



How can private equity firms transform to find new routes to value creation?

Preparing for the
NextWave of Private Equity

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Are you ready for the NextWave of Private Equity?

The private equity industry has matured, but it now faces new challenges in a world that is rapidly changing, and firms need to explore new levers of value.

Private equity (PE) as an industry is unlike any other in terms of its breadth. It owns and operates companies across multiple sectors and with vastly different business models. Relatively speaking, it is a “young” industry, but one that has experienced unparalleled success and growth since its inception.

PE has evolved and developed, both geographically and in terms of sophistication. It has expanded from traditional US and European leveraged buyouts to a wide array of alternative strategies and asset classes operating in most countries around the world. Currently, according to Preqin, PE firms and closely related asset classes are estimated to manage more than US\$4.4t of investor capital – an amount expected to effectively double over the next five years.

It is reasonable to assume that PE is now at an inflection point – essentially, it has matured. Success brings growth, but it also creates new challenges. As PE moves into the next phase of its evolution, it must find a way to balance the nimbleness, flexibility, and responsiveness that brought it to this point with the need to manage increasing complexity in a rapidly changing world. Four megatrends – advances in technology, globalization, shifting demographics, and environmental issues – are combining to upset the existing order and create new working patterns and relationships, and PE firms need to adapt to these changing conditions.

One thing is certain: the next wave of PE will look different. The successful PE firms of tomorrow will be those that can effectively differentiate themselves in a more mature and competitive space. For many, this will mean increasing diversification across asset classes and geographies. For others, it will involve greater specialization (by region, sector, or impact) and the development of best-in-class product offerings. For all, it will require operational excellence.

About EY NextWave

EY NextWave is a global strategy and ambition to deliver long-term value to EY clients, EY people, and society at large. The NextWave vision represents the EY organization’s perspective on the most powerful trends and forces shaping an industry’s future. The EY organization brings that vision to life for clients so that they can remain relevant and take advantage of new paths to value.

Crucially, they will also need to find new levers of value creation, with a particular focus on three areas that are becoming increasingly important: digital strategy, purpose and transparency, and talent. The combination of these three levers throughout the deal life cycle can create powerful benefits.

Over the following pages, we will set out our vision and examine some of the key ways in which PE firms and their portfolio companies will need to evolve in order to remain relevant in a world where competition, unpredictability, and the rate of change are accelerating. Are you ready?

US\$4.4t

The amount of investor capital currently managed by PE firms

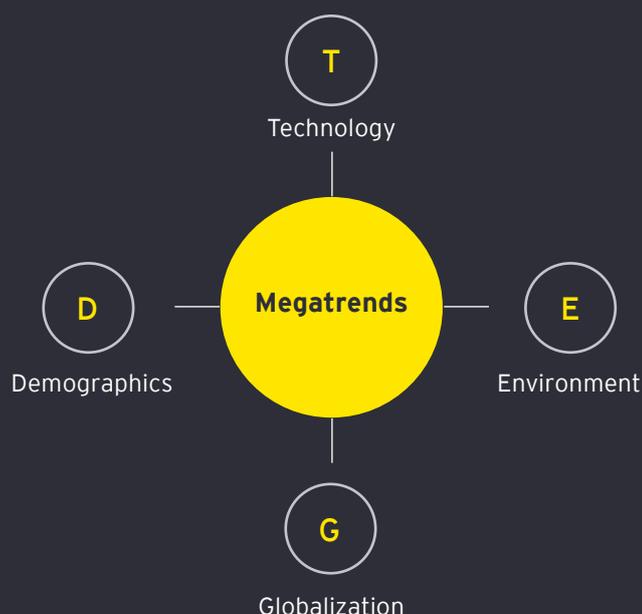
How the operating environment is changing

As PE moves into the next phase of its story, firms are contending with globally disruptive forces as well as trends that are specific to the industry.

PE firms are having to navigate an increasingly complex and competitive environment. Not that they haven't adapted to change before; the past decade has seen tremendous growth in PE and massive changes in the capital markets. From their roots in commingled buyout and venture funds, PE firms have innovated a wide array of vehicles designed to provide funding at virtually all stages of a company's life cycle.

However, the challenge over the next 5-10 years will be markedly different. It will be about finding ways first to adapt, then to compete, and ultimately to thrive in an environment of accelerating change.

Four megatrends reshaping the world



The impact of the megatrends

The 2020 EY Megatrends report outlines four primary forces that are the root causes of disruption in the modern world: technology, demographics, globalization and environmental issues. Both separately and together, these forces will steadily impact the PE industry in the coming years:

- ▶ Technology is changing business models and demanding increasing digital investment (and a workforce with the appropriate skills).
- ▶ A rapidly aging population needs PE to bridge the gap in pension funding.
- ▶ Geopolitical upheaval is reducing certainty and increasing unpredictability, requiring firms to rethink their investment and operating strategies to maintain competitiveness.
- ▶ As the impact of the COVID-19 pandemic has highlighted, resilience is a particular focal point for firms and their portfolio companies.
- ▶ Changes in the environment are precipitating a shift in the way people consume and produce goods.
- ▶ Growing interest from limited partners (LPs) in responsible investing will cause PE firms to more strongly consider environmental, social and governance (ESG) elements in their investment strategy. As millennials continue to make up a growing portion of investors, reporting will need to be more digestible, customizable, and accessible.
- ▶ PE firms also need to embrace the concern for ESG issues shown by younger generations entering the workforce.
- ▶ Societies are recognizing the need to remove unjust barriers to civic inclusion. There is a greater focus on the idea that businesses must do better with respect to improving the diversity of their workforces and making all voices heard.

