Valitas Insights: Three Private Equity Value Creation Principles that Apply to all Business Owners

Fact: Private Equity (PE) portfolio companies outperform public companies, whether performance is measured by return on investment or EBITDA growth.

Do the value creation principles employed by PE firms also apply to business owners?

The short answer to this question is **yes.** While a recent McKinsey article considers how public companies could benefit from utilizing these principles, we believe that value can be derived by all business owners.

There are three universally applicable principles:

1. Vision
2. Investment
3. Management

Adopting a long-term vision: seeking out new opportunities

Private business owners share a critical advantage with private equity firms. Neither are subject to the short-term constraints of public company quarterly reporting requirements. Private equity firms typically have an 3-7 year investment horizon, and take a long-term view of any newly acquired company. Likewise, to sustain growth and competitive advantage, and to maximize value, private business owners benefit by adopting a similar vision: seeking out new market channels and product innovations that can be exploited in the future. This principle is consistent with findings in our recent article linking company courage and innovation to higher revenue growth.

Disciplined investment: establishing the metrics to assess investment opportunities

Like PE firms, business owners benefit from considering disciplined investment with a long-term lens. To establish this practice, each investment opportunity should be measured against a set of guiding metrics. In formulating a decision, management can assess prospective return on invested capital (ROIC) as well as incremental growth in EBITDA and free cash flow, balancing this against the risk associated with each new opportunity. Whether a business owner's plan is to build the organization over decades or to eventually sell, a disciplined long-term investment strategy is most likely to maximize value for the company.

Management: creating meaningful performance incentives

Aligning management interests with the performance of the business is critical in successfully adopting a long-term vision and investment strategy. Performance metrics are most effective if communicated clearly to management. Additionally, where a company operates more than a single business unit, useful performance incentives are linked to the success of the manager's business unit rather than the entire company. This corresponds with the PE firm approach to incentivizing management based on the value creation in its related portfolio company rather than the success of the fund's entire investment portfolio.

A framework for courageous business practice…

Last week, we concluded that courageous Canadian businesses drive higher revenue growth and gain on their competitors. Learning from the successful practices of private equity firms provides a framework for putting business courage to work.