

# Why PE Firms are Restructuring (and Not Just Their Portfolio Companies)

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It is no secret that the current economic crisis has hit private equity firms hard. U.S. PE firms raised \$40 billion in the fourth quarter of 2008, down 60% from the year-earlier quarter.<sup>1</sup> And those fourth-quarter numbers may be only the harbinger of worse times to come, with PE firms considering cutting fund sizes and limited partners having difficulty finding money to commit.<sup>2</sup>

The cutbacks at PE firms have already begun, especially (but not exclusively) in the larger ones. Carlyle Group cut 10% of its workforce last December, its first layoff in 22 years of business, and will be shutting down its recently opened Silicon Valley office.<sup>3</sup> Blackstone Group, 3i, and other PE firms have followed suit. In January, American Capital closed its Chicago buyout operation, leaving only a handful of its 20 staffers there employed.<sup>4</sup> At approximately the same time, Sun Capital Partners in Boca Raton, Fla., laid off 23 people.<sup>5</sup>

Today's economic woes are undoubtedly leading many general partners to scrutinize how their firms are structured. But the trend was already under way last summer before the financial meltdown, according to research we conducted in June 2008. A Parthenon Group survey and interviews with about 70 middle-market PE firms (\$500 million to \$5 billion in fund size) found that 50% had started making changes to the way they organized

functions and did their work. The remaining firms anticipated making changes in the next few years. (That figure rose to 75% among firms with funds over \$2 billion.)

Most general and limited partners we spoke with believed that the often fuzzy issue of organizational structure actually had a significant impact on investment returns and the amount of risk their firms could assume. And more than a third (37%) cited organizational structure as critical to staff retention. In short, middle-market PE firms increasingly view their own structure—the design of how people are organized and how they do their work—as a key to success, and PE firms of all sizes are experimenting with their organizational structures (see Exhibit 1).

Although there is no one right model for every PE firm, organizational structure is increasingly becoming a key lever that influences fund performance. As a result, a PE firm with a deliberate, proactive, well-thought-out approach to evolving its organizational structure will be more competitive in the current market environment than those that take a more reactive approach.

About half (51%) of the PE firms we surveyed strongly believe that an optimized organizational structure could help in achieving the firm's goal of increasing investment returns. The same percentage thought it decreased investment risk, and 46% identified it as a significant factor in attracting

limited partners. Naturally, to attract limited partners, a PE firm's structure at the partner level has to be visible to them, but organizational structure throughout an organization is also becoming increasingly relevant. As one LP told us, a recent presentation from a PE firm "offered transparency with regards to their organizational structure and development of staff. They probably caused us to focus more on this aspect of PE firms than we have in the past." In a market with many PE firms in which an LP can invest, it's far more important now for a PE firm to communicate *why* its structure is strategically sound.

The economy may not be why PE firms began reexamining their organizational structures in the last few years, but the current deep recession undoubtedly moves it toward the top of the priority list. As one interviewee at a PE firm said, "We spend a lot of time talking about optimal structures but know that we have not yet found the answer."

This article examines the forces that are driving PE firms to restructure their organizations and describes some of the most widely adopted forms this restructuring is taking. Finally, we discuss why it is important to match restructuring to the core Context, or

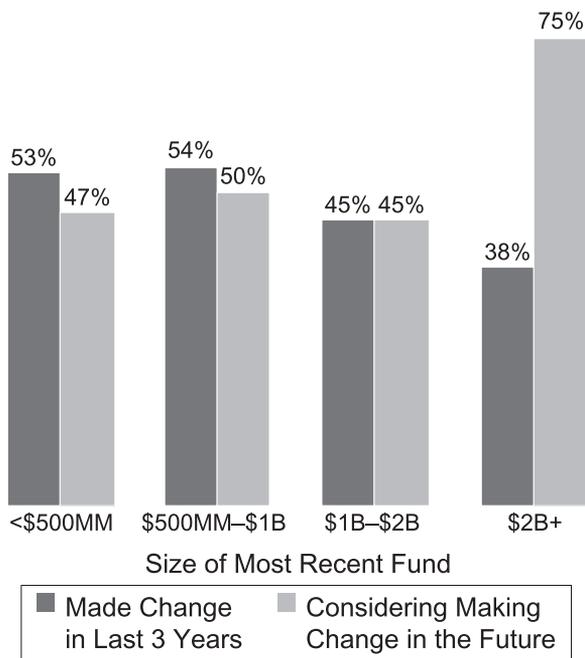
character of the firm—its founding legacy, its culture, and its investment focus—with an eye toward helping PE firms determine the structure that is optimal for their unique organization.

