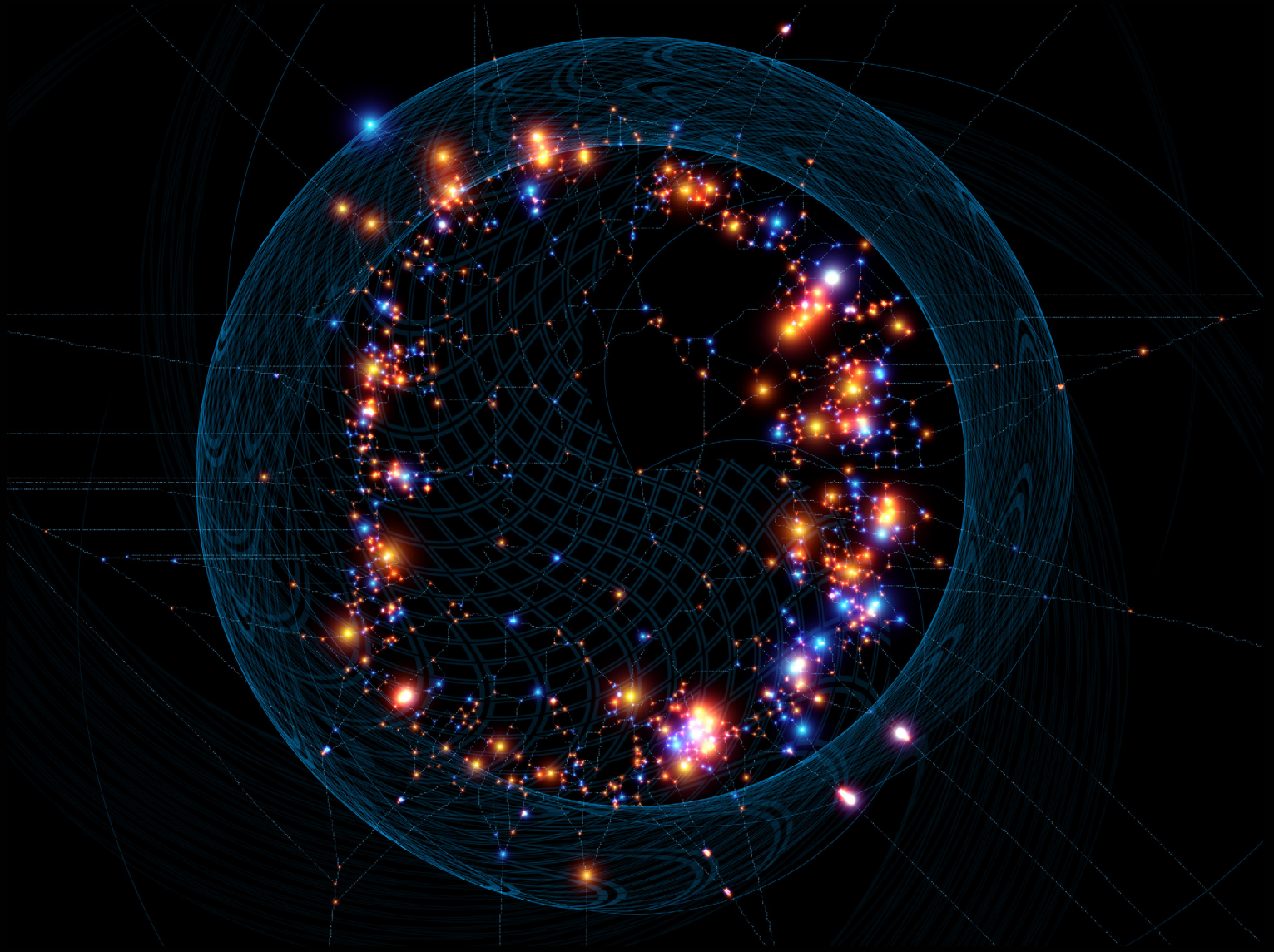


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Private equity:
A new era for
value creation

Private equity: A new era for value creation

As deal structuring and cost-cutting provide fewer opportunities for outperformance, private equity may need a deeper value creation playbook. Financial buyers can tap additional value drivers, which divide into two main categories: *cost transformation driven by structural margin improvements;* and *data-driven growth* informed by cutting-edge analytics.

