How Does Private Equity Create Value?

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Private equity firms are swimming in cash, but a long economic expansion has made it hard to find bargains. In a conversation with *Yale Insights*, Adam Blumenthal ’89, a founder and managing partner of the private equity firm Blue Wolf Capital Partners, says that the future of of the field is returning to its roots, as a tool for value creation for a range of stakeholders.

The firms credited with launching the field of private equity, the American Research and Development Corporation (ARDC) and J.H. Whitney & Co., dates to 1946. “But while the private-equity firm is new,” business historian John Steele Gordon points out in the *Wall Street Journal*, “its methods—venture capital, growth capital, distressed situations, leveraged buyouts, and others—are as old as capitalism itself.” In the 17th century, many of the American colonies were launched by joint stock companies, with capital provided from England. Two hundred years later, after the Union Pacific railroad was run into bankruptcy in 1893, a team of investors bought the distressed firm and were able to turn it into one of the “great cash cows in American economic history.”

In the 1980s, private equity firms garnered headlines with a wave of giant leveraged buyouts, culminating in the $25 billion buyout of RJR Nabsico. “These leveraged buyouts sometimes produced spectacular profits, and sometimes equally spectacular losses,” Gordon writes.

Today, private equity is the beneficiary of a swarm of investors looking for a profitable asset class; according to Bloomberg, PE firms have $2.58 trillion in global assets under management. But the extended economic recovery from the financial crisis has made it a challenging time to find bargains. Nearly a third of the funds under management are uninvested—$963 billion in “dry powder” that hasn’t been put to work.

In a conversation with *Yale Insights*, Adam Blumenthal ’89, a founder and managing partner of the private equity firm Blue Wolf Capital Partners, said that the future of private equity is in returning to its roots, as a tool for value creation for a range of stakeholders—bringing effective management to companies with strong fundamentals and providing financial returns for investors but also jobs, services, and viable businesses that stabilize struggling communities.

Q: What is the state of private equity today?

Private equity has been very successful at raising capital over the last few years in large part because institutional investors have really been stretching to meet their return targets, and they believe private equity’s flexibility, focus, and in particular its operational expertise can help solve the problem of low expected returns.

Private equity managers now face a problem of success. They’ve raised large pools of capital that have to be put to work, but, after a long economic expansion, valuations are quite high, so the question of how to deliver on expectations is a big one.

Q: What are the primary approaches private equity firms are using to reach those return targets?

All are, in some way, a theory about how private equity allows you to solve problems that the public markets can’t.

Public markets have a well-known fixation on short-term results. A strategy that takes advantage of private equity's ability to be long-term, such as turnarounds or operationally intensive strategies, represent one approach.

A second focuses on rapidly changing sectors where any individual investment is likely to be quite choppy and unpredictable in the short term because the broader sector is choppy and unpredictable. I think that applies to healthcare and energy. It's a strategy many firms are pursuing these days.

A third strategy is to focus on opportunities that emerge from the misvaluation of public companies. Markets have been up for so long it's hard to make an argument that there are severe underpricings. Those who prefer that approach are mostly in a wait-and-see mode until there's a correction.

That includes some of the very large funds where return expectations have fallen because a decade of growth and cheap debt doesn't favor what they can do. When markets as a whole are volatile and debt is expensive, companies get nervous about their capital structures, and the ability of mega funds to fix that problem at a large scale for large organizations is extremely valuable. But in today's capital markets, those large funds face a quandary of whether to put money to work at relatively low expected returns or wait for conditions to change. The substantial overhang of capital that's been raised but not deployed is largely the result of people moving slowly in the face of that dilemma.

Q: What does innovation look like in private equity?

I think innovation in private equity, as an industry, really relates to making private equity investors more like traditional businesspeople. For two of the strategies that I articulated—operational intensiveness and deep familiarity with changing industries—there's no magic; it's basic entrepreneurship. The more that private equity embraces the role of bringing industry insight and operational skills to building value, the less it's driven by the ability to arbitrage capital markets or gain access to deal flow and capital, the more successful it's going to be. I think that's a big transformation. The innovation in the industry, oddly, is getting away from the financial aspects and closer to the industrial roots.

Q: What's driving that change?

When I started doing this, after I graduated from Yale SOM, almost 30 years ago, there were very few private equity firms. The fact that you existed, had flexible capital, a long-time horizon, and the energy that comes from strong alignment of interests, was enough. Twelve years ago, when we launched Blue Wolf, you had to differentiate yourself by being good at something others didn't do.

