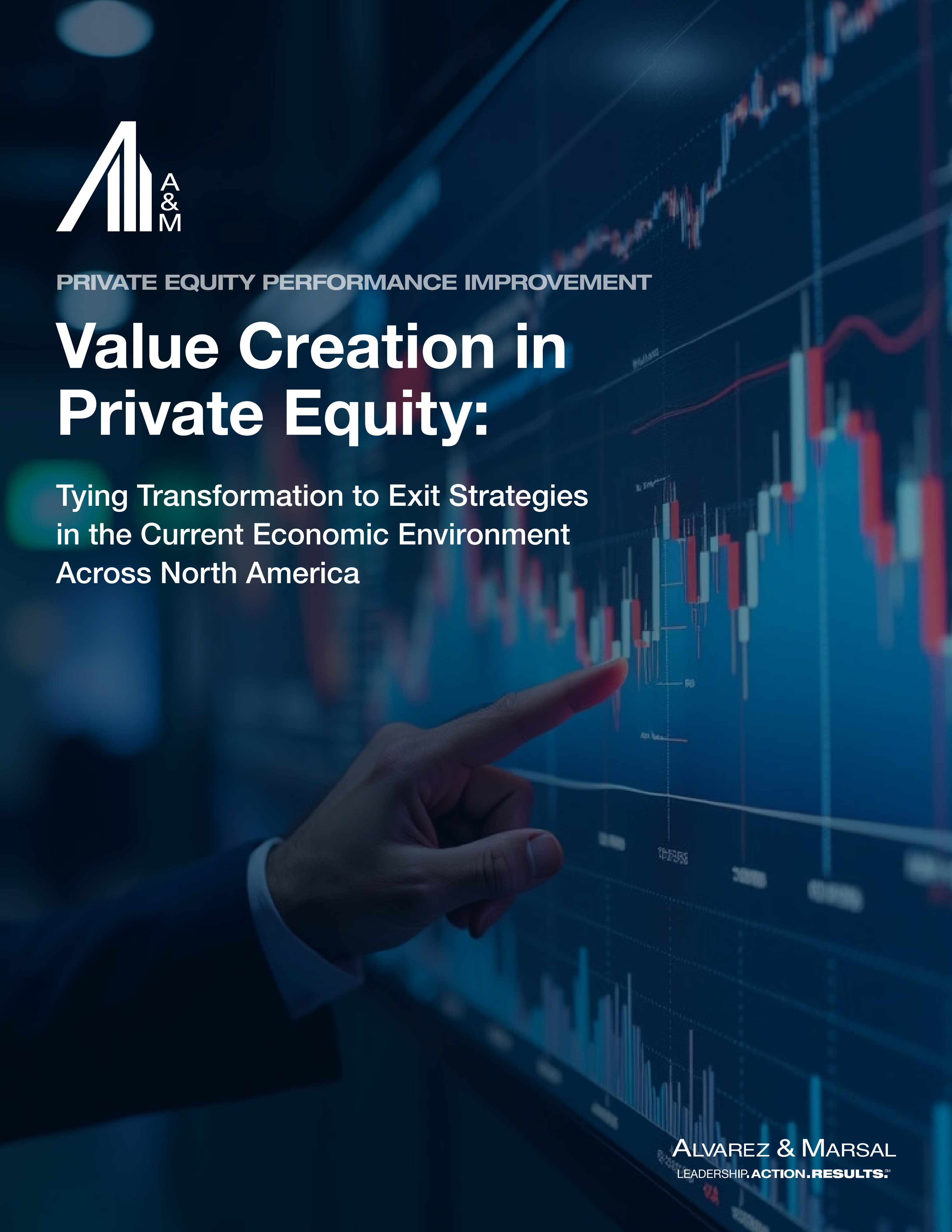

PRIVATE EQUITY PERFORMANCE IMPROVEMENT

# Value Creation in Private Equity:

## Tying Transformation to Exit Strategies in the Current Economic Environment Across North America

ALVAREZ & MARSAL

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# Contents

# Foreword

Private Equity (PE) firms may have gotten a whiff of recovery from the stifling dealmaking market of recent years as M&A activity showed signs of recovery in the second quarter of 2024. Deal value surged 42 percent in the second quarter compared with the same period last year, despite a 7.4 percent decline in the number of transactions.

It's a hopeful sign, but the industry is not out of the woods quite yet. Portfolio companies continue to grapple with the effects of higher interest rates, inflation and post-Covid supply chain disruptions, while a valuation mismatch between buyers and sellers is largely keeping PE exits on hold. As a result, distributions to limited partners (LPs) dropped to a record low, hampering the fundraising that flows during typical markets.

Now, with the U.S. Federal Reserve starting to cut interest rates and inflation mostly declining, the industry is starting to reflect a bit more optimism. According to S&P Global Market Intelligence, the U.S. PE market is expected to recover quicker than Europe's and other global markets as investors put their record dry-powder capital to work.

