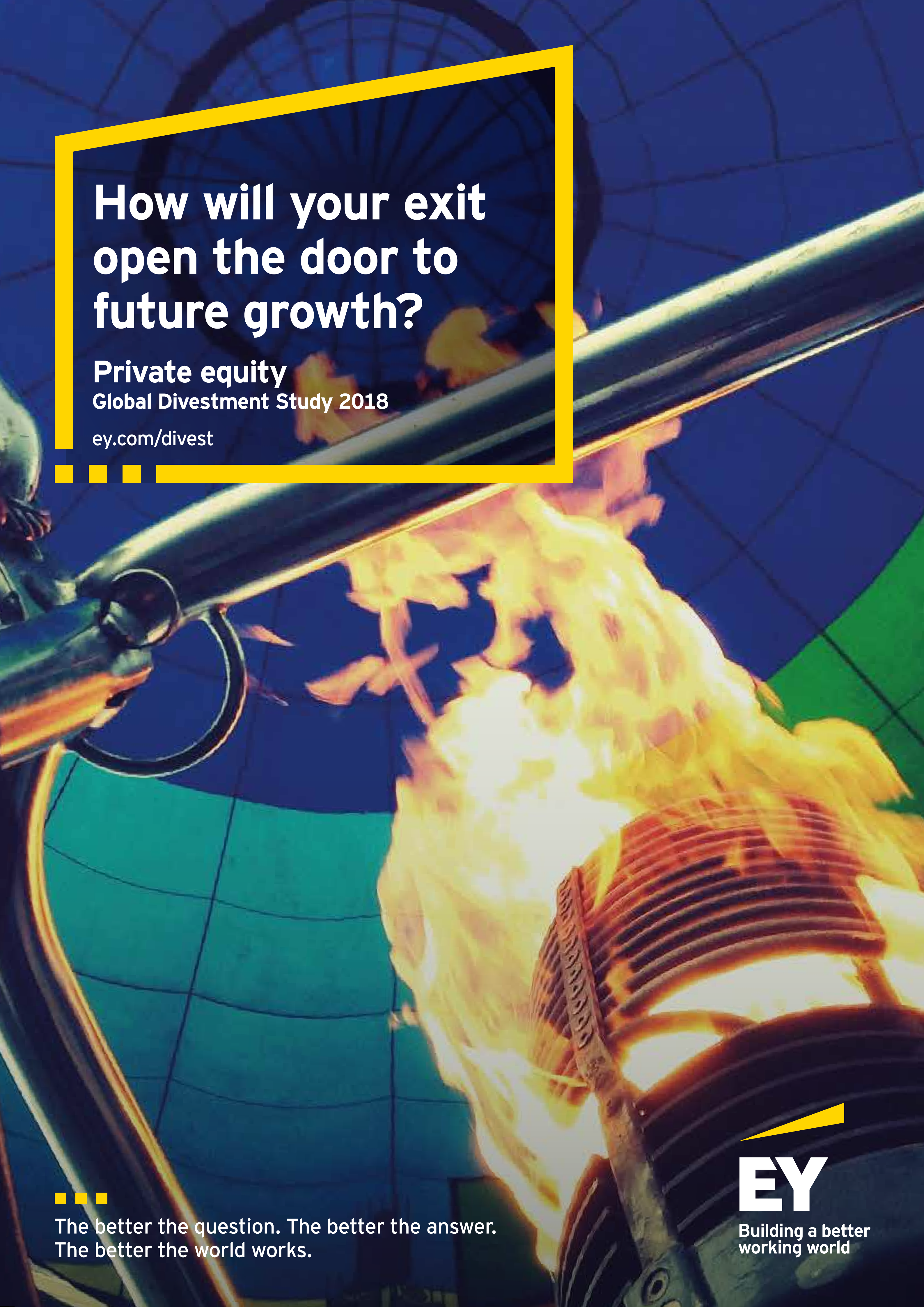

How will your exit open the door to future growth?