Introduction: The changing value creation playbook

Private ownership opens a realm of possibilities, allowing for pursuit of business improvements over longer time horizons and out of the glare of a quarterly earnings focus. This advantage has driven profits throughout the more than four decades that the modern private equity (PE) industry has existed. But many of the other characteristics of PE investing that led to strong returns have shifted over time, and the pace of change is accelerating.

With an ever-growing pool of capital chasing the success that PE funds have offered in the past, buyers are bidding up valuations, and underwriting challenges are growing. Return expectations of 25% or more have given way to a reality in which results in the high teens or even mid-teens count as wins.¹ In this environment, PE buyers need more impactful value creation levers if they expect to consistently outperform benchmarks and peers.

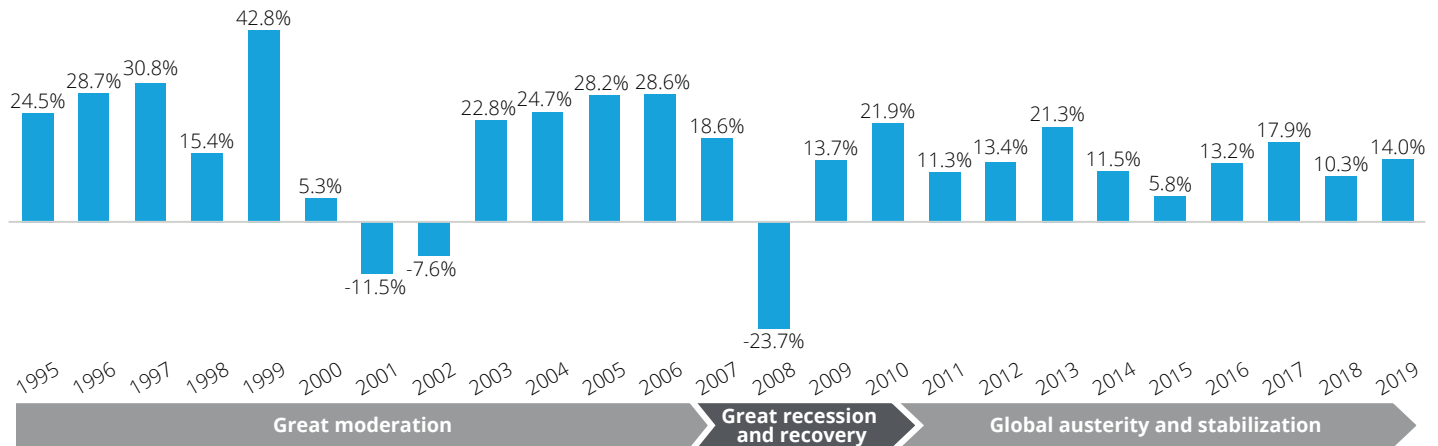
To better understand the challenges that surround PE performance today, it's necessary to tease out returns that stem from the specific structure and timing of a deal versus what comes from value creation opportunities within an acquired business. Managers typically have been focused on growing cash flow and on finding attractive valuations to enter and exit. The ability to make acquisitions with minimal equity financing and significant debt has helped valuation improvements disproportionately accrue to equity investors. Amid a multidecade trend of declining interest rates, a yield-hungry credit market made the leverage possible, with favorable covenant terms.

Returns that come from these sources (rather than deeper value creation) are becoming more difficult to achieve. For this reason, financial buyers need a value creation playbook that extends beyond traditional tactics such as short- or medium-term cost-cutting. In every PE acquisition, the buyer should examine the potential for strategic improvements and, in some instances, pursue more sweeping business transformations. Goals should revolve around unlocking value through revenue growth and margin expansion, not just cost control. The ability to accelerate such value goals is critical, moving from a mindset of stabilization to transformation in the immediate period postclose.

