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Operational Excellence

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Pillars for growth

Seven components integral to creating value today

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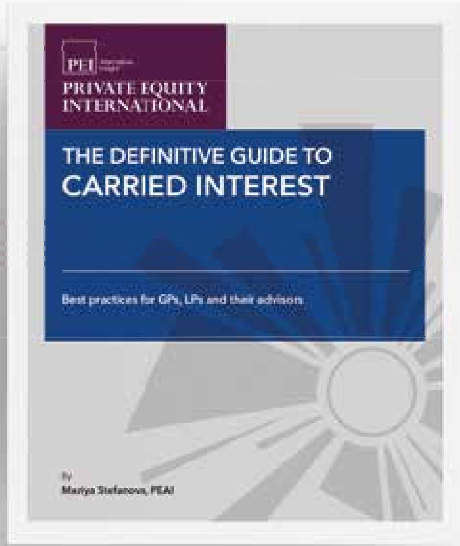
PRIVATE EQUITY INTERNATIONAL
THE DEFINITIVE GUIDE TO
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Best practices for GPs, LPs and their advisors

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Editor's letter

Operating expertise is in demand

Louise Fordham
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The tougher fundraising and dealmaking environment seems to have slowed recruitment activity among private funds, with figures from *Private Equity International*'s *Private Fund Leaders Survey 2023* indicating that this more muted pace of hiring will continue. The survey of 101 senior buyout, growth, private debt, venture capital, real estate and infrastructure executives found that the proportion of respondents who increased headcount at the GP level over the prior year fell from 62 percent in 2022 to 49 percent in 2023. Just 44 percent expect to grow their workforce over the next 12 months, compared with almost seven in 10 respondents in last year's survey.

> **"Operating talent remains high on firms' hiring agendas"**

Not all areas are experiencing this recruitment squeeze, however. Operating talent remains high on firms' hiring agendas – 62 percent of survey respondents rank professionals in value-creation and portfolio management in their top three hiring priorities, second only to deal teams.

Demand for operating expertise will not come as a surprise to many in the industry. Private equity firms have been building out their operating teams over the last few years as portfolio companies have needed more hands-on support in the wake of covid and challenging macro conditions, and as rising valuations and the higher cost of debt have placed greater weight on value-creation strategies.

In addition to recruiting operating talent with the requisite skills to lead transformational growth initiatives, managers have been working to innovate value-creation frameworks. Some have also been exploring newer tech, like artificial intelligence or advanced analytics, to approach traditional levers such as supply-chain and pricing optimisation in novel ways.

Over the course of this report, we dive into these evolving approaches to operational improvement programmes, and review some of the most valuable tools in the operating partner's toolbox today.

Louise Fordham

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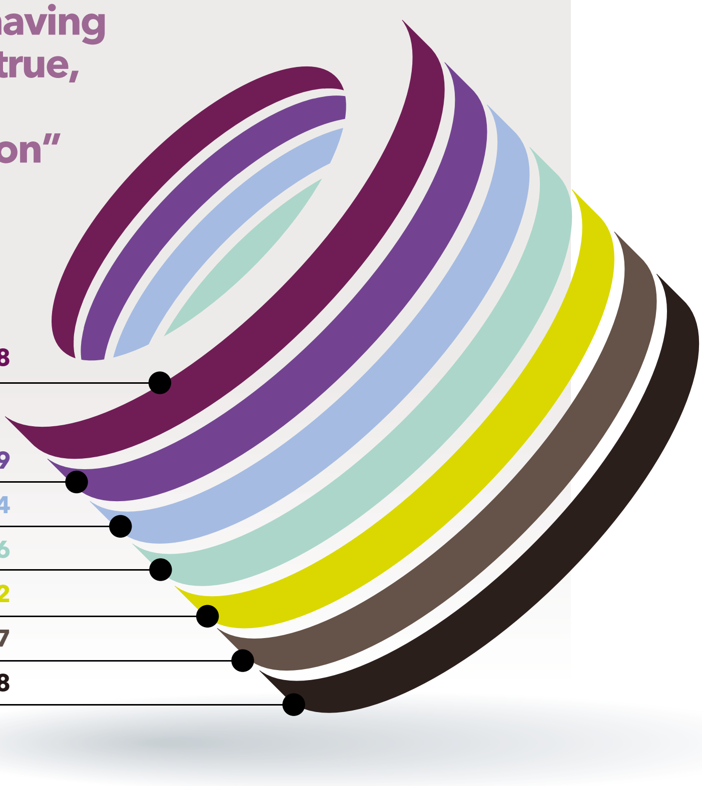

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PEI

Insight

Value creation

Three ways operating teams are keeping pace with today's fast-changing environment

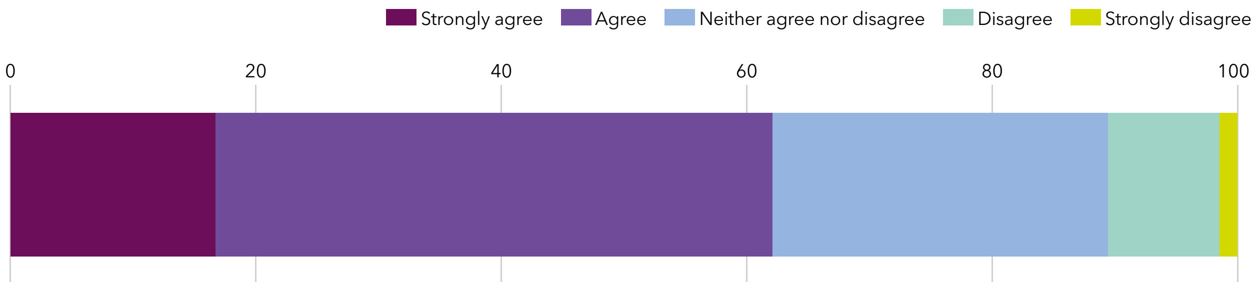
The pandemic shone a light on just how crucial hands-on portfolio management can be, not only to the survival of businesses in fraught circumstances, but also to their ability to thrive through adversity. The macroeconomic and geopolitical events that have occurred since – from the war in Ukraine to rising interest rates and an inflationary environment – have further underscored how important effective value-creation strategies are to managers, their portfolio companies and their investors, ***writes Louise Fordham.***

What impact is this growing onus on operational expertise having on private equity firms' operating teams and their approach to value creation? Here, we look at three ways the operating function is evolving.

1 An experienced pair of hands

While the last 24 months have presented a unique mix of challenges, seasoned operating professionals will likely have witnessed some of its core components, such as labour shortages and wage pressure, before. Others will have navigated portfolios through market-changing events, whether that be the dot-com crash or covid. Operating partners and advisers who can apply the learnings gleaned from such experiences to

To what extent do you agree with the following statement? 'Artificial intelligence will be the most significant technology shaping businesses and industries over the next decade' (%)



Source: Private Equity International's Private Fund Leaders Survey 2023

the current context to drive growth are increasingly in demand. This demand is adding heat to an already competitive hiring landscape, as GPs of all sizes look to build out their operating bench.

"Demand for value-creation professionals has increased sharply," says Rupert Bell, director of DACH at executive search firm Private Equity Recruitment. "This used to be a resource that only large-cap funds could afford, but it is becoming more and more essential at all size levels in light of the transformation workstreams needed to generate returns."

Deep expertise in particular sectors or functions, such as pricing and M&A, are also high on the list of operational skills private equity firms are seeking, Bell tells *Private Equity International*.

2

New skills, new approaches

Although experience is highly prized, it is certainly not the only quality that makes for an effective operating partner.

The environment in which businesses are operating is changing fast, and operating teams must be adept at helping portfolio companies evolve with it.

As PwC value-creation partner Sarah O'Connell says: "Digitalisation, decarbonisation, deglobalisation – these major themes are forcing private equity firms to intervene to ensure businesses stay relevant in a rapidly changing landscape. That is a key driver of value creation as well."

Generative artificial intelligence is perhaps the most recent example of fast-paced disruption. In late 2022, OpenAI's ChatGPT captured the public's attention, reportedly clocking up 100 million users within just two months. Its rapid uptake

> "Digitalisation, decarbonisation, deglobalisation – these major themes are forcing private equity firms to intervene"
>
> Sarah O'Connell, PwC

prompted businesses – and PE sponsors – to reflect on what the technology could mean for their industries and to more closely consider how it could be applied to improve processes, products and services.

Indeed, almost two-thirds of private markets firms surveyed for *PEI*'s *Private Fund Leaders Survey 2023* either agree or strongly agree that AI will be the most significant technology shaping companies and sectors over the next decade. Keeping up to date with such advances is expected to become increasingly vital in the successful formation and execution of growth strategies.

Meanwhile, the ability to apply more traditional value-creation levers in innovative ways will also be key. Pricing strategy, for example, has come to the fore as businesses seek to address rising inflation.

"We have been in a benign inflationary environment for so long that few people have experienced the pressures we are now facing," Tracy Bownes, a partner at private equity investment firm LDC, tells *PEI*. "Having good analytics within the organisation to understand how cost pressures can be mitigated through either good supply chain management or optimal pricing execution is critically important."

The capacity to harness new tools, like data analytics, to create value in such areas, while also engaging portfolio company management and the wider workforce in these transformational initiatives, could be a key differentiator for private equity firms moving forward.

3

Access to expertise

Given the scope and complexity of the headwinds facing businesses, and the broad range of value-creation pathways they could potentially follow, it certainly seems as though today's operating partners have their work cut out. Fortunately, few firms expect their in-house teams to go it alone. Many GPs have carefully curated a network of operating advisers, providers and consultants they can tap into in order to access specialist functional or industry expertise.

"There are certain areas where we are starting to see the bigger private equity firms build in-house capabilities – such as ESG, talent acquisition, digital and technology, sometimes procurement – but the most common approach is an adviser ecosystem where individuals can be pulled in as and when needed," says Sherwin Godinho, a partner at consulting firm AlixPartners.

These networks are particularly valuable to newer managers or those at the smaller end of the spectrum. "First-time funds and smaller emerging managers will often bring in external advisers that work directly with management," explains Godinho. "The key thing for the manager is to have that ecosystem of expertise they can call on." ■

Q&A

Agility and a value-orientated mindset are among a suite of skills required of portfolio company chief financial officers, says experienced PE-backed CFO Victoria Bell

Q What are the challenges involved in working as a CFO in a PE-backed company?

A There are many challenges, often mirroring the role's inherent appeal. The amalgamation of volume, pace and agility forms the crux of these challenges. Despite a three- to seven-year investment horizon, the initial 12-18 months demand significant actions, initiatives and adjustments, which are sometimes accompanied by required cultural shifts and executive reshuffling. Post this initial period, this urgency persists, given that subsequent investments or changes must yield rapid returns as the exit horizon looms.

Q What key skills do CFOs at portfolio companies need?

A In my experience, essential skills for PE-backed CFOs span a dynamic spectrum, from strategic finesse to hands-on engagement. You need to be agile and adaptable. There will not be layers of people to do the work or time for long decision cycles.

Effective leadership throughout the organisation is also paramount, shaping attitudes and behaviours, and ensuring a focus on value creation. This means communication and leadership skills are a high priority.

Navigating the swift tempo of PE demands ruthless prioritisation and an execution and value-orientated mindset. Driving focus, fostering responsibility, instilling accountability and ensuring value delivery while being clear on non-priorities are central tenets. Equally critical is team and relationship building. Assembling a capable, responsive team, making any required changes rapidly, and adeptly managing shareholder relationships are pivotal.

Q What do you wish PE firms better understood about the role of the CFO?

A Misconceptions about the CFO role in PE firms often arise from underestimating its extensive scope. It can be easy for investment teams to assume they understand the CFO role due to their financial and analytical backgrounds. But responsibilities often reach far beyond financial oversight, encompassing some or all of M&A, IT, HR, legal and compliance, procurement, enterprise risk and more. The financial analysis that can be provided is a direct consequence of data management, systems and processes in the organisation, and changing this will likely require investment and time.

In addition, the CFO is a business partner for the CEO and as such often has an informal but important leadership role for the group as a whole.

Q What can PE firms do to support CFOs?

A PE firms should underscore focused prioritisation, including with the CEO and the rest of the executive team if required. Ensure the CFO has the appropriate strength and depth underneath – don't scrimp on the cost and quality of roles reporting to them.

A focus on financial and non-financial data, standardised KPIs and repeatable analysis should trump ad hoc and manual requests. Systems and processes should be invested in early in the cycle to deliver insightful information in a timely manner, improving decision making and value analysis.

Finally, funds need to be honest with CFOs about their style and approach – not all funds are the same – and of their view of the functions underneath the CFO. Funds need to recognise they may not be best placed to assess the current capabilities and therefore must give the CFO time to perform their own assessment, utilising their experiences and perspectives. ■

Victoria Bell has worked across multiple industries and geographies as a PE-backed CFO. She was most recently group CFO at Unilabs

KEYNOTE INTERVIEW

Delivering value in the shift to value-based care



Private equity has an important role to play in the US healthcare system's transition from a fee-for-service model to a system based on outcomes, believe Ravi Sachdev, Ron Williams and Keith Pitts at Clayton, Dubilier & Rice

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Q How would you describe private equity appetite for healthcare in the current environment, and what is driving that?

Ravi Sachdev: The number of firms investing in the healthcare sector has increased significantly in recent years and the breadth of opportunity that private equity firms are targeting has expanded significantly as well.

The drivers behind that are simply the percentage of GDP that continues to go towards healthcare and the pace of innovation that healthcare is experiencing. The only other sector that would match the pace of innovation that we see in healthcare is core technology.

Ron Williams: Healthcare also offers the opportunity to improve management techniques, introduce stronger talent and better technology to help improve outcomes, and meet unmet medical needs in what is a highly fragmented industry.

We see private equity investment in healthcare as a win for patients, physicians and for our LPs.

Keith Pitts: The healthcare system today is fragmented and transactional, which we believe means this is an industry that is ripe for constructive disruption. There are huge opportunities to invest in everything from technology to innovative care models and that is attracting a lot of firms into the sector.

Q Why is the concept of value-based care proving particularly attractive?

RW: With value-based care, the healthcare system is shifting from treating people that are sick, and presenting with symptoms, towards preventive care and active management. To facilitate that shift we believe we need to move away from a transaction-based reimbursement model where, in order for a physician or hospital to be paid, a patient has to present symptoms and have treatment or a procedure.

With value-based care, physicians can choose how best to serve their patients' needs, improve their quality of care, better manage chronic conditions and potentially keep them at home. In other words, value-based care means moving from a transaction-orientated system to an outcomes-orientated system with the patient at the centre of it all.

Q How is PE contributing to the evolution of the value-based care model?

RS: There is clear demand in the US healthcare system for better outcomes, better experience and lower cost, and we believe value-based care is the best way to meet those needs. Five or 10 years ago, Medicare – which dominates the US healthcare system – just wanted to pay for transactions. Now Medicare wants to pay for outcomes. That has forced change and created an opportunity for private equity firms to help companies with that transition.

Value-based care requires different management capabilities, as well as different technology capabilities, different processes and different capital. We believe there is an operationally driven investment opportunity that exists around these assets that is akin to the transition from analogue models to digital or from bricks and mortar retail to online, and it is creating a huge need for smart capital in the healthcare sector.

Q What are the challenges involved in healthcare investing and how can they be overcome?

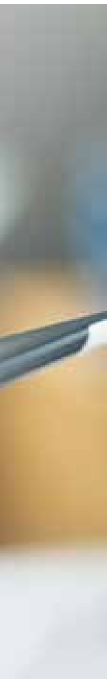
KP: Clearly, there is a great deal of regulatory risk in US healthcare. It is important to have all the proper processes, policies and talent in place to ensure you maintain regulatory compliance at all times. Similarly, it is important to be extremely vigilant around reputational or headline risk when owning healthcare businesses. Of course, things happen, but you need to have the resources in place to manage those situations and, having been involved in healthcare for a very long time, that is something we feel comfortable navigating.

> *"Healthcare offers the opportunity to improve management techniques, introduce stronger talent and better technology to help improve outcomes"*
>
> **RON WILLIAMS**

RS: I think the reimbursement environment can also be challenging. With healthcare, the government is the largest payor in the country, given how big the Medicare and Medicaid population is today. That creates a level of volatility in your core business that you need to manage. You have to understand that a government counterparty is different to the counterparties you might experience in other sectors of the economy.

