DELIVERING TRANSFORMATIONAL VALUE CREATION IN PRIVATE EQUITY-SPONSORED COMPANIES

A EUROPEAN PERSPECTIVE

ALVAREZ & MARSAL
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Foreword

In light of soaring company prices driven by a combination of low interest rates, ongoing Covid government support and an overflow of capital chasing few quality assets, private equity sponsors are challenged more than ever to deliver tangible returns to their investors.

Whilst a decade ago value creation programs were expected to last five to seven years, we're seeing more cases in recent years where this period has been shortened to three to five years. This means that private equity firms, management teams at portfolio companies and their advisors need to be working seamlessly together to find ways to drive value creation from the start of closing or even immediately after signing the deal.

One senior private equity operations partner shared that:

"You see a good investment in its first year of ownership when the value creation programs take off. If you run into issues in year one, chances are high that the transformation will run into more challenges down the line."

This is consistent with our survey findings that management teams as well as private equity sponsors and advisors tend to initiate the value creation programs right out of the gates, in a structured but also quick and vigorous way. Engaging portfolio company leadership teams in the transformation journey with a change-focused management program is another critical key success factor that should not be overlooked.

Steffen Kroner

Managing Director, A&M Private Equity Performance Improvement

Introduction

Creating value starting day 1 has been the mantra for private equity (PE) sponsors for the last 30 years. Value creation programs (VCPs) have been pivotal for financial sponsors and portfolio company management teams to generate higher investor returns and positive economic outcomes through growth, with around 80 percent of all deals over the past three decades involving a specific type of value creation strategy[1].

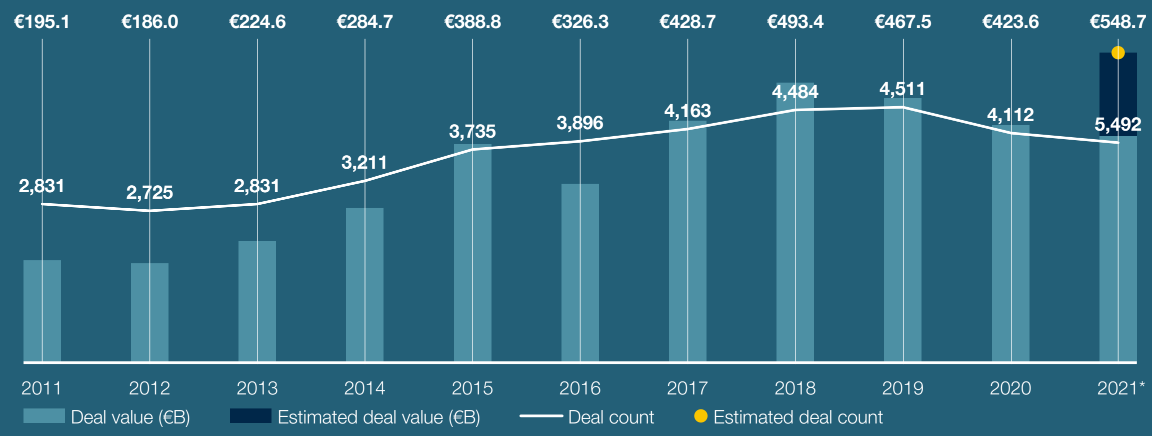
VCPs are typically implemented after the acquisition is completed and involve an enterprise-wide holistic perspective at how the target business can realise its full potential, with a view of maximising returns for private equity investors.

Yet the relevance of transformational programs has never been greater as the private equity model moves away from financial engineering in the face of increasing competition and a frothy valuation environment. European private equity deal making hit a new annual record in 2021, with 5,492 deals worth €548.7 billion being completed in the first three quarters of this year, according to PitchBook data. At the same time, strong competition for assets has catapulted M&A valuations to all-time highs as strategic and private equity buyers compete over companies.

Value creation plans are introduced by private equity sponsors to improve all aspects of operational performance of portfolio companies. They focus on initiatives such as sales growth, productivity improvements in operations, strategic changes or brand/product repositioning and add on acquisitions, as well as cost reduction among others.

SOURCE
PitchBook | Geography: Europe *As of September 30, 2021

Private equity deal activity



[1] Impact Brief. Private equity and value creation. Produced by the Office of the Chief Economist, EBRD. December 2019

What Factors Are Critical to Driving a Successful Transformation?