So what have PE investors been doing to sustain returns while they buy time for better market conditions?

To answer this question, we surveyed 50 PE investors, operating partners and C-suite portfolio company managers across North America to understand how their investment and value creation strategies have evolved in response to the tougher environment, as well as how they are preparing for a new cycle. In this report, we explore the key findings from the survey, including the growing emphasis on large-scale operational transformation within portfolio companies and the integration of generative AI in value creation.

We hope these insights will prove useful to PE leaders as they navigate the challenges ahead and position themselves for the future.

**Markus Lahrkamp**
Managing Director
Private Equity Performance Improvement Group, LLC

1. Private Equity Deal Value Rises in Q2 2024 as Firms Deploy Dry Powder

# Introduction

The PE sector both in the U.S. and globally finds itself in a frustratingly lethargic environment in which high interest rates and longer exit horizons have sharply stifled deals and dented returns. Following the post-Covid boom in 2021, PE M&A activity has finally picked up and is pacing about 12 percent ahead of estimates from a year ago, according to Pitchbook.

In actual volume and deal counts, however, the first six months of 2024 still lag 2023. Year-over-year deal volume and deal activity at the half-year mark declined approximately 8 percent and 17 percent respectively when compared to 2023. North American volumes are aligned with global activity, which slipped about 22 percent during the same time period.

Megafunds, which command $5 billion or more of assets under management (AUM) and comprise more than half of the fundraising market, have been hit hardest by these conditions, recording single-digit or even negative returns after 40 quarters of double-digit profits.

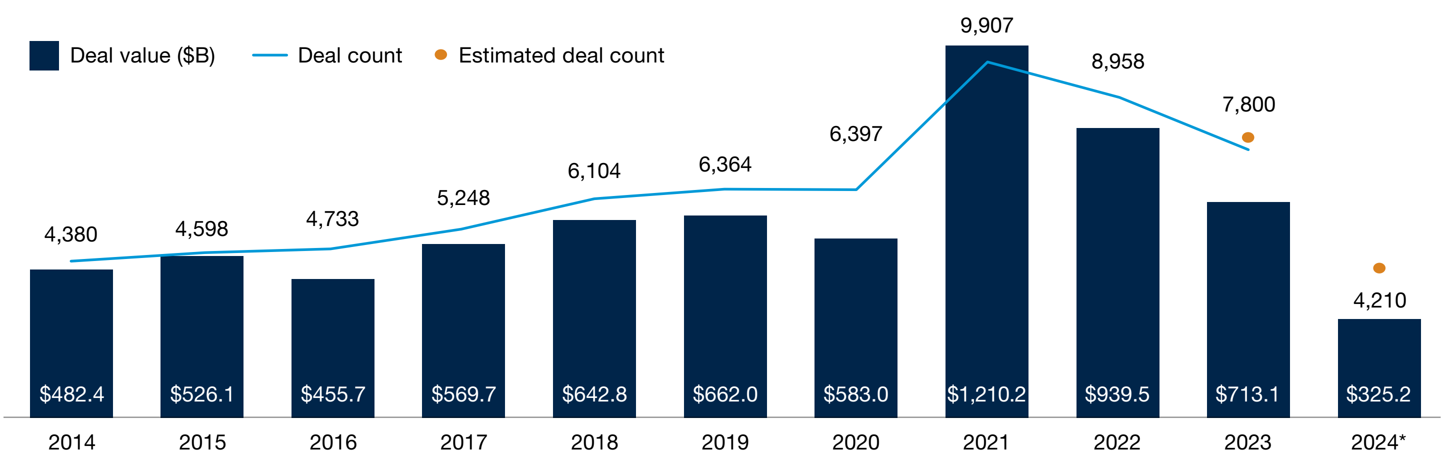
Mid-market funds — those between $100 million and $5 billion AUM — have been more insulated from the current climate given their focus on smaller deals, which are more easily accomplished and give them more opportunities to improve company valuations than Megafunds, whose assets tend to be optimized already and are of larger scale. They have also fared better in terms of fundraising. In the first half of 2024, they raised an aggregate value of about $80.8 billion, representing 52 percent of all PE capital raised so far this year.

Exit activity has been depressed as buyers and sellers battle over valuations, with exit activity in the U.S. down 34 percent since 2021. However, exit value has increased about 15 percent at 2024's midway mark compared to last year. This may reflect fund general partners dangling their prime assets in front of potential buyers to generate deals while holding onto less attractive portfolio companies for much longer.

It's the longer exit horizons that have weighed heavily on funds' returns. The historical hold times of three to five years has lengthened to an annual median exit hold time of about 7.1 years in 2023. In the current environment, funds are testing alternative deal structures, such as employee stock ownership plans — essentially a qualified retirement fund — that can offer tax deferral benefits with creative structuring. It's unique, but it indicates the lengths some managers will go to get returns.

