

THE MCKINSEY & COMPANY REPORT

PRIVATE EQUITY CANADA

2004

**ACTIVE OWNERSHIP:
GENERATING BETTER
RETURNS IN
A COMPETITIVE
MARKET**





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Foreword

This is the fourth installment of the *Private Equity Canada* series produced by Goodman and Carr LLP and McKinsey & Company. Our objective is to provide a fact-based perspective on key trends shaping the Canadian private equity market to help the industry grow and its participants succeed.

We have based our conclusions on the market research Thomson Macdonald conducted in Canada and on McKinsey & Company's proprietary research in the United States and Europe. The 2004 survey was consistent with the 2003 survey to permit year-over-year comparisons, but it also included additional questions exploring the topic of private equity deal management by Canadian investors. The 92 survey respondents represent the firms managing Canada's largest private equity funds – more than 90 percent of the industry's capital pool.

Private Equity Canada 2004 consists of two volumes:

- Volume 1, produced by Goodman and Carr LLP, provides an in-depth review of key market facts. It describes the main characteristics of Canada's private equity market, the preferences of its participants, and the market activity over the past year.
- Volume 2, prepared by McKinsey & Company, draws on the authors' and the Firm's extensive experience in serving institutional investors and other private equity market participants. It offers a perspective on the competitive dynamics in the Canadian private equity market and examines how some investors are seeking to enhance their returns and differentiate themselves through "active ownership."

We hope you find *Private Equity Canada 2004* useful, valuable, and thought-provoking.



Robert Palter
Principal
McKinsey & Company

McKinsey & Company¹ is an international management consulting firm that specializes in helping clients achieve substantial and lasting improvements in their performance. Its Canadian Practice, based in Toronto and Montreal, draws on McKinsey's network of over 80 offices to provide objective counsel to management teams facing strategic, organizational, or operational opportunities and challenges. For more information, please visit us at www.mckinsey.com or contact us by phone at 416 313 3700 or 514 939 6800.

1 McKinsey & Company is not an investment advisor and will not provide investment advice.

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2.0 Executive summary

Canada's private equity market continued to grow in 2004 – and competitive pressures mounted. New capital was attracted mainly to the mezzanine and buyout segments, and both experienced a significant increase in capital invested.

Canada's private equity market will probably continue to grow. However, given the intensifying American competitive environment and the history of the Canadian market evolving similarly but a couple of years behind the US market, Canadian General Partners (GPs) and Limited Partners (LPs) should expect greater competition, not only for deals but also for fundraising.

Many GPs are already adapting, recognizing that delivering attractive returns requires a more deliberate and intensive approach to transaction and portfolio company management. Some industry observers call this approach "active ownership."

At McKinsey, we wanted to gain a deeper analytical understanding of this approach. This would enable us to determine the GP activities that drive better returns, allowing them to raise funds more efficiently and execute better deals. This continuous cycle helps ensure success in an increasingly competitive marketplace.

In this volume, therefore, we:

- Review the competitive pressures LPs and GPs are facing and how they might differentiate themselves in this challenging environment by being more actively involved as owners and partners
- Describe the fundamentals of McKinsey's proprietary research into active ownership; in this effort, we examined 80 different attributes throughout the life of an investment to determine which had the greatest impact on returns
- Identify the five GP activities that tend to be the most important and effective in driving improved performance and compare them to the practices of Canadian buyout and mezzanine deal partners

- Define the potential organizational design choices that investors can pursue to effectively implement many of the key principles of active ownership.
-

We would like to thank everyone who contributed to *Private Equity Canada 2004, Volume 2*, including our colleagues Conor Kehoe and Joe Heel, alumnus Paolo Notarnicola, and the McKinsey & Company communication team.

If you have comments or questions about this volume, please contact any one of the following at McKinsey & Company.

