Creating value throughout the private equity investment life cycle in the digital era
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In a fiercely competitive M&A market, private equity firms must seek new approaches in order to generate appropriate returns. While there is much to gain from successful new strategies, a perceived lack of direction can alienate existing or prospective fund investors. It is no longer enough for private equity firms to be the unseen wealthy backers in deals. They need to be involved in the entire portfolio life cycle, ensuring the right skill set, effective collaboration and organizational buy-in at every stage in order to offer competitive bids and justify investor’s demand on IRR.

From the start of the pre-deal target identification and bidding period, which is dominated by the due diligence process, firms are increasingly discovering the benefits of a holistic approach. This approach enables potential buyers to flag risks and to highlight opportunities prior to the signing date. Besides giving a rounded perspective on tax, legal, IT and business aspects, forward-looking due diligence models integrate traditional as well as digital value creation opportunities.

As digital disruption rips through the sector, investment managers are realizing the potential of powerful analytics, self-learning algorithms and other insightful digital tools. Led by the right skill set, especially at the C-suite level, technological innovation has the potential to transform portfolio companies throughout the investment life cycle – from customer-facing innovation in portfolio companies and ecosystem integration to reporting and communication. Collectively, although digital transformation aspects may extend the overall holding time, they deliver real improvements and a higher ultimate deal value.

In most stories, it’s the end that really counts and successful deals are no exception. More than ever, investment managers need to keep their eyes firmly on the exit even before day one of the acquisition. While the mid-phase of the investment cycle has traditionally been the focus of improvement measures, today’s successful private equity firms pursue and monitor aggressive value-creation paths from the outset, synchronizing outcomes for an optimal deal on exit. And they are creating granular exit stories, enriched with proof of concept studies and digital transformation roadmaps to ensure that all of their efforts are reflected in the final deal price.

EY’s study addresses key opportunities, challenges and pitfalls throughout the end-to-end private equity investment life cycle, identifies industry best practices and pinpoints the capabilities that support the efforts of private equity firms to achieve the maximum possible return from their portfolio companies. We hope you enjoy reading our insights.
Dawn of a new era
For decades, the private equity sector has mainly focused on financial engineering to enhance the value of its portfolio companies, an approach that proved perfectly adequate in times when there were plenty of under-valued and attractively priced targets in the market. However, since the peak in leverage levels under the “leveraged buyout” paradigm pursued by the sector in the 1980s, the advance of globalization and the liberalization of the financial services industry have led to intensified competition on global capital markets. Institutional investors in particular have gained significant power and have become extremely active players in the M&A market. As a consequence of the heightened competition for dwindling targets, multiples and thus deal prices have increased massively (see figure 1).

In addition to rising prices, the number of primary deals has declined while the share of secondary offers in the M&A market for private equity buyers has increased from 19% in 2015 to 27% in the first six months of 2018. In the same period, the share of all secondary deals (including non-private equity buyers) even doubled from 4% to 8% (see figure 2).

Figure 1: Development of EBITDA multiples over the last seven years

Figure 2: Secondary buyouts, 2013–2018 HY
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Dawn of a new era

While the secondary deals offer the advantage of a lower investment risk as the previous private equity owner may have already executed value creation initiatives and demonstrated their sustainability, the reduced risk comes at a price. As there may be limited opportunities to drive conventional efficiency improvement, private equity firms have far fewer options to initiate new measures and generate new efficiencies in a secondary or even tertiary situation compared with the acquisition of a standalone mid-market company.

In view of the high prices in the M&A market, the rising number of secondary deals and limited traditional opportunities to create value as well as rapid changes in technology, we believe that it is no longer sufficient to focus solely on financial restructuring or conventional value creation initiatives to lever a company’s value. Consequently, private equity managers are seeking alternative approaches and new creative solutions such as digital innovation in order to generate appropriate returns.

So what are the options available to private equity managers? How could digital innovation be included throughout the investment life cycle in addition to traditional value creation measures? And which initiatives are proving most effective in achieving the overarching aim of driving returns for firms and their investors?

Figure 3 highlights the substantial shift over time in the main drivers of returns relied upon by the private equity business model: from financial engineering based on leverage and multiple arbitrage1 in the 1980s toward a greater relative emphasis on operational improvements (targeting both costs and revenue).

In contrast to strategic corporate investors, private equity firms have fewer opportunities to capture synergies. As a result, they have to focus more keenly on establishing a strong and sustainable operating model that is compatible with the envisaged corporate strategy, without compromising the organization’s efficiency and flexibility. Ultimately, the model has to be competitive in the bidding process, while subsequently creating sufficient value for the fund’s investors.