Read more about the EY Megatrends

Go to ey.com/megatrends to download the latest EY Megatrends report, *Are you reframing your future or is the future reframing you?*



Industry-specific trends

In addition to the megatrends, PE firms need to address a number of factors specific to the industry. For example:

- ▶ PE's customer base is changing: new paradigms of cooperation and competition are coming from family offices, high-net-worth individuals, pension funds, sovereign wealth funds, and retail investors, all with new and different needs and expectations.
- ▶ While some firms are looking to specialize, others are pursuing a different strategy, expanding their product offerings into new and adjacent asset classes in order to capture more growth and bring more value to investors.
- ▶ There has been a notable increase in PE firms pursuing regional expansion as an alternative way to grow – one that is typically easier than new product launches. It can allow firms to exploit their core competencies.

Standing out from the crowd

Organizations will prosper in the post-pandemic world by putting humans at the center, deploying technology at speed and innovating at scale. Being human-centric allows companies to develop workplaces and market offerings that resonate with workers and consumers. Deploying technology faster is critical in an environment where accelerated technology adoption is reinventing everything – from how we work to how we learn new skills and transfer knowledge.

It is risky for businesses to make long-term assumptions based on today's PE industry structure, market participants and profit pools. In an era in which COVID-19 has closed whole economies and fundamentally reordered the ways we interact and work with one another, we are reminded of the speed and magnitude in which disruption can occur. The disruption we are witnessing now makes extrapolation based on historical trends of limited value, because it creates entirely new markets and ecosystems.

Those who lead companies will need to confront this reality. The demand for private equity itself has not diminished;

in fact, it is more relevant than ever. The shifting balance from public to private markets has seen small and medium-sized enterprises keen to access capital with fewer associated costs and a lesser regulatory burden, while being able to retain greater control over their business. But for PE companies operating in this climate, demand for their capital and expertise is only a part of the equation.

Optimizing the deal life cycle will see increasing pressure over the next decade: pressure to source proprietary deals, to accelerate diligence and operational processes via digital, and to demonstrate value creation, to name just a few examples. As the industry redefines itself, those firms that have not moved in step could become irrelevant.

To remain competitive in an environment that is changing faster than ever, firms will need to continue to maximize value through traditional levers – operational value creation and financial optimization – as well as adopt new levers of value creation; in particular, the three pillars of digital, purpose and transparency, and talent.

Key questions for the PE industry

1. What strategies and asset classes will PE employ to create value?
2. As PE's relationship with technology matures, how will digital transform origination, the back office, and portfolio management?
3. How can PE firms understand and integrate the demands of a more diverse range of stakeholders?
4. How will PE manage the talent agenda amid changing operating models?
5. What does PE need to do to prepare?

Visualizing the future of private equity

In a few years' time, the newspapers may carry some surprising stories about the PE industry.

The future for PE is going to look very different in the coming years. New technology, tighter regulation, retail investor empowerment, growing digitalization, and increased competition are set to impact heavily on how the PE industry functions.

To bring these impacts to life, we've explored a number of hypothetical scenarios for PE in this new landscape and indicated how they relate to the four megatrends: technology (T), demographics (D), globalization (G), and environmental issues (E).

T

New platform allows investors to commit as little as US\$1 to private equity

Retail investors (investing relatively small sums) can participate in the PE universe in a way they have never been able to before. New PE fund structures combine with online trading apps and brokerage platforms to allow ordinary investors access to the same functionality previously reserved for pensions, endowments, and foundations.

D

G

D

A private equity firm becomes the world's largest employer

While this represents great success for the PE sector, it also increases levels of responsibility. Regulatory bodies scrutinize more heavily the duty of care that PE firms have to their employees, portfolio companies, and the general public.

G

T

The first crowdsourced PE fund is launched that is solely focused on sustainable companies

This market takes off as investors are attracted by the high-growth ventures being offered and guarantees that the criteria of these funds clearly adhere to well-defined environmental, social and governance (ESG) principles. Institutional investors such as pensions and endowments give equal weight to nonfinancial value creation measures and ESG investing is no longer seen as a trade-off wherein returns must be compromised for social good – there is recognition they can co-exist.

E

T

First artificial intelligence fund raises over US\$20b

A PE firm competes with top Silicon Valley names for talent and resources to build the first fund driven entirely by artificial intelligence (AI) and data analytics. Pulling data from thousands of disparate sources, the fund algorithmically originates deal ideas, monitors portfolio companies, and charts an optimal path for exit.

**New platform allows
investors to commit
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EY NextWave of Private Equity

To succeed in the NextWave, PE firms will need to focus on three new levers of value creation: digital, purpose and transparency, and talent.



Continuous convergence of megatrends and industry-specific changes requires organizations to adopt new business strategies and reimagine operating models.

NextWave funds that recognize the need to deliver on a broader definition of value will gain a competitive edge. PE funds will continue to maximize future value through operational restructuring, but in addition to the pursuit of traditional levers, value creation at the PE firm level and within portfolio companies will be increasingly driven by the three pillars of digital evolution, a new emphasis on purpose and transparency, and the talent agenda.

Activating a comprehensive, enterprise-wide digital strategy will strengthen the value creation agenda for PE firms and portfolio companies. Digital capabilities will unlock new value creation opportunities and enhance risk

management, operational efficiency, and growth at both the PE fund and portfolio company levels.

