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PRIVATE EQUITY INVESTING AND TOTAL QUALITY - UPDATED

Abstract: *Private equity funds invest money into companies and, in return, receive stakes in the companies' equity, thus becoming the partners who share the business risk. Because of that, private equity funds increase the value of their portfolio companies, by, among other things, improving their internal processes and strengthening their market positions. While doing that, private equity funds place a special emphasis on the implementation of the total quality. In order to do that, they focus on the three key elements for the successful implementation of the total quality: strategy-based organization, focus on consumers, and obsession with quality.*

Keywords: *Private Equity, Investing, Quality*

1. Introduction

The term 'private equity' refers to investments into equity of companies, which are not listed on the stock exchange, as well as to equity of companies, which have stopped being listed on the stock exchange after investing by a fund. In a broader sense, private equity funds invest money into companies, and in return, receive stakes in the companies' equity, thus becoming partners who share the business risk. The private equity investments are classified as follows (Stefanovic, 2009): 1) venture capital investing - where the money is invested in companies being established or in companies getting developed (Stefanovic, 2004); 2) leveraged buyout investing - where loans are invested to buy parts or entire companies (Stefanovic, 2005); 3) mezzanine investing - where the money invested in the companies has the form of shares and subordinated loans; 4) special situations investing - where the money is invested in special situations, such as: a) distressed investing - investments in companies in crisis or facing bankruptcy, b) funds-of-funds investing - investing in the very investment companies dealing with private equity investments, c) secondary investing - investing in equity of companies dealing with the purchase of other private equity funds, and d) other special situations investing - investing for other special purposes, such as turnarounds-workouts investing (investing in companies that undergo the process of reconstruction or reorganization) (Bartlett, 1999; Parrino and Harris, 1999; Alternative Investor, 2004). Currently, the following private equity funds operate in the Serbian market: SEAF South Balkan Fund, Blue Sea Capital Fund, Innovation Fund, EMSA CEE Private Equity Fund and EMSA Special Situations Fund, and Mid-Europa Fund III. Private equity funds, including those listed, in order to increase the value of portfolio companies for successful trade-sales, among other things, perform value-adding activities. Those

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value-added activities are spread through the corporate structure of companies, directly targeting several segments, as well as organizational levels and positions, such as: management, strategic planning, organization, operational system, transparency, control, and, especially, quality (Based on the procedures of SEAF South Balkan Fund B.V. (Serbia), 2012, and Academy Funds (USA), 2005.). In order to successfully implement the total quality, private equity funds focus on the three key elements for the successful implementation of the total quality: strategy-based organization (Stefanović *et al*., 2007a), focus on consumers, and obsession with quality.

2. Private equity investing

Private equity funds realize their profits as a result of intensive work on increasing the company's value. Over the period that usually lasts from three to ten years, private equity funds expect the profit, on exiting investments, realized by selling equity stakes to a strategic partner, selling the stakes to the existing owner of the company, or by selling equity stakes on the stock exchange. Private equity funds also generate a portion of the profits by paying a part of a dividend, in proportion to the ownership share in the company. It is important to note that, during the first year, many private equity funds reinvest all the profits into the company's operations, in an agreement with the existing company owners, in order to fertilize the equity more rapidly and to achieve the desired growth and development of the company (Stefanovic, 2009). The Figure 1 shows the private equity success model (Taken from a PPM, USA, 2005):