The current global environment has only added urgency to the cause of bringing a strong value creation mindset to every PE transaction. The uncertainty the crisis injects into the business environment complicates efforts to build accurate forecasts and develop effective strategies. Weaker growth challenges the fundamentals that support traditional underwriting assumptions and make it possible to deliver on the deal thesis. What's more, given how business circumstances have suddenly shifted (and will surely shift again in future crises), there is a premium on adaptability and on having every tool available to create resiliency and preserve or unlock value.



Figure 1. PE returns



Source: Cambridge Associates US Private Equity Returns Index

Value creation drivers for PE transactions

At Deloitte, we believe additional value creation levers exist beyond those most commonly employed by PE acquirers. To identify and deploy the most appropriate levers for a given situation, a comprehensive and innovative approach is required. PE buyers should keep a clear focus on developing value creation choices during diligence; refining them during the period between signing and closing a deal; and then prioritizing them for execution postclose.

We see the most effective value creation levers available to PE investors falling into two broad categories:



Cost transformation, which shouldn't be equated with traditional cost-cutting efforts. This transformation should drive deliberate operating decisions that will identify and support lasting cost efficiencies.



Data-driven growth, which rests on the exploitation of newly accessible big data sets and the analytics necessary to understand them and put them to use. Data is key to better decision-making and will help inform strategy development.

The ability of private equity firms to execute on value creation levers, especially those with traditionally longer implementation periods, depends on developing a postclose 100-day plan. We often observe missed opportunities that result from a focus on risk aversion and stabilization rather than offensive value creation moves. By not incorporating value creation opportunities immediately postclose, we believe, portfolio companies often forgo meaningful upside through growth and margin expansion initiatives that require longer execution periods.

Across both of these categories, digital technologies are also going to underpin key value creation methods. Some of these technologies are well established, and others are still emerging. Robotics and intelligent automation are key for some aspects of the cost transformation effort, for example. Cloud computing services can also drive new efficiencies. For data-driven growth, meanwhile, cognitive analytics, machine learning, and artificial intelligence (AI) tools are creating a data-rich environment that allows companies to gain a view into a business in real time that once required months of manual analysis and tracking. These insights are valuable in shaping a more sophisticated revenue growth strategy.

Even as companies around the globe embrace digitalization, however, it has yet to be fully exploited as part of the PE playbook. The time and capital needed for a successful digital transformation sometimes makes this a less popular option among portfolio companies, but recent advances in cloud-based technologies and offerings are allowing for quicker and cheaper transformation initiatives that will count as missed opportunities if not explored. PE organizations, with their operational know-how and their experience with diverse business portfolios, are uniquely positioned to understand a target company, bring in the appropriate technologies, and pull the right cost and growth levers. They have an advantage here that begs to be tapped.

Cost transformation

To try to compensate for an increasingly challenging environment, PE managers have faced pressure to pull known cost levers harder in an attempt to squeeze out greater cash flow. In some cases, this can lead to drastic cuts that damage a business. We have witnessed recent instances in which aggressive cost management affected market share, product development, and competitive positioning. Pushing the limits of traditional cost-cutting may often run counter to the intent of value creation.

By contrast, the goal of cost transformation is to find a better way—to seek out the cost advantages that come from more fundamental changes in how a business operates.

A range of value creation levers is available under the rubric of cost transformation. Which of these to deploy will depend on a company's size, the maturity of its cost modernization, and its appetite for longer-term investment. The results, as a business reimagines the operating structure for cost efficiency, may be seen in the form of optimized spending with vendors, automated processes, shared service centers, and more.

Deloitte has identified five main cost transformation levers that can improve margins with lasting effect and without crippling the longer-term prospects of a business.