I would add that the power that technology has to disrupt healthcare should not be underestimated. We believe any sector that is as fragmented and paper-based as healthcare has been is ripe for disruption, and it is vital to ensure you are on the right side of that disruption. Overall, there is a broader set of variables that you need to think about in this industry, including patient experience, physician experience and the ability to deliver outcomes beyond financial outcomes.

Because the government is such an important payor, investment in healthcare is essentially a public-private partnership in which you need to help the



Q What are some of the investments that you have made in the sector and what role have you played in supporting those companies?

RS: We have been extremely active in the broad theme that is value-based care over the past eight years. We invested in a business called naviHealth, a leader in a category called bundled payments. Rather than paying for an individual transaction, the government pays for an episode of care once a patient leaves hospital and goes into a post-acute facility. We carved naviHealth out of Cardinal Health and ultimately sold it to United Healthcare.

We also started a company in partnership with management in 2016 called agilon health and continue to be owners of that business today. agilon helps primary care doctors get paid for the total outcome of managing people aged over 65 in their practices.

In addition, we have recently created a business called apree health in partnership with one of the largest insurance companies in the country and Morgan Health, a new subsidiary of JPMorgan. apree health focuses on improving employer health by extending value-based care topics beyond the Medicare market to under 65s and the commercially insured population. Finally, we have partnered with a group of doctors in Florida, with an organisation called Millenium Physician Group, to help them with their transition from a transaction-based system to a value-based care-driven business model.

government accomplish what it wants to accomplish. I would add that while we are here to support physicians, we are not physicians ourselves. Our job is to ensure that physicians are exercising their independent clinical judgement about what is best for the patient. To do that, we can bring them data and analytics. There is an enormous amount of information available about the patient population and we can help them glean the relevant insights.

Recognising the challenges involved in healthcare investment is one thing. Overcoming them is something else. And that is where I feel we are differentiated, in terms of our deep operating experience and talent.

> *“There is clear demand in the US healthcare system for better outcomes, better experience and lower cost”*
>
> **RAVI SACHDEV**

Q How do you see the value-based care model evolving?

RS: Over the next 25 years, I think we will see a consistent move away from a transaction-based healthcare system towards an outcome-based healthcare system. To date, that transition has primarily been focused on the Medicare population. There has been little focus on the Medicaid population or the commercially insured population. Our belief, however, is that by the middle of this century, the majority of the US healthcare system will in some shape or form be tied to payment for outcome – outcome being defined as an improved patient experience and reduced overall cost.

I would add that there are many categories within healthcare that have yet to be touched by value-based care. Most value-based care today is still tied to primary care doctors and how we can change their payment structure.

There has been very little focus, by contrast, on cancer cost or musculoskeletal cost, and those are very big drivers of spend in the US healthcare system. Ultimately, I think these categories will also be influenced by value-based care in some way, which we believe should help create a much more efficient healthcare system in the future.

At the moment, we have lots of people doing lots of things in order to get paid for a transaction, as opposed to having lots of people spending time thinking about improving outcomes. As value-based care continues to penetrate different sectors of the US healthcare economy, we believe that will also impact what is going on downstream, stimulating innovation in technology and processes on the frontline.

RW: I absolutely agree that the move to value-based care will accelerate the migration of innovation into the frontline of medicine. By changing the parameters of how people get paid, putting emphasis on what is best for the patient, we expect to see an increase in care moving outside of the hospital into ambulatory settings or into the home. Hospitals will be hubs for surgical activity, but we believe a lot of other activities that have previously taken place in hospitals will move to lower-cost settings, supported by tech innovation.

KP: Value-based care will definitely change the nature of care delivery and where that care delivery takes place. That, in turn, we believe will undoubtedly improve the patient experience and is one of the key evolutions that lies at the heart of value-based care for all. ■

Ravi Sachdev is a partner at Clayton, Dubilier & Rice, and Ron Williams and Keith Pitts are operating advisers to CD&R funds

How to set up an operating team from scratch

Developing a value-creation function takes time, but appointing someone to lead on strategy and engage with external advisers can put firms on a strong footing, writes Claire Coe Smith

While the way in which a private equity firm creates value in its portfolio companies sits at the heart of its strategic vision, putting together the resources and tools to execute that plan is not always easy. For first-time funds and emerging managers, developing a portfolio operations team from day one while simultaneously fundraising and sourcing deals is a challenge.

Maria Orlowski joined GTO Partners in early 2023, taking on the value-creation partner role at the European PE firm, which focuses on backing B2B technology leaders. GTO is raising its first fund.

"LPs aren't necessarily expecting you to have all resources in-house, but you do need to have a process for how you identify opportunities and work with the businesses," Orlowski says. "We have prioritised building up a network of advisers, from those that can chair a business to those that can execute on a specific project, whether that is a pricing project or a marketing transformation."

'Who you know'

Often it is about who you know, rather than what you can offer in-house, she says. "What you need from day one will depend on what you are going after in terms of target companies, particular industry focus or size," says Orlowski. "We only look at B2B software and technology-enabled services in the lower mid-market and we find that at this point we don't have to have everything in-house.

"Thinking through how we are going to work with the portfolio companies to add value, what the value-creation plan is, and how we are going to execute on that is at the core. Building an external network of advisers to support on that pre- and post-deal is so valuable."

GTO was founded by former Oaktree Capital Management managing director Federico Canciani. Appointing Orlowski as the second partner in the business, with a value-creation brief, is key to the firm's approach. "If you are a small manager starting out, having an approach to value creation and dedicated resources goes a long way because not everyone does that from the beginning. For us, it is a point of differentiation," Orlowski says.

Taking the lead

Sherwin Godinho, a partner at consulting firm AlixPartners, frequently works with private equity firms leading value-creation projects in the technology, media and telecommunications industry. He agrees that for first-time managers, it is critical to have someone taking the lead on portfolio operations in-house, even if the delivery relies on a network of consultants and advisers.

"First-time funds and smaller emerging managers will often bring in external advisers that work directly with management," says Godinho. "The key thing for the manager is to have that ecosystem of expertise they can call on. In some cases, it falls to the deal team to tap that external resource, but it is helpful to have someone who is tasked with working with management on an ongoing basis because they can be hands-on and really focus on building those relationships."

At more established private equity firms, there is no doubt that operating teams are getting larger and building more capabilities internally, but that is not a must-have from day one.

"The deal teams in PE firms are typically market-specific or industry-specific, while the operating team can be more generalist and tends to bring in external advisers or tap a panel of experts in specific areas," says Godinho. "There are certain areas where we are starting to see the bigger private equity firms build in-house capabilities – such as ESG, talent acquisition, digital and technology, sometimes procurement

> *"If you are a small manager starting out, having an approach to value creation and dedicated resources goes a long way"*
>
> **MARIA ORLOWSKI**
> **GTO Partners**

– but the most common approach is an adviser ecosystem where individuals can be pulled in as and when needed."

Quality, not quantity

As a portfolio company of Permira, fund administrator Alter Domus has seen PE value creation up-front since it was acquired in 2017. Steve Krieger was closely involved with the Permira team leading the value-creation plan before becoming head of key client partnerships in the business.

"From our perspective as a private equity portfolio company, the effectiveness of the operating team is not a matter of size but the quality of the team," says Krieger. "A handful of highly knowledgeable and well-connected individuals in-house that are pulling their sleeves up and getting things done is far more valuable to companies than dozens of people that are giving out theoretical instructions."

He adds that the ability to build relationships and work well with management teams has to be the key feature of any start-up portfolio operations team.

"What is also important is the connections with management and the strength of communications," says Krieger. "There is a fine line between being helpful and being intrusive, so individuals working in portfolio operations need to have that sensitivity. It is not about being the person in the room that has the best idea but being the person with the best idea that actually gets done."

While investors will be tracking portfolio growth closely, they are typically content with an outsourcing approach from the outset. "For us, it has been very beneficial to have someone own portfolio value creation as a function, and then the question is what you add to that over time," says GTO's Orlowski. "Having that one person responsible for the playbook and best practice, for developing the network and for bringing that thinking to the team, allows us to develop those ways of working from day one."

According to Orlowski, the biggest challenge is resources: "You have to do it on a shoestring when you are starting out. We have to be really proactive in reaching out, building relationships and finding people that are a good fit for what we are trying to do. All of that takes a lot of time and effort, too."

At the same time, Orlowski argues that the ability to start from the ground up gives new managers opportunities to lean into next-generation consultants or industry experts that are newly independent, as well as allowing for additional flexibility in the way the function develops. But finding talent is not easy, especially right now.

"What is really in demand at the moment is support around technology – IT integration or separation and carve-outs," says AlixPartners' Godinho. "That is fairly complex and is something where managers tend to reach out to advisers. Another area where there is a lot of call for external help and support is around compliance and cybersecurity, where it is rare to see in-house capabilities at a private equity firm."

For managers starting out, therefore, identifying the third-party providers that will be able to step up and help portfolio companies when needed is a priority. ■

KEYNOTE INTERVIEW

Making pricing a priority

Pricing is a powerful value-creation lever, but poor implementation can lead to disappointing results, say Pearson Ham Group principal Zeba Syed and founding director Tim Ham

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Q To what extent has pricing come to the fore as a value-creation lever for private equity?

Tim Ham: A decade ago, many of the conversations we had with private equity houses were focused on why pricing was something they should care about. Nowadays, it is rare to have a conversation with a private equity firm that doesn't consider pricing to be a priority to some degree.

The focus now tends to be convincing the portfolio company that pricing matters. There are certainly some private equity houses that pursue pricing in a more aggressive and systematic manner than others, but I think they all appreciate its importance.

Q Do companies sometimes simply not understand that they are under-pricing?

Zeba Syed: That is definitely true in some cases where we often see a combination of a legacy cost-plus mentality, plus a lack of confidence or information bias driven by sales teams being led by what they hear from customers. Pricing can be seen as something of a can of worms, and many companies just don't feel skilled and therefore tend to shy away.

To really understand the potential and get people engaged, we use robust counter metrics in the form of detailed customer research, price tests and price elasticity assessments to demonstrate willingness to pay. Clients are often surprised by the insights we can glean to support pricing moves and, of course, in opaque markets that kind of insight is even more valuable as there is no obvious benchmark.

Q Is it a question of lacking dedicated resources and governance around pricing?

TH: Yes, that is part of the challenge. Pricing is often neglected because it is under-resourced, and people are unaware of what good looks like. It is a complex discipline, and most companies lack the critical mass to develop

> *"Pricing is often neglected because it is under-resourced, and people are unaware of what good looks like"*
>
> **TIM HAM**

and nurture the talent. Unfortunately, the lack of pricing resource can lead to a lack of insights, which in turn means that the money that is being left on the table is not appreciated, and this perpetuates insufficient investment.

ZS: We recently worked with a large events company where pricing was the last consideration on the list. They defined the product set and decided what would be included in the ticket price before they agreed on what that ticket price should be. In our view, pricing needs to be at the top of the agenda and not an afterthought, and that should be reflected in the resources allocated to pricing decisions.

Q What other challenges can companies face when it comes to planning and implementing price moves?

ZS: In addition to ensuring that pricing is high on the agenda, it is important that it is viewed as a strategic objective that the whole company has fully bought into. If the pricing strategy is restricted to a single department, it won't get enough traction to succeed.

Pricing often needs to be viewed as an organisation-wide change management exercise. There are knock-on implications for the marketing, systems, account management and product teams. As such, it is critical to have the executive team on board. If the messaging isn't coming from the top, the implementation is unlikely to be successful. I would argue communication is critical as you need to explain the rationale for the price move internally and really take the relevant stakeholders on the journey.

Q Can you share an example of putting a pricing increase into practice?

ZS: We recently completed a project in the life sciences industry where the company was facing myriad challenges. There was a significant degree of unstructured customer discounting and limited levels of governance, as well as variation in the sales team's negotiation experience. Sales managers also struggled to develop a structured rationale for price increases, so the sales team struggled to believe they could achieve more than 6 percent on average. In addition, the team's datasets were often messy and complex to analyse, making it difficult to produce meaningful pricing insights.

In order to help the business overcome these challenges, we focused on 20 key accounts, reviewing spending trends and discount performance overtime. That exercise produced potential negotiation approaches and practical insights that could drive continuous account improvement. These steps were key in providing well-structured, account-specific price increases and helped the client to understand that the increases were achievable. As a result of this support, the company was able to achieve 18.1 percent margin growth – well ahead of the 6 percent target.

Q What are some of the pitfalls you see in terms of an underequipped sales team, and how can these be addressed?

ZS: One of the most common problems we see with sales teams is a lack of understanding around the reasons for the price increase, so it is important to share supportive customer insights and competitor benchmarking. The other common pitfall is not effectively preparing a company's sales teams. If existing customers push back against a price increase, the sales team needs to be armed with counterarguments that shift the focus of the conversation from price to value. With software, for example, that line of thinking can often be tied to product development.

It is also critical to ensure measures are in place to mitigate value leakage, which comes back to tracking KPIs and making sure there is a clear escalation process. We are currently working on a project where the sales team is walking away from deals because they don't know that they can escalate and get approval for a discount. Conversely, other sales teams ignore the escalation process and discount regardless and that, of course, leads to value leakage. In these instances, we recommend running focused training sessions around objection-handling and negotiation, and playbooks can be an effective method of codifying best practice.

We would also strongly advocate piloting any price increase. That helps test market acceptance, but also drives confidence and buy-in. Those selected sales team members that are part of the pilot become advocates, later helping their peers to understand common objections and how they can be handled. The pilot also helps the management team recognise how well the prices are landing with clients and whether adjustments are required.

Finally, I would point to the importance of ensuring that incentive schemes are appropriately structured to motivate the sales team in line with the price changes. For example, if a tiered pricing structure has been introduced, the compensation structure will need to be changed to reflect that, with higher incentives available for the higher tiers.

Q Is pricing a tactical lever or a strategic lever, and why is that important?

TH: Pricing is a strategic lever. Tactical pricing comes in when your hands are tied and you have very little latitude. It often reflects a junior pricing department and a lack of direction from the top of the organisation, with pricing being viewed as something that comes in late in the overall process. Strategic pricing, however, is an integral component of a broader value-creation strategy that starts with a real understanding of what the customer needs and values, rather than starting with the product.

"Pricing often needs to be viewed as an organisation-wide change management exercise"

ZEBA SYED

"There is an increasing awareness of the disciplines of pricing and the value associated with delivering them well"

TIM HAM

Q How sophisticated is the private equity industry generally when it comes to pricing today? Are firms bringing in specialists in the same way that they bring in data and cybersecurity consultants?

