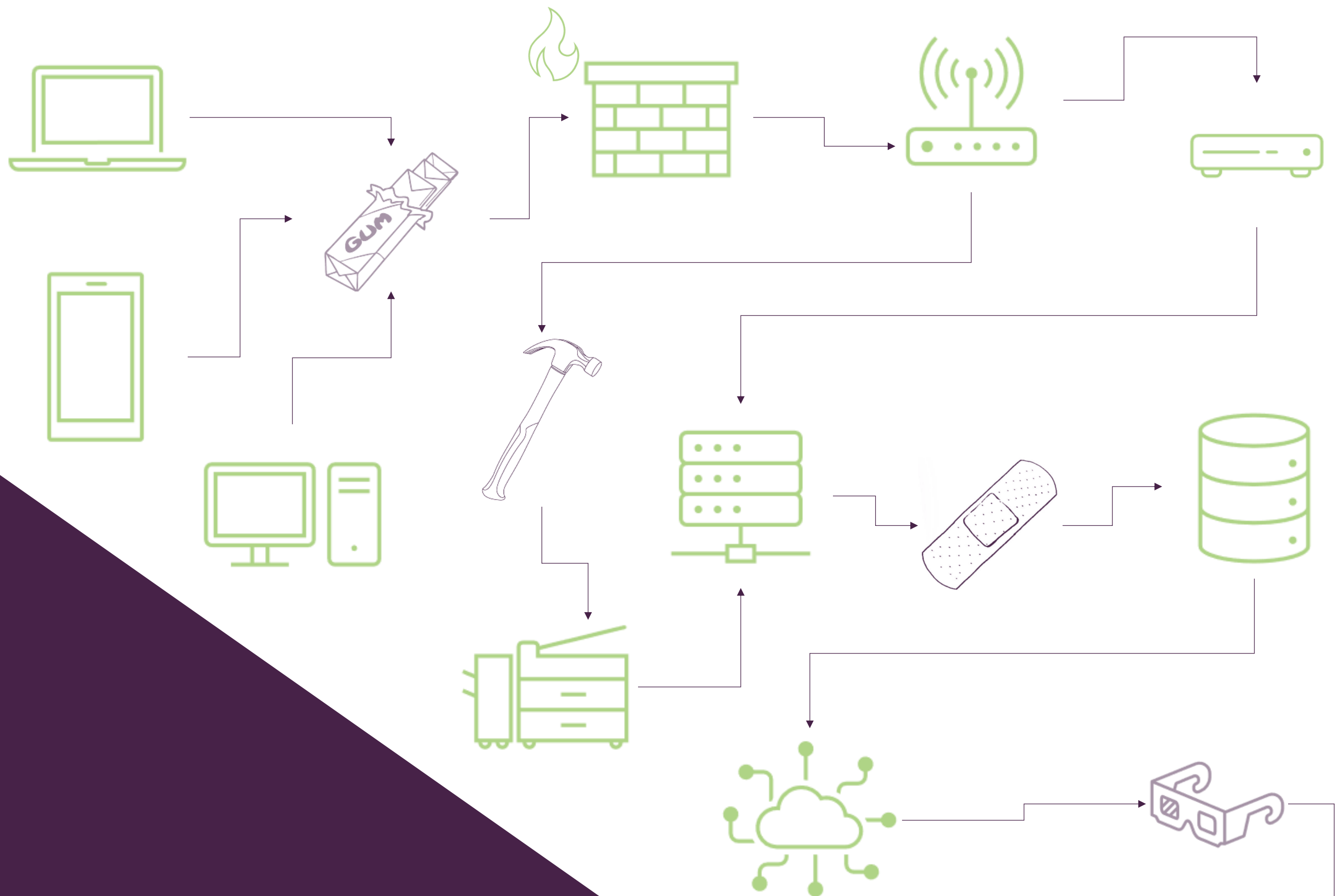
# FOCAL POINT | A Closer Look at Technology Debt




