Grant Thornton

Private Equity

The future of growth and the private equity industry:

Value creation and scalable returns in an era of change

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Contents

Introduction

The years ahead will be challenging for the private equity (PE) sector. Disruptive forces will drive PE firms to evolve rapidly and take decisive measures to thrive in tomorrow's marketplace. "It's really about survival," explained Sal Fira, Grant Thornton LLP's national managing partner for Private Equity. "The funds that evolve and respond to the forces of change in the industry will survive by continuing to find innovative ways to deliver returns for their limited partners. To be blunt, funds that do not adapt will not survive."

Evolving the scope

PE managers have always aligned investor sentiment and appetite with their investment strategies. But with increasingly sophisticated investors demanding exemplary performance, the PE industry needs to do more — and more quickly.

All funds, whatever their size, need to identify opportunities for value creation and tackle the increasingly competitive nature of the industry head-on.

The competition for deal-making intensifies

Increasingly sophisticated and diverse investors know they can choose from many options when they invest. Research shows that almost half of limited partners get more than 10 fund pitches each month. In this intensely competitive environment, PE firms will stand out by focusing on what is required from their investors.

- **Going beyond fund performance:** Some PE firms design their portfolios around social responsibility or sustainability criteria, which are important to public pension funds.
- **Moving to an industry-centric approach:** PE firms with an industry focus outperform generalist funds. Industry depth and insight are table stakes for PE.
- **An expanding investment strategy:** Some PE firms are consolidating and expanding with hedge funds, debt funds and other alternative assets to offer a wider suite of investment opportunities with different elements of liquidity, risk and return.

Value creation becomes part of the operating model

Traditionally PE firms operated on a model that allowed for winners and losers in their portfolios. But in today's maturing, hypercompetitive environment, portfolios need more winners. Firms' limited partner investors — the lifeblood of the asset class — demand higher returns. Financial engineering (changing the capital structure, for example) is a key strategy for generating strong returns for investors, but forward-looking PE firms realize that true value creation — the ability to build stronger, more sustainable companies — has become an integral part of the operating model for PE.

"Value creation is fundamental to what PE does, and it's more important than ever to institutions," said Fira. "You will continue to see all kinds of value creation models used, but all firms will work toward institutionalizing the process, either through in-house capabilities or through partnerships with external consultants who can provide vital sector know-how and skills."

Finding alpha in a bull market

The rise of low-fee passive investments, such as index funds and exchange-traded funds, coupled with the bull market of the past eight years, has meant PE firms need to work harder to find alpha. While some leaders have met the challenge, many funds have not delivered. Over the past decade, PE overall delivered returns at par with public equity.

Eventually, the bears will beat the bulls. Political and economic surprises create heightened volatility, and we are most certainly living in unpredictable times. The lifetime returns for PE illustrate why it remains an attractive asset class, but PE leaders must increasingly deliver more value to beat the public equity markets.

The appeal of public-private infrastructure partnerships increases

Institutional investors, such as pension funds, insurance companies, asset managers and sovereign wealth funds, are interested in the long-term, inflation-linked income streams generated by physical assets such as airports and toll roads.[1] The public-private partnership approach is already working in infrastructure projects across the country, including major port projects, rail lines, and water and other utilities.

Infrastructure is one area where there is across-the-aisle support in Washington, D.C., even if the policy decisions related to funding remain divided. During his campaign, President Trump proposed a significant tax credit (82%) for PE investments in infrastructure projects. While the proposal is somewhat controversial, it signals an interest in putting private money to work on important public projects. The challenge for private capital is huge. There is a huge backlog of projects. The American Society of Civil Engineers grades the overall U.S. infrastructure a very disappointing D+.[2]

The challenges come with considerable opportunities, but only if private and public sectors can devise sustainable partnership structures to invest in a new generation of infrastructure assets. Many states are not waiting for Washington to take action. One notable example is a partnership between the state of Florida and Fortress Investment Group to build a high-speed rail link that will eventually connect Miami and Orlando. This would represent the first passenger rail system developed by a private company in nearly 35 years. The bold move by Fortress could provide the template for other states and regional authorities that are looking to improve the value of their existing and, in many cases, deteriorating rail infrastructures.

[1] See *Financial Times*.
[2] American Society of Civil Engineers, "2017 Infrastructure Report Card."

