PRIVATE EQUITY INSIGHTS | MOONFARE

# Navigating Private Equity

Value Creation Primer

# Private Equity's Sustainable Value Creation

Since the private equity heyday of the 1980s, when financial engineering ruled the playbook for this novel type of investing, a lot has changed.

This white paper outlines this shift and explains the way the industry developed, diving into the intricacies of private equity value creation. Our thesis is simple, that there is a fundamental difference between strategies that directly alter the operating dynamics of portfolio companies and other types of value creation, such as leverage and multiple expansion. The difference lies in the fact that successful operational value creation drives persistent returns.

We present private equity's value creation strategies in four sections:

1. What Makes Private Equity Unique?
2. Private Equity Focusing on the Fundamentals
3. Persistence in Value Creation
4. Case Study: Phadia

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# What Makes Private Equity Unique?

Private equity is a unique asset class, often distinguished from public equities due to the asset's illiquidity. This illiquidity has a clear rationale and direct consequences.

A fund lifetime of 10 years allows private equity managers to maintain a multi-year horizon for their investment thesis to play out. In turn, private equity managers' control position and active ownership of underlying companies materialize over an extended timeline, allowing better alignment interest between shareholders and management.

How do private equity funds create the value increase identified in their investment theses and how are they often able to outperform public markets?[1] In general, sources of value creation can be divided into three categories:

**1. Operational Improvements**
Successful private equity managers often apply their deep industry and functional expertise to make substantive operational changes and improve a company's efficiency and bottom line. Such improvements translate into value creation via revenue growth and margin growth, thereby driving increases in EBITDA. Some of the most important operational adjustments a GP can make to improve organic revenue growth are optimizing the supply chain, implementing more effective pricing, revamping marketing strategies, and driving international as well as digital expansion, among others.

1. Operational Improvements

$$\frac{\textit{Enterprise Value}}{\uparrow \textit{EBITDA}} \Rightarrow \uparrow \textit{Financial Value}$$

**2. Multiple Expansion**
There are two main ways in which private equity managers can create value through multiple expansion. First, managers may attempt to increase the valuation multiples of their underlying assets through strategic re-positioning. This includes growing synergies and market share through mergers & acquisitions as well as increasing efficiencies and management focus through carve-outs and spin-offs. In addition, managers can drive multiple expansion via market timing. This strategy depends on the regions and sectors in which the manager chooses to deploy capital and the timing chosen for exiting the underlying deals. This type of value creation leads to gains via improved valuation through growing the EV/EBITDA multiple at which the underlying asset is valued.

2. Multiple Expansion

$$\uparrow \frac{\textit{Enterprise Value}}{\textit{EBITDA}} \Rightarrow \uparrow \textit{Valuation Multiple}$$

**3. Leverage Effect**
The use of leverage is a third method for creating value within portfolio companies. By financing a proportion of the acquisition through debt, a generally less expensive source of capital, fund managers enhance the return on equity for investors. In successful deals, and as management de-leverages the company over time, the equity value owned by the fund grows in proportion.

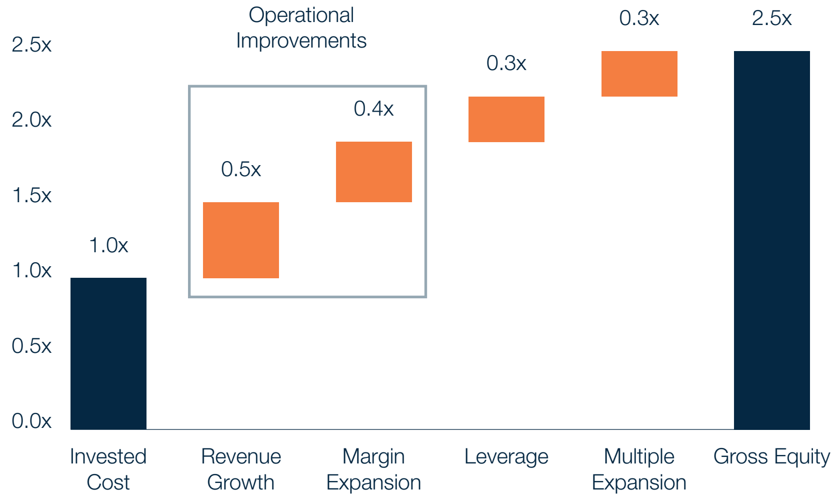
3. Leverage Effect

$$\textit{Return on Assets} \times \uparrow \textit{Financial Leverage} \Rightarrow \uparrow \textit{Return on Equity}$$

1 As of Cambridge Associates' Q3 2019 index figures, the Private Equity Index has outperformed the S&P 500 by 5.9%. Please refer to the Cambridge Associates report for further info on the calculation methodology.

