The Private Equity Opportunity

Creating New Value in Stressed Funds and Portfolio Companies

CapTech

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At the outset of 2020, the private equity (PE) market was continuing its decade-long growth, with seemingly nothing on the horizon to slow it down.

Over the prior 10 years, the total value of North American PE transactions grew more than threefold from its low point during the Great Recession, and deal counts held steady at more than 12,000 per year. In addition, the level of uninvested capital ("dry powder") reached record levels of near $2 trillion USD[1] globally, a sizable savings account that reflected a growing investor appetite for excess returns from PE portfolios.

In effect, PE had raised more money than it could invest in new portfolio companies, and the performance of existing funds continued to attract new capital. A "PE bubble"—from overpaying for a reduced supply of target companies—seemed to be the main possible storyline on the horizon.

Of course, all storylines were rewritten with the arrival of the COVID-19 pandemic. In just a few months, the tides turned dramatically, and PE ownership became a potential burden for companies seeking stimulus funds, deal volumes were greatly reduced, and some PE firms abandoned high-profile target companies. To compound these developing challenges, many PE managers lacked the freedom to target distressed companies and "buy low" due to portfolio risk limits and fewer acquisition targets.

THE NEW PRIVATE EQUITY OPPORTUNITY

Where does that leave PE firms and their portfolio companies? In our view, quite well-positioned, particularly compared to privately owned, competing companies. In fact, given the widespread industry disruption that's already occurred and the significant uncertainties ahead, creating value in existing portfolio companies might be more critical now than at any time in recent memory.

