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October 2023 • privateequityinternational.com

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KEYNOTE INTERVIEW

Using data to drive value creation in a downturn

Amid a challenging macroeconomic environment, private equity firms can draw important value-creation insights from well-managed data sets, say Glenn Mincey and Richard Chen at KPMG

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Q What dominant themes are you currently seeing in the private equity ecosystem and where is the market headed?

Glenn Mincey: We have certainly witnessed a slowdown in exits, not just over the past 12 months but for at least the past year and a half. Recent data tells us that private equity deal volume fell by 63 percent to $321 billion in 2022, and figures from the first half of this year have largely shown a continuation of that downward trend. We know that the deal market will return, and, while we can't pinpoint that moment, we can say with certainty that every time the market returns, it returns more quickly than anticipated.

Even before the recent macroeconomic headwinds took effect, there was a huge divide between buyer and seller pricing expectations. With the introduction of higher interest rates, increasingly restricted access to capital and a more complicated regulatory regime, that gap is getting even wider. Many funds are approaching maturity and need to distribute capital back to investors, which is putting pressure on sellers.

GPs have been holding on to assets for longer and waiting for valuations to recover, and with those elongated hold periods comes a need to drive more value out of those assets.

Right now, we are waiting for some level of clarity on the economic outlook so that investors can make predictions, build these into their models and start to move forward. Buyers have a significant amount of capital available and plenty of time to deploy it, meaning they can wait for sellers to blink on pricing.

Richard Chen: We believe dealmaking activity will come back sooner rather than later, and likely faster than we expect. It is likely we have hit the bottom of the downturn. Now we need the right triggers to kickstart activity.

People understand that money is no longer cheap. Private equity has historically returned mid-double digits, and the ultra-low accommodative interest rates of the last decade have contributed to roughly a third of returns in this period. Private equity has consistently outperformed the market, and in a high interest rate environment we expect investors to lean further into value creation to maintain that level of performance.

Q How does due diligence play a role in investors shifting their focus to value creation?

GM: This value-creation trend is not something that has just started – it is something we have been observing for some time. It started back when valuations were at historically high levels, when there was an intense need to enhance operational value. We saw then that value-creation processes were being implemented earlier than usual, and that data analysis around that process was being integrated at the due diligence stage of dealmaking.

RC: In the current market environment, it is even more imperative to use data to test value-creation theses and drive these levers earlier on. Over the past few years, operating partners have increasingly been involved in diligence processes and are starting to integrate even more into the deal teams, identifying and testing the key growth and cost levers that underpin a thesis and using that to inform a go/no-go decision.

They can then come in with a level of confidence around four or five key value-creation levers that will impact how the sponsor thinks about that particular asset.

Q In terms of value levers, what imperatives and priorities are you seeing in your work with clients?

RC: It is important to note that all value levers can be applied in different circumstances, but most people choose to start with thinking about costs and synergies. The rapid pace of dealmaking in the last few years meant that it was possible to generate returns without really integrating businesses and addressing synergies. Now, with elongated hold periods and a focus on bolt-ons, the ability to capture those opportunities is critical.

Similarly, the cost levers that have typically gone unaddressed because they were hard work to implement are now coming into focus because they are directly under the control of the management team. Other avenues to growth include understanding your customer base, segmenting the customers, and understanding how you orientate your commercial organisation – be it sales, marketing or services – to address the existing customer base and maximise growth.

The next thing, of course, is using analytics to understand where the new and adjacent markets are projected to grow and how that fits with your existing core offerings so that you can expand your market. The ability to aggregate all the disparate sources of data to gain insights into both the business and the end market is hugely valuable. In the last few years, there has been less of a focus on investing in technology at platform companies, but that is changing. If you are going to hold a business for longer, that is an investment worth making.

Having industry specialists is also particularly important on the growth side. While functional expertise can help in many areas, industry expertise is vital when it comes to growing the customer base, understanding the competitive landscape, and pricing strategy, for example.

Q What do you consider to be the key elements of successful value-creation initiatives?

RC: From day one, it is critical to build conviction when underwriting a deal. That is still the case in a very competitive environment, but it is even more crucial to be sure on what you can underwrite and what you can build conviction around in a downturn, which often starts with understanding cost and synergy capture. You can't cost-cut your way to long-term value creation so you also need to focus on the growth value-creation levers, which includes evaluating the quality of your customer revenues, your routes to market and the adjacent markets you may enter.

When we surveyed operating and deal partners earlier this year, we had assumed there would be a big focus on costs in the value-creation story, but in fact the split was around 50/50 in terms of prioritising cost levers versus growth levers.

GM: The era of using inexpensive capital to benefit from growth solely by bolt-on is waning. When interest rates devour one-third of your anticipated ROI, that means value-creation initiatives become markedly more important.

RC: A key element of successful value creation right now is improving analytics and offering deeper insights.

> *"The ability to aggregate all the disparate sources of data to gain insights is hugely valuable"*
>
> **RICHARD CHEN**

We see the role of technology and data coming into processes earlier and earlier, to support the themes that appear during the due diligence stage. Given there is a greater likelihood of holding an asset for longer in the current market environment, you are unlikely to be buying something, holding it for one or two years and then retrading it to another sponsor. You are going to need sophisticated value-creation plans that you can execute, which means putting maths, sector analytics and data behind that strategy to get more granular on what is actionable from the moment you pencil the deal.

Such an approach also drives an immense amount of credibility with management teams. The auction process in the last few years has been very competitive and every private equity firm talks about partnering with management. Firms that are able to demonstrate they can achieve that goal and adopt a credible and well-developed value-creation strategy will ultimately win out.

GM: The private equity model has always focused on placing people with proven industry expertise, superior management capabilities, and proven track records onto deals. The dealmakers placed on portfolio company boards have often been in high-level executive positions in companies of their own and bring credible sector insights that management teams can trust.

Q What advice would you give to PE deal professionals who may be navigating their first serious set of headwinds?

GM: In the short term, lending conditions favour smaller deals, so we see growth equity having a banner year and more smaller deals getting done.

In the longer term, the more successful private equity firms don't invest in the cycle but, rather, through cycles, so being acutely focused on potential headwinds allows them to invest in the long game. There is at least some stability in monetary conditions right now, so we will likely see liquidity begin to kick in and exit volumes will increase.

Instilling value creation into your thesis early and continuously throughout the deal process will remain key to navigating these challenges, but sponsors are already anticipating that the volume of deals to be explored before elimination will become more intense, and the successful deals in this market will require significantly more elbow grease.

RC: There is a lot of great long-term growth to be captured in this market, and those vintages that are focused on investing now will likely become the winners over time. Some of the models for creating value, which focused on buying an asset for the right price, adding it to a platform and then selling for a bit more down the line, are no longer feasible. Financing levers are not the focus anymore, but there is still huge potential to capture value using levers underpinned by data-driven insights and sector know-how. ■

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> **GLENN MINCEY**

Glenn Mincey is the global and US head of private equity and Richard Chen is a principal and the US private equity lead for strategy at KPMG