Crucially, private equity sponsors and management teams of their portfolio companies need to boost growth and profitability while navigating the rapid changes in consumer behaviour and disruption to business models triggered by the Covid-19 pandemic.

The "buy and transform" approach delivered through VCPs allows private equity sponsors to move faster and achieve strategic growth at pace. However, embarking on this value creation journey is a challenging task. Decisions around when to launch a transformation program, how to engage and align management teams with the VCP's objectives and when to bring in external consulting partners, are critical to a successful transformation.

To shed light on these and other challenges faced by private equity leaders and portfolio company CEOs when planning and executing such plans, Alvarez & Marsal (A&M) and research firm Statista Q conducted this survey, which is based on interviews with 65 executives within private equity firms and portfolio companies across Germany, France and the U.K.

A study from the European Bank for Reconstruction and Development (EBRD) showed that PE investments have delivered returns in excess of public equity benchmarks, suggesting that the improvements in operational efficiency and revenue growth delivered through value creation plans are strongly associated with higher investor returns.

According to the EBRD's analysis, operating revenues and EBITDA increase by an average of 39% and 25% respectively during the time that companies spend in a PE funds' portfolio[2].

[2] Impact Brief. Private equity and value creation. Produced by the Office of the Chief Economist, EBRD. December 2019

Timing Is Key When It Comes to EBITDA and Sustainable Cash Generation

In our research we found that the majority of respondents acknowledge the need to implement VCP plans during the first 100 days of ownership. There are differences between countries though, with a higher percentage of respondents in Germany saying that they prefer to launch the value creation activities immediately after the take-over. More respondents in France than in the U.K. and Germany tend to start a VCP only in year two, although the overall trend is still to launch it soon after the closing of a transaction.

Private equity firms are trusting the management teams at portfolio companies to execute the transformation plans, with investors' responses suggesting a tendency towards supporting management for two quarters before any intervention.

The research also hints at an openness to bring in consulting partners to help management deliver on these plans, with only 14 percent of investors saying that they prefer to use internal experts. One reason for this is certainly that incumbent management is busy managing the day-to-day business and external partners can be brought in to accelerate program execution through more horsepower in a short time frame.

Some subtle differences across different countries in relation to using external consulting partners also emerged from the survey. The survey suggests that in Germany, private equity firms turn to consulting experts more in search of strategic guidance and direction for the mid-term business roadmap, while in France, one of the areas of focus is using external services for holistic management support or to augment the leadership team. In the U.K., there's an inclination to bring in consulting partners to address performance issues or opportunities with the help of analytics and data.

The results show that while private equity sponsors are being agile in deploying their VCPs following the acquisition, there's still potential to use the time between signing and closing the transaction more proactively. The first days of ownership in the sign-to-close period offer the momentum to create an alignment with management on the key value creation hypotheses and develop a joint view on how to address the transformation potential. Clearly there is a trade-off with "gun-jumping" to be managed.

Wherever possible, A&M's team of private equity focused professionals will develop accelerators in order to have the company embark rapidly on the value creation journey in the critical first 100-day period, preparing the organisation for change and fostering alignment without overwhelming the management team.

Key Findings

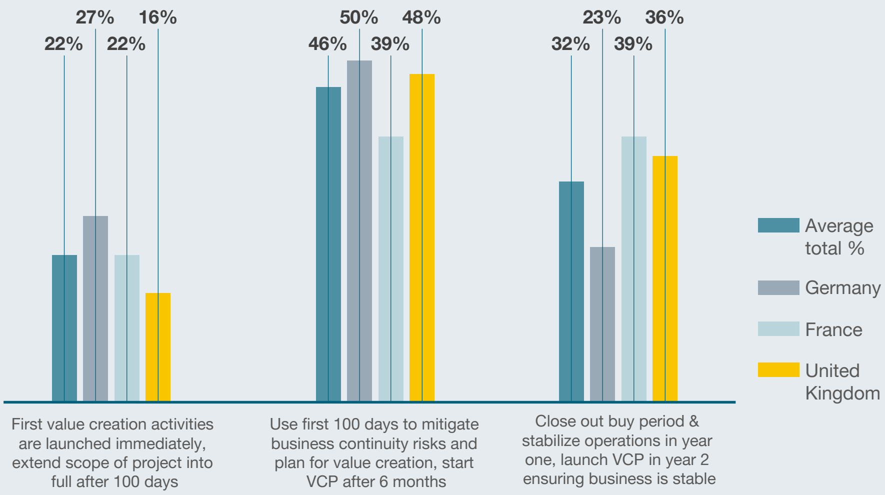
1 First 100-days is King

The survey shows that the VCP is mainly rolled out during the first few months of ownership, when there's a basic understanding of the portfolio company's business processes.