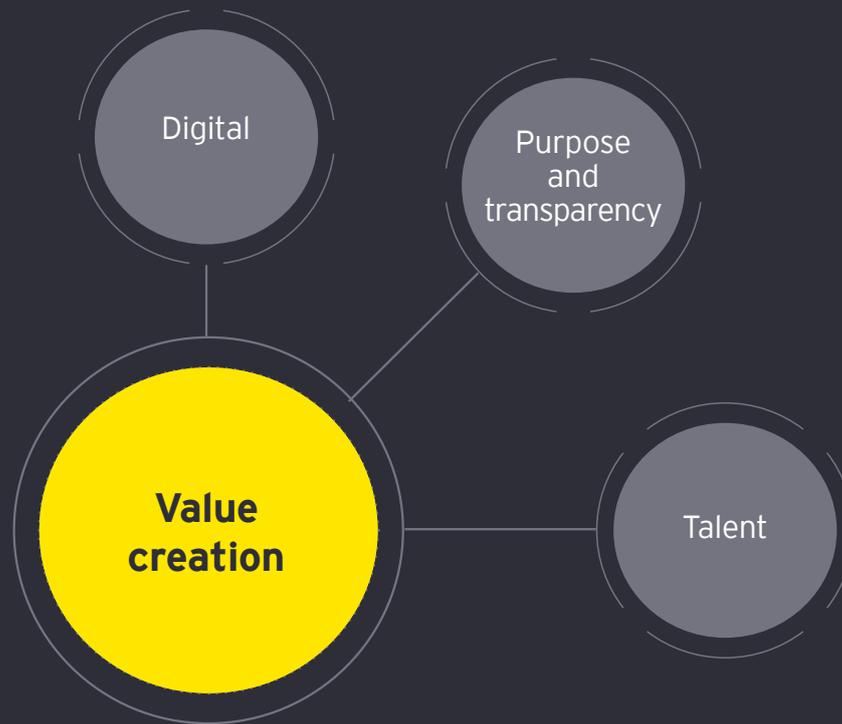
Firms with a well-defined purpose and the ability to effectively integrate nonfinancial elements of value creation into their models will find themselves in demand by investors. Identifying new value triggers tied to creating sustainable social value, and communicating that value clearly to investors and other key stakeholders, will be more important than ever.

Finally, in terms of recruitment, attracting and retaining futuristic-minded, digital-savvy, and diverse talent focused on delivering value will be key to differentiating the fund of the future. Greater long-term value will be realized by enhancing diversity, equity and inclusion (DEI) in the talent strategy.

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NextWave funds that recognize the need to deliver on a broader definition of value will gain a competitive edge.

New levers of value creation



The power of positive equity

In the future, PE will embrace new strategies to unlock unexpected paths to value creation while driving positive change. This is what we call positive equity.

The power of positive equity is the means by which PE creates growth, delivers long-term value, turns around failing businesses, improves their health, and prepares some for a successful IPO. It's the positive impact that the PE industry can make on the world.

Positive equity is:

- ▶ Innovating the enterprise through digital advances to increase the value and attractiveness of the business
- ▶ Finding new ways to make a lasting impact on society with job creation, ESG measures, trust, and transparency; this drives growth and performance for portfolio companies and the communities they affect
- ▶ Preparing the workforce of the future by creating value through education, reskilling, and DEI – making improvements that benefit employees and contribute to the overall health of investment

The digital landscape

Digital technology helps PE firms and their portfolio companies to increase efficiency, optimize risk management, and boost growth.

Before the COVID-19 pandemic, in a world of historic high pricing multiples and record dry powder, digital was already emerging as a value creation lever to gain an edge in a highly competitive market.

Today, the need to prepare for and adapt to crises has never been more pertinent. Embracing digital is less an option now than a necessity; the pandemic has forced companies to digitize in areas that were previously considered too high risk. But digital technology also allows investment firms and portfolio companies to anticipate and navigate externalities that come from uncertain economic climates, changing consumer tastes and needs, and a dynamic regulatory landscape.

Furthermore, a strong digital agenda is leaner and not bound by physical real estate, empowering workers with flexibility and connectedness.

As the focus on digital technologies rapidly accelerates, activating a digital strategy throughout the deal life cycle is becoming a core component of the value creation agenda and leading to higher multiples on exit.

60%

Companies with a CIO or similar leadership role show a 60% greater return on assets than companies that don't have such roles.

How digital impacts value in PE

According to Harvard research:¹

- ▶ Shares of listed non-technology companies that implement digital technologies are valued significantly higher than firms that don't, by between 7% and 23%.
- ▶ Moreover, their price-to-earnings ratios are higher, by anything from 3% to 9%.
- ▶ Firms that embrace digital have greater returns per dollar of incremental earnings than those that do not, by between 30% and 90%.
- ▶ Companies with a chief information officer or similar role within the senior leadership structure (i.e., someone with responsibility for researching new technologies) outperform those companies that have no such designated roles, with a 60% greater return on assets.

The benefits are clear: non-technology firms that invest in digital are valued higher than their peers – and these benefits increase over time.

Embedding digital in the PE fund

At the PE fund of the future, the imperative for digital will run throughout the enterprise.

In the front office, proprietary algorithms will unlock new investment opportunities and reduce the effort required to track potential acquisition assets. Predictive analytics will identify value creation levers, and product digitization will identify new segments and approaches.

In the back and middle office, operations teams will use advanced analytics to unlock greater insight to a portfolio company's potential. Real-time interaction with LPs will occur via customizable reporting platforms, and firms will employ cloud computing to increase connectivity with portfolio companies and enable real-time alerts.

