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Tackling human capital costs: What corporate executives can learn from private equity firms

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By Dr. Eric Warner

With human capital costs consuming an ever-increasing share of corporate revenues, both C-suite and HR executives are seeking ideas for reining them in. One place to look for new ideas is among private equity firms, which have earned a reputation as value generators. While these private firms are sheltered from the pressures of public reporting, their corporate cousins can still benefit from some of their methods.

The Economist has described private equity (PE) firms as the "sharp edge" of contemporary capitalism.[1] These firms engage in leveraged buyouts, venture capital, angel investing and mezzanine financing. The ones of particular interest here purchase entire companies, corporate divisions or several small operations that can be bundled together (platform deals). These investments can take many forms: businesses in emerging markets, turnaround situations in mature markets such as Japan, and the purchase of subsidiaries from larger multinational companies in Europe or the Far East, to name a few.[2]

Buying however, is not the essence of the PE firm's art. Once their deals close, PE firms focus on strategies that will give their investments greater immediate value – value they can capture through an exit strategy (usually a sale to a corporate buyer or an initial public offering) three to five years down the road. "The key driver in our business," Henry Kravis, co-founder of KKR, once told a conclave of analysts, "is what you can do with the company after you own it."[3]

Depending on the situation, PE firms generate *greater value* through some combination of the following:

- A change in strategic focus
- A restructuring of the company
- More effective financial management
- Horizontal consolidation (platform deals)
- Installation of an experienced management team with clear and focused financial interests in the venture's success

And what they do seems to work. Not only has the rate of return for PE firms overall been substantially greater than that of public corporations, but their companies – once returned to public ownership – have outperformed other initial public offerings and the market as a whole.[4] For managers at public companies, a close look at how PE firms function is a useful first step in considering some of their methods in controlling human capital costs.

The essence of private equity firms

By any measure, PE firms move quickly and are wholly focused on financials in how they acquire and run businesses. Five factors explain this behavior:

1 *The firms have a short and defined window in which to implement their strategies – between three and five years.*

By then, they want to be in a position to exit profitably, usually through a sale to a corporate buyer or via an inital public offering (IPO). Therefore, their job of creating value means they must bring a sense of urgency to the business and hit the ground running from the day the transaction closes.

2 *As private firms, they are not subject to quarterly public reporting and other transparency requirements.*

Corporate CEOs must keep one eye on the business and the other on the daily stock price, while at the same time managing analysts, regulators and board members concerns and attending to the other requirements listed companies face today. PE managers can ignore the quarterly earnings demands of the public markets and focus solely on how the business will look in three to five years.[5]

3 *The compensation of PE managers is closely aligned with the returns they produce – or fail to produce.*

The business press routinely reports cases of misalignment between corporate CEO pay and performance. Senior executives have been known to take home big bonuses even as their stock price sputters. A failed CEO is often ushered out the door with a princely reward. These practices don't exist in the portfolio companies of PE firms. Correspondingly, PE firms are not wedded to incumbent management teams; they move quickly and decisively in distinguishing those who are capable of creating value from those who are not and give a much freer hand to effect change to those who fall in the former class.

4 *The penalty for failure is high.*

PE managers know that failure to produce a high return on today's investment will handicap their ability to raise financing for their next deal. They can only stay in business if their returns are notably higher than those produced through traditional investments.

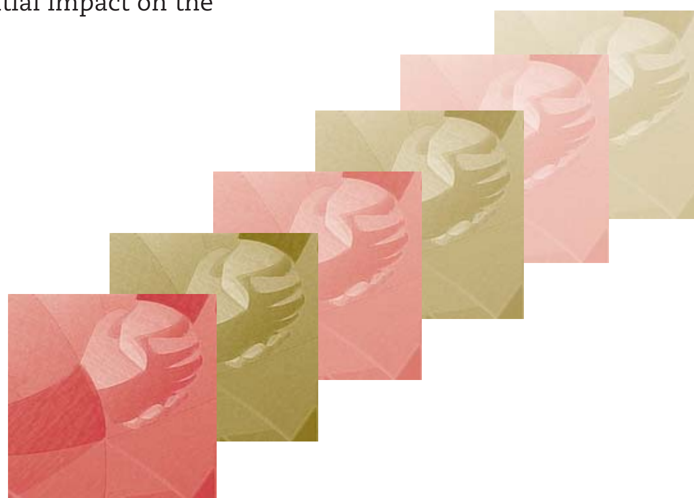
5 *They use debt judiciously.*

The private markets put a more accurate value on the risk of debt than public markets. Private equity has grown up with leverage, enabling ready access to efficient debt markets where credit risk is calculated according to the merits of a business plan rather than the potential impact on the share price.[6]