The majority of respondents either launch the first value creation initiatives immediately after the transaction is closed, assuming some pre-alignment has taken place during the sign-to-close period, or use the first 100 days to mitigate business continuity risk and plan for value creation, starting the program after the first six months.

Only a minority prefers to launch a VCP in the second year of ownership after stabilizing the business, with a higher proportion of respondents in France adopting that approach comparatively to other countries.

Survey question:
"What is your preferred approach to value creation for the first 100 days/the first year of ownership?"



What A&M Says

Early implementation is crucial for the success of the transformational value creation plan. Our experience shows that early alignment with management teams, active listening to the specifics of the situation and jointly presenting the plan are essential steps for sustainable change management. The switch in ownership creates a window of opportunity to also break with incumbent business conduct, practices and behaviours that are not beneficial for the future path of a transformation. The longer the period stretches out before change happens, the harder it is to get the organisation moving.

Key Findings

2 A Collaborative Approach Helps Advance Acceleration

In terms of capability, most respondents across countries tend to drive a value creation plan with a mix of external experts and internal staff. This is not surprising as company management have a day job to run. Investing in external support to kickstart or accelerate improvement activities usually shows a quick payback, as the incremental EBITDA is cumulative in recurring operational and financial benefits.

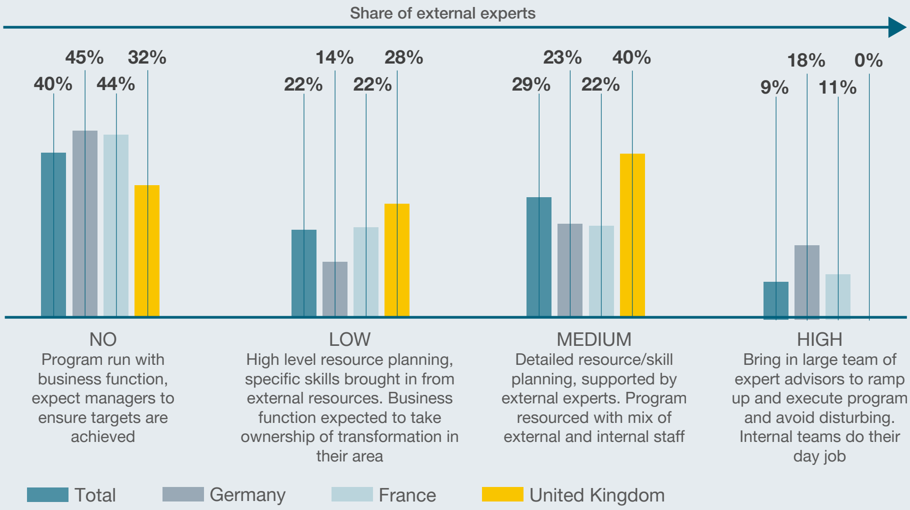
The decision to bring in a large team of external experts happens when a specific skillset is needed, if a big ramp up of the transformational program is required and in circumstances where a management team needs to be stood up from day 1, for example in the case of a carve-out.

This approach is consistent with respondents across the three countries where the survey was conducted.

A high percentage of respondents in Germany say they run the VCP using the business' existing capability and expect targets to be achieved, suggesting lower adoption of external advisors.

Survey question:

"What is your approach to executing a value creation transformation program?"



What A&M Says

External consulting partners play a key a role in helping PE firms execute these transformations. They understand the importance of speed of execution to prioritize the key areas of improvement that will impact EBITDA and ensure sustainable cash generation. Free from any legacy baggage, they also bring in objectivity, specific expertise and experience that may not be available in-house, allowing sponsors to optimize resources and allocate them where a high return on money invested can occur.

Key Findings

3 Decisions to Bring in External Partners Vary

Private equity leaders often encourage firms to bring in consulting partners, with 86 percent of surveyed investors saying they often or occasionally suggest working in partnership with a consulting firm to deliver the VCP. Only 14 percent said they rarely do so because they have their internal experts working alone on these projects.