- **Robert Palter**, Principal
T: 416 313 3774
Robert_Palter@mckinsey.com
- **Bruno Roy**, Associate Principal
T: 514 939 6914
Bruno_Roy@mckinsey.com
- **Andrew Cockwell**, Engagement Manager
T: 416 313 3858
Andrew_Cockwell@mckinsey.com

2.1 Growing pressure on private equity returns

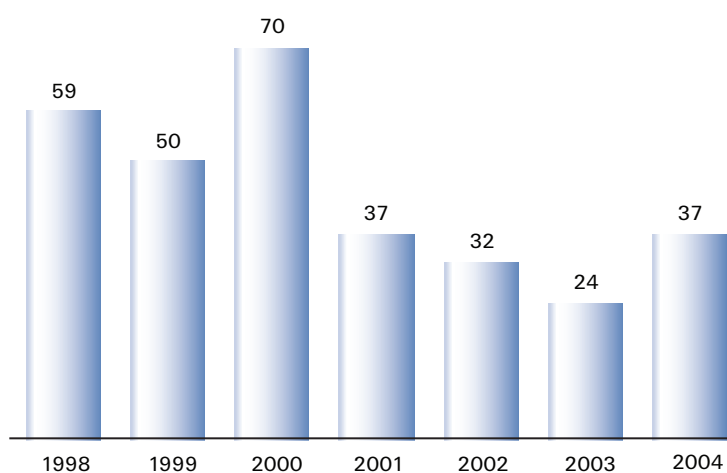
In 2004, competition intensified in the Canadian private equity market. With the entry of new capital and players, fundraising and investing became more difficult.

In Canada, buyout fundraising in 2004 was \$956 million, down from approximately \$3 billion in 2003. However, capital continued to flow into the market leading to increased competition.

In the United States, the fundraising story differed considerably. US buyout funds raised \$37 billion last year, up from \$24 billion in 2003. This was the largest amount committed to private equity as an asset class since 2000, when approximately US \$70 billion was raised. This fundraising was concentrated in fewer, and generally larger, established firms (e.g., those raising the 15 largest funds in 2003-2004). As such, the mid-market buyout funds appeared to be getting squeezed.

Exhibit 1
US BUYOUT FUNDS RAISED
US \$ Billions

ESTIMATE



Source: *Buyouts*; Venture Economics

These pressures will probably grow, forcing LPs and GPs to develop different strategies in their quest for attractive returns as investors continue to be drawn to the risk/return profile of the asset class.

In this chapter, we review some of the market dynamics affecting fundraising and investing beyond those identified in Volume 1 and the different approaches GPs can take to succeed in this environment.

MARKET DYNAMICS

Significant overhang remains

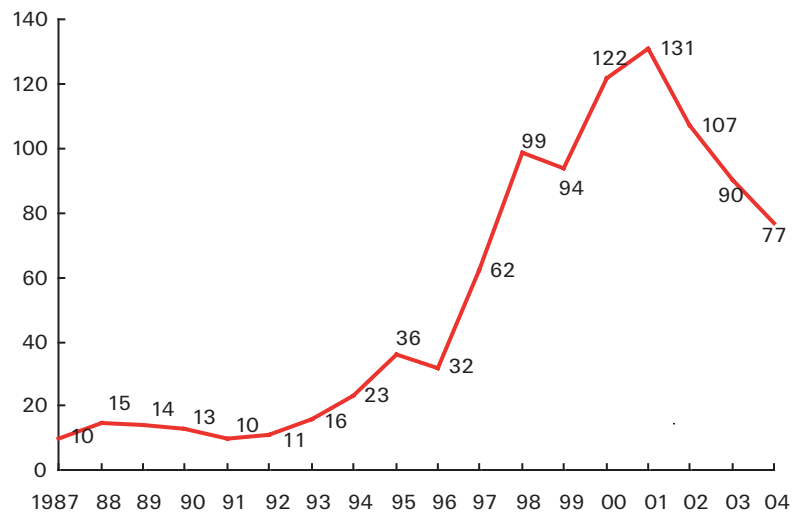
In the United States, the environment for investing private equity capital has improved over the past few years. The capital overhang (capital committed to general partners but not yet deployed) in the buyout market declined from approximately US \$120 billion in 2000 to approximately US \$80 billion in 2004. The ratio of US buyout overhang as a multiple of annual buyout activity declined from 5.6X in 2000 to 3.8X in 2004.

