Generating Private Equity Returns in the Face of High Asset Pricing

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The ground is shifting under private equity (PE) firms. Strong fundraising in vintage years combined with slower deal flow has led to PE firms holding onto more and more capital, with few true value-creating opportunities available in developed industries and markets. Combine those facts with ongoing economic uncertainty, the low cost of borrowing, and larger funds increasingly seeking out opportunities in the middle market, and it all adds up to escalating competition and ever higher deal multiples for PE players.

It's not surprising, then, that many traditional private equity approaches have proved unsuccessful in recent years. There are simply not enough genuine growth opportunities available to be able to rely on a combination of a good company and a capable management team to deliver returns for investors, without the need to make fundamental changes to the business.

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Forward-thinking firms are replacing the traditional leveraged buyout approach with new operating models in which the initial investment thesis increasingly relies on a value-creation plan (VCP) to help secure and justify competitive deals at higher prices. With the VCP approach, potential EBITDA growth is front and center, and speed of implementation is increasingly important—ideally within 12 months of acquisition (**Figure 1**).

It's widely accepted in post-merger integration theory that the 100-day plan—the program for the three months after a deal has closed—is most critical to the success of the deal. However, the new thinking is that the preparation in the preclose period and the first 30 days of ownership truly build the path to success. To be able to move so quickly there must be deeper and earlier alignment between management and shareholders than was previously accepted, and the question facing forward-thinking PE leaders is this: how can we use this new approach to set ourselves up for repeatable success?

Experience indicates that defining a clear, structured, and repeatable approach to delivering the VCP on each new deal is now a necessity for any firm looking to deliver top-quartile investment returns. By investing time upfront to create supporting tools and approaches, benefits include maximizing the impact of scarce resources within the PE portfolio team, stronger alignment with management, and delivering more value from the most appropriate external support.

Maintaining Momentum

PE firms employ due diligence to validate the investment thesis and support critical investment decisions. Most deals involve highly competitive auction processes, with limited information and access to management. The due diligence process is expected to deliver a detailed view of a three- to five-year plan, to show revenue and cost- saving opportunities, and to demonstrate the plan's consequent impact on the EBITDA of the business.

Traditionally, the due diligence phase focussed almost entirely on the intellectual exercise of developing a business plan, with only cursory attention given to how improvement initiatives were to be delivered. However, this approach can run out of momentum when management of the portfolio company doesn't adequately define the priorities for year one of the deal or has not been at the center of developing the plan in the first place. In the post-close period, it's common for senior management to think that the hard work is done; they experience a kind of "deal fatigue." It can be very hard to regain the momentum of the deal once management's attention is focussed back on the "day job," so maintaining momentum at this stage is key.

Forward-thinking investors are careful to bring management along on the journey and make sure they are focussed on developing an implementation plan during the due diligence and closing phases to support the delivery of the VCP immediately after the deal closes. Recent experience suggests that it is essential, before the close of the transaction, to articulate and agree upon the operational levers that will truly deliver value creation and also to discuss with management and agree on the year one strategy for doing so. Investors can take advantage of the period between signing and closing to reinforce the importance and urgency of the VCP and to set expectations for the planning, delivery, and monitoring of executed benefits as soon as the deal is concluded.

One way to ensure that momentum is maintained is to engage operational advisors to develop an implementation plan together with management, develop an achievable timetable, and mitigate implementation risks, and also to highlight to investors any concerns over the ability of management to deliver on the plan. This sets the tone for the relationship from the outset and ultimately reassures the PE firm about its investment and provides visibility of progress.