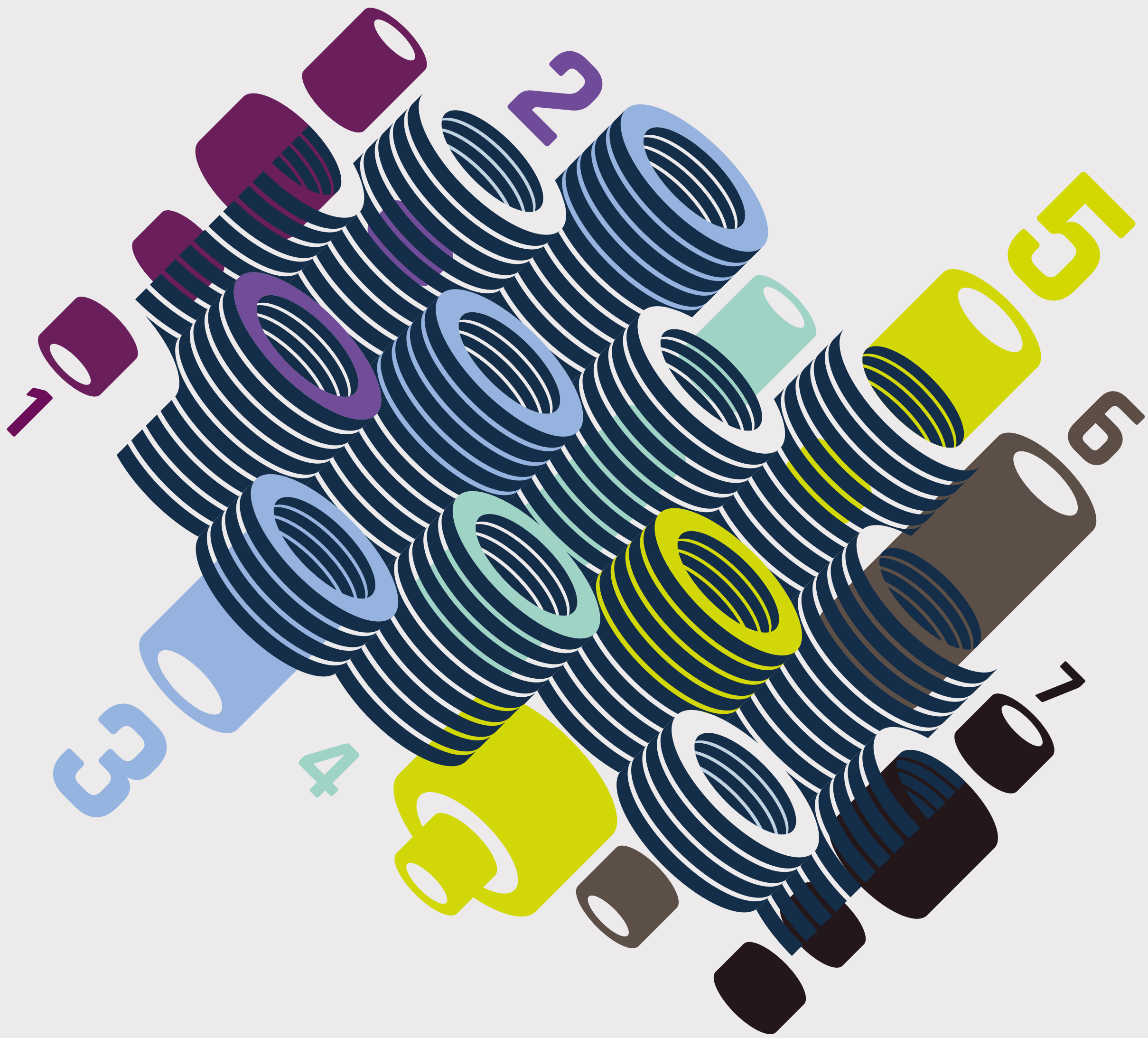
ZS: There is definitely an awareness of the importance of pricing but often the implementation process is underestimated. Defining a price increase is arguably only half the battle. Private equity houses are becoming more cognisant of this fact and value the change management aspect, which requires more planning, time and buy-in from the relevant teams for a price move to be successful.

I would add that the cross-sector experience we can bring to pricing is very valuable. We are often viewed as the bridge between the portfolio company and the private equity firm. As outsiders, our broad experience can really resonate when we are talking to sales teams and other departments about the required changes.

TH: There is an increasing awareness of the disciplines of pricing and the value associated with delivering them well. This is driving a steady increase in the use of specialists. We are observing a steady evolution in attitudes and behaviours in this regard.

Q There has been increased emphasis on pricing due to rising inflation. Do you see pricing as a cyclical value-creation lever or something that will continue to remain relevant?

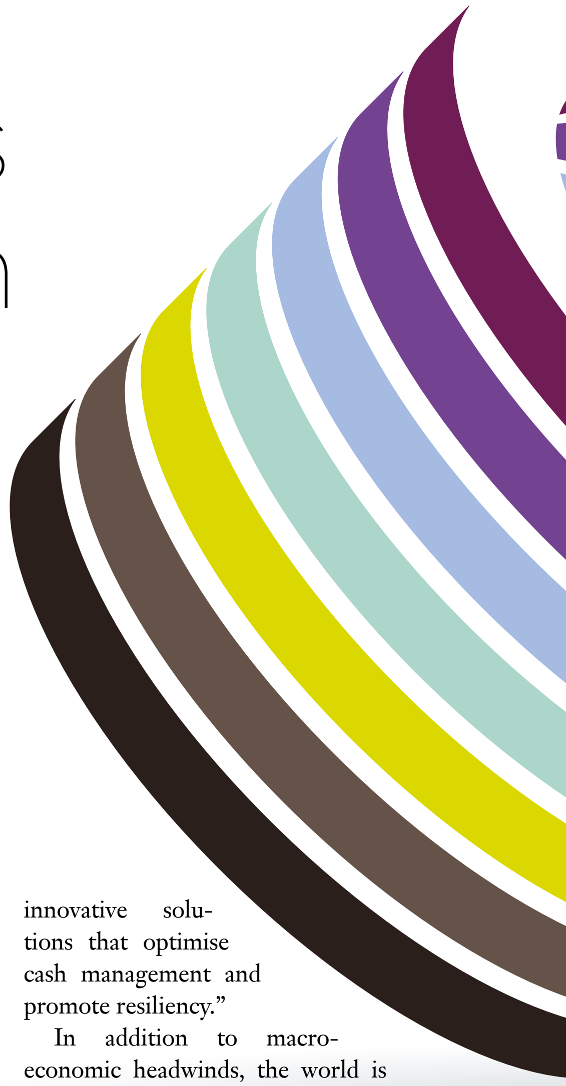
TH: This period of high inflation has been a catalyst for engagement with pricing, but this is something that has nonetheless been on an upward trajectory. We expect that upward trajectory to continue as people continue to gain a greater appreciation of the value. I can't imagine this being a trend that will reverse. ■



Pillars for growth

Amy Carroll provides a rundown of seven hands-on value-creation initiatives that can help transform investment outcomes in challenging times

The ability to construct a robust value-creation plan and strategically pull the appropriate growth levers has always been integral to the private equity playbook. But with the cost of capital climbing and entry valuations remaining stubbornly high, GPs will need to leverage all the operational expertise at their disposal to support and grow portfolio companies and generate returns for investors.



New frameworks for value-creation

In the face of rising headwinds and competition, private equity firms are shoring up areas that could have an outsized impact on portfolio company growth

When private equity was still in its infancy, back in the late nineties and early 2000s, there was significant value to be derived simply by taking operating cost out. “Then private equity entered a second stage and a number of funds generated great returns through financial engineering on the back of a low interest rate environment, supported by steadily rising valuations,” says Hugh Lloyd Ellis, leader of PwC’s private equity business in the UK. “Now, of course, interest rates and therefore the cost of debt are far higher and private equity firms are having to focus on true, sustainable value creation.”

Louise Kingston, a director in the global portfolio operations team at Baird Capital, agrees: “This combination of economic uncertainty, high inflation and expensive finance creates an even greater requirement for value creation during a private equity firm’s ownership. Portfolio companies are having to increase their rate of profit growth if they are to keep pace with the rising cost of capital, and only triple-A quality businesses are successfully transacting. This means even more work for investors to drive growth and prepare companies for sale.”

At Ardian, Christopher Sand, a managing director on the buyout team, says the firm is partnering closely with the executive teams at portfolio companies to mitigate financial headwinds and continue to drive growth and improved cashflows through the current challenging economic environment. “The broader economic weakness across the US and Europe is causing many companies to rethink their day-to-day strategies, but with that comes an opportunity to double down on innovative solutions that optimise cash management and promote resiliency.”

> *“Portfolio companies are having to increase their rate of profit growth if they are to keep pace with the rising cost of capital”*
>
> **LOUISE KINGSTON**
> **Baird Capital**

In addition to macroeconomic headwinds, the world is changing at breakneck speed, says Sarah O’Connell, a value-creation partner at PwC. “Digitalisation, decarbonisation, deglobalisation – these major themes are forcing private equity firms to intervene to ensure businesses stay relevant in a rapidly changing landscape. That is a key driver of value creation as well.”

Competitive edge

Despite relatively brutal fundraising conditions, the market remains extremely competitive, and value-creation levers have become essential for underwriting the returns that LPs have come to expect.

“Deal volumes for the first half of this year are down and deal values are

74%

European PE executives who say they are looking for new value-creation opportunities in light of the tougher market environment

Source: Alvarez & Marsal's A New Era for Value Creation: Transforming European Private Equity-Owned Businesses in Uncertain Times report

down even further," says O'Connell. "But the reality is that the same amount of capital is chasing those deals. Auctions are being hotly contested and valuations remain high, so private equity firms are having to seek out value-creation potential in order to be successful in those processes."

Lewis Bantin, a partner at mid-market private equity firm ECI Partners, believes the growing importance of value creation has less to do with the economic environment and more to do with competition to generate returns. "We are in a world where, despite reverberations throughout the economy, an awful lot of equity capital has been raised while the flow of companies coming to market hasn't increased at the same rate. That means pricing for quality assets remains high. The challenge then becomes how to underwrite a 3x return. What value-creation levers do you need to pull to get there?"

> *"We are seeing private equity firms establishing urgency around value-creation levers much earlier in the process"*
>
> **STEPHEN MOON**
> **Alvarez & Marsal**

Stephen Moon, a managing director in Alvarez & Marsal's private equity performance improvement team, says the identification of value-creation levers has become critical in due diligence in order to bridge the buy price: "We are seeing private equity firms establishing urgency around value-creation levers much earlier in the process with a view to implementing those levers immediately following completion."

Indeed, as other historical drivers of returns, such as favourable financing conditions and rising valuation multiples, have faded away over the past 18 months, managers have relied almost exclusively on operational value creation to generate returns. From shaking up management teams, to strategic M&A, smart pricing, supply chain optimisation, digitalisation and value-accretive ESG, hands-on intervention has become critical.

Chris Mauss, a senior asset class manager at private markets firm Partners Group, points to the industry's extensive history of boosting value. "Private equity has decades of experience and track record in identifying and rolling out operational value-creation initiatives. Initiatives are varied and can range from regional expansions, market consolidations and introduction of new products on the revenue side, to lean management, procurement and digitalisation on the cost side. The private equity industry is at a stage now where innovation in value creation is coming from the frameworks being introduced to efficiently use operational levers in a systematic fashion and from the talents and organisations that are built around them." ■

Corporate governance

Portfolio company support and oversight provide the foundation for operational improvements and growth

Good corporate governance is the bedrock of value creation. "It all starts with corporate governance," says Selim Loukil, a managing director in the portfolio support group at Advent International. "As active investors, we don't just hand our leadership teams the keys and say, 'Good luck, we'll see you at the next board meeting'. We partner with them to design, resource and monitor the transformation plans that lie at the core of our investment thesis."

Corporate governance is about far more than board meetings and committees. "It is first and foremost about what's happening outside of the boardroom: the weekly calls with CEOs and daily interactions with specific executives," says Loukil. "And in these times of uncertainty, when it is important to be dancing on both the front and back foot at the same time, being as close as possible to leadership teams and having that tight governance is essential."

Stephen Moon, a managing director in Alvarez & Marsal's private equity performance improvement team, agrees that good corporate governance goes hand in hand with leadership. "A leader has to be empowered to make decisions, but they must also have checks and balances around them to ensure those decisions are the right ones. It works well when there are clear rules of engagement, but I have also seen situations where leaders have gone rogue, either doing too much, too quickly, because the governance was not in place to stop them, or else doing too little."

The founding principles of a corporate governance framework must also be disseminated across the wider team. "Good corporate governance is integral and, for us, this means ensuring a company has a clear mission, vision and operational framework that is not only understood by the executive team, but also cascaded through the organisation so that everyone identifies and recognises their contribution to the bigger picture," says Tracy Bownes, a partner at private equity investment firm LDC.

Good governance is critical for the deployment of value-creation levers, in particular. "Private equity firms are now driving transformation of businesses across a number of different levers and are deploying significant capital investment to do so," says PwC value-creation partner Sarah O'Connell.

62%

Portfolio companies that say PE investors actively engage with them post-deal

Source: KPMG's Delivering on the Promise of Value Creation: 2022 Market Insights Report

"Corporate governance is therefore more important than ever. You need to be scrupulous in your decision making to ensure that capital expenditure is generating shareholder returns."

Chris Mauss, a senior asset class manager at Partners Group, adds: "If your ambition as an investment manager is to drive transformational initiatives at portfolio companies, you need to have a clear and efficient decision-making process, as well as the right calibre of professionals setting the strategic vision, making decisions and leading initiatives. Corporate governance should be the very first priority in any ownership phase. This means an engaged board of directors with industry experience, an entrepreneurial mindset and clearly defined roles for delivering on strategic growth objectives."

Staying aligned

It is important to create alignment between the board of directors and with management to ensure everyone is rowing in the same direction. "Without a proper corporate governance framework in place, you might have a disconnect between the vision of the owners and what is effectively happening at the company, lose momentum in your transformational initiatives, or even worse be late at identifying issues that require immediate actions," Mauss says.

Once a framework is in place and a clear value-creation plan has been laid out, the next crucial step is to identify the most relevant KPIs for measuring and monitoring the progress in transformational initiatives.

The saying 'what gets measured gets managed' is also relevant to PE transformations, adds Mauss: "Naturally, some value-creation levers, such as platform consolidations, digitalisation or geographical expansion, are easier to track than others. Finding the relevant KPIs to measure can take our investment teams and boards quite some time, but the results are powerful." ■

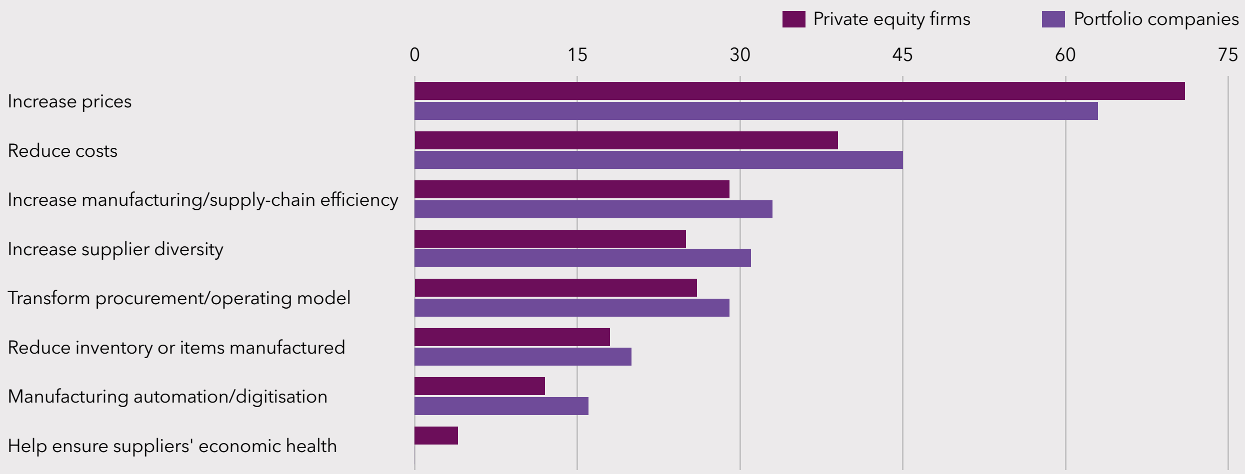
Supply-chain management and procurement

Recent economic and geopolitical events have laid bare the importance of ensuring supply-chain and procurement strategies are both optimised and robust

Brexit, swiftly followed by a global pandemic and then war in Ukraine, has placed supply-chain management and procurement firmly in the spotlight. "The focus has shifted from increased globalisation to supply-chain resilience," says Sarah O'Connell, a value-creation partner at PwC. "In that sense, there is a strong value-protection angle here, particularly in the context of high inflation. But procurement itself can be an important value-creation lever given that it represents such a huge part of the cost base of many businesses."

Christopher Sand, a managing director on the buyout team at Ardian, agrees: "Supply-chain management is a way

The top three strategies PE firms and portfolio companies have taken to address ongoing supply-chain issues (%)



Source: AlixPartners' Eighth Annual Private Equity Leadership Survey

to mitigate risk and creates an opportunity to drive value. There has been a heavier focus on supply chains in the last few years than ever before, and the pandemic highlighted just how important it is to have a diversified supply chain. Many supply chains became overextended during covid, and some companies started to build up extra inventory to compensate for the shortages."

At Partners Group, Chris Mauss, a senior asset class manager, says the firm led a number of supply-chain initiatives across portfolio companies in the wake of the pandemic, initially to protect value and then eventually turning this into an advantage. Industrial belting solutions company Ammega, for example, proactively introduced safety stock initiatives and systematic dual-sourcing policies, positioning the company to take market share at a time when competitors were unable to fulfil customer orders under reasonable timeframes.