Exhibit 2

US BUYOUT OVERHANG

ESTIMATE

US \$ Billions



Source: Capital IQ; Venture Economics; McKinsey analysis

This overhang is typically attributed to the difficulty of closing attractive transactions, as proprietary deals are increasingly being replaced by

public auctions. This trend is increasingly prevalent among large buyout transactions (those above an enterprise value of US \$500 million), as investment bankers have begun to aggressively enter this segment and savvy sellers try to maximize multiples by managing a competitive bidding process for their businesses.

Greater difficulty in closing attractive transactions is not the only reason for the overhang. It also stems partly from more money flowing in from institutional investors moving into the market for the first time or increasing their allocations to this asset class. These investors are seeking to take advantage of private equity's risk/return characteristics, particularly with today's low expectations for returns from public equities and fixed income markets.

Is the overhang too high? Industry observers can make a case for both sides of the argument. Whichever side one supports, this overhang clearly highlights the competition in the marketplace to put money to work. The net effect of increased auction activity and more capital chasing fewer deals is a competitive marketplace for completing transactions at attractive valuations.

Hedge funds stir the mix

The entrance of hedge funds is another significant market dynamic driving increased competition. Although still the exception, transactions like Highfields Capital Management's bid for Circuit City and Edward Lampert's involvement with Kmart Holdings Corporation suggest that some hedge funds are interested in private equity type deals. Interestingly, several private equity firms have launched hedge funds – for example, Blackstone's US \$9 billion in hedge funds and Texas Pacific Group's US \$2.5 billion in its TPG-Axon Capital.

* * *

We acknowledge that this view of the market is very high level and US-centric, but the Canadian market's development has typically tended to lag that of the US by several years. While competitive intensity in the Canadian

market has partly increased because of greater US participation (e.g., KKR's and Bain Capital's continued activity in Canada), we are also seeing some new fund creation. Consequently, we believe the competitive intensity seen today in the United States will likely develop in Canada over time.

DIFFERENT RESPONSES

In other industries, the typical response to greater competitive intensity is either to pursue scale or to specialize. In banking, for example, Citibank and JPMorgan Chase have focused on scale, whereas ING DIRECT has focused on carving out a unique niche to create value. Clearly, ING has achieved the minimum scale necessary to be cost competitive, but its primary differentiator is to pursue a niche strategy. ING DIRECT provides high-yielding savings accounts and some loan products directly to consumers in North America. Private equity investors face the same choice: pursue scale or a niche approach – or something in between.

Funds pursuing scale

The trend toward pursuing scale is becoming increasingly evident in private equity. We are seeing ever-larger funds being raised not only to do non-traditional deals (like megacap transactions) but also to take advantage of scale economies. Greater scale enables these firms to pursue transactions that are beyond the reach of most other participants and to gather resources (e.g., expertise) that smaller firms struggle to achieve. In addition, the larger deals enabled by the larger funds tend to produce significant fee income (e.g., deal completion fees, monitoring fees) that helps improve returns. US buyout firms that raised large funds in 2003 and 2004 included Texas Pacific Group and Bain Capital, both of which closed funds with more than US \$4 billion in commitments. Firms like Blackstone, Goldman Sachs, and Warburg Pincus are also marketing large funds. In March 2005, The Carlyle Group announced that it had received US \$7.85 billion in commitments to its latest US buyout fund, Carlyle Partners IV. The first US \$10 billion American buyout fund might be just around the corner.

In Canada, EdgeStone and Birch Hill (formerly TD Capital Canadian Private Equity Partners) recently announced the launch of their fundraising efforts.