1. "Going Digital: Implications for Firm Value and Performance," Wilbur Chen and Suraj Srinivasan, May 2019, HBS Working Paper #19-117

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Embedding digital in the portfolio

At the portfolio company level, a digital agenda can encompass e-commerce platforms, sales force automation, demand generation, supply chain efficiency tools, and using the Internet of Things to enable predictive and preventive maintenance and

improve energy efficiency, among other things. All strands of a portfolio business can incorporate these technologies to provide essential improvement in a hugely competitive market. We have identified six key areas:

1. Strategy and product development

Firms can align their operating model with the digital world, driving agility and innovation. Incorporating digital can help identify new business segments and can also develop new models and routes to market for product launch.

2. Marketing and sales

Embracing digital can help develop multichannel distribution, pricing and marketing strategies to optimize reach. It can increase the volume, accuracy and sophistication of customer data. It can simplify and automate business and fulfill orders in real time. Technology can also help extend marketing activities across the entire customer life cycle.

3. Customer experience

Technology can be used to enhance and optimize the customer experience and deepen relationships. It can collect intelligence across touch points and media channels, helping to provide more detailed insight.

4. Support functions

Intelligent use of automation and cyber can improve processes and controls. For instance, automated processes and controls across support functions such as finance and HR can bring great efficiencies. There is an incentive to digitize invoices and documents and to integrate front-office apps with back-end systems. Firms will be expected to balance digital innovation with IT maintenance; this means keenly adopting the latest ideas while at the same time verifying that what is currently operational is running as it should.

5. Sourcing and procurement

Data analytics and blockchain can establish an agile and resilient digital supply chain. Technology can help improve inventory management, oversee just-in-time delivery, and remove the need for intermediaries. Digital can help manage in-house and third-party providers more effectively and automatically communicate with production lines for input orders.

6. Manufacturing and distribution

Machine learning and AI can streamline manufacturing processes and simplify distribution. Technology can provide real-time feedback on the condition of critical assets. This allows quicker responses to market changes, as well as enabling goods to be traced through the supply chain – improving times and limiting losses.

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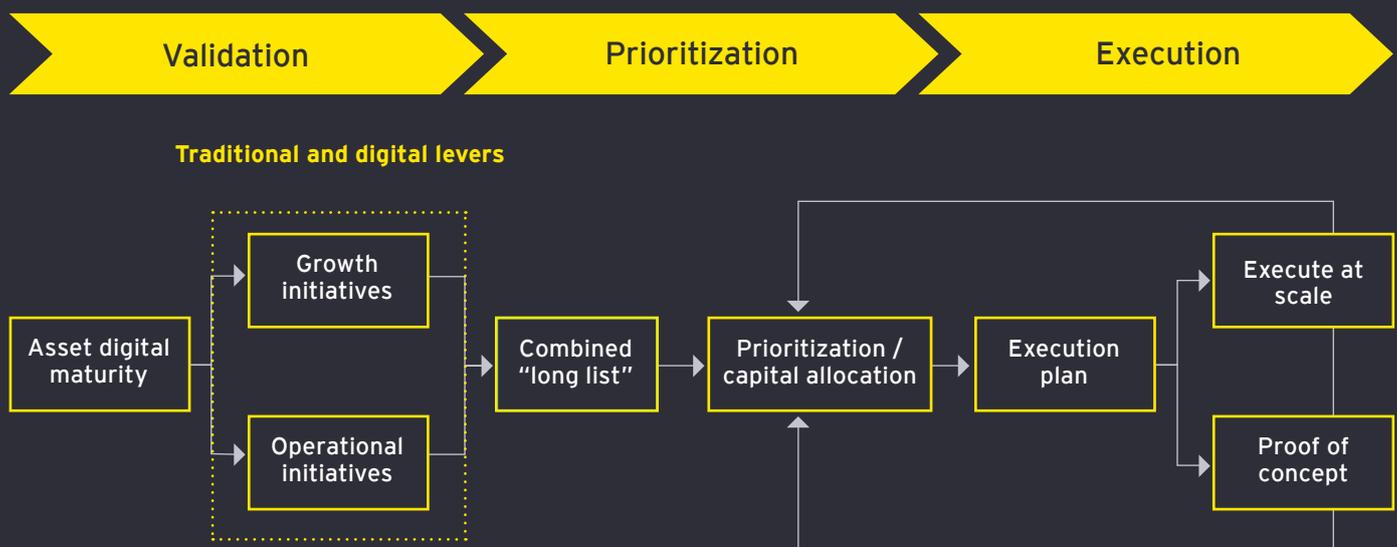
Embracing digital is less an option now than a necessity; the pandemic has forced companies to digitize in areas that were previously considered too high risk.



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The three stages of digital transformation

PE firms looking at digital transformation in portfolio companies typically follow a three-stage process:



Validation

The PE firm needs to conduct a detailed assessment of the asset's digital maturity to confirm opportunity areas and identify key success factors and any barriers to execution. There is the opportunity at this stage to develop detailed business cases across both digital and traditional initiatives, with input from the original investment case. It is important at this juncture to consider both tactical and strategic benefits from digital transformation.

Prioritization

There is a need to conduct robust prioritization across the combined initiative portfolio, including ongoing and new initiatives. Informed capital allocation will be based

on greatest return and potential for value creation. It is important for firms to understand the tax implications of digital transformation – for example, research and development credits.

Execution

Companies need to establish that key execution enablers are in place and close any gaps identified during the maturity assessment. Agile governance is necessary to support continuous reassessment of investment priorities based on returns, and to leverage proofs of concept for complex use cases before committing investment.

Purpose and transparency

As the business world increasingly focuses on creating long-term value for society, firms with a well-defined purpose are attractive to investors and employees alike.

In the current PE environment, there is an increasing emphasis on purpose and transparency. This is being driven by a combination of things: demand from LPs, the dynamics of origination, regulatory developments, and being able to attract the best talent.