Private equity

Global Divestment Study 2018

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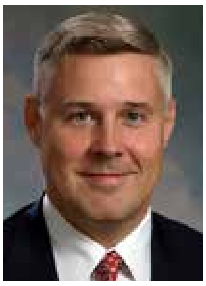

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Despite three years of frenetic exit activity, private equity (PE) firms continue to focus on divestments, with exits up 10% in 2017. Looking to the future, firms have more than US$633b in available capital—more than ever before—and we expect to see more deployment of capital in the upcoming year.

Competition for quality assets has been fierce and valuations reached new heights, with the average EV/EBITDA multiple closing in on 11x last year,[1] the highest since the financial crisis. PE firms seeking to maintain or improve valuations can expect to be challenged on their pricing.

Unlocking portfolio businesses' potential to benefit from digital and technological changes could be the key to securing greater value. PE firms that exploit the power of data and analytics tools at every stage of the transaction process will be able to build a powerful value case for their most attractive assets.

[1] Source: Pitchbook, as at 31 March 2017.

About this study

The EY *Global Private Equity Divestment Study* focuses on how PE should approach exit strategy amid rapid technological change.

The 2018 study results are based on 100 interviews with private equity executives. The survey was conducted between October and December 2017 by FT Remark, the research and publishing arm of the *Financial Times Group*.

- Executives were from companies across the Americas (45%), EMEIA (30%), Asia-Pacific (20%) and Japan (5%).
- Managing-level partners made up 63% of executives surveyed.
- Six percent of the PE executives represented firms with greater than US$50b in assets under management (AUM); 13% represented firms with US$30b-US$50b AUM; 34% represented firms with US$10b-US$30b AUM, and 47% represented firms with less than US$10b AUM.

Key insights

Portfolio review and strategy

Strengthening your business

Exit planning

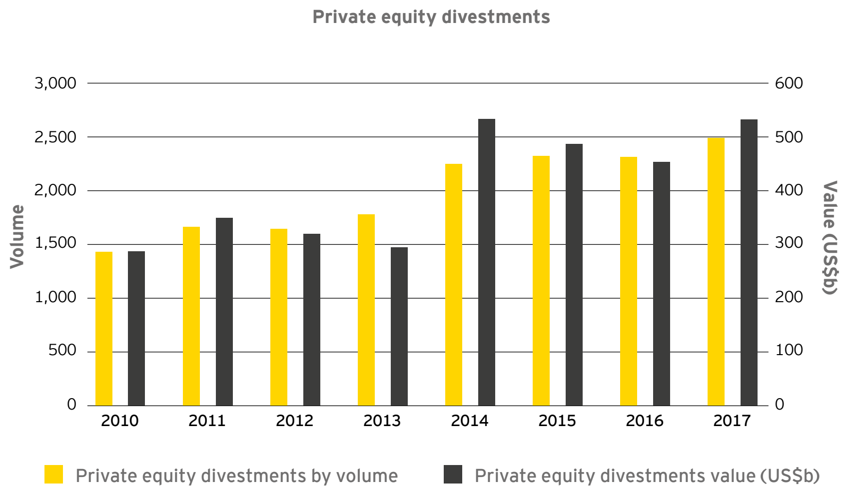
Market overview

Just over half (51%) of PE executives say their firm has made between five and ten divestments in the past three years, up from 32% last year. This elevated level of activity has allowed many to improve their strategic and data-driven exit preparation practices at every stage of the deal.

2017 was a record year for PE exits, with nearly 2,500 global exits worth almost US$535b, more than any year since 2007.

Firms are holding more frequent and detailed reviews of portfolio companies. And they are using advanced analytics to drive better decisions. They are also using technology to build a more compelling value case for a wider pool of buyers, and increasingly sharing more data with buyers to protect and enhance value during diligence, as well as speed up the process.

At the same time, emerging technology is becoming the dominant theme in many sales discussions. PE firms recognize the power of digital disruption to drive or destroy value in their portfolio businesses—and the need to address this ahead of an exit.



