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Team Stability and Performance in Private Equity

Joint research findings from Capital Dynamics and the London Business School
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Confidential

Summary

Team stability has traditionally been considered one of the paradigms of private equity and is embedded in most due diligence processes. Many general partners assert, and many limited partners have come to expect, that team stability is key to continued performance. However, until now, there has been limited data or research to support this theory. Furthermore, following the financial crisis and continued slow growth environment, it is questionable to what extent this theory holds true. During 2002-2008, buyout firms expanded their teams that focused on the transaction and leverage aspect of buyouts. Yet today, the buyout model has shifted to a more traditional approach, with an increased emphasis on operational aspects. With this in mind, investors might expect that those teams that do not evolve with the market may not be the best positioned to profit from current opportunities and to generate attractive returns for investors.

Thus, Dr. Katharina Lichtner and Kairat Perembetov from Capital Dynamics, and Dr. Francesca Cornelli, Dr. Elena Simintzi, and Vikrant Vig from the London Business School (LBS), embarked on a research project to look at the data behind the performance. The project examined the backgrounds and investments of senior management teams and their corresponding deal and fund performance attributions, using the data from Capital Dynamics' due diligence database. To discover how team stability affects performance, we assembled a unique, detailed dataset of private equity teams, including background and turnover information on 5,500 senior professionals, as well as fund and deal performance. Furthermore, we split professional backgrounds into three categories; operational, private equity, and financial, depending on a professional's predominate experience prior to joining the manager. The depth of the data set enabled us to analyze not only the overall link between turnover and performance, but also to gain granular clarity on how the turnover of professionals with the above-mentioned backgrounds affected fund performance.

The initial study sample included 56 managers. Preliminary findings were communicated in 2011, and contrary to widely held beliefs, the research showed that turnover is actually *positive* for performance.
The full findings on 145 managers worldwide and analysis of turnover and performance data dating back to 1990 provide even stronger evidence that **turnover is indeed positive for performance**.

The study utilized regression analysis to determine the relationship between the turnover and performance at two levels: deal and fund. Analysis at the deal level showed that turnover of investment professionals responsible for deals is associated with reduced performance. However, such deal-level analysis suffers from "reverse causality", leading to the above-mentioned misconception that team stability contributes to performance. At the deal level, team stability may contribute to higher performance, but higher performance often results in lower turnover.

At the fund level, we focused on turnover that occurred between funds, as turnover recorded during the investment period of a fund produced inconclusive results. **Analysis revealed that turnover between funds has a strong, positive impact on performance**. Thus, teams that adjusted to changing market environments performed better compared with more stable teams. In fact, those firms that experienced the highest turnover between funds (or those in the top turnover tercile) outperformed those firms that experienced the lowest turnover (or those in the bottom turnover tercile) by 13.5 percentage points.

Furthermore, our findings reveal that all turnover is not equal. The impact varies according to the professional background of those people leaving or joining. Those funds that replenished with operational expertise demonstrated improved performance. The positive impact of turnover by professionals with operational expertise is especially evident during recessions. Interestingly, the turnover of professionals with financial backgrounds did not impact performance. On the other hand, turnover of professionals with private equity experience negatively impacted performance. These results suggest that due diligence on team turnover should look beyond overall turnover figures and focus explicitly on the composition of the turnover.

Key findings

Turnover between funds leads to higher performance

To account for individuals joining and leaving funds at different points in time, our data set allowed the creation of a time-series view of turnover across different funds for the same fund manager. The final study sample included 145 managers: 40% were from Europe, 35% were from North America and 25% were from the rest of world. The funds' net performance data was from inception until the end of December 31, 2011.

The study distinguished between turnover during the investment period of a fund and turnover occurring between investment periods of two successive funds. The regression analysis showed a strong positive effect of turnover *between* funds on the performance of the subsequent fund, whilst the impact of turnover *during* the investment period was statistically insignificant.

As shown in Figure 1 below, a 1% increase in turnover led to an approximate 10% increase in net IRR. The effect is much stronger than the initial results on 56 managers released in 2011 suggested. To estimate how funds with various levels of turnover performed, we averaged the net IRR across funds with the highest and lowest terciles of turnover. As demonstrated below, the higher the turnover, the better the performance. Funds in the top tercile of turnover produced 25% net IRR on average, whilst the performance of funds in the lowest tercile of turnover averaged only 11.5%. The outperformance of 13.5 percentage points is substantial. The results suggest that turnover is value enhancing as funds benefit from team evolution.

