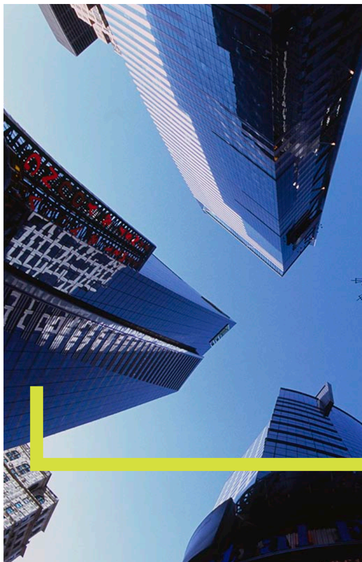

HOW INFORMATION TECHNOLOGY CHANGES IN A PRIVATE EQUITY WORLD

/// VIEWPOINT PAPER

EDS

Introduction

As more corporations move under the ownership of private equity firms, CIOs often fear their technology budgets will fall victim to cost restructuring. Privatization, however, actually helps the information technology (IT) structure within the company. It places enhanced emphasis on technology as a critical resource for growth. Privatization also gives the CIO more control and autonomy, and significantly reduces regulatory requirements. CIOs can use this opportunity to redefine and strengthen their role and gain a seat at the executive table, but it takes careful navigation to capitalize in this brave new world.

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Introduction

As more corporations are acquired by private equity (PE) firms, CIOs may find themselves bracing to prepare for unknown impacts on IT strategy, budgets and in-flight initiatives. Will the new owners bring in their own IT leadership, focus on cost restructuring, or redirect current technology budgets and programs? And how closely will the operating units of the acquiring private equity firm engage with day-to-day IT governance activities?

With a surge in private equity investment over the past two decades, more and more CIOs are learning how to effectively align the strategies, styles and cultures of IT organizations with the management principles that characterize most PE firms. CIOs who successfully prevail are finding that privatization can help transform IT operations. It can accelerate change and drive strategic investments, which in the prior world are often slowed by organizational inertia or other factors. CIOs are using this opportunity to drive effective change, generate top-line revenue growth, redefine internal governance models and achieve new levels of cost-effectiveness.

Surviving in a Private Equity World: A CIO Lens

The market is witnessing a tremendous rise in power and influence of private equity firms, large investment companies or funds that acquire a controlling interest in businesses, usually by purchasing enough stock to becoming a majority shareholder. These firms often restructure the target company's reserve capital, management and organizational infrastructure.

With a nearly 11 percent compound annual growth rate over the past decade, current estimates from the *Private Equity International Journal* have the industry growing to about $300 billion[1] in funds raised annually. With this magnitude of buying power behind the equity firms, even the largest public companies are potential targets. In fact, eight of the top 10 largest deals in the history of private equity were completed in 2006 and 2007, with each investment in the tens of billions of dollars range. (*See illustration in next column.*)

In the immediate term, a significant shift in private equity's market dynamics is changing the focus of many of these firms. Starting with the sub-prime mortgage crisis in August of last year, the cost and availability of credit for private equity deals has significantly tightened. Credit concerns – combined with the intense pressures of a highly competitive industry – have slowed the flow of new deals. This is forcing many firms to shift focus to enhancing the performance of their existing investments. Thus, the role of private equity firms' operating units, chartered with overseeing value creation within the portfolio of investments, now occupies an even more visible role across the industry.

Top Private Equity Deals

2007		
TXU	KKR	$43.8B
Equity Office	Blackstone	$38.9B
Hospital Corp of America	Bain, KKR, Merrill Lynch	$32.7B
Alltel	Texas Pacific Group	$27.9B
Hilton Hotels	Blackstone	$25.8B
Archstone Smith Trust	Tishman Speyers, Lehman Brothers	$20.6B
2006		
Harrah's Entertainment	Apollo, Texas Pacific Group	$27.4B
Clear Channel Communications	Bain Thomas H. Lee	$25.7B
KinderMorgan	Carlyle, Riverstone, Goldman Sachs	$21.6B

Source: Dealogic

For a CIO operating in a target company for private equity acquisition, this market force may appear ominous. Given private equity firms' relentless drive to enhance value of portfolio companies, can the CIO deliver results that align with a new set of expectations? And, for CIOs who remain in public company environments, will the overall bar be elevated, creating still further competitive pressures?