The growing backlog of portfolio companies are forcing funds into uncomfortable positions. They must either squeeze more value from their assets and wait on a more favourable deal landscape or face the significant challenge of refinancing at much higher rates. The longer wait times are translating into limited distributions to limited partners, which in turn stifle fundraising on the back end of the cycle.

## PE deal activity




Source: PitchBook • Geography: US • *As of June 30, 2024

2. All exit and fundraising data are from Pitchbook Data Inc., unless otherwise noted.

## The Path Ahead

So how is the PE environment evolving from here? And what value creation strategies are being put in place as the industry heads toward this new cycle? We are optimistic that PE dealmaking will continue to improve as interest rates subside and borrowing costs ease. An improved outlook for the global economy in 2024 — with inflation slowing and growth returning to many economies — is also helpful.

In fact, we are already seeing some signs of life coming back to the market. The increase in M&A activity in the first half of 2024 stems largely from the return of big-ticket transactions. In the U.S., large deals including the $15.5 billion buyout of Truist Insurance Holdings by a group led by Clayton, Dubilier & Rice, Mubadala Investment and Stone Point Capital confirm that trend.

Additionally, we continue to see some funds actively pursuing transformative deals via smaller add-on acquisitions. While add-ons have been key to PE deal volumes remaining resilient in the last two years, executing these platform strategies has become more complicated.

One reason for that is the rise in interest rates, which is limiting financing for such transactions. Secondly, the longer timelines for completing M&A deals means that businesses are often being acquired halfway through the enlarged company's holding period, reducing the window for realizing synergies.

Consequently, funds are having to work harder on their buy-and-build strategies, putting emphasis on integrating platforms, making business models fit for digitalisation, incentivising management and undergoing meticulous exit planning.

### Exit Readiness: The A&M Approach

The exit logjam in PE has deep implications for value creation and exit readiness plans. As discussed in our survey findings, funds are taking a more targeted approach to value creation, doubling down on interventions to generate top- and bottom-line growth at speed to insulate firms from the current headwinds. Data-based and AI techniques have become a critical pillar of such programs.

When it comes to exit preparation, we have also seen a few changes. PE funds and portfolio companies' management are being more proactive than before in financial loss — or disaster — prevention and exit preparation, with a view to maximizing transaction value in the tough dealmaking environment of today.

In our experience, a careful and well-thought-out exit preparation program should start at up to two years before the planned exit transaction date. Funds need to show demonstrated improvements to get full credit for valuation upon sale, especially in the current environment of longer holding periods, to increase the viability of a successful exit. The plan must include the creation of a consistent equity story to protect value, as well as the launch of some "quick win" initiatives to validate the value creation opportunity for potential bidders.

Generally speaking, buyers think they can always improve the performance from the former owner, and a robust equity story helps the seller kick-start the buyer value creation process and bridge the gap between any price expectations.

## A Paradigm Shift

In this new cycle, we see PE firms increasingly pursuing new — and sometimes more radical — ways to create value at their portfolio companies, as revealed by our survey this year. Typically, our study found this involves the use of data-based techniques, including AI, to find opportunities for margin expansion and revenue growth.

This represents a significant paradigm shift for an industry that for years relied on multiple expansions and more traditional levers such as moderate and cautious cost cutting to achieve value on exit. While Megafunds tend to focus on carve-outs of large Fortune 500 corporations to secure assets, mid-market funds prefer buy-and-build models. What's new is that about 70 percent of all respondents were very likely to rely on organic growth for added value within their current portfolio companies versus just buy-and-build strategies.

Now, value creation interventions have a sharp focus on generating higher organic, profitable growth. Some of the levers being pulled to achieve that are market diversification, an increased focus on high, profitable service business growth, better pricing, improved customer experience and optimized processes — many of which are being executed with the help of cutting-edge data analytics and tested-and-proved digital tools, including but not limited to AI.

In the next chapters, we will look further into the key findings of our survey to understand how these new approaches are taking shape.

# Executive Summary

**50%**
of investors are underwriting value creation opportunities during their diligence.

**80%**
of investors want to go beyond traditional cost cutting to find incremental value creation levers.

**18%**
of U.S. respondents say they are already deploying AI in their value creation plans, compared with 45% in Europe.

**66%**
of Megafunds are already including AI initiatives in their value creation plans, outpacing other fund tiers.

**56%**
of Megafund respondents anticipate long-term positive financial impacts from ESG initiatives.

**50%**
of total respondents do not attribute any returns to ESG investment initiatives.

**90%**
of mid-market PE respondents stated that their firm is moderately or very likely to pursue a buy-and-build value creation strategy.

## Sample Comments from Survey Respondents

We're focused on pricing, salesforce effectiveness, revamping and the product roadmaps to improving the product portfolio, cost cutbacks, doing things more efficiently. We may be a little more focused on cost as well.