There is also social pressure and the question of PE's license to operate. The PE industry is under greater scrutiny than ever before, and PE firms must do a better

job of capturing and tracking the value they are creating and the impact of their activities.

It is not difficult to grasp that value these days is increasingly being driven by nonfinancial factors. For PE, incorporating these new value elements can open doors – offering new types of investment opportunities, as well as partnerships with entrepreneurs and family owners who care about their business's legacy.

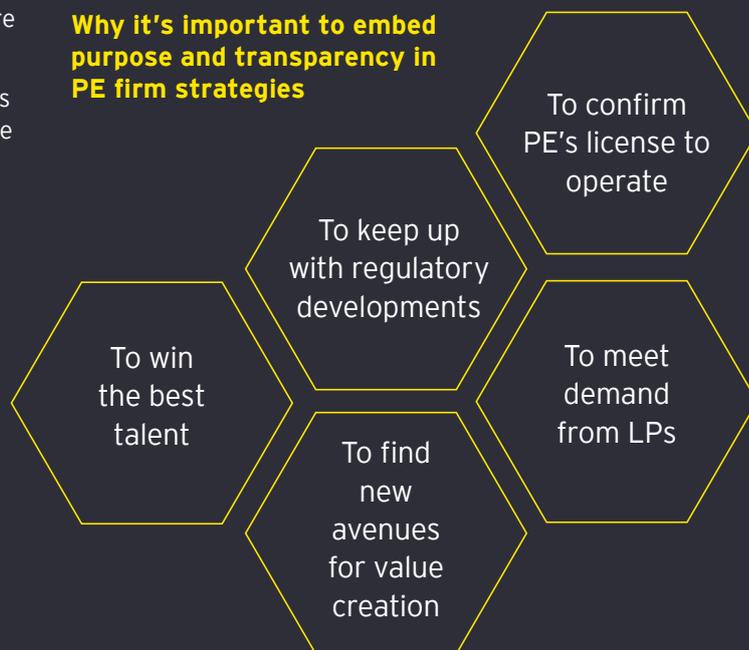
The PE purpose and transparency imperative

A variety of drivers show the importance of embedding purpose and transparency into PE strategies, and there are abundant statistics to support this:

- ▶ 95% of LPs are either already evaluating ESG risk factors or will be increasing their focus on ESG risk factors in the coming year.²
- ▶ 80% of CEOs believe government, business, and the public will reward companies for taking meaningful action over the next 5-10 years.³
- ▶ Companies that rank well on ESG metrics have outperformed the market by up to 3% per year over the past five years.⁴
- ▶ Employees at purpose-driven companies are 1.4x more engaged and enjoy 1.7x more job satisfaction. These employees are also 3x more likely to stay at their company.⁵
- ▶ An estimated US\$3t-US\$5t per year is needed to meet the United Nations Sustainable Development Goals (UN SDGs), and PE is likely to play an important role in contributing financial support to achieve this.⁶

While the COVID-19 pandemic has forced a reassessment of operating models and investment priorities, it also provides PE with an opportunity to embed purpose and transparency more deeply throughout its business – at the firm, fund, and portfolio levels.

Why it's important to embed purpose and transparency in PE firm strategies



2. Pitchbook 2020 Sustainable Investment Survey

3. 2019 EY CEO Imperative Study

4. "ESG Matters – US: Top 10 reasons you should care about ESG," Bank of America Merrill Lynch Global Research, September 2019

5. [nytimes.com/2014/06/01/opinion/sunday/why-you-hate-work.html](https://www.nytimes.com/2014/06/01/opinion/sunday/why-you-hate-work.html)

6. un.org/sustainabledevelopment/wp-content/uploads/2019/07/UN-SG-Roadmap-Financing-the-SDGs-July-2019.pdf



The journey from compliance to long-term value

PE firms that authentically anchor their approach with meaningful purpose are best positioned to benefit from, demonstrate, and measure the value that they create.

The long-term value (LTV) continuum traces a company's journey as it moves from activities that establish compliance with ESG mandates to creating long-term value from its ESG initiatives.

There has been a concerted shift from the old world, where the thinking regarding corporate social responsibility was: "We contribute to society because we are successful and then give back," to the new world, where the philosophy is: "We are successful because we create shared value with society."

The journey from compliance to LTV is made in a series of steps, with each one building on the progress of the former:

Where do you fall on the ESG/LTV integration scale?

Compliance:
PE firms establish compliance with national and international initiatives and regulations as well as LP agreements.

Risk management:
ESG is used as a tool to manage nonfinancial risks during the entire investment life cycle.

Opportunity-seeking:
Use ESG and LTV as a tool to identify opportunities for value creation during the entire investment life cycle and align to opportunities within the UN SDGs.

Impact-focused:
Selected portfolio companies create value to a double or triple bottom line. Active ownership seeks to adapt or transform the portfolio companies while delivering superior returns.

Long-term value:
PE firms find comparable and meaningful ways to better measure and articulate strategic value creation for stakeholders.

