firm receives the resources required to achieve the ambitious goals of the performance improvement plan. This is particularly important when the portfolio company has been burdened with significant debt and restrictive collaterals, which is often the case in a PE buyout or purchase of a stake. With full awareness of these challenges, an experienced operations manager must begin work to implement detailed plans for value creation immediately following the close of a deal. Intensive engagement with management of the portfolio business ensures that the CEO, CFO, and other top managers of the business will validate and support the plans and revise them as necessary.

The third recommendation is to implement transparent governance, financial, and cash reporting systems across all new portfolio businesses in order to enable continuous monitoring, evaluation, and benchmarking activities. Real-time decision-making and continuous financial reporting to achieve turnaround targets must become one of the core competitive competencies of the portfolio business. Introducing and implementing these systems along with training the business finance team at the portfolio company to produce accurate, timely financial and cash management reports becomes a priority.

Success will likely require a significant upfront investment of time from the operations manager. In the best case scenario, where the portfolio firm already has a competent CFO supported by a skilled finance team, the efforts of the operations manager will likely be focused on mentoring. For example, producing a weekly sales flash report, a rolling 13-week cash flow forecast, and timely and accurate projections for the month, quarter, and year can be huge burdens on the finance team of a small portfolio company. Most CFOs are highly competent and can often produce such information with considerable speed and accuracy, but not necessarily on a weekly basis. More importantly, CFOs are accustomed to managing businesses through longer term profit and loss measures rather than through short-term cash and working capital.

Indeed, managing the business by preserving and proactively managing cash and working capital requires a paradigm change for these personnel. Where competent finance personnel are not already in place, the operations manager must devote time to assembling a team and then start the process of orienting them and the firm to the difficult cash and working capital issues. Obviously, the time required from the operations manager to get these systems in place at the portfolio company will be greater when significant recruitment of finance personnel is added to the mix. Staying close to the business, particularly immediately after closing a deal, will almost invariably be a full-time job; the shift to continuous monitoring of operational finance targets that are linked directly the performance improvement plan will not be achieved by remote control.

The fourth recommendation is to offer access to expert networks and shared service centers to portfolio companies as needed, including sourcing, legal services, and property management, for example. Most PE portfolio businesses in the MENA region are small- to medium-sized enterprises with limited in-house pools of specialist knowledge. To illustrate this point, consider a local clothing retailer that operates a number of outlet stores; the core capability of this business is to market and sell clothes in its domestic market. An operations manager working across a number of portfolio businesses can immediately see the benefits of setting up a shared garment sourcing unit in China with the objective of supplying the portfolio businesses with the best quality products at the lowest price.

We can generalize this point by returning to our earlier discussion of the ecosystem to support PE investments. Offering shared in-house dedicated service centers, whether for logistics, information technology, management consulting, banking, or legal issues, can compensate for gaps in the development of these capabilities in frontier markets like MENA. Whether the PE firm sources or supplies these services, pooling demand across the portfolio businesses creates volume that can yield significantly lower costs, which is a win-win for both the PE firm and the portfolio companies.

The final, and perhaps most important, recommendation is to set up and agree on a well aligned and transparent reward structure with clear value creation targets for the CEO and senior managers of the newly acquired portfolio businesses. The operations manager must negotiate and finalize the reward structure, including the management option plan, either before or soon after the deal closes. As a guideline, most management option pools are between 5% and 10% of the total equity. Setting up such a reward scheme requires the full coordination of all stakeholders, including external advisors. Complex activities such as estimating potential exit values, obtaining approvals from the remuneration committees of funds, and understanding the tax and legal implications in the geography of the operating business require a range of expertise. The challenge is even greater when this knowledge must be deployed quickly and with requisite due diligence.

3. Conclusion

This list of recommendations is not exhaustive nor complete for building the capability for operations management; rather it offers important, pertinent discussion points for PE businesses in MENA and other frontier markets. Becoming an active shareholder and adopting an operational approach is not a new phenomenon in the PE industry. Over the years, many of the top global PE firms have developed and continuously refined their in-house operations capabilities to suit specific geographies and business sectors. Some of the best known PE firms began operations with an explicit focus on operational capabilities; for example, at The Carlyle Group, two of three co-founders, William Conway and Daniel D'Aniello, came from an operating background. Other leading PE firms have established dedicated units to service their portfolio companies; for example, at KKR, all portfolio businesses have access to KKR Capstone, a team of more than 60 operating executives.

In the MENA region and other emerging markets, it is often the case that operational value creation is even more challenging than in the industrialized economies. Indeed, local GPs in the MENA region, such as Mubadala and Abraaj, have adopted the operational philosophy. Over the last decade, Mubadala has developed and refined its operational philosophy by centralizing certain functions such as finance, new business development, property, and legal services. Simultaneously, they have decentralized sales, human resources, and logistics at the portfolio company level. They have also actively managed the rotation and secondment of senior executives to new portfolio companies in order to ensure that operational expertise is transferred across portfolio business. These actions by GPs such as Mubadala and Abraaj are consistent with the operational approach that we have advocated.

Building operational capability in MENA and other emerging markets requires active investment and a long time horizon. More to our point, given that a finance approach will generally not be successful, any PE investor in the region should assess potential deals with an eye towards creating value through operations. GPs must focus on the long term by building their operational capabilities and investing actively in developing operational managers. This will not only improve their chances of delivering higher returns to their LPs; it will also fulfill the promise of PE activity as a central part of broader economic development. By building great companies, PE investments will help to build a new generation of business leaders for the region. We have little doubt that such an injection of human talent and organizational capability would be like a shot of economic adrenalin to help propel and grow the MENA economies. This long-term investment in people and firms could have a profound effect on the regional economy, its competitiveness, and the overall integration of MENA (private and public) equity markets with global financial markets.

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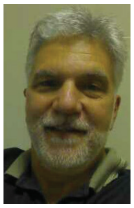
Endnotes

1. http://thecaucus.blogs.nytimes.com/2012/01/08/gingrich-says-bain-capital-looted-companies/ provides one example.

2. This definition, retrieved on 1 March 2013, is from the Financial Times: http://lexicon.ft.com/Term?term=frontier-markets.

3. http://online.wsj.com/article/BT-CO-20111215-705545.html

Author Bios



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