Addressing inflation

Another macro change that has had a particular relevance to procurement optimisation, of course, is the structural return of inflation. "While many private equity managers primarily limited their response to price increases, this strategy ultimately brings no value to clients," says Mauss. "Our procurement consolidation and optimisation strategies have unlocked an additional lever for portfolio companies to mitigate cost inflation and, in certain cases, to share some of the savings with end customers."

For example, Pharmathen, Partners Group's contract development and manufacturing organisation in the pharmaceutical industry, has worked to expand localised manufacturing capacity and identify alternative sources of supply.

Private equity firm Apax Partners, meanwhile, has delivered almost $2 billion of cumulative savings through margin-expansion, cost-reduction and procurement programmes. "It is a critical and classical toolkit that gets more and more data-driven every day," says Seth Brody, a partner and global head of the firm's operational excellence practice. "Our procurement team uses our proprietary Spend Insights platform to plug directly into our portfolio company's vendor management and spend data feeds, turning that data into opportunity assessments and targeted cost-reduction programmes.

"Process optimisation and supply-chain programmes are often our highest ROI efforts. We recently completed a post-Brexit warehouse and distribution centre programme that delivered more than $13 million of savings in just a few months."

Stephen Moon, a managing director in the private equity performance improvement team at Alvarez & Marsal, agrees that supply-chain and procurement optimisation are usually the largest value drivers in any project because that is where most of the cost lies. "You can introduce digital components and analytics and, because the world is changing all the time, there is always the ability to re-evaluate, test and reshape your supply chain.

"Brexit, the pandemic, war in Ukraine, geopolitical tensions between the US and China – all of which we've seen over the past four years – could create problems or opportunities in terms of who you are buying from and how you price the contract. It is an area of huge potential." ■

KEYNOTE INTERVIEW

Using data to drive value creation in a downturn


Amid a challenging macroeconomic environment, private equity firms can draw important value-creation insights from well-managed data sets, say Glenn Mincey and Richard Chen at KPMG

SPONSOR
KPMG

Q What dominant themes are you currently seeing in the private equity ecosystem and where is the market headed?

Glenn Mincey: We have certainly witnessed a slowdown in exits, not just over the past 12 months but for at least the past year and a half. Recent data tells us that private equity deal volume fell by 63 percent to $321 billion in 2022, and figures from the first half of this year have largely shown a continuation of that downward trend. We know that the deal market will return, and, while we can't pinpoint that moment, we can say with certainty that every time the market returns, it returns more quickly than anticipated.

Even before the recent macroeconomic headwinds took effect, there was a huge divide between buyer and seller pricing expectations. With the introduction of higher interest rates, increasingly restricted access to capital and a more complicated regulatory regime, that gap is getting even wider. Many funds are approaching maturity and need to distribute capital back to investors, which is putting pressure on sellers.

GPs have been holding on to assets for longer and waiting for valuations to recover, and with those elongated hold periods comes a need to drive more value out of those assets.

Right now, we are waiting for some level of clarity on the economic outlook so that investors can make predictions, build these into their models and start to move forward. Buyers have a significant amount of capital available and plenty of time to deploy it, meaning they can wait for sellers to blink on pricing.

Richard Chen: We believe dealmaking activity will come back sooner rather than later, and likely faster than we expect. It is likely we have hit the bottom of the downturn. Now we need the right triggers to kickstart activity.

People understand that money is no longer cheap. Private equity has historically returned mid-double digits, and the ultra-low accommodative interest rates of the last decade have contributed to roughly a third of returns in this period. Private equity has consistently outperformed the market, and in a high interest rate environment we expect investors to lean further into value creation to maintain that level of performance.

Q How does due diligence play a role in investors shifting their focus to value creation?

GM: This value-creation trend is not something that has just started – it is something we have been observing for some time. It started back when valuations were at historically high levels, when there was an intense need to enhance operational value. We saw then that value-creation processes were being implemented earlier than usual, and that data analysis around that process was being integrated at the due diligence stage of dealmaking.

RC: In the current market environment, it is even more imperative to use data to test value-creation theses and drive these levers earlier on. Over the past few years, operating partners have increasingly been involved in diligence processes and are starting to integrate even more into the deal teams, identifying and testing the key growth and cost levers that underpin a thesis and using that to inform a go/no-go decision.

They can then come in with a level of confidence around four or five key value-creation levers that will impact how the sponsor thinks about that particular asset.

Q In terms of value levers, what imperatives and priorities are you seeing in your work with clients?

RC: It is important to note that all value levers can be applied in different circumstances, but most people choose to start with thinking about costs and synergies. The rapid pace of dealmaking in the last few years meant that it was possible to generate returns without really integrating businesses and addressing synergies. Now, with elongated hold periods and a focus on bolt-ons, the ability to capture those opportunities is critical.

Similarly, the cost levers that have typically gone unaddressed because they were hard work to implement are now coming into focus because they are directly under the control of the management team. Other avenues to growth include understanding your customer base, segmenting the customers, and understanding how you orientate your commercial organisation – be it sales, marketing or services – to address the existing customer base and maximise growth.

The next thing, of course, is using analytics to understand where the new and adjacent markets are projected to grow and how that fits with your existing core offerings so that you can expand your market. The ability to aggregate all the disparate sources of data to gain insights into both the business and the end market is hugely valuable. In the last few years, there has been less of a focus on investing in technology at platform companies, but that is changing. If you are going to hold a business for longer, that is an investment worth making.

Having industry specialists is also particularly important on the growth side. While functional expertise can help in many areas, industry expertise is vital when it comes to growing the customer base, understanding the competitive landscape, and pricing strategy, for example.

Q What do you consider to be the key elements of successful value-creation initiatives?

RC: From day one, it is critical to build conviction when underwriting a deal. That is still the case in a very competitive environment, but it is even more crucial to be sure on what you can underwrite and what you can build conviction around in a downturn, which often starts with understanding cost and synergy capture. You can't cost-cut your way to long-term value creation so you also need to focus on the growth value-creation levers, which includes evaluating the quality of your customer revenues, your routes to market and the adjacent markets you may enter.

When we surveyed operating and deal partners earlier this year, we had assumed there would be a big focus on costs in the value-creation story, but in fact the split was around 50/50 in terms of prioritising cost levers versus growth levers.

GM: The era of using inexpensive capital to benefit from growth solely by bolt-on is waning. When interest rates devour one-third of your anticipated ROI, that means value-creation initiatives become markedly more important.

RC: A key element of successful value creation right now is improving analytics and offering deeper insights. We see the role of technology and data coming into processes earlier and earlier, to support the themes that appear during the due diligence stage. Given there is a greater likelihood of holding an asset for longer in the current market environment, you are unlikely to be buying something, holding it for one or two years and then retrading it to another sponsor. You are going to need sophisticated value-creation plans that you can execute, which means putting maths, sector analytics and data behind that strategy to get more granular on what is actionable from the moment you pencil the deal.

> *"The ability to aggregate all the disparate sources of data to gain insights is hugely valuable"*
>
> **RICHARD CHEN**

Such an approach also drives an immense amount of credibility with management teams. The auction process in the last few years has been very competitive and every private equity firm talks about partnering with management. Firms that are able to demonstrate they can achieve that goal and adopt a credible and well-developed value-creation strategy will ultimately win out.

GM: The private equity model has always focused on placing people with proven industry expertise, superior management capabilities, and proven track records onto deals. The dealmakers placed on portfolio company boards have often been in high-level executive positions in companies of their own and bring credible sector insights that management teams can trust.

Q What advice would you give to PE deal professionals who may be navigating their first serious set of headwinds?

GM: In the short term, lending conditions favour smaller deals, so we see growth equity having a banner year and more smaller deals getting done.

In the longer term, the more successful private equity firms don't invest in the cycle but, rather, through cycles, so being acutely focused on potential headwinds allows them to invest in the long game. There is at least some stability in monetary conditions right now, so we will likely see liquidity begin to kick in and exit volumes will increase.

> *"When interest rates devour one-third of your anticipated ROI, that means value-creation initiatives become markedly more important"*
>
> **GLENN MINCEY**

Instilling value creation into your thesis early and continuously throughout the deal process will remain key to navigating these challenges, but sponsors are already anticipating that the volume of deals to be explored before elimination will become more intense, and the successful deals in this market will require significantly more elbow grease.

RC: There is a lot of great long-term growth to be captured in this market, and those vintages that are focused on investing now will likely become the winners over time. Some of the models for creating value, which focused on buying an asset for the right price, adding it to a platform and then selling for a bit more down the line, are no longer feasible. Financing levers are not the focus anymore, but there is still huge potential to capture value using levers underpinned by data-driven insights and sector know-how. ■

Glenn Mincey is the global and US head of private equity and Richard Chen is a principal and the US private equity lead for strategy at KPMG

Digitalisation

Technology and data are playing an increasingly wide-ranging role in growth initiatives, with AI opening up even more avenues of possibility

Digitalisation has become one of the most prolific and powerful value-creation levers that a sponsor can apply, irrespective of sector, and firms are ramping up relevant resources as a result. "We have a view that there are no companies today that are not digital enterprises in one way or another," says Seth Brody, a partner and global head of the operational excellence practice at Apax Partners. Indeed, Apax has invested over $10 million in its own proprietary analytics platform and toolkit as a result.

"Data analysis is a fundamental skill in asset management and a strategic way to create value," adds Christopher Sand, a managing director on Ardian's buyout team. "That said, it is still early innings when it comes to harnessing the full potential of data analysis, and we believe that data and digital tools will play an even greater role on a go-forward basis. That's why we are institutionalising how we deploy data in our business.

Are private markets firms implementing artificial intelligence solutions within their portfolio companies? (%)

Source: Private Equity International's Private Fund Leaders Survey 2023

"We now have a dedicated data science team that works hand-in-glove with each of our investment activities to collect and analyse data and find new ways to improve performance – from basic blocking and tackling, to implementation, all the way up to cybersecurity for Ardian and our portfolio companies. This allows our investment teams to get a more granular view of a company's operational performance and helps us find new levers for value creation."

Far-reaching applications

Digitalisation can be used to enhance the customer proposition, the employee proposition or to promote efficiency and productivity. "We put a lot of effort into the digital transformation of some of our more traditional assets. That can involve making them more customer-centric through personalisation and automation," says Selim Loukil, a managing director in the portfolio support group at Advent International. "It can also mean measuring, predicting and optimising on a constant basis."

GPs are also building out expertise within their portfolios. Partners Group, for example, built a team of 80 in-house developers at property management services company Emeria in order to create a bespoke software platform that not only increased efficiency, supported sales and reduced costs, but also resulted in better customer service.

52%

PE firms that want portfolio companies to use tech to increase productivity and reduce costs

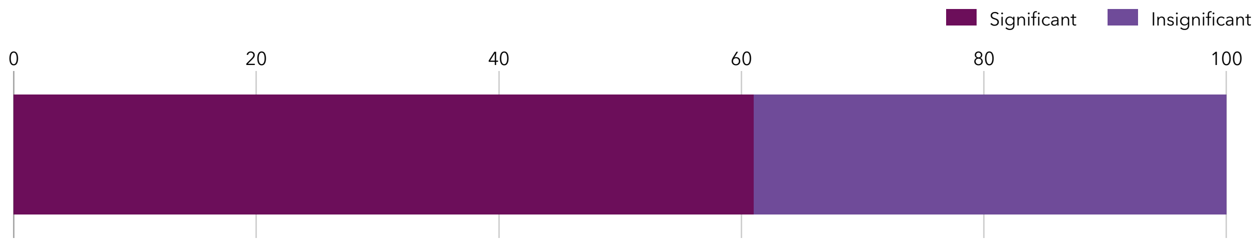
Source: AlixPartners' Eighth Annual Private Equity Leadership Survey

"Digital initiatives at portfolio companies have become an increasingly common and powerful lever to create value. Regardless of the sector or the portfolio company's tech maturity at the time of our entry, Partners Group will systematically evaluate and implement digital initiatives," says Chris Mauss, a senior asset class manager at the firm. "The spectrum of such initiatives is large, ranging from very targeted improvement initiatives that focus on particular lines of activity or functions to full digital transformations of an entire business model."

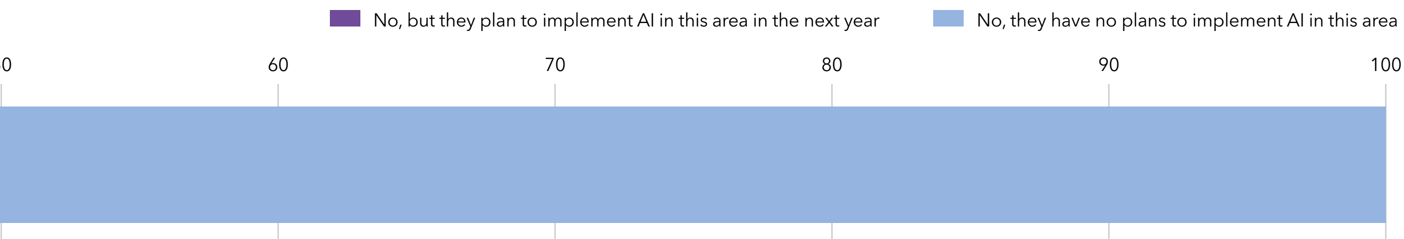
Lewis Bantin, a partner at mid-market firm ECI Partners, points to the digitalisation of the customer journey at Bionic, a marketplace for SME services, which ECI recently sold to OMERS Private Equity, generating a 4.8x return. "That was an important part of how we accelerated new business growth," he says.

But Bantin adds that it is the integration of artificial intelligence and ChatGPT tools that dominates digitalisation initiatives right now. For example, ECI's insurance business Avantia uses AI and machine learning to calculate risk and price home insurance, while outsourced communications business Moneypenny uses ChatGPT to help automate the role of virtual receptionists and remote personal assistants. "The adoption of technology can

LP views on the significance of using artificial intelligence in post-deal portfolio company engagement over the next five years (%)



Source: Coller Capital's Global Private Equity Barometer: Summer 2023



35%

PE firms encouraging portfolio companies to employ tech that aids customer acquisition

Source: AlixPartners' Eighth Annual Private Equity Leadership Survey

deliver efficiency, productivity and help drive growth, while helping make jobs less monotonous and more rewarding."

GrowthCurve Capital, meanwhile, is a firm that has carved out a niche targeting data-rich companies primarily across the technology and information services, healthcare and financial services sectors, and then deploying AI as a route to value creation.

"We focus on needle-moving AI-led value-creation initiatives for each company," says the firm's head of data, analytics and machine learning, Sajjad Jaffer, "while simultaneously executing a proprietary mid-market private equity playbook, including investing in sales talent, product expansion, market expansion and M&A roll-ups, among other areas. We have chosen the path of driving profitable growth in our portfolio companies by deploying AI, supported by technology and talent, as the route to scaling these companies while seeking to deliver strong sustainable returns for our LPs."

Digitalisation already plays a crucial role in value creation and is only going to increase in importance, notes Liam Smith, director of energy infrastructure at Actis: "The availability of asset data and the analytical power has materially improved over the last five years alone, with machine learning, in particular, unlocking opportunities to operate assets in a holistically optimal fashion." ■

While digitalisation is playing an increasingly prominent role in value creation, the human component remains key. "We are increasingly seeing private equity clients investing in human capital as part of their value-creation efforts because they are undertaking bigger and bigger transformations," says Sarah O'Connell, a value-creation partner at PwC. "We have seen a trend for corporates starting to introduce chief transformation officer roles and that is starting to spread into private equity as well, reflecting the fact that they are pulling so many more levers."

Optimising human capital has become increasingly challenging in recent years, however, given a pervasive talent shortage in many sectors. "It is vital to invest in the people you have because the cost of acquiring and training new talent is huge and it is taking longer to fill positions than it did in the past," says Jim Clayton, private equity national co-leader and PE advisory national leader in the US at BDO, who adds that he is seeing wider usage of retention compensation to entice people to stay.

"Human capital is an Achilles heel for many businesses that just can't find the talent they need," Clayton says. "We are also seeing companies that had previously embraced a remote workforce pulling back from that and restricting hiring to those living in areas that enable them to come into the office. That is cutting the labour pool significantly."

