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Private equity operating groups and the pursuit of 'portfolio alpha'

While this function has become ubiquitous at private equity firms, they have yet to adopt a standard approach.

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As private equity firms seek to boost investment returns, operating groups have become an increasingly prevalent feature of their organizations. Today, each of the top 25 funds (by *Private Equity International* rankings) has an internal operating group. Firms have expanded these groups, which focus on providing strategic direction and support to their portfolio companies, in part as a response to rising competition for acquisitions that has contributed to higher valuations. This proliferation of operating groups aligns with a broad philosophical shift among private equity investors from the historical "buy smart and hold" approach to "acquire, align on strategy, and improve operating performance."

To get insight into how private equity firms are using operating groups to support their investment strategies and create alpha in their portfolios, McKinsey conducts a regular survey, the latest of which concluded in the fall of this year.

The 2018 survey results reflect the strategic shift toward generating alpha and the increasing prevalence of operating groups within firms. In 2015, for example, operating groups spent 29 percent of their time focused on "monitoring and reporting" portfolio company performance, compared with 19 percent in 2018. Further, the focus on "driving measurable performance improvement" increased from 40 percent in 2015 to 49 percent in 2018. Respondents expect this area to continue to represent an increasing percentage of their activity and plan to expand their operating groups accordingly over the next three years to support this approach. Specifically, they indicated they would add former functional executives (56 percent of respondents), former consultants (54 percent), and former C-level executives (44 percent) to their internal teams.

During this same period, concentration on "work supporting broader change processes" has remained roughly constant (31 percent in 2015, compared with 32 percent in 2018).

While a smaller percentage of survey respondents in 2018 reported having a well-defined model, or playbook, for creating value (59 percent versus 65 percent in 2015), firms that have such models currently are using them more consistently across the portfolio (75 percent in 2018, up from 50 percent in 2015).[1] These findings suggest an emphasis on taking a more deliberate and consistent approach to value creation across the portfolio.

Our analysis also revealed significant variance in the size and composition of this function across firms. We found a minimal correlation between operating group team size and fund size as measured by assets under management (AUM) and fund number (Exhibit 1). Across the surveyed firms, one-third of respondents have five or fewer operating group members on their internal teams, and just 37 percent have more than ten professionals. Few firms, even those with more than $25 billion in AUM, have internal operating groups larger than 15 professionals. The once-common practice of building out large internal operating groups that effectively serve as internal consulting and implementation practices does not appear to be a priority among our respondents.

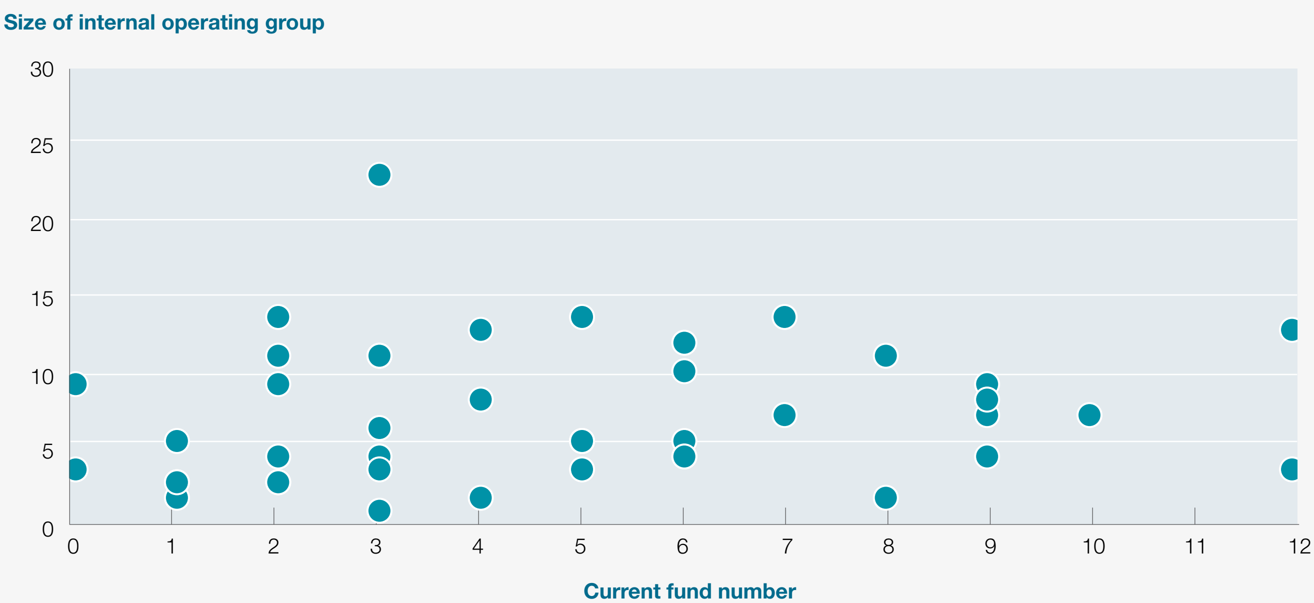
We also examined operating group composition as part of the survey. Of the 45 firms surveyed, 30 have operating groups that include both professionals working in a part-time, often ad hoc capacity (external operating group members), as well as professionals working in a full-time capacity as firm employees, or occasionally at portfolio companies (internal operating group members). The 15 remaining firms have internal operating groups exclusively.

External operating group members are typically former C-level executives and, to a lesser extent, former functional leaders (such as vice presidents or senior vice presidents). They often serve firms in an advisory role to identify and evaluate potential investments and provide CEO coaching and governance support to portfolio companies. These

Exhibit 1 **Assets under management (AUM) and fund number have no correlation to size of operating group.**

Note: Excludes four firms with operating groups with more than 30 professionals to preserve respondent anonymity.