## How Digital Transformations Drive Growth and Value Creation in the COVID World and Beyond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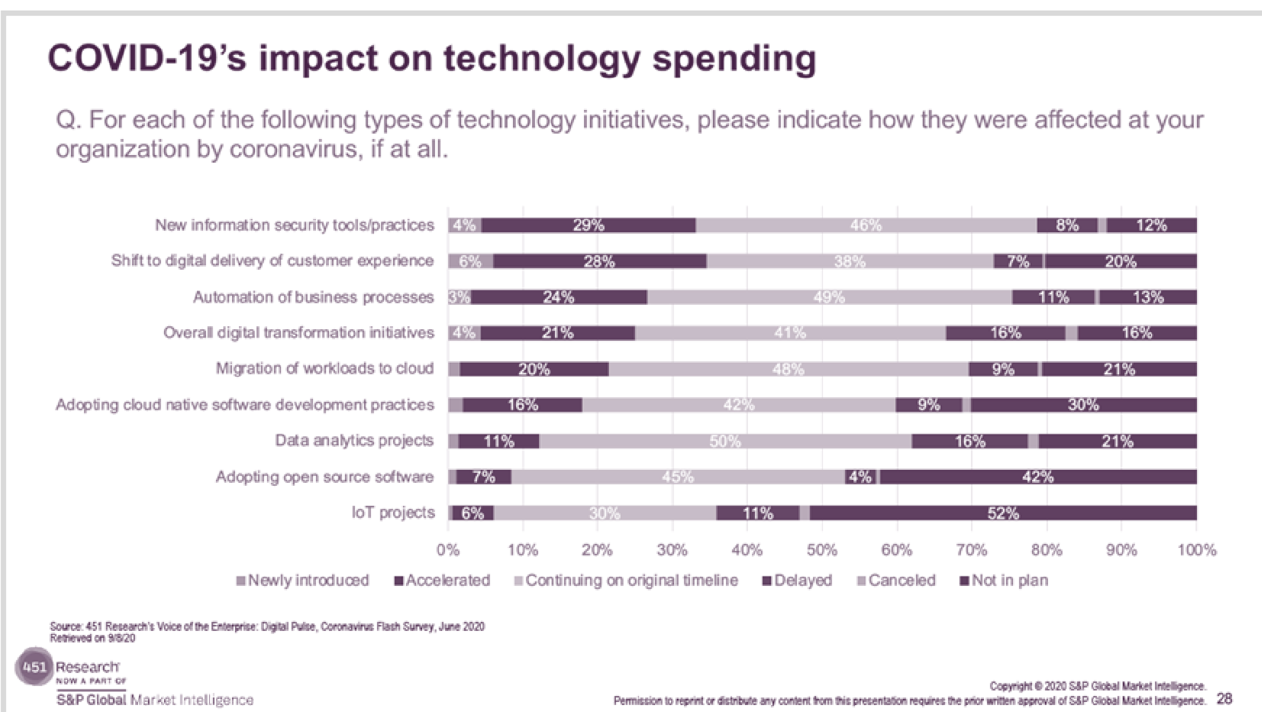
Digital Transformation initiatives have been a top priority for most Private Equity (PE) portfolio firms for several years now. Whether it's a need to gain order-to-delivery speed through coordinated process automation, or creating unique user experiences and customer journeys through content management systems, or enabling the organization to collaborate and engage from 30 kitchen tables, digital transformations are a powerful way to boost productivity and revenues. With so much uncertainty in the foreseeable future, PE firms are expected to place even more emphasis on helping Management accelerate digital transformations and in-house data analytics capabilities when acquiring new companies (platform acquisitions and add-ons alike).

With the emergence of pronounced COVID-19-related business disruptions: *how has the pandemic changed the technology and planning landscape?*

**First Implication**: business contingency planning, which in many cases has not been a focus of the acquired entity, has immediately moved into the spotlight for middle market companies as they preserve cash, grow revenues through unique, positive customer experiences and retain the human and financial assets to drive growth. Most firms need the flexibility of Plan A, B, and C with a well-vetted Plan D in the back pocket as markets change and morph with unprecedented speed.

**Second Implication**: Customer-centric and Consumer-facing technology projects have been accelerated as teams find new ways to delight customers and generate more revenue. Other digital initiatives further away from the Customer such as major Internet of Things (IoT) projects, adoption of open source software across the organization, and cloud-based initiatives have initially been delayed or in some cases cancelled. (1)



This shift in technology spending has significant implications, too, for PE's new platform investments and add-on acquisitions. As a result of COVID changes to operational and onboarding strategy, new investments are being driven into digital transformation of customer facing experiences, automation of business processes and security tools and practices/remote working initiatives immediately.

