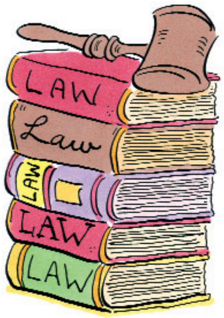

Unlimited partnerships

The combination of private equity and outsourcing is a compelling one, with the potential to transform the performance of portfolio companies, say **Graeme Sloan** and **Alex Hamilton**

Graeme Sloan (top) is a private equity partner and **Alex Hamilton** is an outsourcing partner at Latham & Watkins

The significant impact of outsourcing on the world of private equity is inevitable. The only questions that remain unanswered are how soon will it be felt and how great will it be.

For too many, the concept of outsourcing starts and ends with low-cost regional call centres. This displays the same level of understanding as those who view private equity as simple financial engineering.

Of course, outsourcing can lead to cost savings, but properly used it is a business tool which challenges the strategic thinking of an organisation, releases important resources for wealth-producing opportunities and secures reliable delivery of business functions.

It has already become commonplace at large, sophisticated organisations. Inevitably, these companies are heavily dependent upon IT resources and business processes. Many companies have realised that transferring the responsibility for the delivery of some of these systems to a specialised supplier is preferable to reliance on internal resources. Here, outsourcing is used to add new capabilities as well as freeing up an organisation's resources to focus on what it does best.

For anyone – especially lawyers – to say that something is inevitable is a bold assertion. However, all the available information suggests that outsourcing will play an increasingly important role in private equity transactions.

Perhaps initially the overlap between private equity and outsourcing will be seen during due diligence exercises.

The increasing reach of private equity is widely recognised. Even though the most sophisticated outsourcing arrangements are currently being put in place by large organisations, it is likely that these organisations will at some point become private equity targets. At the same time, as outsourcing becomes more commonly used by smaller organisations, the review of existing outsourcing deals will also feature in mid-market transactions.

Where an investee company has been acquired with arrangements already in place, the continued performance of the supplier will need to be monitored and almost inevitably the private equity house will oversee the renegotiation or replacement of these agreements during the investment period.

The next stage in the development of the relationship between private equity and outsourcing is likely to be more traditional forms of outsourcing being used by investee companies following investment by the private equity house. For example, the business plan for the investee company may envisage the replacement of its IT estate with an outside provider.

In the longer term, there is scope for private equity houses to combine outsourcing projects across a large number of their portfolio companies.

Where the overlap has the potential to become much more exciting is when outsourcing is used to transform an investee company. Where the future development of the investee company is dependent upon adding business capability, contracting out could become an attractive alternative to a buy-and-build programme. Indeed, it may provide more certain business planning since it would remove the risk of not being able to complete the transforming M&A transaction.

> "All the available information suggests that outsourcing will play an increasingly important role in private equity transactions"

Supporting this trend, the outsourcing market has recently been going through a period of rapid evolution, significantly increasing the range and sophistication of the business tools on offer. Three areas are of particular interest to the private equity world.

First is the rise in markets of commoditised IT and business process services, ranging from computer support and telecoms through to financial transaction processing and human resources services.

While diverse in subject matter, all of these areas share the characteristics of well-understood services, which can increasingly be bought on a short-term basis through a market that is driving down costs. With these services, as long as you keep to the standard supplier offerings, it is difficult for in-house departments to compete with the best market offerings in terms of quality and price.

At the other end of the scale, a whole new type of transformational outsourcing deal is available, where the supplier doesn't so much take over management responsibility for a business unit, but instead infuses the unit with new personnel at all levels, who bring new skills and processes. These people are then rewarded, or penalised, based on the performance of the unit as a whole.

This option is particularly attractive to senior management for areas where the unit is not ripe for complete outsourcing, but needs more external help than, for example, consultants, to take it to the next level.

Finally, the outsourcing market has grown up when it comes to negotiating the legal and commercial terms. Although there is still the occasional horror story of long-term fruitless negotiation, there is a broad consensus developing of what is standard on any given topic, allowing the parties and their external advisers to focus on getting the deal fundamentals right and negotiating better deals more quickly.

One of the attractions of working in the private equity area is that it is dynamic, with a willingness to embrace new thinking and methodology if that produces the desired results.

Outsourcing is a kindred spirit in this respect, and the combination of private equity and outsourcing is compelling. The two are new best friends.

KEY POINTS

- Outsourcing has become common at large organisations and is set to play an increasingly important role in private equity transactions.
- Where a company with existing agreements has been purchased, these will need to be reviewed.
- Outsourcing in private equity could evolve from simple provision of services, such as IT, to an increasingly broad range of sophisticated business tools.
- Options include infusing personnel into an existing department, as opposed to a full outsourcing.
- The market is maturing in terms of the negotiation of legal and commercial terms, leading to quicker, more effective results.