— PE Investor

We apply increased scrutiny on identifying the value drivers of growth plans because of the high-interest rate environment. We continue to look for ancillary revenue streams with a deeper dive into them.

— PE Investor

We are much more tech focused, leveraging digitization, AI, etc. We're also leveraging the deal team more, as deal team is less focused on new deals.

— PE Investor

# Key Findings

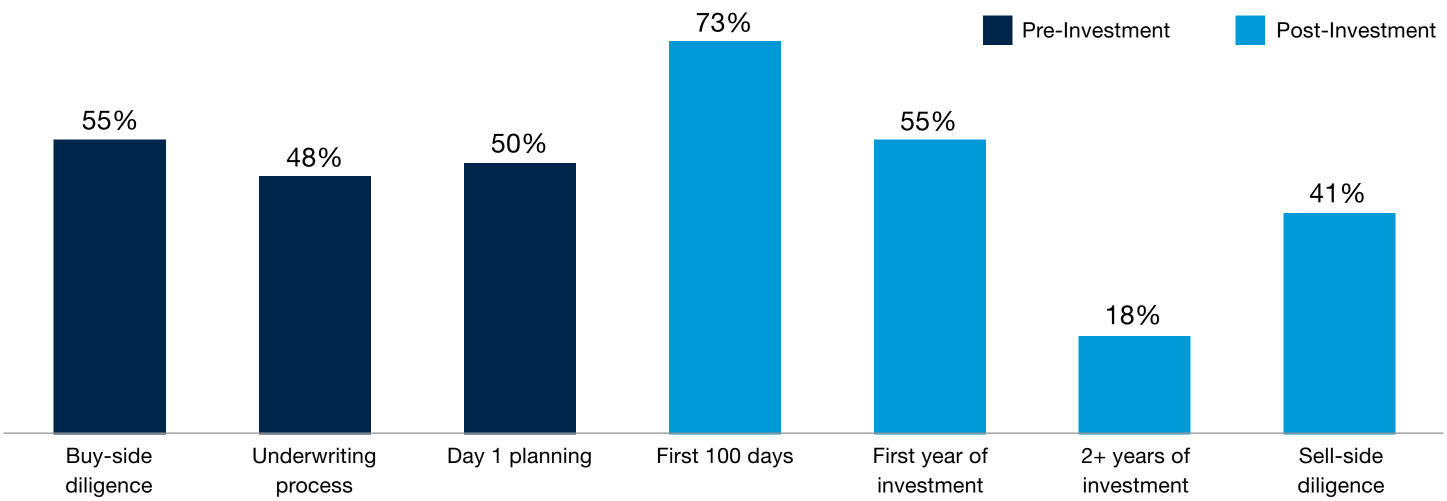
## Technology Becoming an Important Tool to Drive Value Creation

The survey shows a strong focus on value creation for PE firms to generate returns, with half of respondents underwriting value creation opportunities within their current portfolios in the current high-interest-rate environment. Investors want to find incremental value creation initiatives, with 80 percent of respondents seeking to go beyond traditional cost cutting.

An important new trend in recent years indicates that more funds are starting the value creation process in pre-deal activities and diligence phases and carrying on that activity over the first 100 days, or longer, maybe even throughout the entire holding period until exiting the asset.

### Value Creation Planning is Critical Throughout the Transaction Cycle

***A majority of respondents start investing in value creation resources during the diligence phase and continue support services through the first year of ownership...***




Large-scale operational transformations have become a very powerful way to create value, often with technology as one of the tools to enable transformations and change. Eighty-three percent of survey respondents say they are moderately or very likely to pursue such transformations or expansions of capabilities within their current portfolios.

The pace of the market regarding technology has changed significantly in the last decade, and it must continue to keep pace with change. With that in mind, large scale transformations are becoming more likely to create or preserve value.

Buy-and-build investment strategies are a core focus of mid-market PE firms, with 90 percent saying their firm is moderately or very likely to pursue a buy-and-build value creation strategy to enable scalable growth platforms. Nearly 41 percent of survey respondents said they are “very likely” to put buy-and-build strategies in place, while only about 11 percent of Megafunds said they were very likely to do so and 33 percent said they were not likely to at all. A strong new trend is to align buy-and-build models with revenue and bottom-line improvements to make assets more productive and more desirable at exit.

Digital infrastructure continues to drive transformation initiatives, with 96 percent of investors saying it’s critical for success. Executing technology enhancements is increasingly more critical to generating returns in the current macroeconomic environment.

Eighty-four percent of respondents who are looking for new value creation initiatives beyond traditional operational performance improvement consider digital transformation as critical to a value creation plan’s success. In particular, investors are increasingly looking to AI to find new opportunities for improvement.

## AI to the Rescue?

Both survey responses and our view of the sector show investors are interested in diversifying revenue streams, optimizing supply chains and enhancing customer engagement through data-driven insights. As they do this, 70 percent say it comes with a balanced strategy of revenue and cost reduction initiatives. This will be accomplished with enhanced digital technologies.