In today's business environment, IT budgets are one of the most substantial components of a company's capital and operating budgets.

Recent CIO Executive Board estimates place average IT spend at approximately 3 percent[2] of a company's revenues, reaching as high as 9 percent for industries such as financial services. Given IT's role as not only a significant consumer of capital and expense, but also as a strategic lever to enable top-line growth, the IT function is squarely in the sights of new owners, who are focused on rapidly assessing effectiveness of current leadership and operations.

Given these market forces, EDS interviewed a cross-section of executives from the private equity world and CIOs in businesses recently acquired by private equity interests to gain perspectives on:

- How private equity views the IT function and how it approaches enhancing the value of its portfolio investments with IT as a strategic lever
- How CIOs and IT leaders have adapted to management principles and styles of the private equity sector
- Key success factors for CIOs working within a private equity structure

The study found that whether the business is established or new or part of a start-up or a Fortune 500 company, there are clear actions and attitudes that distinguish effective CIOs and make them successful in the private equity world.

Managing Due Diligence: The CIO Role

Due diligence is a key milestone in the private equity investment cycle. Typically it sets the tone for future interactions with the current leadership team and for key functions such as IT.

The focus of this effort is to identify and quantify risk factors that will affect the firm's ability to meet the investment's financial goals. IT current-state assessments are usually a key part of this process.

During due diligence and in the early phases post-investment, CIOs must demonstrate alignment to the business with a track record of delivering measurable and successive performance and productivity improvements. Transformation success, strong fiscal management, tight IT controls and solid business acumen are table stakes. They are there to determine if IT and the current leadership team are seen as part of the problem to be fixed – or part of the driver to elevate the game across the business as a whole.

According to Giovanni Vacchi, executive chairman and CEO of Bertram Yacht and of Ferretti Group USA, acquired by a consortium of private equity firms and individual investors, "Our owners and management team view IT as an important service to our business functions. When looking at our past acquisitions, it was very important for the CIOs to validate that their systems effectively support their businesses. By gaining confidence in the acquisitions' technologies, we reduced our risk exposure and ensured that the synergies of the deals would be captured."

In companies where IT is central to delivering products or services, CIOs can expect even closer scrutiny during due diligence. In these companies, private equity firms often deploy a dedicated set of in-house technology experts. Typically managed by the lead private equity firm, a team is sent out in advance of a deal to conduct a comprehensive assessment of the strengths and risks associated with the company's technology assets.

To gain the confidence of the private equity investors, CIOs must demonstrate they have built modern, standardized systems and services for their companies and that they bring effective models for interacting with the business. CIOs also must provide a long-term vision of how future technologies will enhance the competitiveness of the company. In an increasingly global marketplace, how effectively CIOs have implemented global tools and standards, successfully integrated a mix of offshore strategies, and created IT architectures that support – rather than inhibit – growth are all factors in navigating the due diligence process.

> *"By having invested in IT systems, the investors have improved business performance while also preparing the company for any exit strategy, be it public offering or acquisition."*

Trude Van Horn
CIO
Haggar

Private equity leaders such as General Atlantic Partners (GA), a firm founded in 1980 with more than $17 billion in assets under management, view technology as an integral factor in the growth opportunities of their target investments. To best assess opportunities, the firm has created a specialized, on-staff team led by Peter Bloom (former CIO of Salomon Smith Barney) that evaluates IT strategies and plans of portfolio companies and provides the CIOs with expert consulting assistance and oversight.