Source: Mergermarket

Portfolio review and strategy

Improving the review process

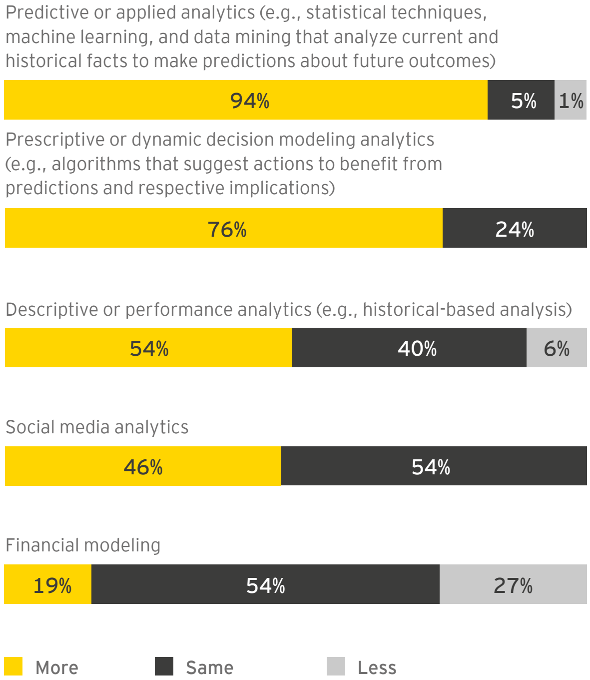
On average, 74% of PE executives struggle to assess the effect technology may have on portfolio company value. Among firms with AUM greater than US$30b, the percentage climbs to 95%. This needs to improve if PE expects to make the most of divestments in a technology-driven marketplace.

Use technology to value technology. PE funds need to take a formal, data-driven approach to assess how technology will affect each of their portfolio companies. Analytics can identify sources of value and anticipate impact on exit valuations.

Build your data. Analytics tools need accurate and consistent data to generate relevant insight. Focus on collecting and managing data in each portfolio business. This may include finding new ways to measure intangible asset value that does not appear on a balance sheet, like customer satisfaction or talent management.

Put emotional attachments aside. Management bias is a perennial problem, with 62% of PE executives citing this as a challenge in their portfolio review. But insights gleaned through analytics mitigate this risk by demonstrating how value is created based on data and not emotions.

Q Within the next two years, will you use the following more, less, same?



Key steps of the portfolio review

Phase 1	Define your strategic objectives
	Develop key metrics
	Agree on ratings and weightings for metrics
	Collect and analyze data
	Develop base-case valuation and dashboard
Phase 2	Build or customize scenario model
	Assign business units to preliminary buckets: grow, exit, fix, sustain
	Evaluate standalone impact of potential actions
	Combine actions into plausible scenarios for value assessment
	Evaluate *pro forma* range of metrics
	Recommend portfolio strategy and execution plan
Phase 3	Execution through divestments, acquisitions, joint ventures, IPO, tax structurings, margin enhancements and enterprise cost reductions

Analytics to support your portfolio decisions

Performance (descriptive) analytics focuses on the base business and its historical performance, including strategic, financial and operational levers.

Applied (predictive) analytics provides insight into the likely future performance of the business and helps optimize decision-making – based on predictions and other broader market factors.

Dynamic decision-modeling (prescriptive) analytics helps make strategic and operational decisions based on predictive scenarios to optimize portfolio performance – including divestment decisions.

Automating decisions

A large pension fund with key investments in life sciences, retail, business services, technology and energy needed to create an automated review process to better understand industry convergence and remove management bias from historical performance.

The fund created a real-time platform that combined industry benchmarks, public domain data (e.g., news feeds), syndicated data, financial filings and a comprehensive set of financial/operational data with machine learning-based algorithms.

As a result, they can predict performance of the overall portfolio and a subset of companies, drive the capital allocation process and measure return on invested capital. The fund is also able to simulate growth-related scenarios to stress test any investment thesis. By identifying underperforming parts of the portfolio earlier in the process, the fund is able to provide adequate time to resolve issues or prepare for divestment.

Q Which of the following do you consider a challenge associated with your portfolio reviews? Select all that apply.

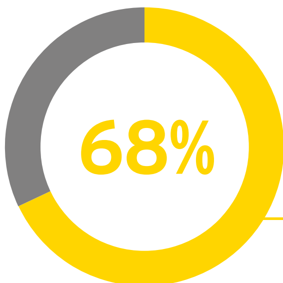
Building a tech-driven team

Just as important as using the right analytics tools are the people. Almost three-quarters of PE executives (73%) find it challenging to identify the right team to assess the impact and value of evolving technologies in their portfolio.