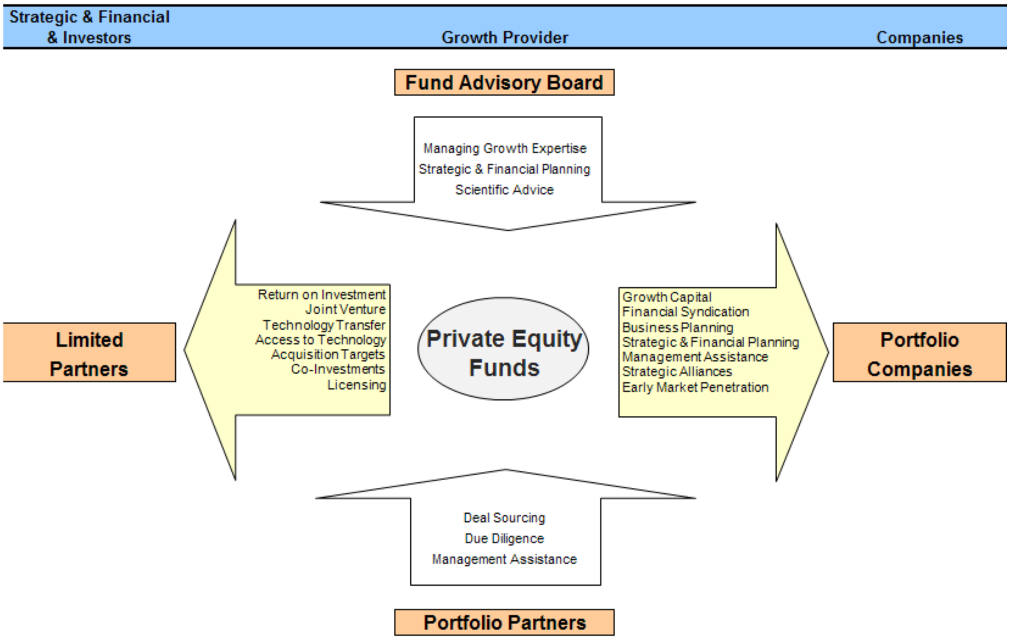

Figure 1. Private Equity Success Model

Private equity investing in the emerging markets is typically highly profitable. Because of that, many investors, such as pension funds or insurance companies, invest in this investment class. In addition, private equity investing has a very low correlation with other investment classes, such as, for example, investing in stocks or bonds, thus leading to increased diversification of the portfolio itself. Because of that, private equity industry is constantly expanding (Stefanovic, 2009).

The data shows that the five largest investments, made by private equity funds, are greater than the combined annual budgets of all the countries in the world (except for the 16 largest). In addition, the five greatest private equity investments are higher than the annual budgets of Russia and India. Also, the largest 20 private equity funds in the world are controlled by the companies that employ more than 4 million workers (Service Employees International Union, 2004). The private equity investment process can take many forms, depending on the type of investment. It usually consists of:[2] the deal origination, due diligence, structuring and negotiation, monitoring and growth, and exiting. The deal origination step focuses on finding and analyzing deals, and it may include steps such as the review of the business, screening against the investment criteria, and the analysis of the source and reliability. The due diligence step focuses on a deeper analysis of the opportunity. During this step, the industry, company, management team, co-investors, and the investment return potential are analyzed. During the structuring and negotiation step, the type of security, terms, valuation, and the objections are taken into consideration. The monitoring and growth step focuses on working closely with the investees in order to make it sure they meet the targets. The exit step focuses on realizing the returns through one of several ways, which can include a management buyout, strategic sale, initial public offering, or a financial sale. Private equity funds invest into different types of instruments, such as: common stock, preferred stock, convertible preferred stock, participating convertible preferred stock, convertible loans, warrants, etc. (Lerner and Schoar, 2004). When investing in those instruments and constructing their investment portfolios, many private equity funds expose themselves to the controlled systematic risk, in search of above the average returns. In order to reduce some of the unsystematic risk, private equity funds carefully utilize the portfolio approach. When constructing their portfolios, private equity funds take a very close look at the industries, which have contra-cyclical characteristics, such as factoring, or those which fare well in the economic downturns, such as energy, food and beverages, and natural resources. Furthermore, private equity funds also carefully analyze other industries, which have high barriers to entry, such as healthcare, telecommunications, financial services, and media.

When investing into companies, private equity funds can obtain minority or majority stakes. Through the minority investment model, private equity funds actually enter into a partnership with management teams, which are well-informed about the market, thus having good predispositions for successful business operations in the future. In these cases, private equity funds want to build the partners' credibility through improvements of business operations in the fields of funds' expertise.[3] The advantage of this model lies in the fact that the interests of the majority shareholders and private equity funds are in line, and that they result in the achievement of the mutual business success in the future. On the other hand, private equity funds assume full control over the companies through the majority investment model, and they increase the companies' value by using funds' expertise and contacts. In other words, either with the minority or majority investing, private equity funds invest in companies in order to increase their value with the assistance in the areas critical for the future development, thus making

[2] Based on the procedures of SEAF South Balkan Fund B.V. (2012), Serbia, and Academy Funds (2005), USA.