Each has reported that it is planning to raise over \$600 million – significantly larger funds than the typical Canadian buyout fund raised in the past. Clearly, these firms see the benefits of scale in differentiating themselves from the competition.

It remains to be seen how other Canadian firms will respond and if the Canadian marketplace will follow a similar path of ever larger funds as in the United States. Given our country's relatively modest market size and the limited presence of foreign capital providers, it may be difficult for the Canadian market as a whole to migrate toward bigger funds. This makes alternative value creation approaches more intriguing.

Firms embracing alternative approaches to improve returns

The competitive deal environment and the growing sophistication of target companies have resulted in fewer opportunities for private equity investors to acquire companies cheaply and rely primarily on the traditional buyout model of using leverage or financial engineering to produce attractive returns. To offset higher entry multiples and limitations on leverage, many investors are increasingly seeking to produce good returns through unique deal strategies that focus on industry, deal type (growth capital, outsourcing, etc.), or deal size, for example. In addition to these strategies, many GPs are shifting their investment approach from being somewhat passive financial investors to becoming deeply informed investors and operating partners – in other words, taking an active ownership approach.

Many will argue that buyout investors should not become more active in the operations of their portfolio companies since they are investors – not operators. In addition, a GP that commits too much time to portfolio companies may potentially undermine the authority of management and take time away from deal sourcing.

We agree. But being a passive financial investor is less likely to be effective in a competitive marketplace. So, where is the middle ground? Our analysis has highlighted a trend toward leading buyout investors becoming much more involved. They are acting as sounding boards for their CEOs and

management teams and leveraging their resources and networks to help their investee companies. Yet these investors are not actually operating those companies. They are being actively involved as owners and partners whose interests are aligned with those of management. In many cases, this active ownership approach results in better returns that, in turn, lead to more effective fundraising and investing. But what are the specific activities a more active owner can undertake to produce better returns without becoming the operator of the portfolio company?

To better understand what was involved in the active approach many US and European buyout GPs were starting to pursue, McKinsey undertook a research effort to determine the practices of active owners that produce better returns. In the next chapter, we take a step back to describe the fundamentals that underpin McKinsey's research into active ownership.

2.2 Active ownership – research fundamentals

McKinsey conducted proprietary research² into the drivers of returns in individual buyout investments in the late 1990s. It segmented the overall returns generated by any single private equity investment into three sub-elements: 1) returns associated with overall capital markets appreciation; 2) returns from sector growth; and 3) returns generated by improvements in a portfolio company's performance. In most high-return private equity investments,³ we found that improving the performance of a portfolio company typically represented over 75 percent of the total value created.

But what was it that GPs did to drive these improvements in portfolio companies? Our first step in answering this question was to interview a number of leading LPs who had a broad view on the activities of a large number of investors. The LPs voiced three broad perspectives.

- Some LPs believed the best PE firms were *active governors* – those that are involved as owners not operators. “Our top GPs leverage deep industry expertise to cut their losses and quickly exit bad deals instead of trying to fix them.”
- Others considered the best PE firms were *active controllers* – those that strictly monitor execution against plan and get involved when things go wrong. “Our top GPs intervene to try to save dog deals. They dedicate additional resources and engineer a merger or other exit to try to avoid bankruptcy.”
- And still others argued that the best PE firms were *active operators* – those that actively engage in operations. “They help management understand what industry leaders do. They invest time and resources to ensure that the company remains on track.”

Given these different views of LPs – and given our observation that many US and European buyout investors were becoming increasingly involved with

2 Excellence in Private Equity, proprietary research conducted by McKinsey & Company in Europe and North America.

3 Investments with IRRs greater than 60 percent and hold periods of more than 3 years.

their portfolio companies to produce returns in a competitive marketplace – we wanted to determine what specific GP practices translated into better returns. We believed that there were several activities during deal sourcing and due diligence that were as important to producing returns in the portfolio company as those undertaken when the deal was closed. Therefore, we set out to understand quantitatively what activities during deal sourcing, due diligence, 100 days after closing, and over the long run tended to produce the best performance in portfolio companies – and thus overall returns.