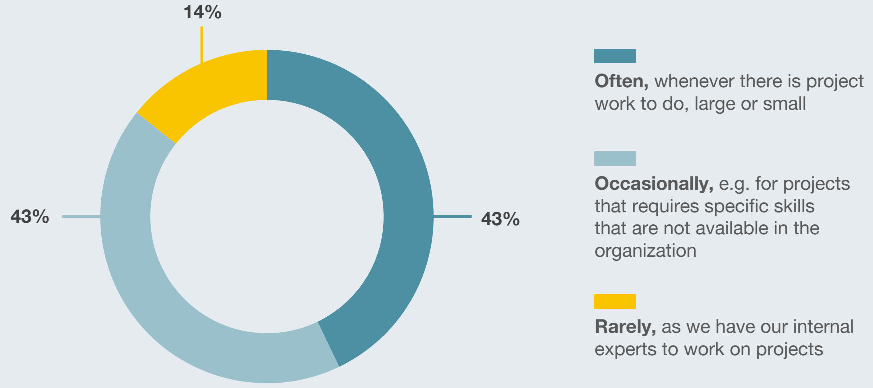
The final decision about bringing in a partner involves management most of the time, either alone (46 percent of respondents) or in conjunction with the PE firm. Only 9 percent of respondents say the PE firm makes the decision on their own.

The survey also shows that expectations around using a consulting partner differs slightly between the three countries.

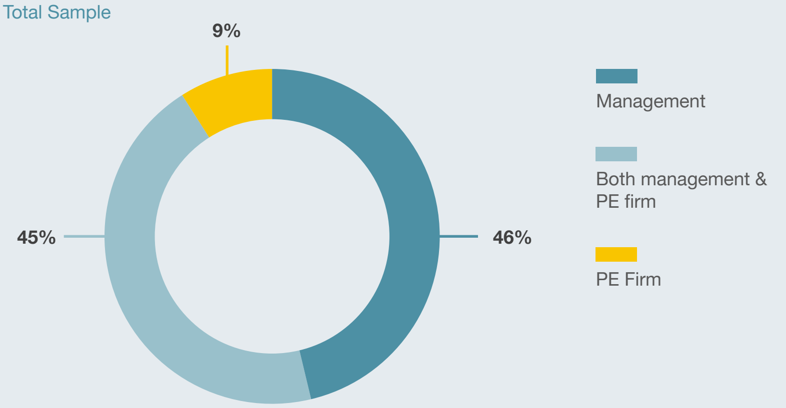
Survey question:
"How often would you encourage management teams to bring in a consulting partner?"

A Breakdown of Key Decision-Makers

Investors



Total Sample

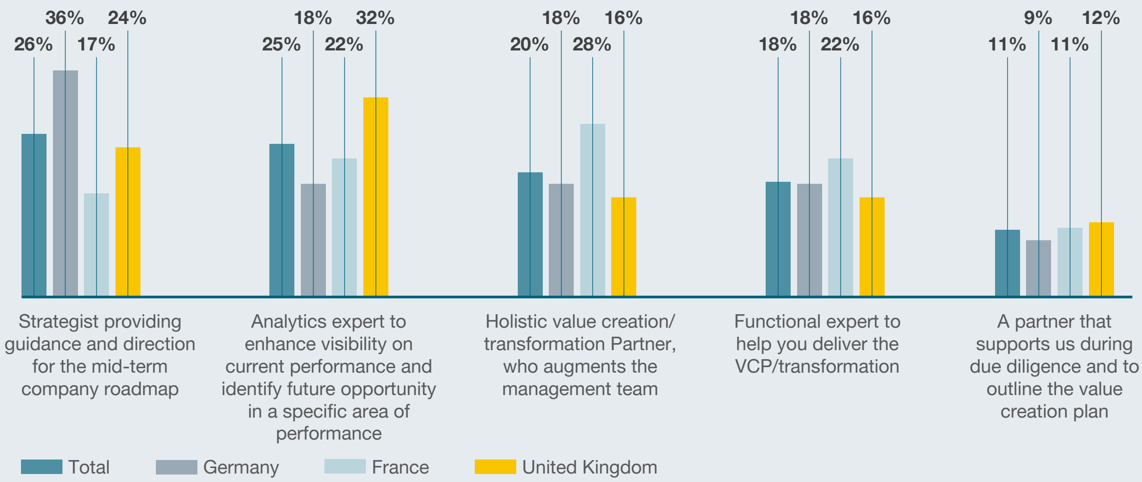


86% percent of surveyed investors say they often or occasionally suggest working in partnership with a consulting firm to deliver the VCP.

