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FOCAL POINT |

Rapid Value Creation Plays Through Add-Ons

What are some challenges while managing add-on integrations remotely?

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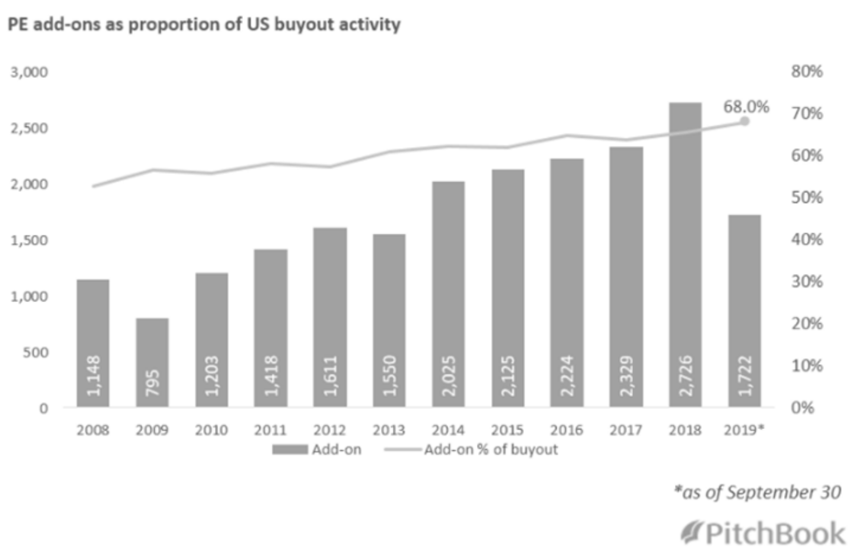
The current Private Equity M&A market will continue to prioritize add-on acquisitions. Studying add-on transactions, Bain reviewed the North American add-on market as recently as early 2020 with Pre-COVID data and, what they saw was the trend of add-ons growing in proportion to new investments and taking on greater weight in the investment thesis. (1) Pitchbook data corroborates Bain's findings with their assertion that 30% of the add-ons done in 2019 were the 4th or later and reached over 70% of US buyout activity in 2018. Over the last 3 years, add-ons represent over 75% of the US buyout activity according to Preqin. (2)

Will prolific add-ons continue to make up a large percentage of the buyout market today? Trend data suggests the answer is a resounding "Yes". The new EBITDA-C valuation challenge will include diligence and assessment of investments with more questions and uncertainty on revenue streams.



Will enough decision-supporting data and reporting consistency - considering financial implications such as blending cash positions, revenue pipelines, working capital utilization and cash conversion cycle trends - be able to be modeled pre-close in a remote collaboration? Perhaps, not as much as desired, but all core value drivers can be assessed and transformed remotely.

As we experience reduced industry travel, conduct more video conferences, and test digital ways of performing diligence, funds who prioritize the implementation of remote tools have created more comfort in this agile, less formal approach to integrating add-ons into a portfolio company platform. Acquiring new platforms also have adopted these tools, but the jury is still out on the sufficiency to gain enough confidence to close major platform deals. Stable management, or even management in transition, can help fill critical early hold gaps in expertise. Add-on acquisitions also have the benefit of platform management team engagement, along with PE sponsor, and comfort in their leadership contributions.

Thesis execution, growth, due diligence, onboarding, and rapid plan execution must now be thought through with less physical presence by the PE fund's Operating Partners. To keep performance visibility and prevalent operational support from eroding, a more structured project management office (PMO) comprised of the best people from fund, platform, and new acquisition teams is required. A well-designed PMO can help drive change management support and assimilation efforts through remote technology so collaborations can be timely, clear, and visible.

Core integration elements accelerated by a PMO include:

1 | Revenue Capture

Before enhanced (combined) operational & financial reports can be developed, the leadership team of the combined organization must first articulate the vision for the assimilated companies and how the new entity provides new opportunities for the team. Having change management and skilled communication experts working on the integration through the PMO is imperative. The new entity needs to have the most experienced, problem solving resources from both sides as stakeholders. With a communication plan underway, both the platform company and the acquired firm need to align data governance and data normalization practices before reports can be combined.

Core data sets that need scrubbing and auditing should incorporate:

A. *Client Revenue Roster* for a minimum of three years, five is preferred.
B. *Existing and net new logo revenue* per year must be clearly defined and broken out.
C. *Potential loss due to overlap or cannibalization* must be jointly defined and agreed to before modeling.
D. *Opportunity/Lead/Client journey* defined via client relationship channels, business development sources, and other revenue-generating processes must be mapped and supported by data.
E. *Percentage of revenue from new products* and offerings that have had capital expenditure or expenses assigned for the development must be categorized.

As these data sets are developed, account assignments, modeling growth of revenue (by segment, product, geography, or sales territory leader/office) can be more confidently developed. A leader from the combined companies who is not the chief revenue officer (CRO) needs to manage the leadership of data and revenue model transformation for the first 12-20 months. The company's CFO ultimately is the stakeholder who owns the data governance, data management and known good dataset from where reports are derived. The CRO of the combined entity needs to own the revenue measures, KPIs and results. A cross-functional team from the combined entity is necessary with an appropriate stakeholder defined.