Service delivery model. A business can reap big benefits by finding improvement opportunities for support services based on the value they create and their relationship to the business. Low-skill jobs and transactional work can shift from a local support model to shared service centers. Higher-skill jobs, including knowledge transfer and management-involved positions, might move to centers of excellence. This allows portfolio companies to leverage process standardization and enjoy some benefits of scale. PE firms may be able to partner with specific managed services providers to negotiate lower rates for portfolio companies. A streamlined service delivery model can result in 15% to 25% improvements in functional labor costs, based on our experience with clients.

Changes in how services are delivered should be scalable. This can be achieved when the right performance management tools, online training programs, and internal chatbot capabilities are deployed for more routine support tasks.





Organizational design. Reducing overall headcount is a familiar tactic in PE acquisitions, but a more sophisticated approach to workforce changes, built around strategic goals, can create more value. Assessing talent and management structures to optimize supervisory burden and streamline reporting can be an important part of a cost transformation. We have seen clients achieve considerable cost efficiencies from a rethink of their organizational design. The goal is to remove redundant management layers and simplify the chain of command. Decisions should be made regarding placement of leadership within or above business units to align with governance structures and confirm the PE owner maintains a high degree of agility.



Business process optimization and automation. Identifying processes across a company that can be simplified, standardized or automated can figure prominently in a cost transformation.

Automation through the digitalization of operations is an easily accessible and proven alternative today for high-touch and repetitive sales and administrative tasks. The development and investment in automation capabilities often serves as a gateway for other value creation opportunities. For instance, robotic process automation (RPA) can be used for execution of low to moderate complexity rules-based tasks and to provide important organizational experience in leveraging data and technology to create sustainable value. The underlying infrastructure implemented for such projects also acts as a steppingstone for larger analytics and AI-driven projects, which complement human decision making for more complex tasks that are not rules-based.

A recent Deloitte survey indicates that, on average, 20 percent of what employees do today can be replaced by robots and robotic processes.² Intelligent automation has the capacity to reduce business process costs 25 to 40 percent, resulting in attractive project payback periods of less than a year.

Deloitte recently helped a multibillion-dollar PE owner implement an intelligent automation effort at one of its portfolio companies in the industrials sector, reducing operating costs through predictive manufacturing equipment maintenance and manufacturing process improvement. The results of the proof of concept were promising and are expected to result in a 4.6% bottom-line improvement. The PE firm is now proceeding to deploy similar technologies across other portfolio companies in a variety of applications.



Demand management. The level of effort dedicated to support services can often be eased by reducing unnecessary work. To deploy resources efficiently, it will help to quantify the amount of use and the costs of discrete support services across the company. PE managers will sometimes find unnecessary travel for meetings when virtual conferences can achieve the same objective, for example. Or, they may find opportunities for significant savings by moving IT functions to a cloud-based system, shifting spending away from capital intensive assets toward flexible services. Reductions of up to 30% in total cost of ownership can be realized from the adoption of a cloud-based IT model.³