Source: McKinsey 2018 Private Equity Operating Group Benchmarking Survey (Fall 2018), n = 45



Note: Excludes three firms with operating groups with more than 30 professionals to preserve respondent anonymity.

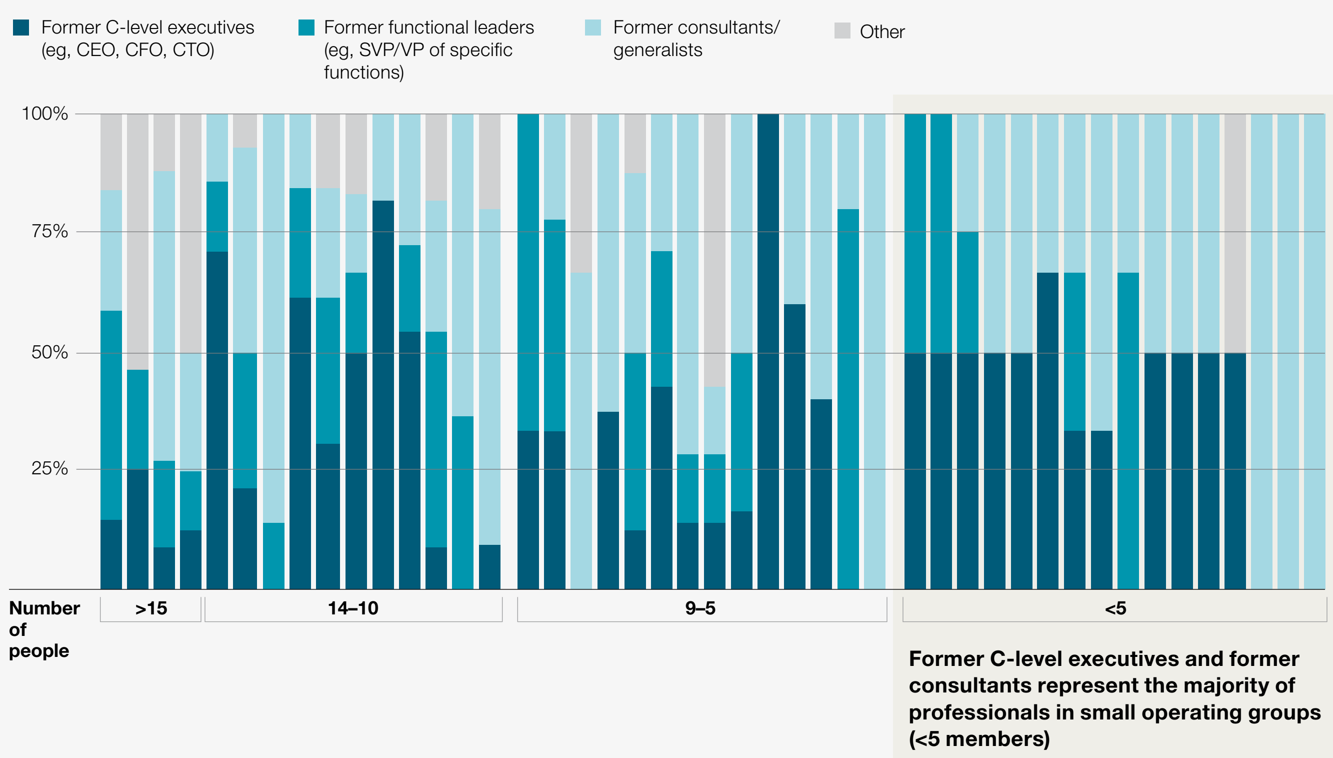
Source: McKinsey 2018 Private Equity Operating Group Benchmarking Survey (Fall 2018), n = 45 members are compensated for their board service and often have the opportunity to invest alongside the fund in deals they helped to find or complete. Survey respondents believe their external operating group members spend 30 to 40 percent of their time, on average, supporting the firm or its portfolio companies.

In contrast, internal operating groups comprise three types of professionals: former C-level executives, functional leaders, and former consultants. Fewer than half of the groups in our survey have more than half of their members from any one background; 11 groups are primarily former consultants, seven are primarily former C-level executives, and three are primarily former functional leaders. Five groups are split evenly between former C-level executives and former consultants. The majority of small operating groups (those groups with fewer than five professionals) are staffed primarily by former C-level executives and former consultants (Exhibit 2).

The survey also offered some insights into the evolution of operating groups in the coming years. Respondents anticipate that internal operating

Exhibit 2 **Operating groups primarily comprise three types of professionals, but the mix varies significantly.**

Composition of internal operating group: Prior roles, % of total internal operating group members



Source: McKinsey 2018 Private Equity Operating Group Benchmarking Survey (Fall 2018), n = 45 groups will continue to expand, particularly in midlevel roles such as vice president and principal. Firms are looking to a talent pool of former functional leaders and consultants to fill out their teams as opposed to leaning more heavily on former C-level executives. This composition suggests that firms plan to engage more actively with their portfolio companies in the coming years. In contrast, respondents indicated that external operating groups are slightly more likely to recruit former C-level executives for future staffing needs, reflecting in part an increased focus on sourcing proprietary deals and expanding their bench of potential portfolio-company board members. The survey findings and industry trends suggest that the size and composition of internal operating groups will continue evolving in the coming years. For this reason, firms will likely see heightened competition for qualified candidates, so attracting and retaining talent for operating groups could take on added importance. ■

[1] One significant difference between the two surveys was the number of respondents, with 45 firms participating in 2018, compared with 20 in 2015. The collected responses from the 2018 survey came from companies with a range of fund sizes, geographies, and operating group models.

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