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1 Adjustments to the business model of portfolio companies aimed at improving the multiples underlying the enterprise value in business valuations in a bid to maximize the deal price.
The industry’s forerunners are consequently adopting an aggressive value-creation approach that addresses the four stages of the investment life cycle (see figure 4):

- Identifying value – the due diligence period, encompassing the transaction strategy and associated due diligence process before striking a deal
- Planning for value – the first 100 days after closing the deal
- Realizing value – the holding period, when most of the operational improvements are implemented
- Maximizing value – the exit period, which focuses on maximizing the sale price

This new “value-based” paradigm requires a systematic process for adopting and integrating the right capabilities and – even more importantly – digital technologies. The present study sheds light on the different approaches being adopted by private equity firms, and identifies the related challenges, pitfalls and industry best practices in different phases of the investment life cycle.

“We face more and more competition on deals both from other private equity houses as well as from strategic buyers, so we have to focus on generating strategic value through growth or efficiency throughout the life cycle of a portfolio company.”

Director of a European mid-cap private equity firm
Identifying value – the due diligence period
Whether private equity firms choose to seek out increasingly rare and expensive targets or grow the share of secondaries in their portfolios, a fast but accurate and comprehensive due diligence process is key to obtaining a much more in-depth evaluation of the potential investment. In interviews conducted in mid-2018, we asked investors what they encountered as the most common causes of delayed or failed deals. Most interview partners confirmed the importance of comprehensive due diligence, and cited last-minute changes in scope as the most common stumbling block in the due diligence process.

Traditionally, buyers have made their investment choices based on a limited scope due diligence assessment of historical financials as well as the tax implications of deals. Today, there is a growing awareness and appreciation of the vital need to expand the scope of due diligence into a forward-looking evaluation of existing and potential value drivers throughout the target company in order to get a holistic and forward-looking view of its full value potential. Such integrated due diligence can span from finance, tax and legal through commercial and operations to IT, value-creation as well as EHS (Environment Health & Safety) and other topics relevant for the respective situation at the target company.

Moreover, our analysis reveals that most of the value generated at the operational level during the holding period is driven by quick EBITDA improvements focusing mainly on cost-saving measures (see figure 5), followed closely by cash flow optimization, support function optimization, as well as digitalization and innovation. The only way to foresee and assess all of the areas with potential value for private equity firms is to conduct an integrated and comprehensive due diligence process. This process supports potential buyers to identify prior to the deal the few topics/levers to focus on rather than conducting a holistic overloaded approach to value creation.
“An integrated approach is the best way to obtain comprehensive due diligence today. It helps to identify all potential risks up front, while uncovering new opportunities as well as saving time and money.”

Director of a European mid-cap private equity firm

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Even in cases where private equity firms initially prefer to conduct only red-flag due diligence focusing on conventional parameters, as the deal’s signing date approaches they often tend to seek a better understanding of value-creation opportunities in order to justify a higher purchase price to their investment committees. Investors often underestimate the additional effort associated with changing the scope of due diligence so close to the signing date. In the end, scope changes can lead to higher costs compared with setting a full scope from the beginning and increase the risk of error due to the time constraints, thus endangering the signing.

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3 Due diligence limited in scope to potential deal breakers (“red flags”) designed to save time and resources.

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Figure 5: Most important value-creation measures at portfolio companies

<table>
<thead>
<tr>
<th>Most important value creation measures on a scale of 1 to 10</th>
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<tbody>
<tr>
<td>Operational cost savings</td>
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<tr>
<td>Cash flow optimization</td>
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<td>Support function optimization</td>
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<tr>
<td>Digitalization and innovation</td>
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<tr>
<td>R&amp;D</td>
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<tr>
<td>Value creation on top-line</td>
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<tr>
<td>Procurement savings</td>
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<td>Channel/sales force effectiveness</td>
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Accommodate risks and opportunities from digital disruption

Private equity firms are increasingly utilizing digital innovation as a creative solution to generate value. Some have already begun to adopt fully integrated due diligence models that extend far beyond the traditional due diligence scope (e.g. financial, tax, legal, commercial and operational aspects) to include digital due diligence. Indeed, forward-looking due diligence models are increasingly integrating digital value-creation opportunities and the potential for digital disruption as key levers to be considered. These new models consider aspects such as the target’s innovation strategy and the potential for disruption in its industry, technological maturity, cyber security and data capital. Such insights help private equity firms identify and resolve key risk exposures and uncover new opportunities, while saving resources and time in the longer run.

