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VIEWPOINT

TECH GIVES PRIVATE EQUITY AN EDGE

Private equity firms take a more hands-on and tech-centric approach to manage their portfolios, as market values drop.

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No one could have foreseen what the market has experienced since 2020. Value is getting harder than ever to create. High inflation, supply chain disruptions, geopolitical tensions, talent shortages, and impeding recessions together, or one at a time, challenge businesses to execute their strategic growth plans in the short and medium term.[1,2]

Amid increased shareholder lawsuits and regulatory constraints, organizations see the private equity (PE) route as an alternative investment strategy. Even public companies now prefer the PE route to go private for alternative investments. In all, PE has gained much prominence recently.

Infosys' PE Practice analyzed our clients' 100-days plans and discovered the following trends:

- As holding periods get longer and general partner (GP) led secondary transactions rise, operating partners (OPs) have more time to improve assets and grow value.
- As valuations fall, PE firms acquire targets with sounder fundamentals and high growth potential companies that can capitalize on the current market situation.
- OPs increasingly look to optimize costs and target high growth by extending their portfolio companies' offerings into new markets or through digital disruption.
- OPs support their management teams to bring in external transformation resources to enhance a firm's digital metabolism and to meet the ambitions of their first 100-day plans.
- They assess value creation levers to improve profitability, mitigate cybersecurity risks, reduce costs, etc.

This suggests a big shift in the role of OPs. They now not just oversee and direct executives to deliver on plans, but also work with portfolio companies and recruit technology and business transformation specialists. That said, OPs are more than ever embedded and take a hands-on approach in these decisions.

Evolving role of OPs

Traditionally, OPs' role was to ensure the right management team at the portfolio company and work more in an advisory capacity. But now, they work with the management team to have the right people, processes, and access to the cutting-edge technology providers. PE lures cutting-edge Tier 1 technology partners who traditionally work with Fortune 500, owing to the volume it can provide with billions of assets under management to attract the best available resources for their portfolio companies.

As the markets change direction and inflation rises, OPs today have fewer exit opportunities that will generate value. As such, they are more focused on business transformation at pace.

OPs now look at value creation levers that can help improve key metrics such as EBITDA, lower costs, and explore broader transformation agendas for growth and optimization.

Based on our experience as a leading global technology transformation specialist for PE firms, we explain here the six value creation levers and provide our recommendations.

1. Use the power of data and analytics to boost progress

Following the great fundraising year of 2021, PE firms have sufficient dry powder to execute take-private deals. As such, 18 take-private deals with $58.6 billion in aggregate value were closed in 2022.[3]

But as value creation becomes harder in the current market, PE firms invest in ever more complex data analytics and predictive models to identify opportunities. Companies must have digital metabolism to capture data and insights – especially for senior executives who are not digital natives.

Given technology transformation is core to success, it is essential to have a thorough understanding of technology, and the value levers it touches. As such, more PE firms partner with technology consulting and execution partners to identify targets and develop the first 100-day plan.

2. Reduce costs and manual efforts with automation and AI, and focus on core

Companies increasingly automate repeatable errands to use human intelligence for innovative and productive tasks. AI is commonly used to bring some predictability to tasks and provide automatic resolution. This allows them to focus on core activities and eliminate redundancy from the mix.

3. Embrace technology modernization

- **Cloud enablement and transformation** – Allows companies to become more agile as they grow. Companies then focus on the core rather than worrying about data center maintenance, patch deployment, and other activities that can be either automated or outsourced in the pay-per-use model. Firms can change capital expenditure to operational expenditure and reduce the total cost of ownership (TCO).

- **Enterprise resource planning (ERP)** – The lifeline of companies, which can be transformed and consumed in an as-a-service model to bring in cost efficiencies and service delivery excellence.

- **Legacy modernization** – Upgrading old infrastructure and software can reduce complexity and cost while increasing data consistency and improving communication and collaboration between teams.

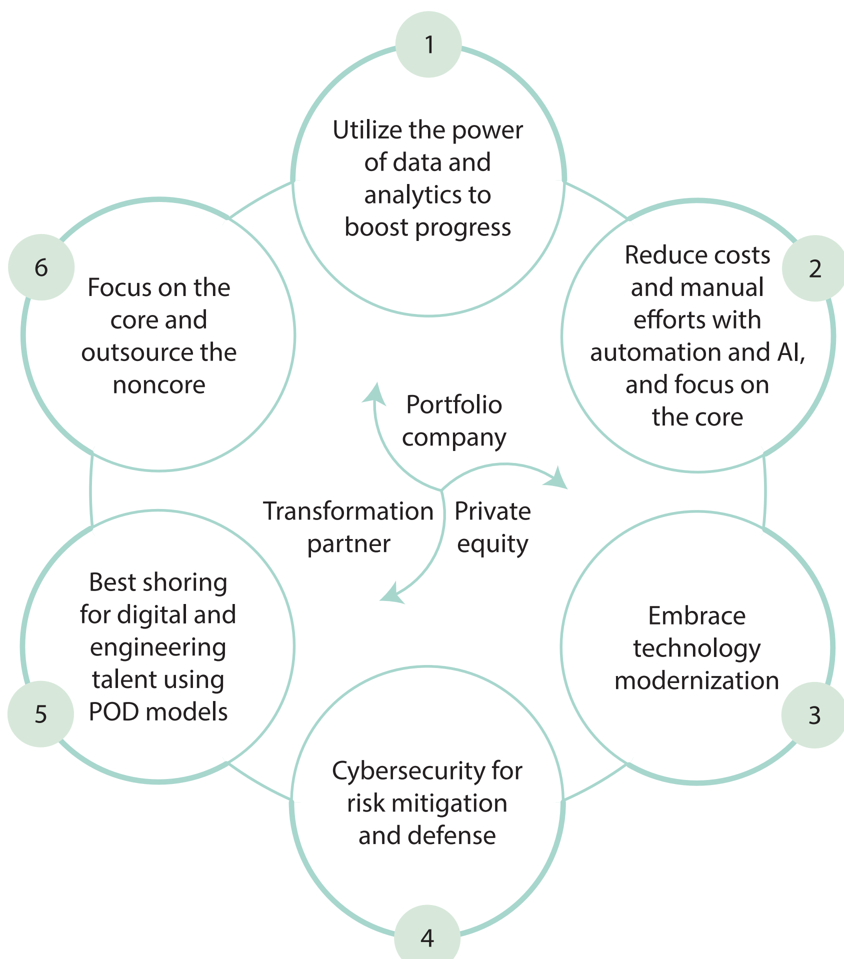
4. Cybersecurity for risk mitigation and defense