### COMPLEXITY DRIVES THE NEED FOR REORGANIZATION; CONTEXT DETERMINES ITS SHAPE

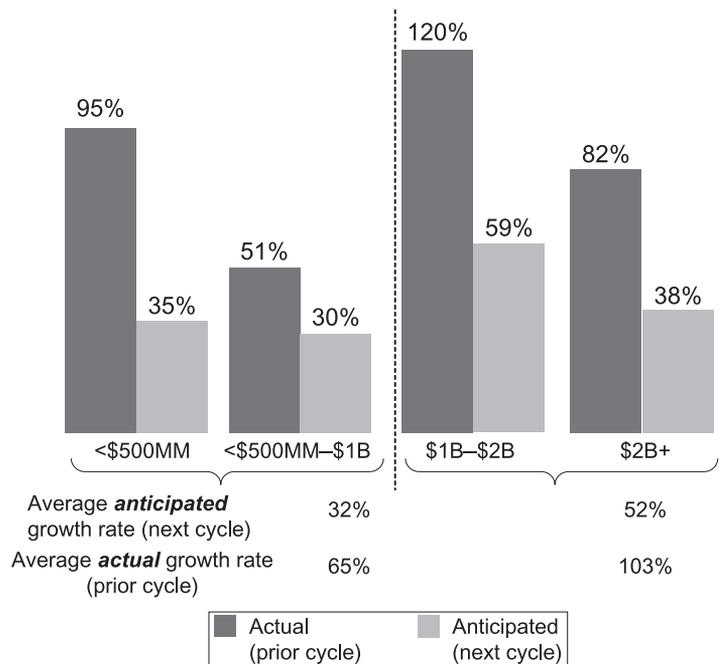
Regardless of whether it's irrational optimism, most PE firms anticipate that their next funds will grow, although not at a level enjoyed in the last fund-raising cycle (see Exhibit 2). PE firms managing funds of less than \$1 billion forecast a 32% average growth rate in the next cycle. PE firms with \$1 billion to \$5 billion in funds predict a 52% average growth rate. To achieve that growth in an environment of fewer deals and more time needed to raise funds, PE firms must become more efficient.

But the enemy of efficiency is Complexity. As middle-market PE firms have grown (the number of funds and the average fund size both have doubled in the last five years), they have added Complexity along with assets. For example, the ratio of staff to partners is about

**EXHIBIT 1**  
Percentage of Firms Indicating Major Changes to Their Organizational Structure



**EXHIBIT 2**  
Actual and Anticipated Fund Growth



1.5 to 1 for funds of less than \$500 million; that grows to 4 to 1 in funds of over \$2 billion. Along with staff, these larger PE firms have added Complexity in the form of a greater number of portfolio companies, a proliferation of funds, more assets under management, more limited partners, more offices and until recently, increased deal velocity.

Consequently, PE firms must choose between growth and moderating Complexity. The larger the fund, the more structure it requires. This is a strategic decision that almost all PE firms must resolve, and it must be informed by the Context in which the firm was founded. For example, if a PE firm was founded with a culture of making sure everyone has “skin in the game,” where equity is shared broadly from the general partners down to the people who answer the phones, the tendency will be for that firm to reach decisions by consensus. This, among other things, naturally would predispose the firm to be averse to assuming a great deal of Complexity (which renders consensual decision-making cumbersome if not impossible) and reluctant to engage non-equity partners, which can limit its ability to add investment or functional specialists. In a case such as this one, limiting fund growth is likely a wise decision, as rapid expansion could pose conflicts with that organization’s core Context. This is neither good nor bad; it is simply a choice. However, it is important to be conscious of the drivers behind one’s choices.

