INSIGHTS

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Value Creation

FROM LOW-HANGING FRUITS TO HIGH-IMPACT STRATEGIES:

The future of value creation in Private Equity.

By Michelle Sartorio, Founder and CEO, True Value Creation

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What lies ahead for value creation in Private Equity?

Private Equity (PE) has experienced a roller-coaster journey from the early 2000s to 2024, encompassing periods of volatility, prosperity, and transformation. In recent years, rising inflation and borrowing costs have created a challenging environment for private capital, prompting a shift away from traditional value creation methods in response to this evolving landscape.

This paper offers a forward-thinking perspective on the transformative journey of value creation in PE.

Relying solely on 'low-hanging fruits' is no longer a viable strategy to sustain value; we advocate for a holistic, comprehensive approach encompassing revenue growth, margin enhancement, operational excellence, innovation, and the integration of sustainability considerations.

Additionally, we highlight the significance of purpose-driven organisations in driving value creation, alongside opportunities in impact-driven investments, Artificial Intelligence, and sustainable solutions. The importance of diverse thinking and effective leadership is emphasised as vital catalysts for innovation and market performance.

Within this landscape of change and opportunity gaps, readers will uncover actionable insights for adapting operations, prioritising revenue growth, mitigating risks, and investing in purpose-driven ventures.

Whether you're an investor, private company, or PE professional, this paper equips you with insights to navigate the ever-evolving PE landscape.

Reach out to discuss your projects or explore how we can assist you in realising value.

Enjoy the read.

Key takeaways

1. Adapt your operational strategies:

Take practical steps to adapt operational strategies in response to changing market dynamics. Conduct thorough due diligence that integrates operational, strategic, and commercial considerations to drive sustainable growth and value alignment.

2. Prioritise revenue growth and margin improvement:

Direct efforts towards revenue growth and margin improvement, acknowledging their significance in value creation. Implement operational and strategic initiatives aimed at achieving tangible improvements in these areas.

3. Mitigate risks amidst market uncertainty:

Develop contingency plans to mitigate risks associated with rising debt costs and limited liquidity in debt markets. Diversify investment portfolios and explore alternative financing options to maintain financial stability and resilience in volatile economic conditions.

4. Invest in diversity and purpose-driven ventures:

Recognise the competitive advantage of diverse thinking and purpose-driven approaches in driving innovation and enhancing market performance.

5. Stay agile and responsive:

Remain agile and responsive to market changes by continuously monitoring and evaluating portfolio performance. Adapt investment strategies and resource allocation based on real-time data and market insights to capitalise on emerging opportunities and mitigate potential risks.

6. Bridge the knowledge gap for value creation:

This includes leveraging expertise in areas such as sustainability, operational excellence, and market diversification to increase sustainable value and drive long-term success.

Traditional value creation methods in Private Equity are fading, driving a shift to holistic strategies.

In today's ever-changing economic scenery, the conventional concepts of value creation are undergoing a significant transformation. This change is fuelled by the convergence of macroeconomic trends, societal shifts, and technological advancements, reshaping our perception and pursuit of value within private markets.

Leading the charge in this transformation are Limited Partners (LPs), influential figures in PE, who are prioritising operational value generation and growth strategies. LPs acknowledge the constraints of traditional financial measures and are increasingly directing their attention towards integrated due diligence processes.

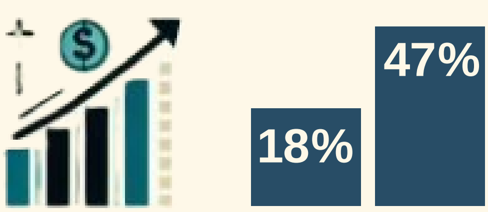
This methodology amalgamates strategy, operations, and commercial prowess to ensure enduring growth and aligned investment strategies. LPs are seeking a balanced approach where commercial and operational insights drive growth strategies, signalling a transition towards more comprehensive value creation playbooks.

There is mounting evidence of value creation through revenue expansion and margin enhancement, primarily achievable through operational and strategic approaches.

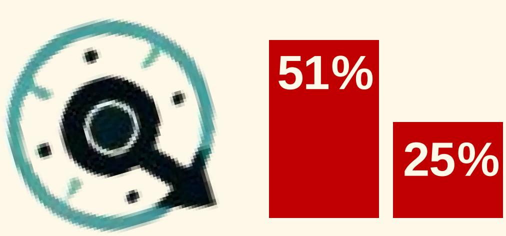
Research conducted by the Institute for Private Capital reveals that value growth through operations, such as revenue growth and margin enhancement, has surged to 47% since 2010, up from 18% in the 1980s, while the value achieved by financial engineering has dwindled from 51% to 25%.