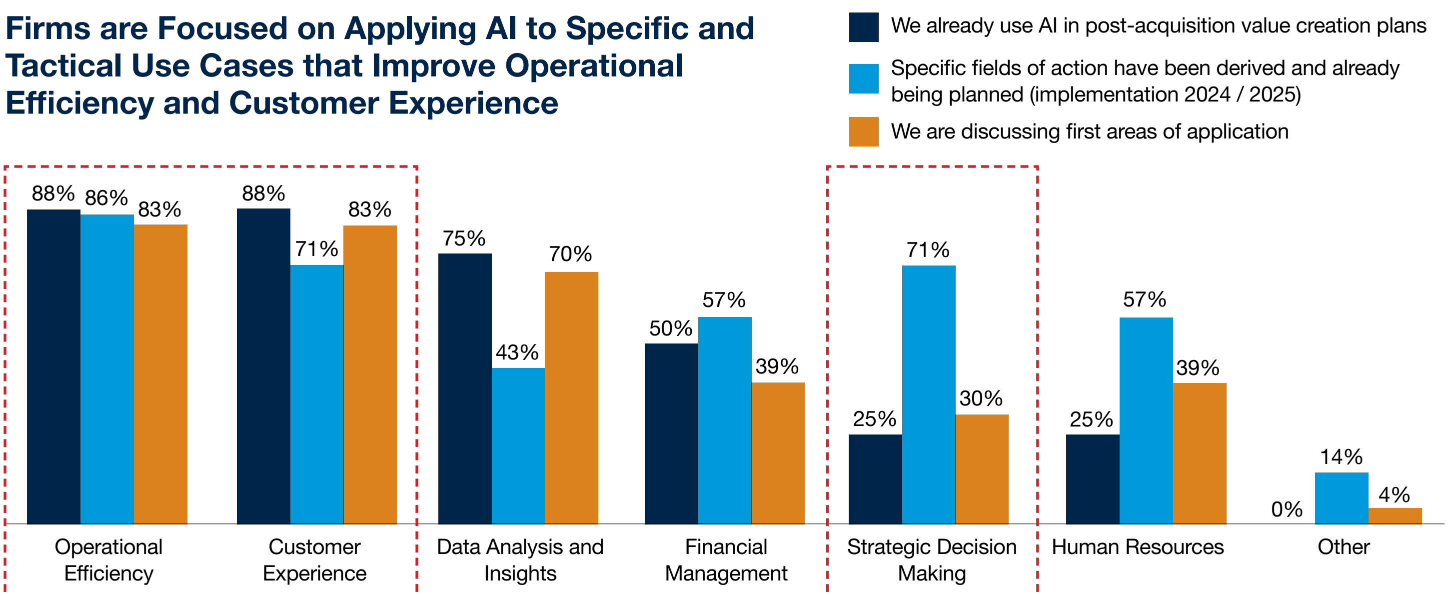
The new levers that investors are using to enhance these areas include:

- Artificial intelligence (35 percent);
- Other technology (20 percent);
- New products and markets to enhance revenue (15 percent);
- Procurement (15 percent); and
- Shared services or offshoring (15 percent).

Portfolio companies are focused on leveraging generative AI, but a majority are still in the early stages of idea generation. Of the PE firms who are in the process of implementing or using generative AI, portfolio companies are mainly investing in tactical, operational improvements — process automation, supply chain optimization and customer support efficiencies.

The survey shows that 88 percent of firms already implementing AI are focusing on operational efficiencies, customer experience and strategic decision making.

### Firms are Focused on Applying AI to Specific and Tactical Use Cases that Improve Operational Efficiency and Customer Experience