[3] Based on the procedures of SEAF South Balkan Fund B.V. (2012), Serbia.

profits both for themselves and for other owners of the company (Stefanovic, 2009). The Figure 2 shows the private equity cycle (Academy Funds presentation, 2005).

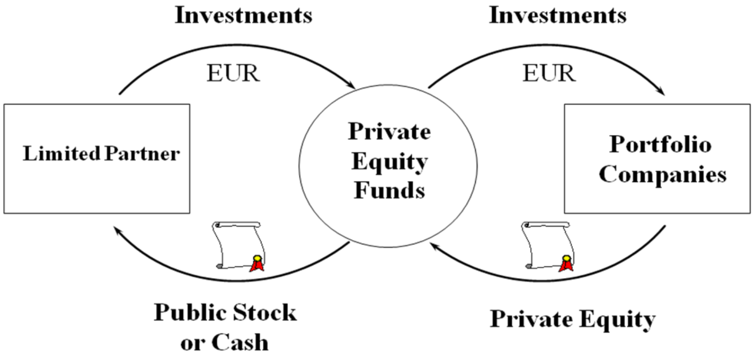

Figure 2. Private Equity Cycle

3. Private equity investing and value-added

Having invested their funds into a company, in exchange for equity, a private equity fund aims at increasing the value of the company it co-owns, thus improving the competitive advantages of the company and strengthening its market position. In order to increase the value of companies for successful sales, private equity funds, among other things, add-value. To accomplish this goal, private equity funds: 1) consider the current state of the corporation and the development potential within the local and regional environmental factors; 2) define, identify, and implement future development trends; 3) implement the necessary development strategies, and 4) monitor the company's development and correct the necessary strategies. In addition, private equity funds improve the organizational structure of the company, i.e. the management organization, organization of the vertical structure (i.e. departmentalisation and the chain of command) as well as the systematization. Private equity funds also help develop the business plan of the company, i.e. define the company's activity, analyse the market and competition, define the product and sales, develop the operational plan, develop the financial plan, and analyze the company's management. Private equity funds also improve the company's marketing, i.e. assist in the market analysis (i.e. trends, market segments, target markets: primary and secondary), competition, services and products, SWOT, goals (i.e. sales-oriented and marketing-oriented), marketing strategy (i.e., positioning, pricing, distribution, communications, promotions, etc.), public relations (PR), action plan and implementation thereof (i.e. budget, schedule, responsibilities). Private equity funds also help in developing strategic plans of the company, and the company's strategic development (i.e. the development of a strategic vision and mission). They help, inter alia, in: converting the strategic vision and mission into measurable goals of the company, developing a strategy to achieve the expected results, implementing efficient and effective strategy defence, conduction performance evaluations, reviewing new documents, and changing strategies in the light of new internal and external events. In order to increase the value, private equity funds also help the companies develop a financial plan, i.e. the future predictions (*pro-forma* financial projections) as well as other necessary financial documents (i.e. quarterly, semi-annual, and annual). In some cases, funds also improve the human resource management, i.e. human resource planning, training and human resource development, the personnel performance evaluation and development of internal human resource books (i.e. laws, benefits, behaviour, etc.) (Stefanovic, 2009). Lastly, private equity funds focus on quality.

3.1 Private Equity Funds and Quality

In order to provide the necessary conditions for private equity funds investing and the efficient use of the invested funds, the companies need to be transformed in the level of ownership, structure, the mode of operations, and the management mechanisms (Stefanovic, 2009). In addition, the successful operations of the company, i.e. their survival and development, require the development of critical factors of operations based on quality, independency, and responsibilities of the management structures (Nelsnon, 2004). This includes the design of business activities on the basis of the given conditions and perceived tendencies to overcome the obvious obstacles to the fast growing markets. Therefore, the impact of private equity funds are spread through the corporate structure of companies, directly targeting several segments thereof, as well as organizational levels and positions such as: management, strategic planning, organization, operational system, transparency, control, and quality[4].

