

HOW VALUE CREATION TEAMS ARE KEY TO HELPING MAXIMIZE RETURNS FOR PRIVATE EQUITY

Value creation teams come in many shapes and sizes, and the value they bring to private equity firms is becoming widely recognized.

Value creation initiatives and the teams that execute them have become an increasingly important part of the private equity investment life cycle. Sponsors and management teams alike view value creation as both a strategic opportunity and a key differentiator in a competitive and uncertain market. This has led sponsors to refocus their attention on creating dedicated teams and defined playbooks that seek to maximize portfolio company returns through value-add projects that span a company's core functions, from institutionalizing financial reporting to improving operational efficiency.

Over the past 10 years, M&A transaction activity has skyrocketed in the private markets, as evidenced by the number of deals that have been done. In 2021, there was a record high of 9,278 transactions for a combined \$1,245.5bn in deal value.¹ Over the first three quarters of 2022, 6,530 deals were completed and, while the number was down 20.4% from the same period in the prior year, activity is expected to recover given the large amount of dry powder, with \$1,258bn globally as of September 30, 2022.^{2,3} In an environment with such a large number of active private equity firms paired with pressure on valuations from macroeconomic headwinds, sponsors are struggling to find ways to generate consistent, attractive returns and differentiate themselves in the market.

Conventional value creation practice within private equity has been built on fundamentals such as financial engineering, expense reduction (including labor cuts) and add-on acquisitions. While these activities have helped to reduce costs and increase earnings in the short run, they do not always offer long-term value creation and sustainable company growth.

Sponsors and management teams are increasingly seeing the benefit of supplementing these traditional strategies, and recently PNC's Financial Sponsor Coverage team has seen an increasing number of sponsors adopt and find success with new value creation initiatives centered around technology and digitization, human capital, and Environmental, Social and Governance (ESG). "In our discussions with private equity (PE) groups in the market, we have seen a greater focus on generating more long-term value for the company, building out a more formal strategy around value creation and starting earlier in the M&A process to identify areas of value creation," said Aimee LeWinter, managing director of Financial Sponsor Coverage at PNC.

To execute on these initiatives, sponsors are using a variety of value creation team structures, including the following:

- **Internal Teams:** Centralized internal team that works across the firm's portfolio specializing in and addressing tactical functions, such as marketing/sales, human capital and technology, among others
- **Industry Professionals:** Operating partners who have C-suite or significant experience within a specific industry or sector, who typically assist in the sourcing and diligence of new investment opportunities, and who serve in a CEO or board-level role at a specific portfolio company or small subset of portfolio companies
- **Affiliate Consulting Groups:** Consulting groups that operate as an affiliate company of a sponsor, focusing only on the portfolio of that sponsor

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Managing Director of Financial Sponsor Coverage

The shift toward a more robust value creation philosophy and the growth of value creation teams stems, in part, from speculation around a potential downturn and the need to continue to optimize investment returns. This is further evidenced by the 2008 Global Financial Crisis, where there was strong correlation shown between having a value creation team and fund performance both during and after the crisis. Throughout the recession (2009–2013), private equity groups with value creation teams had an average IRR of 23%, while those that did not had an IRR of 18%. Additionally, fund sizes for sponsors with value creation teams fell only 19% as compared to 82% for firms without. This also translated post-recession, as value creation firms' fund sizes rose by 53%, while those without fell 15%.⁴

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Another reason for the increased adoption of this value creation philosophy by sponsors is that it is a differentiator in a competitive market. These sponsors tend to develop value creation plans (VCPs) earlier in the investment process to clearly articulate the growth and optimization opportunities for the target company, distinguishing them as a partner of choice in comparison to other potential buyers. VCPs outline strategic initiatives and lay out key performance indicators (KPIs) to transform and grow the company, encompassing both near-term and long-term goals. Partnering with management teams by providing the necessary plan and resources to execute on future growth resonates with sellers, particularly those retaining equity in the company post-sale.

PROVIDING THE NECESSARY PLAN AND RESOURCES TO EXECUTE ON FUTURE GROWTH RESONATES WITH SELLERS, PARTICULARLY THOSE RETAINING EQUITY IN THE COMPANY POST-SALE.

Expanding VCPs to focus on operational transformation in addition to cost cutting has shown tangible benefits. According to a KPMG survey, investments that take both revenue growth and cost savings into consideration in their approach to value creation achieve 15% EBITDA growth. However, when considering only cost savings in value creation, companies only attain 5% EBITDA growth.⁵

In particular, three more recent levers that financial sponsors and their value creation teams have been integrating into their VCPs are tech/digitization, human capital and ESG.

TECH/DIGITIZATION VALUE CREATION

By implementing relevant and impactful new technologies, a sponsor's goal is to help decrease manual operations and increase efficiencies. Identifying processes that can be streamlined, standardized or automated can help to create actionable value creation opportunities. In fact, 66% of survey respondents expect to invest more in digital transformation for back-end processes.⁵ Some of these technologies help with the automation of reconciliation processing, invoice payments and payroll processing and with creating a better online shopping experience for customers.

"PNC continually invests in Treasury Management [TM] solutions that can be leveraged to optimize working capital; achieve faster, more secure transactions; and take advantage of data-driven insights," stated John Puhatch, TM sales executive. A few of these solutions are featured below:

- **Integration & Digital Services:** Simplify bank account management, transaction enablement and business process automation through the utilization of APIs, Integrated Information Reporting, banking portal connections and online portals to plug ERP systems directly into banking platforms.
- **Payments Platform:** Optimize payments and receivables to accelerate incoming payments, streamline accounting functions, increase insight and take control of the cash position.
- **Fraud Prevention Tools:** Stay informed about ongoing threats and trends, as well as stay up to date on the solutions and tools that could help protect a company from the harmful effects of payments fraud.
- **Escrow:** Mitigate counterparty risk with rapid turnaround and flexible solutions for escrow needs.
- **Liquidity:** Manage operational, reserve and strategic cash with a full continuum of liquidity solutions combined with interactive access to data.