Indeed, the transition out of the covid period has created a plethora of challenges. Lewis Bantin, a partner at ECI Partners, says: "Making sure people are well paid, have meaningful careers and development opportunities has been a key area of focus for us over the past 18 months in particular, as the world recognises the secondary effects of working from home for long periods. The covid shock showed that many people could work effectively remotely,

37%

US portfolio company CFOs who say access to talent with the right skill sets in critical areas is an obstacle to meeting their PE owners' investment theses

Source: BDO's 2023 Private Capital Survey

Human capital

As portfolio companies navigate labour shortages, talent strategies are becoming ever more crucial to the successful execution of value-creation plans

but that inevitably means a loss of colleagueship, and so figuring out how to balance that line has become critical."

Andros Payne, managing partner and founder of Humatica, a PE advisory firm focused on portfolio company organisational effectiveness, says maximising the effectiveness of human capital has also become more of a priority, simply because other value-creation levers have already been pulled. "The first wave of value creation involved financial engineering and then, around 15 years ago, operating partners started to be hired into funds to drive operational improvements post deal. A third wave began around six years ago with talent operating partners being integrated into operating teams. This has been a steady migration based on the need to address more complex value-creation levers over time given the growing challenge of generating an adequate risk-adjusted return."

Some blue-chip investors have committed to growing value through organisational effectiveness and have been building talent teams. "We are talking about far more than a single talent operating partner today, and these teams are being organised to address different aspects of organisational effectiveness," Payne says. "It's much more than just finding the right CEO. It is about supporting the portfolio companies with culture change, analytics, organisational transformation and with specific functional competencies like compensation. Any one of these issues could impair the ability of a portfolio company to execute the plan."

Beyond recruitment

Selim Loukil, a managing director in the portfolio support group at Advent International, agrees that human capital optimisation is about more than just hiring. "It is about cultural transformation and leadership team effectiveness. It is about building an ecosystem of leaders that you work with repeatedly, and we have developed an internal capability to up our game around these important strategic themes."

Meanwhile, Pete Stavros, a partner and co-head of global private equity at KKR, believes that employee ownership programmes represent the next frontier in optimising human capital. "The most overlooked and underappreciated value-creation tool in private equity today is the creation of ownership cultures in portfolio companies.

"The idea sounds simple, but it is so much more than granting stock ownership to all employees – from senior executives to entry-level colleagues. It is a difficult, long-term journey that requires building trust and fundamentally changing the culture of a company. This includes treating employees like owners and giving them a voice, sharing information transparently, boosting financial literacy and so much more."

Those companies that can effectively implement these programmes have the potential to see breakout results. Research by Gallup found that an engaged workforce drives 14 percent higher productivity and 23 percent higher profitability.

One example from within the KKR portfolio is Ingersoll Rand, an industrial manufacturing business where the firm supported the provision of equity to 16,000 employees, says Stavros. "Over time, the company's quit rate dropped from 20 percent to below 3 percent, and employee engagement scores grew from the 20th percentile to the 90th percentile.

"In addition to boosting employee engagement, the programme created substantial gains for both investors and non-management employees. It took years to see these results, but the employee ownership programme created a win-win for everyone involved. When we think about creating value in private equity, there is no better place to start than with an engaged workforce." ■

"Human capital is an Achilles heel for many businesses that just can't find the talent they need"

JIM CLAYTON
BDO

33%

Portfolio company executives that view talent strategy as a top priority when it comes to generating value

Source: AlixPartners' Eighth Annual Private Equity Leadership Survey

KEYNOTE INTERVIEW

The path to tech-driven growth

Collaboration, alongside access to the right expertise and systems, is key to effectively executing value-creation initiatives, says Nick Maglaris at SAP

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SAP

Q When it comes to technology, what does the value-creation journey look like for operating partners?

The value-creation journey with the operating partners starts at the point of due diligence. During this stage, the SAP Midmarket Strategic Initiatives team has a value network for growth, which works in conjunction with advisory firms and the SAP M&A Ambassadors Program – a network of partners who provide a prompt response to M&A events. Together, they delve into understanding the technology infrastructure of the target company under consideration for acquisition.

In this collaborative effort, the primary objective is to determine the most appropriate course of action. This involves deciding whether it is more advantageous to introduce a new, well-established technology system or to enhance and refine the existing technology ecosystem. Both approaches may also involve the removal of redundant functionalities that are no longer essential.

We have seen operating partners take both approaches, using technical support and analysis to inform their decision. They will also look to the capabilities and expertise of the people already at the target company, and the extent to which they can help provide that technical support. There may not always be a chief technology officer or a chief information officer, so in those instances, those technical resources would need to come from the operating partners instead. In all cases, the effectiveness of the value network for operating partners comes down to leveraging and orchestrating all of the resources in line with the investment thesis.

Q How can firms engage the CIO, CTO and tech team to unlock tech-driven growth?

To facilitate growth within mid-market

companies, we interlock with the private equity operating partner, leveraging the expertise of the advisory firms and M&A Ambassadors. The operating partner, in turn, leverages the expertise of CIOs and CTOs, and the transformative effects become evident, provided that the business is receptive to change.

When the strategy involves driving growth through technology, there is also a need to address the integration of both front-office and back-office functions, along with managing relationships with vendors and suppliers. This is where the value network for growth comes in, as it can provide insights, tools and solutions powered by SAP, to help streamline operations, optimise processes, and drive growth through technology.

Delivering technology-driven growth outside of the technology industry is about leveraging a platform that allows for the type of execution and reporting that a business needs. For example, we have an offering, GROW with SAP, which has embedded ESG solutions to track the impact of ESG initiatives throughout the business. Additionally, artificial intelligence is embedded to automate and increase productivity to positively impact margins.

For the technology industry, it is about interlocking with other technology vendors to connect applications with the clean core platform. Building all those apps on the same platform can allow for exponential technology-driven growth.

Ultimately, it all comes down to taking a holistic approach to working with cross-functional teams. The technology we provide at SAP does not require a firm to hire a CIO or a CTO; instead, the operating partners are able to provide that capability and drive growth by pulling everyone along on the value-creation journey. With GROW with SAP, we have worked through success models with hundreds of customers and created preconfigured processes. Businesses can now easily adapt those models to get the technology platform up and running, and to help further enhance their strategy.

Q Can you give examples of effective strategies for implementing technology-driven value-creation initiatives?

The SAP Midmarket Strategic Initiatives team is currently collaborating with an advisory firm to support a private equity firm that intends to acquire a division from a large chemical company. This scenario serves as an example of the available value-creation strategies in this domain.

In this case, the advisory firm has suggested that, from a technological standpoint, the asset doesn't need to replicate the entire previous technology setup. Instead, it would be more advantageous to adopt a 'fit-to-standard' approach, aligning with SAP's best practices, and implement it on a public cloud solution – GROW with SAP. This approach has the potential to yield significant time savings and empower the new business to establish the technology platform as a catalyst for growth.

Not every business process has to be inside your technology platform, but understanding how to keep the core clean and then being able to innovate and drive new routes to market with that technology platform in place is critical. It is no longer the total cost of ownership that people are concerned about when implementing technology-driven value-creation initiatives; instead, it is the total cost to innovate that matters today.

Q How can value networks support go-to-market strategies across industries?

Our value network is underpinned by the force multiplier approach. PE firms can obtain scale through their different vendors to support all their portfolio companies, and they can create shared services models for companies in similar industries. Our value network creates operational effectiveness through the expertise across industries and the ability to develop new routes to market through our business technology platform. This kind of approach reduces the need to hire more people in a constrained talent market and amplifies the effectiveness of the capabilities already available.

Q What skills do you expect to be most in demand among operating teams in the coming months?

The number one skill needed right now is the ability to make a decision and move forward – decisiveness is crucial. From a tech perspective, given the number of products available and the boost in productivity from AI at the moment, the critical factor is to ensure that your decision-making process revolves around a few key pillars: predictability, the ability to build your own breakthroughs, the speed of your expansion, and an ecosystem of resources to ensure you go live with confidence.

The other skill that operating teams need is an ability to create relationship capital with portfolio companies and external vendors to lead organisations through change. Continuous progression through the orchestration of resources is the key element to get the business moving forward and to deliver a function for that growth.

To fulfill this skill set, the SAP Midmarket Strategic Initiatives team has brought together a consortium of advisory firms through the SAP Technical Advisory Program, alongside SAP M&A Ambassadors, to interlock with PE firms, providing access to the people that can lead organisations through change. We have put relationship capital at the core of everything we do, as we know that people are the most critical resource for unlocking growth. ■

Nick Maglaris is vice-president of the Midmarket Strategic Initiatives team at SAP America

ESG

GPs are increasingly viewing environmental, social and governance considerations through a value-add rather than a purely value-preservation lens

While ESG is now firmly embedded in private equity's armoury as a tool for value preservation, its role as a value-creation lever is more nascent.

"ESG can be used to drive top-line growth by appealing to customers looking for more sustainable products," says PwC value-creation partner Sarah O'Connell. "It can also be used to take cost out, through a reduction in energy consumption or water usage, for example. Finally, it is possible to improve your access to talent based on strong environmental or social credentials. Some private equity houses are very aware of this potential and are genuinely thinking about ESG as a value-creation lever. Most, however, are fairly early on in their ESG journey."

"Although it is still early days," adds Selim Loukil, a managing director in the portfolio support group at Advent International, "there are massive opportunities out there, particularly in the consumer and retail sectors where it is possible to extract economic value through environmentally friendly or health-conscious products, where customers are ready to pay a premium. There are also opportunities around energy efficiency in the industrial space, for example. Of course, beyond the value-creation potential, actively pursuing ESG principles is simply the right thing to do."

Leveraging data

Access to timely, accurate data is critical to leveraging ESG as a value-creation and value-preservation tool. "We have long been focused on ESG data collection and more recently climate and carbon measurement as a risk management tool and a critical issue for many of our LPs," says Seth Brody, a partner and global head of the operational excellence practice at Apax Partners.

37%

PE firms that rank value creation as the top driver for ESG activity

Source: PwC's Global Private Equity Responsible Investment Survey 2023

"More recently, we have recognised the potential to deploy our ESG toolkit as a point of differentiation in commercial settings. For example, many of our IT services companies are being asked to include carbon and climate data as part of their responses to new business opportunities. Potential customers are weighing raw price along with carbon intensity in awarding contracts. To this end, it will be more important for all of our B2B businesses to have a solid grasp on their carbon footprint and take their commitment to reducing emissions seriously. Over time, this can and will become a competitive advantage and driver of growth."

Christopher Sand, a managing director in Ardian's buyout team, meanwhile cites the example of the firm's investment in Cérélia, a trans-atlantic provider of bakery solutions. "Cérélia has focused on positioning its facilities in closer proximity to the end-consumer and local farmers to enable the company to source high-quality, local ingredients while minimising the amount of travel and food product wasted. The firm conducts regular audits on Cérélia's sustainability and energy targets, and the company is on track to achieve a multi-year plan to reduce greenhouse gases by 50 percent. Lastly, the company is working toward eliminating plastic from its packaging.

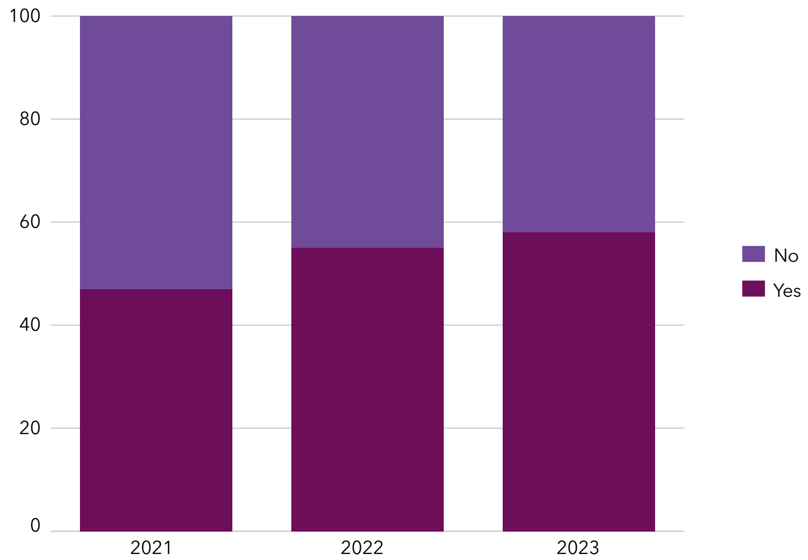
"Each of these innovative solutions comes with an economic benefit as well, which supports our belief that enhancing ESG and sustainability metrics can add tremendous value to the company and its investors, to consumers and to society at large."

Elsewhere, Partners Group has developed proprietary software to make rostering and route planning more efficient at USIC, a provider of utility location services in North America. With worker health and safety a top priority, the focus was on restricting left turns wherever possible to cut the biggest cause of worker accidents. "In turn, this better route planning also increased operational efficiency, reduced costs caused by accidents and ultimately improved profitability levels," explains Chris Mauss, a senior asset class manager at Partners Group.

Good ESG also opens up new sources of value-accretive capital. "Other components to consider include the green money available to ESG-friendly businesses, as well as the opportunity to take advantage of tax credits," says Jim Clayton, national co-leader of private equity and national PE advisory leader in the US at BDO.

"Yes, private equity firms want to be good world citizens, but they also see that actual value can be derived from having ESG programmes in place." ■

Can private markets firms demonstrate a positive impact between ESG and investment performance in their portfolios? (%)

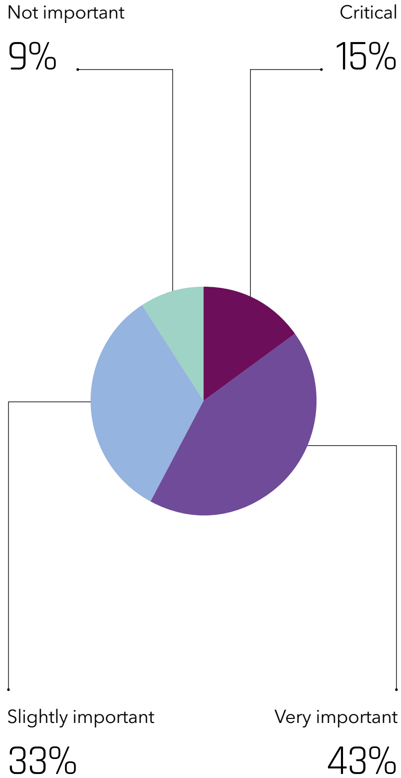


Source: Private Equity International's Private Fund Leaders Survey 2023

"ESG can be used to drive top-line growth by appealing to customers looking for more sustainable products"

SARAH O'CONNELL
PwC

How important are ESG considerations in value-creation plans at the portfolio level for private markets firms?



Source: Private Equity International's Private Fund Leaders Survey 2023

KEYNOTE INTERVIEW

Tailoring the value-creation playbook

Adjusting value-creation plans to suit the needs of specific industries and deal types can help maximise the impact of operational improvements, say Montagu's Tim Cochrane and Claudia Paniker Rumeu

Q Is the current macroeconomic environment impacting the value-creation playbook?

Tim Cochrane: We are witnessing a period of ongoing inflationary pressure and some slowdown in economic activity, although GDP growth is probably more robust than we expected. As a firm, we invest in must-have businesses, primarily B2B, providing must-have products. That means we are not that exposed to raw material nor energy inflation; instead, it is wage cost increases that have the biggest impact on our portfolio.

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In the last 18 months we have been focused on managing that inflationary pressure and working with portfolio companies to create product extensions that drive more value for clients and customers.

We have found our businesses have huge potential to increase their offering to customers and to monetise that value through price increases above inflation, so we have seen margin expansion across the portfolio.

In addition to addressing wage increases, we have been doing a lot of work around the talent agenda across the portfolio. That involves looking at how we ensure all companies are spending enough time thinking about employee satisfaction, addressing key employee needs and building more loyalty to reduce unwanted attrition. We also have a strong focus on attracting senior talent, and we continue to find people excited about the opportunity and wanting to work in our portfolio.

Alongside addressing inflation and talent, the other big lever we have been focused on is M&A.

Q With add-ons such a dominant feature of the PE market today, what are the essential elements to successful integration?

Claudia Paniker Rumeu: We are very focused on M&A, and clearly bolt-ons are becoming a dominant feature of value creation. We have seen a five-fold increase in add-on acquisitions undertaken by our portfolio companies over the past few years and this trend is accelerating.

