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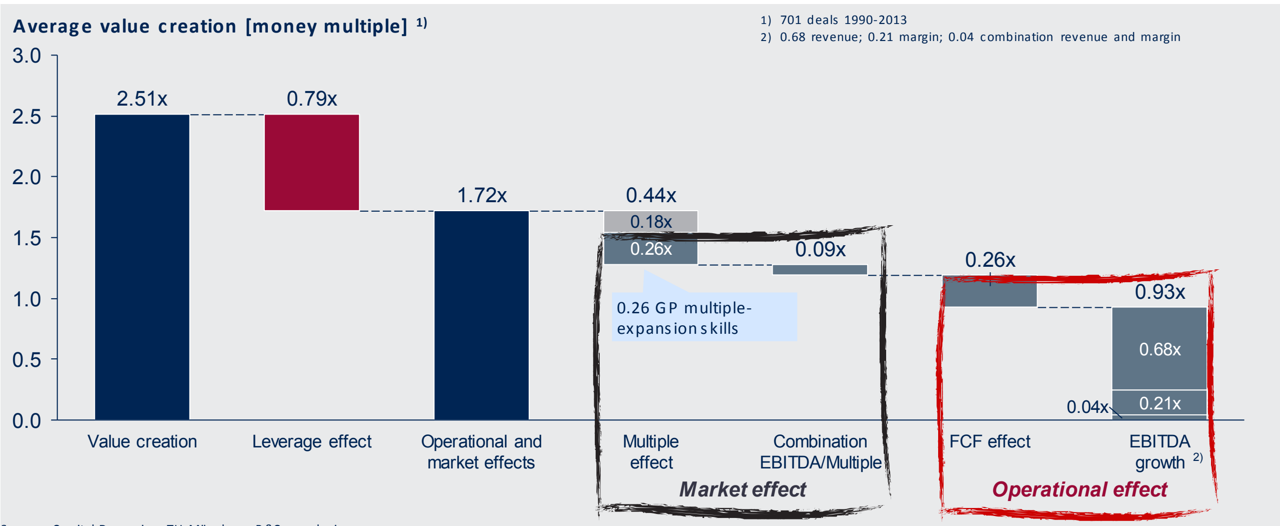
# Value Creation in PE: Equivalent to the post-Christmas diet

**When it comes to operational value creation in private equity portfolio companies, Arndt Rautenberg, Managing Partner and Boris Herzog, Director at Rautenberg & Company suggest that it's similar to the annual post-Christmas diet; almost everyone claims to do it, but very few actually do. Instead of inventing ever new terms to promote their capabilities for increasing operational value, funds should finally start to realise the upside potential, they argue and formulate five key theses on how to actually do it.**

For years, all market participants appear to be singing from the same song sheet: Deals are extremely expensive, potential for multiple expansion limited and leverage levels highly homogeneous. What really matters, therefore, is operational value creation. A glance at the websites of numerous PE firms reveals that this has been at the core of the DNA of the respective house for decades – happily embellished with synonyms such as entrepreneurial approach, hands-on style and active portfolio management. We are sceptical.

In order to assess the actual importance of operational value levers, we take an analytical look at the average money multiple of 2.51x achieved by the private equity industry since 1990:




Source: Capital Dynamics, TU München, R&Co analysis

1. The **leverage effect** represents the extent of the increase in shareholder value through the use of debt versus no debt and empirically contributes approx. 31% to the total value added, however it also raises the risk factor of a transaction.
2. The **multiple effect** describes the arbitrage between entry and exit multiple and drives a further 18% of the effective value added. While a part of this multiple-uplift is a result of an improved market environment (~7%), the 11% increase is driven by a higher asset quality at the time of the exit, e. g. an increase in size of business or market share. This part of the multiple effect therefore can be considered as an operational lever.
3. The third lever, the **free cash flow effect** (~10%), is clearly operational and is mainly influenced by working capital, capital expenditure, tax and interest payments as well as the generation of EBITDA.
4. The **increase in EBITDA** is definitely the most important factor, accounting for 37% of total value added. Empirically, the increase in sales has been of higher importance (~28%) than the margin increase (~9%).
5. Strictly speaking, the **combined change** in EV/EBITDA multiples and EBITDA is a fifth lever, a secondary effect that contributes another 4% to value added.

This means that almost 60% of the PE sector‘s total added value can be attributed to operational effects. There is therefore no doubt as to the importance of operational value creation for private equity, and given the fact that non-operating value levers are obviously more difficult to implement in the current environment, their significance will undoubtedly continue to gain importance.
Nevertheless, we continue to observe a considerable spectrum of influence levels which PE firms exercise on their portfolio companies' value creation efforts. This ranges from the standard board meeting, to the occasional monitoring of key projects all the way to operational interference at the management level. Most of the involvement is however focused on the lighter touch rather than the heavy-handed intervention.

