How private equity is unlocking cash from working capital to enable strategic transformations

> PE is shifting toward a longer-term buy-and-build strategy to generate superior cash-on-cash returns, and is increasingly turning to working capital improvement programs for results.

While global markets responded to hostile trade rhetoric and geopolitical uncertainty with varying degrees of volatility last year, PE continued to boom. Strong PE deal activity was driven primarily by a robust investment environment in the Americas, with the region representing 48% and 50% of global deal value and volume, respectively. Overall, PE firms in the region announced acquisitions worth US$229.5b during 2018, up 26% from 2017.

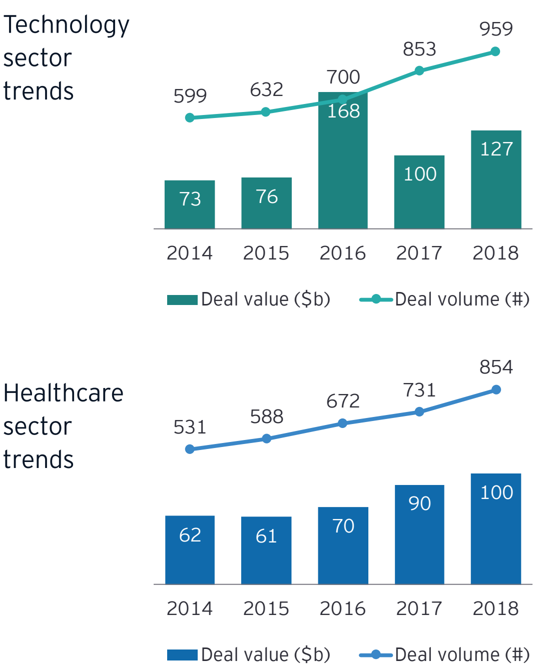
EY research suggests that most companies continue to have enormous opportunities to improve in many areas of working capital (WC). A high-level comparative analysis indicates that the leading 1,500 US and European companies, many PE-backed, may have as much as US$2.5 trillion in excess WC, over and above the level they require to operate their business model efficiently and meet all their operating requirements. This figure is equivalent to nearly 10% of their combined sales. In other words, for every US$1b in sales, the opportunity for WC improvement is, on average, US$100m.

Technology and healthcare are still a focus

Technology has been the infallible sector of PE deal making over the past five years, driving 40% of overall volume and a third of total capital invested by PE firms. With cloud computing and mobile technology markets maturing, sponsors are looking to invest in emerging verticals such as artificial intelligence (AI) and machine learning (ML), robotic process automation (RPA), internet of things (IoT), robotics, drones, blockchain, and virtual reality. A standout area in emerging tech plays has been smart mobility, with $120b invested over the last 24 months. Despite the headlines in emerging technologies, software as a service (SaaS) companies continue to drive the bulk of tech sector deal volume, given the potential for recurring revenue streams to buoy debt-funded buy outs. While the SaaS subscription revenue model provides assurance in earnings predictability, PE firms should be aware of WC hurdles to the delivery cash flow benefits to ultimately fuel the next portfolio investment.

Healthcare is just behind tech, with deal volume and value both growing at a 12%-13% CAGR from 2014-2018, including four megadeals of over $4B. The US healthcare market has outpaced GDP growth for decades, with pharmaceutical companies presenting attractive buy-and-build opportunities for PE funds. New sub-sector business models in behavioral health and healthcare tech are expected to be key focus areas, with a projected growth rate of 14% through 2023. Healthcare investments present sector-specific WC challenges — including insurance, legislative change, and costly product development cycles — warranting a keen focus on cash management.

Figure 1: Deal value and volume trends in hot PE sectors



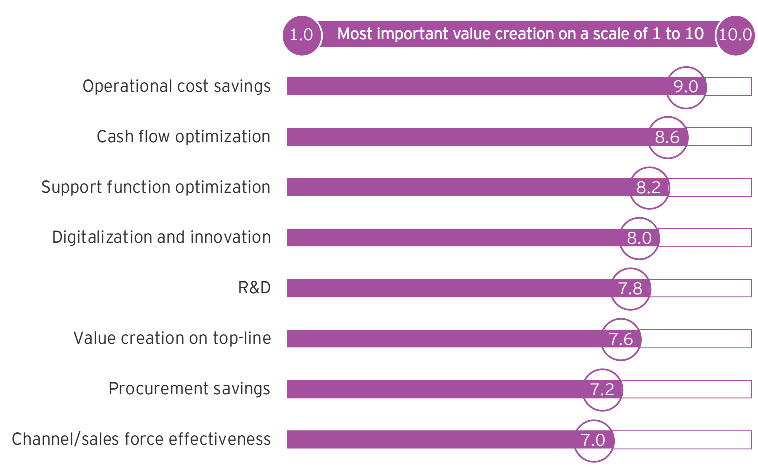
Source: EY analysis

Cash flow is a key value creation driver in PE

Value creation remains a top priority, in view of a competitive deal market and all-time high levels of dry powder. However, the PE value creation strategy has seen a shift over the past two decades — from one of multiple expansion (1990s) and revenue (2000s) to operational improvement (today).

