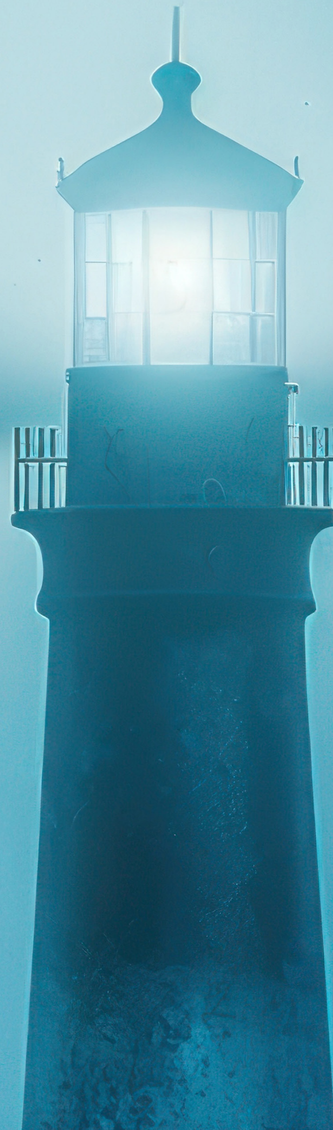
AlixPartners

Private Equity

MAXIMIZING VALUE CREATION DURING TIMES OF UNCERTAINTY



In the past 10 years, the average buyout fund has consistently outperformed the S&P 500—by a significant margin across multiple time periods and geographies. Not surprisingly, money has followed success. In 2022, private equity (PE) firms raised a record $938 billion; today, they have about $2.5 trillion waiting to be deployed.

But that record of superior performance is in danger. The PE industry has been greatly affected by global macroeconomic shifts, including short-term disruptions like high inflation, rising interest rates, supply chain issues, and geopolitical tensions. Moreover, long-term changes such as technology advancements, and climate issues have put downward pressure on returns for PE investors. PE buyout multiples declined slightly in 2022, dropping from a record 13.2 times EBITDA to 12.9 times. PE funds began to post negative returns across the globe for the first time since 2008, for vintages between 2000 and 2019, ending its five-year run as the highest-performing private asset class.

Portfolio company (portco) leaders are facing a difficult trifecta of higher interest rates, inflation, and slower economic growth. Together those challenges dampen customer demand and increase costs, which results in compressed margins. The pressures come on top of long-term structural changes in the PE industry: more roll ups and add-ons, which require more intensive management; longer holding periods; and more intense competition for the most attractive targets, all of which serve to increase the importance of operational excellence as the focus of value creation.

> The **AlixPartners Disruption Index** survey of 3,000 high-ranking executives worldwide documented the fact that executives are struggling to balance the imperatives calling for short-term responses to a downturn, inflation, and other factors with the need to find new business models and new paths to value creation in the face of long-term change.
>
> **Faced with so many disruptions, 85% of executives say they don't know where to start.**

But a focus on operational excellence is sure to help both now and for the future. Margin improvement through operational improvement already accounts for close to half of PE value creation (see exhibit 1)—~2.5 times more than in the 1980s—and that trend will strengthen even more, especially because holding times are lengthening. Considering all of those factors, PE leaders and portco executives should be prepared to drive operational efficiency throughout their businesses through a coordinated combination of tactical and structural initiatives that meet the test of today and build the capabilities needed for the future.