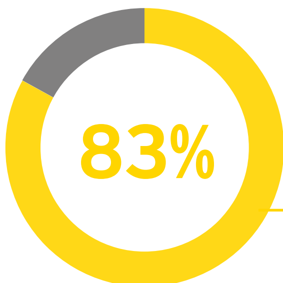
Find the right talent. Across all PE firm sizes, 83% are looking for operating partners with digital or technological expertise (94% among firms with US$10b-US$30b AUM). On average, 68% are seeking management teams with similar expertise. These executives should have the skills to identify, manage and articulate the detailed, data-driven value creation strategy needed to secure higher valuations.

Apply as needed. Operating partners with digital expertise can be parachuted in as needed. They can plot a better growth strategy through a digital lens and bring in the tools needed to capture business performance data at a granular level from exit strategy to planning.

Move to more flexible working practices. According to 41% of PE executives, they are using operating partners more than in the past. And by using contractors with specialist expertise, PE firms can access best-in-class resources when they are most needed.



Say their selection of management teams has shifted toward people with digital/technological expertise.



Say their selection of operating partners has shifted toward people with digital/technological expertise.

Strengthening your business

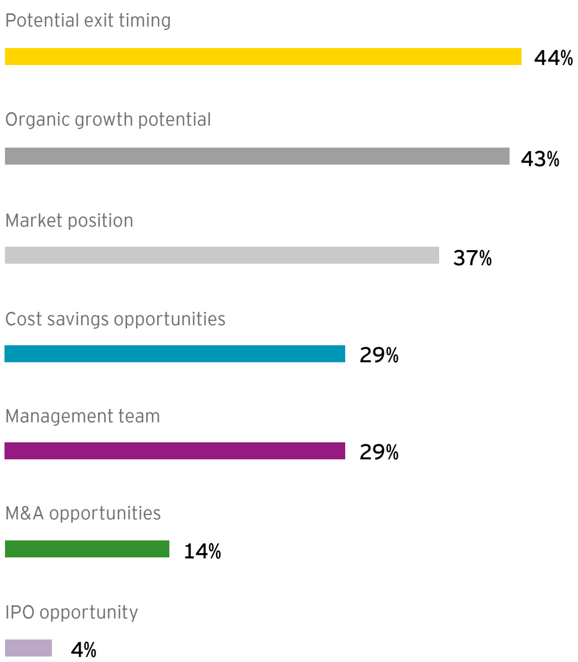
Investing in organic growth potential

The organic growth potential of a target is becoming critical to the PE exit strategy. While a quarter of firms cited this last year, it now sits near the top of the list at 43%. Amid high valuations, growth opportunities will help PE firms build on their purchase price and offer future buyers a growth trajectory for the business.

Don't miss opportunities. Identify any under-exploited improvements that might influence price. For example, 76% of PE executives say they rightsized the organization to improve performance in a portfolio business before putting it up for sale. The same percentage conducted operational improvements to cut costs and improve margins.

Delve into the data. Analytics can identify untapped growth potential based on a combination of business data and market trends. For example, using performance analytics — also referred to as descriptive analytics — to analyze historical customer buyer patterns can help determine product preferences and streamline the sales cycle. Using analytics tools to learn from past behaviors — whether around customers, cash flow, logistics or workforce — can help you better understand how they may affect future outcomes.

Q What are the most important aspects of your exit strategy that you consider when you make an acquisition? Select the top two.