Key Findings
Continued

Survey question:
"When considering a consulting partner:
What do you expect your consulting partner to bring to the table?"

Expectations Towards Consulting Partners



In Germany, leaders prefer to bring in an external consulting partner in order to provide guidance and direction for the company's mid-term roadmap, putting management in a better position to execute the plan.

In France, one of the main expectations towards external partners is in relation to their ability to provide a holistic approach to value creation programs and augment the management team, while in the U.K. they are expected to bring analytics expertise to deal with a specific performance issue or opportunity.

What A&M Says

Based on our 20-years of experience working with private equity-backed transformations in portfolio companies across Europe, a joint decision on bringing in an external partner to execute a VCP helps the success tremendously by forging ownership and accountability with management. A management team co-selecting a consultant ensures that the team is in charge and accountable. Otherwise, management may not engage fully in the pursuit of a joint project goal and change may not be effectively implemented. Our goal is to achieve a common decision with the management team and the private equity sponsor and build trust early on in the relationship.

Key Findings

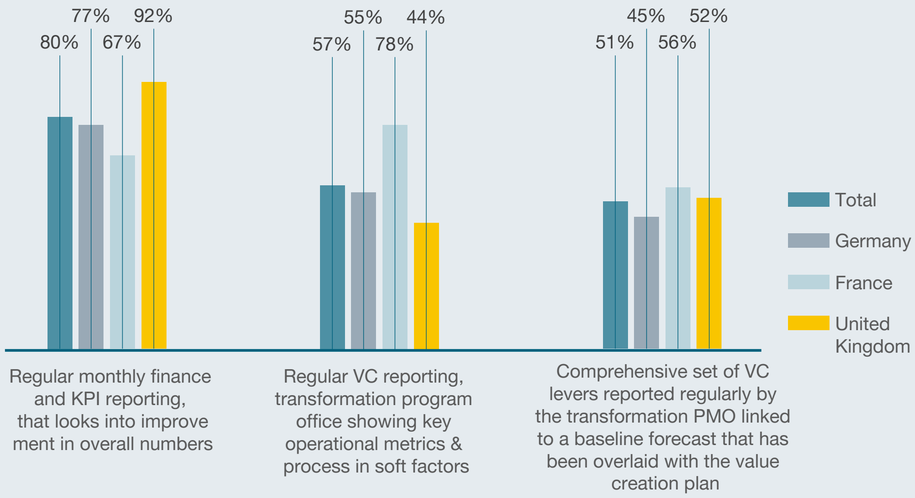
4 Monitor Carefully and Adjust as Necessary

Monthly financial and KPI reporting are the most important ways of monitoring and measuring the pace and results of a value creation program. Respondents in the survey say that these are the main metrics giving them confidence as an investor that the business can deliver the desired outcomes of the plan.

The survey shows that reporting which includes other operational metrics and soft factors – typically provided by a transformation office, also known as a PMO – is an approach more commonly used by private equity/ management teams in France than in Germany or the U.K.

Survey question:
"What are the specific things you are looking for in an operation that gives you confidence as an investor, that the business can drive the pace and results of a value creation program?"

Reporting Metrics by Country



*multiple answers possible

What A&M Says

Based on our experience, A&M views short interval monitoring as key to achieve results quickly. A transformation office needs to drive and track progress. Weekly or bi-weekly monitoring is recommended over monthly reporting in situations where performance is below plan or when it requires a quick turnaround time to get results delivery back on track.