It is true that integrating the full plethora of perspectives – spanning operations and IT through to tax and legal – together with digital considerations can be a daunting undertaking. However, we believe that the effort involved in creating a culture of innovative thinking is by far outweighed by the resulting benefits, ranging from a holistic perspective of the transaction to business transparency and a consistent data set to work with during the later stages of the investment cycle.

“In the past, we did not check potential digital value initiatives or associated risks during the due diligence period. However, in the last two years, we have built up capabilities for digital transformations and now we try to factor digitalization measures into the equation as much as possible.”

Director of a large-cap private equity firm
Assemble an effective value-creation team

Another common hindrance that can jeopardize a smooth due diligence process is the involvement of too many different internal and external partners, leading to known and unknown gaps in data as a result of diverging methodologies and stakeholder interests. Private equity firms can mitigate this risk by assembling an effective core value-creation team for the respective acquisition from the outset, and limiting the number of stakeholders and parties involved in the due diligence to the absolute minimum.

This dedicated value-creation team for the transaction, which is ideally led by an experienced manager of the private equity firm who will be assigned to continue managing the portfolio company after its acquisition, needs to have the appropriate skill set and entrepreneurial latitude (as described in chapter 4) to ensure the identification of value-creation opportunities from the very start of the investment cycle.

Special focus topic: Digital transformation as a new value-creation lever

Digitalization is disrupting industries and at the same time serves as a key lever for supporting private equity business cases. It offers optimization potential along the entire value chain, for product/service enhancements and for new business models. However, these value-creation levers follow a non-conventional logic and require new approaches to accommodate the private equity framework conditions such as risk acceptance and time horizons. Furthermore, digital technologies require investments to integrate them into existing infrastructure.

Some private equity firms have started to focus on digital value creation, introducing appropriate fund structures and building value-creation teams. Others are expected to follow suit and establish a dominant focus in this field.

In this study, we present the strategies, opportunities and threats related to digitalization within the value-creation process throughout the investment life cycle.

“To powerfully drive value-creation initiatives and especially transformations, you need an experienced team or partner with very good consultants who take the lead.”

Director of a mid-cap private equity fund
Creating value throughout the private equity investment life cycle in the digital era

Identifying value – the due diligence period
Planning for value – the first 100 days
Empowering entrepreneurship to boost (digital) innovation

Once the deal is closed, the next step is to draw up the future strategy as well as an initial 100 day plan based on the due diligence findings and any additional insights obtained by the clean teams. The execution of the 100-day plan is critical for setting a steady course for a successful investment.

Building on the in-depth analysis and reliable data set obtained in the preceding due diligence and post-signing phase, investment managers are under pressure to move fast with their implementation plans in order to start growing earnings and capturing returns as quickly as possible so they can make the case for a favorably priced exit later.

In sectors marked by fast-pace innovation (i.e. practically all industries today), it is important to allow the senior management of portfolio companies sufficient entrepreneurial latitude and to infuse into portfolio companies the capabilities that are vital to take advantage of unforeseen opportunities and deal with sudden market disruptions that appear during the investment period and might not have been predictable during the due diligence phase. This requires an iterative process that consolidates market analysis, a good understanding of the portfolio company, the vision of the private equity firm and external expertise. The overarching aim is to enable controlled development of the business model and the requisite capabilities.

“"We operate in an industry that has experienced significant digital disruption in the past five years, therefore we need to act quickly and grow our business based on new opportunities. While our general strategy is aligned with that of the private equity owners, my senior management team and I have sufficient freedom to bring this company forward based on the entrepreneurial ideas from our teams.”"

CEO of a private equity-owned building materials company
“We test some business model innovations, pick a successful case and start to implement. Even if the transition is not completed by the exit date, we present a clear case for upside potential that supports our equity story. The approach is similar to the startup model, in that we indicate a clear path to success.”

Executive at a large-cap private equity firm

Yet few private equity firms consider the potential inherent in, and repercussions of, digital disruption in the early stages of the investment cycle. Many are weary of the complexities and risks associated with digital transformations and innovation-based operating models. In this early stage of the investment cycle, it is crucial for private equity firms to collaborate with portfolio management and to set up a high-profile team assembled from across the organization and supported by external experts to drive and support the effort. Such collaborative approaches further empower the portfolio company by establishing the required digital capabilities and knowledge, as well as clear roles and decision-making responsibilities.

Competitive pressure and market opportunities are fueling a perpetual cycle of digital transformation that is sweeping across virtually all sectors. We believe that a focused three-step approach with clear and actionable measures (see chapter 4 for more details) can help private equity firms realize new digital value levers, reduce risk and drive increased returns in portfolios. Our observations across industries and regions clearly indicate that the ability of targets to deal with digital disruption – be it in the form of process automation, business model and customer-facing innovation, or ecosystem integration – is going to become a key criterion that investment managers will need to carefully consider and monitor throughout the investment cycle, as a source of both risk and upside potential for their investments.