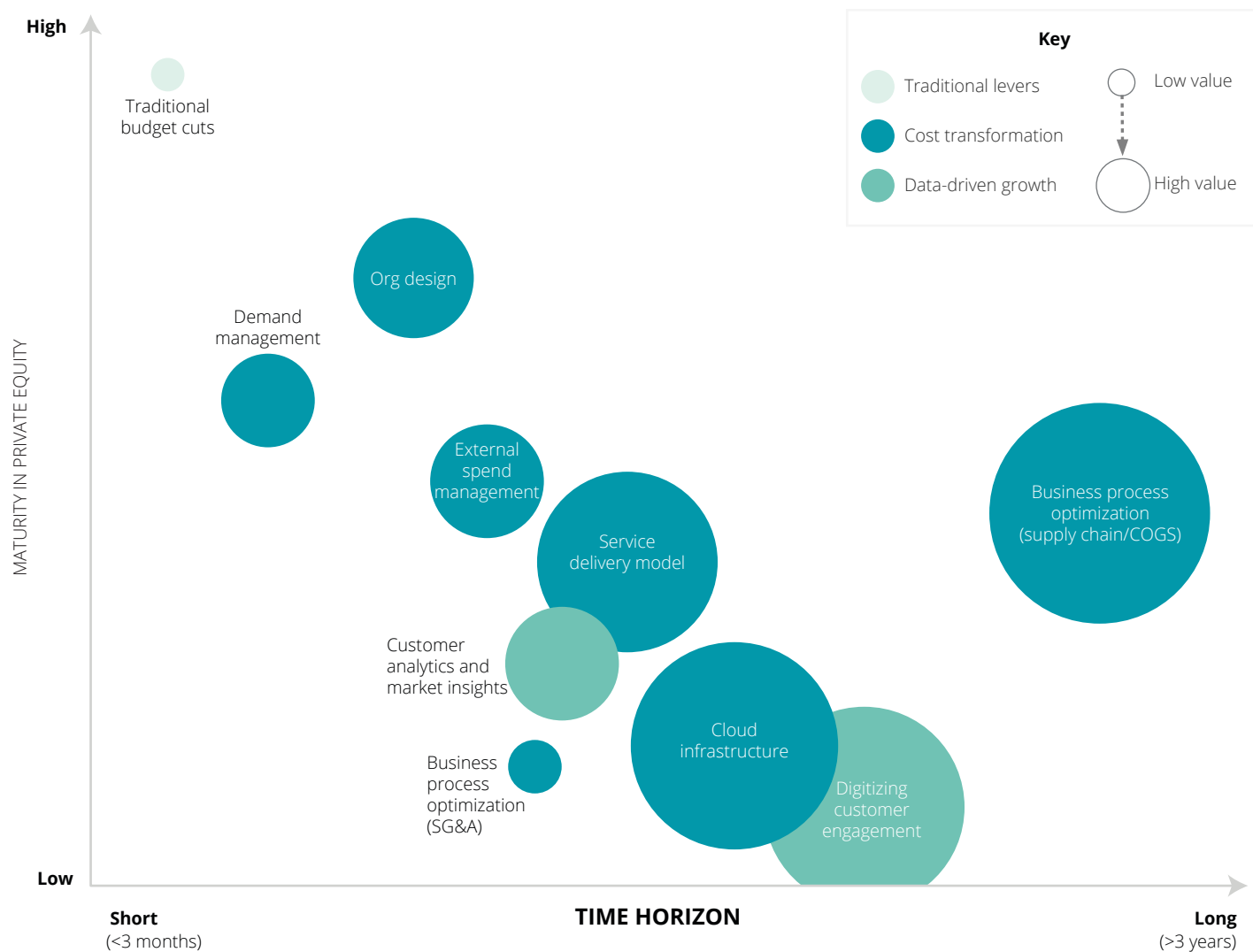
Some operations-focused PE managers have embraced one particular approach to demand management, known as zero-based budgeting (ZBB). The goals are similar to more traditional cost-cutting, but yield more meaningful results over a short time frame of three to five months. Digital ZBB capabilities can even accelerate implementation, providing immediate transparency and insights to create better cost structure flexibility to adapt to periods of business interruption. The deeper understanding of a company's cost structure that ZBB can help reveal can be particularly useful during times of disruption, such as the current crisis period, when it may become necessary to match shrinking revenue with lowered costs. We recently worked with a client to implement such an approach, and the company achieved a 16% reduction in general and administrative expenses.



External spend management. The intent here is to identify opportunities to leverage or reduce spending on purchased goods and services. This lever can redefine what a business needs and take advantage of scale to improve pricing. One method, known as indirect spend rationalization, achieves cost savings through reevaluation of procurement practices, renegotiation of existing contracts, and consolidation of vendors.

The use of cognitive tools supported by data visualization can rapidly uncover vendor fragmentation, offering a pathway to achieve volume discounts. Where there are multiple contracts with the same vendor, a business may benefit by putting pricing and contract terms under a single master agreement. These spending management opportunities may be difficult to identify in isolation, but PE owners are often in the enviable position of being able to drive value through both shared experience and price transparency across portfolio companies.