Opportunistic versus strategic buyers

In terms of acquisitions, private equity firms enjoy one clear advantage over corporate buyers: the world is their oyster. They don't care if a target company designs computer chips or makes potato chips; they are free to pursue investments wherever they exist, but ***only*** if the financials make sense. Most corporations, in contrast, are strategic buyers. They seek out companies whose businesses will complement their own in some strategic way. Consequently, they draw from a smaller pool of candidates and may have to accept a less-than-perfect marriage.

Can corporate executives really learn from private equity firms? They can if they carefully observe (1) how PE firms conduct due diligence on prospective buy-outs or venture capital opportunities; (2) how they approach unfunded liabilities; (3) how they manage benefit and compensation costs; and (4) how they approach senior management selection, assessment, and remuneration. Each of these can be a source of insight for corporate executives.



Due diligence

A PE firm begins its journey toward value creation long before an investment is made, during the due diligence phase. Carrying out due diligence is analogous to paying a master mechanic to check out a used car before you buy it. PE firms are rigorous practitioners of due diligence; they enter into a transaction only when they fully understand all the problems and opportunities they'll be acquiring. They want no post-deal surprises that require extra cash or reduce exit value. The transaction team's focus is sharpened by the fact that it must justify the quantum of the investment to both the PE firm's general partners and its investors (limited partners). To accomplish this, they must understand the financials and the business model in excruciating detail.

A recent European transaction, for which Mercer provided full due diligence services, clearly illustrates this point. The PE firm wanted to know about *every* cash flow item for the next five years and every variation in true cost. A corporate buyer, in contrast, typically is much more interested in big-picture synergies and post-deal integration. This emphasis on financial due diligence is a hallmark of private equity firms. Mercer has observed the same difference between private equity and corporate buyers. One corporate buyer he worked with recently focused heavily on the people side of its acquisition target, with only half an eye on the financials. A PE firm would have taken the opposite approach.

Private equity firms recognize the value of robust due diligence, and they are willing to invest in it. Corporations often feel that they can do all the work themselves. Consequently, they often don't examine the financial consequences of a transaction to the same degree as do their PE counterparts.

Unfunded liabilities

Among the potential problems PE firms look for during due diligence are hidden liabilities, such as underfunded pension plans, retiree health and life benefits, and other compensation program obligations. PE firms are rigorous with respect to employee benefit liabilities and to employee entitlements in general. They won't enter a transaction that is so encumbered with financial burdens that it cannot be turned around in three to five years. Almost one-fifth of PE respondents to a 2006 study by MMC Companies said they had pulled out of a deal because the target company had an underfunded pension scheme.[7] In cases where unfunded liabilities and other legacy costs don't scuttle the deal entirely, they make certain that these burdens are fully reflected in pricing discussions. Sellers have to accept the fact that underfunded schemes can have a great impact on the value of their businesses.

Private equity firms recognize the value of robust due diligence and they are willing to invest in it.

In their work with acquirers, both PE and corporate, Mercer consultants identify and analyze unfunded liabilities and assess other risks, including Pension Benefit Guaranty Corporation intervention and change-in-control agreements. These are then reflected in an accurate measure of a target company's cash flow. This call for a due diligence methodology that extends beyond the recognition of liabilities to what can be done to mitigate them, with an eye toward 'best practices' and cost-saving opportunities that will generate long-term value.

Tackling benefit and compensation costs

Many industrial giants in such sectors as automobiles, steel and chemicals are being crushed by employee and retiree health care and pension entitlements that were created years ago, when competition was limited and many labor costs could be passed on to customers. In the United States, this is particularly true among domestic automakers and the larger, more established airlines.