Berkshire Partners is an excellent example of a firm that has made a choice to stay true to its Context and Culture by limiting the Complexity commonly associated with growth. Berkshire Partners’ Culture—described by them as one in which compensation is shared; there are 12 partners but no CEO, and the rule is by consensus—has had a direct impact on its organizational structure, even as the firm evolves. It is likely to remain more generalist than highly specialized. It operates out of a single office rather than multiple offices around the globe, and its funds are not likely to experience the explosive growth that some other firms have pursued. One might even say Berkshire Partners has deliberately limited its growth to stay true to its core Context and Culture, a model that has served their companies and their investors very well for over 25 years.

Conversely, Bain Capital is a PE firm founded with a more traditionally organized structure, with a CEO and a defined decision-making hierarchy that lends itself to assuming the Complexity that comes with growth.

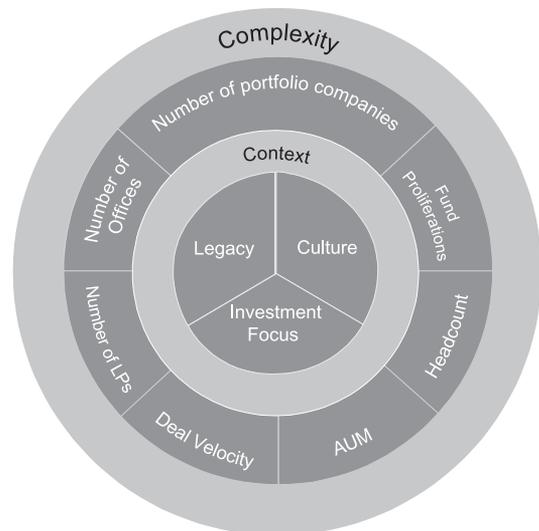
Indeed, Bain Capital has more than tripled in size over the past eight years. As part of this growth, the firm has added Complexity, branching into new asset categories, operating in multiple geographies, opening offices in many different locations, and hiring many, many more people. To handle this Complexity, it has added in-house dedicated management resources in order to help evolve an organizational structure capable of keeping pace with and managing this explosive growth.

As can be seen, one can view an organization’s Context (its founding legacy, culture, and investment focus) as the hub from which decisions on the organizational model—the size of the firm, its structure, the amount of Complexity it is willing to assume—must all radiate (see Exhibit 3).

For example, say a small or mid-market PE firm wishes to grow to be a large firm. In our experience, a PE firm cannot sustain a simple organizational model past a certain size (\$1 billion to \$2 billion) given fund proliferation, deal velocity, and the number of limited partners it wants to attract. (There is almost no end to the choices that influence degrees of complexity.) Therefore, if a PE firm chooses to grow rapidly (as many have), it is at the same time choosing to assume the Complexity that comes with growth.

To manage that Complexity, a PE firm needs to standardize and institutionalize its processes—i.e., it must make them predictable and repeatable, and put more of

### EXHIBIT 3 Elements of Context and Complexity



them in place. As one PE executive put it, “When you have around 100 people, you need a COO. If you have less than 100 people, you can get away with having a good CFO.” However, a firm that was founded and is still run by seat-of-the-pants GPs with an aversion to process will have difficulty working in (let alone implementing) this sort of environment. Therefore, it will have difficulty following a growth strategy—with all the Complexity it entails—no matter how devoutly it wishes to do so.

Many PE firms, in fact, are still operating with organizational structures and processes that go back to the time when they were founded. But so much has changed since then. In many cases, their founders are reaching their 50s and 60s. As one partner pointed out, “Some firms may be temporarily top-heavy as some partners are phasing out.” (Indeed, 14% of the surveyed firms brought up succession, unprompted, as a current primary issue, and specifically the challenge of transitioning leadership to junior partners.) In addition, staffs have grown rapidly, portfolios have grown, and the number of limited partners has increased, requiring that more resources be dedicated to investor relations, reporting, and disclosure. One PE firm partner said, “The more investors you have, the more you have a need for an internal investor relations person and tax and accounting expertise.”