The entry of private equity funds into companies make the issue of quality actual, and it makes room for the improvement thereof, or the introduction of a quality system, international standards governing the quality of products, services, contracting systems, security, storage, delivery, etc. (Goetsch *et al*., 1997). The concept of the total quality management (TQM) includes all corporate levels, business areas, modes of operations and responsibilities. The application of the international ISO standards is in the interest of all the stakeholders, especially buyers who require quality, appropriate appearance, and mental satisfaction. In an arrangement of private equity funds, the standards of information and presentation of certain facts is specifically insisted on by contractual terms and conditions, i.e. content, shape or form, treatment or use. The special attention is paid to financial accounting standards and harmonization thereof with the international requirements and practice. The application of appropriate standards has a polyvalent function: a) it facilitates the communication between the stakeholders; b) it unifies or formats business documents and the contents thereof; and c) it respects the principle of rationality, clarity, obviousness, and importance (Stefanovic *et al*., 2007b).

4. Private equity investing and value-added

Private equity funds achieve total quality through a range of instruments and measures taken from the moment of the adoption of the planning assumptions, to the moment of the evaluation of the system (and the corrections and the improvements thereof). Within the key assumptions of realizing the planned quality, there are various structural elements that determine the manner and the extent of the changes of organizational processes, through their comprehensive redesign, thus making a comparable basis with other companies, actual and potential competitors affecting the production and economic performance, market positions, and other aspects of the business operations (Goetsch *et al*., 1997; SEAF, 2012). The efficient implementation of the overall quality, by private equity funds, depends on several factors, such as the level of quality achieved, the structure of production programme and the product feature, the technical and technological level achieved, the level of competitiveness, the market

[4] Based on the procedures of SEAF South Balkan Fund B.V. (Serbia), 2012, and Academy Funds (USA), 2005.

perfection and benefits, the number of customers, the estimated level of satisfaction, as well as the percentage of customers lost and retained. In addition, the effective implementation, conducted by private equity funds, depends on the level of management satisfaction with the business results achieved, as well as with sales, employment, profit margins, etc. (Stefanovic *et al.*, 2007b).

There are three key elements, i.e. prerequisites for the successful implementation of the total quality, including: strategy-based organization (Stefanović *et al.*, 2007a), focus on costumers, and obsession with quality (Goetsch *et al.*, 1997). The Figure 3 shows private equity funds' business assistance focused on quality (Modified - SEAF South Balkan Fund B.V., 2012):

Figure 3. Private Equity Funds' Business Assistance

4.1 The Concept of the Strategy Focused Organisation

The management, ready to change, in the process of the total quality implementation, should be focused on the area of defining a new vision and mission (Stefanović *et al.*, 2007a), and the conceptualization of the business policy and philosophy, within which it would be able to implement it. These changes often require innovation and the change in the strategic choices, as well as a clear definition of strategic directions for achieving the necessary quality in an efficient and a cost-effective manner. These strategic choices require changes in the so-called hard organizational factors, primarily in the systems, and in the so-called soft organizational factors, in which the old mental matrix is gradually replaced by a new one, without questioning the existing values, efforts, and beliefs, thus constituting the culture based on the values of quality and responsibility arising from the requirements thereof (Goetsch *et al.*, 1997). Finally, the strategic focus on quality implies a reduction of the dysfunctional consequences of the resistance of social factors in the stages of preparation and implementation of total quality. Furthermore, private equity funds and their companies, focused on the implementation of the total quality, have to, on the basis of the SWOT analysis, prepare an adequate strategic plan that relies on a mission, vision, and desired outcomes, as well as the corresponding set of activities to be organized and implemented in accordance with the terms and requirements of the strategic choices. The key role rests in internal companies capacities and management skills to achieve their goals through a successful combination of the production factors (Stefanovic *et al*., 2007b). The strategic plan should contain all the necessary elements vital for the achievement of the planned quality, within the given organizational and technical objectives, which are the prerequisite for implementation, maintenance, and quality improvement.