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Many companies are now addressing these costs by asking current and former employees to pick up a larger share of their health care tabs and, on the defined benefit pension side, by choosing from a variety of cost-reducing options: reducing benefit formulas for future service; closing plans to new employees; freezing benefits for all employees; and, in some extreme and difficult cases, terminating plans and eliminating a portion of benefit obligations through bankruptcy. To replace some of these pension benefits, many companies are shifting dollars toward defined contribution plans. All of these options can be constrained by collective bargaining considerations.

Except in the most extreme cases, these options do not eliminate legacy underfunding and its associated financial risk; it can take years before the full impact is felt on the financials, leaving the immediate cost and risk issues on the table. Nor is replacement with a defined contribution plan inherently cheaper, absent a benefit reduction – and the defined contribution approach brings up other human resource and productivity concerns, particularly the retention of peak-productivity employees and the orderly retirement of static- or declining-productivity employees.

PE firms aim for more rapid change. European PEs, for example, have been known to close established pension plans to future accruals or to new enrollments. Observing their success in rolling back benefit costs, some corporations are adopting the same tactic, albeit at the risk of damaging relationships with employees. For example, with the opening of the European Union, some German corporations demonstrated a willingness to sell off poorly performing operations or move them to low-wage countries if employees and their unions would not meet them part way. Thus, PE firms are not the only ones to play hardball with benefits and compensation, although companies need to consider the full implications of such an approach.

Senior management assessment and selection

Studies have shown that about 40 percent of a firm's superior return on investment and 35 percent of its income growth stems from a strong CEO and senior management team.[8] While PE firms would argue that a strong management team is the most important part of their process, few corporations approach management assessment, selection and even succession planning through a formal process.

What corporate executives can learn

As stated above, PE firms and corporations have different approaches to transactions. And the evidence is impressive: private equity firms have repeatedly demonstrated how distressed enterprises can be returned to health. Burger King, Hertz, Polaroid, Toys "R" Us, Universal Studios Florida, Houghton Mifflin and the Savoy Group represent just a handful of the cases in which private owners were able to make a big difference. Can corporate executives learn from their example or adopt their methods? The answer is yes and no. Let's start with no.

In terms of acquisitions, private equity firms and companies operate within very different time periods. PE firms focus on buying, building, managing and exiting-quickly. For them, ownership is necessarily short term. In contrast, corporate acquisitions are generally strategic with a "till death do us part" mind-set. Corning, Inc., for example, has survived and grown for more than 150 years. Many of the technologies that enrich that company today – fiber optics being just one example – took more than 10 years to find a market and still more years to become profitable. That long-term, strategic view is usually observed in corporate acquisitions. Exiting is seldom the goal. Organizational design, cultural integration and benefit harmonization are generally an integral part of their process, and all luxuries (in terms of time) that PE firms cannot afford.

On the affirmative side, however, corporate executives who aim to reduce inefficiencies and above-market human capital costs *can* learn a few things from PE firms:

Do more robust HR due diligence

Human capital costs consume nearly 40 percent of corporate revenue, and are more complex to manage and measure than those of physical or financial capital.[9] The first step in managing these costs is to understand the magnitude and sources of the cost base. PE firms do substantial due diligence on the people side of the business; they know that those costs can make or break their chance of producing a more profitable and valuable enterprise in a relatively short time. Corporate executives should do the same on potential acquisitions, while at the same time getting ready for those acquisitions by analyzing their own human capital cost structures.

Deal with legacy costs

With the globalization of the marketplace, what was common practice a few years ago may not be best practice today. PE firms analyze pension plans, health care plans, retiree medical and life benefits, collective bargaining contracts, and change-in-control agreements in great detail. They then work quickly to move those plans to a level that will allow the business to produce a healthy and sustainable profit. Corporate executives, in comparison, may be more willing to live with practices in excess of market and try to offset them by cutting other expenses and/or through revenue growth – a longer-term proposition. Corporate executives could benefit by adopting the PE mindset, asking, "Which of these legacy costs can I reduce through a buyout or conversion program or through bargaining with unions and/or employees?"