Reinventing the future, today

PE managers are no strangers to long-term planning and, in fact, are stalwarts of long-term investment success. In a time of increasing market and macroeconomic uncertainty, they would be wise to adopt an agile approach, preparing for whatever the future holds.

Execute on value creation across the life cycle of the deal

Successful PE firms must navigate complex transactions — whether buying or selling, restructuring or providing capital solutions — with speed and agility to meet the rising expectations of investors. The lifeblood for PE firms requires a laser focus on the life cycle of the deal, from assessing opportunities to executing the transaction to accelerating value.

In assessing opportunities, successful PE firms develop targeted and consistent criteria for search and selection. They develop sophisticated financial and valuation models to assess both the viability of the prospect and the fit of the company with their overall portfolio.

In executing the transaction, the focus shifts to due diligence, deal terms and structure. PE firms need to make sure the future portfolio company's finances are consistent with what they have discovered. Healthy skepticism is always warranted. PE firms are investing in future earnings, so it is critical to develop confidence in the ongoing execution of the core business model.

Accelerating value is all about creating sustained, improved performance. Many larger PE firms have developed in-house value creation teams. Value creation is key to smaller firms as well. "Most can't hire in-house consultants, but what they can do is construct 100-day plans and build teams of people with the help of outside consultants to validate the transaction and uncover the value," said Fira.

Protect the value of the investment

Risks are rising for PE funds. Increasingly, the funds are seen as deep pockets for actions taken by their portfolio companies, as litigants seek to pierce the PE veil. Cyberrisks are increasing exponentially and pose threats to the funds, their portfolio companies, and the broader ecosystem of value chain partners of their portfolio companies. The rise of sovereign wealth funds as limited partners for PE creates new challenges to comply with Foreign Corrupt Practices Act rules, a lesson that Och-Ziff Capital Management Group has learned the hard way. See *Financial Times*.

Sophisticated risk management processes and expertise are vital tools deployed by leading PE managers at the fund and portfolio-company levels.[3]

At the fund level, regulatory risk management capabilities are crucial. In particular, the SEC is examining investment advisory agreements and investigating whether fund managers' actions match the promises made in their fund documentation.[4]

[3] Private Equity International. *New Strategies for Risk Management in Private Equity: The Investor's Guide to Protecting Asset Value*, May 2014.
[4] Staff of the Investment Adviser Regulation Office, Division of Investment Management, U.S. SEC. *Regulation of Investment Advisers by the U.S. Securities and Exchange Commission*, March 2013.

There are several areas where failure to fully or accurately disclose fees warrants SEC scrutiny, according to Michael Rose, an Advisory Services partner at Grant Thornton:

- Fee and expense disclosures
- Improper allocation of transaction-related fees to funds
- Use of fund assets to pay for expenses that advisers should have paid for (dead deals, for example)
- Fair trade allocations to all the funds

Other areas that might be on the SEC's radar include improper valuation of illiquid assets, use of valuation methods that differ from fund agreements, failure to disclose investment risk and inadequate disclosure of conflicts of interest.

PE managers know how prepared they must be for the regulators, even if that is difficult to achieve. Rose suggests that his clients review and document their allocation processes, compare them with investment advisory agreements to ensure consistency, and employ technology and analytics systems to provide accurate allocations. "Get ready now for questions from the SEC," he said. "They're coming, so be ready to respond."

Limited partners, in some cases supported by state legislatures, are pushing for greater transparency about how PE managers value assets. And many investors are keen to become more involved in the overall valuation process.[5]

The promise versus the threat of integrated and connected data

The advanced technologies of the internet of things, artificial intelligence and robotics offer tremendous promise to both PE firms and their portfolio companies to create the digital enterprise. But as data is shared more freely across the value chain, new vulnerabilities arise.

To keep up the pace of digital innovation while effectively managing increasing cyberrisk, PE firms need to ensure that their cybersecurity teams partner closely with the business. Understanding the strategies for both the fund and the portfolio companies will help identify appropriate risks to data privacy and security. Using data-driven scenario analysis, they can take intelligence-based decisions and, crucially, help PE firms and their portfolio companies understand whether high-risk digital projects will deliver high reward.