U.S. PRIVATE EQUITY ACTIVITY

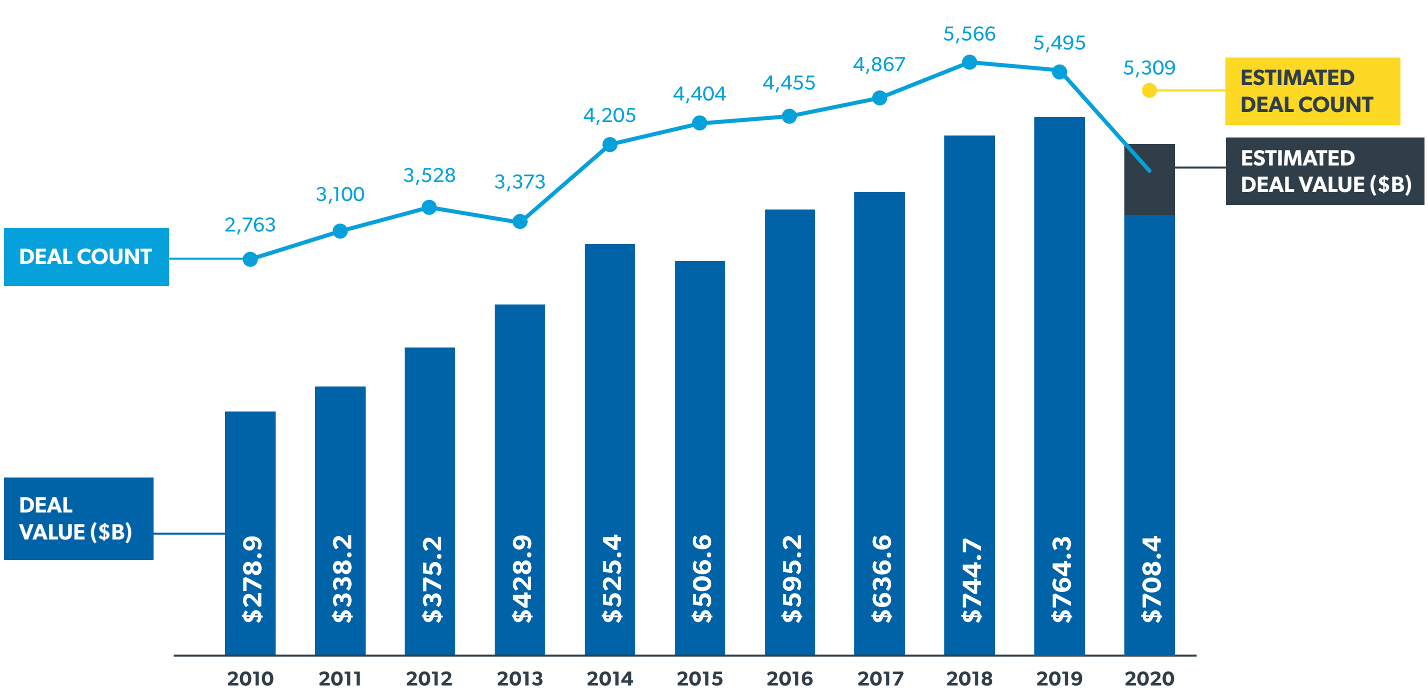


Figure 1. Deal volume and value for North America. Pitchbook

[1] Gottfried, M. (2020, April 13). Private-Equity Firms Scramble to Shore Up Coronavirus-Hit Holdings. Retrieved from wsj.com: https://www.wsj.com/articles/private-equity-firms-scramble-to-shore-up-coronavirus-hit-holdings-11586770202

The combination of dry powder, strained PE portfolios, and crippled investment strategies create a tremendous opportunity for fund managers to refocus on an unexpected opportunity: their existing portfolio companies. We present a framework for evaluating and executing the right investments, and recommendations for both PE firms and portfolio companies to navigate these investments together.

By practicing agility to adjust and adapt to portfolio companies' shifting needs, and with strategic deployment of capital in the right places, PE firms can guide their companies — and their funds—to outsized performance.

REFOCUSING ON THE PORTFOLIO

With tight budgets due to market and economic uncertainty, it is even more critical that strained portfolio companies modernize systems and operations, re-evaluate processes, and increase operating partnerships with their PE owners. We see three primary ways that PE firms can refocus their attention on owned companies:

1. **Revamping the investment thesis:** The current crisis broadly affects PE investment theses, valuations, investment horizons, and exit strategies for their portfolio companies. These changes can create strategic opportunities, such as shifting a largely hands-off company investment into a technology-driven modernization or new product innovation.
2. **Using adversity to drive change:** Business slowdowns associated with the current environment can lower barriers to change, empowering companies to undertake major projects that would previously have been inconceivable.
3. **Putting capital to work:** While preserving liquidity might be required, leadership should look to strategic capital investments in existing portfolio companies to build a competitive advantage or lay the groundwork for accelerated progress as the economy recovers. In fact, availability of capital can be a competitive advantage for companies owned by PE.

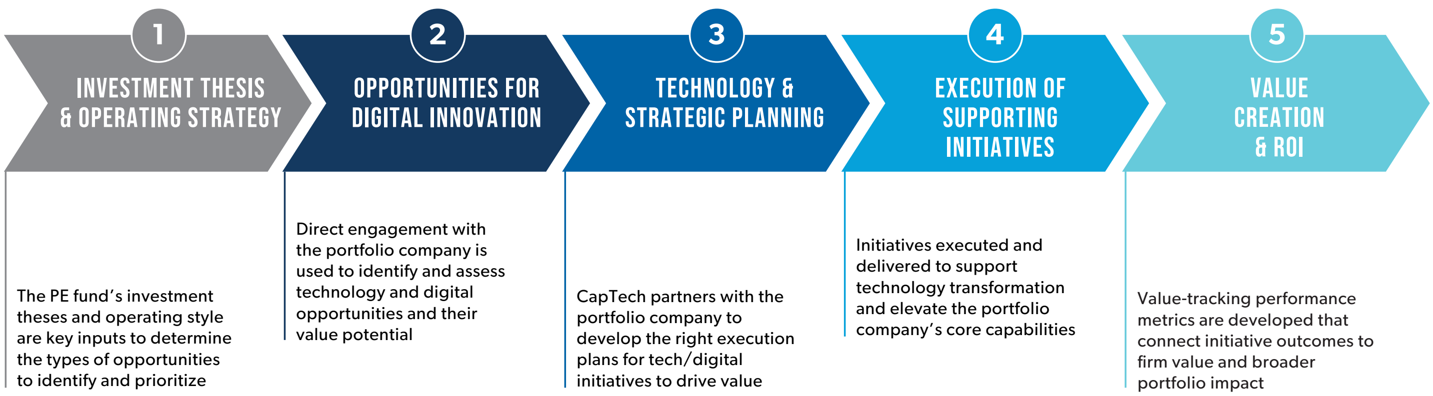
TACKLING TRANSFORMATION IN PORTFOLIO COMPANIES

Current operational conditions that limit in-person activities are increasingly driving companies to focus on leveraging technology to either enhance or holistically change the way they do business. Given the commitment to unlock new (or different) value in their companies—particularly via large-scale modernizations and digital transformations—it's helpful to understand where and why companies often struggle with such efforts.

