Private Equity

Accelerating the Pace of Returns from your Portfolio companies leveraging AI

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Introduction

Every company today is trying to understand how to put AI to work in support of its strategy. This is a race that private equity firms have to address quickly to maintain returns relative to the overall market. This becomes even more urgent given that PE firms overall had a tough 2023 as deal volume slumped markedly. As the new year begins, the market appears to be settling into a new normal with higher interest rates, and lower valuations of companies. For investors, there is a lot of dry powder, and they are looking to identify targets to invest in to show LPs they can return capital to keep the flywheel going.(1) Another marked change is that where PE firm's investments were traditionally held for three to five years, with market uncertainty many investors have been forced to hold on to their portfolio companies("portcos") for longer periods, around five to seven years. With the slowdown in deal activity, smart investors are looking for ways to improve the performance of companies in their existing portfolio. The challenging environment is expected to continue in 2024 with high costs of capital and macro-economic headwinds across most industries.

Traditional Pathway to Growth

Historically, the traditional approach taken by PE firms and their portcos to achieve top line growth and grow EBITDA (earnings before interest, taxes, depreciation, and amortization) included:

i. **Accelerating scaling** – Usually most PE-funded companies tend to achieve top-line results through inorganic growth, i.e., making add-on acquisitions to the existing business. Based on a study(2) PE backing increases the expected number of acquisitions by as much as 84%–99%, as compared to non-PE backed companies. This PE-induced boost is short-lived, with the average number of acquisitions per year reverting to prebuyout levels within 4 years. Additionally, many of the businesses tend to struggle with inorganic growth, to successfully leverage the benefits of the acquisitions to scale the business.

ii. **Leveraging technology to optimize performance** – Most portcos have attempted to maximize performance leveraging the traditional technology stack but have not been very successful. According to an HBR report (3) while 89% of companies globally use technology to transform and grow their business, they have only captured 31% of the expected revenue lift and 25% of expected cost

savings from their efforts. Additionally due to the rapid pace of acquisitions, the leadership team of portcos often do not have bandwidth, time, and resources, to effectively integrate the acquired businesses and are left with multiple technologies and solutions that do not seamlessly work with each other.

Leveraging AI as a Game Changer for Growth

Given the slowdown in pace of acquisition, we believe that Artificial intelligence (AI) has the potential to be the game changer for investors to grow revenues from their portfolio companies, by using the technology to ***create new revenue streams***. In addition to generating new revenue streams, AI can also transform ***traditional businesses into data businesses*** and increase the ***EBITDA multiple*** for future transactions. Additionally, AI can be used to augment human capabilities by providing insights, recommendations, or assistance that can improve decision making, enhance productivity or performance, and create new products or services that can meet customer needs or solve customer problems in novel ways. For PE-funded companies, some examples of using AI to generate additional revenue streams from traditional businesses are:

- A PE firm invested in a ***utilities' services business*** that is a provider of comprehensive transmission and distribution services to the utility industry, such as engineering, procurement, and construction of transmission and distribution, substations, underground cables, etc. The investor recognized that the firm was gathering significant amounts of data that would be valuable to their customers and leveraged drones to gather data on the status of the substations and cables. Using AI, the team was able to convert the information gathered into actionable insights, which were useful for the utility company, to track areas that would require the services of the provider. The services firm was able to provide a much more valuable deliverable to their utility clients and significantly differentiate themselves in the market. In addition, they built a proprietary data set that was of interest to utilities outside of their geography – either to run their own data through the algorithm or purchase it in order to mine for new predictive maintenance-related insights. What began as a traditional construction firm has now evolved into a data firm, and they have increased their valuation through the creation of a technology product with associated client services.

