REPORT

2022 PRIVATE EQUITY OUTLOOK

westMONROE

CONTENTS

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INTRODUCTION

As of January 2021, global private equity (PE) dry powder sat at an all-time high of $1.9 trillion.[1] The number is likely to climb higher, but this growing stockpile steadily increases competition for assets. Of course, more competition means higher prices. But it also places intense pressure on the due diligence process to identify sources of value creation. Not only do PE deal teams have to use the diligence process to determine whether it's possible to create enough value to justify escalating multiples, they also have less access to management and far less time to do it. In 2014 the average hold period was six years. Today, it's under five.

These converging pressures mean genuine insights—often based on outside-in analysis and third-party data—are much more important than they used to be. So are operational improvements. And our analysis and experience suggest that becoming a digital organization will be the linchpin for realizing improvements in operational KPIs, financial performance, and ultimately exit multiples.

PE deal teams should be aiming to underwrite technology and think digitally within their deals. PE leaders that hope to generate real insights and create value will need to ensure a consistent posture of data and technology literacy, not just during diligence but throughout the entire investment process.

To succeed, most midsize and large PE firms still need to invest substantial resources to build their data analytics capabilities. What's more, they need to do this work in the context of a tight labor market, which makes hiring and training for the required levels of digital and data literacy more difficult and resource intensive.

With these challenges in mind, this report outlines three trends PE firms will continue to face in 2022, and how to take action.

CHAPTER 1

Diligence is evolving

CHALLENGE

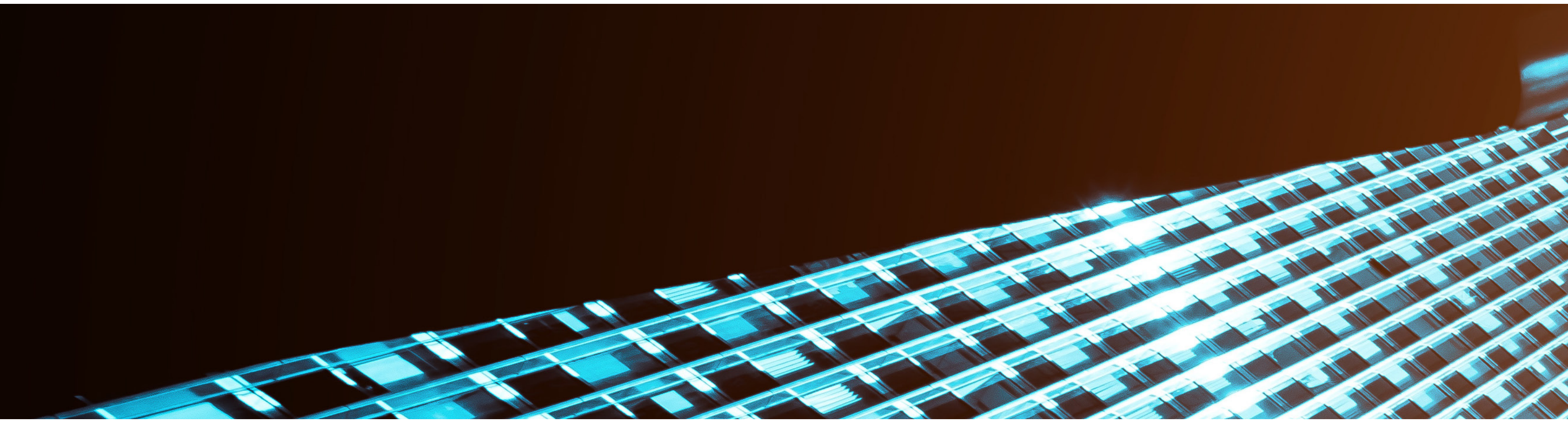
The private equity ecosystem continues to be crowded and intensely competitive—and this competition squeezes the due diligence processes timeline. Dedicated and unfettered access to management during diligence is becoming the exception, which means PE firms must be selective with their requests to management and willing to underwrite deals with less-than-perfect information. This makes an outside-in approach that is focused on data-driven insights more important than ever.