Many PE acquisitions face technical hurdles when return on investment (ROI) is tied to unlocking value through improved technical architecture, systems integration, and other modernization activities. As a result, portfolio companies often struggle with transformation for many reasons, including:

- **Transformation inexperience:** Acquired companies sometimes lack clear IT direction or may not have prioritized technology needs. They also may lack the experience required to drive large-scale opportunities for value creation via transformation. Transformation inexperience compounds limited ownership engagement by driving companies to invest in technology that does not address existing issues or drive value.
- **Outdated processes and systems:** Older acquired companies often face additional hurdles adapting to digital marketplaces and data-driven business processes. These companies may have relied on homegrown technology that has evolved over time in response to demands. These systems often intersect with processes in a way that limits overall flexibility, creating significant barriers to change.
- **Lack of commitment:** Business transformation requires significant, sustained attention to people, processes, and technologies. But company leadership often employs a cautious approach and focuses on short-term financials, leading to pauses or reversals on planned transformation efforts.

CAPTECH'S FRAMEWORK FOR PORTFOLIO VALUE CREATION



A FRAMEWORK FOR PORTFOLIO VALUE CREATION

We have developed a flexible, five-step process to identify opportunities to create value in portfolio companies. This often begins with an evaluation of the PE's strategy and investment focus, then an assessment of opportunities through direct engagement of individual portfolio companies, prioritization of initiatives for investment, and establishment of the right processes and metrics to guide execution. Though the strategy should be revisited periodically, the remainder of the sequence operates as a continuous feedback loop.

1. **Investment Thesis/Operating Strategy:** The investment thesis and operating strategy are key inputs to the value creation plan. Much of this will have been outlined during the diligence process, but it should be refined and built upon as a post-close activity. This step should be revisited as part of annual operational planning to ensure that the strategy reflects the most current operating reality and investment horizon.

2. **Portfolio Company Opportunity Analysis:** As an option, quick assessments of one or many portfolio companies are performed to identify and prioritize near-term opportunities. These assessments include estimating potential value against cost, as well as operational, execution, and other risks. These opportunities are also evaluated for potential quick wins and low-hanging fruit. As a result, PE firms can opportunistically invest in a way that creates the most value across the portfolio, potentially leveraging scale (e.g., the same solution across multiple portfolio companies) to optimize implementation costs.

   Engaging a partner that supports both assessments and implementation is a helpful strategy in managing through change. The partner is also able to support decision-making, such as when to leverage internal resources or where an external team might be more beneficial.

3. **Case and Roadmap to Value:** PE ownership and portfolio company leadership can partner to flesh out the business case for short-listed initiatives to include well-vetted estimates of run-rate, cost to implement, and potential limiting factors. This exercise should include sensitivity analysis around important assumptions. The validated roadmap of value-creating initiatives will inform top initiatives to pursue. Leadership can then define timelines and milestones to capture associated value.

4. **Leadership Alignment and Execution:** The value roadmap should be widely shared and understood with portfolio company leadership. A solid understanding of value created and alignment with operational incentives will drive buy-in from important stakeholders. Similarly, external project teams should be closely integrated with related portfolio company teams to ensure that existing processes and systems are understood and accounted for, while also enabling seamless hand-off of new capabilities

and shared understanding of value drivers. For companies with limited transformation experience, technology consulting vendors can be especially helpful partners in upskilling internal teams and identifying critical gaps.

5. **Tracking Progress Against Plans:** Intentional execution of steps 1–4 should inform transparent tracking of performance against playbook objectives. PE firms and company leadership should be closely aligned on assessing realized value against the plan to evaluate and address any gaps. This information can be used to cycle back through a re-plan or inform an exit strategy, ultimately translating to tangible value for the new owners.

PRIVATE EQUITY FIRMS: THREE RECOMMENDATIONS

1. **Increase engagement with portfolio companies:** Whether the management strategy has been relatively hands-off or highly integrated, this is an ideal time to partner with portfolio company leadership and be extra mindful of their mindset. The shift from PE-as-operator to PE-as-asset -manager has reduced ownership's ability to actively engage with portfolio companies. Working together will foster a shared understanding of new challenges and creative thinking about how to address them.

2. **Re-examine playbook roadmaps/investment theses:** Longer-term strategic initiatives may need to be put on hold to pursue more near-term cost take-out initiatives or other investments in riding out a business downturn. Ownership should work with vendors to seek flexibility in the short term with an eye towards long-term goals—particularly where there is opportunity to work with the same vendors across portfolio companies.