Don't allow politics to hamper restructuring efforts

Eliminating unproductive people costs isn't easy in public companies. People in profitless business units and cost centers will lobby hard in defense of their interests. Others will exploit personal relationships with decision makers in an effort to blunt restructuring programs that may affect them negatively.

Corporate decision makers also worry about reputation – in both their communities and the global marketplace – and they do not want their companies to be viewed as heartless or unfriendly to employees. Corporate "brand" issues are at stake.

PE firms are concerned with these issues as well. As articulated recently by Henry Kravis, "Private equity investing leads not only to value creation but also to economic and social benefits, for example, increases in employment, innovation, and research and development."[10]

However, as outsiders, PE firms have no long-term relationships with current employees and are less susceptible to politics.

Assess and select the best management team for the job

PE firms take a firm view on the quality of the management teams they acquire in their investments. This process begins in the due diligence phase and carries through from the signing of the deal to the close and the post-close period. Considerable time is spent weighing and assessing whether one or more individuals managing the company are up to the task of delivering on the revenue generation expectations that will be placed on them. Often the deal closes with one or more replacements in mind, particularly in carve-out of divisions from large conglomerates. Sometimes this instinctual approach is complemented by a period of formal assessment, with competency-based analyses of both individuals and the team dynamic. Choosing the right person for the job is routine in a private equity deal. This is not always the case in a corporate transaction; as discussed above, politics are often allowed excessive sway, and a "to the victor belong the spoils" mentality can result in more competent managers exiting the combined entity unnecessarily.

Align senior management compensation more closely with the company's share price

PE firms usually require their senior managers to take a substantial equity stake under terms that parallel those of the investing partners. And they cannot execute options or cash in their stake before the transaction is completed. Nor are managers insulated from failure with golden parachutes or generous change-in-control agreements. PE firms demand a clear link between performance and rewards. Corporations can learn from this example.

Looking forward

As we have seen, the global market has evolved at an accelerated pace over the last five years. But what will the longer term trends be? On the basis of what we are seeing today, we believe the future will contain some of the following trends:

- **Global scale.** Multinational, multibillion-dollar deals requiring detailed, expert supervision are now commonplace. In response, the leading players are taking on the attributes of global corporations, with branches in every important investment hub from New York to Hong Kong. They are staffed by a phalanx of accountants, compliance teams, and other members of a substantial and growing back office.[11]

- **The flow of talent from public companies into private equity will increase.** PE firms will continue to attract the most talented members of the business, political and cultural establishments, including many of the world's top managers (Jack Welch and Lou Gerstner, to name two). Indeed, a 2005 survey by the *Financial Times* and the UK's Finance Directors' Forum found that among a sample of senior managers at 160 companies, 57 percent of all respondents – and an even higher proportion from quoted businesses – thought that public companies would find it harder in future to prevent key executives leaving for a job in private equity. Seventy-five percent said they would definitely or probably consider a position in that industry. In addition, it is becoming an established trend that the best and brightest business school graduates make their initial career choice in private equity firms. This is very different from a decade ago, when it was more of a place for mavericks and outsiders.[12] This trend will continue.

- **Emerging markets.** The world's four major emerging markets – Brazil, Russia, India and China (BRIC) have plenty of potential but still have substantial risk factors, and PE firms will move cautiously in these markets. Countries that offer stable regulatory frameworks, encourage market-based competition, have highly developed financial systems, and foster entrepreneurial policies and attitudes are likely to experience higher levels of private equity activity.

- **Joint transactions between PE and corporates.** In the future, we will see an emergence of joint deals between private equity and corporates likely to accelerate as a way of mitigating risk and enhancing value.

