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Private Equity Operational Overview
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Introduction

While there are a number of books, articles and case studies that dwell on the investment criteria and portfolio companies of private equity funds, few deal with the challenges of running a firm. For the purposes of this writing, private equity ("PE") takes on the classical definition of any non-public equity investment; this includes venture capital, buyout, as well as other illiquid alternative investments. In this document we outline the primary operating functions of a private equity partnership and use that as a template to map operational improvements. Our focus in this document is on operational activities, and while there are clear implications for investment strategy, we take that as a given in our examples and leave it for future discussion.

Objectives of Private Equity Operations

In the public markets we encounter a wide variety of rules and regulations that define the acceptable set of behaviors for an investor. It is through following these rules and regulations that a firm is able to become publicly traded; in exchange for conforming to these rules operating firms are able to access broad capital markets with minimal transaction costs. Private equity markets are the opposite. While many laws apply, there is much more flexibility in their application and interpretation. The goal for a private equity firm is to maximize the impact of this flexibility to create investment advantages for their investors. The public equity investment is constrained by the legal environment which enables its existence; absent these constraints the private equity investor has a much greater degree of flexibility and a much larger ability to differentiate its investment operations from its public equity cohorts.

Directionality – Upstream / Downstream

Private equity firms serve as market makers between their investors (often referred to as limited partners or "LPs") and operating companies looking for investors. If we evaluate the activities based on the flow of funds, the LPs are "upstream" of the PE organization, and the operating firms are downstream. The activities of the PE firm when pursuing LP investors mirror those of the operating firm when pursuing the PE firm; in this observation we note symmetry in the performance of activities. For any activities performed by a PE firm, we can assume that they are performed both in pursuit of investments and in pursuit of investors.

Investment Process Activities

We outline five phases of the investment process;

1. Sourcing. Sourcing is the act of identifying and pursuing investment opportunities. The actual investments, and resulting portfolio, emerge as a subset of the prospects evaluated during deal sourcing.
2. Diligence. Diligence is the act of evaluating an investment opportunity. Only well qualified deals will pass through diligence and into deal structuring.
3. Deal structuring. Deal structuring is the combined act of negotiating, creating legal documentation and closing of a transaction. While deal structures have numerous conventions; the fact that private equity transactions are in fact private, negotiated deals provides substantial variation in the way they are closed. Differences in legal conventions between agents, lawyers and accountants create great influence in deal execution as well.

4. Operations. During the Operations phase the investment is managed following the closing of the transaction. The methods of exerting influence are identified during the deal structuring phase, and may include fees, board positions, preferred returns, pre-identified rules, advisory boards, etc. The operations phase can be the longest and most involved phase of the investment process, and this ability for differentiation in activity is definitionally absent in public equity investments. Of the five investment phases outlined here, operations is the most interesting for future decomposition and analysis.
5. Exit. Exit is the act of selling the investment and bringing the relationship to a close. In the public markets it is a rare case where an investor can create an advantage in the way they exit a holding; in the private markets the timing, method, structure and even the purchasing party are all variables which impact the value of the investors' returns.

Operational Template

When we combine the directionality of investment activities (upstream and downstream) with the five investment process activities, we find a 2 x 5 grid which allows us to analyze the discrete functional areas of a PE firm. By laying out the capabilities, we can (i) conduct orderly diligence of their capabilities, (ii) create side by side analysis between firms, and (iii) look for ways to improve the operations of a firm. The grid below is a rough outline; further materials are available upon request.

	Downstream	Upstream
Sourcing	Targeting of investments Promotion of the PE firm in target markets Trade show attendance Networking Talks, etc.	Identification of potential LPs Pursuit of LPs Meetings Research
Diligence	Technical Legal Market	Technical Legal Diligence kit
Deal Structuring	Unique advantages (Financial structures, etc.)	Knowing the market Cornerstone Anticipating change
Operations	Adding value post deal Common methods Use of operating partners	Customer service LP Reporting Annual meetings
Exit	Multiple / EBITDA growth	Recycling Speed

Strategic Implications

The strategy of a PE firm is dictated by its assets under management, the transaction pipeline and the expertise of its operators. Given two firms with the same strategy, a relative ranking across the 2 x 5 grid will demonstrate areas where the firms could be expected to have differentiated performance.

Conclusions

Private equity firms are small, rare and highly differentiated. Understanding the activities of a firm with fewer than 20 employees, of which there are fewer than 2,000 in the US, and which invest in dramatically different types of businesses makes comparison between firms difficult. Our 2 x 5 operational template provides a first attempt to decompose, define and codify the activities that go on within these firms. We believe it will serve as an important first step in improving LP diligence as well as GP investment performance.