A hypothetical value bridge of a private equity fund is shown in Figure 1, whereby the 2.5x Gross Multiple of Invested Capital (MOIC) realised through the life of the fund is attributed to the three categories. The graph shows that from the invested capital, a gain of 0.9x is attributed to EBITDA growth, a gain of 0.3x to leverage, and a gain of 0.3x to multiple expansion.

**Figure 1:** Indicative Value Creation Bridge




Note: Illustrative numbers

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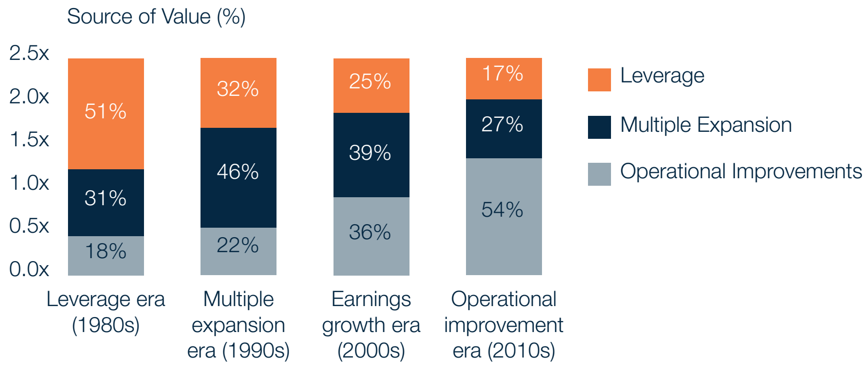
# Private Equity Focusing on the Fundamentals

In the wake of strong competition and rising valuation multiples, successful fund managers have differentiated themselves by focusing on operational value creation, as a more persistent and replicable way of creating value within their portfolio companies.

Research carried out by BCG and IESE sheds light on these shifting priorities, indicating the change in value attributed to leverage, multiple expansion, and operational improvements (see Figure 2). Since the 1980s, when leverage contributed over half of the value creation, there has been an evident trend towards operational improvements – despite a strong availability of debt as well as a low interest rate environment.

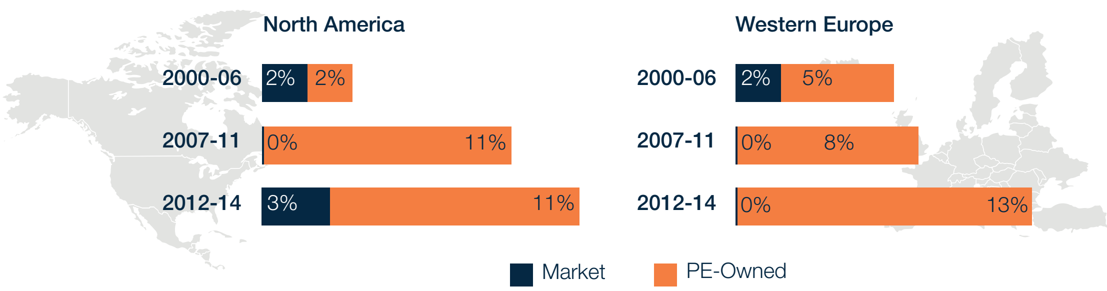
Not only have private equity fund managers shifted their attention to operational value creation, their capacity to take active ownership and leverage their informational advantage has also resulted in consistently higher revenue growth compared to broad market trends in both North America and Western Europe (see Figure 3). One hypothesis is that this is why private equity has outperformed public markets across most time horizons and why, in our opinion, it is likely to continue to do so.

**Figure 2:** Private Equity has Shifted Away from Leverage As Share of Value Creation




Sources: Goldman Sachs; BCG-IESE estimate

**Figure 3:** Revenue growth of PE-owned companies compared with underlying market growth




Source: CEPRES, IHS, Bain analysis

We can see the shift to operational value creation and top-line growth over the past decades. A natural question is whether the development is a strategic evolution of the industry or if the development is less well-founded. Both leverage and multiple expansion prove to be skills that are heavily dependent on the ability to time the market, a skill that has been proven to be extremely difficult and unreliable. On the other hand, the skill required to improve a company's bottom line is operational in nature and qualitatively different.

# 3

# Persistence in Value Creation

Whilst the persistence of performance in private equity funds is a highly debated topic, research has shown that only operational improvement is a replicable source of value creation as compared to the other performance components.

## "Only operational improvement is a replicable source of value creation"

One such study, conducted by Dr. Gottschalg of HEC Paris, explored the different performance components' impact on persistent value creation amongst 1,119 private equity funds. The study proposed a novel methodology to measure a private equity fund's performance, by comparing data on tens of thousands of underlying investments and controlling for three different factors: the time period in which the funds were raised; the timing of the investment deals based on acquisition years; and the sector, size and geographic location of the underlying target companies.