According to Bill Grabe, managing partner at GA: "IT absolutely plays a role in our investment decisions. In many cases, our team will only invest in a business if the technology is ahead of the curve and stable. Moreover, we view IT as a key growth driver with the potential to be transformative to a company and to industries."

Leaders such as GA use their technology acumen as a strategic advantage by going so far as to offer premiums against competitive offers for a business when they believe there is significant value in the business' underlying technologies. They also avoid getting caught in value traps through early recognition of any technology-related problems that might require significant rework.

For GA, this strategy has paid off with handsome returns. One recent example is an investment the firm made in Archipelago Holdings, the world's largest all-electronic stock exchange. Realizing that Archipelago's trading platform was truly unique and revolutionary in 2003, GA secured a $125 million, 23 percent position. Less than three years later, Archipelago was merged with the New York Stock Exchange for more than $12.5

billion. This made GA a 6 percent owner of the largest global exchange and increased the equity value of their investment more than 6.6 fold.

No longer is the CIO or IT considered an afterthought in the private equity world. CIOs need to be prepared for action when new private equity owners take operational control.

Navigating in a Private Equity World

CIOs also will witness significant changes almost immediately after a private equity deal has been finalized. Private equity investors are relentless in moving their investments toward specific financial targets set over a multiyear period – most importantly the all-important EBITDA financial metric (earnings before interest, taxes, depreciation and amortization). This metric approximates operating cash flow by removing the impact of the most significant noncash expenses from operating profit.

In contrast, public companies typically manage to quarterly earnings, making their focus much shorter term in nature. In fact, a recent survey of more than 400 executives found that 78 percent would give up economic value in exchange for smooth earnings[3]. This short-term focus can delay or disrupt a public company's ability to invest in large, value-creating IT opportunities to avoid a "miss" of analyst expectations.

Private equity's longer-term focus can bring a renewed rigor and speed to a former public company's capital investment strategy. For progressive CIOs, this is a tremendous opportunity to elevate IT's role in shaping the future of the business. CIOs can challenge past delays caused by quarterly budget decisions and push for an acceleration of their strategic plans. As an example, Sabre Holdings CIO, Barry Vandevier, highlighted that when Sabre was taken private by the Texas Pacific Group (TPG) and Silver Lake Partners, the new owners made a stronger commitment to his IT integration strategy. After gaining the confidence of the new owners, Vandevier was able to accelerate his program and thereby achieve business-value targets faster. In this manner, private equity firms can help the CIO cut through entrenched bureaucratic processes and streamline the technology investment decision-making.

As the CIO of Haggar recalls: "I inquired about the IT decision-making process under the new private equity owners, and a private equity investor answered, 'You'll have my number ... Call me ... We'll make the call.'"

As nearly all CIOs will admit, most companies' IT portfolios are not optimized for top-line revenue growth. On average, companies spend 70 percent of the budget on "keep the lights on" investments, the vast majority of which is fixed cost.

Accordingly, CIOs can use this opportunity to reignite the commitment of the business executives to their technology strategies. One common problem CIOs face is gaining adequate business attention in the design and delivery of new technology solutions. Too often these projects are "thrown over the wall" to the CIO. This results in disappointment and diminished confidence in the underlying IT strategy when business benefits are not achieved. In these situations, private equity's activism can be used to the CIO's advantage.

For a CIO of a large financial services institution, this was an opportunity that she welcomed. Working with a dedicated team of operations specialists from the private equity firm, the CIO was able to strengthen the project governance practices at her company. According to her: "the private equity firm not only increased the discipline in our capital investment process, they strengthened the commitment from our business partners to deliver on our projects. High quality business cases for large IT investments were required."

Most companies' IT portfolios are not healthy – on average, companies spend 70 percent of the budget on "keep the lights on" investments, the vast majority of which is fixed cost.