While revenue growth remains central, value creation in PE encompasses a plethora of factors beyond traditional metrics. Factors such as cost-effectiveness, capital optimisation, margin expansion, digital transformation, and operational flexibility all play crucial roles in enhancing organisational value.

Together, these elements can drive sustainable growth and foster competitive advantage, underscoring the multifaceted nature of value creation in current business settings.



Value created through operations has surged from 18% in 1980s to 47% in 2010.



Value created through financial engineering dwindled from 51% to 25%.

https://uncipc.org/index.php/research/

> **A new poli-crisis reality is emerging, with businesses grappling with unprecedented macroeconomic uncertainties.**

The ongoing macroeconomic uncertainty has made it challenging for buyout managers to achieve historical levels of returns in the PE buyout industry using conventional value creation methods.

While traditional methods like cost and operational efficiency, team restructuring, and balance sheet optimisation remain crucial, PE teams now face increasing challenges due to the changing environment and limited time for realigning portfolio value propositions or developing robust considerations aligned with consumer interests.

To adapt, PE firms must integrate commercial, operational, and sustainability into a well-rounded approach. Buyout managers need to concentrate on operational value creation strategies for revenue growth and margin expansion to counterbalance multiple compression, and to deliver desired returns to investors.

> **The cost of debt is now up and liquidity in debt markets is harder to access.**

Historically, PE buyout managers capitalised on declining interest rates and rising asset prices through financial engineering. They relied on financial leverage, optimised tax and debt structures, and increasing valuations of high-quality assets to deliver substantial returns for investors and create value.

However, circumstances have shifted since 2020, with rising debt costs and limited access to debt markets due to interest rates, asset valuations, and bank borrowing standards.

A recent study by McKinsey revealed that PE buyout entry multiples have decreased in 2023, dropping from 11.9 to 11.0 times EBITDA in the first nine months of 2023.

It becomes imperative for investors and firms to emphasise revenue growth and margins expansion in this evolving investment landscape.

https://www.mckinsey.com/industries/private-capital/our-insights/mckinseys-private-markets-annual-review

There’re clearly less low hanging fruits out there.

The ‘new value creation’ originates from quality rather than quantity and requires a shift in focus for PE executives.

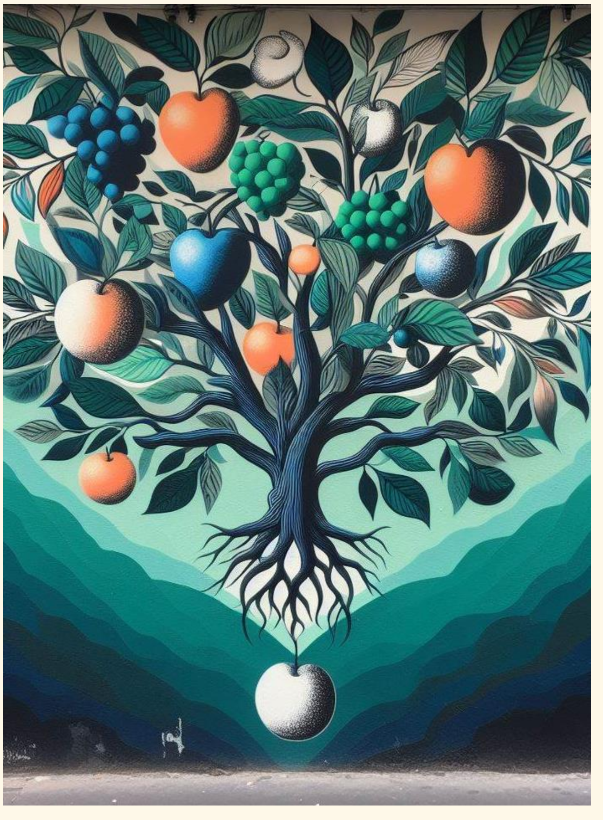
Focusing solely on low-hanging fruit implies concentrating efforts on the most critical opportunities, which typically means a narrow focus on enhancing bottom lines through financial engineering.

