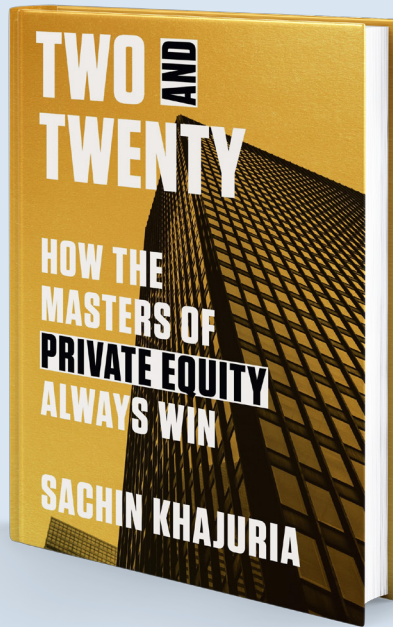


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Two and Twenty

How the Masters of Private Equity Always Win

By Sachin Khajuria

Sachin Khajuria is a former partner at Apollo, one of the world's largest alternative asset management firms, and is also an investor in funds managed by Blackstone and Carlyle, among other investment firms. He has twenty-five years of investment and finance experience. Sachin holds two degrees in economics with honors from the University of Cambridge.

A Book Review by Soundview

Thriving Among The World's Hungriest Dealmakers

In *Two and Twenty: How the Masters of Private Equity Always Win*, author Sachin Khajuria attempts to open the door to this industry that holds the possibility of creating massive wealth for select individuals while helping struggling companies succeed. This is an industry that despite its impact on economic systems is largely misunderstood or not understood by the general public, and with his book, Khajuria hopes to rectify this ignorance and misunderstanding. The private equity business has the potential to provide massive benefits for companies and communities through the businesses private equity firms are able to help and usually save. As with any investing, private equity investments are not foolproof, but Khajuria maintains that through a unique combination of factors, most noticeably the diligence and intelligence of key members of the game, private equity firms very often have high returns and rates of success. Khajuria writes of his intention for his book, "I have worked in this industry for twenty-five years, first as an investment banker and then as an investor at one of the major firms at the partner level. I am hugely supportive of this industry and invest actively in it across the major firms - from my own account. I am your insider, but I am also independent. I'm not interested in spin or corporate talk. I call it like it is."

How It Works

Khajuria initiates his reader into the world of 2008 when the economic systems that so many people relied on were breaking. He refers throughout his book to a private equity firm that he simply calls "the Firm." The Firm's investment community is conducting their weekly meeting as the Founder urges all members to get ready for Europe to fall into financial chaos shortly just like the United States has. This will be the Firm's time to act. Decisions the Firm has to make are difficult, but they are made less risky by the massive amount of information the Firm gleans about the situation concerning potential investments as well as on the massive level of expertise and finesses members at all levels of the Firm embody. Unlike other investors, private equity firms do not merely infuse

money into an entity. Rather, they infuse massive amounts of money and then back up that money by working themselves to improve the entity at hand. It is their job to know the business, so they can successfully make the decisions necessary to make the business more successful and make themselves and their investors massive amounts of money in the process.

As Khajuria states, the intent is to “buy the target, control it, improve it, and sell it for a profit.” Khajuria insists that it is this symbiotic relationship that makes private equity work. When the company makes money, the Firm makes money. The success of both the Firm and the entity is dependent upon each other. He maintains that private equity is essential, in part, because the life spans of people are increasing, and because of this, healthy pension entitlements are necessary for retirees. The same is true for college endowments: growth is necessary to help generations that come after. He sees private equity as necessary for helping these industries raise the money they need, and as such for helping average Americans achieve their financial goals: “And so teachers, firefighters, healthcare workers, and other employees who are part of retirement systems depend on private equity to make the math of their pensions work. They need places like the Firm.”

In general, private equity firms will purchase enough of a company to have either controlling interest or at least considerable influence. Once this is in place, members of the Firm begin acting within the enterprise to increase value in the company. The Firm is not interested in the long term. They look to make improvements necessary in the company in order to increase its value. At that point, they sell off their portion of the company, to the financial benefit of all involved. The endgame is always to sell. This crystallization can take numerous forms. It “can be the sale (partial or full) to a large corporation or another private equity fund, or a listing (or relisting) on the stock market, after which point the private equity fund would ‘sell down’; its stock in an orderly fashion over a period of months.” This is possible because of the Firm’s “deep understanding of both the financial side and the operating side of a situation.” This requires the Firm to have a solid understanding of management as it is management team members that they rely on for the day to day operations. For this reason, the Firm must have a clear understanding of the job management is doing as well as what their goals are for the investment. In short, they do not just invest money. They invest their expertise and business acumen as well.