At the same time, as the PE industry has quadrupled in the past five years, competitors seemingly have cropped up everywhere. But only 20% of middle-market PE firms believe they possess a highly differentiated organizational structure. This leaves 80% with structures that still rely heavily on the expertise of the GPs and founding partners, who often don’t know what a truly differentiated structure would look like (and might not like it if they did).

Our study found that PE firms see several structural elements as critical to handling the rising complexities of their business. These include:

- Adding specialized functional expertise as the firm scales (58% of respondents said that once headcount grows past 50, adding functional specialists, instead of relying on the jack-of-all trades style of the firm’s founders, correlates to positive performance).
- Developing a dedicated business development staff (instead of leaving that to GPs leveraging their relationships).
- Choosing between maintaining continuity of oversight via partner involvement through the entire life of a deal (providing internal transparency) or rotating partners (to provide fresh views and distribute accountability).
- Granting operating and deal partners equal status within the organization (thereby resolving compensation disparities).
- Assigning ownership of the due-diligence process and company portfolio management to the operations group in order to reduce risk.

In other words, there are many structures and combinations of structures that PE firms can use to deal with Complexity and improve performance. Again, to be successful the choices the firm makes must align with its Context. However, our research indicates that increasing specialization is becoming a defining characteristic of many PE firms.

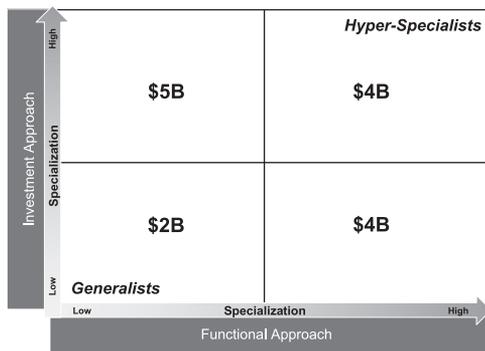
## TYPES OF SPECIALIZATION

Our research indicates that firms can take two different routes to staffing specialization: functional and/or investment specialization.

Competition has forced PE firms to increase the specialized skills of their staffs. “The trend,” said one GP, “is to move away from the generalist model. It used to be good enough to be a renaissance man, but not anymore.” Specialization is a trend within PE firms that correlates strongly with size. One can still be a highly successful generalist firm, but our research suggests that to do so one must forgo size. In other words, you can be a successful generalist firm, just not a big one. Firms that are specialized either by investment (i.e., staffing by industry verticals, geographies, or other investment criteria) or by function (i.e., a dedicated operations group or a dedicated sourcing team) are on average at least twice the size of firms with low degrees of specialization amongst their staff (see Exhibit 4).

This is not to say that all PE firms *must* specialize; it simply indicates that firms maintaining a generalist model (which comprises about 27% of the middle-market PE industry), and that wish to continue doing so, are not structured to assume more Complexity and therefore would be advised to limit their size. Investment specialization entails organizing all professionals (not just partners) by industry verticals or geographies or some

## EXHIBIT 4 Average Buyout Assets Under Management



combination of the two. Indeed, investment specialization is pursued by firms of all sizes. Code Hennessy Simmons, LLC, for example, is a top-performing middle-market PE firm that has successfully organized by investment vertical (business and services, consumer, distribution, and infrastructure and industrial products). Among PE firms with more than 50 people, 67% are organized by investment focus. Among PE firms with no more than 20 full-time staff, 71% are organized by investment specialization. Of firms with 21 to 50 people, 63% are similarly organized.

Attributes of functional specialization include having an operations group and adding process to how partners manage deals among themselves. The operations group may participate in parts of the due diligence process and may own portfolio company management. Functional specialization may also refer to dedicated staff managing investor relations, reporting, and disclosure. Having a greater number of investors and funds translates into increasingly complex accounting and tax reporting. Therefore, the more investors a PE firm has, the more it can leverage an internal investor relations person, as well as deep tax and accounting expertise.