Creating pre-sale value through technology

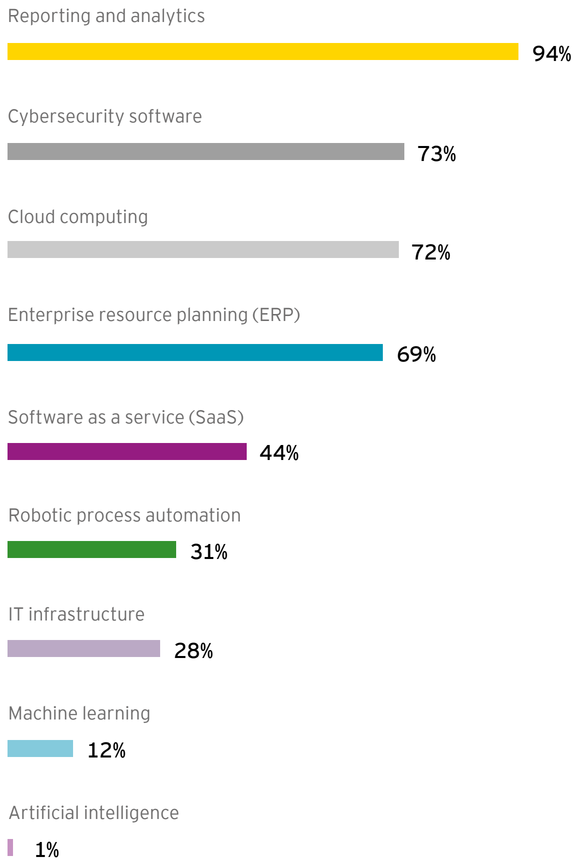
Technology can create pre-sale value, whether by resolving vulnerabilities (e.g., by improving cybersecurity) or improving margins (e.g., by cutting costs through automation). The key is to identify which technology will add the most value in the time available and determine who will own this process (e.g., operating partners, deal teams or a combination of both).

Use analytics to identify value early. While 32% of PE funds say that pre-sale preparation is the one area where they wish they had used analytics but didn't, only 60% exploited this possibility. For example, in using predictive and prescriptive tools to identify likely future scenarios for the business, sellers can make improvements to put assets in the best possible position for a sale process.

Don't ignore the middle and back office. While 72% of funds say cloud technologies have helped them create pre-sale value in the past, almost two-thirds (65%) cite the potential of "as-a-service" models enabled by cloud computing. The gains will be varied, with externally-hosted platforms helping businesses to strip out cost, while harnessing more power and capacity to underpin scalable growth.

Build the case for buyers. Some 76% of funds say digitalizing the portfolio company ahead of an exit provides the means to tell a stronger value creation story. For example, a digitized inventory management system that monitors in-store stock and allows customers to find out if an item is available can improve sales performance.

Q Which technologies did you use to create pre-sale value in your portfolio companies? Select all that apply.



Capturing returns on technology

A UK private equity firm with a midsize software company wanted to double the size of the business within five years, but the company's in-house technology was a major obstacle. Its legacy systems were too complex for employees to efficiently navigate and did not provide the functionality to deploy new products or business models (like the cloud).

Next, they identified the company's top IT issues and opportunities across nine work streams. Workshops with leadership then followed to identify key actions that would enable growth.

A two-year implementation plan with strong program governance began, benefiting marketing, sales and customer service. Although the plan required a £10.5 million cash investment over five years, it yielded a 20% internal rate of return.

Exit planning

Timing the exit right

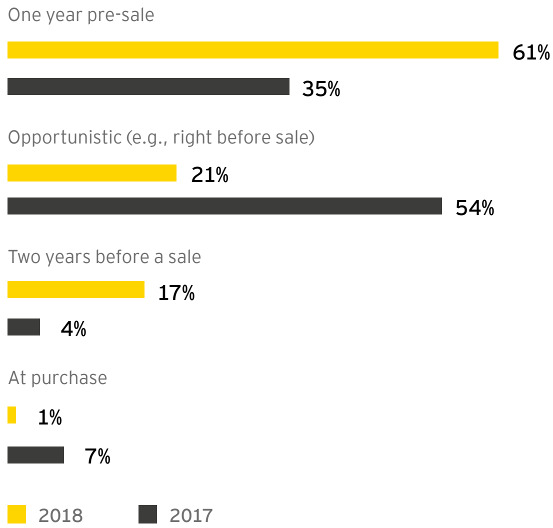
Almost two-thirds (61%) of PE executives now determine the right time to sell 12 months before the exit – up from 35% in our 2017 study. With rising valuations, PE funds cannot expect an opportunistic approach to automatically work.