One way of mitigating the risk latent in transformative processes is to initiate organic change early on rather than resorting to late efforts to catch up with early adopters and born digital outfits. In this context, well-conceived metrics can serve as an effective means of equipping and honing incentive systems that encourage value creation thinking throughout the organization, a topic we discuss in more detail in the next chapter.
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Planning for value – the first 100 days

Capturing value with fewer but more relevant KPIs

“We used to have our own set of KPIs and initially struggled to accept the ‘private-equity way’ of reporting. We didn’t understand why private equity imposes a different set of KPIs. But after an initial adjustment phase, we quickly saw the value and now have a lean set of company-wide KPIs that help us to better steer the company, besides getting the right input from the private equity owners.”

Controller at a private equity firm’s portfolio company

The progressive shift seen over the years in the way the private equity sector has generated returns – from financial engineering in the 80s and 90s to the industry’s current focus on creating durable value through organizational transformation – requires new methods and means for gauging progress. It is no longer sufficient to monitor the array of legacy financial KPIs that have become unchallenged proxy indicators of operating performance and incentive systems.

Investment managers are finding it more expedient to focus on a small number of highly relevant metrics that are carefully selected for each specific transaction. This approach can pose a challenge for the portfolio company in the beginning as it entails broad restructuring of reporting and governance mechanisms. However, in the long run it allows earlier detection of signs that business performance is deviating from the investment case. Investment managers can thus take appropriate recovery actions without delay and endeavor to ensure the alignment of interests of the key stakeholders: their firm, the portfolio company’s senior management and the future buyer.

In addition, in cases where the portfolio company is owned by several firms under a “club deal” agreement, it is particularly important to have a standardized, lean approach in place with fewer but more relevant KPIs in order to avoid overwhelming the business with multiple reporting requirements.
Integrating smart reporting tools for effective communication

While the importance of having the right management team at the helm is undisputed, empowering it with the right reporting and communication tools to execute successfully is just as important. Some private equity firms prefer a hands-on approach and quickly define and establish official communication channels and protocols, backing them up with advanced reporting tools.

Conversely, leading private equity firms are taking a systematic approach to communication and reporting - and the benefits are undeniable. Unambiguous rules of engagement upfront, pre-defined accountabilities and efficient workflows are not only essential for running the business effectively, they play a pivotal role in organizational transformations. Indeed, industry leaders define rules of engagement and accountabilities even before acquiring a portfolio company.

Regular interaction routines between the private equity firm’s investment manager and the portfolio company’s senior management are also important. In fact, market benchmarking indicates that best-practice firms assign a dedicated investment manager as a first point of contact who regularly interacts and aligns with the management team of portfolio companies, especially during the initial holding period (see chapter 5 for a more detailed discussion).

Aside from defining effective communication channels and protocols, it is also crucial to integrate advanced reporting tools. Purpose-built solutions are reaching previously unimagined levels of sophistication, driven by business analytics and self-learning algorithms. Powerful advances are also evident in the tools and dashboards used to track value-creation initiatives (consider the case of cash flow optimization, for instance). Similarly, digital-based value creation is another domain whose impact hinges on structured processes, clear workflows and timely progress reporting.
Establishing best-practice support functions

Particularly in the case of carve-outs, establishing support functions from scratch or achieving organizational integration in existing infrastructure can pose a major challenge for private equity firms. A common, if temporary, remedy to this problem is to sign a transitional service agreement (TSA)\(^4\) with the seller. That said, TSA-based transitions can be costly, as support functions commonly account for 28% of a company’s running costs (see figure 6) and are usually granted only with an additional surcharge. Also, an increasing number of sellers are refusing to offer TSAs. Moreover, replacing “gold-plate” support structures with best-practice back-office functions affords an important lever for creating value in many transactions.

An alternative approach increasingly gaining in popularity due to its reliability, scalability and cost efficiency is the use of managed services, both in the transitional phase and longer term. By recruiting the support of managed services providers, private equity firms can focus on the core value-creation activities of their portfolio companies and avoid a myriad of operational distractions – among them complex regulation in multiple jurisdictions, global talent mobility, internal audit and risk control, tax reporting and cybersecurity.