Third Implication: Historically, mergers and acquisitions initiatives occurring in Year 0 into Years 1 and 2 within Private Equity-backed companies provided relatively quick, standardized integrations along with formulated growth and value creation models offering a high probability of success. While month-end reporting packages have always been a necessary discipline early in the investment, the underlying data integrity and longer-term data management must be considered earlier in the PE-Management partnership. Due to disruptions in our COVID world, more regular check-ins, more comprehensive cash-centric reporting and more visible revenue pipeline data, along with operational efforts around data (cleansing, structuring, distribution, visibility, analysis, etc.) have become the foundation building viable, data-driven value creation models and the normal practice going forward.

During pre-close due diligence, understanding existing IT strengths and concerns has become more important in the assessment of the technology debt/deficit in the context of the value creation road map moving forward post-acquisition. Technology powers many of the equity value driver plays in Private Equity valuation growth, including Sales & Marketing, Operations / Tech Ops, and Finance & Accounting Excellence.

***Technology debt,*** as defined by Accenture's Abbosh, Nunes and Downs in the book Pivot To The Future refers to an organizational state where the aggregated sunk costs of hardware & software, fixes/band-aids/one-off codes, and all the short-term fixes result in enterprise-wide inefficiency, duplicate processes and frustrating extra work attributed to outdated and out-of-control technology architecture. With COVID, these issues are coming to the forefront faster. The drive to deploy capital without truly assessing technology debt lurking within company operations and key systems, the elevated importance of remote work environments, and the necessity for increased visibility of results at the PE group level are all precipitating factors.

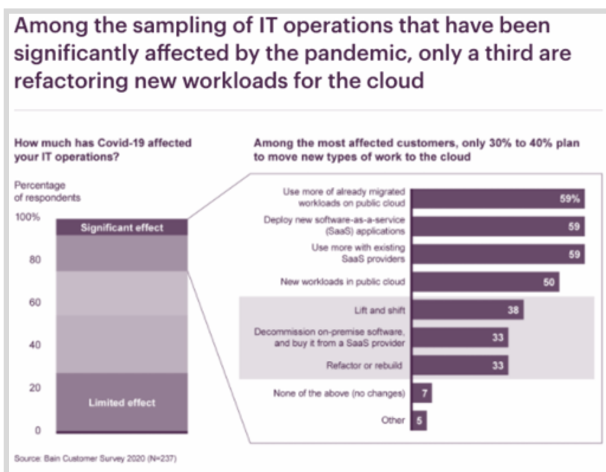
New PE-backed investments, whether they are platforms or add-ons, have growth strategies contingent upon clean, coordinated, visible data. This places additional pressure on the acquiring firm to fully understand data set integrity, the flexibility and scalability of its technological ecosystem, and if the portfolio company has architecture in place to drive the near-term revenues and integrate in future M&A growth opportunities. Internal capability build-ups and EBITDA expansion from improved financial metrics, operational insights and opportunity pivots come from an appropriate, user-defined, scalable technology infrastructure and managed with easy-to-access, easy-to-understand reporting customized to the needs of the PE-Management partnership.

The markets Private Equity portfolios seek to capitalize on and drive value through process institutionalization require technology to be relevant to the needs of the business, leverage company assets, inclusive of the users' needs, and help turn data into useful decision-making information. Our experience has been middle-market companies (with revenue between $20 to $200 Million) tend to have some aspect of a broken technological infrastructure. Outdated hardware assets, disjointed reporting hierarchies, incompatible inherited software mixes are all inhibitors of the information Management needs to make prescient decisions to propel the firm's growth (and clouds the information investors need to buy low and sell dear). The deficit has been created by more than outdated reporting software and mixes of technology.

Building the appropriate infrastructure for the business model may well have been sacrificed by looking at ephemeral fixes and not fully considering pivots to agility supported by technology. Depending on the firm in question, risks may be identified in isolation, during an IT Diligence analysis, or through partner-initiated solution routes. However, specific digital transformation risks, costs, and time may not be fully studied or underwritten in the deal valuation.

The inefficiency and duplication of technology and human effort to enable month-end reporting for consistent accounting closes become a chore taking away from CXOs' time to drive the strategic vision and deliver upon expectations.

