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A harder look at value creation by private equity

“Operational value creation goes far beyond slashing costs or implementing a land-grab for revenue growth. A sustainable operating model should be established to execute on the corporate strategy, but without jeopardizing efficiency or flexibility.”

Value creation is a term commonly heard in private equity (PE) houses. How is value obtained and have the PE value levers changed over time? Specifically, what is the role of operational value creation in PE firms, and how important is operational excellence to supporting deal execution and managing portfolio companies?

PE houses have come a long way over the past three decades. The era of high leverage in the 1980s gave way to a period of increased focus on entry and exit timing in order to achieve increased valuation multiples in the 1990s. In the early 2000s, the focus shifted to ride the wave of earnings growth.

However, with austerity hitting many markets in recent years, these traditional PE value levers have become far less effective as the spotlight casts firmly on operational value creation. The general consensus in the industry is that the leverage effect in the 1980s accounted for roughly 50% of value creation for PEs, with less than 20% attributable to operational improvement. This contrasts against recent estimates of the leverage effect accounting for only around 20% of value creation, and operational improvements now as high as 50% of value creation.

As such, many PE firms are evolving the skillsets of their teams and opting to establish inhouse operational specialists, in addition to deal makers and portfolio managers. The extent of a PE firm's operational involvement in the portfolio companies can vary from being a silent partner, active monitor, or owner and operator. In fact, most opt to install entire leadership structures into portfolio companies and implement big-scale performance improvement projects.

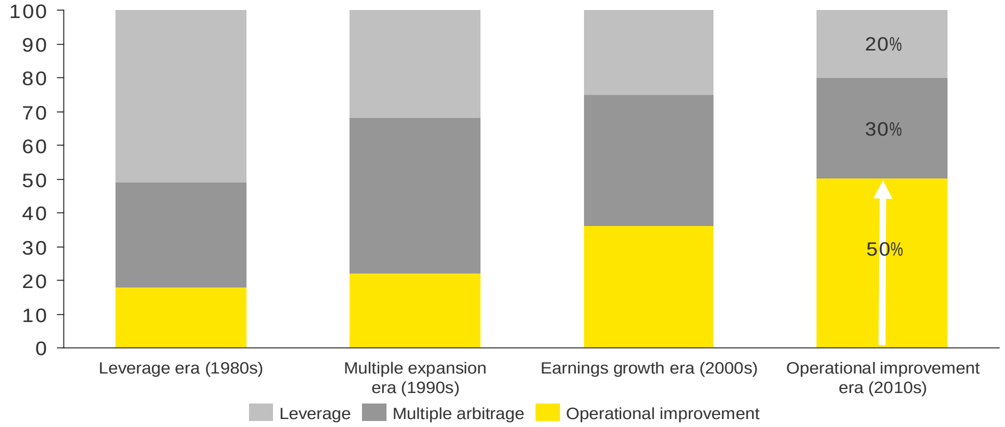
Understanding operational value creation

Operational value creation goes far beyond slashing costs or implementing a land-grab for revenue growth. A sustainable operating model should be established to execute on the corporate strategy, but without jeopardizing efficiency or flexibility.

EY's analysis reveals that approximately half of the operational value created is generally attributable to sales growth, with the remainder coming from margin and free cash flow improvements. When assessing how best to extract value from operations, some typical considerations include:

- Sales growth: Establish an appropriate management reporting framework to expose underperforming components of the business (i.e., products or markets), and complete market studies to develop a route-to-market that will improve price, volume, and product mix.
- Direct cost value creation: Improve the efficiency of manufacturing facilities and enhance asset utilization. This would typically include footprint consolidation, supply chain management, labor productivity assessment, and improving network efficiency.
- Leveraged sourcing: Spend analytics and sourcing solutions to drive cost savings across portfolio companies. Components of this include portfolio spend classification, and spend data analysis to examine variances by segments such as category, supplier, or region.
- Indirect cost value creation: Transform general and administrative functions to drive margin improvement. This may include headcount consolidation, such as increasing span of control, combining roles, reducing layers of management, and increasing usage of low-cost staff; outsourcing; facility rationalization; establishing shared services; customer service productivity improvements; and lean R&D and engineering.
- Information technology value creation: Short- to medium-term implementable solutions to improve performance across all business processes. This may include application rationalization; infrastructure consolidation; cyber security; emerging technology such as digital, advanced analytics, big data; and enterprise intelligence.
- Processes and performance: Design process improvements and operational excellence to sustain competitiveness. Are there processes that could be automated or standardized? Are there activities that are undertaken that are no longer valid or adding value? Are there activities for which the frequency could be reduced?
- Free cash flow: Improve cash flow forecasting and implement tighter working capital management in order to reduce cash requirements and increase future free cash flow.

Estimated contributors of PE value creation since 1980s



Source: EY analysis; Brigl, Herrera, Meerkatt, Liechtenstein, Prats, & Rose, 2008

Approaching operational value creation

There is no single formula for generating an operational advantage, as this depends on multiple factors such as investment strategy, deal size and sector.

However, a PE firm looking to create a sustainable capability in improving the operations of the portfolio companies must include operational representation (via inhouse teams or external consultants) as early as possible in the deal process as set out below:

- Diagnostic: An operational team should provide an operational perspective when assessing a target, typically through strategic and operational due diligence, and may include an opinion on purchase price or the feasibility of a buyout. Generally the deal team will develop a business plan for a potential portfolio company that includes aspects of operational change, and it is critical to involve operational specialists to test the validity of the assumptions in the plan.

- Between signing and closing: Involvement of the operational teams prior to deal close can accelerate the planning and execution of any restructuring program to be implemented after deal close. This is also an opportunity for the PE firm's operational team to work closely with the target to develop a close working relationship, and kick-start the operational improvements.

- Post-close: Initially execute and track towards "quick-win" operational value targets, and establish a foundation for the longer-term transformation projects. Proceeding the quick-wins, the process changes and operational performance improvement projects should be designed and implemented to push the company towards the value targets. Generally a specialized operational team would not be required after a year or two following deal lose, as the operational value targets should be in place by this time.

Avoiding pitfalls

Typical issues in the implementation of an operational value creation program often arise as a result of a few key oversights. Not involving the operational team early in the deal process can result in a disconnect between the deal team and implementation team, and this is more likely to be an issue in the event that the PE firm does not establish a dedicated operational team to support the portfolio company in achieving the value targets.

Additionally, the proposed value creation program should be tested by operational specialists to confirm the validity of the targets, so that the operational change program will not undermine the corporate strategy of the company.

As with any review of a business and operating model, it is important to consider the tax implications. A key issue is sustainability of the model and the tax outcomes, particularly in light of the Organisation for Economic Cooperation and Development (OECD) Base Erosion and Profit Shifting (BEPS) initiative.

While commercial considerations remain paramount, effective tax planning, particularly with regard to transfer pricing and sustainable holding structures can result in lower effective tax rates, giving a boost to after-tax cash flows either for investment, working capital purposes or to support an optimal debt structure.

Increasingly, this involves modeling tax outcomes for groups under a range of different scenarios and holding structures in a due diligence context particularly where significant leverage is involved.

The BEPS initiative is gaining momentum with a number of countries in this region, notably Indonesia, which is adopting various Actions highlighted by the OECD. Different countries will move at their own pace and may not embrace all of the Actions. However, companies restructuring or changing their operating model need to consider the sustainability of such changes across the various tax jurisdictions in which they operate or intend to hold investments through.

No time to lose

Market conditions are accelerating the trend towards operational improvements as the primary source of value creation, and PE firms can no longer afford to overlook operational value creation.

Operational specialists should be included in the deal process as early as possible, with dedicated teams to assist with the implementation of operational value targets. PE firms may consider engaging professional services organizations such as EY, which can help to both assess the value opportunity for a potential deal, and ultimately to manage the process of executing a plan to achieve the value targets.

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