However, when considering external services, it is important to keep in mind the varying degrees of difficulty involved in the realization of different models. For instance, while it is a fairly common practice to outsource basic accounting or payroll tasks with proven simple steps for implementation, it is more difficult to shift IT-related functions, especially hardware infrastructure. Therefore, in practice, private equity firms often tend to assign the typically large portion of transactional work to external providers, while keeping more complex and critical activities in-house. Additionally, some assign a small number of staff from each function to managing external suppliers and acting as an interface and point of contact within the organization and externally.

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4 An agreement under which the seller commits to continue providing the portfolio company infrastructure and service support (e.g. accounting, IT, HR services) for a transitional period after the transaction is completed.
Most of the overall value created at portfolio companies is obtained in the medium-term holding period. That is when the value-creation programs launched earlier in the investment cycle have to gain traction and deliver measurable results. In our experience, the propensity for value to be generated in the medium-term holding period hinges on three key factors: building the right skills for value creation, fostering teamwork and collaboration and driving value creation with the support of digital levers.
In order to capture the maximum value from an investment it is essential that the right skill set – including strong operational capabilities and broad experience across sectors – is in place, both at the level of the private equity firm as well as at the portfolio company. Essential skill sets and capabilities can be assembled or built up organically within the private equity firms, or bought in from external advisors. While some leading private equity firms deploy special in-house teams dedicated to the identification and tracking of key value-creation initiatives, others hire industry generalists and functional specialists at the executive level. In-house value-creation teams are often staffed with former consultants alongside highly experienced sector and functional experts (often former C-suite members of a portfolio company). They are tasked with ensuring the rigor and persistence of investment development efforts, enabling flexible restructuring and empowering innovation objectives. All of these tasks require strong operational capabilities at the private equity firms, although the portfolio company’s industry-specific and regional knowledge and experience are just as important.

In practice, many private equity firms use a combination of internal and external capability building. For instance, some private equity firms prefer to recruit external advisors and integrate them into the deal and portfolio team as additional value-creation experts so they can draw on their conventional (i.e. sectoral and operational) and digital expertise. These external advisors are typically equipped with a wide range of skills, tools and methodologies (e.g. agile and cascaded development) that they can easily adapt to the given circumstances. The job of external advisors is to analyze the status quo, design a transformation plan and support the implementation process and the final transfer of knowledge to the portfolio company so it can operate independently afterwards.

“We built up an operational excellence team about five years ago. It consists of former management consultants who drive the day-to-day work with portfolio companies as well as of senior industry experts, mostly former COOs, who bring the relevant expertise required to design and implement operational excellence in our portfolio companies.”

Operational excellence lead at a mid-cap private equity firm
“A CFO is definitely one of the key roles whose performance we monitor closely after the deal. Lack of technical or leadership skills at CFO level is never sustainable and would require an immediate replacement.”

Executive at a large-cap private equity firm

In addition to external advisor support, private equity firms tend to focus on building strong management teams at their portfolio companies, either by incentivizing the former top management to stay with the company and remain focused on performance (e.g. with equity shares) or by replacing the CEO and/or CFO from the start of the ownership commitment. Figure 7 shows that both CEOs and CFOs were very often changed during the last ten years, emphasizing the importance of having the right skills in place, especially at C-level.

Indeed, the CFO of the portfolio company has a key role to play, firstly as a catalyst for value creation, but also in the process of monitoring, managing and incentivizing operational performance. They also have full control over working capital – one of the main levers of deal value. A CFO with the right technical skills, leadership capabilities and entrepreneurial mindset can make a substantial difference with regard to the returns realized by private equity firms when the time comes for divestment.

Recognizing the potential impact of management capacities on the deal price upon exit, leading private equity firms conduct assessments during the pre-deal phase to better understand the leadership capabilities of the portfolio companies. Many complement this pre-deal due diligence with on-going performance reviews during the holding period.
Fostering teaming and collaboration

“It is our responsibility to bring the knowledge to the portfolio company. We have digital value-creation teams in place that we complement with external consultants to outline strategies and drive forward projects. If a company’s management has only limited digital expertise, we are happy to provide the best available experts for support.”

Director at a large-cap private equity firm

Whether they choose to invest in in-house value-creation teams, develop a network of experts or hire external advisors, private equity firms need to build a new kind of partnership in order to improve their capacity to create value at the portfolio company. From start to finish, the buy-out process depends on people, so any miscommunication or teaming mistakes made in the early phases of the deal will invariably impair the potential to create value and reach operational targets during the holding period.

In the past, private equity firms have tended to limit their involvement in portfolio companies to an oversight role, with the occasional attendance at board meetings when absolutely necessary. Many still tend to adopt a top-down approach to control, mapping out the time frame for the actions that the portfolio company’s management has to take, and then monitoring progress from the sidelines, sometimes with the help of specialist or generalist external advisors, leaving the business of implementation to the portfolio company’s management. Yet market observations show that it is not enough to introduce strategic initiatives and value-creation programs and then sit back and wait for the gravy train.

