Private equity and digitisation: the hidden equity story

Firms can use the lens of digitisation to pick the right targets, avoid potential losses and maximise portfolio value.

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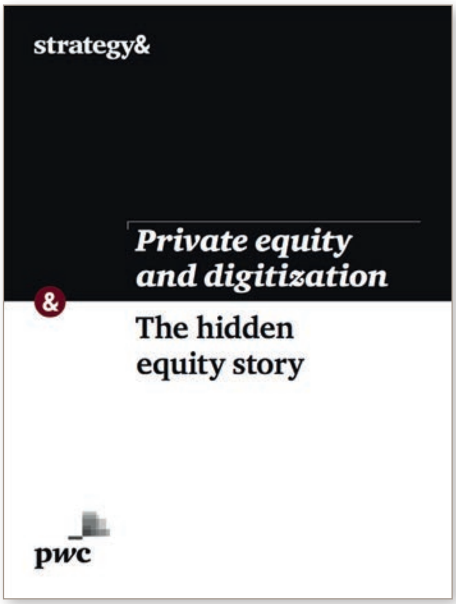
For private equity funds, the days of buying stakes in companies at a low price and selling high are over. Prices are high across markets, competition is fierce, and opportunities for multiple arbitrage are scarce. More than ever, private equity managers need special insights to find value where others can't. They also need the skills to take a fairly priced asset, implement hands-on management, and create value that will boost their returns.

There is still a largely untapped area that offers extraordinary opportunities for value creation, but most private equity firms – in fact, most investors – aren't fully aware of the potential here and therefore aren't yet asking the right questions: to what extent has the target company digitised its services and products, operations, and back office? How does the level of digitisation compare with that of its competitors? How much more can be done, and what's the best way to do it? These are some of the questions that should be a big part of any private equity investor's due diligence. But except for technology-focused funds, many private equity investors are neglecting digitisation's importance and may need additional expertise in recognising and developing a strong digitisation strategy.

Digitisation has by now made its way into nearly all industries. It isn't just about tech companies, or sales channels, or a little more cost savings on the margins, it's also about creating new products and services, new production methods, and new ways of collaborating with customers and suppliers. It's about the revolution of the industrial sector under the banner known as Industry 4.0, and beyond, though few people associate such sectors as natural resources and chemicals with the latest



technologies, digitisation can change every sector of the economy – and it is. All of a company's physical assets and all of its partners along the value chain can become part of an ecosystem in which data moves seamlessly throughout. In a fully digitised company, production and supply chains will be lean and flexible. Marketing will be omni-channel and responsive to customer needs. The company's internal structures will be efficient and integrated. Product and service offerings will be digitised and expanded. The company will have, in sum, much greater potential for growth and profitability.

The advantage of digital knowledge

Understanding this big picture is just one piece of the puzzle. Private equity managers also need to be able to assess precisely where individual target companies and their competitors stand in this ongoing movement. They also must be able to provide hands-on management when needed so that they can help their portfolio companies develop comprehensive digital strategies and build necessary capabilities.

When private equity firms have this knowledge and this ability, their view of potential acquisitions will change, sometimes dramatically. In some cases,

paying a premium is justified because the target company is digitally advanced. Other companies lag so far behind digital leaders that they're not worth buying, regardless of the price.

Still other companies, digital laggards in sectors with no clear leader, have enormous value that can be unlocked. For that, private equity managers must have the capabilities to guide a digital strategy and the implementation of new technologies. With some companies, these technologies can do far more to improve performance than traditional cost-cutting methods can.

Creating value

In the current investment market, it's more important than ever for private equity firms to choose target companies wisely and to develop them to their full potential. But unless firms embed due diligence on digitisation inside their standard commercial due diligence, they increase the risk of missed opportunities and unexpected losses.

In the acquisition phase, due diligence on digitisation will look not only at target companies but also at their competitors. In the development phase, the concepts outlined above give an idea of the many ways digitisation can create value and prepare companies for a profitable exit. And digitisation is an ongoing process. A proper base for digital development, combined with effective communication, can add an extra layer to the equity story; Would-be acquirers that understand the potential for further growth may be willing to pay a higher multiple.

Experience and specialised skills are needed to take advantage of digitisation's potential in both the acquisition and development phases. Private equity firms that don't have these skills may have to invest to build out their own digital capabilities, or align with strategic partners that know how to assess target companies, support digital transformations and capture the potential value.

With the right capabilities, a firm can use the lens of digitisation to pick the right targets, avoid potential losses, maximise its portfolio's value and build a reputation in the markets for preparing companies for future success.

This article is an extract from a paper also entitled 'Private equity and digitisation: The hidden equity story'.

Private equity and digital transformation

Digitisation is very high up the private equity agenda, and is the most important mega-trend influencing their new investments, according to a survey of 100 European private equity houses published by PwC in November 2016. Survey respondents rated it 1.77 on a scale of 1-5 (with 1 being the most important).

62% of respondents believe it can create sustainable value for a company and 88% have already either finalised the assessment phase or are in the phase of implementation. Private equity houses believe digitisation to mostly boost growth, decrease risk and decrease working capital and Opex.

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