Additionally, neglecting the entirety of a business is likely to result in two main problems: increasing the risk of a portfolio company becoming unfit for its customers and delaying the resolution of more challenging issues that deliver meaningful results, such as creating sustainable sources of competitive advantage.

Embracing sustainability initiatives and reorienting marketing strategies can lead to superior returns. Looking at the example of venture capital General Catalyst: despite the fundraising drought faced by the market in recent years, General Catalyst is poised to secure $6 billion for their investments emphasising a "responsible innovation" approach. Led by Hemant Taneja, they advocate for societal impact and strategic investments in overlooked sectors like healthcare and education. Their success underscores investor interest in socially conscious ventures. General Catalyst's ability to attract significant investment in challenging times highlights its dedication to innovation for positive societal change.

Embracing AI. Additionally, PE executives and their portfolio companies must collaborate to understand and leverage the power of AI for value creation. More than ever, portfolio companies need to strengthen their change capabilities and PE firms need to provide earlier operating support.

With PE firms globally holding approximately $2 trillion worth of dry powder following 2023’s weak deal activity, it's only a matter of time before some of this capital is deployed in companies with the right strategies.



https://www.ft.com/content/17c03819-4566-4fd2-b0b4-45f5677d8749

Impact investing in the spotlight.

The convergence of social and environmental imperatives with economic objectives presents new opportunities for value creation.

Entrepreneurs are increasingly focused on sustainable solutions to tackle societal and climate challenges, fostering an environment conducive to impact-driven investments. The demand for capital to sustain or scale impact-generating activities underscores the growing importance of purpose-driven organisations in driving value creation.

According to a 2020 report from the Global Impact Investing Network (GIIN), nearly all respondents (87%) consider 'impact being central to their mission' and 'their commitment as responsible investors' as 'very important' motivations for making impact investments. The same report found that 88% of impact investors met or exceeded their financial expectations, suggesting a shift from the outdated view of an inherent tradeoff between impact and financial performance.

A report by Business & Sustainable Development Commission (BSDC, 2017) identified 60 market opportunities to deliver the Sustainable Development Goals (SDGs). Although many entrepreneurs entering the market are dedicated to addressing societal and climate issues to respond to the SDGs, success will depend on innovative financing and a “new social contract” between business, government and society.

The business case for impact is becoming clearer. There is growing evidence of new investment opportunities, with some delivering significant efficiency gains, driving innovation, and building reputation. Companies known for sustainability and social or climate impact attract and retain employees, consumers, B2B customers, and investors, securing their ‘license to operate’.

> Success in impact investing depends on innovative financing and a “new social contract” between business, government and society.

88%

of impact investments meet or exceeded their financial expectations

https://thegiin.org/research/publication/impinv-survey-2020/

https://www.wbcsd.org/Overview/News-Insights/General/News/Achieving-the-Sustainable-Development-Goals-can-unlock-trillions-in-new-market-value

Diverse thinking and courageous leadership for a multifaceted client base

According to AlixPartners' eighth annual PE leadership survey (2023), when asked which levers are most important for creating value in their portfolio companies, PE executives cite leadership effectiveness more often than anything else - in fact, 70% more often than they cite operational effectiveness.

Identifying a problem is one aspect, but finding an effective solution is another challenge altogether. The high turnover rate of executives in portfolio companies serves as evidence of this difficulty. Approximately three out of four CEOs depart after a PE acquisition, with over half of these departures being unplanned and occurring within one to two years of the acquisition. In 54% of the cases the CEO turnover is unplanned and often takes place a year or two after the acquisition, causing considerable disruption, such as eroding the rate of return on their investments.

Recognising the value of diverse thinking in driving innovation and accessing diverse deal flow, PE firms are increasingly embracing diverse-owned investment vehicles. Women-owned firms, in particular, offer distinct perspectives and investment opportunities, contributing to a more inclusive and dynamic private market ecosystem.

In his book 'The Power of Diverse Thinking', Matthew Syed explained that a diverse team consistently yields superior solutions. Teams inclusive of outsiders achieved a 75% success rate, compared to 54% for homogeneous teams, and 44% for individuals working alone.

> Leadership effectiveness is considered one of the most critical levers for value creation.

A Harvard Business Review paper highlighted that PE firms historically paid limited attention to the art and science of leadership. However, these firms now recognise the importance of strong executives in overseeing acquired companies. They often appoint new top-level leaders, particularly in CEO and CFO roles, and provide them with challenging targets and lucrative financial incentives to align management and investor interests.