3. **Ensure agility for multiple re-plans:** Current conditions are rapidly changing. Leadership should be prepared to make rounds of proactive changes and pivot as new information is learned.

PORTFOLIO COMPANIES: THREE RECOMMENDATIONS

1. **Embrace change in partnership with PE owner:** In this ever-changing landscape, look at challenges with an opportunistic lens to evaluate where changes that would have previously been too difficult to tackle have become more feasible. Consider absorbing any excess bandwidth created to redefine roles and expand capabilities, and view reduced volume as an opportunity to test process or system redesign.

2. **Balance long-term innovation with short-term financials:** Avoid the urge to focus entirely on the existing business, and work with an expanded stakeholder group to proactively innovate systems and products in response to

PRIVATE EQUITY FIRMS

1. **INCREASE ENGAGEMENT WITH PORTFOLIO COMPANIES**
Working together will foster a shared understanding of new challenges and creative thinking about how to address them.

2. **RE-EXAMINE PLAYBOOK ROADMAPS / INVESTMENT THESES**
Longer-term strategic initiatives may need to be put on hold to pursue cost savings initiatives or other investments in riding out a downturn.

3. **PREPARE FOR MULTIPLE RE-PLANS WITH AGILITY**
Current conditions are rapidly changing. Leadership should be prepared for rounds of proactive changes and pivot with new information.

PORTFOLIO COMPANIES

1. **EMBRACE CHANGES IN PARTNERSHIP WITH PE OWNER**
Evaluate where changes that would have previously been too difficult to tackle have become more feasible in the changing landscape.

2. **BALANCE LONG-TERM INNOVATION WITH SHORT- TERM FINANCIALS**
Work with an expanded stakeholder group to proactively innovate products in response to changing environment and/or customer needs.

3. **FIGHT THE URGE TO TAKE FOOT OFF THE GAS**
Current conditions may dictate a faster pace of change. Successful portfolio companies will adapt and continue driving hard toward targets.

the changing environment and/or customer needs. In particularly disrupted industries, this innovation may be the difference in remaining solvent while competitors fail.

3. **Fight the urge to take the foot off the gas:** Current conditions dictate a faster pace of change and innovation. Company financial goals are unlikely to change significantly despite a drastically different operating environment. Successful portfolio company leaders will adapt their approach and continue driving hard toward targets.

LET COLLABORATION LEAD TO TRANSFORMATION

It's clear that silver linings exist for PE and portfolio companies during this unprecedented pandemic. While the environment has created its share of distinct challenges, unforeseen obstacles often lead to new opportunities. For PE and portfolio companies, collaboration has the potential to quantify and clarify these opportunities.

From there, both sides must be willing to reevaluate their entire operations to survive during the downturn, then later thrive when markets begin to recover and expand. As noted at the outset, many storylines have been rewritten this year. And for PE and portfolio companies, the path to a happy—and prosperous—ending begins with an abiding commitment to ongoing adaptability.

CAPTECH'S PRIVATE EQUITY PORTFOLIO SOLUTIONS

1

CROSS-PORTFOLIO OPPORTUNITY ANALYSIS

Evaluation of a PE firm's individual portfolio companies to prioritize opportunities for key investments, platform synergies, and value creation broadly across a portfolio

2

PORTFOLIO COMPANY STRATEGIC PLANNING

Best-practice assessments of platforms, processes, and skills needed to support business growth with technology and digital modernization, including actionable roadmaps

3

SUPPORT OF PORTFOLIO COMPANY INITIATIVES

Execution that delivers high-priority capabilities across technology and business to elevate a company's products, performance, and value over the PE investment horizon

CAPTECH'S PRIMARY TECHNICAL AND DIGITAL CAPABILITIES FOR PRIVATE EQUITY

TECHNOLOGY

- Modern Architecture & Cloud
- Microservices & APIs
- Front-End Development
- DevOps & Continuous Delivery
- Mobile & Devices

MANAGEMENT

- Program Management
- Product Analysis & Leadership
- Business Process Engineering
- Organizational Change
- Risk & Compliance

DATA & ANALYTICS

- Data & Analytics Strategy
- Data Architecture & Platforms
- Machine Learning & AI
- Data Science & Visualization
- Data Privacy & Governance

CUSTOMER EXPERIENCE

- Customer Research & Insights
- Design Thinking Workshops
- Digital Experience Strategy
- Interaction & Visual Design
- Accessibility Guidance

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