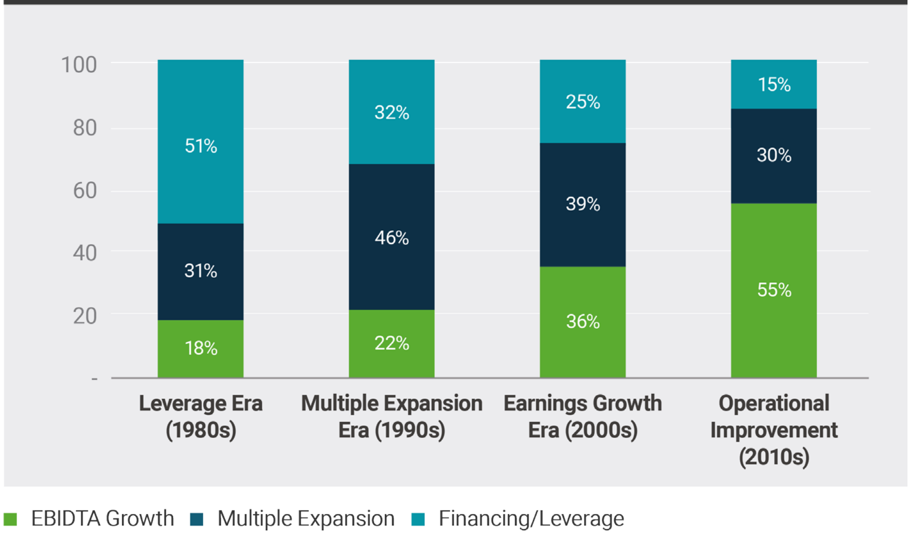
Laying the Foundations of Value Creation

During these early exchanges, it's important for the PE investor to guide management on what is expected from the VCP. Some common sources and enablers of transformation that form the basis of value creation are shown in **Figure 2**. Although not universally applied, the full suite of levers should be discussed to assess how they may fit into the VCP.

Successful VCPs are often targeted toward specific initiatives that have the potential to deliver the greatest benefit. They are also clear about implementation steps, including the sequencing and timing of actions and when those actions are expected to translate into measurable financial improvements in the form of EBITDA and/or cash.

The program should consider each of the key sources and enablers noted in Figure 2 but will not necessarily cover all of them. It is more critical that there is a well-managed transition from identifying levers during due diligence and preclose implementation planning through to execution and monitoring once the deal is done. By the time the

FIGURE 1: PRIVATE EQUITY FIRMS INCREASINGLY UTILIZING VALUE CREATION PLANS



Source: London Business School

deal is completed, the team should have developed a timetable and be setting up an execution management office to drive delivery and reporting.

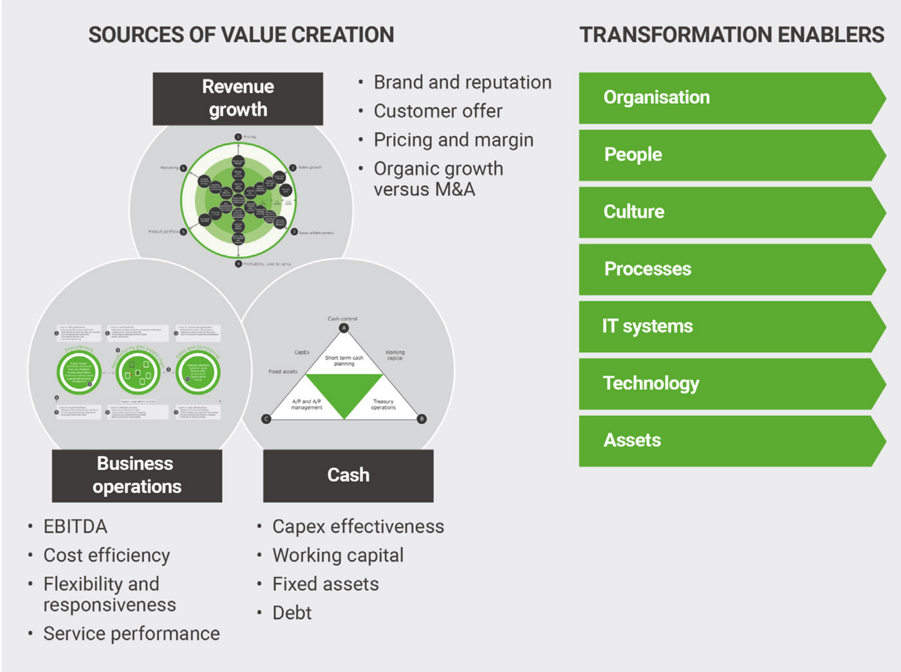
Although these overarching frameworks are well-known to PE portfolio teams, what is more relevant is that the teams pinpoint those actions that can drive momentum and impact in the first 30 days of ownership. One of the most important of those actions is quickly establishing alignment between the investment thesis of the PE investors and the value creation plan owned by the portfolio company's management team.