Instead, and as already outlined in chapter 3, a genuine transformation requires both the deal and value-creation teams of the private equity firms to be involved in the deal from the beginning of the pre-deal period and to remain invested through to exit. Both teams need to be perfectly in sync with the target organization’s corporate culture and the behavior of its people so that they can play a significant contributor role. In addition, the target company, for its part, has to have the commitment to innovation and value-orientation deeply embedded within the organization and embraced at all levels. A fruitful approach in order to foster the requisite commitment from the portfolio company’s front-line people is to link value-creation targets to both operational KPIs and incentive systems.

In chapter 3, we also highlighted the importance of establishing appropriate channels to ensure clear, effective and timely communication internally and externally, empowered by advanced reporting tools. Good communication is key to ensuring buy-in throughout the organization for the transformation ahead. Working together, deal teams, value-creation teams and the portfolio management can create a culture in which all three groups feel that they are equal partners and value-adding contributors. That is how organizations can secure a competitive advantage going forward and private equity firms can improve the prospects of a profitable early exit.
Driving value creation with the support of digital levers

“Multiple cost saving potentials are available along the value chain and can be achieved especially by applying big data analysis of machine data, digital simulations and automation. In addition, new targets and new business models will arise along the technology stack to provide these technologies and offer new services.”

Executive at a small cap private equity firm

Even though many private equity firms are still hesitant to proactively drive digital value creation, leading players have already started to focus on three distinct value levers, namely value chain optimization, product and service innovation and business model transformation (see figure 8).
Value chain optimization

Digitalization measures and associated investments can largely be planned along the value chain and offer benefits related to established KPIs such as material and labor cost, equipment efficiency, batch size optimization, quality improvement and efficiency of support processes. New technologies like Industry 4.0 platforms (solving the biggest challenges of interfaces, mass data handling and secure data transfer), readiness kits (providing connectivity for older equipment as well) and production software are on the rise and already available. Initial cases put forward by pioneers provide an indication of the potential that can be achieved (figure 9):

<table>
<thead>
<tr>
<th>KPI</th>
<th>Benchmark potential</th>
<th>Measures implemented in example cases</th>
</tr>
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| Cycle time           | -25–30%             | • Integration/automation of production line ranging from CAM, ERP and MES systems  
• Virtual production planning, simulation and testing with digital twins  
• Better process alignment through automated production planning (MES)  
• Implementation of predictive models and alignment of maintenance cycles to prevent downtime  
• Online monitoring and control of production lines  
• AI-driven supply chain and logistics optimization  
• 3-D printing for spare parts  
• Sensor-based production control and real-time optimization of process parameters |
| OEE                  | +10–20%             |                                                                                                                                                                                                                                     |
| Set-up time          | -25–75%             |                                                                                                                                                                                                                                     |
| On-time-delivery     | +40–60%             |                                                                                                                                                                                                                                     |
| Lot size             | 1                   |                                                                                                                                                                                                                                     |
| Labor cost           | -30–50%             | • Automation through better sensors, smoother production processes through design  
• Replacement of human interfaces through networked production |
| Material cost        | -10–20%             | • Identification of problem areas based on production data analysis  
• Automated material layout  
• Real-time detection of quality deviations and rework or early rejection  
• Data-driven raw material analytics to optimize feedstock costs  
• Human-robot collaboration  
• Employment of smart energy management systems |
| Scrap rate           | -10–50%             |                                                                                                                                                                                                                                     |
| Quality cost         | -10–30%             |                                                                                                                                                                                                                                     |
| Energy cost          | -15%                | • Detection of leakages and demand planning through smart energy management  
• Alignment and automatic regulation of machines (automatic standby) |
| Parts design         | -25–50%             | • Automation of labor-intense 3D design, 2D construction plans and NC programming  
• Introduction of co-creation through online interfaces and configurators |

Sources: EY analysis of past project cases, Platform Industry 4.0, IIC, several online case studies

MES = Manufacturing execution system  
CAD/M = Computer-aided design/manufacturing  
ERP = Enterprise resource planning  
NC = Numerical control

* Depending on industry and initial situation
Digitally enhanced products and services are a must in today’s business world. The key driver for the development of such digital innovation is the customer. Digital products and (additional) services are a basic requirement of customers, both in the B2C and B2B sectors. At the same time, they offer the opportunity to obtain access to completely new customer groups and markets and help to create differentiation momentum by increasing user value and reducing the associated cost of operation, integration, maintenance, etc. By creating a direct touchpoint to the customer via digital channels, digital products and services not only constitute an important sales instrument but also provide companies with in-depth knowledge about their customers.