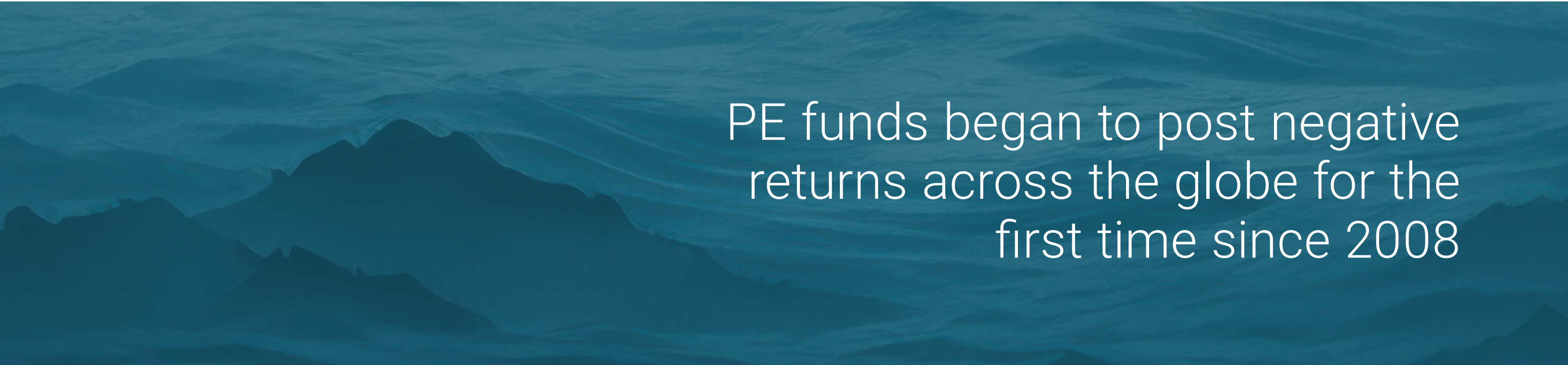
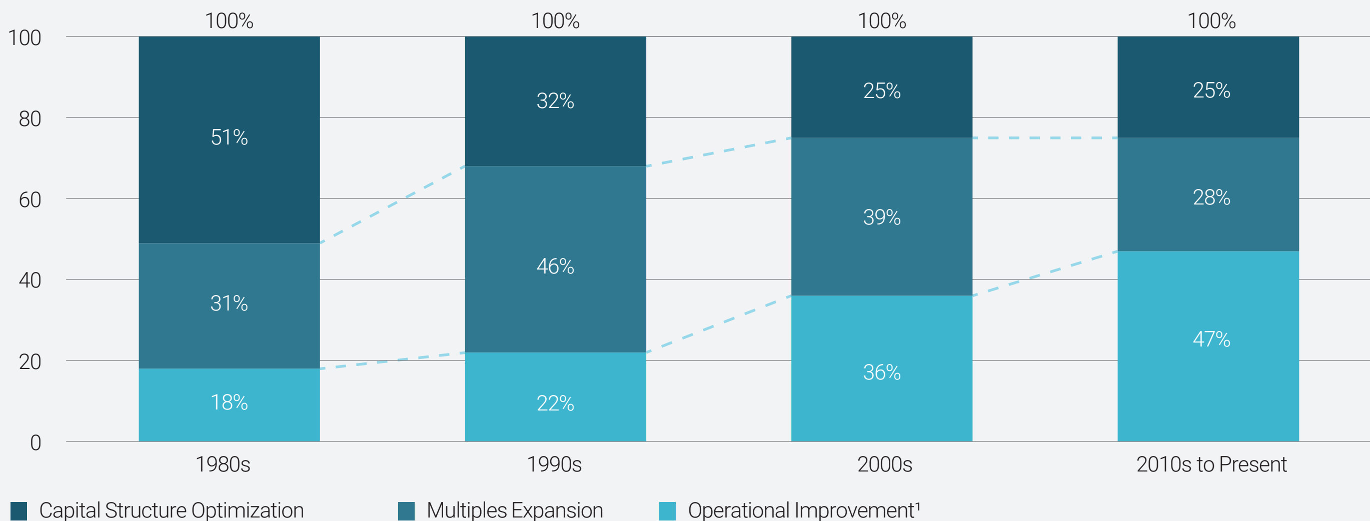


EXHIBIT 1: DRIVERS OF VALUE CREATION IN PE INVESTMENTS (%)



1. Revenue growth and/or margin improvement

Source: Institute for Private Capital

Operational improvements are difficult to identify and implement without joint effort and tight alignment between PE teams and portco leaders. Together they must be intentional about implementing rigorous value creation programs as key pathways to margin improvement.

Effective value creation programs enable PE investors and portcos to identify and deploy levers that make a significant impact both quickly and over sustained periods of time, regardless of where we are in the economic cycle.
Our experience tells us that the following four levers have the greatest potential to produce the value that investors expect over an extended holding period and during an era in which traditional strategic planning is likely to find itself blindsided by disruption.