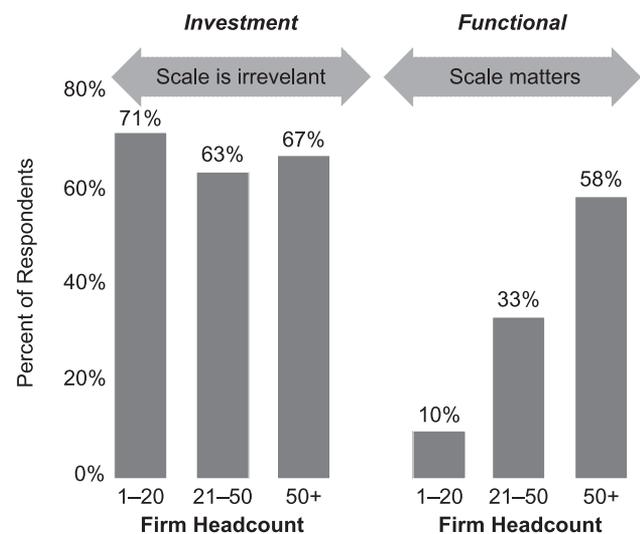
In our experience, a PE firm doesn't need functional specialization if it is large. But it is hard to achieve functional specialization without the requisite scale. Again, this depends on the Context of the firm and the Complexity it is willing to take on. For example, a firm founded with an emphasis on attracting large numbers of investors and close relationships with its LPs can certainly benefit more strongly from a dedicated investor relations person or persons than a firm less focused on marketing to new investors.

Among firms with more than 50 employees, 58% possess an organizational structure that features functional specialization. By contrast, only 10% of PE firms with 1–10 people are organized around functional specialization, and only 33% of those with 21–50 people are so organized (see Exhibit 5).

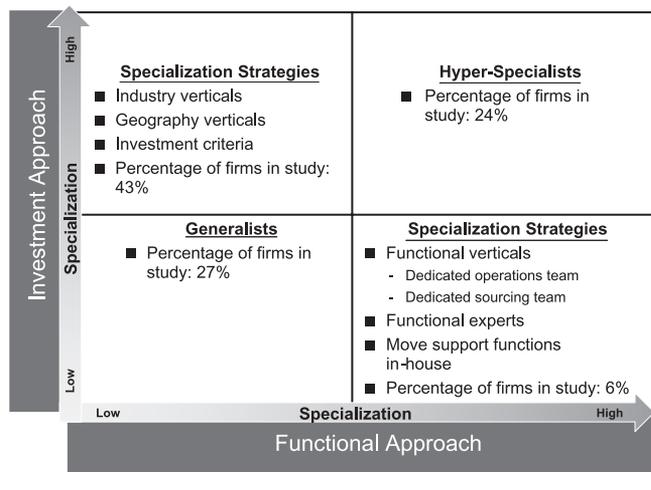
A significant plurality of firms (43%) has chosen the investment approach, adding staffing specialization in industry verticals (e.g., energy or financial services) and/or geographies (e.g., Europe or Asia); while 24% have added functional specialization (ranging from creating dedicated sourcing teams to hiring functional experts to moving such support functions as finance, HR, IT, etc., in-house) in addition to investment specialization. Only 6% of middle-market firms have chosen to pursue functional specialization without investment specialization as a way of organizing their professional staff (see Exhibit 6). That said, there are some functional experts in-house at more than one-third of all mid-market PE firms, including small funds of less than \$500 million, and at 45% of firms in the \$1–2 billion range.

The functional expertise most often brought 100% in-house (by 76% of all middle-market PE firms) is investor relations, closely followed (at 70%) by funds administration and reporting. Sixty percent of the PE firms we surveyed have in-sourced their entire HR function. But only 19% have internal IT expertise, and even fewer (8%) have internal tax preparation specialists.

## EXHIBIT 5 Staffing Specialization



## EXHIBIT 6 Staffing Approaches



To gain either in-house investment or functional expertise and specialization, 38% of smaller funds (less than \$500 million) work with outside partners with operating, industry, or consulting backgrounds. Of course, in pursuing such a hiring strategy, the economics must work for the firm. As one partner reported, “We pay them a modest stipend/salary, but they are rewarded with significant stock option opportunities.”