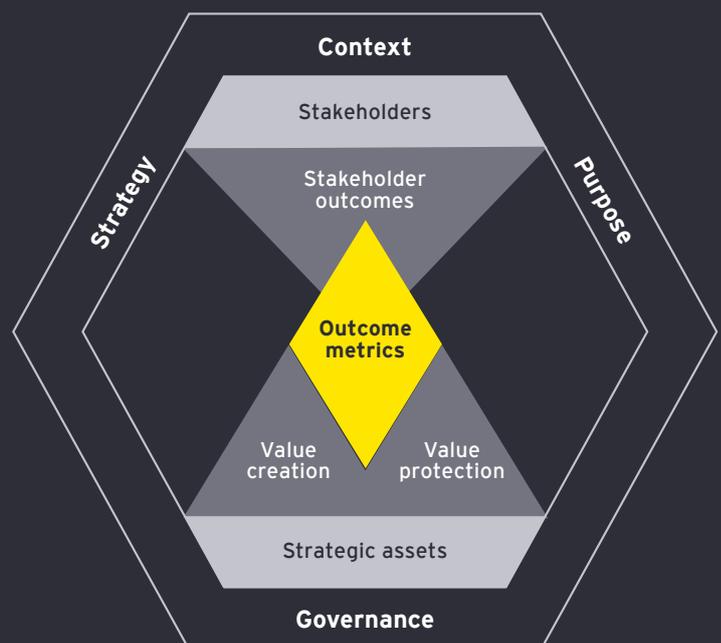
	Compliance	Risk avoidance	Opportunities	Select solutions	Long-term value
Deal origination	No formal exclusion criteria are used	ESG screening or due diligence uses a checklist approach	Strategic approach that seeks to create opportunities via ESG screening	Selection of certain portfolio companies based on megatrends and SDGs	ESG and LTV considerations fully embedded as part of origination process
Portfolio ownership	Primary focus is on improving fiscal balance	Focus is on improvement of risk management	Financial gains are made by managing ESG value creation opportunities	Develop portfolio companies to better address global challenges or serve societal needs	Full range of externalities is identified, tracked, managed and reported



Establishing an LTV framework means expanding your focus from traditional financial metrics to include consumer, human, and societal metrics. The Long-Term Value Framework devised by the Embankment Project for Inclusive Capitalism (an initiative led by the EY organization and the Coalition for Inclusive Capitalism) lays out a four-step process that shows how PE firms can measure and articulate how they create and protect long-term value:

- ▶ Establish the business context (context, purpose, governance, and strategy)
- ▶ Determine stakeholder outcomes
- ▶ Understand drivers of value creation and value protection
- ▶ Develop metrics to articulate value by creating key performance indicators (KPIs) and drivers

The Embankment Project Long-Term Value Framework





Seven principles for developing long-term value metrics

To better articulate to investors how they create and measure long-term value, companies need to develop new metrics. Here are seven principles to bear in mind:

1. Alignment

The metric is connected to the purpose of the company. It is aligned with the business model and strategy, and influences internal decision-making. The metric is oriented to stakeholder outcomes and reflects the health of the strategic capabilities the company needs to invest in to achieve those outcomes.

2. Completeness and balance

The metric is comprehensive and measures financial or pre-financial outcomes in an unbiased way, including the net change in both positive and negative outcomes or impacts.

3. Empirical testing

The metric is supported by evidence and credible data assured to an appropriate level. The metric is based on an established methodology, with no significant deviations or alterations that compromise the integrity of the data or its interpretation.

4. Accuracy

The underlying data quality behind the metric is high and based on credible internal and external data sources, with few estimations. The underlying methods and approaches are publicly available and follow accepted approaches and leading-practice data-gathering procedures. The data reporting process is standardized, with automated collection where possible, and data security is high.

5. Credibility

The metric is founded on reliable underlying processes with high standards of internal governance and effective controls. The data is verified, preferably by both an internal second party and an external third party, to an appropriate level of assurance. Assumptions and underlying information can be traced back to their sources.

6. Clarity

The metric presents results in a transparent manner that is clear and understandable for stakeholders in the context of the company's operations. The criteria, concepts, and assumptions are accessible and can be easily understood by stakeholders.

7. Additionality

The metric uses data before and after an action (e.g., investment) to monitor outcomes versus the baseline, and any change in outcome can be attributed to that action. The metric measures a result that would not have otherwise happened. The metric's scope is defined as relevant to a part of the company's value chain and is monitorable at the relevant scale, in the relevant location, and across a relevant time-bound period.

All companies want to create long-term value, but it requires careful thought and planning; implementing the framework, criteria, and metrics around what this means to your firm and your LPs is the first step in long-term value creation.

The talent agenda

The PE workforce of the future will be more digitally focused and more diverse, to capture new perspectives and move the industry forward.

The combined effects of globalization, demographic shifts, technological advances, the COVID-19 pandemic, and increasing regulation mean that companies are looking to create more agile and adaptable workforces. In light of all these factors, it is getting harder to recruit, manage, motivate, and retain talent.

For the first time ever, there are four generations co-existing in the workforce: traditionalists, baby boomers, Generation X and millennials. It is clear that new entrants to the workforce have differing expectations to previous generations: millennials want to join firms whose values align with their own. And, while Gen Z are not yet working in full force, early indicators suggest they will be seeking out organizations that make a positive impact on society and have a highly diverse workforce.

Purpose-driven, socially responsible organizations have become magnets for young talent. But it is not just the new entrants who are forcing employers to rethink. The make-up of the workforce itself is changing, with the definition of “employee” now encompassing full-time, contingent, remote, and even robotic. Digital applications will continue to expand their presence, in some instances replacing and in others enhancing current roles. A future talent agenda will also need to incorporate a proactive approach to diversity, equity and inclusion (DEI) – ensuring a strong tone is set from the top down. Incorporating a comprehensive DEI strategy will address a firm’s commitment to elevating society while expanding its talent pool and creating new perspectives in investing.

Leadership and succession in the PE fund of the future

PE is unique in that many of the founders of the industry are still active today. As leaders increasingly retire, the issue is: how do companies handle effective succession?

One thing is certain: a new set of leaders equipped with fresh digital competencies are needed to lead tomorrow’s workforce. These leaders must understand the growing importance of digital fluency and the need

for new skillsets. This will need to be reflected in their recruitment strategy, as future PE firms will differentiate themselves from their peers by attracting, retaining, and developing digital-savvy and diverse talent focused on realizing value.