Institutional investors consistently advocate for transparency of investment policies and processes in regard to the underlying data applicable to the portfolio's holdings. The state of California, a leading investor in alternative investments, has enacted a law designed to increase transparency about the fees and expenses paid by the state's public pension or retirement systems to the PE funds, venture funds, hedge funds and absolute-return funds in which they invest.[6]

[5] See ILPA, Reporting Template.
[6] Marphatia, Raj, and Skulan, Catherine. "Squaring the Letter of California's New Fee Disclosure Law With the Realities of Alternative Investment Funds," *Pensions & Investments*, Dec. 28, 2016.

Transform value for a more scalable business model

Leading PE firms are moving to a more scalable business model that allows them to grow (or scale back) the operational end of their businesses, based on the size of their portfolios.

They need to find efficiencies in both front- and back-office operations, examining functions that are ripe for outsourcing and/or investing in third-party fintech tools that automate processes and reduce costs.

PE leaders are examining their business processes to make sure the processes support their firms' visions, growth strategies and abilities to serve customers. They benchmark selected processes against best-in-class companies to identify which improvements will bring the greatest business returns.

A fresh look at technology

The future of PE is increasingly intertwined with technological advances. In particular, data will determine how to manage key priorities — from how they handle their portfolios to creating value for their portfolio companies.

But this sort of sophisticated analytics is impossible if complex legacy systems and siloed data stand in the way. Leading PE firms undertake due diligence to assess and select best-of-breed IT solutions that are aligned to their strategies and growth goals, and enable them to extract insight from their data.

Cloud computing offers PE firms the opportunity to optimize productivity and efficiency, but it also implies a loss of control over some critical data.

This will force leading PE firms to put in place a stringent set of standardized criteria for their evaluation of vendors, including vendor viability, technology functionality, security measures, and contractual and support needs. Service organization control reports will help to drive uniform selection standards.

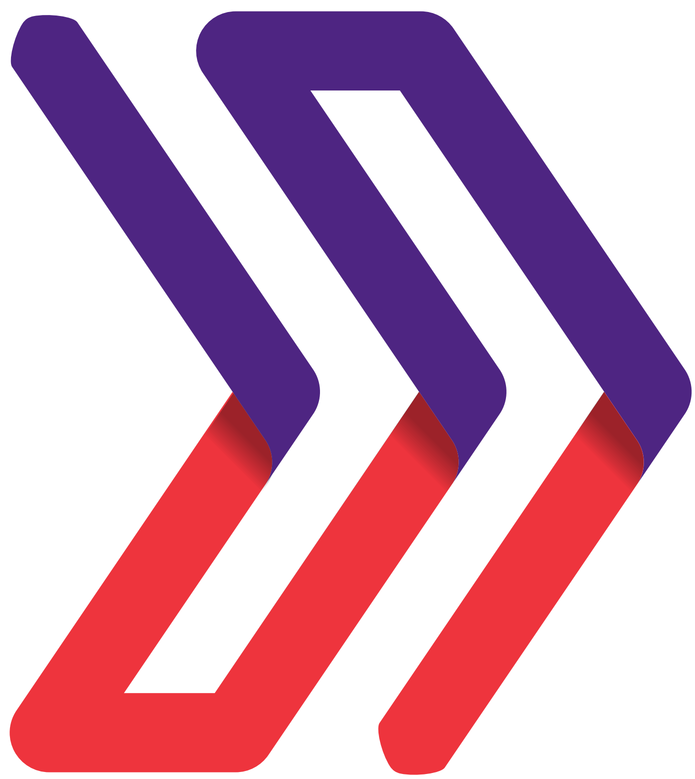
Finally, PE firms need to manage vendor relationships post-sale — and make changes if their goals are not being achieved.

Conclusion

These are challenging times for the PE industry. The industry may look very different five years from now. Survival will depend on execution of smart strategies and adapting to new market demands and realities.

PE firms have always been responsive and agile to win the best deals. They will grow their portfolios through opportunistic new deals, such as helping to play a pivotal role in rebuilding the country's infrastructure.

But growing the portfolio is only part of the formula. Today's PE leaders also look for bottom-line and sustainable growth at both the fund and their portfolio companies. They are transforming value by embedding value creation at every stage of the investment process. When it comes to risk management, they will be ahead of the game by understanding the regulatory environment and by learning how to mitigate the risks presented by advances in the digital economy and technology.



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