Controlling for fund vintage, the other two factors enable the evaluation of peer funds across two of the most important investment decisions of a private equity firm: the *When*, i.e. how is capital deployed over the investment period of the fund; and the *What*, i.e. what type of investment targets were acquired. These two factors comprise what we call the strategic positioning of the fund.

Gottschalg's study, therefore, assumed that the difference in performance between funds with similar *Whens* and *Whats* must be attributable to the *How*, i.e. the operational improvements implemented by a fund manager which enable the fund to differentiate itself from its peers and hopefully outperform.

**2.03x**

net portfolio return if an investor would have picked 25 of the 257 funds studied by Gottschalg using only those with the highest previous "implementation-based" returns

Gottschalg found that fund managers differ most in their ability to create value during the "implementation phase", which refers to the phase in which operational improvements are affected at the company level. The research concluded that a statistically significant positive performance persistence occurred only in the implementation-related performance component. Conversely, after controlling for other factors, timing and strategy had no significant or even positive level of persistence.

The impact of this factor is profound; had an investor picked 25 of the 257 fund pairs studied using only those whose previous fund iteration had the highest "implementation-based" returns, the portfolio would have yielded a total value to paid-in (TVPI) multiple of 2.03x, which is significantly higher than the sample average TVPI of 1.73x. Given the large returns dispersion between median and top quartile funds - which on average since 2000 (based on Cambridge Associates' Q3 2019 index figures) have amount to a larger than 7% IRR difference - even small improvements in fund selection can have a notable impact on a portfolio's expected risk-return profile. In other words, managers that have proven they can roll up their sleeves will be in position to separate their funds from the rest of the pack.

**Figure 5:** Improved fund selection based on operational value creation

TVPI performance


Average sample of 257 fund pairs

The average subsequent fund of the 25 funds with the best operational value creation

Source: Gottschalg, 2016

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# Phadia Case Study

Based in Sweden, Phadia is a leading in-vitro allergy diagnostics and autoimmunity diagnostics business. Private equity firm Cinven acquired the company in 2007 with a strategy to assist Phadia in growing its core business in order to reach its full strategic and operational potential.

Under Cinven's ownership, Phadia transformed into a global leader in the healthcare sector by the time the company was acquired by Thermo Fisher in 2011. Cinven accomplished this through a programme of investments in people, geographic expansion and products.

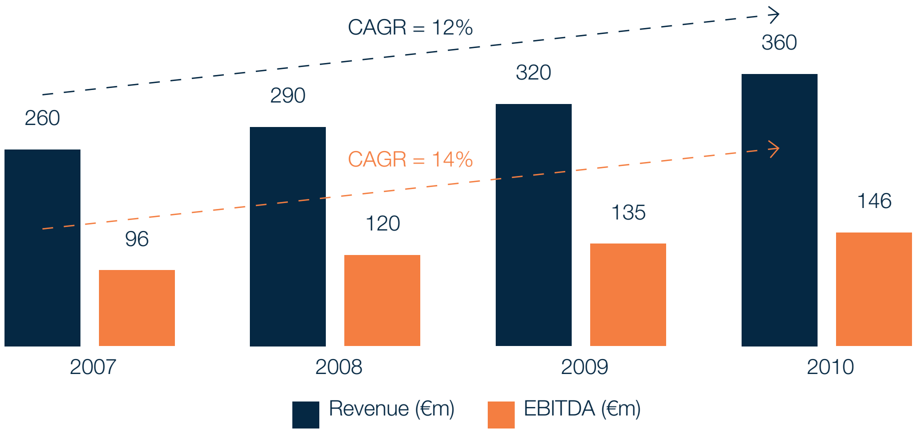
— The roll out of Phadia's full product suite and revamped marketing campaigns in the U.S. was accompanied by an expansion and optimization of the U.S. sales force from 40 outsourced representatives at acquisition to nearly 200 representatives at exit. As a result, U.S. sales grew at a 23% CAGR since 2007-2011.

— Cinven's Asia team developed a number of initiatives, including the acquisition of Phadia's main distributor in China and a roll out of products in India.

— In 2011, Cinven's investment into product development led to the release of two new allergy and autoimmunity testing instruments. Capable of combining allergy and autoimmunity testing, these new allergology technologies delivered a throughput 4 to 5 times higher than any other combined instrument at the time. This was one of the many ways Cinven aided Phadia in meeting high volume clinical laboratories demand with shorter lead times and higher efficiency.

These initiatives successfully translated to building Phadia into a lucrative business and attractive target. During Cinven's ownership, EBITDA increased by over 50% from €96m to €146m, despite operating in a recession. In a strategic move by a leading biotech product development company, Thermo Fisher acquired Phadia in 2011 - a testament to the significant value Cinven had helped create. The €2.47bn sale of the company resulted in a €1bn capital gain and 3.4x return for investors. Value created: check.

**Figure 6:** Phadia's revenue and EBITDA growth during Cinven's ownership




Source: Invest Europe: Phadia Case Study

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