Private equity firms' action-orientation and willingness to take measured risks to achieve high-value returns also can be used to cut through organizational politics and refocus IT's efforts. This was the case for Trude Van Horn, who became CIO of Haggar Clothing Co. after the company was acquired by a consortium of private equity firms in 2005.

Van Horn met with a member of the private equity investment group every three weeks to set a new course for Haggar's technology strategy. Teaming with her private equity investors, Van Horn aligned the IT investment portfolio with the business' strategic plans. The result was an IT budget in which 80 percent of the money spent was focused on new business value, a significant jump from only 20 percent the year prior.

While these benefits sound promising, the flip side to private equity's activism is increased scrutiny and pressures on the CIO. Although private equity firms take a longer-term approach to create value in their investments, they are also very quick to replace underperforming management. To be successful, CIOs must demonstrate several key skills that drive innovation and value creation for their businesses.

Critical Success Factors for CIO in the Private Equity World

Understanding the goals of the private equity owners is critical to navigating in this world. Private equity's IT mission is simple: Release the value constrained in the legacy operations of the acquired company and use technology as a strategic lever to reach their financial goals.

The activism of private equity ownership will require the CIO to deliver on commitments and operate at a rapid pace. CIOs can use this opportunity to redefine and strengthen their role and gain a seat at the executive table. To be successful, a CIO must put the following actions into practice:

- **Reach out early and often:** The first step to success is to establish a direct relationship with the private equity owners early on in the due diligence process. Demonstrating to the potential owners that CIOs can bring vision and leadership to support their plans for business growth will secure a place on the new owner's executive team. Private equity owners want a CIO they can trust. For one CIO at a large financial services institution, she began meeting with her new private equity owners on day one. She took a proactive attitude by "providing them with performance metrics that demonstrated the effectiveness of our team." Being open, honest and direct about IT's performance is essential to building a trusted relationship.
- **Communicate in clear business language:** Being able to translate technology jargon into business lexicon is critical to surviving in the private equity world. As an example, Sue Cho is a principal at The Wicks Group, a mid-market LBO fund with an estimated $900 million of assets focused on media and information management businesses. Cho described how she would reinforce with the CIOs of her portfolio companies the need to translate technical speak into simple business terms – helping convince her team that the investment was accretive to the company. According to Cho: "Sometimes, I will call a CIO back right after the CIO has presented to our investment committee to better understand the business impact of its initiatives. The bottom line is we will not agree to fund the CIO's plans unless we fully understand the risks associated with the investment and believe we will achieve the project's business benefits." CIOs need to build an IT narrative – a simple communication approach discussing IT decisions that impact the business. For example, they could include recent investments, personnel issues/decisions, information security risks/enhancements and IT services performance. It's a huge credibility-building exercise and also simplifies an IT audit.
- **Make portfolio management part of the IT DNA:** Having effective portfolio management and IT governance practices create a critical capability. Translating opportunities into actions, and then actions into results are the name of the game in the private equity world. Leading CIOs have internal portfolio management processes that ensure IT projects are linked to business strategies, and are executed to plan and scope. They also have reporting mechanisms to communicate results in a timely fashion to executives and owners.
- **Change the IT organization's pace:** Even with the best internal IT practices, you will find things need to run at a higher velocity in the private equity world. According to one CIO: "The new owners demanded faster response from IT and superior delivery capabilities. We tweaked our internal processes to include rapid prototyping. This reduced development cycle times and allowed IT to react more quickly to our business' needs." Creating a 30-day rhythm for project and investment reviews can create the pace a CIO needs to keep up in a private equity world.
- **Demonstrate IT's ability to execute effectively:** Nothing builds trust and confidence with the investors and business leadership more effectively than a prior track record of delivering results. Build a strong team, get commitment to the top business priorities, and deliver results on time and on budget. Bhanu Singh, a partner at Bain & Company who works with a number of private equity firms during their due diligence process, explained: "IT must ensure they are running a lean and effective organization, otherwise you lose all credibility." Singh goes on to explain that CIOs would do well to provide efficiency comparisons against outsourcing options they have at their disposal – for example, application development outsourcing and data center outsourcing that demonstrate they are open to, and have researched, opportunities to enhance IT productivity.
- **Be open to oversight and new ideas:** In the early stages of the relationship, a CIO may perceive private equity oversight as micro-management. Keep in mind that there is a relationship and trust-building effort required. More importantly, the investors are simply interested in understanding how IT can generate value for their investment. In many cases, private equity will bring new ideas on how to expedite the implementation of new sourcing options and talent.
- **Master the art of business partnering:** CIOs must develop a strong partnership with their business peers to be successful in the private equity world. The pace of change and decision-making are too fast to require consensus building. A CIO must be smart about how they address business opportunities and understand what incentives will drive the business to be a good IT partner. Make sure each business leader can point to key IT initiatives that are driving value for their teams.