Tomorrow’s leaders will not only have to recruit well: they will also need to motivate the talent they bring in. They will need to convey a vision of the future that inspires action and energy, drives engagement, and enables their workforce to perform. How is the firm’s purpose defined, and how transparent will the metrics tracking this purpose be? Does the approach to leadership change in a world of remote working, freelance contractors, and robotics? They will need to select and develop leaders and teams prepared to direct the future organization.

The portfolio company: where will differentiation come?

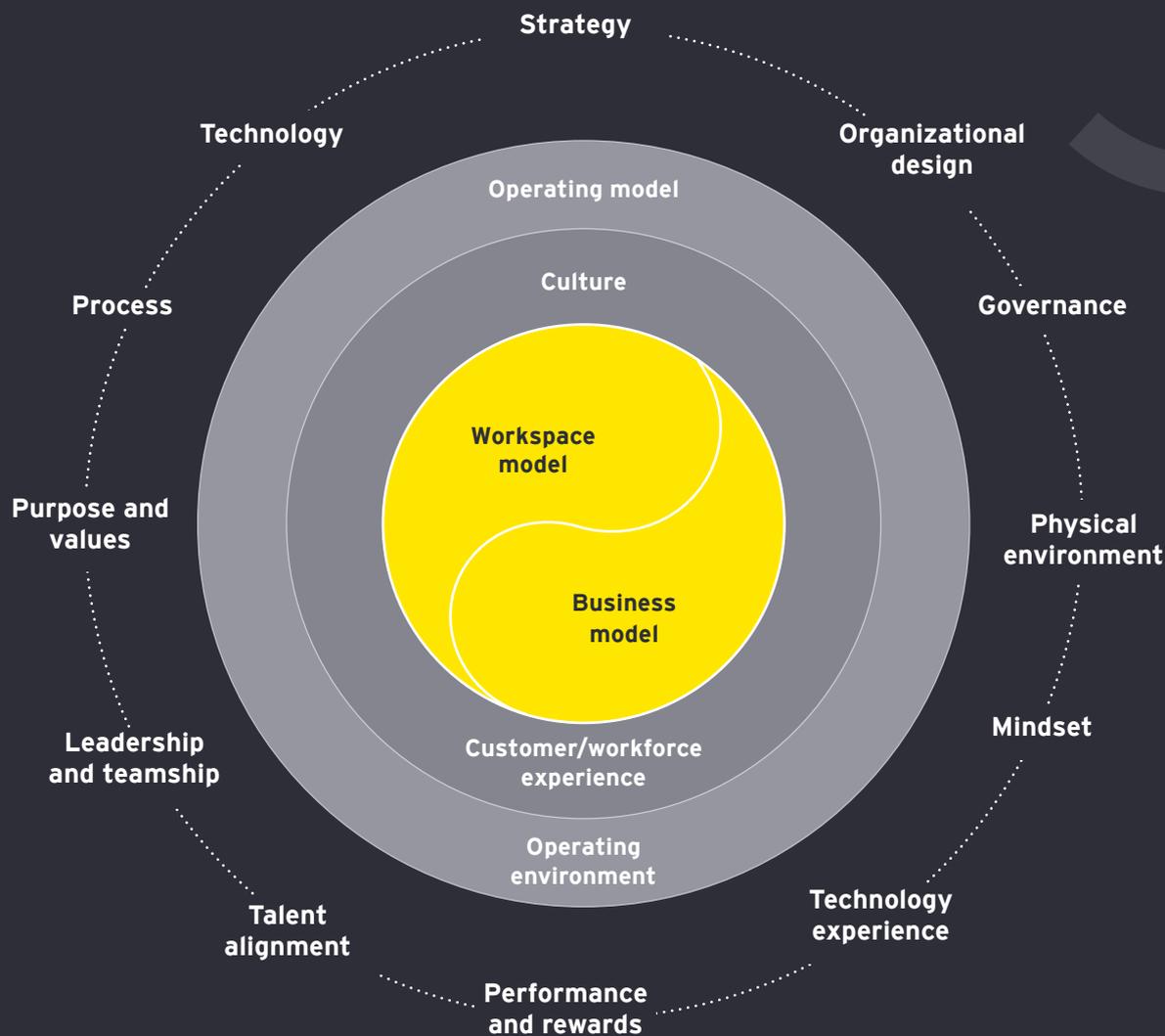
Even before COVID-19, PE firms were beginning to consider the workforce through a fresh lens, and the pandemic has accelerated thinking about a comprehensive talent agenda at their portfolio companies – one that focuses on the employee, the business, and the value derived from an optimized workforce. How can your talent strategy drive your growth strategy? By aligning the operating model (business) with the operating environment (workforce).

Going forward, organizational design will need to be adaptive and resilient, allowing the organization to quickly and effectively deploy and reallocate resources as strategy and needs shift. Integrated coordination and governance will facilitate an enterprise-wide organizational design process.

Strong employee culture and employee engagement

Clearly defined values and effective engagement with employees will help to create and maintain a strong company culture. It will be important to specify how employee engagement is measured and how this can

Issues affecting the talent agenda



be used to inform workforce strategy. This could be evidenced in apprenticeship model evolution, reward and retention strategy, remote working, and respecting the work-life balance.

Employee wellbeing needs to remain a key priority. More than ever, employees are demanding greater flexibility and the desire to work remotely as needed. Leaders need to change the definition of performance and productivity from time in office to outcomes.