Based on our experience and observations from the past few years, we have formulated five hypotheses in relation to successful value creation.

1. **A clear value creation plan is a prerequisite for a competitive purchase price offer.** In order to be able to meet LPs' demanding return expectations in a highly competitive environment with rising purchase price multiples, a clear route to value creation is essential from the outset. It is simply not sufficient to know how much you wish to increase this value, nor to rely on financial engineering. A clear plan for operational value creation must be developed before a bid is submitted. This should set out how exactly operational and financial levers will be pulled or pushed to achieve the targets. Only on the basis of such a value creation plan can an investor justify the extremely high purchase price expectations and secure the deal in competitive processes.

2. **Experience in operational value creation will become an even stronger differentiating factor.** A successful track record of supporting companies in increasing their value provides a positive differentiation from other bidders already during the initiation of a transaction and the approach of potential takeover candidates. In addition to the purchase price, „Smart Money“ also increases the sellers‘ return expectations in the case of earn-outs and share buybacks. It further eases management‘s common concern that an investor may stifle their freedom to operate, leading to a possible loss of control and influence.

3. **Operational value creation requires a good toolbox.** The anchor point of value creation during the holding period is a detailed and action-oriented integrated business plan, backed by clearly defined measures. Naturally, this requires a considerable focus on identifying value creation levers as well as the derivation of such measures during due diligence, which are then reflected in the business plan, including a precise description of the assumptions. In the course of a 100-day-programme, such measures will be detailed, prioritised and, of course, rigorously implemented - not all at once, but with a clear focus on relevance and impact, and also on feasibility, managerial constraints in the organisation and associated costs. Stringent tactical tracking supports the implementation, while a structured annual strategy and budget process ensures that changing external and internal requirements are met and, if necessary, planning refocused or prioritized.

4. **Operational value creation depends on the integration of internal and external capabilities and resources.** It pays off to draw on operational experience in value creation planning as early as the composition of the deal team. When selecting a CDD consultant, you should look for his or her specific competence in value creation planning and avoid those who provide no more than a mere travel report . Establishing a dedicated value creation function in the form of an operational or portfolio team depends primarily on the tax status (asset management vs. commercial) and the investor‘s budget. While large funds increasingly rely on their own teams for value creation, smaller firms depend primarily on the role of supervisory or advisory boards. Members of such committees should not be chosen based on their illustrious biographies but more by their ability and willingness to support management in overcoming operational and strategic challenges - including with significant time commitment. Ideally, external advisory boards offer companies diverse functional competencies as well as a profound contact network into the respective industry. Last but not least, it tends to bode well for the board members to be personally and substantially invested in the company, as nothing sharpens the analysis and dedication as much as the likelihood of benefitting from the value creation personally.

5. **Operational value creation is at least as much attitude and experience as craftsmanship.** Most post-Christmas diets fail not because of a lack of diet types, but because of the proverbial battle against the personal comfort zone. The same applies to value creation programs: they are challenging, time-consuming and cost a great deal of money. To ensure success, it is essential to persevere and not just occasionally reflect on those good intentions made at the outset of a deal. In any case, supporting a portfolio company in increasing its value requires a

great deal of dedication; whether it be in discussions with management, in the preparation and follow-up of board sessions, but above all in these meetings themselves - in strategy discussions and discussions with suppliers, customers and other business partners. The decisive question is always: How exactly does this help the company become more valuable? Whenever the answer is „not at all“, or “I’m not sure”, it is worth questioning the agenda, and quite possibly also one‘s own role.

In summary, we see operational value creation as a key success factor in the contemporary PE sector, and one to remain crucial for the foreseeable future. It continues to be subject to a range of interpretations, with each fund acting in a different way. In any case, successful operational value creation requires a common understanding of its relevance as well as the specific competence and experience of all involved - and last but not least the willingness to grant the effort the highest priority.
Finally, a few words of comfort, summed up in a last analogy to the ever so despised post-Christmas diet: It‘s never too late to start - but whatever you do, don’t forget to also indulge beforehand...!

**About Rautenberg & Company**

Rautenberg & Company advises financial sponsors and their portfolio firms during all phases of a transaction: from deal origination to execution, post-closing and portfolio management. The unique support comprises two core components – advising clients in corporate finance, strategy and operational improvement with an experienced and highly competent team, and investing into the equity of companies, alongside clients if requested, either directly or by converting fee components from consulting engagements.

www.rautenbergco.com

Contact

**Arndt F. Rautenberg**
Managing Partner
Rautenberg & Company GmbH
Königsallee 61
40215 Düsseldorf
rautenberg@rautenbergco.com

**Jens Moritz**
Managing Partner
Rautenberg & Company GmbH
Bockenheimer Landstr. 24
60323 Frankfurt
moritz@rautenbergco.com

**Boris A. Herzog**
Director
Rautenberg & Company GmbH
Bockenheimer Landstr. 24
60323 Frankfurt
herzog@rautenbergco.com