The Structure of Private Equity

Khajuria goes on to explain the basic pyramid structure of a private equity firm. This pyramid has three levels: “the analytic base, the middle layer, and the senior set, called the partners or managing directors, who are the individuals most directly responsible to investors for the firm’s investment performance and conduct.” Members of the base typically spend about five years on the lowest rung. Khajuria describes the middle rung “as the day-to-day deal quarterbacks.” They manage quality control on those below them whose job is to fully understand “the business model and the finances of an investment.” Those at the middle level are generally promoted from the bottom of the pyramid, and they work closely with both those below

them and above them. Those at the top of the pyramid are “the partners who run the investment activities of their firm. They find deals and lead the execution of these opportunities.” Khajuria describes them as being the elite who “bear the biggest burden for success or failure.” They also benefit the most financially from the firm’s payment structure.

Promotion is not guaranteed by any means: it must be earned and there must be a position open. Firms generally promote more than they rely on lateral hires although this is changing to a slight degree. Of the teams working on deals, Khajuria says, “At every point, the team is obsessed with protecting the investment against capital loss and increasing the company’s value to be in a position to capture more profit on the deal at the exit.” The team’s goal is to win with every investment rather than to back a large number and hope some succeed. The teams are generally both small and tight knit although a member of the Firm could be working on multiple different teams at one time.

Khajuria turns his attention to how firms work. Oftentimes firms have presence around the world and in many different industries. In a fictional firm Khajuria describes, the mission is explained as being one that serves retirement systems while benefiting both the retirees and shareholders. In Khajuria’s opinion, it is a genuine intent. Firms often are decentralized and rely on checks and balances. He describes the fictional Firm as feeling more tight-knit than corporate. Still, power is concentrated. “The magnitude of investment decisions that rest on perhaps a few dozen sets of smart shoulders is immense. As the assets under management grow, the responsibility these individuals have grows too.” While members of the Firm mingle between levels and those at the top are happy to help those who work under them, there is no real equality. Those at the top hold the money. Those at the top have amassed so much wealth that they do not have to work any longer. They are there because they want to be. People at the Firm are loath to waste time, and they prize face to face communication over digital communication. Responsibility is given to those who can handle it, and there is so much work and pressure that wasting time is not really an option. Those at the top of the pyramid hold most of the power over what happens. This helps a few people amass large sums of wealth, and it is those at the top who “have profound influence on increasingly broad swaths of the economy.” These people generally stay out of the limelight. Because private equity firms hold so much influence, it is imperative that they act with ethics and transparency and that they rely on sound judgment.

Traits of Those Successful in Private Equity

Khajuria turns his attention next on the particular characteristics common to private equity team members. Private equity team members invest massive amounts of money into companies, but they also take a sense of ownership over the companies. They make the tough decisions and spend the time researching every aspect of the company in order to turn struggling companies around. These team members compete for a small number of positions that hold massive amounts of responsibility and have



... one of the factors that sets private equity apart from other financial industries is that those in private equity only make money when their investments make money.”

the potential to both create and lose tremendous amounts of wealth. When making tough decisions, Khajuria says, ‘In order to make any kind of move, whether in the form of the requested cash infusion or otherwise, we first have to look the deal in the mirror and report back to the Founder exactly what we see. We look squarely at the blemishes and scars on the investment and ask honestly, what, if anything, still looks good enough to salvage.’”

Khajuria maintains throughout the book that one of the factors that sets private equity apart from other financial industries is that those in private equity only make money when their investments make money. This gives them tremendous incentive to succeed. On top of that, however, they also must be ruthless in their analyses. They have an “iron grip of the owner mentality” because they make their money when they exit the deal and the company is sold. As Khajuria writes, “You eat what you cook. The hardest work often happens after you have closed a deal. This kind of discipline, to accept that you must stick with investments without an easy option to separate, can act as a clear litmus test for commitment and determination.” This sometimes requires years of sacrifice on the part of the team members. He explains that in troubled situations that arise from investments by the Firm, team members do not try to cover up what has happened. They admit to their mistakes, but there are also consequences should a deal not be as lucrative as expected.

Another aspect of private equity is chaos. Khajuria says, “This belief [that chaos can lead to profit] is core for the master of private equity. They Love a mess to analyze, some disruption to decipher, or an economic firefight to bring to heal... They actively seek dislocation.” Because private equity team members put themselves in difficult situations that others will not touch means that they have to be attracted to complexity. While most people seek out quick fixes, private equity team members avoid simple answers because they know that difficult situations can provide the best opportunity for success. Because of this, Khajuria says, “The attraction to complexity is one of the most important mental frameworks and identifiers in private equity.” Still, he insists that private equity team members are not just drawn to complexity because of the possibility of enormous returns. Rather, they view risk differently. Because they do so much work and research to understand the whole system at play within a company, they are able to understand which risks should be taken because they only make decisions that they believe are achievable.