Allow time for divestment planning. The percentage of PE funds relying on opportunistic buyers has fallen from 54% to 21%. PE funds are spending more time positioning the business for exit, with a sale strategy established well in advance.

Leverage the power of your data. Analytics can turn business performance, market trends and customer preference data into a time-sensitive value case for potential buyers, giving sellers more control over the exit timing. For example, analytics can validate assumptions around customer retention rates, providing greater certainty in the numbers for buyers and speed the time to close.

Embed digital into the business strategy. Build any digital transformation into the exit schedule, particularly for long-standing portfolio holdings that may need updating. Devote time and resources to maximize value at your chosen point of sale.

Q When do you determine the right time to sell?



Highlighting tax upsides to buyers

More than ever, tax policy can make exit plans less viable, or alternatively, offer new opportunities to improve value. New policies are reshaping the tax profile of businesses, from US tax reform to the OECD/G20 Base Erosion and Profit Shifting (BEPS) project cascading through Europe. Sixty-eight percent of PE executives say they highlighted tax upsides to purchasers in their last exit. Sellers should complete their tax assessment before the buyer develops its own quantified model. For example, a seller can highlight tax efficiencies and opportunities associated with the supply chain structure (e.g., reduced-rate principal structures or tax holidays) to enhance value in the buyer's eyes.

68% of PE executives say they highlighted tax upsides to purchasers in their last exit.

Making digital part of the value story

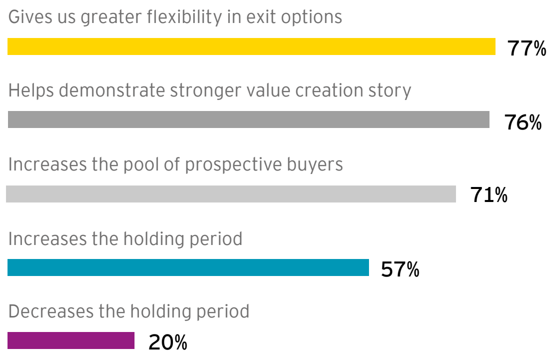
Most buyers will expect digital to be part of the sale narrative, predicated on changing business models, processes, products and services. Sellers must be prepared to show how the business performance has fundamentally changed as a result of digital improvements.

Seek exit flexibility. Seventy-seven percent of PE executives say digitalization gives them greater options when it comes to the type of exit they choose, so identify the strategic options that maximize the flexibility of exit timing and structure (IPO, full enterprise sale, carve-out, JV).

Drive value creation through reporting and analytics. Although almost all (94%) have used analytics to create pre-sale value in the past; only three-quarters of PE funds provided buyers with access to the output of advanced analytics to validate their equity cases. Sharing of analytics with buyers drops to 63% among those with US$30b+ AUM.

Demonstrate how digital improvements benefit revenue and costs. Technology can create multiple revenue streams, for example, software-as-a-service functionality; Internet of Things for workflow automation to drive step-function cost savings and unlock downstream revenue; and blockchain to drive secure transactions. Share the results of improvements to potential buyers so they can clearly see the benefits.

Q In what ways does the digitalization of a portfolio company impact the exit strategy? Select all that apply.