1. RELEASING CASH AND LIQUIDITY FROM WORKING CAPITAL

While looking for operational savings and synergies, leaders ought to meticulously assess their balance sheets to maximize liquidity and improve working capital. Working capital is bound-up cash that is not available for growth; managing it better can release a considerable amount of internal financing capacity.

Portcos have a variety of levers available to improve their working-capital positions. For example, high inventories often signal weak processes and lack of controls. Reducing inventory levels can be the first step toward tighter spend control and can produce near-term savings. High accounts receivables represent a similar threat. Reducing receivables can decrease the risk of bad-debt expenses and improve working capital. In addition, portcos can free up resources by outsourcing assets or operations, thereby (i) converting fixed expenses into variable ones, which enables the business to adapt more easily to fluctuations in cash requirements, and (ii) further improving working-capital management. Both immediately and in the long run, balance sheet restructuring can make a business less capital-intensive—which also can reduce the cost of organic growth when the economy turns around. Consider the many well-known examples of companies that have successfully shifted to cloud-based operating models like Adobe, Intuit, Netflix, and Spotify. Originally built with on-premises infrastructure, these companies "variabilized" key infrastructure costs, reduced capital expenditures, offloaded assets, improved working capital, and increased scalability, ultimately insulating their balance sheets from future market disruptions

2.

IMPROVING EFFICIENCY THROUGH TECHNOLOGY

Investing in automation and other technological tools can be a viable solution for dealing with the costs and shortages that affect labor-intensive industries due to demographic changes and tight labor markets. But automation can do much more.

As robotic process automation, machine learning, and artificial intelligence (AI) capabilities expand, so does the potential for automation can reduce costs, enhance scalabilities, and increase revenues. For example, smart factories can change the economics of production and enable companies to reshore or redesign operations that shorten supply chains while reducing operating cost. AI-driven predictive maintenance strategies can use diagnostic data from connected devices to maximize equipment uptime in a wide variety of industrial and consumer markets. Machine learning and natural language processing-enabled customer service capabilities can help companies break the trade-off between highly responsive customer service and increased costs, as our colleagues Jason McDannold and Saurabh Singh point out in a **Harvard Business Review article**.

In addition to seeking efficiency through technology, PE-owned businesses—like all others—are making the shift from digitization (using digital to increase efficiency, cut costs, and automate) to digital transformation (using digital to fundamentally change how work is done, how customers are served, and how value is created). **The AlixPartners Annual PE Leadership Survey** shows that PE firms and portcos are putting growing emphasis on technology investments that support growth and margin expansion, such as real-time data and analysis for decision support. Based on the AlixPartners Disruption Index, substantial numbers of PE leaders are urging portcos to use technology to acquire more customers (35%), to devise new and higher-revenue business models (34%), and to increase customer intimacy (30%). It's a shift from digital on the inside (operations and control) to digital on the outside (customer experience and revenue).

3.

PROTECTING BOTH REVENUE AND MARGINS THROUGH SUPPLY CHAIN RESILIENCY

According to the 2023 AlixPartners Disruption Index, 52% of executives say supply chain disruption is more of a challenge for their companies than it was a year ago. Investing in a resilient supply chain supported by strong operational processes is critically important to containing cost, preventing stockouts, and avoiding resulting losses of sales—particularly in the current market environment.

Portcos should prepare their supply chain organizations for market shocks by having a readily deployable supply chain crisis management playbook to quickly resolve shortages, as well as an early-warning system based on robust key performance indicators, supplier surveys, commodity market monitoring, and tight alignment with inventory management. But supply chain excellence is not just a matter of availability; it is also about also price and margin. Once structural risks in the supply chain get addressed, portco leaders should leverage their supply chains for integrated margin management and inflation defense. Developing models for cost input mapping and customer profitability analysis can be helpful in identifying customers with whom undefendable margin exposure can be layered in by customer or product.

4.
IMPROVING RESILIENCE THROUGH ROBUST PERFORMANCE MANAGEMENT

Developing a holistic portfolio of leading and lagging performance indicators, and taking a systemic approach to enterprise performance management can serve as an early warning system for market disruption and margin risk. As the adage goes, "You cannot manage what you cannot measure."