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PE trends move with economic, market and shareholder conditions

1980 1999	2000 2005	2005 2006	2006 2007+
Financial engineering ■ Buy and bust ■ Limited competition ■ Maximum leverage ■ Quick exits	**Industry focus** ■ Buy and build ■ Fragmented industries ■ High tech plays ■ Shrinking leverage ■ Longer holding periods	**Business improvement** ■ Buy and operate ■ Too much money chasing too few deals ■ Minimal leverage ■ Tough exit enrollment	**What does the future hold?** ■ PE deals a target share of total deals ■ More and more mega funds being created >$10B ■ More and more mega deals on the rise ■ Auctions are the norm ■ Continue to search for more and exotic techniques to increase usage ■ High deployment of cash worldwide and in emerging markets

How private equity firms work their magic

The most successful PE firms have developed solid techniques to ensure the creation of value in the companies they purchase. What are they? Paul Rogers, Thomas P. Holland and Dan Haas studied more than 2,000 transactions to find the answer, which they describe in a *Harvard Business Review article.*[13]

Rogers et al. identify four management disciplines that help the top-performing PE firms work their magic:

- For each of their holdings, they define an investment thesis: a brief statement of how to make the business more valuable within five years. That thesis – typically tied to growth – is used to guide future decisions and actions.
- Management uses a small set of financial metrics to measure progress toward greater value. Those metrics are unique to the business and are watched closely. Cash is one of the key metrics.
- PE firms don't waste time with nonproductive assets; they are either redeployed or sold.
- Headquarters are kept lean, with one-quarter the number of staff found in public corporations using the same level of capital; both executives and employees behave like owners.

As a corporate executive, do you see any "magic" in these? Is there any reason you cannot apply these value-creating disciplines to your own company or business unit?

How Mercer can help

Whether an M&A transaction is in your business strategy or you are simply looking for opportunities to eliminate inefficiencies and above-market human capital costs, Mercer can help.

Human capital is Mercer's only business. Its consultants are experts at conducting robust and strategic due diligence and helping companies gain the highest return on their investments in human capital. Mercer also helps with the critical issues of management assessment, talent development and succession planning. Planning for an M&A transaction with respect to human capital issues will go a long way toward achieving the full value of your deal.

With offices in more than 180 cities and 42 countries around the globe, Mercer's local experts guide clients through unfamiliar terrain. Mercer professionals help with due diligence, post-deal integration, leadership assessment, attraction and retention of key talent, and change management.

About the author

Dr. Eric D. Warner – Eric is head of Mercer's European Private Equity and Merger and Acquisitions (PEMA) business. He has substantial corporate finance experience in the UK and Europe from many years in the investment banking industry. Eric has a degree magna cum laude in English from Yale University and a DPhil from Oxford.

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Endnotes

[1] "The new kings of capitalism," *The Economist,* November 25, 2004.

[2] Henry R. Kravis, keynote speech delivered at the Dow Jones Private Equity Analyst Conference, NYC, September 22, 2004.

[3] Henry R. Kravis, keynote speech delivered at the Dow Jones Private Equity Analyst Conference, NYC, September 22, 2004.

[4] Peter C. Arnold, "Investing in private equity," *Benefits & Compensation Digest,* December 2005; also Harvard Business School study, *New York Times,* October 19, 2006.

[5] "If the price is right," *New York Times,* October 18, 2006.

[6] "Unlocking global value: Future trends in private equity investment worldwide," Apax Partners Ltd and The Economist Intelligence Unit, 2006.

[7] "Successful investments: overcoming deal risk," Marsh, Mercer and Kroll, October 2006.

[8] "Strong management teams, not hero CEOs, make companies prosper: Organizational performance and CEO personality: Explaining more of the variance through top management team group dynamics," Pamela Owens and Paul V. Martorana of the Department of Psychology at the University of California at Berkeley. The paper was selected as a "best paper" (top 5 percent) by the Academy of Management and was presented at its conference.

[9] This is the average reportedly spent on human capital each year for salaries, benefits, hiring costs, training investments and the like.

[10] "Henry Kravis, a barbarian no more," *The Economist,* March 30, 2006. Taken from the keynote speech delivered by Henry R. Kravis at the SuperReturn 2006 European Private Equity & Venture Capital Summit in Germany on February 21, 2006.

[11] "Unlocking global value: Future trends in private equity investment worldwide," Apax Partners Ltd and The Economist Intelligence Unit, 2006.

[12] "The new kings of capitalism," *The Economist,* November 25, 2004.

[13] Paul Rogers, Tom Holland and Dan Haas. "Value acceleration: Lessons from private-equity masters," *Harvard Business Review,* June 2002.

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