In terms of integration, having a disciplined approach is key. We find it helpful to start that process early and articulate a clear value-creation plan that drives what needs to be integrated, when and how. Nothing is more important than people when it comes to getting integration right, which means bringing them on the journey and incentivising them correctly.

TC: The reduction in venture capital funding and the drop-off from some of the high valuation expectations that were around 18 months ago mean this is a ripe market for bolt-on M&A. People are more willing to accept conversations around valuations that make sense. Plus, the slowdown in the market for primary deals has increased appetite on both sides.

Q How are GPs developing value-creation plans to suit specific deal types, such as carve-outs?

TC: From our perspective, when it comes to value-creation plans, there are several important areas to work through. We start at onboarding, ensuring companies meet a standard 'Foundations for Good Governance', including in relation to ESG and financing requirements. Next, we turn to a light-touch assessment of the functions in the business, looking at, for example, whether HR systems are set up for the hiring required and whether the IT systems are where we want them to be for our growth plans.

Q What makes for an effective integration plan between different industry sectors or businesses?

CPR: Where you need to be on an integration spectrum varies greatly by industry and subsector. As an example, our portfolio company Galileo, a leading global higher education business, tends to keep its schools independent to retain their academic identity but provide core central support, rather than going down a full integration route.

More generally, we typically integrate tuck-in or scale deals more fully and at pace to secure the value. Whereas for deals where the rationale is to acquire strategic adjacencies – for example, where it is often critical to retain intellectual capital – we may take a slower and more hybrid approach.

TC: We want to extract as much synergy as possible, particularly in scale deals within smaller industries or product markets, and a lot of that will involve cost take-out and integration in areas such as sales force. In a scope deal, meanwhile, there may be some back-office synergies, but typically you integrate less because there are different sales forces.

With fast-growing founder-led businesses, the question is how you create the right incentives for the founder. In roll-ups of funeral chains or eye clinics, for example, we find that having the founders on board as shareholders rather than employees is important. It is a blend of addressing cost synergies and maintaining the excitement and entrepreneurship of the key individuals, which may mean less integration to give those founders all the opportunity you can to deliver their ambitious growth plans. You can structure the deal with meaningful earn-outs so founders can benefit and in return we integrate less and hold them more accountable.

Then we get to strategy and commercial diagnostics. This leads to what we call the full potential plan, where we seek to understand the opportunities and size of the growth levers available to us, and align management and the board around the plan. The next step is setting KPIs for the first four or five years.

We expect to do all these things for most deals, but the order and duration of each step will vary. More than half the deals we do are carve-outs, typically coming out of large multinational companies with management that has never run a stand-alone, leveraged business before. There, we need to spend more time on how the business is going to work as a standalone entity, addressing gaps in IT, HR and elsewhere.

On the other hand, if we invest in a secondary deal, which we do less often, we can usually onboard the business faster because it has already spent a few years under private equity ownership. If we know the business is fit for purpose, there is a lighter touch on commercial modelling and we may move to the strategy stage more quickly.

Q What are LPs expecting managers to prioritise in their operating teams today?

TC: Fundamentally, LPs want to hear that the decisions we have made around setting up our operating partner team are consistent with our firm's strategy.

The sorts of deals you do and the levers you use to create value will impact how you structure your operating team. We invest in must-have businesses in the mid-market across Europe and the US and, as mentioned, more than half of the deals we do are carve-outs from multinationals. This means the operating partner team we need has several requirements.

First, we have a strong carve-out capability because we need someone who can sit in on those early conversations with the head of M&A at the seller and the business unit head and reassure them that we can deliver. You need to build up a bench of experts to do that. Having undertaken 28 carve-outs since 2002, Montagu has this experience.

Second, we have found that what the CEO and his or her team really value is a set of generalist or specialist partners that can come and act as mentors to them across the key value levers. They don't necessarily want large groups of consultants arriving because typically they cannot handle that level of support and they do not have the data required to keep those people busy.

> *"Nothing is more important than people when it comes to getting integration right, which means bringing them on the journey and incentivising them correctly"*
>
> **CLAUDIA PANIKER RUMEU**

We have a small group of partners that can work with the CEO across a broad range of issues, typically former CEOs or general managers that have done it before. Plus, we have a range of specialist partners who can go in and spend time with the relevant department heads, whether that be M&A, marketing, finance, or technology, to help drive forward those agendas. LPs are reassured by alignment across how we originate, what deals we do and how we deliver value.

CPR: LPs recognise that M&A is an attractive value lever and see the opportunity in the current environment. The majority of our portfolio companies operate in markets with high potential for M&A, but they may not have done many deals or have a full set of M&A capabilities. Our ability to bring a rigorous and repeatable model to sourcing, execution and integration to accelerate M&A is appreciated.

Q What will value-creation teams be focused on going into 2024 and beyond?

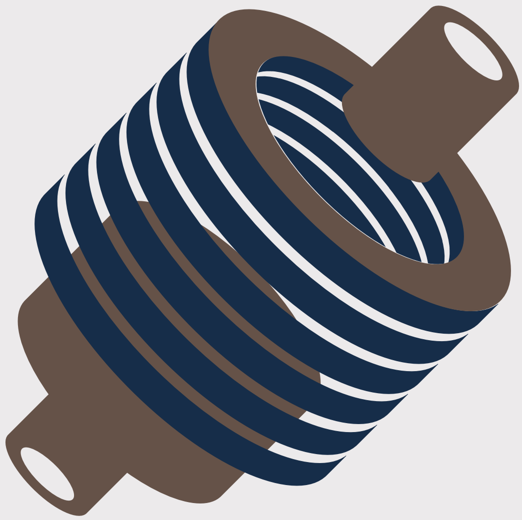
TC: Some of the things that are more important now than they were 18 months ago relate to helping companies through the economic environment. How do you think about the increased cybersecurity risk across the portfolio? How are you thinking about maximising value opportunities around ESG, and what support are you giving to companies to pursue their priorities there? How do you think about emerging opportunities around artificial intelligence?

We have a strong team in-house that focuses on ESG, as do most of our peers, and that team can help companies work through a range of governance, environmental and social issues. In our case, that is mainly carbon reduction targets, diversity and inclusion, and setting up the right governance in terms of structures, committees and policies.

Another big focus is going to be AI and cybersecurity, where there is a debate about the right way to provide that support to portfolio companies. The tension there is that having someone in-house provides benefits, but the market is moving so quickly that there are challenges around staying current. We have a range of third-party firms that we work with on a regular basis on this, as well as some in-house resource.

The fundamentals will remain the same for us, which means the biggest value levers we talk to CEOs about will continue to be creating commercial excellence, extracting better pricing, expanding into new geographies, particularly in the US, through both organic growth and M&A. That will also include exploring new products, embracing technology and data to improve processes and provide a better experience for customers, supporting talent in the business, and leveraging ESG to create stronger sustainable businesses. ■

Tim Cochrane is a partner and head of the Full Potential Partners team at Montagu and Claudia Paniker Rumeu is a partner at Montagu FPP



Pricing

High inflation has prompted sponsors to place more focus on pricing, with many making increased use of data analytics to inform their strategies

Warren Buffett once described pricing power as the single most important decision in evaluating a business, and, after decades of low inflation, the past 18 months have added extra weight to his aphorism. Companies are now facing a once-in-a-generation opportunity to hike prices, and private equity firms have been pulling the pricing value-creation lever like never before. "I have never seen pricing used as aggressively as I have in the past two years," says Stephen Moon, a managing director in the private equity performance improvement team at Alvarez & Marsal.

"Pricing has been in the spotlight over the past year and a half given the high inflationary environment," adds Lewis Bantin, a partner at mid-market private equity firm ECI Partners. "Indeed, a number of companies are using the pricing lever for the first time given that we have been in a low inflation environment for so long."

But it is not enough to simply opportunistically impose price increases. Pricing has become increasingly tactical, and smart decision making must be supported by analytics.

"The ability of a management team to react quickly to cost inflation and pull pricing levers is critical, and to do so requires access to accurate and timely data," says Hugh Lloyd Ellis, UK private equity leader at PwC. "Informed decision making [that leads] to differentiated pricing on a client-by-client basis is extremely high up private equity's priority list when it comes to value creation."

Tracy Bownes, a partner at private equity investment firm LDC, adds: "We have been in a benign inflationary environment for so long that few people have experienced the pressures we are now facing. Having good analytics within the organisation to understand how cost pressures can be mitigated through either good supply chain management or optimal pricing execution is critically important."

A lot more technology is coming into play with pricing,

53%

CFOs at US portfolio companies backed by funds with more than $15 billion in AUM that cite pricing as an area where their PE owners' guidance provides the most value in terms of revenue creation

Source: BDO's 2023 Private Capital Survey

agrees Jim Clayton, national co-leader of private equity and national leader of PE advisory in the US at BDO, who adds that he is also seeing pricing locks shorten. "Nobody wants to be locked into a situation where they are losing money with every sale, given volatile economic conditions."

Indeed, the current environment is highlighting a gap that exists in many mid-market private equity firms around financial planning and analysis talent, according to Clayton: "Pricing modelling can be complex and there is a definite shortfall in experience."

Selim Loukil, a managing director in the portfolio support group at Advent International, meanwhile, says there is now an increased emphasis on value-based pricing as a way to justify price rises.

Pricing moves up the agenda

Pricing strategy is only going to become more important over the next two years, according to Christopher Sand, a managing director on the buyout team at Ardian. "We have all had to contend with inflationary pressures. At Ardian, we have focused our efforts during this time on developing a cohesive pricing strategy for our portfolio companies and taking the necessary steps to execute on it. The pricing environment today remains dynamic, and we believe having a strong pricing strategy in place will become even more essential in the coming 12-24 months."

However, Alvarez & Marsal's Moon believes that while there is still more to do in the realm of pricing, we are now starting to see some counter pressure. "The closer you are to consumers, the more pressure you are now facing given the cost-of-living crisis," he says. "I think that will soon start biting in the B2B space as well, and we will start to see some price movements going into reverse." ■

M&A is a perennial value-creation lever and, in times of market dislocation, the opportunities to pick up bargains only increase. This tuck-in approach is particularly relevant in an environment where platform valuations remain notably high. Equally, from a value-creation perspective, mergers of equals can have transformative power.

"In times of uncertainty, there will always be winners and losers, and so there will be opportunities to consolidate markets through M&A," says Selim Loukil, a managing director in the portfolio support group at Advent International. "There are also opportunities to grow through adjacencies or to create market leaders through mergers of equals, as we have recently done in the chemicals space."

Hugh Lloyd Ellis, leader of PwC's private equity business in the UK, underscores the potential for buy-and-build platforms that have access to balance sheet cash or existing facilities: "There is a real opportunity to consolidate fragmented markets where smaller operators may be struggling due to the economic environment. We are also seeing appetite for transformational acquisitions. A recent survey we carried out found that 40 percent of CEOs don't believe their business will be economically viable in 10 years based on its current course, so I think we will see more of these transformational acquisitions as a means of futureproofing assets."

M&A can also help build out services for clients, according to Lewis Bantin, a partner at ECI Partners. He points to former portfolio company, technology services business Content+Cloud, as an example of this.

"There is still value potential to be found in acquisitions," explains Bantin. "Platforms may be expensive, but acquisitions made through those

M&A

Acquisitive strategies can provide benefits through cycles, while downturns offer additional opportunities for market consolidation and expansion

platforms can be a little cheaper. Acquisitions can also enable you to take on different types of risk. For example, the degree of client concentration at Sipcom [a unified collaboration and communications provider], which was acquired by Content+Cloud in the year before we exited, would probably have made it challenging as a standalone private equity investment, but the deal worked in the context of the group.

"M&A is certainly a powerful value-creation lever in terms of consolidation, as well as the acquisition of new capabilities or entry into new markets. Moneypenny [an ECI-backed outsourced communications provider], for example, has made several acquisitions in the US and is actively pursuing more."

64%

LPs that say buy-and-build investments have outperformed organic growth-focused investments

Source: Coller Capital's Global Private Equity Barometer: Summer 2023

Accelerating growth

Chris Mauss, a senior asset class manager at Partners Group, says add-ons remain a powerful means to accelerate business transformation: "This can take the form of very targeted acquisitions to provide new market access or new capabilities for the portfolio company. It can also consist of a broad platform consolidation strategy in industries that are still fragmented and where a portfolio company can expand its leadership position. Most benefits of add-on acquisitions remain intact in the current environment, as they typically relate to commercial and cost synergies that are structural in nature."

Last year, for example, Partners Group portfolio company Rovensa, a provider of inputs for sustainable agriculture, acquired Cosmocel, which expanded its agricultural bio-solutions product segment and increased its access to the North American market.

"Ultimately," Mauss says, "the success of an add-on strategy will depend on successful integration. Add-on acquisitions can also unlock value through multiple arbitrage, where a platform company is more valuable than smaller acquisition targets. Recent market dislocations have actually increased that gap in certain cases, making buy-and-build strategies more accretive for private equity owners.

"Unfortunately, this has also caused some headwinds, as portfolio companies will need access to competitive financing facilities to maximise returns on add-on acquisitions. A more limited access to debt financing can prevent companies from raising enough capital to pursue such acquisitions or can increase the cost of capital, thereby causing certain opportunities to be less value accretive. Our capital markets team has been instrumental over the past 18 months in positioning some of our platform companies… to proactively tap financing markets when favourable windows opened." ■

KEYNOTE INTERVIEW

Finding value amid changing global dynamics

As China's manufacturing influence wanes and we move to a more diversified production and consumption model, investment and value-creation strategies must adapt, says Kyle Shaw of ShawKwei & Partners

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Q How would you describe the dealflow that you are seeing globally right now?

For context, ShawKwei & Partners is an Asian-focused private equity industrial investor with a portfolio of investments in Asia, the USA and Europe. We were early investors in developing China's manufacturing supply chain from the 1990s to about five years ago, when we saw an opportunity to bring our industrial investment experience to Southeast Asia, India, Australia, Europe and the USA.

We are currently seeing very strong dealflow out of the US; average dealflow out of Southeast Asia, India and Australia; below average dealflow out of Europe; and very little out of China.

At ShawKwei & Partners, we have certainly been more active in the US than anywhere else over the past 12 months, and while valuations were high at the beginning of the year, they seem to have come down a little after the summer months. I think sellers are becoming more reasonable.

Q How have dynamics shifted in Asia, in particular, and how have you adapted your strategy in response?

From the early nineties to around 2015, we were very active in China. That period was a mega-cycle in which China became engaged with the world, both economically and socially, and the Chinese economy was booming, growing by about 10 percent per annum.

By 2015, however, China had started to lose its appeal because of increased deal competition and rising valuations. There was no longer the opportunity to dig deep into due diligence of companies. To win deals, you had to be fast, and you had to overpay.

At the same time, labour costs were increasing dramatically. Every year, there was a 9 percent to 10 percent wage increase for local staff, which was eating away at profit margins. Finally, there was also a general decline in government support for foreign investors. As a result, in 2015 and 2016, we started to rotate out of China and naturally began looking to Southeast Asia instead. That region shared many of the characteristics that we had initially liked about China. It was less competitive, valuations were lower, it was near to China, and we knew it well.

Q How have shifts in global supply chains impacted these markets?

Fast forward to 2021 and 2022, and it was clear there had been a dramatic shift in supply chains. China had moved from being the workshop of the world, to having a national strategy of domestic production and consumption, while foreigners were concerned about over-reliance on China and wanted to de-risk their supply chains by shifting production into places such as Southeast Asia, Australia, India and the Middle East.

Of course, replacing the huge economic machine that is China will not happen overnight. But it will happen. Supply chains will diversify over a five- to 10-year period. After all, if you think back to 2000, foreign trade in China was negligible. Think back to 1990, when China was completely unimportant to the global economy. Thirty years might sound like a long time, but historically it is quite short. We are moving into a period that will be characterised by a more diversified and global production and consumption model, and ShawKwei is capitalising on that trend right now.

Q What do you believe it takes to be successful as a private equity manager?

It may sound obvious, but to be successful as a private equity manager, you need to deliver returns to your investors. Every day, therefore, you need to be thinking about how you are increasing the value of the companies that you back. The advantage that we have as private equity investors is a long-term horizon. Hedge fund managers are thinking about the monthly or quarterly returns that they need to generate. Our money is typically locked up for 10 to 12 years.