PE deal teams, however, can't always access the right data to complete their desired analyses. This has led to more firms building their own data and analytics infrastructure—or in some cases, looking to external partners to bring their own curated insights to the process. These capabilities and assets allow them to make assessments that are specific to situational factors based on sub-industry, company size, and past performance in similar deals. The challenge with comparative data and analytics systems is not having a complete and relevant dataset to find correlations and insights that can be trusted.

TREND

While PE firms have certainly been focusing more diligence energy on a target's technology environment, they traditionally have assessed technology with a risk-focused lens. Value creation is at risk if the right steps aren't taken to assess IT operations of a potential acquisition. Equally as important? Developing perspectives on how technology and datasets can be used for digital transformation during the hold period. Gaining this insight and identifying opportunities requires deep industry knowledge and some well-practiced capabilities within the diligence team. And it's critical that firms learn to generate meaningful data insights that allow them to evaluate and prioritize these opportunities.

More progressive PE firms holistically consider how they can use data to determine the right places to apply digital technologies—and then build a plan integrated across the technology and operations of a target company. Firms are finding that, ultimately, this approach increases their portfolio companies' EBITDA.



More prospective buyers are considering the risk that comes with higher carbon footprints, negative effects on marginalized populations, and inadequate cybersecurity and compliance.

TAKING ACTION

During diligence, it's key to evaluate how integrating digital technologies into all areas of a business in a coordinated way can increase value creation post-close. In addition to evaluating the strengths and shortcomings of a company's technology infrastructure, PE firms should holistically consider the benefits of digitizing a company while determining which of these benefits they are willing to underwrite as part of the deal.

Specifically, it's important to know how to harvest and use data and tools to assess the value that can be created during the hold period. For deal teams, gaining a detailed view of a target company's KPIs, customer and transaction data, revenue, and cost data is key.

Diligence with a digital-focused approach will lead to stronger ESG practices. More prospective buyers are considering the risk that comes with higher carbon footprints, negative effects on marginalized populations, and inadequate cybersecurity and compliance. Technologies that can help reduce these risks create more value over time.

Private equity firms that recognize digital strategies as a value –creator—both inside and outside their own walls— will be better equipped to evaluate targets, increase enterprise value, and ultimately result in greater financial returns.

CHAPTER 2

Generating data-driven insights—faster

CHALLENGE

Not everything all "digital" is created equal. This means that PE firms need their deal and operational teams to be data-literate, not only to develop insights and identify transformation opportunities but also to understand which opportunities will create the most value. Those opportunities should then be prioritized. Gaining this understanding requires a culture that consistently links operations and technology when building value creation plans.

While many PE leaders understand that digital should be high on their agendas, most think of the transformation in terms of how technology can enable scale. Few ask questions about how technology can be applied more broadly within a specific business to create value. However, deal and operating teams with a mindset that links technology with operations—coupled with the appropriate data insights to inform decisions—can see realize far more upside than they had ever even considered in a base investment case.

TREND

Across the board, shorter hold periods have changed relationships within the market and have encouraged a continuous investment in data-oriented and analytics-oriented organizational capabilities. During the diligence process, deal teams typically look at technology primarily to determine whether any solutions could be inadequate or malfunction and cost money—or whether their existing systems would be able to effectively scale.

But a select few leading funds have been able to link technology and operations in their digital strategy. To execute on this as an investment thesis, organization-wide literacy—knowing what to do with that data once it's collected—is imperative.

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TAKING ACTION

Yes, it is important to ask the right questions during diligence and know how to use available data to answer those questions. But the ability to evaluate data at a deeper level, correlate that data to external sources, and generate proactive insights around customer profiles, segments, and buying behaviors is key to finding sources of value others won't. From every perspective, data literacy within PE is no longer a nice to have; it's a critical capability.