We approached 11 GPs from North America and Europe, which gave us access to 60 of their transactions. Each GP submitted 5 to 6 deals they had exited prior to 2002, with “poor” to “very good” returns. We disaggregated the returns of each individual deal into value created by overall stock market appreciation, sector appreciation, the effect of financial leverage on those

McKinsey’s active ownership sample covered:

- 11 private equity firms in North America and Europe with track records that were above average
- 60 exited transactions completed between 1992 and 2002
- Transactions with over US \$100 million in enterprise value representative of the overall market, since 80 percent of capital invested during that time was in transactions over US \$100 million
- Transactions typically in the top end of the portfolio, with over half of them producing top quartile IRRs and only 10 percent producing bottom quartile IRRs.

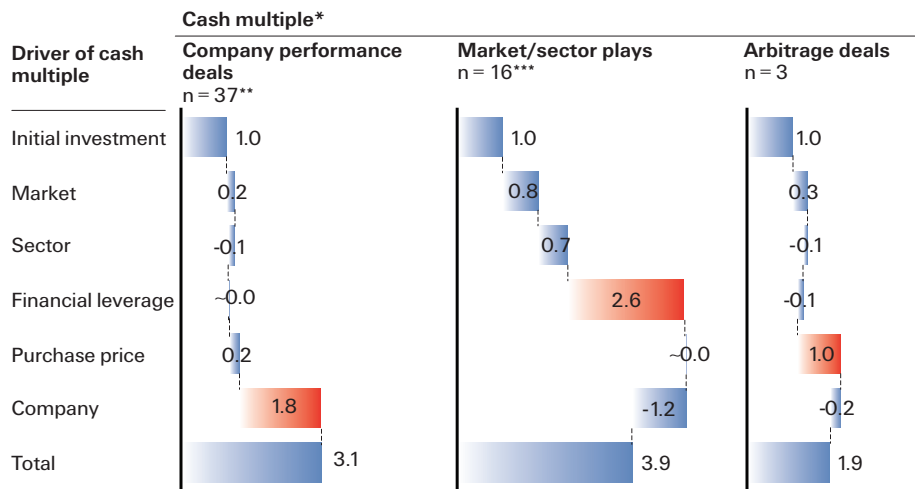
To our knowledge, this is the largest sample of private equity deals analyzed in this type of research. As the sample size was still relatively small (n = 60), we “stress tested” our conclusions with GPs and LPs around the world to confirm their robustness.

Source: Deal database; Capital IQ; Venture Economics.

market or sector gains, purchase price arbitrage and, finally, improvement in the company's performance.

As with the research we completed in the 1990s, improvement in a portfolio company's performance was the main source of value in nearly two-thirds of the deals. Market or sector increases accounted for the rest.

Exhibit 3
THREE TYPES OF DEALS WITH SIGNIFICANTLY DIFFERENT VALUE GENERATION PATTERNS



* Cash proceeds from investment divided by total cash outflows
 ** Insufficient data for a detailed value creation breakdown for 1 deal
 *** Insufficient data for a detailed value creation breakdown for 3 deals
 Source: GP interviews; deal database; McKinsey analysis

In addition to disaggregating the sources of returns, we also conducted a detailed survey of the deal partners and the CEOs of portfolio companies. In this survey, we reviewed 80 different activities throughout the life of a deal to determine which had the greatest impact on returns (see sidebar for details).

In the next chapter, we examine the five primary active ownership attributes that typically drive improved performance.

Research methodology

For each deal sample, we determined:

1. Cash multiple drivers. We disaggregated the overall cash-in/cash-out multiples, using financial information collected from the participating GPs and supplementing it with market data. This enabled us to attribute how much value was created from:

- Market appreciation
- Sector appreciation
- Financial leverage
- Purchase price arbitrage
- Company performance improvement.