Margin analysis should be a focus while utilizing business intelligence (BI) tools and other modeling so there is a clear understanding of the revenue composition. This is especially important if the firm is in a high growth industry or not. Otherwise, the market share battle in slower growing markets is not going to drive value creation as modeled in the investment thesis. Margin analysis can help to determine if problems exist with pricing, team composition, product or service offerings, execution, or overdue time-to-exit-a-market.

As platform and add-on(s) continue to integrate, a critical question is *"Which GAP was filled through the execution of the add-on, and which one(s) should be next to accelerate the value creation of the combined entity?"*

2 | Blended Reporting and Transitions to Consolidated Reporting

There are several cost considerations and limits to value creation in migrating an entire enterprise data set from the add-on to the platform company's data warehouse or data lake. Critical issues that can raise costs include geographic locations to be assimilated, staff & cultural integrations, and risks of a weak PMO that does not utilize weekly onsite migration teams to execute the transfer and reporting into one system. Depending on the complexity of the migration, the reporting timeline may have to be kept more fluid. Using BI consolidation tools may prove to be a near-term solution over the initial 12-24 months so performance visibility and optics of an add-on can be separated within the integrated data set. Greater consideration in team sharing through technology and real-time tools will also allow the integration team to efficiently collaborate with the stakeholders.

Bolder, higher risk initiatives in enterprise system transformation should probably be delayed and reconsidered due to current constraints suppressing onsite program management and value creation contribution considerations. Capturing revenue upside and reporting consolidation options will come first as those two have the data closest to cost synergies. This tracking may go on for a longer period, but its governance will need to be established early.

3 | Enhancing the new Operating Model with Human Capital Analytics for the Sales/Revenue team

Measuring sales leadership and team members remotely can be done and can give immediate insight into the question:

Are the appropriate people in the right jobs creating value for the firm and for the markets and customers they serve?

This has been a growing area of attention as add-ons focus on expanding teams. Leadership needs to be well-practiced team builders and demonstrate flexibility. They should understand (or be taught):

Value creation will = Data Integrity and Reporting aligned to go to market (GTM) plans of the New Company and measured against the original deal thesis and model...

The Add-on Sales team needs to quickly assimilate into the expected processes, cultural norms, and communication expectations of the combined company.

Other considerations that can drive value in a human capital review can include:

Elimination of human and/or client and marketing redundancy
An operational excellence opportunity is understanding the current breadth and depth of team skills tied to the combined business model. While this area has been of high interest to most PE

value creation models, it has not been utilized to the level it should. The remote consulting environment can allow the human capital analytics to provide more insights into enhanced human capital excellence in the current environment. *Estimating the go-forward value creation growth initiative becomes enhanced with revenue, talent, and data review and alignment.*

Leadership assessment has traditionally been in demand, yet the deal compression process has limited the analysis brought to bear on understanding leadership strengths and improvement opportunities. Remote collaboration has slowed some deal diligence steps down at a cadence to now consider the team's collective skill sets, the team dynamic, expertise gaps and the steps that should be taken as the firm upgrades data flow, BI insights tools, and even firm talent in the combined entity.

Core Questions to Consider

Add-on acquisitions are expected to play an even bigger role in the US buyout activity going forward due to the difficulty in evaluating new platform investments and opportunities. The core questions will advance the assessment if the first add-on addressed an identified gap and if a model for more rapid assimilation becomes less complex as better, tested models and increased scale both drive value creation.

This elicits the following questions that must be considered as deal teams and operating models at the PE level evolve:

a. *Who will drive the initial and the subsequent gap analyses?*
b. *How will add-ons be evaluated and integrated into the platform entity?*
c. *With the "new normal" being more remote diligence and integration models, what resources will be utilized to ensure data integrity and implementation of financial and operational reporting?*
d. *At the PE firm level, how will the operating partner model and utilization of outside PMO and data analytics firms be structured?* And finally,
e. *How will data analytics and machine learning be effectuated in this environment to leverage the integrated portfolio company's new ability to evaluate performance both at customer experience and human capital levels?*

Footnotes:

(1) Global Private Equity Report 2020, Bain & Company
(2) Preqin Deal US Buyout Data Sources from September 2017 through August 2020

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Steve leads the Private Equity Practice for Catalyft LLC, a practitioner-led, boutique operating partner firm focused on strategy implementation and operational improvements in Middle Market businesses acquired by Private Equity, investment firms and Family Offices. Steve has held several senior executive positions with the sovereign wealth fund Abu Dhabi Investment Company, Huron Consulting Group, and as C-level executive and Board member of private firms in the US, Europe and Middle East. He earned his MBA from Harvard Business School and has two Bachelor of Science degrees in Mechanical and Materials and Metallurgical Engineering from University of Michigan, Ann Arbor and speaks conversational Greek, German and Arabic.

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John is a Transformation and Operational Excellence Leader in Private Equity Firms and Portfolio Companies. John has played many roles in the private capital space over 30 years Including senior executive to fast growing middle market companies, Independent Sponsor, PE and Family Office Advisor and Consulting Practice Leader.