Firms must learn to move beyond simply using data during diligence to assess prior performance. Rather, deal teams must use this data analysis to analyze future-state scenarios that are core to their investment thesis.

PE firms should sharpen their ability to efficiently gather the right data and use increasingly mature reporting and analytical methods to inform and manage their investment strategies. Data insights can help develop common KPIs across multiple investments in a single sector. Real-time access to these insights can also help organizations to better understand customer profiles and segments and their buying behaviors, which in turn can help them create value through increased revenue, cross-selling, retention, marketing, and sales effectiveness. Insights gleaned from data can also enable machine learning and AI applications that create competitive differentiation.

To effectively interpret raw data, firms should know how to correlate their own individual data points with other companies in the industry to understand what buyers care about and the different factors that lead to certain data points. Additionally, they should know when to use alternate datasets from external sources to make more informed predictions and conclusions.

In a retail setting, for example, analysts could assess store performance by looking at internal data like sales per square footage. While that may show which stores are performing better than others, it doesn't show why. External data—foot traffic, weather patterns, macroeconomic factors, or socioeconomic factors—would then allow analysts to understand why certain locations are more profitable than others and correlating those datasets would illuminate how they can make changes.

Firms should also consolidate data across the portfolio. Regardless of their digital maturity, most companies gather core operating KPIs for individual businesses. But many don't have the foresight to unify that data across the entirety of their portfolio to identify patterns that help them predict business-related trends and make better decisions. Ultimately, PE firms should enable machine learning and advanced analytics to correlate and unify data across investments.

As speed becomes more relevant, firms should build advanced ML and AI programs that help their deal and operational teams generate insights faster and better than competitors. Those that succeed will put themselves in a better position to get to deals quicker and create value faster.

CHAPTER 3

Using cybersecurity to protect enterprise value

CHALLENGE

Notably, in the past two years, large companies such as Keystone Pipeline, Kaseya, and JBS were victims of ransomware attacks that resulted in the loss of millions of dollars.

Every company is at risk. Smaller companies that don't have significant resources or intellectual property at risk—in industries such as manufacturing or distribution, for example—may consider cyberthreats minimal. Those companies may consider technology and cybersecurity standard reporting items in diligence.

Sophisticated cyberattacks mean that the financial impact now includes operational consequences, which is almost universally applicable and more difficult to recover from. What's more, while mid-cap companies may not be significant targets on their own, with PE-backing they may easily appear the radar of bad actors.

In addition, firms must consider how cybersecurity can safeguard their enterprise value as part of the ever-important ESG mandate Taken together, these issues result in an imperative for private equity firms to learn about the full scope of cyberthreats to protect themselves and their investments.

TREND

As the world has become significantly—and abruptly—more remote, technology has had its time to shine, bringing new solutions to communication, money transfer, data logging, and more in record time. But with those advancements also comes an increased risk for cyberattacks.

While cyberthreats have always been important to probe during due diligence, more PE firms working outside of heavily regulated industries such as healthcare and finance have had to prioritize this step as cyberattacks become more monetized and as LPs have turned up the pressure on ESG mandates.

TAKING ACTION

The key to cybersecurity is using it to boost enterprise value. A focus on cyber risk should be as relevant as a focus on profit margin and revenue stream.Without a good cybersecurity structure in place, those gains could disappear entirely.

The first step is to recognize what the potential vulnerabilities are to their targets and portfolio companies. To find security gaps, firms can use interview-based discovery, cybersecurity tool inventory, vulnerability scanning, and threat intelligence scanning. These same approaches may be used to determine which areas are or will be the most impactful to a company based on its size and industry.

Having a list of security tools is not enough—it's about knowing how every tool and process in the organization is operationalized. Companies should consider the outcome of a cybersecurity attack and the possibility of them withstanding it. Their toolbox should branch outside software to include backup capabilities, a disaster recovery site, and an incident response plan.