We have found that high-performing firms (as determined by average quartile rankings for buyout funds) have partners with more diverse backgrounds: 21% of the partners of the highest performers possess strategy consulting experience, versus a much smaller percentage for lower-performing funds. Not only does possessing a diverse mix of general partners affect performance, it also becomes a marketing tool for attracting investors. As one limited partner told us, “We look at the backgrounds of the firm’s partners. We prefer a mix that includes operational or strategic consulting backgrounds versus purely financial.”

PE firms of all sizes have been increasing their degree of specialization along the investment axis, and it increasingly is seen as a competitive advantage and differentiator. However, as one GP told us, “If you specialize too much, you fracture a firm that is small.” As is the case with all change, the degree and character of the specialized investment skills a PE firm adds is a risk. Before becoming more specialized, a PE firm’s management must consider the character, or core Context, of its firm—its legacy, culture and investment

focus. Beyond that, it must consider all the elements of Complexity that come with scale and specialization. Lastly, it must consider external forces which will always be present, and always changing (such as competition, the economy, industry multiples, etc).

Becoming more specialized along the functional axis assumes that a PE firm is adding Complexity through more and larger funds, moving more support functions in-house, and facing intense competition. As one GP said, “If we had three times the number of portfolio companies, we would need functional and operating experts in-house.” And as another said, “High deal velocity could justify internal functional specialization.”

Reorganizing through functional specialization best serves PE firms that have requisite scale and are comfortable with distributing responsibility and accountability beyond the founding GPs. The institutionalizing of internal processes is critical to functional specialization. A PE firm that makes that strategic choice must be prepared to alter its organizational structure more than it might anticipate, with ramifications greater than it can foresee.

### LOOKING AHEAD

If anyone needs a lesson that the world is not static, remember what it looked like two years ago and then contrast that with what it looked like one year ago and today. Similarly, Complexity changes over time even if a PE firm has a good grasp of its core Context and its ideal organizational structure. Competition from other PE firms changes, interest rates change, regulations change, and people change. So as your firm addresses these issues, ask yourself these questions, taking into account the Context of your firm and the Complexity it is willing to assume:

- Do your stakeholders know what your organization’s structure is? (They want to know.)
- Have you made a decision for growth? (If so, is your organization ready for the added Complexity that comes with size?)
- Is your organizational structure competitive in today’s environment? (To be agile, to be efficient, to keep up with the speed of transactions, your processes must be institutionalized, repeatable, and transparent.)

- Do you possess the skills to compete? (Specialization strategies can vary according to your firm's Context, but adding expertise, either on the functional or investment sides, increasingly is a market requirement.)

Change is the one certainty in an uncertain economic environment. It is a PE firm's responsibility to make sure that it is organized effectively to handle it.

## ENDNOTES

A recent Parthenon Group study of middle-market private equity firms reveals a new trend toward viewing an organization's structure as a driver of business performance.

<sup>1</sup>According to the *Dow Jones Equity Analyst* in January 2009.

<sup>2</sup>*Dow Jones Private Equity Analyst*, January 8, 2008, <http://www.portfolio.com/resources/company-profiles/NWSA/press/2009/01/08/us-private-equity-firms-raise-2656-billion-in-2008-18-less-than-2007-as-fund-raising-pulls-back-in-4q>.

<sup>3</sup>*Wall Street Journal*, <http://blogs.wsj.com/deals/2008/12/03/the-bell-tolls-for-private-equity-carlyle-cuts-10-of-staff/>.

<sup>4</sup>Chicagotribune.com, "Private-equity firm American Capital Ltd. Cuts back Chicago Office," January 7, 2009, <http://www.chicagotribune.com/business>.

<sup>5</sup>Thedeal.com, "Finance Layoffs," [http://www.thedeal.com/dealscape/2009/01/finance\\_layoffs\\_barclays.php](http://www.thedeal.com/dealscape/2009/01/finance_layoffs_barclays.php).

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