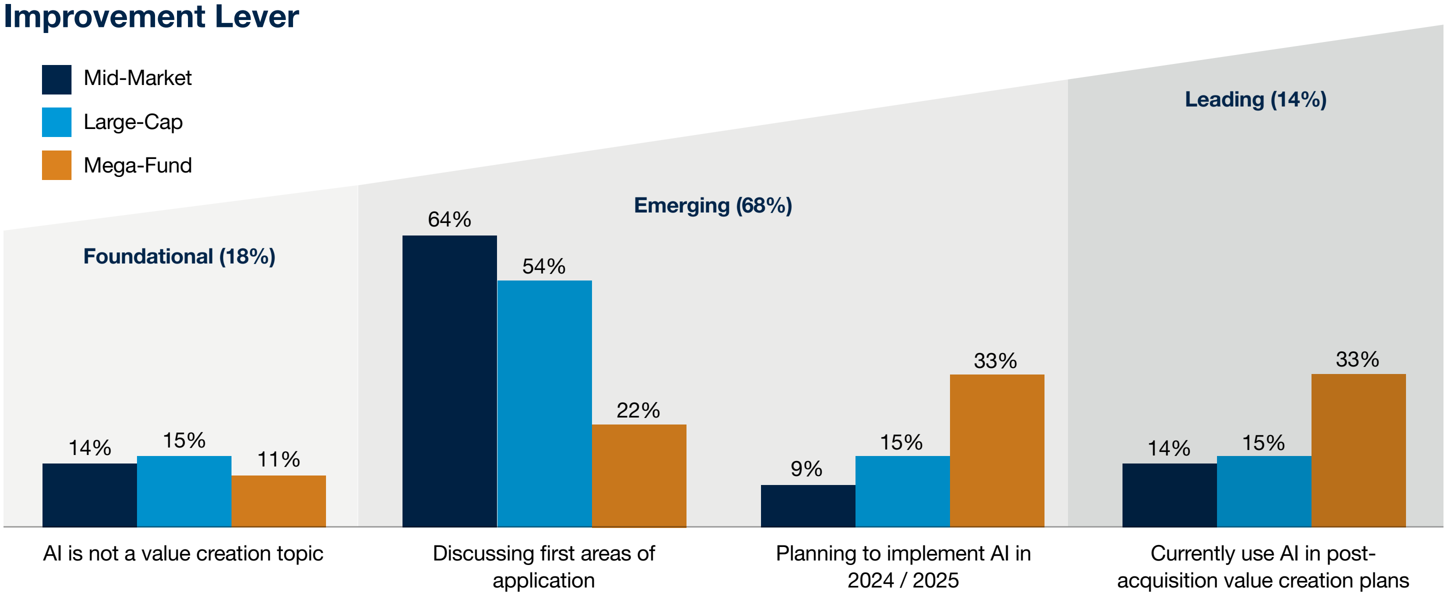

Broadly, the majority of firms surveyed — 68 percent — fall into the "emerging" middle camp, meaning they are discussing AI or planning to implement the technology in 2024 or 2025. Megafund firms lead in initiatives to deploy AI, with 33 percent saying it is already in use within their portfolio company operations and another 33 percent planning to implement the technology in 2024 and 2025.

Not surprisingly, the majority of mid-market firms say they are just at the discussion phase. Only about 14 percent of survey respondents across all fund types are actively deploying AI in post-acquisition value creation initiatives.

That's a key difference between the U.S. and European PE markets (based on results from a similar study in Europe A&M commissioned in 2024). In Europe, 45 percent of firms say they are already using AI to support their value creation plans and 38 percent plan to deploy it by 2025.

With the apparent lack of ready-to-deploy AI solutions, mid-market players often settle for trial and error to get it right, especially since smaller portfolio companies often lack the data infrastructure needed for AI solutions. From our experience, AI solutions are just not effective when data management is a mess. Megafunds' bigger (carve-out) investments tend to be larger in scale, more sophisticated and use data that has already been managed effectively to align with AI requirements.

## Expanding Digital Capabilities with AI is Increasingly Considered as a Value Creation Margin Improvement Lever



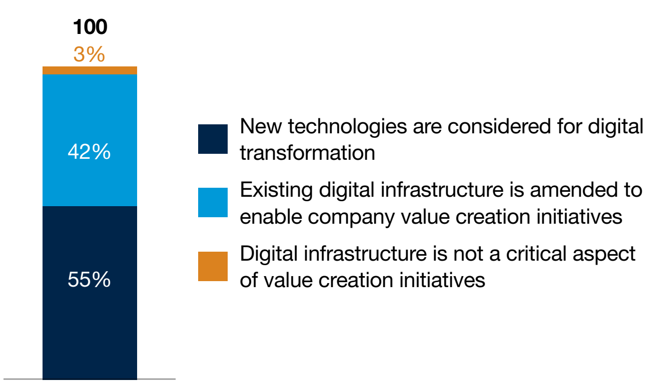

Among firms actively pursuing value creation plans, most respondents said they are either actively pursuing new digital opportunities or optimizing existing technology to generate value creation initiatives.

The need for digital enhancement is almost universally understood. Ninety-six percent of respondents say investment in digital infrastructure is critical for success, either by looking for new value creation opportunities or extending the timing of digital value creation capabilities.

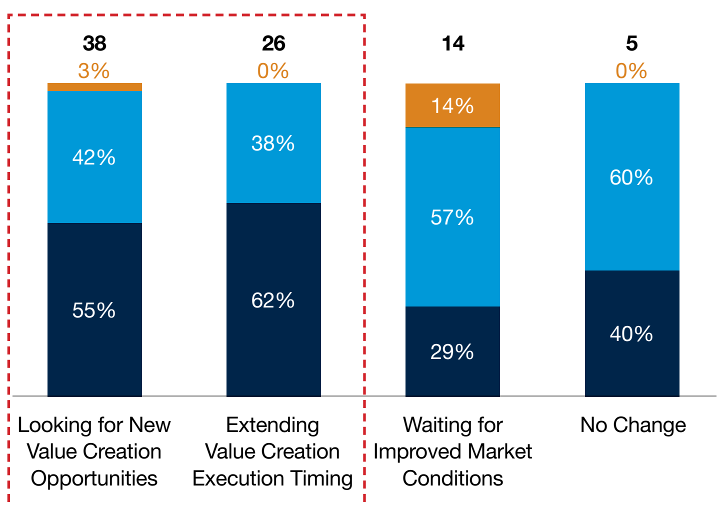
## Firms Looking for New Value Creation Levers are Increasingly Investing in Digital Transformation Strategies