- **Become an effective transformation agent:** A CIO must be ready, willing and able to lead significant changes across the company. With many of the impediments to change being stripped away by the private equity owners, a CIO needs to fill that gap and become a change agent for the company. Focus on high-value opportunities that can be implemented quickly to demonstrate an early success.

Requirements for a CIO's success are not unique to the private equity world. Clearly, such counsel is fundamental to success in any business environment.

Given the increased pressures to deliver value and to operate in an accelerated, results-oriented environment, these smart moves become even more critical. Private equity acquisition changes the game in countless ways. Executives who adapt to the new rules will be most successful.

And looking at the change as an advantage, rather than a challenge, can position CIOs in pivotal roles for their companies'' future, as well as their own. Ultimately, private equity ownership can be an enabler for the best CIOs – and a very short experience for those who can't compete.

About This Viewpoint Paper

Research and analysis for this study was conducted by Mainstay Partners, an independent consulting firm. The findings are based on interviews with private equity executives and CIOs of private-equity-owned business, analysis of private equity industry research, and industry literature.

Mainstay Partners is a leading provider of independent value assessments and IT strategy services. Mainstay's clients include top high-tech companies such as EMC, HP, Dell, Motorola, Honeywell, EDS, Oracle, SAP, Microsoft, Citrix, and BearingPoint. For more information, please visit us at www.mainstaypartners.net

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Sandra Devine

Sandra Devine is a vice president at EDS. She brings more than 25 years' experience in consulting and systems integration, working with companies in financial services, communications, government and other industries to execute effective business and technology transformation programs.

She commissioned this study after seeing this trend emerge through her work with *Fortune* 500 clients.

Notes

1 "Private Equity Going Public: Global Private Equity Report 2006", PriceWaterhouseCoopers, 2007

2 CIO Executive Board's 2006 IT Budget and Spending Survey

3 "The economic implications of corporate financial reporting," J. Graham, C. Harvey, S. Rajgopal, NBER working paper #10550, 1/2005

About EDS

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Contact us

Corporate Headquarters

United States
5400 Legacy Drive
Plano, Texas 75024
USA
1 800 566 9337

Regional Headquarters

Asia
36F, Shanghai Information Tower
211 Century Avenue
Pudong
Shanghai, SHA
China 200120
86 21 2891 2888

Australia & New Zealand
Level 1, The Bond
30 Hickson Road
Millers Point
New South Wales 2000
Australia
612 8965 0500

Canada
33 Yonge Street
Toronto, Ontario
M5E 1G4
Canada
1 416 814 4500
1 800 814 9038
(in Canada only)

Europe, Middle East & Africa
2nd Floor
Lansdowne House
Berkeley Square
London W1J 6ER
44 20 7569 5100

Latin America
Estrada Samuel Aizemberg, 1707
Tower C – 4th Floor
São Bernardo do Campo, SP
Brazil 09851-550
55 11 4399 8875

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