75%

Success rate achieved by teams inclusive of outsiders, compared to 54% success rate for homogenous teams.

https://features.alixpartners.com/private-equity-leadership-survey-2023/

https://hbr.org/2023/11/private-equity-needs-a-new-talent-strategy

Pristine narratives and propositions on the spotlight.

Authenticity and purpose-driven narratives have emerged as key drivers of reputation and financial performance.

Purpose-driven brands command significant valuation premiums, while companies excelling in nonfinancial ESG measures command higher valuations, reflecting the growing importance of sustainability in value creation.

Strong narratives significantly impact capital raising and market value enhancement in PE: portfolio companies with compelling narratives could experience a 20% higher success rate in raising capital compared to those with weaker narratives.

Additionally, companies with strong narratives achieve, on average, a 15% higher market value growth over a five-year period compared to their counterparts with less effective storytelling.

Analysis of Kantar BrandZ report, looking at brand value growth in the 12 years from 2006 to 2018 shows that brands with a strong brand purpose grew value by 175%, more than double that of brands with a weaker purposeful positioning. To illustrate, Patagonia attracts 9,000 CVs for one job without advertising.

Companies excelling in nonfinancial ESG measures also deliver better financial performance and command measurably higher valuations.

This highlights the importance of authenticity and novelty in driving reputation.

+20%

Companies with compelling narratives achieve 20% higher success rates in capital raising.

15%

Companies with strong narratives achieve, on average, a 15% higher market value growth over a five-year period compared to their counterparts.

+175%

Purpose-driven companies grew brand value by 175% over a period of 12 years, more than double that of brands with a weaker purposeful positioning.

https://www.kantar.com/inspiration/brands/brand-purpose-when-good-intentions-arent-enough

Growth remains the core of value creation.

Growth remains the core of value creation, as it has the power to propel companies to new heights of market dominance and financial prosperity. It is the catalyst for innovation, revenue generation, product or solution pricing modelling, and investor interest, underscoring its unrivalled role in shaping a company's destiny. Investments in growth projects, such as customer acquisition, repositioning, product development, and market diversification, are the catalyst for innovation.

Growth drives revenue and captures investor interest. While other factors like operational efficiency and customer satisfaction are important, they often follow in the wake of a company's expansion. Growth can open doors to new opportunities and markets, laying the groundwork for a company's long-term success. It's the bold pursuit of growth that has historically separated industry leaders from the rest, underscoring its unrivalled role in shaping a company's destiny. In essence, growth is not just a driver but the engine of value creation, essential for a company's evolution and the hallmark of its triumph. As a note of cautious: growth must always be pursued with a balanced approach that considers both its benefits and potential pitfalls.

In 2017, a British PE firm acquired Poland's largest convenience store chain, which was facing challenges like high franchisee turnover and negative customer satisfaction. The firm implemented various ESG-related initiatives, such as reducing plastic packaging, increasing sales of plant-based foods, and using recycled materials. These efforts led to significant reductions in waste and carbon emissions, with a 20% increase in aggregate sales growth over the last three years and a 3.9% point increase in gross margins between 2017 and 2020. Additionally, the company saw improvements in customer satisfaction, marketing and employee engagement. As a result, the store chain received recognition from industry associations, being awarded as the 'Green Portfolio Company of the Year' in 2020. This case highlights not only the importance of operational or strategy value creation, but also the growing importance of ESG factors and their potential to drive positive outcomes for both investors and stakeholders.

The landscape of value creation in private equity is radically changing, driven by macroeconomic trends, societal shifts and technological advancements. To thrive in this evolving landscape, investors must embrace a holistic approach to value creation, prioritising revenue growth, margin expansion and sustainability.

By fostering strategic partnerships and adopting a balanced growth approach, investors can unlock sustainable value and navigate today's economic complexities.

True.

GET IN TOUCH WITH US. GROW WITH IMPACT.

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True Value Creation is a growth advisory specialist.
We are trusted by leaders to turn their vision into actionable sustainability, go-to-market and communications strategies.

Our expertise spans over 20 years of knowledge, leading and collaborating with growth strategies for some of the globe's leading multinational firms, international organisations as well as innovative scaling up businesses, in fast-moving sectors such as investment management banking, insurance, consumer & retail, media and telecommunications.

Let's grow together, sustainably. Contact us.

www.truevaluecreation.com

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