Cybersecurity often exists in a patchwork of technologies that can be upgraded and standardized across portfolio companies to ensure data privacy and help PE firms oversee governance, risk, and compliance standards. PE firms are more concerned about technology lately, given its direct impact on the company's valuation, and cybersecurity gaps that can lead to massive erosion of value. They also look at value-driven cybersecurity programs. Investments in cyber defense help companies capitalize on new technologies without creating new threats. Lastly, it is important to invest in the right talent strategy and expertise alongside cutting-edge technology for definite results.

5. Best shoring for digital and engineering talent using POD models

PE firms work with their portfolio companies on engineering talent strategy. With the shortage of skilled talent, especially in the engineering and product development space, OPs are working with transformation partners to engage resources through product-oriented delivery (POD) models and help outsource product development activities. All companies have different types of requirements. Such arrangements help companies of all sizes access skilled talent through agreements of their investor firms with transformation partners, where all firms are treated equally, and all their requirements are met. As a part of these agreements, the portfolio companies have access to talent from multiple locations. Depending on their requirement, companies can 'best-shore' talent.

Figure 1. The six technology value creation levers for today's PE firms



Source: Infosys

6. Focus on core and outsource the noncore

As OPs transform their portfolio companies, one of the best approaches is to focus on the core and outsource the noncore. This can be either through an analysis and outsourcing exercise or by creating shared services for their portfolio firms. In this arrangement, the shared services entity performs all noncore needs of portfolio firms.

While all these technology interventions can help generate value, their implementation with a clear and efficiently targeted road map is crucial. Together or individually, these transformations can directly contribute to better valuation and multiples. Some PE firms also acquire niche technology companies that can benefit their other portfolio companies.

To achieve the six agendas, PE firms **optimize their technology partnerships**. Technology service providers come up with innovative outcome- and performance-based pricing. OPs realize the potential of having a set of strategic partners to drive investments and value creation thesis and work with an outcome-based model.

Companies focus on digital transformation and customer experience through the following:

- Cost optimization through cloud partnering with hyperscalers and system integrators.
- Emphasis on the core for growth.
- Additional avenues for value creation other than the traditional, e.g., environmental, social, and governance (ESG), automation, AI, and digital experience.
- Hygiene issues pertaining to cybersecurity and cyber defense.

Technology can be the single thread for improving the experience of investors. Technology transformation should not be compartmentalized and looked at in silos. Agility can impact growth and expansion to new geographies. It is crucial to develop programs for business transformations, not just technology transformations.

Become creative on shared services

OPs already consolidate portfolio companies to create a one-stop shop, end-to-end customer experience, or to put together pieces of a strategic puzzle. PE operating teams are equipped with extensive research and actionable intelligence to develop solutions that end customers want. But by consolidating technology providers behind these conglomerations, they can provide a 'complete' experience. A single technology partner that operates across portfolio companies can help find synergies across multiple companies to create mammoth efficiencies or capture new market opportunities that require technology scale and efficiency. Appropriate positioning of these partnerships can enable PE firms to derive maximum value for the investor, the investee, and the end customer.

Integrate sustainability

A company's financial statement reflects much about its financial performance but little about its sustainability journey. Many investors now look for ESG integration for better reputation, long-term profitability, and viability of the portfolio companies.

Leading GPs and limited partners (LPs) worldwide have joined to establish a standardized set of ESG metrics and the mechanisms for comparative reporting through the ESG Data Convergence Initiative (EDCI), powered by Institutional Limited Partners Association.[4]

This helps streamline the collection and reporting of ESG data to help meaningful, performance based, comparable ESG data from private companies. It also allows GPs and portfolio companies to benchmark their current position and progress toward ESG improvements while enabling greater transparency and comparable portfolio information for LPs.

Now that ESG has become codified and embedded, technology partners bring their expertise in managing complex ERP and business reporting systems. The integration of ESG performance metrics with the data already being managed by a company's technology systems and service partners can boost the decision-making power of executive teams and help them identify value generating opportunities quicker.

Technology: a cornerstone of value

While governments try to tackle inflation, PE OPs carefully navigate through the troubled waters of rising interest rates and volatility. In this slow deal-making environment, PE firms can concentrate on unearthing value from their existing portfolios. All possible value creation initiatives are on the table. Clearly, technology-led business transformation is the critical game changer to give portfolio companies an edge.

The range of options for PE firms can sometimes seem overwhelming. And clearly, not all technology investments payoff, making the decisions around them ever more critical. But closer partnerships with experienced technology strategy and execution partners can add more tools to their armory as they look for better, future-proof, and valuable businesses.

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