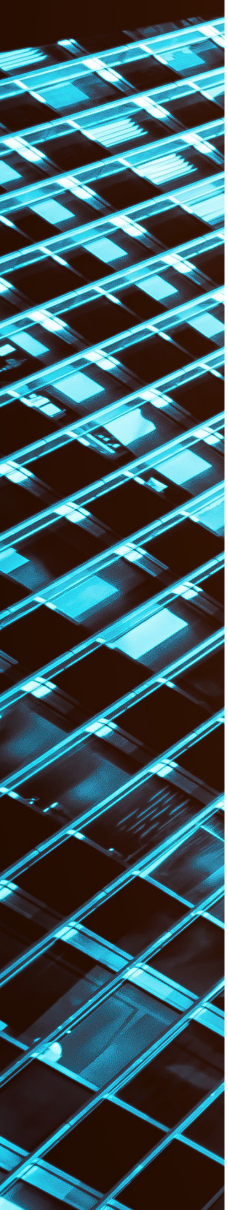
Many funds now have operating partners with industry-specific knowledge who can examine portfolio companies with a security-focused lens. That knowledge and sophistication can be applied to portfolio companies' practices and operations, and CEOs should have a front seat in how those decisions are being made—with cybersecurity as a vital factor.

Portfolio companies should invest in at least a small internal team of full-time staff to govern cybersecurity. There are limitations to how effective outsourcing cybersecurity can be—third parties tend to have an incomplete understanding of companies' operations, which can lead to overlooked threats. By contrast, internal staff can provide a more tailored cybersecurity perspective and position the company so that it can best recover if an attack takes place. This team also plants valuable knowledge inside the organization so that it can move forward with a security-focused approach. One example is ensuring that third-party application providers have appropriate security controls.

Finally—and crucially—cybersecurity awareness and training programs for all employees can lay a foundation for success. Its people are often an organization's weakest link when it comes to cybersecurity. Investing in employee education programs should teach employees how they can do their part to keep malicious actors at bay.

Of course, senior decision-makers shouldn't rely solely on the IT department to do this training or to champion cybersecurity. Much of it should come from the top. Prioritizing cybersecurity at the board level and in the C-suite is the best way to ensure proper funding for training programs as well as for implementing safeguards and solutions and conducting risk assessments to raise stakeholders' awareness of how cyber risks impact the company.

Cyber security should be as much as much of a priority as identifying growth opportunities—value retention is at stake.



CONCLUSION

Whether creating value through cybersecurity improvements or analyzing a potential target during diligence—data and technology will play a key role. In fact, as diligence and operations meld together and technology and operations become ever more intertwined.

Indeed, whatever insights a deal team uncovers during diligence should carry over into their 100-day plan, and into implementing that plan and subsequent value-creation projects, and finally into telling a compelling equity story in preparation for exit. As we head into 2022, the most successful PE firms will consider all elements of the investment process together, ensure everyone involved is technology- and data-literate, and infuse the entire process with technological and data analysis capabilities.

Those that don't could easily miss great investment opportunities during diligence and miss the boat on value creation. Without digital transformation of their own operations, PE firms will need to make larger investments during their holding periods to optimize their portfolio companies' operations and manage their businesses effectively, to create competitive differentiation, and to mitigate cyber risks. They may also see value erosion, resulting in lower multiples on exit, due to missed opportunities to improve EBITDA, time-to-market, customer loyalty and engagement, and retention.

Incorporating the use of data and technology into everything they do will be critical for success.

ABOUT WEST MONROE

West Monroe is a digital consulting firm that was born in technology but built for business—partnering with companies in transformative industries to deliver quantifiable financial value. We believe that digital is a mindset—not a project, a team, or a destination—and it's something companies become, not something they do. That's why we work in diverse, multidisciplinary teams that blend industry expertise with deep operational and technology capabilities—moving clients from traditional to digital operating models and creating products and experiences that transcend the digital and physical worlds. Our 2,000 employees have the opportunity to own a stake in the company, so when you partner with us you know we are committed—because your success is our success. Our undeniably different approach breeds undeniable results.

Visit westmonroe.com to learn more.

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