Examples of leading operational indicators can include customer satisfaction metrics like net promoter score, and customer satisfaction score. Employee satisfaction indicators like employee attrition and engagement can also powerfully signal failure points across the enterprise.

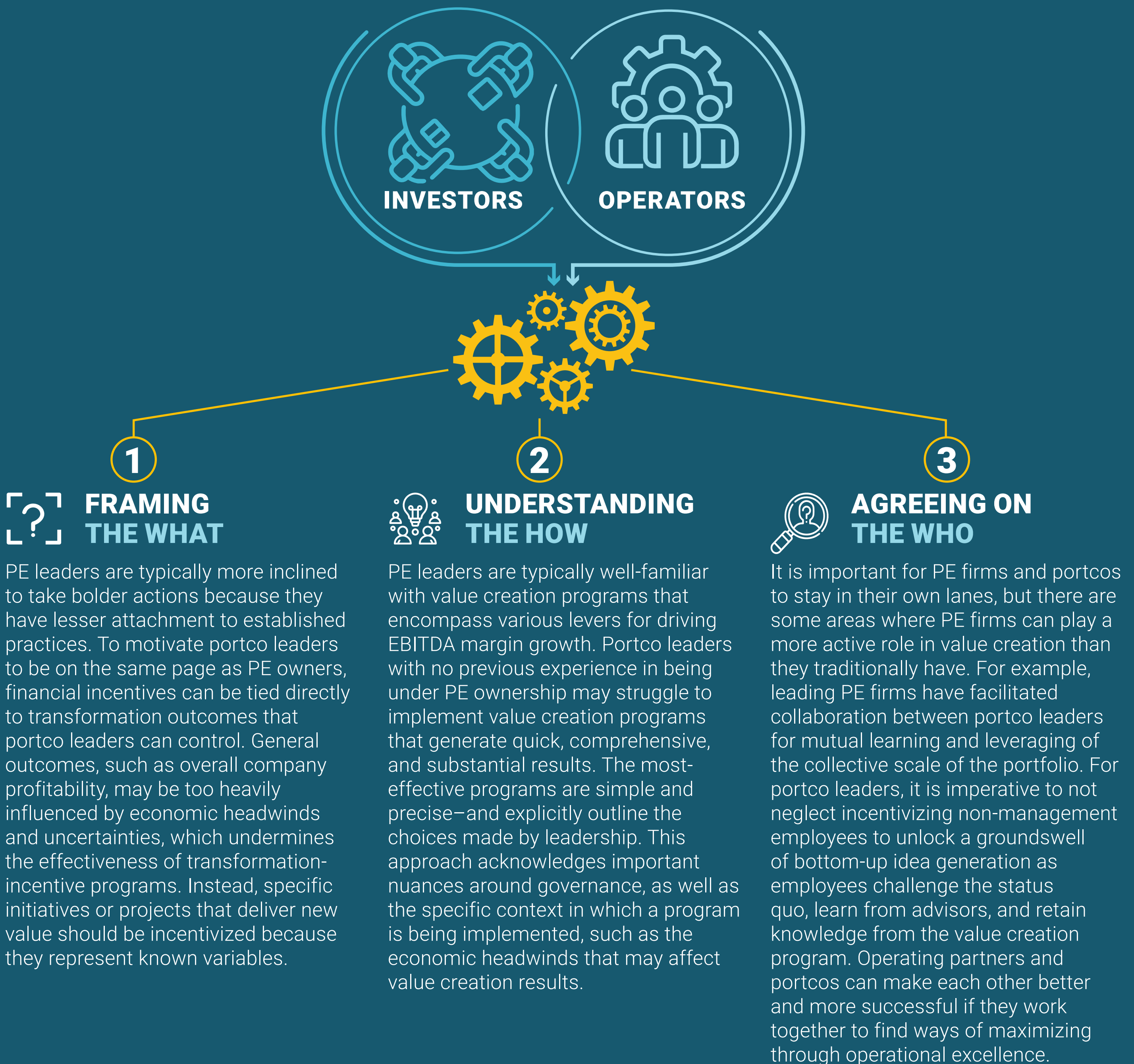
As Simon Freakley and Lisa Donahue wrote in a recent **Harvard Business Review article**, robust financial indicators can identify potential risks and opportunities early on and enable leaders to take proactive measures that will mitigate risks and capture opportunities. And even though portco leaders are likely to be the first to spot operational issues such as slowing orders, growing inventory, or delayed collections, it is also important that they and their investors pay attention to other indicators, such as the cost of capital and changes in industry dynamics, which may reveal broader sets of opportunities and risks.