Rapid Alignment Is Crucial

For obvious reasons, a project that gets put down is often not picked up again. So it's crucial for there to be alignment between PE investors and the portfolio company's management from the very start, with management taking ownership for the delivery of the VCP and the investor supporting the process and monitoring implementation.

The benefits of such alignment are evident in the recent acquisition of a business carved out from a global conglomerate, followed by an add-on acquisition. Although external advisors were not part of the due diligence phase, they were engaged to support the reorganization of the business and improve cash flows post-closure. Quick execution of this process stabilized the business, enabling the advisors and management to focus on the small bolt-on acquisition through the due diligence and integration process.

FIGURE 2: THE KEY ELEMENTS OF A SUSTAINABLE BUSINESS TRANSFORMATION



Source: AlixPartners

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Alignment between management and investors enabled the company to move fast when there was an opportunity to make another transformational acquisition. During this process, advisors worked with management on an integrated three-stage process, with work in each stage building on prior-stage work and reinforcing the alignment among all parties: investor, management, and advisors. The process included:

1 Accelerated due diligence, including an initial draft of the VCP. Working with management to assess the possible synergies, the deal team wrapped up the initial diligence phase in just two days.

2 Supporting the PE owner in developing an investment thesis to gain support for a successful preemptive strike, gaining immediate exclusivity on the asset and short-cutting the due diligence process. The team also performed operational due diligence on the target, enabling the PE firm to accelerate signing.

3 Making best use of the period between signing and closing of the deal. Due to antitrust concerns, a confidential clean room was set up post-signing to facilitate ongoing work on the integration and value creation plans, including: a review of the target's management capability, experience, and fit for the new organization; continued refining of the investment thesis and development of a detailed implementation plan to deliver the VCP; and creation of an organizational design of the new business, including roles, responsibilities, and support for the post-merger integration process.

Using this approach, detailed plans were ready for both parties upon antitrust clearance, which rapidly accelerated the integration. Management was engaged throughout the development of the integration plan, supporting a seamless transition into the integration execution from day one post-closing.

Through a combination of this robust approach to generating the VCP, ongoing management ownership, and the continuing 100-day support to maintain implementation momentum post-deal, delivery of synergies from the deal was accelerated by six months and the company successfully exited its transitional services agreements six months early.

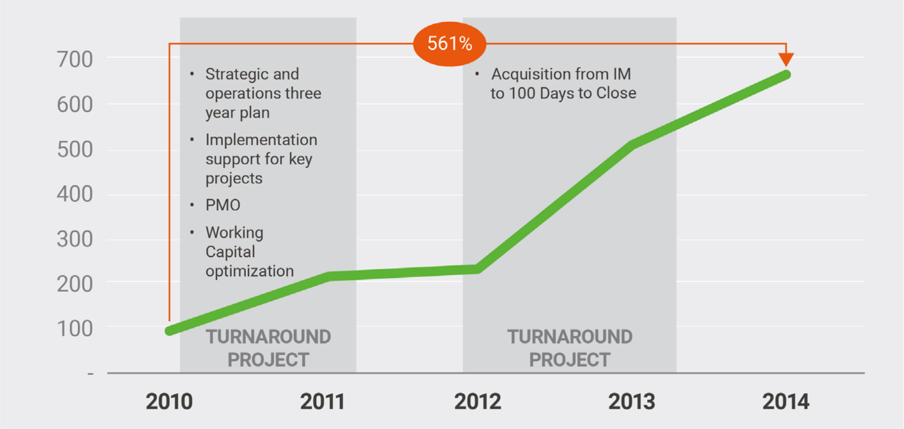
The PE portfolio team referred to it as one of its best-ever deals, which it attributed to the exhaustive work in the planning phase. Post-deal, the business performed very strongly, realizing a 143 percent increase in revenue and 561 percent increase in EBITDA (including acquisition synergies) over a four-year period. In terms of valuation, this translated into a $1.8 billion increase in enterprise value for an investment of about $500 million (**Figure 3**).