***Ninety-six percent of respondents think digital infrastructure improvements are critical for successful transformation initiatives, but firms are split between pursuing smaller systems enhancements and larger-scale digital capability expansions.***

***When surveyed, "How critical is digital infrastructure for successful transformation initiatives?"***




***Among firms proactively expanding value creation initiatives in response to changing market conditions, a majority are pursuing digital capability expansion.***



## Organic Growth Is Winning

In this inaugural U.S. survey, organic growth, rather than buy-and-build acquisition strategies, is clearly the preferred value creation strategy, with fully 86 percent of respondents saying they are moderately or most likely to pursue internal improvements and 80 percent favoring revenue and operational expansions within their own portfolio. A smaller group, 61 percent, say they are moderately to very likely to focus on buy-and-build strategies or pick up new platform investments, accounting for 48 percent, to diversify their portfolios.

The majority of survey respondents aren't just relying on traditional cost cutting approaches, as 70 percent are considering an equal mix of revenue or cost-out value creation strategies with cost reduction plans. It appears smaller firms are more likely to rely on revenue generating initiatives, with mid-market funds leading the way at 29 percent, while just 13 percent of large-market funds and 20 percent of Megafunds are focused on revenue-only strategies.

## AI-Powered Reviews

An A&M Case Study

A PE fund owned a portfolio company in the professional utility maintenance field. The company, which had a highly distributed footprint across North America, had to quickly assess the viability of cost takeout opportunities due to the unexpected loss of a large customer. As a result, the company was quickly running close to unsustainable liquidity levels given the drop in revenue. In collaboration with the PE fund's deal and operating teams and portfolio company management, A&M employed "A&M Assist," its AI-based tool solution, to cleanse and analyze readily available client data of several million datasets, compare the data with proprietary data from other A&M projects and benchmark the results against publicly-available KPI's. In one week, the joint team was able to re-baseline the business to account for lost revenues from the client's large customer and identify more than $50 million in potential cost takeout opportunities in several COGS and SG&A areas. These and other cost takeout opportunities were immediately prioritized for implementation, helping the company to return to profitability and generate positive cashflow. The portfolio company is now able to plan a recapitalization and focus its efforts on organic growth after operations and finances have been stabilized.

These findings resonate with what we have observed in the market and in our interactions with PE clients. We are indeed seeing funds moving from general to more specialized value creation initiatives that truly deliver organic growth and margin improvement for their businesses.

However, in the U.S., mid-market funds' ability to deploy AI is only as good as its asset's data, which often contains gaps and inconsistencies that must be reconciled before implementing the solution. Megafunds are much better prepared to roll out AI initiatives.

Still, there has been a lot more discussion around digital strategies. In our view, this reflects the rapid maturation of data analytics capabilities within the PE industry more recently. In some cases, we have seen many funds establishing dedicated digital functions within their operational performance teams and hiring data specialists to support such programs at portfolio companies, but this is still rare across North America.

The buzz around generative AI has added momentum to this trend, putting funds in a race to find solid use cases for the technology throughout their investment journeys. Technology and data are playing an increasingly wide-ranging role in value creation. More than a tool to drive operational efficiency in back-office processes, they are now seen as the engine behind several growth initiatives.

## ESG's Role in Value Creation

Our survey also probed PE investors' sentiment toward environmental, social and governance (ESG) considerations at the portfolio company level in the current market volatility. Overall, ESG is not a main driver of value creation in North America, with less than 50 percent of total respondents attributing any returns to ESG initiatives.

However, we identified nuances in the approach to ESG between larger and mid-market funds. While the majority of mid-market firms do not consider ESG initiatives as an aspect of value creation, ESG is a growing focus area in larger funds. For example, 59 percent of mid-market managers said improved ESG credentials had little to no financial impact on financial performance in the long run, while 40 percent said it would have a moderate to high impact.

> *"From an investor perspective, there is increasing preference for ESG, such as ESG dedicated funds, as well as retail investors, who are likely to increase P/E multiples for ESG-positive companies in future."*
> — Survey respondent

Compare that to Megafunds, where 55 percent of respondents viewed ESG initiatives as having some kind of impact, mostly at a moderate level.

Overall, only 48 percent had a positive view. That's a good bit short of European firms, where 62 percent viewed ESG as contributing to value over the long term.

Yet the survey's qualitative answers indicate that some industry leaders tend to believe that the transparency brought about by stricter reporting requirements and the preference of investors for ESG and ESG-dedicated funds will help drive sustainable growth.