The power of workforce data

The PE firm of the future will use AI and other digital tools to gather comprehensive data on the workforce at each

of its portfolio companies, including metrics on individual employees. By harnessing and analyzing all the data from previous acquisitions and integrations, the PE firm of the future will be able to build a predictive model that will help it to decide how best to approach the talent agenda upon acquisition of a new portfolio company.

While each acquisition is unique, there will be strategies that can be leveraged across different portfolio companies to drive a more efficient workforce transformation process and a more engaged workforce – and, ultimately, to drive value.

Tomorrow's deal life cycle

The power of the three levers of value creation lies in the way they combine to provide benefits at every stage, from deal origination to exit.

Digital evolution, purpose and transparency, and talent can't be developed in a silo. Their power comes from integrating them into the existing elements of the deal life cycle and each firm's playbook to create sources of value that did not exist before.

The impact and benefits can be seen clearly when tracing the deal life cycle from start to finish:

Origination

With increasingly intermediated markets, firms need new playbooks for uncovering the best opportunities. Firms will use advanced analytics and AI to enhance deal sourcing and evaluate investment opportunities. Technology can also be used to manage the pipeline of potential deals, as well as the PE firm's network of relationships. Low-value-add activities can be automated, which frees up more time for strategy, trust-building, etc.

Attracting and developing the right people will allow new talent to uncover fresh investment opportunities. And deal origination will expand to include the identification of investment opportunities based on all potential value drivers – not just financial, but also social, environmental and other factors.

Diligence

Diligence will expand, bringing in the best of the virtual and the physical. New sources of data will identify hidden risks and provide deeper insights into potential opportunities. AI

and machine learning will enable robust scenario planning that allows buyers to look at companies from a multitude of angles. Advanced analytics will allow PE firms to better understand a company's customers, suppliers, partners, and employees.

Tech-enabled diligence will further allow firms to better understand the levers available to create nonfinancial value as well, with the ability to measure the impact of leadership reputation and LTV-related objectives on stakeholders. Digital tools, combined with the skillsets of the new talent entering the industry, will improve the diligence process.

Value creation

The shift from balance sheet optimization to operational value creation will continue as firms rethink how to create value from investments in innovative ways. Real-time reporting will enable firms to enhance their decision-making about portfolio companies, and they will employ digitally empowered transparent reporting to boost investor confidence.

The PE fund workforce will be optimized and split between in-house capabilities, outsourced and shared services, and human augmentation.

Once again, embedded ESG principles and a firm focus on digital technologies will contribute significantly to value creation. Firms will use AI and cloud solutions to articulate ESG and LTV metrics to both LPs and the public.

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Digital evolution, purpose and transparency, and talent can't be developed in a silo. Their power comes from integrating them into the existing elements of the deal life cycle.

Exit

Preparation for exit will start sooner and will involve a broader array of potential buyers. Firms must tell a compelling story that makes sense for tomorrow. This is where the refined skillsets of new and existing talent in the industry will play a pivotal role.

They will use predictive analytics instead of EBITDA targets to better plan exit timings. They will reach exit targets sooner by optimizing workforce models to drive value. And they will employ digital capabilities to simplify the transition process of the investment for the buyer.

They will articulate the full range of value creation, highlighting ESG and LTV actions taken to date to maximize valuation; help buyers visualize the way forward; and think more expansively around opportunities to create value.

A time for transformation

For PE firms to transform to meet the challenges of the next wave, they need to apply the skills they use on their portfolio companies to themselves.

There is no denying the phenomenal growth of the PE industry. According to Preqin estimates, over the past decade, assets invested in PE and related asset classes have grown from US\$1.7b to more than US\$4.4t. Most significantly, assets under management are expected to exceed US\$9t within the next five years. Including the entire universe of alternatives drives estimates past the US\$17t mark – more than the combined GDP of Japan, Germany, India and the UK. However you look at it, it is a tremendous evolution for an industry that is, in its modern form, just three decades old.

As PE has grown over the last 20 years, the number of publicly listed companies in the US has declined by half. Similar trends are evident in Europe and are starting to be seen in Asia. In short, private capital sources are supplanting public ones.

US\$9t

PE assets under management are expected to exceed US\$9t by 2025.

7,000

The number of PE firms currently operating worldwide

This does not mean PE firms can rest on their laurels – far from it. The factors that got PE to this point are not the ones that will take it into the future. The environment has changed significantly from when the PE model was first deployed at scale.

The market is becoming crowded as new competition enters the space. According to Preqin, there are now more than 7,000 active PE firms operating throughout the world. In this new landscape, PE firms must find ways to differentiate themselves and reinforce the value they can bring. Firms need to develop new skillsets and new ways of relating and connecting to their investors, their employees, the businesses they partner with, and the community at large.

As this paper has shown, megatrends are forcing their hand. PE firms need not only to invest in digital to improve their proposition and make it more relevant, but also to recruit the talent with the right skills to make it happen. To attract that talent, the firm must put the right culture in place, and this may require an overhaul of the organizational structure.

Diversity, equity and inclusion are key factors – not just tokenism, but a realization that, in this new world, they are essential components of a progressive, innovative, and ultimately successful business.

Growing interest from a wider range of stakeholders will cause PE firms to place a greater emphasis on ESG elements in their investment strategy. PE firms will need to rethink what it means to create value for these stakeholders and look further than just financial return. Regulators, and society in general, are also increasingly focused on responsible investing.

As with any industry transformation, there are immense challenges that will require major shifts in thinking and culture. The PE industry is no different. However, it is worth remembering that PE has built its business around helping companies to transform themselves and adapt to changing conditions. There is no reason that it cannot now employ those same skills in relation to its own model.



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