Fortunately, customizable applications exist in new assets or better scalable, asset-light cloud solutions. Teams can benefit from more modular approaches to drive value and collect, refine, and mine data or engage customers. Today, the ability to rapidly act, with technology pushing, requires different considerations of data as an asset, different technology tool integrations, and custom infrastructures.  However, cloud solutions may not be utilized as often as previously projected. Bain & Company reported IT operations have been significantly affected by the pandemic and only a third of survey respondents are refactoring new workloads to the cloud. (2)




**What are the implications to PE firms and their portfolio investments navigating disruptions?** There are two paths for consideration. Choosing a path involves a number of considerations ranging from executive leadership perspective, human capital depth, business strategy, business disruption drivers in play, and ultimately answering the question *"what do we need to do today for our tomorrow?".*

**Path # 1**: Scrapping everything and starting from scratch is an advantage fast-moving venture-backed industries or startups can consider. Mature companies going through new ownership, management changes, and strategy shifts don't have the same advantage.

**Path # 2**: Remediation of the deficit to develop accelerated business performance made possible with improved insights and reporting excellence. With this choice, there must be a commitment to a discipline to not accumulate assets that serve a single function or silo at the expense of enterprise optimization. A deeper assessment of the asset structure in Year 0 to Year 1 in PE company ownership must help the team to understand what can be decoupled from the old. Considerations to building robust data lakes and then distilling into timely reports with useful KPIs is the development route we've seen that drives value.

Decisions on technology require a broad stakeholder-oriented team communicating regularly with the Private Equity team, Management and Executives taking care of customers and any other partners tasked with building up the firm's in-house capacity for value creation. The discussion on technology comes down to a question of balance: *will the decision propel the enterprise or eventually weigh it down technically and financially?*

What we can call "small r" remediation could include upgrading and adding modules to existing platforms, rethinking architecture needs, considering what to do in-house versus outsourcing, and what smart third-party applications to implement. Just enhanced reporting alone is an undertaking. Stakeholder alignment, reporting integrity, and data asset ownership still must be worked through as an early step. Demands on program management and asset vs cloud decisions must be decided early to ensure an agile platform. Future pivots and scaling cannot be underestimated.

The "large R" remediation is not only a more intense investment but also arrives with longer implementation timelines which may outlive the PE sponsor's ownership phase. However, this may be the stronger approach depending on the company's value proposition and intellectual property. While the ROI and payback are difficult in a PE ownership period, it may be the only play to drive financial and operational levers with the expected speed and magnitude. This decision needs stakeholder alignment and a program excellence plan (or strong project management office) to limit possible distractions and missteps.

Longer-term remediation and restructure do require different human capital skill sets, technologies, cost considerations, risk mitigation steps, strategic needs, and, most certainly, time. A new enterprise resource planning (ERP) scoping project and new implementation is considerable. If the company is PE-backed, *how can you think about ROI and actioning specific strategy pivots if the company will be owned for only four more years? How can your valuable revenue-generating leadership realistically oversee and support the implementation of customer relationship management (CRM) systems, digital marketing platforms, process automation workflows, and the litany of operational and financial data visualization dashboards when their time is better spent focusing on customers and the home team?*

In today's environment of remote working, disruptive markets and proliferating implementation & integration challenges, driving value via technology is not "just a phase". The home team's capacity to set out on a path quickly and decisively to growth is imperative. The team should be well-versed in the technology they have to work with and vigilant in reducing the pain of technology debt. By lowering the team's day-to-day organizational frustrations, business can grow with pace. (And, thus enhance the probability of commanding a better-than-expected multiple for the PE side of the team).

## Footnotes:

(1) S&P Global Market Intelligence, 451 Research's Voice of the Enterprise: Digital Pulse, Coronavirus Flash Survey, June 2020

(2) Bain & Company, Bain Customer Survey 2020 (N231)

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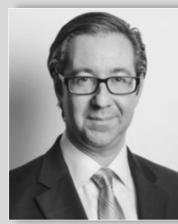
Steve leads the Private Equity Practice for Catalyft LLC, a practitioner-led, boutique operating partner firm focused on strategy implementation and operational improvements in Middle Market businesses acquired by Private Equity, investment firms and Family Offices. Steve has held several senior executive 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.