2. Management and organizational practices. We then interviewed the deal partner and the portfolio company's CEO to gain an understanding of the GP's key activities throughout the entire deal cycle – sourcing, due diligence, structuring, first 100 days after closing, monitoring, and exiting.

This enabled us to identify approximately 80 management practices (such as how GPs leveraged advisors, the size and distribution of incentives, and board composition), as well as a number of organizational practices (such as team structures, team skills, team styles, and management systems).

3. Active ownership practices. And, finally, we cross-referenced the financial information and the management and organizational practices and used statistical regression analysis to identify the practices most closely correlated with a deal where a large part of the value created could be attributed to improvement in portfolio company performance.

2.3 Attributes driving performance

ACTIVE OWNERSHIP TRENDS IN THE UNITED STATES AND EUROPE

Our interviews with deal partners and with CEOs of portfolio companies and the correlation of the results with cash-in/cash-out multiples enabled us to identify the five following GP activities throughout the deal process that tended to be the most important in consistently driving performance.⁴

1. Actively developing proprietary knowledge during due diligence

Successful deal partners sought to develop deep expertise before committing. In 83 percent of the best deals, the GPs began by developing proprietary knowledge. They developed this knowledge by having their internal resources conduct significant research before investing, as well as mining sources such as board members, management, and trusted outside resources. In the worst third of deals, GPs actively sought to develop this expertise less than half the time.

Some leading funds went to great lengths to build knowledge. Not only did they focus on a limited number of sectors, but they also hired former CEOs to help them monitor specific industries. Some firms also developed formal relationships with consulting firms, securing senior partner “bandwidth” on retainer so they could move swiftly when a potential transaction arose. This also gave them access to proprietary databases developed over time by industry analysts or consultants. Finally, many of these firms were starting to organize themselves internally so that deal partners developed deep expertise in a few industries.

2. Using focused performance incentives and requiring management investment

While getting management to invest significantly in a buyout transaction as an incentive and tool to align interests with the investor is not a new concept, our research revealed that, *in the best performing investments, incentives were typically focused on the first line of management (CEO,*

⁴ Of the 80 activities we sampled, a handful did not seem to add any value to the process; the others were, to varying degrees, helpful in producing better performance.

CFO, COO, and a few others reporting directly to the CEO). We typically found that 15 to 20 percent of equity was allocated to align a limited number of managers with the investing fund's goals.

A substantial financial commitment from senior managers was also key. Although there was no set formula, the financial commitment was significant enough to tie a material portion of a manager's net worth to his or her company's success. One GP interviewed commented that "the incentives really have to be meaningful. You don't want the CEO to have to sell his house if things don't work out...but you want him to sell his country house."

3. Actively developing a value creation plan pre and post closing

What distinguished the top deals from the merely average for this activity was the GPs' overall level of intensity in carrying out the following practices:

- **Overhauling the management plan.** Almost all our sample deals involved plan overhauls. In the top ones, however, the partners invested significant time upfront in developing new plans. They also leveraged independent experts. In fact, in the best third of our sample, these companies completely overhauled management's strategic plan just over two-thirds of the time and addressed deviations about half the time.
- **Adjusting the plan in the first 100 days.** In almost all cases, deal partners made adjustments in the first 100 days based on a close tracking of basic financial metrics. In the top ones, they ensured continuous interaction between the deal partners and the management teams, created new KPIs directly linked to the value creation plan, and ensured the organization was change ready. In our research, we found that the best third refined their strategic plans and KPIs within the first 100 days after closing.
- **Reacting immediately to plan deviations.** Deal partners typically spotted deviations to plans through monthly reports and made adjustments immediately when deviations were serious. They would often call the board quickly or work directly with management. In the

sample, the top ones rapidly spotted deviations through weekly tracking and corrected them immediately.