That means we can take a view on something like building a new facility, which is typically a three-year process. We can take a view on investing in enterprise resource planning, which might be a two-year process. We can take a view on branding, which again, is a multi-year endeavour. We can invest in people, execute on M&A and do all of these things with a view to building business value over a five-year period rather than making plans predicated on the quarter or even the fiscal year.

I would add that it is also important to nurture the employees within your own firm and within portfolio companies. They are the ones that are doing this work every day. Plus, you need to bring in additional expertise from time to time, whether that is in marketing, branding or technology, finding consultants who are familiar with you as an organisation and can work seamlessly with the rest of the staff. But ultimately, as long as you remain focused on doing what is best for your LPs, then you will be successful.

Q To what extent is automation supporting this move to a more diversified and balanced model?

There is a pronounced trend towards reshoring – moving production back to places like the US and Europe, driven by the need to diversify out of China, certainly, but also supported by robotics. The biggest challenge that a market such as the US faces when it comes to industrial production is labour costs, but as robotics prices have come down, it has become compelling to task robots with menial tasks. You can make use of robotics wherever you are – whether you are in Singapore, Stuttgart, or San Diego.

Q In addition to robotics, what other value-creation techniques are particularly relevant to the industries where you operate?

We focus on operational improvements. We move businesses into newer factories that are more appropriate for their stage of development, for example. We take advantage of economies of scale and of new technologies. We also spend a lot of time and effort on enterprise resource planning – managing information flow within the company and tracking products from raw materials all the way through the supply chain.

Data management is really important. We produce millions of parts per month for critical items in healthcare, automotive and tech. These are products – medical instrumentation for instance – that cannot fail and we produce them for customers around the world. Ensuring the quality of the product and ensuring complete traceability through its lifecycle, including what went into making a product, where it was made, and at what date and time, is essential for our customers.

There is value-add in data management. The Internet-of-Things (IoT) is able to provide us with all sorts of information from production equipment, ensuring it is appropriately serviced, for example, in order to optimise efficiency. I would also point to branding. We take the companies in which we invest and raise their profile, making it sharp and distinct through messaging to staff, customers and suppliers. That messaging is also important when it comes to potential buyers, who can see exactly what that company does and what it stands for.

Creating appropriate incentives for employees is also critical. You need to ensure that interests are aligned, and that people are moving in the direction that you want them to move.

> *"You can make use of robotics wherever you are – whether you are in Singapore, Stuttgart, or San Diego"*

> *"Ensuring the quality of the product and ensuring complete traceability through its lifecycle… is essential for our customers"*

Then there are global connections. Twenty years ago, we were building businesses in China. Ten years ago, we had moved on to regional plays. Today, we are building global companies. We have a health and beauty business called Icons, for example, which has operations in Asia and Australia and now in North America as we recently announced a deal to buy a factory in North Carolina.

In Australia, we make lotions and hair treatments using natural products that exist in that country. In the US and Asia, we make packaging materials – bottles, caps, tubes and jars. The expansion into the US was important because consumers in the beauty space today are concerned about the environment. They want local production, rather than having something they will eventually dispose of shipped half the way around the world. We may only be a relatively small fund, with around $1 billion of assets under management, but having that global footprint is still a necessity in order to serve our customers and meet all of their needs.

Q Do you view decarbonisation as a value-creation lever, or more as an investment opportunity?

We see it primarily as an investment opportunity and have been very active as investors in a variety of decarbonisation themes including lithium batteries. Solar and wind power are important, but you still need an effective way of storing that energy in order for solar and wind to be viable and, of course, electric vehicles also have huge demand for batteries, alongside everyday appliances from vacuum cleaners to power tools.

We have been invested in a German company that makes equipment for the manufacturing of solar cells and have recently invested in a US business, based in Houston, that has developed an ecofriendly chemical that cleans and decontaminates petrochemical facilities, oil refineries and liquified natural gas plants. That product allows waste to be flushed back into any sewage system and makes these facilities run more efficiently and therefore have a lower carbon footprint themselves.

We very much see decarbonisation as an investment opportunity that is right in our sweet spot in terms of industrialisation, services and developing new technologies to allow these things to be done in a better way. ■

Kyle Shaw is founder and managing partner of ShawKwei & Partners

PE starts to embrace employee ownership

Workers appear to be figuring into value-creation plans more frequently as GPs explore shared ownership models, writes Kirk Falconer

Private equity's playbook has long focused on giving financial incentives to management teams to ensure alignment. But what about a portfolio company's workforce?

There are signs that workers are more often figuring into value-creation plans as GPs explore shared ownership models.

KKR, a pioneer of employee ownership, is playing an outsized role in this regard. Early on, the firm developed a conviction that an owner mindset – created by giving workers a voice in decisions – is key to business optimisation. It could, for example, address overlooked issues, such as high turnover rates.

The private equity giant has applied shared ownership principles to its investing since 2011. Beginning with deals in industrials, led by Pete Stavros, co-head of global private equity, activity has expanded to take in control investing in other sectors across the Americas platform. KKR aims to eventually bring the practice to dealmaking on a global scale, though there are cultural and legal challenges to grapple with first.

Having so far introduced shared equity programmes to 30-plus businesses, KKR's influence is being felt more widely. In July, the firm announced it had agreed to sell audiobook publisher RBmedia to HIG Capital. This will

result in a cash payout to workers based on their tenure, with long-term personnel earning up to 2x their annual salary. HIG reportedly said it would continue RBmedia's programme, possibly the first time this has happened in a sponsor-to-sponsor deal.

Growing movement

But KKR is not alone in advancing employee ownership. There are several private equity firms that have over time implemented their own schemes, while others have expressed an interest in doing so. GPs are also talking about it.

In a May interview with affiliate title *Buyouts*, Matt Nord, co-head of private equity at Apollo Global Management, said: "If you're protecting and investing in your employees, if you're keeping them healthy and safe, if you're allowing them to participate in the value creation, they're going to be happy. And if they're happier, they're going to stay and they're going to be more productive."

In another sign that employee ownership is catching on in private equity, sponsorship of non-profit advocate Ownership Works appears to be growing. This summer, Advent International and Sterling Group joined the organisation, upping the number of GP founding partners to 24, *Buyouts* reported.

Founded in 2021 by Stavros, Ownership Works was initially backed by 19 private equity firms, including Apollo, Ares Management, Goldman Sachs Asset Management, KKR, Leonard Green & Partners, Silver Lake, TPG and Warburg Pincus. They pledged to carry out programmes in at least three portfolio companies by 2023.

This effort is meeting with success, Ownership Works executive director Anna-Lisa Miller told *Buyouts* in August. At the time, Miller said the non-profit had seen 72 board-approved shared equity programmes in private equity-owned businesses, impacting about 100,800 employees. ■

Value creation's next phase

Some of PEI's Future 40 operators share their outlook on how value-creation levers will evolve over the coming decade

Since its launch in 2019, *Private Equity International*'s 40 Under 40: Future Leaders of Private Equity list has celebrated rising stars that hold operator roles in the industry, from specialist and generalist operating partners to up-and-coming leaders focusing on areas such as ESG, talent and DE&I. Many of the Future 40 operators featured over the last five years have remits that have a significant bearing on the value-creation activities undertaken by their firms.

We asked some of the Future 40 operators from the class of 2022 and 2023 to select a value-creation lever in their area of expertise and to explain how this lever has changed over the course of their career and how they expect it to evolve further over the next five to 10 years. ■

Khalida Ali, vice-president, diversity and inclusion at Vista Equity Partners, on DE&I:
"In recent years, private equity has made considerable strides in its recognition of DE&I as a fundamental value-creation driver, both at the firm and portfolio level. While we've seen increased engagement from GPs and LPs alike, there is also a recognition that more work is needed to achieve meaningful progress.

"Our industry has the unique opportunity to effect change at scale, and I expect we will continue to see the increased adoption and sophistication of DE&I initiatives, including systems designed to create more equitable access to opportunities through diverse recruiting pipelines, inclusive cultures, and more executive and board-level accountability."

Ellen Köhler, chief financial officer, Elevate at Verdane, on the role of the CFO:
"The function of the private equity CFO has shifted from a technical role, with focus exclusively on financials and good governance, to a strategic role with greater emphasis on value creation. Today the CFO serves as a strategic partner to the executive team and the board; the CFO acts as a decision engineer who enables data-driven decision-making throughout the organisation.

"Over the next five to 10 years, we can expect these trends to continue and potentially evolve towards further integration of finance and IT functions, to fully leverage the power of data analytics and digital transformation. There will be an increased reliance on advanced analytics and artificial intelligence, and the CFO will expand towards owning the digital strategy of their companies. Furthermore, there will be a growing importance of ESG factors: CFOs will likely be tasked with incorporating ESG factors into their strategies, to meet the growing demand for responsible investing from both investors and regulators."

Robert Massey, managing director at AnaCap, on technology:

"Technology continues to have an enormous impact on the financial services industry. Over the last decade we have seen rapid deployment of technology to solve business challenges and create competitive advantage. In the lower mid-market this has typically been case by case, for example through automation of key processes.

"However, to become truly technology enabled, we favour a 'system first' mindset, as opposed to wrapping the technology around existing processes. This way we can capture data front to back, enabling an effective target, monitor and review framework, which in turn captures sustainable competitive advantage."

Andy Pickens, managing director, data and digital transformation at Apollo Global Management, on technology:

"Over the last five years, private equity firms have shifted from regarding digital as a disruption risk to embracing it as a potential catalyst for portfolio growth and multiple expansion. We have seen how strategic investments in digital customer experience and operating models can transform companies into higher growth businesses with greater operating leverage.

"Now, as generative AI emerges, this next chapter will involve helping companies leverage their data to automate and personalise customer experiences and processes to amplify results. Alongside this, we expect continued focus on recruiting world-class management teams with strong digital fluency to navigate these transformative shifts."

Julia Wikmark, head of corporate sustainability at EQT, on sustainability:

"One key change within the area of sustainability is the shift from 'why' to 'how'. In the early days of my career, a large part of the work was spent on education, helping people make the connection to why sustainability is an important value-creation lever. Today, sustainability proficiency is much higher and sustainability is often a core part of our investment thesis and value-creation plan.

"We're focused on understanding how to best continue the work to embed, scale and automate the more operational aspects of sustainability and how our insights can help us become a smarter investor and owner." ■

KEYNOTE INTERVIEW

Operating skills for a new era

Operating partners must continue to hone their skills to best support portfolio companies through market challenges, say Alvarez & Marsal's Richard Jenkins, Jeffrey Klein and Markus Lahrkamp

Q What do you consider to be the critical skills needed by in-house operating teams to effectively support portfolio companies and deal teams?

Markus Lahrkamp: First, it is important to note that market conditions have changed significantly. We have seen a drop-off in transactional activity throughout 2023 and today's high interest rate environment has made it difficult to execute deals and has changed portfolio activity.

Private equity relies on leverage, and if that becomes more expensive then portfolio companies need to re-baseline to make more money to service debt. For example, there are situations where portfolio companies that were paying \$100 million last year to service debt are now paying more than \$250 million at the same EBITDA level – that is around 2.5x the debt service they experienced in 2022. That has created challenges for portfolios, along with a need for private equity operations professionals to help manage cash and pull on more operational levers to service debt.

Over the last decade, private equity firms have found their own operational focus areas. While many are very familiar with dealing with distressed assets, others are used to dealing with traditional growth, putting in equity and banking on a certain amount of top line growth to get to a healthy EBITDA. If that growth does not come, then higher interest rates make it even more important to make operational improvements.

Richard Jenkins: Knowing how to strike the balance between when to get involved and when to trust management is a core skill for operating teams.

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They need to have a set of parameters in place to evaluate company performance and ascertain when to take action.

They must also be able to assess talent. C-level executives for mid-market companies are tough to find and it can be difficult to know if you have someone you can rely on to take the company through the journey it needs to go on.

Knowing when to bring in third parties and when to rely on management is important. Operating partners have to determine where there are critical issues and how to best deploy additional resources to address these concerns.

Q How do current market conditions, including longer hold periods, impact these requirements?

RJ: Competition in private equity has increased significantly, as has the industry's sophistication, making it more challenging to capitalise on an inefficient market. Private equity must be prepared to improve companies operationally at a fundamental level.

Before this current slowdown, we saw six quarters – starting at the beginning of 2021 – where historic amounts were invested at high multiples, so there is even more pressure on companies to improve operating performance to get a good return. In summary, portfolio companies were purchased at high multiples with significant leverage, and then consumer sentiment changes, supply chain issues, cost inflation and interest rate increases added further pressure and requirements to improve performance. Businesses must think about how they can optimise their resources by being prudent about working capital and prioritising where to spend money to get the best return.

ML: When it comes to longer hold periods, these are not necessarily something private equity firms plan for. In fact, until last year, we were seeing hold periods shortening.

Q How can PE operating teams ensure they are upskilling in real time to meet fund growth demands?

RJ: Being able to partner with management is a crucial skill. If you are a generalist, it is harder to act as counsel to the chief financial officer and help them identify issues. Some of the more effective operating partners will get heavily involved in the weeds, working alongside the CFO. Having the requisite experience allows them to be accretive to the process and garner the respect of the management team.

Using finance as an example, staying up to date with the latest tools is key. There are a number of new analytical tools out there today around workflow, analytics and data synthesis, so making sure you are in tune with how a company can best make use of what is available is important.

ML: When you look at the operating partner community in the US, it has grown significantly. However, the generalist operating partner is now less utilised because that approach does not work anymore. You need very specific functional expertise – whether that is in pricing, supply chain, manufacturing or liquidity, for example – or you need industry professionals with insights into those dynamics.

What is effective now is high-powered, enabled teams that can work with management, not as outsiders but as an extension of the team. They can also pull in other service providers or experts in particular areas so that issues are addressed quickly.

When it comes to upskilling, private equity is not set up like consulting firms, so there is rarely continuous training on these topics. The ongoing education of operating partners is certainly a need that has been identified. At Alvarez & Marsal, we are establishing a PE Operators' Academy, which will address that need by developing training programmes that help operating partners, their team members, as well as portfolio company management, stay current.

Right now, longer hold periods are a consequence of the market environment, but while funds might need to hold an asset for longer, that does not mean operating teams should delay initiatives. They must be on top of things because eventually markets will open and those that have completed portfolio improvements will be the winners, as good assets always have a market.

We are also getting feedback from our PE clients that skilling up the management team members in portfolio companies is necessary, especially as portfolio companies are being held beyond the normal hold period.

> *"Operating partners will need to be proficient in AI to keep pace"*
>
> **JEFFREY KLEIN**

Q What are the skills that you believe portfolio company management teams will need to develop and how can operating partners support that?

ML: Two of the topics that we think will have a huge impact are ESG and artificial intelligence, which will both require new tools and new skills. Consultants are quick in developing and adopting new tools in their processes and operating partners in private equity need to do the same.

There is also a huge need for situational leadership skills and change management skills, which are not always front of mind when people think of private equity operating partners. Learning how to get the most out of management teams and manage their progression and skills development will be really valuable.

Jeffrey Klein: One challenge the private equity industry faces is that competition in the deal market is starting to ramp up going into 2024. We are seeing the introduction of AI into diligence processes, and we have spent a lot of time building and launching our own tool called A&M Diligence GPT. As AI becomes more commonplace, we are going to see a further acceleration of deal timelines.

While not all operating partners are involved in pre-acquisition activities, they certainly should be. There are going to be those that understand how to use AI and those that are frightened by it, but operating partners will need to be proficient in AI to keep pace.

In the software technology and services space, operating partners have been supporting management teams and portfolio companies in an era of super expansion, where growth at any cost was not only acceptable but the norm. There has been a significant reversal in that trend, and operating partners will instead need to turn their attention to profitability, margin, sustainable growth and managing churn.

Emotional intelligence and communication skills will also be valued when dealing with management teams as they help them shift gears.

Q What do you see as the biggest challenges facing in-house operating teams going into 2024?

JK: What we are starting to see in the software and technology space is more opportunities for distressed deals, especially given the realignment of multiples in the tech services sector. A lot of those companies transacted at software-as-a-service multiples but are actually tech services companies and they have faced a lot of margin compression. Dealing with those distressed opportunities requires a different type of diligence, a different turnaround plan and a different value-creation plan.