In addition to these above traits, private equity members must be highly competitive. While members of the same organization want their firm to make money, some internal competition between private equity teams can benefit everybody when it prompts team members to work even harder. A will to win is necessary for success. In addition, Khajuria claims that team

members must have some level of desperation. They must be insistent on winning and in creating inroads to new sectors and new ways to make money. While desperation is often seen as a negative, Khajuria describes it as “not just the hunger to succeed but also the primordial need to win.”

What Sets Private Equity Apart

Khajuria states that many people believe that “Private equity investors target vulnerable companies to buy, saddle them with debt, cut costs to the bone, and sell for a quick profit.” The myth goes on to say that any improvements to the business are secondary because all private equity cares about is selling for profit. He maintains that this is not the case. One reason for this is that private equity understands that they cannot sell an investment to others if the company is not in good standing. This does not mean, however, that the exit is not of primary concern. They need “a single-minded focus on the outcome,” and everyone on the private equity team needs to understand just how much money they can make if they sell at the level they want to. This requires the ability to constantly reassess and to pivot when necessary. Large entities generally do not have this ability to pivot with such speed.

Khajuria discusses the industry in the wake of Covid-19 when “certain members of the administration appear to have the private equity industry in their sights.” He describes how the Firm’s Founder had started to receive some negative publicity. As a response, the Firm began to highlight the benefits they accrued for pension funds. The Founder also explains that for the risk involved, the unit of return is better than they can get elsewhere. He is able to win over some of his detractors with his response to the negative publicity. What stands out to Khajuria is the fact that the Founder chose to respond to critics rather than to react to them. He did not skirt responsibility. Rather, he explained the situation and explained how they were going to grow from the lessons learned from it. Khajuria believes this speaks to the imperative of temperament in a private equity professional. Most private equity decisions are made without the influence of emotion, and this is what sets them apart from other areas of business.

In private equity, success is said to be binary. You either win or you do not. Because of this, team members must need to be highly motivated to win, and they must be able to put making money on deals as the highest priority. Khajuria believes that successful deals validate the hard work put in over many years especially as he believes the industry is now pivotal for the success of retirement pensions. Private Equity understands that they carry the huge burden of stewarding other people’s money, and they know they can not rely on excuses when they

fail. They are committed to transparency. Khajuria believes that there is no room for ego in these businesses and that this culture where everybody is intensely invested in the success of deals helps promote a culture of hunger. Negotiation plays a large role in this because team members will always be asking themselves if the current route of a plan is good enough or if it can be improved. This personal investment in the company is what makes private equity different.

The Library

The library is what Khajuria refers to as the massive amount of information and understanding private equity has over many different companies and industries due to the breadth of their investments as well as the massive amount of time and effort they put into understanding the businesses they work with in order to help them turn a profit. Because the information is not always public, private equity firms must at times create silos so as to avoid conflicts of interest. Usually, however, the most senior members of the private equity firms will be above many of these silos and can use this vantage point to determine when these silos should be maintained and when they should not. Khajuria explains that firms follow non-disclosure agreements and shred files when required to do so and do what is necessary to maintain the confidentiality that they are tasked with maintaining. He goes on to say, however, that human beings cannot erase what it is they know about companies and industries. He claims that this gives team members a deep understanding of the macroeconomy, and this can provide a distinct advantage. This library of knowledge and intelligence only gets bigger as the Firm gets bigger and develops even more experience, ultimately giving the Firm even more of an advantage over others.

Throughout his book, Khajuria extols the virtues of the private equity system. He sees the system as being able to combine a work ethic second to none with a driving desire to win and an insistence on massive research and deep understanding of the workings of companies to make money not only for themselves but for others as well. He maintains that pension systems are reliant on the smooth operations of private equity. He also insists that private equity firms are also interested in helping those around them. While private equity firms must make the tough decisions, they insist that what is left is a stronger company. Sachin Khajuria maintains that while private equity firms are committed to making massive amounts of money, they are also interested in bettering the world around them. All of the points mentioned above are fleshed out in his book as he gives examples of fictional and masked organizations and companies that illustrate how these principles are at play in the actual world of private equity. While Khajuria is adamantly committed to the idea that private equity is a benefit to the world, he backs up his statements and propositions with anecdotes and analysis in an attempt to prove the claims he makes about the industry, its benefits to society, and its key players.