Dealing with Implementation Challenges

A structured and detailed plan is irrelevant without effective execution. This invariably requires management buy-in, appropriate resource allocation, and executive sponsorship to overcome the pitfalls associated with the implementation of a transformation or integration plan. However, even with the best preparation, implementation can falter. When this happens, an investor must rapidly diagnose the cause of underperformance and act swiftly to get implementation back on track.

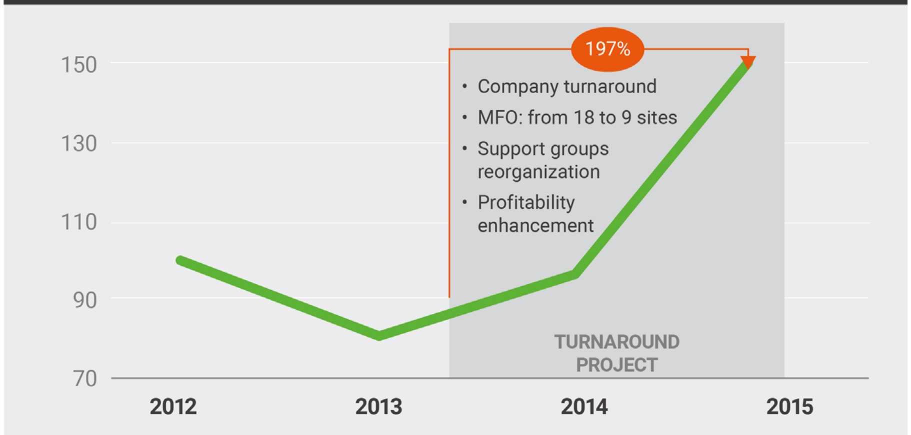
The example of a PE-owned European industrial products company shows what can happen. Multiple acquisitions over a five-year period had resulted in the company growing revenue significantly, but, worryingly, EBITDA had dropped to well below the industry average. By trusting a relatively inexperienced management team to deliver integration benefits, the PE firm lost both visibility of the structural issues in the business and three years' worth of benefits.

FIGURE 3: EBITDA INCREASED BY 561% OVER 4 YEARS



Source: Company information

FIGURE 4: A SUCCESSFUL TURNAROUND DELIVERED AN EBITDA INCREASE OF 197% OVER 2 YEARS



Source: Company information

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The PE firm's response was to make changes to the senior management team and set the tone for a new approach to the company. This was followed by a six-week diagnostic project, which demonstrated that the acquired businesses had never truly been integrated and that a large matrix organization had evolved to act as an interface between the stand-alone units.

Once new management was onboard, the company implemented a retrospective integration and turnaround plan over 12 months. The plan consisted of a review of pricing and go-to-market strategy to identify loss-making product lines; a reorganization of the procurement group and setting major direct and indirect savings targets; simplification of the organization, with major SG&A cost savings; a reduction from 18 manufacturing sites to nine (the overall manufacturing footprint had not been touched following the integration); and evaluation of the executive team and their fit for the future direction of the business.

The program delivered a 197 percent increase in EBITDA in two years, driven by headcount reduction and procurement cost savings (**Figure 4**). However, those gains could have been delivered earlier if there had been an effective onboarding process aligned to the original investment thesis.

Sustainable Business Transformation

These examples demonstrate that alignment between a PE firm and management supports effective execution of integration or a restructuring plan by:

- Validating the investment thesis and due diligence findings
- Successfully onboarding the PE and management teams and managing both sides' expectations for a successful cooperation
- Clearly articulating the year one priorities (revenue growth, business operations, and cash management)
- Identifying the business transformation enablers that can be applied in the medium term
- Evaluating management's capability to deliver on the VCP and where support is required
- Prioritizing implementation of the quickest and highest value improvement opportunities

Defining a clear, structured, repeatable approach to aligning year one with its portfolio companies looks set to become a necessity so that firms can deliver on the value creation plan within their investment thesis.