Owner-Operator

One of my goals as a research analyst is to attempt to use critical thinking to uphold or dispel the mystique behind certain widely accepted aspects of private assets investing. Many of these notions sound good when spoken or written but ring hollow when put under acute scrutiny. I have witnessed depictions of seemingly logical and very desirable traits turn out to be just mere buzzwords that convey nonexistent rigor. These buzzwords are on many occasions simply Trojan horses that superficially satisfy the need for self-placating good judgment when investing. However, the nuances encased within these words must be dissected to validate the assurances they carry as well as to ensure due diligence thoroughness. “Owner-operator” or “operator” is one such term/word that is chock full of innuendo and hidden meanings – in private investing, this term is most commonly used to insinuate being in the weeds of a business and having the ability to actively make improvements that enhance enterprise value.

Most research analysts are pre-programmed to rank investment opportunities with pullable operational levers above prospective investments that lean heavier on financial manipulation. Put a little differently, operational-leaning investment prospects brought forward by sponsors regarded as operators tend to automatically garner higher desirability by prospective LPs over ones that primarily require financial savvy – but why? This is maybe because: (a) financial tinkering in the private assets world is viewed by many as table stakes (i.e., not a sustainable edge because this kind of expertise has low barriers to entry), (b) financially manipulated deals are subconsciously branded as some form of capitalist cheating, or (c) returns attributed to balance sheet or income statement fidgeting can easily be dismissed as financial engineering (i.e., tweaking some numbers to make other numbers look better).

On the other side, deals presented as operationally malleable by people claiming to have the requisite operational improvement expertise are likely preferred because: (a) Operational improvement is generally viewed as having higher resiliency to market cycles, (b) Operational skillsets are seen as having more areas of differentiation, and (c) Value enhancement through operational improvements better fits into the private investing narrative of long term noiseless capital illiquidity for increased future value potential.

Activities relegated to the financial manipulation backroom include leverage infusion, debt refinancing, financial restructuring, etc. Conversely, exalted operationally focused activities include organic growth (sales improvement, product/service expansion, entry into new markets, etc.), inorganic growth (mergers and acquisitions), management team enhancements, updating internal systems, etc.

In the present day, LPs’ preference for “operators” or investors who have worked in their targeted industries, over those who have investment banking backgrounds, is no secret to fund managers. This explains why most GP pitches make a special effort to accentuate their hands-on operational improvement capabilities by obsessively highlighting team members who have had long tenures in key roles in particular industries. It is not rare to hear GPs say things like, “We are not investment bankers trying to improve companies from behind a desk” or “Most principals at our fund have actually worked in industry roles” or “We understand the pain points of running a business because we have experienced them from the frontlines”. Even funds that are known to be managed by former investment bankers and career investment professionals make it a point to emphasize their cohort of operating partners (captive or noncaptive), fund advisors, and broad networks of industry bigwigs – this is strategically done to eliminate any “non-operator” labeling. So, if every GP is now an operator, how do we

as prospective LPs tell them apart? Also, is financial engineering really so wrong or bad? To push this a little further, does a history of operations linearly equate to future investment success?

There are many qualitative and quantitative ways to verify the effectiveness of asserted operational capabilities. With accurate cash flows, dates, financial terms, etc. information, several technological tools enable researchers to quantitatively determine the source of investment success (or failure for that matter). These tools allow one to see what mixture (and in what amounts), financial engineering, multiple expansion, or operational improvements contributed to the generated returns.

Qualitatively, reference calls with portfolio companies, deep assessments of value creation plans, scrutiny of plan execution, etc. are a few ways to gauge and compare the operational prowess of GPs. Another practical thing to do while investigating the role operational improvements play in a GP's investment strategy is to assess how those designated as operators are incentivized/compensated. This type of probing gives a good sense of whether operational activities are integral/important to the manager or if the operators are second-class citizens that serve as a form of substitutable window dressings. Many GPs, as a way of denigrating competitors, will say things like "Our operators are actually part of our investment team/committee" or " We just don't parachute experts/operators into deals because they are an integral part of our investment process from the beginning" or "Operators get to invest in deals on a no fee/carry basis and they also earn a healthy portion of the overall carry pool". No matter what variation of seniority or importance is bestowed upon the operators, it is critical for research analysts to verify how this plays out in practice.

It is my view that simply dismissing financial engineering as a bad thing is a myopic stance because, like most things in life, there are various degrees/levels to understand. Relationships/goodwill with service providers, the comprehension of cycles due to experience, the adroitness related to the use of financial instruments, etc. are all things that could make one GP superior to another even in a category that tends to be viewed as table stakes. As long as financial processes are executed transparently and within legal boundaries, financial engineering can be a worthy differentiator.

On an investment desirability scale where operational capability tends to always weigh more than financial engineering, there is a temptation to directly correlate operators with a higher likelihood of success. However, benchmarks, track records, and practical surface analysis all show that despite almost all private investment players claiming to have operational know-how, there is still a broad degree of returns dispersion. So, were only the good deals operationally enhanced? Why did operational improvement activities fail in the bad deals? Would it have been better to parachute specific experts into deals versus using a one-size-fits-all approach? If the GP uses outside operators, does the fund get credit for investment success or should that be attributed mainly to the operating individuals? The string of investigative questions rapidly starts to mutate - digging deeper for answers to these helps us as research analysts to debunk or extol the "operator" moniker.

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