Figure 1: Effect of Turnover on Net IRR

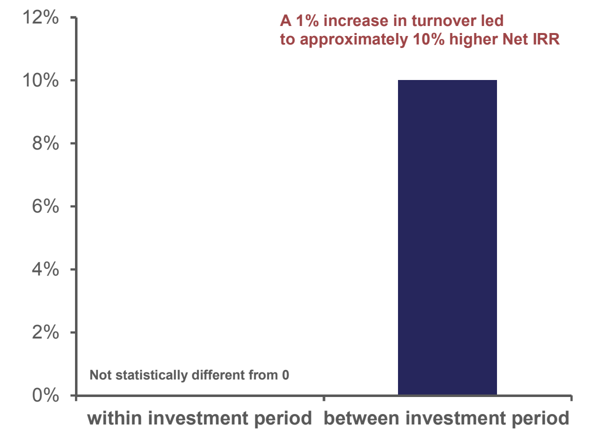
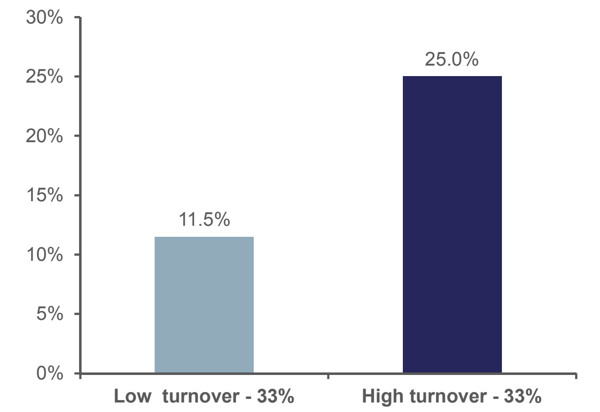


Figure 2: Average Fund Manager Net IRR at the bottom and top of Turnover Terciles



Teams that replenish operational skills between funds perform better

As a next step, we broke the turnover between funds down according to professional background. To perform this analysis, all professionals in the data set were categorized into three major groups based on their experience prior to joining the manager: operational, financial and private equity. The operational group of professionals included those with prior experience in running operations in an industry. The financial group included professionals whose predominate experience was in banking, and financial institutions outside of the private equity industry. The private equity group included professionals whose predominate experience was in private equity.

Our analysis of the data distribution across these three groups again showed that contrary to common perceptions, over half of the key decision makers (those appearing in key man clauses), or 51%, have solid operational and private equity experience.

Our data shows that 30% of all senior professionals left their firms at some point in time, indicating that turnover has always been a facet of private equity, and more common than originally assumed. Furthermore, 18% of those individuals mentioned in key man clauses and 29% of those entitled to carry departed their firms. That 30% segment also carried some important characteristics: 58% had financial backgrounds and 42% had operational or private equity backgrounds.

Results showed the impact on performance varied significantly across the three groups, according to professional background. Higher turnover of professionals with operational backgrounds led to a significant increase in performance – suggesting that frequently refreshing a team's operational skill set is beneficial to performance.

Between funds, the higher turnover of professionals with private equity backgrounds led to a decline in performance. The results prove statistically that professionals with private equity backgrounds are critical for performance. Therefore, retention of, and succession planning for these professionals is very important.

On the other hand, and also between funds, turnover of professionals with financial/investment banking backgrounds had little impact on returns. Financial skills appear to be a commodity.

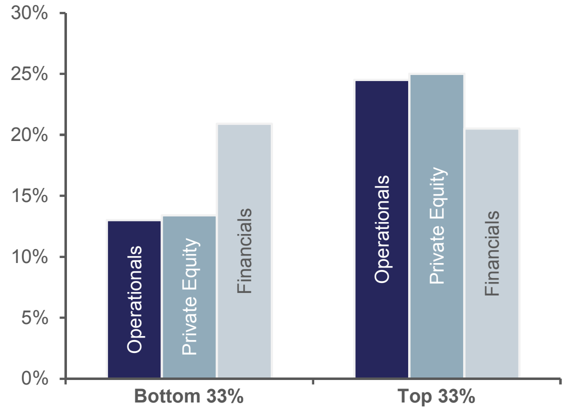
Figure 3: Turnover impact on returns between funds

Background	Impact
Operational	positive significant
Private equity only	negative significant
Financial	insignificant

Teams that had a higher share of professionals with operational and PE experience performed better

A closer look at team composition showed that teams with a higher share of professionals with operational and private equity backgrounds perform significantly better compared to those with a lower share. As shown in Figure 4, the difference in performance between teams in the top and bottom terciles was 12 percentage points. In contrast, there did not appear to be a significant difference in performance between teams with a high or low share of financial professionals.