Uncertainty and disruption in the current market environment will require PE teams and portco leaders to take multifaceted approaches to value creation going forward. Their operating model changes must address immediate threats, while capturing efficiencies that will fuel future growth.

PE / PORTCO LEADER ALIGNMENT

In the face of economic uncertainties, PE firms and portco leaders must pull together to create long-term value. They bring different perspectives and strengths to the task—and those are not always aligned. In general, PE operating partners rightly zero in on the first year of ownership—the critical first few quarters during which they and their portco counterparts need to capture synergies and get a running start on value creation—and they admire the hard-driving leader who gets such results. (But, the AlixPartners Annual PE Leadership Survey finds that 49% of PE operating partners say that portco leaders don't have a great enough sense of urgency.) Portco leaders, for their part, emphasize team building, collaboration, and building a strong leadership bench more than their investors do.

THE DIFFERENCES IN INCENTIVES AND MINDSETS CAN PRODUCE MISALIGNMENT—OR CAN PRODUCE HIGH-ENERGY COLLABORATION. TO ACHIEVE THE LATTER, INVESTORS AND OPERATORS SHOULD FOCUS TOGETHER ON THREE THINGS:



1 FRAMING THE WHAT

PE leaders are typically more inclined to take bolder actions because they have lesser attachment to established practices. To motivate portco leaders to be on the same page as PE owners, financial incentives can be tied directly to transformation outcomes that portco leaders can control. General outcomes, such as overall company profitability, may be too heavily influenced by economic headwinds and uncertainties, which undermines the effectiveness of transformation-incentive programs. Instead, specific initiatives or projects that deliver new value should be incentivized because they represent known variables.

2 UNDERSTANDING THE HOW

PE leaders are typically well-familiar with value creation programs that encompass various levers for driving EBITDA margin growth. Portco leaders with no previous experience in being under PE ownership may struggle to implement value creation programs that generate quick, comprehensive, and substantial results. The most-effective programs are simple and precise–and explicitly outline the choices made by leadership. This approach acknowledges important nuances around governance, as well as the specific context in which a program is being implemented, such as the economic headwinds that may affect value creation results.

3 AGREEING ON THE WHO

It is important for PE firms and portcos to stay in their own lanes, but there are some areas where PE firms can play a more active role in value creation than they traditionally have. For example, leading PE firms have facilitated collaboration between portco leaders for mutual learning and leveraging of the collective scale of the portfolio. For portco leaders, it is imperative to not neglect incentivizing non-management employees to unlock a groundswell of bottom-up idea generation as employees challenge the status quo, learn from advisors, and retain knowledge from the value creation program. Operating partners and portcos can make each other better and more successful if they work together to find ways of maximizing through operational excellence.

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ABOUT US

For more than 40 years, AlixPartners has helped businesses around the world respond quickly and decisively to their most critical challenges – circumstances as diverse as urgent performance improvement, accelerated transformation, complex restructuring and risk mitigation.

These are the moments when everything is on the line – a sudden shift in the market, an unexpected performance decline, a time-sensitive deal, a fork-in-the-road decision. But it's not what we do that makes a difference, it's how we do it.

Tackling situations when time is of the essence is part of our DNA – so we adopt an action-oriented approach at all times. We work in small, highly qualified teams with specific industry and functional expertise, and we operate at pace, moving quickly from analysis to implementation. We stand shoulder to shoulder with our clients until the job is done, and only measure our success in terms of the results we deliver.

Our approach enables us to help our clients confront and overcome truly future-defining challenges. We partner with you to make the right decisions and take the right actions. And we are right by your side. When it really matters.

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