Digital technologies also offer the potential to change value creation and capture logic to better serve demand. The most prominent digital business models to date are platforms in the B2C space that connect industry participants as an intermediary between demand and supply. Frequently observed business model changes in B2B markets are from producers to service providers, e.g. offering software-as-a-service, or atomizing part of the service or moving from hardware production toward software and service design, or outsourcing part of the processes to digitally well-integrated contract manufacturers, resulting in an asset-light model.
**Case: Klöckner & Co – Value chain optimization**

Klöckner & Co SE is one of the largest independent distributors of steel and metal products and one of the leading steel service center companies worldwide. In 2014, Klöckner started a comprehensive digital transformation of its entire supply chain, driven by its innovation unit. This transformation project included the development and implementation of a contract platform with international rollout, an online shop and several digital services. The goal was to reinvent the supplier and customer processes to become more efficient and effective. In 2017, Klöckner’s digital sales accounted for nearly 20 percent of its total revenue by generating more than 1 billion EUR.

**Case: WASH – Product/service innovation and business model transformation**

Acquired by private equity investor EQT in 2015, WASH Multifamily Laundry Systems operates common-area laundry rooms for a variety of clients, including multifamily housing locations, colleges and universities at more than 65,000 sites. In 2018, WASH partnered with PayRange to provide a mobile payment option to consumers and to serve as a platform to re-imagine the customer journey for having laundry cleaned in WASH laundry rooms throughout Canada and the United States. The mobile payment systems leverage a customer’s smartphone functionality for value-adding convenience. At the same time, the system improves security and eliminates the need for complex hardware in the laundry room as well as costly cash handling.
Maximizing value – the exit period
Creating an early exit story synchronized with value-creation efforts

The last critical step of the private equity investment cycle is the exit. When all is said and done, it is the market that decides the real value of a private equity deal. Regardless of the exit strategy, increasing multiples and rapidly changing technology are posing a challenge for all market players and making it very difficult for the seller and buyer to form a consensus regarding the valuation of the portfolio as well as the potential value-creation measures. So how do industry leaders prepare for exit in order to ensure that their value-creation efforts are properly reflected in the buy-side valuation? We have found that private equity firms can overcome the challenges and secure an optimal valuation through three areas of focus: creating an early exit story synchronized with value-creation efforts, strengthening the selling position with digital initiatives and carefully preparing for the vendor due diligence process.

Given the high prices in the current market, pursuing aggressive value-creation paths from the very beginning of the investment life cycle is critical for justifying deals. To that end, leading private equity firms start all deals with a vision outlining both the exit strategy and timing, and then update their vision to incorporate the value-creation efforts undertaken during the investment life cycle. As a result, the value-creation approach chosen as well as the way in which it is translated into a consistent exit story can make a big difference to the final outcome.

Leading players usually substantiate their proposed approach with a primary proof of concept based on pilot transformation results. They also strengthen their position by conducting a readiness scan, aside from the regular checks against the exit strategy, at least 18 months before the intended exit time. Their aim is to increase confidence among owners in the portfolio company’s value, ensure that investors have full visibility of the anticipated exit, identify potential improvement points, mitigate risks and set up meaningful performance tracking.
Strengthening the selling position with digital initiatives

“We have planning horizons of three to five years and need to be finished by then. We set a clearly defined value-creation agenda. There is little time for experimentation on large digital projects. Business model transformations cannot be completed in that kind of time frame.”

Executive at a large-cap private equity firm

Digital value-creation initiatives follow a different logic to traditional operational optimization measures. Apart from the quantification of benefits, the main challenges concern implementation risks as well as the potentially long time horizon needed in digital optimization efforts and transformations. As a result, it is becoming increasingly important for leading private equity firms to include digital transformation roadmaps in their equity and exit story.

Some private equity firms, however, have developed ways to work around the time frame and mitigate risks by outlining additional incentives for future investors in a post-exit value-creation roadmap that indicates further buy-side strategic and value-creation potential. This approach allows them to show buyers the value they will be able to capture during their holding period.

“Even though the transitions are usually far from finished, we manage to present clear upside potential in support of our equity story. It is the kind of approach you might expect for a startup or venture, but it works out very well.”