Today, PE firms are prioritizing two key core operational levers: cost reduction to the bottom line and cash flow optimization. In the first 100 days post close, we see revenue and cost being prioritized while working capital improvement is typically targeted between days 100-365. By standardizing processes through a cohesive working capital strategy and cash focus, benefits of balance sheet improvement and G&A optimization are realized.

Figure 2: Which of the following is part of your value creation strategy?



Source: EY analysis

Working capital in the transaction lifecycle

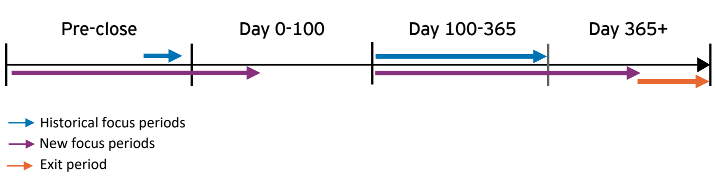
While days 100-365 post close are the typical period for executing working capital improvement initiatives, the cash flow transformations are beginning to be incorporated throughout the entire transaction lifecycle for private equity groups (PEGs) that have an operational focus.

During diligence, the market has matured beyond traditional working capital PEG analysis to incorporate diligence in cash flow risk and upside. From the buy-side, we've seen working capital become a more strategic item in due diligence and after pre-close, into day one planning. While lever execution may not occur until day 100+, an advanced planning process lays the groundwork by functional area and establishes the benefit realization timeline.

From the sell-side, we've seen an increased focus on working capital when determining the investment exit, which allows PE to extract cash while also optimizing operational performance. Implementation typically begins 12-18 months prior to investment exit, with a focus on Account Receivables (AR) and Account Payables (AP), and includes advanced strategies that go beyond typical terms negotiations for customers or suppliers. This allows ample runway to recognize improvement and ensures working capital levels are sustained six months prior to the pre-close process.

As we continue to monitor trends in how PE's prioritize value creation, we will continue to see working capital improvement be a prioritized strategy across portfolios in each stage of the transaction lifecycle.

Figure 3: Working capital improvements in the transaction lifecycle



Source: EY analysis

Working capital levers

As the shift toward leveraging working capital improvement as a value creation lever becomes increasingly more important, we are seeing strategies to drive improvement evolve beyond the negotiation of payment terms and the tracking of standard DPO, DSO and DIO metrics. While these can serve as a measure for working capital health, they fail to explain the underlying inputs of each focus area and leave management with an unfocused improvement approach.

First, from an AR perspective, billing acceleration, optimized collections process, and dispute management are at the forefront. On average, we have seen billing timeliness and dispute management provide AR improvement of 5%-6%, as a percentage of revenue over a 90-180 day period. A cohesive strategy that reduces days in unbilled AR, segments collection activities by historical customer payment profile, and timely dispute resolution, will maximize working capital opportunity while also addressing people, process, and technology deficiencies.

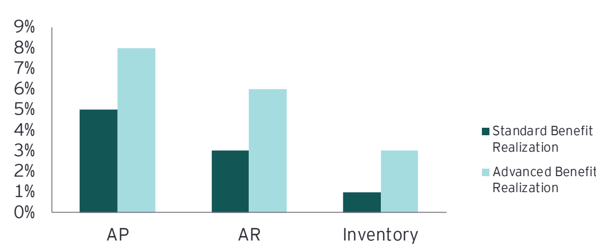
Second, from an AP perspective, vendor terms by category are still a central focus; however, the scope has widened to encompass the adjustment to the accounts payable function policy and processes, including centralization of efforts. We also see supply chain financing, e-payment strategies and other cost take out levers deployed in a consolidated initiative. When leveraging this holistic strategy, we have seen an average improvement of 8%, compared to 5% previously, as a percent of revenue when focusing solely on the extension of vendor payment terms.

Third, inventory levels are traditionally the most difficult working capital lever to pull from a time and cost perspective. Today, we are seeing a shortened benefit horizon relative to target setting of safety and cycle stock inventory using advanced SKU segmentation strategies. This includes strategies that analyze demand or supply variability, lead times, replenishment frequency, and forecast accuracy. Combining inventory optimization strategies along with a framework to burn down excess inventory, we have typically seen inventory reduction between 10-30%.

Lastly, we are seeing the importance of a cash culture become a lever of its own. Through management buy-in and communication of organization objectives, we have seen an unprecedented top-down shift in the prioritization of cash improvement.

By leveraging advanced strategies in each area, we are seeing the time horizon to recognize working capital benefits become shorter and will continue to do so as the market evolves in the competitive landscape.

Figure 4: Benefit realization as a reflection of evolving working capital levers



Source: EY analysis

Timing is critical

As PE continues to evolve and plan for uncertainty in a potential economic downturn in the near to mid-term, speed to value is critical. The shift toward a buy-and-build strategy versus a short-turnaround acquisition strategy is being seen by PE firms as resulting in a focus on sustainable results for portfolio companies. The preferred approach is to generate superior cash-on-cash returns, leveraging liquidity from working capital as a focal lever to meet debt obligations, fund growth, and pursue new value creation initiatives.

No matter the approach taken, current trends suggest private equity firms will continue to dominate the deal market – and so continue to change both the way companies position themselves and, ultimately, how assets are valued.

How EY teams can help

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across processes impacting:
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- Accounts payable
- Inventory
- Non-trade working capital

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