Figure 2. Value Creation Lever Assessment



Other cost transformation options, aside from these five key levers, will depend on the characteristics of a specific company. A business may invite procurement optimization, footprint rationalization, talent management, or the consolidation of distribution networks and logistics. The cost transformation toolbox is not entirely new. Many measures have been embraced by business leaders over the past two decades, but they still are too often neglected by PE managers.

The implementation of these various cost levers may require different levels of change. Some require a significant strategic or structural transformation; others can be driven by tactical adjustments. Some longer-term cost transformations demand a greater focus on change management and significant investment to uncover value. However, these longer-term projects also tend to have much greater savings opportunities that can help boost value.

Data-driven growth

The value creation methods that we group into the data-driven growth category are about driving sustainable revenue growth by leveraging data-rich environments. Newly accessible data sets and analytic capabilities are vital today for their ability to inform strategic decision-making and for providing novel avenues for customer engagement and acquisition. The capabilities to fully exploit big data allow an organization to be agile and effective in uncovering and monetizing new market opportunities, especially through all-important digital channels.

The amount of real-time data available to businesses continues to proliferate. In some cases, though, investment in more advanced digital technologies is necessary before an organization is able to access and analyze data effectively. A shift to cloud-based IT services, mentioned in the cost transformation section, will also underpin the collection and manipulation of important data sets. The analytic software tools needed for increased use of massive volumes of data are becoming more available and easier to use, boosted by machine learning and AI. Organizations gain advantage by designing systems in which humans, machines, and data are deployed in a coordinated fashion to improve the speed and quality of business decisions.

We see two primary categorizes for PE owners to develop data-driven growth capabilities that can boost revenue and expand addressable market opportunities. They can significantly increase customer lifetime value through *digital customer engagement* and *make better decisions through data-backed market insights*.



Digital customer engagement. Customers now expect a coherent and seamless journey and a level of engagement that is only created in a data rich environment. This trend predated the crisis, but as the spread of the disease foreclosed many in-person interactions, online business became more important.

Digital interactions should no longer start and end with an online sale. Rather, the engagement begins with customer enticement through omnichannel marketing and continues beyond the transaction to online reviews and social influence. Producing an enjoyable and flawless customer journey has become central to customer acquisition and retention. Customers now expect a coherent and seamless journey and a level of engagement that is only created in a data-rich environment.



Data-backed market insights. Data has also become vital to strategic management decisions. By combining

real-time data on customer behaviors and buying decisions with traditional business experience and knowledge, businesses can pinpoint customer segments, refine pricing, and measure market success. For instance, management can now track several real-time data streams to identify market-specific trends and develop advanced pricing capabilities to maximize customer value.

Insights grounded in data allow executives to have a more fact-based and science-backed decision making process. Deloitte recently helped a fintech company with a growth opportunity by analyzing customer data that helped management to uncover customer segments and geographies that had potential for greater penetration. The use of both descriptive and predictive analytics on better defined customer segments also offers opportunities to mitigate against customer churn through optimized marketing campaigns and improved understanding of customer behavior.

A recent pilot program concluded at a large consumer packaged goods company resulted in 2.5% growth through incremental sales, while an existing portfolio company of a large financial sponsor may be expected to realize about 1% in incremental sales through initiatives focused on segmentation and AI-powered pricing optimization.

Data-driven growth capabilities provide promising opportunities. The PE industry can realize compounding benefits, unlocked by the power of data collection across multiple interrelated portfolio businesses. Clustering of customer data allows portfolio companies to better understand customer profile characteristics and develop an intimate understanding of what consumers want. This infusion of data into sales, marketing, and even product development can lead to increased opportunities to penetrate new markets, cross-sell products, and improve the customer experience.

An approach driven by use case, and informed by return on investment, is likely to foster significant growth across various customer and market opportunities. We've seen this in action across several industries, with clients becoming better at predicting customer behavior and finding ways to increase revenue.