Today, there are so many private equity firms that if you are not the group that the stakeholders in the business think will give them the best future, you're unlikely to be selected as the buyer because other firms will get to your price. In order to be able to make the best investments, managers, regulators, organized labor, all of the stakeholders in the situation have to view you as the preferred acquirer.

Blue Wolf's approach is to go deep enough into each industry that we invest in that we have a perspective, a reputation, and a track record. That way, we're offering something more than simple purchase price. If we don't do that, we don't get to invest in the businesses that we want to invest in.

Q: Where does Blue Wolf fit in the private equity universe?

We consider ourselves a special situations fund. We have three core competencies. We are good at managing situations with government or regulatory involvement in the value chain. We are good at managing organized labor involvement in the value chain. And we're good at managing operational and financial distress. Those competencies have defined us since day one.

We apply those competencies in sectors where we have relationships and insight that allow us to be industry insiders rather than outside investors. We have embraced the idea that bringing strategic value to companies in times of change is the only way to justify our existence.

Q: How do you approach the relationship with investors?

Private equity investors sign up for very long periods of time. They don't know what companies they are going to buy. They're just committing to allow our team to manage their money over an extended period of time, so we provide not just transparency around the investments, but also transparency around our process in evaluating potential investments and managing change in companies after we own them. We try to treat our investors the way we expect to be treated by our portfolio companies. That is with transparency about results, strategy, and organization.

Q: And how do you approach the relationships within Blue Wolf's team?

Our investors evaluate us and we in turn evaluate each other and our portfolio companies by the financial returns that we develop. I don't want to downplay that. It goes without saying; that's the price of admission. But once you've said you're going to do that you also want to be proud of what you do and you want to be surrounded by interesting, smart people that you trust.

We have about 20 people working full time at Blue Wolf itself. But our team isn't just the folks with our business card; it's a dense network of relationships: investors, managers, strategic advisors, and other consultants. That network is central to the way we think about our capabilities. Drawing on that network effectively is critical to making good decisions.

Q: How do you evaluate potential investments?

I don't think that participating in a market and creating value is the same thing. As Keynes famously said, prices fluctuate. It's obviously possible to make a lot of money by benefiting from those fluctuations. When we think about a value creation plan, we don't assume that we bought something for four times and we're going to be able to sell it for six times because the market's going to go up. That's not a version of value creation that we feel is predictable.

We think that value creation has to do with managing people better, in having a better strategy, in getting and delivering a service at a higher quality for lower costs. Those things deliver better outcomes to people with less resources and less effort. That's at the heart of value. The private equity markets reward you for doing that, generally speaking, because you measure those things by the financial results. But what's driving the creation of financial value is fundamentally the creation of better outcomes resulting from deployment of fewer resources.

When we're considering investing, it's important for us that we have very concrete ideas about, how are we going to help the organizations we're invested in change, how are we going to make them more valuable? We understand how to do that in the middle market because we're large enough to have relationships throughout the capital markets but small enough that every investment is quite meaningful to us.

We never have a problem knowing what it is we're supposed to do next and that really motivates our team. We have always been wary of growing beyond our core markets. Our disciplines are creating a value creation plan, identifying what we're going to execute on over a multi-year period, and knowing when we've gotten to the end. As companies get larger and larger, it's harder to have those crisp plans.

Q: Given the longer timeframes involved in private equity investments, is there a tension between patience and impatience?

Our value creation plans typically relate to fundamental, operational, and strategic change in organizations. Those things don't happen overnight. And you inevitably make a lot of mistakes along the way. I wish we could make those kinds of changes in organizations faster, but you have to respect how much there is to learn, so you do need patience.

At the same time, entropy is a super strong force in the world. Everything tends to drift. Our statement of values includes the words "relentless daily execution." The only way you make change is through a sense of urgency. Even with relentless daily execution, change takes years. And without it the change doesn't happen at all.

Q: Could you explain how Blue Wolf works with organized labor?

Anyone who's followed the American labor movement for the last 30 years knows that every year, the percentage of the private sector workforce that's unionized declines. Where unions are wedded to contracts in a form that may have been appropriate 30 or 40 years ago but are hard to sustain today and don't really address the challenges that workforces have these days, they lose members. The industries where unions have managed to grow, which they have in some areas of healthcare and in the building trades, they've typically been willing to be very creative about what their core objectives really are.

We've been able to negotiate agreements with unions that put an emphasis on flexibility, on gain sharing and alignments of interest, on training and career pathways for workers. We have those kinds of agreements with the Service Employees International Union, United Steelworkers, and Unifor, which is Canada's largest private-sector union.