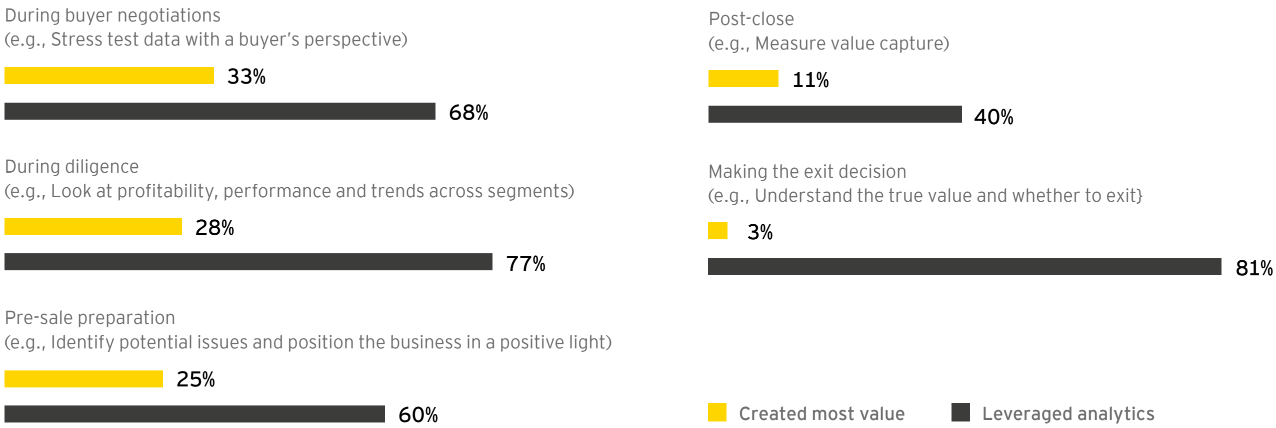


Embedding analytics into the sale process

Only 68% of PE executives say they used analytics during buyer negotiations, but this was the activity that the largest group of sellers we surveyed (33%) say created the most value. Financial modeling analytics and scenario planning with potential buyers can resolve doubts and help determine where to deploy resources and prove the value case.

Drilling down into a portfolio's performance can give buyers the information they seek during diligence, reducing potentially conservative valuations. Over three-quarters (77%) of firms did so, with 28% saying this uncovered the most value during an exit. Analytics can shorten the diligence period by helping buyers identify opportunities to grow revenue, such as customers or markets; improving operations to deliver better margins; or rightsizing or outsourcing the workforce.

Q In your last major exit, in which of the following areas did you leverage analytics? Select all that apply.



Power of data through analytics

One PE portfolio company serving the pharmaceutical sector had built up a patient claim database, not only for its own drug programs but also other non-covered drugs that its patients are prescribed. With analytics, the PE firm was able to measure the market potential of service offerings—including penetration of their drugs, efficacy by patient profile, duration of treatment and interactions with other drugs—and attracted buyers outside its sector. Ultimately, the business was sold to a medical data analytics powerhouse at 9x its original investment.

Conclusion

Amid higher valuations, private equity sellers must work harder to justify pricing during exit processes, even in an era of tough competition for the most attractive assets.

Start by pinpointing how technology can drive greater value in your portfolio companies — for example, through updated middle- and back-office processes or improved frontline customer engagement — and prioritize those areas. Decide whether your priorities are to change the business model or simply confirm how the current business is operating.

It's time to think differently — by exploiting data and analytics tools to prove value during every stage of ownership. Investing in talent with strong digital and technology experience, as well as the tools to extract and process data, will improve decisions around exit strategy and planning.

Quantifying the value of your business, and using technology to do so, will help build a compelling value narrative to appeal to a wide a range of buyers. Collaborating with buyers during the diligence process, by sharing data and identifying areas for revenue growth, can also help increase the value of exits.

How EY can help

Private equity firms, portfolio companies and investment funds face complex challenges. They are under pressure to deploy capital amid geopolitical uncertainty, increased competition, higher valuations and rising stakeholder expectations. Successful deals depend on the ability to move faster, drive rapid and strategic growth and create greater value throughout the transaction lifecycle. EY taps its global network to help source deal opportunities and combines deep sector insights with the proven, innovative strategies that have guided the world's fastest growing companies. Our clients discover powerful new ways to create unexpected paths to value — generating positive economic benefits for both investors and society. That's the power of positive equity.

Further insights

For more insights on key business issues affecting private equity, go to ey.com/privateequity.

How can private equity transform into positive equity?

Based on insights from PE visionaries, academic pundits and EY leadership, we address challenges and opportunities for the future state of PE as the industry evolves.

ey.com/future-of-PE

Can private markets boom if public markets bust?

Our 2018 Global PE Watch outlines key imperatives in fundraising, investments and exits, and reveals value creation trends for PE-backed companies across industries.

ey.com/PEwatch

Operational excellence: one path or many?

Our 2018 survey finds that PE CFOs are taking bold steps to achieve operational excellence in three main categories: technology transformation, talent management and outsourcing.

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