The consideration of ESG goals and initiatives is evident at nearly all firms represented in the survey, with only 4.5 percent indicating they don't incorporate ESG in long-term planning. However, ESG in the U.K. and other European countries is louder and stronger, likely due to both regulatory initiatives and stakeholders' interest. To that extent, U.S. funds don't seem to see the true value, particularly for mid-market funds.

# Conclusion

Today's macroeconomic pressures are significantly changing how PE firms are thinking about driving value in their portfolio companies. Our survey identifies certain trends in value creation strategies focusing on both growth and cost opportunities. None of this is new in the world of Private Equity; what is new is the broader adoption of value creation strategies in Private Equity. Historically, before COVID-19, value creation strategies were mostly deployed as interventions when things didn't go as planned for a smaller percentage of portfolio companies. Our study found that the majority of PE funds are now pursuing value creation in the face of more challenging market forces, moving away from intervention-based engagements to broader value creation programs for a higher percentage of portfolio companies at a much earlier stage than we have ever seen before. Additionally, those initiatives have had a greater focus on organic growth driven by internal value creation initiatives.

Our study also found that neither AI nor ESG are seen as major differentiators for driving value creation initiatives yet. There is no doubt that the use of technology will accelerate a better understanding of the impact of value creation and enhance decision making. Mid-market funds appear to be behind on that journey compared to their larger PE peers.

From a practitioner's perspective, it will be instrumental to keep any form of value creation agenda simple. Portfolio companies that focus on more than two or three initiatives usually fail to yield desired results. While our study shows an increasing focus on organic growth, any kind of growth needs to be supported by an efficient underlying platform. Growth for growth's sake will, in most cases, create more complexity and impact operational, financial and management performance.

Finally, our study clearly indicates that a challenging PE market environment presents the opportunity to focus more on value creation opportunities. Portfolio companies that focus on streamlining and simplifying their operations now will be in a much better position to benefit from future growth. The core guiding principles will be to "never let a crisis go to waste" and "keep it simple" when it comes to value creation in the future.

## How A&M Can Help

With our operational and action-oriented approach, A&M has been assisting management teams to unlock value and kickstart performance for the last 40 years.

Our experts work with clients during due diligence, sign-to-close and subsequent value creation plan phases, focusing on topline, operational and service excellence as well as working capital and cash initiatives to accelerate performance and help clients deliver value.

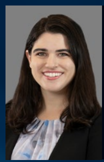
A&M also has deep experience in running exit readiness programs and positioning businesses for sale based on a sound operating plan.

## Methodology

In the second quarter of 2024, A&M partnered with research firm Opinium to survey 25 private equity fund investors and 25 operating partners and C-level executives from portfolio companies in North America, primarily within the U.S. The survey contained closed and open questions, and additional interviews were conducted over the telephone. Results were compared to a similar study conducted in EMEA earlier this year and were analyzed and collated by A&M and are presented here anonymized.

## AUTHORS


**MARKUS LAHRKAMP**
MANAGING DIRECTOR
New York, NY
+1 212 763 9558
mlahrkamp@alvarezandmarsal.com

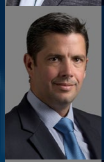


**RACHEL JURGENSMEYER**
DIRECTOR
San Francisco, CA
rjurgensmeyer@alvarezandmarsal.com

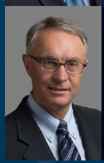

## KEY CONTACTS


**NICK ALVAREZ**
PRIVATE EQUITY PERFORMANCE IMPROVEMENT NATIONAL PRACTICE LEADER
New York, NY
+1 646 495 3550
malvarez@alvarezandmarsal.com

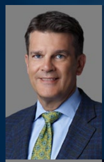
**JEFFREY KLEIN**
MANAGING DIRECTOR
Miami, FL
+1 212 762 9626
jklein@alvarezandmarsal.com



**CARLOS VINCENTELLI**
MANAGING DIRECTOR
Miami, FL
+1 212 763 9567
cvincentelli@alvarezandmarsal.com



**CLIFFORD HALL**
MANAGING DIRECTOR
Morristown, NJ
+1 917 291 6412
chall@alvarezandmarsal.com



**RICHARD JENKINS**
MANAGING DIRECTOR
Denver, CO
+1 303 704 4240
rjenkins@alvarezandmarsal.com

**TOYA ASBURY**
MANAGING DIRECTOR
New York, NY
+1 347 931 6275
tasbury@alvarezandmarsal.com

**MICHAEL BEETZ**
MANAGING DIRECTOR
San Francisco, CA
+1 415 490 2300
mbeetz@alvarezandmarsal.com

**TIM KENEALLY**
MANAGING DIRECTOR
Chicago, IL
+1 312 601 9036
tkeneally@alvarezandmarsal.com


A & M

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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 10,000 people providing services across six 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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