4.2 Focus on Costumers

The changes in the environment, primarily in the areas of technology, both manufacturing and information oriented, in products, applications and quality, as well as in competition, reinforced by the process of business internationalization etc., impel modern companies to rapidly transform and adapt to new conditions. Over time, companies depart from the production philosophy, from the accumulation of production factors, and from forcing the production volume in order to meet the growing market needs, and orient towards market, customers, and their sophisticated requirements and needs. For such reasons, private equity funds insist that the key role should rest in the quality of products and services given the fact that customers require variety of quality features, as well as fulfilment of relevant aesthetic and status criteria. They believe that the policy of creating and winning-over customers is important, and not just the product design and development. In the modern business environment, quality becomes a tool for: a) maintaining and creating competitive advantage in the market for products and services, and b) achieving values for customers. The customer's sole value is a balance of the potential purchasing benefits and tasks arising when purchasing products or services that meet the needs, as well as the tasks that arise in the stages of using the products and services purchased over time. The level of customer's satisfaction is conditioned by evaluation of the values obtained in the relation to expectations, expressed or hidden. Therefore, private equity funds insist that, under modern circumstances, the companies' priority goal should be to meet the consumers' requirements, given the fact that it is a precondition for their survival and development (Stefanovic *et al*., 2007b).

4.3 Obsession with Quality

Private equity funds believe that the requirements and preferences of customers, both actual and potential ones, influence the selection of products' and services' quality. The functional characteristics of quality, such as quality of service, as well as aesthetic characteristics, such as the design and colour, and the overall impression and the status dimensions are defined by consumers' attitudes and ratings, regardless of the ratio of the rational to, perhaps, irrational attitudes, and the choices thereof. In order to meet the various requirements of individual users, within the expected range and scale, private equity funds insist on constantly improving quality and expanding the offer of variety of qualities, relevant to particular consumer groups or market segments. However, in order to ensure the prevailing attitudes of the staff towards quality, as a requirement of efficient business operations, maintenance or development in the market of products and services, it is essential that private equity funds, and management, make the psychological preparation of social actors, and to create a powerful coalition dedicated to the idea of change, to the new business philosophy on the basis which holds the message all for consumers. A powerful tool in reshaping the organizational atmosphere is a combination of directive and participative actions, and a system of negotiation and persuasion of the resistant forces to participate in the promotion of quality at the meetings, in the media or otherwise. Private equity funds and management actually assess what is more effective in the given circumstances - the pressure, or tactics of seizing the organizational units and levels in which a number of undecided members operates, waiting for a specific outcome or wishing to join the social winners (Stefanovic *et al*., 2007b). Prior to becoming a prevailing value, the key segment of the business policy, the idea of quality, its importance and impact on the fate of the company, goes through the transformation phases: 1) the phase of questioning its validity in comparison with others, 2) the phase of introducing individuals and social groups to the basic idea that change is inevitable and that quality is basis of progress, 3) the phase of identifying the strategic choices, offered by top management, and 4) the phase of accepting the readiness of social factors to participate in quality implementation believing that quality is the right thing at the given moment (Goetsch *et al*., 1997). Private equity funds and management should take advantage of the created atmosphere and, by personal example, enhance and spread enthusiasm and a firm belief that success is inevitable. The table 1 shows private equity fund's portfolio companies on the three key elements for the successful implementation of the total quality:

Table 1. Private Equity Fund's Portfolio Companies and Quality

Company	Strategy-based Organization	Focus on Customers	Obssesion with Quality
Adore Chocolat	Yes	Yes	Yes
ET Servis	Yes	Yes	Yes
Finera Factoring	Yes	Yes	Yes
Gomex	Yes	Yes	Yes
Logo	Yes	Yes	Yes
PC Centar	Yes	Yes	Yes

5. Conclusion

Private equity funds perform many value-added activities for their portfolio companies and place a special emphasis on quality. In order to do that, they focus on the three key elements for the successful implementation of the total quality: strategy-based organization (Stefanović *et al*., 2007a), focus on consumers, and obsession with quality.

Duet the ongoing economic crisis, it is possible that private equity funds will put even a stronger focus on quality. During the five years, companies have been negatively influenced by the economic crisis. First, companies suffered a significant drop in demand for goods and services, which increased their operating risks. Second, companies struggled against limited access to finance, which adversely affected their cash flows. Because of that, as companies continue to face those challenges in the upcoming years, private equity funds and their focus on quality will continue to be important factors in development of companies in this market.

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