Other sectors have experienced more cyclicality, but software has been going in one direction for 15 years. So, management teams have grown up only seeing one thing. It is often senior operating partners who saw the tech bubble burst in the early 2000s and can bring insights to create operational improvement plans. They also need to have the difficult conversations with investors, with the board and with the management team to address the current reality.

RJ: Operating partners are going to have to be upfront in having conversations about what they expect from management teams and their framework for getting involved. A lot of necessary portfolio improvement work was delayed last year due to the prioritisation of liquidity management, which means there is a great deal of work to do.

Operations teams will need to be able to help with all the elements of cost cutting and driving growth. The best operating partners are now moving into quarterback roles and are prioritising getting the right subject matter experts in underneath them.

ML: I think 2024 is the year that all of this comes to a head. Interest rates are unlikely to come down, so firms have to re-baseline their portfolio companies and make tough decisions about who to support and where to put operating resources. We have some clients with 100 operating partners and even they are stretched given the needs of portfolio companies right now. At some point there will be triage to do, and we expect that to occur in 2024.

We are also entering a period where we will need operating partners who can cut costs and hold together liquidity while taking complexity out of businesses just to survive. ■

Richard Jenkins, Jeffrey Klein and Markus Lahrkamp are managing directors in the private equity performance improvement practice at Alvarez & Marsal

The war for operating talent

Plans to grow headcount have slowed among private funds, but recruiting operating professionals remains a priority. Evie Rusman reports

Challenging market conditions appear to be taking their toll on the pace of hiring in private markets. According to *Private Equity International*'s *Private Fund Leaders Survey 2023* – which compiled responses from 101 senior buyout, growth, private debt, venture capital, real estate and infrastructure executives in June and July – only 38 percent expect portfolio company headcount to increase over the coming 12 months, down 39 percentage points from last year's results. The proportion of respondents that plan to increase headcount at the GP level has dropped from 69 percent to 44 percent.

Sandra Hatugari, founder and managing director at executive search firm Follett Parker, cites covid alongside a difficult market as reasons for this. "We saw a boom in recruitment at both the portfolio and GP level during the pandemic, so the current slowdown is partly a natural reflection of this. However, there are other factors at play: the slowdown in fundraising coupled with the harder dealmaking environment means that PE hiring has had to slow, though not stop completely, which is good news."

Mary Gay Townsend, founder and managing partner at executive search firm Norgay Partners, adds that slower AUM growth is one of the biggest challenges. "When you think about AUM, the one thing that we have heard for the past year is just how hard the fundraising market is, which means that raising capital and closing a fund is really challenging. This then tells us there are fewer investments to be made, and because the market's not quite as active, it becomes self-perpetuating."

> *"Past hiring behaviour, where you could rely on the strength of your brand to draw the rock stars to you, is not sufficient today"*
>
> **RUPERT BELL**
> **Private Equity Recruitment**

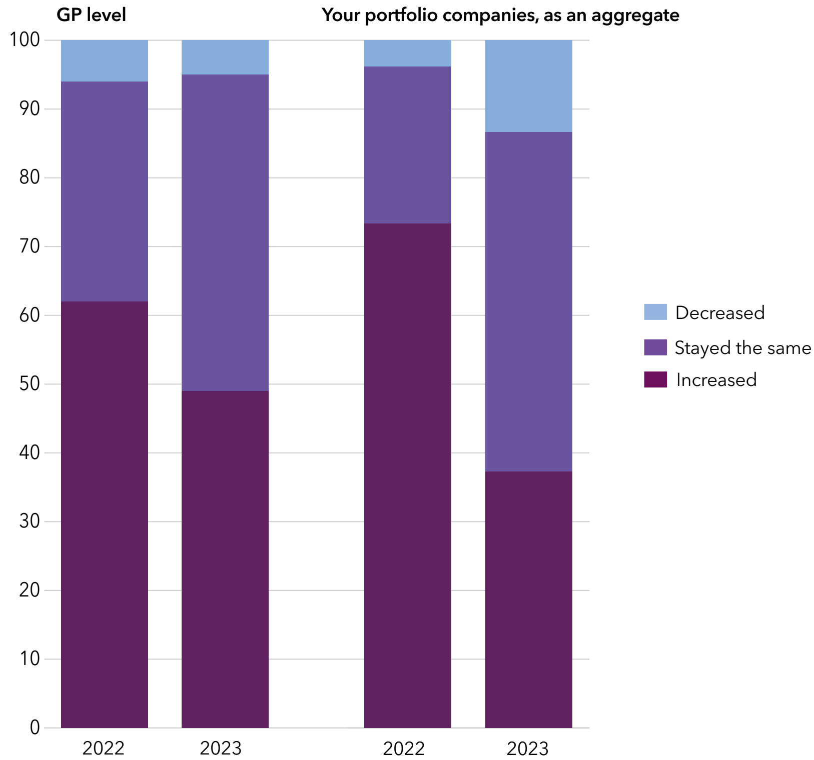
Because of this, Townsend believes firms are pulling back in terms of hiring, and instead relying on people they know and trust, and with whom they also have previous relationships.

Value-creation expertise needed

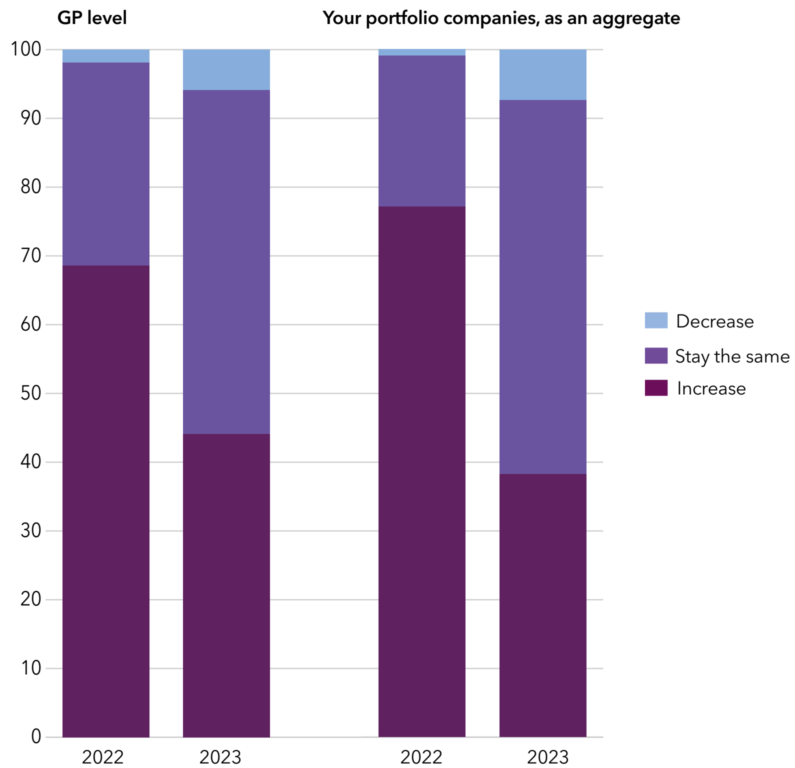
Despite this pullback, the *Private Fund Leaders Survey 2023* indicates that value creation and portfolio management remain a top priority, with nearly two-thirds of respondents citing them among their top three areas for increasing headcount.

"Demand for value-creation professionals has increased sharply," says Rupert Bell, director of DACH at executive search firm Private Equity Recruitment. "This used to be a resource that only large-cap funds could afford, but it is becoming more and more essential at all size levels in light of the transformation workstreams needed to generate returns." Bell adds that firms

How has headcount changed over the past year? (%)



How do you expect headcount to change over the next year? (%)



Source: Private Equity International's Private Fund Leaders Survey 2023

are looking for real operational leadership experience. This includes sector and also subsector credentials to add knowledge and credibility to their value-creation plans; but also functional skills in areas such as pricing strategy, digitalisation, M&A, cost reduction and so on.

The more challenging economic environment has further intensified demand for operating talent, says Kylie Hart, director at Norgay Partners. "Companies are moving in a different way that requires a different set of skills and a different set of leadership. I think even those individuals who have experienced the market when it's been in a downturn, in some cases, they're going to want operating talent that can navigate that a little bit differently than maybe someone who's only seen things from a strong market.

"We had a pretty healthy market for a good 10 years or so, and now it's not necessarily unhealthy, but there is just different criteria and things happening that need more experience."

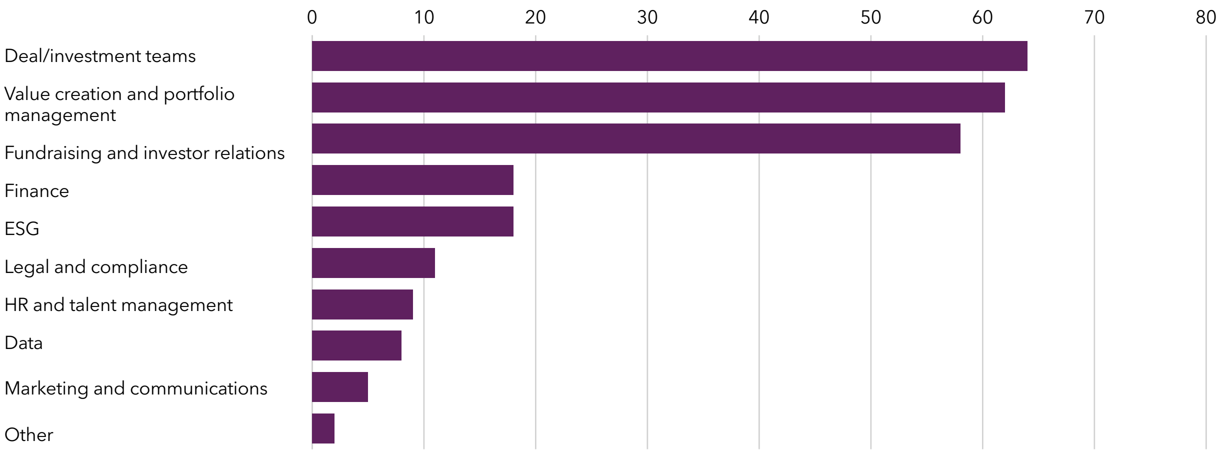
However, attracting the right talent remains an issue. According to this year's *Private Fund Leaders Survey*, half of GPs list value creation and portfolio management among the most difficult areas to recruit for.

Engaging with candidates

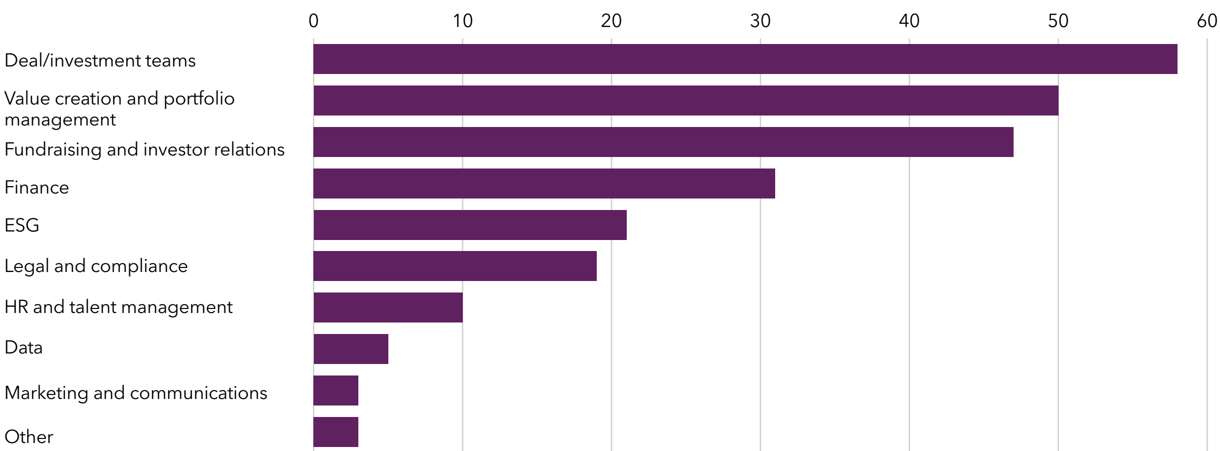
Why is this? Townsend considers competition a significant factor. "You're competing against a lot of other GPs to find that talent. And one thing I will say in recruiting that we see over and over again is: the right talent makes a difference. Having someone who has experience, who has that leadership ability and is a good problem solver, they're invaluable. And so, to find those people it's going to be competitive, it will remain competitive. They are worth every penny you pay them, because you get one person like that and then you can build a team around them."

How can firms ensure they win in this war for talent? Bell argues that it

In 2023, which three areas are priorities for increasing headcount? (%)



In which three areas is it most difficult to hire talent? (%)



Source: Private Equity International's Private Fund Leaders Survey 2023

begins with firms recognising they are in competition. "If someone is good enough for you, they will be good enough for your competitors, so you need to be in sales mode from the get-go. Past hiring behaviour, where you could rely on the strength of your brand to draw the rock stars to you, is not sufficient today."

Bell emphasises the importance of cultural values in today's hiring landscape, with more candidates wanting to align with the values of the firm to understand how their career might develop over time, what they need to do to be promoted successfully, who the role model and mentor figures are and how they will help to nurture new hires, as well as to understand themes such as who has recently left the organisation and why. "Transparency on these topics has become one way in which firms can differentiate themselves and engage with candidates."

Another way GPs can differentiate themselves is by building relationships with their ideal candidates long before the need to hire, says Hatugari. "This long-term view to nurturing external talent ensures ample time to gain an alignment of goals and motivations, and I always advise clients not to forget to build a robust outreach and interview method to uncover soft skills, too; skills that help you understand, for example, how an individual engages, motivates and develops others in a team – whatever level the candidate may be."

As a skilled operating partner bench becomes increasingly essential for firms to succeed in periods of volatility, fund managers will need to think carefully about whether their recruitment and retention strategies are still fit for purpose. ■

'Management equity' is not just for management

Guest comment by **Sonia Gilbert** at Clifford Chance

Enabling the wider employee base to benefit from equity plans can drive business performance, but they must be carefully designed and clearly communicated

Offering board members and senior management some equity in the portfolio company they run has long been standard practice. It helps align the interests of management and the PE firm in driving the business (usually towards an exit event) and can, if the business performs well, offer real opportunities for wealth creation for management.

For many businesses, the management equity plan (MEP) has been just that – a plan for management, not for other employees. But an increasing number of portfolio companies and their PE firm backers want something more democratic. There is a trend to extend MEPs to a broader range of employees in portfolio companies in almost all sectors. Employee equity plans (EEP) can be a useful retention and recruitment tool for the wider workforce and allow employees to share in the success of the business in a way that is often more tangible than a simple cash bonus.

While we've seen popular and successful EEPs, they can become complex, expensive and fail to drive the right behaviours. So, how do you get it right?

First, have a clear commercial rationale for having an EEP and ensure both company and PE firm buy into this. Is it to drive a 'one business' mentality? Or to replicate employee share plans that the business used historically? Or to supplement modest pay packages?

Second, stick to a simple plan structure. In an MEP, management equity is usually subject to a long and multifaceted set of terms, which makes sense given the amounts that may be at stake in an MEP, the desired tax treatment and seniority of participants. By contrast, the best EEPs will focus on key terms that are designed to incentivise a successful exit event and deliver value to employees, and that make the plan easier to administer and for employees to understand.

On structure, for PE firms, consider having a consistent EEP design across portfolio companies. A less bespoke plan offers consistency, time and cost efficiencies and will usually work in almost all jurisdictions globally.

"Employee equity plans can be a useful retention and recruitment tool for the wider workforce"

The third element is strong communication. Particularly for EEPs that involve employees investing funds or in a business where there is not yet a culture of employee share ownership, the plan (including risk, as well as reward) should and can be clearly explained. It does not need a lot of heavy legal documentation and can be made suitably employee friendly. It's not just written communications; we have seen some great oral presentations from portfolio companies on their EEPs that have really brought the plans to life for the workforce.

Finally, think carefully about the economics. For an EEP to be attractive, particularly where it involves employees investing, a 'buy some, get some free' plan often works well. Statistics show that a relatively modest employer contribution for each investing employee increases participation significantly.

EEPs can be a great addition to an employee's package and, if planned and communicated well, can be a positive and uniting force to help drive business performance. Equity for all. ■

Sonia Gilbert is a partner at Clifford Chance and London leader of the firm's tax, pensions, employment and incentives practice