Executive at a large-cap private equity firm
Carefully preparing for the vendor due diligence process

The exit should not be a game of chance. Instead, it pays for private equity firms to plan in detail for the final exit and present the business in the best possible light to potential buyers, while maneuvering into a better position to deal with any objections raised by potential buyers during the process. With this in mind, leading private equity firms prefer to conduct vendor due diligence that potential buyers can rely on – in order to shorten the timeline by retaining full control and also maintain the competitive tension by keeping all potential buyers involved throughout the process.

It is also of utmost importance to fully understand the potential buyers’ investment parameters, their needs, their ambitions and their broader context. By the same token, it pays to keep track of changes within the group of possible investors so that the deal tactics and exit story can be adjusted if necessary. Indeed, private equity firms should be prepared to take advantage of rapidly changing market environments and flexibly accommodate opportunistic buyers at short notice. Ultimately, such efforts result in a timely, continually updated and granular vendor due diligence process that is polished for the target audience in order to maximize the exit deal value.

“Targeting as many buyers as possible from the outset, creating bespoke equity stories for each one and refining these throughout the holding period are essential steps. Private equity firms today must customize the vendor package – you can’t rely on broad market appeal.”

Partner at EY, Divestiture Service Leader
Key takeaways

Private equity has long relied on financial engineering in the form of leverage and multiple arbitrage to drive returns on their deals. However, faced with persistently high deal prices, historical peaks in EBITDA multiples and rapid technological changes they are increasingly under pressure to find alternative means of capturing appropriate returns. In response, the industry’s forerunners are adopting an aggressive value-creation approach that focuses more sharply on all four stages of the investment life cycle and are making the most of the potential afforded by digital capabilities and innovation-driven business models.
Key takeaways

STAGE 1: Identifying value – the due diligence period

- **Adopting a fully integrated due diligence model**
  Integrated, multifaceted, holistic due diligence models powered by advanced analytics can identify and resolve key risk exposures and uncover new opportunities before signing the deal, while setting up the database for quick progress if the deal goes ahead.

- **Accommodating risks and opportunities from digital disruption**
  As a new trend, forward-looking due diligence models are also increasingly integrating digital value creation opportunities and the potential for digital disruption as key levers to be considered.

- **Assembling an effective value-creation team**
  The reliance on operational and digital value creation has required private equity firms to assemble a value creation team right from the beginning of the deal and evolve their skill set in order to conduct fully integrated due diligence.

STAGE 2: Planning for value – the first 100 days

- **Empowering entrepreneurship and (digital) innovation**
  To enable innovation at speed, it is important that senior management of portfolio companies are allowed the entrepreneurial latitude and are provided with the capabilities needed to take advantage of unforeseen opportunities and deal with sudden market disruption.

- **Capturing value with fewer but more relevant KPIs**
  Focusing on a small number of highly relevant KPIs helps keep the investment case on track, avoid unnecessary complexity and align the interests of multiple stakeholders.

- **Integrating smart reporting tools for effective communication**
  A systematic approach to communication can be a key determinant of success in the buy-out process and in organizational (digital) transformations.

- **Establishing best-practice support functions**
  Establishing best-practice support functions is an important source of value that can be captured with the help of managed services providers – lowering the cost of transitions and avoiding operational distractions from complex non-core activities, among other benefits.
STAGE 3: Realizing value – the holding period

Building the right skills for value creation
A factor of crucial importance is the skill set in the private equity firm’s deal and value-creation teams, as well as at the portfolio company. Particularly a CFO with the right technical skills, leadership capabilities and entrepreneurial mindset can have a big impact on the final deal price.

Fostering teaming and collaboration
Good teaming throughout the investment life cycle ensures sell-side support to help identify value-creation opportunities, enables the assembly of an effective and streamlined value-creation team, allows regular interaction between them and the portfolio company’s senior management as well as partnering with external experts (particularly in the digital realm).

Driving value creation with the support of digital levers
Leading investors focus on three distinct digital value levers – optimizing the value chain, enhancing products and services innovation and transforming the business model.

STAGE 4: Maximizing value – the exit period

Creating an early exit story synchronized with value creation efforts
Leading private equity firms prepare for exit so that the preceding value creation activities are favorably factored into the buy-side valuation.

Strengthening the selling position with digital initiatives
Forerunners supplement their exit stories with digital transformation roadmaps and a preliminary proof of concept based on pilot transformation results.

Carefully preparing for the vendor due diligence process
The aim is to produce a timely, continually updated and granular vendor due diligence process that is polished for the target audience in order to maximize the exit deal value.
Creating value throughout the private equity investment life cycle in the digital era

Study design

Study scope and methodology

This study combines the results of market research and interviews conducted by the EY Analytics team with executives in the European private equity sector with field experience and observations made in the course of providing professional services to the world’s leading private equity firms and institutional investors.

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