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John Puhatch
TM Sales Executive

HUMAN CAPITAL VALUE CREATION

According to the 2022 Global Private Equity Survey done by EY, 68% of respondents from sponsors over \$15bn AUM listed talent management as a strategic priority, which was consistent with 81% of respondents from smaller firms between \$2.5bn and \$15bn AUM and 54% of respondents from sponsors under \$2.5bn AUM.⁶ In the wake of the COVID-19 pandemic, the ability to attract and retain talent has become more difficult and costly due to increased competition for top talent, which has been further exacerbated by the Great Resignation/Reshuffle.

IN THE WAKE OF THE COVID-19 PANDEMIC, THE ABILITY TO ATTRACT AND RETAIN TALENT HAS BECOME MORE DIFFICULT AND COSTLY DUE TO INCREASED COMPETITION FOR TOP TALENT.

As companies attract talent, potential employees are not only looking at compensation but also considering the additional benefit and wellness packages offered. Part of these packages include employee financial education and wellness. A 2021 survey done by PwC showed that 40%

of employers cited improving employee financial wellness for adding to and improving their current programs.⁷ Offering benefits for employees is not only beneficial for retaining and attaining talent but can also positively impact company efficiency as employees stress less about their financial concerns at work. It has been shown that financially stressed employees cost American businesses an average of \$500bn a year in productivity alone.⁸

OFFERING BENEFITS FOR EMPLOYEES IS NOT ONLY BENEFICIAL FOR RETAINING AND ATTAINING TALENT BUT CAN ALSO POSITIVELY IMPACT COMPANY EFFICIENCY.

In line with employee preferences, PNC's Organizational Financial Wellness (OFW) program offers financial wellness education tools and resources, employee and executive banking, 401(k) fiduciary services and Health Savings Account (HSA) guidance to portfolio companies and their employees at all levels. This consultative approach has assisted with improved employee retention and productivity.

ESG VALUE CREATION

Environmental, Social and Governance (ESG) has been another topic of focus for general partners (GPs), limited partners (LPs), end customers and employees across virtually all industries. With the growing awareness of ESG issues, PE firms have been more deliberate about including ESG values in their investment strategies. In fact, KPMG's survey found that over 70% of PE firms consider ESG factors in the early stages of the investment life cycle.⁵ Banks such as PNC recognized the trend

in the market and developed sustainable finance programs, which can lower cost of capital. "We have seen increased adoption by companies of sustainable finance programs, which incorporates the adoption of ESG-related operations and agreed-upon KPIs to obtain more competitive pricing," shared Kristi Eberhardt, head of PNC Sustainable Finance.

Further supporting the importance of ESG in the PE space, more than 240 GPs and LPs, collectively representing \$24tn+ in AUM, came together and formed the ESG Data Convergence Project.⁹ This project is working to standardize the ESG metrics being used to report on portfolio companies: 1) greenhouse gas emissions, 2) renewable energy, 3) board diversity, 4) work-related injuries, 5) net new hires and 6) employee engagement. The long-term goal of this project is to increase the quality, availability and comparability of ESG data in private markets. Other groups such as Solebury Strategic Communications, a PNC company, also work with GPs and their portfolio companies to develop and scale ESG strategies, embed ESG across business units, and report and communicate progress to stakeholders.

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Kristi Eberhardt
Head of PNC Sustainable Finance

CONCLUSION

Value creation teams come in many shapes and sizes, and the value they bring to PE firms is becoming more widely recognized. As PE firms have become more focused on value creation, they have looked to the market for tools and resources.

To build upon its sponsor solutions, PNC created the Financial Sponsor Coverage group in 2019. This team focuses on solving the needs of its PE and other financial sponsor clients across the entire fund life cycle. They work closely with value creation teams to further execute on value creation initiatives, automate more manual processes and implement products that can be leveraged to maximize impact. Value creation teams and portfolio companies can also utilize the PNC Concierge Banking Portal, an innovative platform that can be leveraged to identify

areas of interest and need across working capital and cash flow optimization, liquidity management, international solutions, deal support and employee services.

PNC and its subsidiaries have a long-standing track record of achievement and a full arsenal of financial products and services to help sponsors and their portfolio companies throughout each fund life cycle phase, including the solutions referenced herein. By working strategically to enhance liquidity and propel growth through all economic cycles, as evidenced by PNC's 750+ private equity relationships, more than \$75bn in financial sponsor commitments, and significant investment in technology, it has become one of the top five treasury management providers in the United States.

If you have an interest in discussing these market trends or would like to leverage the Financial Sponsor Coverage team and its tools for your value creation objectives, please contact:

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1 Q1 2022 US PE Breakdown — Pitchbook.

2 Q3 2022 US PE Breakdown — Pitchbook.

3 Q3 2022 Global Private Market Fundraising Report — Pitchbook.

4 Lessons for Private Equity from the Last Downturn — McKinsey & Company.

5 Delivering on the Promise of Value Creation: 2022 Market Insights Survey — KPMG International.

6 2022 Global Private Equity Survey — EY (www.ey.com/en_gl/private-equity/will-seeing-what-lies-beyond-bring-new-opportunities-into-focus).

7 2021 Health and Well-being Touchstone Survey — PwC.

8 Mind the Workplace — MHA Workplace Health Survey 2017 FINAL.pdf (mhanational.org).

9 EDCI (esgdc.org).

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