4. Significantly involving senior deal partners in the first 100 days after closing

Instead of signaling the start of a well-deserved holiday for the deal partners (after weeks of sleepless nights devoted to understanding the company, valuing it, and negotiating terms), the transaction's closing signaled the start of a 100-day sprint for top performing deal partners.

In the best performing deals, the partners spent more than 50 percent of their time focusing on the company, meeting almost daily with the executives. The partners created or refined the strategic plans, challenged management's assumptions to ensure successful implementation, and evaluated overall management capabilities. In contrast, deal partners in the middle and bottom third devoted only 20 percent of their time to the company during this period.

5. Proactively strengthening management teams

The top third of performers were most likely to strengthen their management teams before closing and to identify additional replacements within the first 100 days post closing. The worst third, however, identified additional replacements after the first 100 days, potentially stifling momentum from the transaction and extending the period of upheaval.

* * *

Despite a clear link between these active ownership activities and typically better company performance (and a positive impact on returns), we were surprised to find that, although some firms executed them well, most did not apply them consistently in their portfolio companies.

Of our 11 participating firms, only 2 applied a high level of active ownership intensity in over 75 percent of their deals. The other 9 displayed a relatively

inconsistent use of these practices. This leads us to believe that active ownership, at this stage, might be more partner-driven than firm-driven.

Exhibit 4

ACTIVITIES THAT HAVE LITTLE IMPACT ON COMPANY PERFORMANCE

Most GPs...	GPs rarely...
<ul style="list-style-type: none"> • Assess auctioned opportunities 	<ul style="list-style-type: none"> • Introduce a change/program office
<ul style="list-style-type: none"> • Thoroughly assess management during due diligence 	<ul style="list-style-type: none"> • Invest in deals not in line with PE firm strategy
<ul style="list-style-type: none"> • Offer equity-based incentives to management 	<ul style="list-style-type: none"> • Leave management incentives far from finalized before closing
<ul style="list-style-type: none"> • Design a significant cash bonus program for management 	<ul style="list-style-type: none"> • Obtain a superior financial package
<ul style="list-style-type: none"> • Review company performance and deviations from plan at least monthly 	<ul style="list-style-type: none"> • Develop a contingency plan • Require the deal partner to play the role of Chairman
<ul style="list-style-type: none"> • Offer equity-based incentives to board members 	<ul style="list-style-type: none"> • Use formal reviews of management talent
<ul style="list-style-type: none"> • Require top managers to invest in the deal 	<ul style="list-style-type: none"> • Require board members to be actively involved outside board meetings <ul style="list-style-type: none"> – During first 100 days – After first 100 days

Source: GP interviews; deal database; McKinsey analysis

ACTIVE OWNERSHIP IN CANADA

To compare our proprietary research on the active ownership activities of US and European investors with the approaches used by Canadian investors, Thomson Macdonald asked domestic buyout and mezzanine deal partners to indicate how often they undertook those activities.

The results indicate that Canadian GPs practice a number of these activities. However, one should note that we did not have the opportunity to verify these assertions with portfolio company CEOs (as we had done for our European and American samples).

Consistent with our proprietary research:

- During the first 100 days after closing, a significant proportion of Canadian deal partners “always,” “very often,” or “often” *spent substantial time with company management*. In about 80 percent of transactions, Canadian investors committed resources early on to confirm the business’ trajectory after closing.