Although harder to achieve, incremental sales growth has a large sustainable impact on the value of a company. A \$1 increase in sales translates to a \$3.16 increase in enterprise value, according to one analysis. This implies that any digitalization initiative that can successfully drive growth will have significant impact on exit valuations.

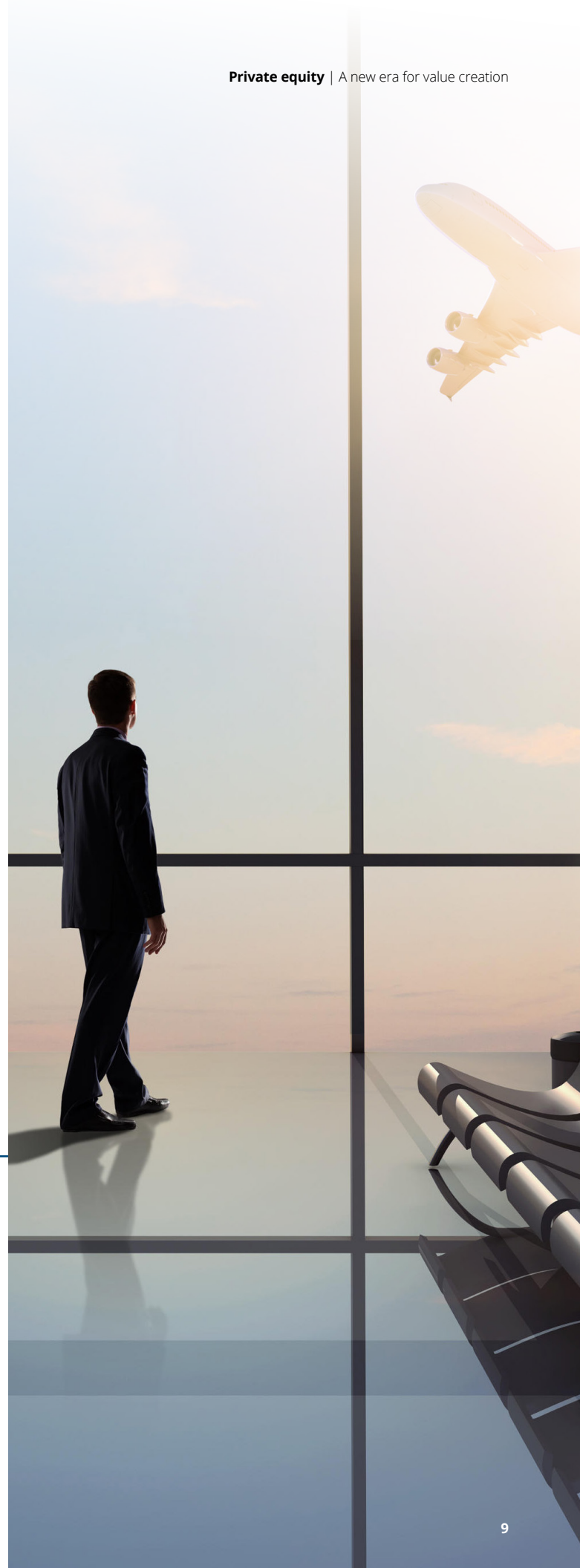
Conclusion: The potential to increase value

In this report, we have sought to define a more sophisticated value creation playbook available today for PE managers. With a greater understanding of the cost structure of a potential acquisition or portfolio business and a more complete embrace of big data (all underpinned by the right digital tools), buyers gain significant potential for building value and boosting returns for investors.

As much as the current global environment has highlighted the need for such measures, which can make portfolio companies more resilient and more likely to thrive in an uncertain and volatile marketplace, the current crisis is only the latest twist. A longer-term trend, which will outlast this crisis and transcend whatever disruption comes next, is driving private investors to find deeper and more reliable tools to create success among the companies they own and operate.

Endnotes

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