- A PE-funded (and now public) sleep mattress company embedded proprietary technology into each of its smart beds. Its proprietary, dynamic algorithm measured sleep time, restful and restless sleep, average heart rate and respiratory rate and gathered billions of longitudinal biometric and sleep data points from real-world sleepers. The goal was to use the proprietary biometric data collected by the smart beds to benefit consumers and aid them in general wellness and chronic sleep and health-related ailments. The company offered customers the ability to combine that with an individual's wrist tracker to generate personalized insights and create an additional revenue stream in doing so.
- A multi-owner global beauty products manufacturer has long used weather and sales data to predict geographically specific buyer purchase trends. They were an early adopter of enriching their data sources with social media and sentiment data mined from the internet. They further enhanced their historic data sets with financial and macro-economic trends and developed machine learning algorithms trained on that data and have greatly improved consumer demand predictions based upon how event combinations affected sales. Material side effects for them were the cost savings due to lower reliance on overstocks as well as providing the in-house analysts with better forecasting and analysis tools, facilitating strategy development.

Since most portco leadership teams are busy growing their business, PE firms have the opportunity to guide portco leadership to think outside-the-box and transform themselves into data-driven businesses and increase EBITDA multiples and profitability. For each portco, to ensure a successful transformation the PE firm should ask the following questions:

1. What are the areas where AI is likely to unlock value, prioritized by potential ROI?
2. Given the speed at which AI adoption is taking place, and where the portco is on the AI maturity curve, what would it take to up-skill the right workers to work effectively with these new tools?
3. Overall, how do we create an AI-enabled strategy, by business, and what pieces can be leveraged across the portcos?

Approach to Leveraging AI for Growth

These questions are unique to each PE firm and the companies in their portfolio and are influenced by a different mix of variables. Working with an experienced partner and using a consistent framework has the potential to accelerate speed to value and address risk along the way. We recommend a three-step process to execute on this approach:

1. **Bring in Subject Matter Experts** - The investor would need to acknowledge that the capabilities to leverage data science to create an additional revenue stream may require bringing in a SWAT team of experts in business strategy, artificial intelligence, and data science, to create the solution.
2. **Execute AI strategy for a couple of portcos** – Have the team examine the business of one of the portcos:
    i. ***Conduct External Market Analysis*** - Examine the business environment of each of the portfolio companies, to identify the shifts in their customer needs, competitive landscape, regulatory environment, innovative technologies, etc. Ascertain the opportunities provided by these market shifts, existing gaps in data and knowledge needs to run the business more efficiently and how your portfolio company can fulfil those needs. The key is to relentlessly focus

on understanding consumer needs, identifying "unmet" needs and then determining optimal ways to meet them.

ii. ***Internal Business Review*** - Work with the C-suite of each portfolio company to share the information gathered from the market analysis. Combine those insights with the internal maturity level and available technology footprint to leverage investments that have already been made. Identify the potential product offering that could be developed given the existing resources and target client base of the portco, the type of data gathered and the ability to harness the data, ensuring that all legal, risk and regulatory issues are taken into consideration.

iii. ***Create AI-enabled Solution for Portco*** - Once the SWAT team is able to create the solution for one portfolio company, the option exists to replicate the success to other companies in the portfolio. GPs will need to determine how to manage the delicate balance between ensuring that firm leadership continues to stay focused on driving the growth strategy to achieve the desired returns, while working with the SWAT team to generate add-on revenues.

3. **Replicate for future investments –** Have the SWAT team develop a playbook for transforming traditional businesses into data-enabled businesses for use in future investments.

Conclusion

Speed is of the essence. All businesses are trying to gain the AI advantage, but we are still in the early days. Most firms have not been successful in unlocking the value AI represents. The focus of every PE firm should be to take advantage of opportunities in the current environment with an eye towards identifying the right opportunities within each portfolio company as well as having a relentless focus on growing revenues for their entire portfolio. Bringing in the right expertise to assist in the process will enable you to make informed decisions while accelerating growth.

In conclusion, there is no single approach for a PE firm to take to position its portfolio for success. The approach that the PE firm takes would depend on the companies in its portfolio, their market position, products, and services offered, business model, leadership team, growth potential, and the vision that it has for its entire portfolio.

To discuss this article further, or for additional information, please contact us at nsanger@ideainnovate.com or Xena@genrexconsulting.com.

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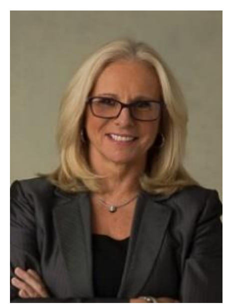

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