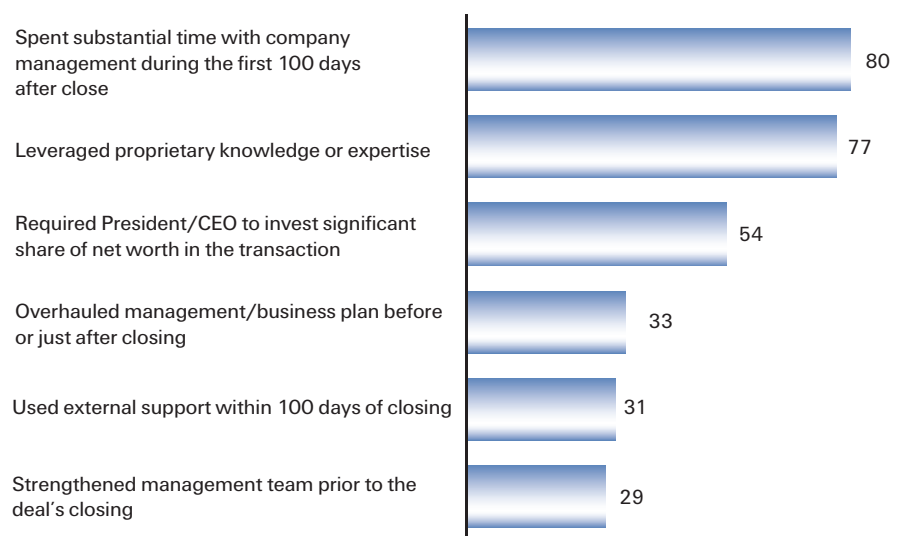
- A high proportion of survey participants – 77 percent – responded that they “always,” “very often,” or “often” *actively leveraged outside expertise/privileged knowledge* (proprietary, management, or board) in their deal activities. A significantly lower 31 percent of respondents indicated that they used external support “always,” “very often,” or “often” within 100 days of closing.
- In 54 percent of transactions, the deal partners “always,” “very often,” or “often” *required the President/CEO to invest a significant portion of his or her net worth*.

The Canadian survey appeared to diverge from our proprietary research in *overhauling management or business plans* and *strengthening the management team*. It indicated that 33 percent “always,” “very often,” or “often” revised the business or management plan. Also, in Canada, just 29 percent of respondents “always,” “very often,” or “often” strengthened the management team.

Exhibit 5

CANADIAN INVESTOR USE OF ACTIVE OWNERSHIP PRACTICES

Percentage of respondents indicating they “always,” “very often,” or “often” employ these practices



* * *

Based on this research, it seems that Canadian investors are pursuing many of the same activities as leading US and European buyout investors. The ability of an investor to consistently apply the five key activities we have highlighted and the many other incremental activities consistent with being an active owner should help generate better returns in an increasingly competitive marketplace.

2.4 Concluding remarks

Our research clearly demonstrated that five active ownership activities can help drive performance and several others can provide incremental benefit. Yet, to consistently and effectively execute these activities in each transaction, private equity firms may have to re-examine their organizational structures, systems, and staff to ensure that they are configured appropriately.

The final element of our active ownership research was to analyze the different organizational approaches firms were using and then to determine if one set of structures, systems, or skills was the most effective in consistently delivering active ownership practices. We analyzed organizational structure (i.e., the use of operating partners and associate: partner ratios), skill sets (i.e., financial versus operational and the use of external resources) and systems (i.e., formalized versus informal 100-day processes).

This research revealed that the deals most characterized by the active ownership approach (and typically better returns) had:

- A high associate:partner ratio
- A combination of financial and operational expertise
- A highly structured 100-day process
- Customized KPIs
- A very high level of interaction intensity.

Interestingly, the structure of deal management (single versus dual partners) was not an organizational characteristic that had impact on delivering active ownership activities.

* * *

Given the findings of our active ownership research and the increasingly competitive marketplace, Canadian GPs should consider becoming more active owners and partners. By doing so, they will likely be able to drive performance and may enhance the potential to generate better returns that will enable them to raise funds more efficiently and execute better deals.



110 Charles Street West
Toronto, Ontario M5S 1K9
T: 416 313 3700
F: 416 313 2999

1250, boulevard René-Lévesque Ouest
Bureau 4430
Montréal, Québec H3B 4W8
T: 514 939 6800
F: 514 939 6810

www.mckinsey.com