About a third of our portfolio is unionized companies. The quality of the relationship that we're able to forge with a union is very important in our decision to go forward with an investment. We pride ourselves on being able to find constructive solutions to intractable problems. We think we've created some groundbreaking agreements with unions, but if organized labor is part of the investment, and we can't get to a solution of that type, we just won't invest. There certainly have been situations in which we had to walk away.

Q: You noted investing in situations where regulation or other government is involved as a core competency. How do you approach those situations?

We're a middle market fund. We don't have high-powered political relationships. What we have is a process for working with government regulators and bureaucracies. We try to identify objectives that are important to government regulators, develop business strategies that are aligned with those objectives, and use that alignment to create mutually beneficial agreements.

For instance, we've been substantial investors in forest products companies, and we've made it a rule to really understand the objectives of both environmental and economic development agencies that oversee the forest lands where we do business and to find solutions that are aligned with the objectives of those kinds of agencies.

For instance, we bought Finch Paper in Glens Falls, New York. The paper mill was associated with 161,000 acres of timberlands largely located inside the Adirondack State Park. Those timberlands have great environmental value. They'd been owned by the same family for 100 years. We knew that the state of New York was very interested in acquiring the most environmentally sensitive of those lands for the state-owned, forever-wild park system.

We worked to create an arrangement where the Nature Conservancy wound up owning and managing the timberlands and we wound up with the Finch Paper manufacturing assets and contracts that assured the company of access to fiber. The arrangement helped the state meet a long-held objective of enlarging the park system since the Nature Conservancy turned over the most ecologically valuable land to the state. It helped the Nature Conservancy enter into a long-term management plan for the land. And it helped us stabilize the company and acquire manufacturing assets at very attractive terms.

That process of identifying the state objective, finding a strategy to help them meet it, and aligning the business with that created both great returns and very stable businesses which otherwise might have found themselves in a lot of conflict with the state agencies.

Q: Blue Wolf has invested in healthcare. Where are the opportunities in that sector?

The healthcare sector is an enormous percentage of the American economy, yet it's dysfunctional as an industry. The patterns of contracting, management, and regulation are expensive and don't produce good results. It's offensive how much money we spend for outcomes that are not great by global standards. On the other hand, it's a great sector for private equity investment because the opportunity to experiment and develop alternative solutions present themselves all the time.

In a part of central Brooklyn that is a federally designated physician shortage area, we've built an urgent care business that provides very cost-effective healthcare from storefronts in second-tier shopping districts. It's again a situation where we're working with government. Providing adequate healthcare in these sorts of urban areas is a federal priority. Many of the Medicaid plans the patients rely on are quite local to New York City. By finding a private sector solution that is very flexible and non-bureaucratic with low overhead but high quality, we've gotten tremendous support at every level of government.

Q: To what degree do the communities where your portfolio companies are located play into your thinking?

The companies that we invest in typically are very tied to their communities. In many rural areas, we are the largest private sector employer in a county or in a region. Our healthcare companies provide unique solutions in inner-city areas with severe healthcare shortages. The life of these businesses is very enmeshed with that of their surrounding communities.

Five or ten years ago, we may have been an important employer but it wasn't an aspect of our investment that we spent a lot of time thinking or talking about. Today, our leadership teams take their responsibilities to their communities very seriously and think about it strategically.

Whether the problems are a lack of good manufacturing jobs, a lack of workforce preparedness, or the extent of the addiction crisis in many of the neighborhoods where our companies operate, nobody else is going to address these issues. Government simply doesn't seem equal to the challenge of managing those problems, so it has become the role of companies and corporate leadership to address them just so that they're in a community where they can hire and train and retain great people.

The biggest change that I've seen over the last few years is the emerging leadership role of companies in society. It's quite striking and still rapidly evolving.

Q: Do you see that as part of a larger shift in the roles of the public and private sectors?

In the 50 years before I was born, it's easy to say that government led the way. For better or worse, many of the major events of my lifetime have been the result of significant business leadership. The developments in technology, the ease of travel and communication across borders, the tremendous advances in healthcare and biotechnology have made the world a different place, affecting the quality of life of nearly everyone in the world. It's obvious that business played an enormous role in creating that change. The financial crisis of 2008 had enormously negative and disruptive impacts on hundreds of millions of people around the word; it was a private-sector-led disaster.

But if you look at current events, the extraordinary dysfunction of our government is obvious. As is the lack of accountability. Particularly in the last decades, I think CEOs and investors have developed an increasing awareness of these trends. I don't think private sector leaders set out to take on additional responsibilities. I think that the world has developed in such a way that they have those responsibilities. Increasingly business leaders recognize it, and we're acting accordingly.

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