Key Findings

5 Aligning Teams Drives Performance

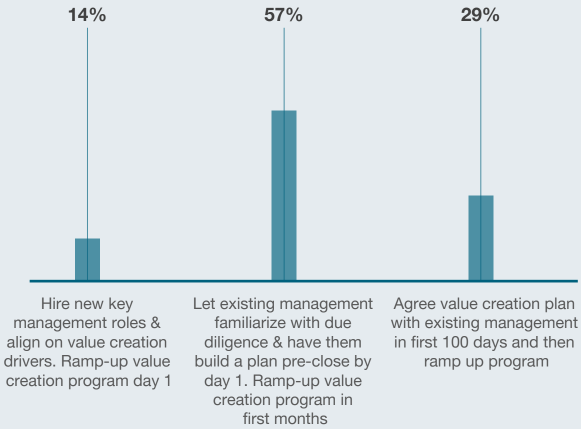
The survey shows that PE sponsors have tendencies to take a careful approach when it comes to hiring new key management roles and replacing existing staff if a value creation plan is not delivered as expected. This suggests a preference for a partnership approach with management.

Fifty seven percent of respondents said they prefer to let existing management get familiar with due diligence hypotheses and have them align to a plan or build a joint plan before the close of the sale. Only 14 percent of respondents said they hire new key management executives to accelerate the value creation program from day 1.

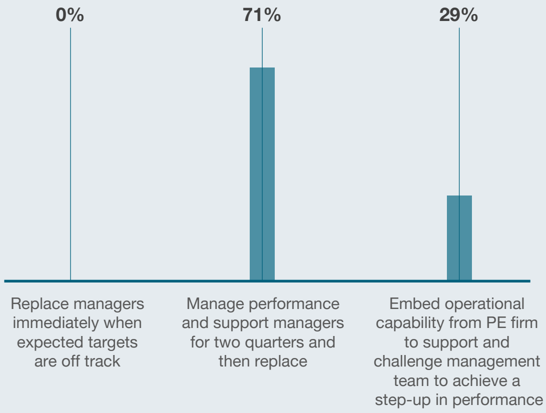
Respondents also tend to be cautious on decisions about management replacement. Around 70 percent said they will support managers for about two quarters before taking action if the outcomes of the VCP are not delivered as planned or if there is resistance to be an active implementor of change.

The remaining said they would embed operational capability from within the private equity firm to support and challenge management in achieving a step-up in performance.

Typical Approach to Align Management Team with VCP



When value creation outcomes are not delivered as expected



Percentage of respondents

What A&M Says

At A&M we take an active partnership approach with management of portfolio companies. Supporting leadership teams with the delivery plan is our key focus to show joint progress and produce results. We aim to build sustainable programs for transformational value creation that last way past our departure.

Conclusion

This survey looked into approaches and decisions that are critical to the successful transformation of a private equity-owned business in a value creation program.

The results showed that private equity sponsors and management teams of their portfolio companies in Germany, France and the U.K. are aware of the benefits of developing a value creation plan early in the deal lifecycle.

But it also suggested that there is potential to use the time between signing and closing the transaction more proactively, taking advantage of the momentum of the first days of ownership to build trust and create alignment with management teams on the key value creation drivers. The research also suggested that the majority of private equity leaders are open to bringing in consulting partners to help management deliver on these plans, with a few nuanced differences by countries in the type of expertise sought by sponsors when hiring these partners.

Such decisions are often done jointly between private equity partners and portfolio company management.

This is a thoughtful approach which ensures that the team is in charge and accountable and enables a more effective implementation of the plan.

At A&M we take an active partnership approach with management of portfolio companies, supporting them with delivering on value creation programs while also focusing on achieving quick but long-lasting results.

Methodology

In September of 2021, research firm Statista Q, on behalf of Alvarez & Marsal, surveyed a total of 65 C-level executives within private equity firms or from companies owned by private equity firms in Germany, France and the U.K. The survey predominantly contained closed questions, and interviews were conducted over the telephone. Results were analyzed and collated by Statista Q and are presented here anonymized.

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ABOUT ALVAREZ & MARSAL

Companies, investors and government entities around the world turn to Alvarez & Marsal (A&M) for leadership, action and results. Privately held since its founding in 1983, A&M is a leading global professional services firm that provides advisory, business performance improvement and turnaround management services. When conventional approaches are not enough to create transformation and drive change, clients seek our deep expertise and ability to deliver practical solutions to their unique problems.

With over 5,500 people across four continents, we deliver tangible results for corporates, boards, private equity firms, law firms and government agencies facing complex challenges. Our senior leaders, and their teams, leverage A&M's restructuring heritage to help companies act decisively, catapult growth and accelerate results. We are experienced operators, world-class consultants, former regulators and industry authorities with a shared commitment to telling clients what's really needed for turning change into a strategic business asset, managing risk and unlocking value at every stage of growth.

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