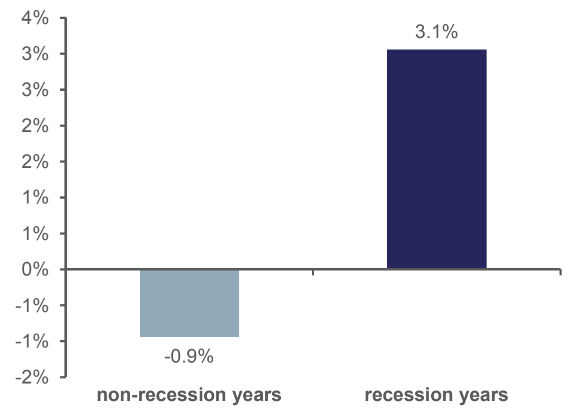
Figure 4: Bottom & Top % of Operationals, Private Equity and Financials in the team and Net IRR



Turnover during economic recessions was more beneficial than in non-recession years

The study analysed fund performance and the impact of turnover during various economic cycles. The results show that turnover during recessions resulted in increased performance. As shown in Figure 5, a 1% increase in turnover led to a 3.1% increase in net IRR. Economic recessions often result in a substantial change in value creation drivers for private equity firms. This necessitates an aggressive update of team composition and skill sets. Therefore, the importance of team turnover analysis in due diligence processes increases substantially during recessionary and post-recessionary periods.

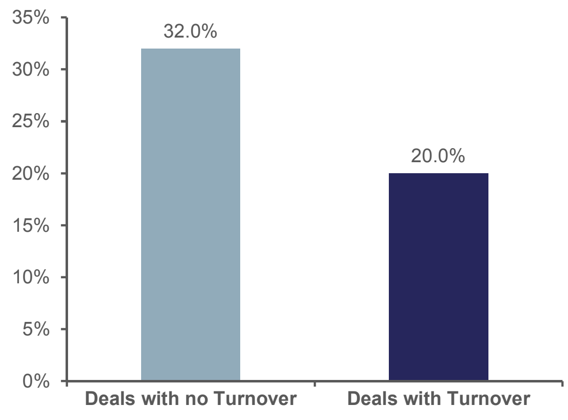
Figure 5: Effect of Turnover on Net IRR during recessions



Deal turnover is associated with weaker performance

With respect to individual deals: when there was turnover of investment professionals responsible for the deals, those deals did not deliver returns as high as those deals conducted by teams without turnover. Stable deal teams averaged a gross IRR of 32%, whilst deals made by teams with turnover delivered 20% gross IRR. However, it is possible that the deal underperformance led to the turnover. Thus, the research does not exclude the fact that turnover could have resulted from underperformance. Also, deals that had good prospects of delivering substantial carry for investment professionals generally didn't exhibit team turnover. Thus while the "the chicken or the egg" dilemma remains, in general, we can maintain that deal turnover is associated with weakened performance.

Figure 6: Effect of Deal Turnover on Gross IRR



Conclusion

Our findings on the link between team stability and performance have substantial practical implications. They underscore why it is more vital than ever to conduct a comprehensive team assessment in the current private equity environment. They also suggest a narrow focus on team "stability" might not be the best approach for evaluating managers – as performance does not appear to be driven by team stability, but rather by a team's ability to adapt to different economic cycles and a changing market environment. An in-depth and differentiated understanding of overall turnover appears to be very important as private equity managers that update their teams with professionals with industrial experience demonstrate an improvement in subsequent performance. Finally, our research findings correspond with observations from our current due diligence: that astute managers recognize the value of team evolution and that deep operational/industrial expertise is required to unlock value in a businesses and create subsequent value for investors.

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[1]Capital Dynamics comprises Capital Dynamics Holding AG and its affiliates; assets under management, as of March 31, 2013, include assets under discretionary management, advisement (non-discretionary), and administration across all Capital Dynamics affiliates. Investments are primarily on behalf of funds managed by Capital Dynamics. *Capital Dynamics China is a legally separate company operating under a strategic cooperation with Capital Dynamics.

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