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How to 'value-add' your storytelling

Investors want GPs to go beyond the numbers when hearing fundraising pitches. Duff & Phelps directors PJ Viscio (pic) and George Pushner explain how fund managers can both create and communicate their value-add capabilities.

For many private equity firms, the challenge of raising capital has not become any easier. Limited partners bring more sophistication, awareness, and diligence to their investing activities, even forming member-driven organizations (i.e. the Institutional Limited Partners Association) to advance their collective interests. While still a bottomline business, there is little dispute that LPs are demanding more transparency from General Partners into how value is created.

Specifically, with respect to manager selection criteria, how a GP creates value is becoming increasingly important. And while selection and deleveraging continue to constitute important sources of returns, investors are increasingly monitoring and measuring the GP's ability to build better (and more sustainable) businesses through operational and/or strategic value-add. This evolution mirrors investors' increased awareness of value-for-fees as well as responsible investing concerns.

The benefits to GPs are clear: if investors have a better, more informed sense as to how the GP creates value, then it stands to reason that investors will be more invested (literally and figuratively) in the GP's overall investing approach and ability to generate future returns.

Our experience and research suggests that the industry convention of attributing created value to changes in EBITDA, the multiple, and net debt, while readily calculable and familiar to investors, provides an incomplete picture to evidence post acquisition value-add on the part of the GP. EBITDA, for example, can be purchased rather than created. Similarly, valuation multiples can decline as a result of a variety of disparate reasons, including a successful execution of growth strategies, a deterioration of growth prospects, or an increase in market rates of return.

In seeking to identify and communicate the metrics of value-add "beyond the numbers", GPs face several challenges: (1) providing a sufficiently detailed attribution analysis to cull out changes in value attributable to macro factors, as well as selection and deleveraging in order to isolate company-specific value change drivers; (2) separating the organic company specific drivers from those that are transactional (i.e. created vs. purchased value change drivers); and (3) communicating the results in a meaningful, but not overwhelming, fashion to investors.

Importantly, it need not be a herculean feat for GPs to meet (and overcome) these challenges. Our experience suggests that there are three critical analytical steps required to assess GP value-add:

1. Deconstruction of the apparent value change drivers (i.e. changes in EBITDA, multiple, and net debt) into their primary components: changes in revenue, margin, cost of capital, growth profile, as well as a number of capital structure and balance sheet items;

2. Integration of portfolio company performance benchmarking analysis to separate the impacts of industry and company-specific value change driver ; and

3. Analysis of value change driver impacts stemming from add-on acquisitions.

If appropriately presented, this analysis can be an effective complement to and validation of the GP's narrative of their value creation programs, mapping the value creation impacts of specific value change drivers to specific initiatives or sets of initiatives (e.g. marketing initiatives, cost reduction initiatives, productivity improvement programs, product mix changes, market expansions, etc.). Combined with the GP's narrative, the presentation of the results of this "deep dive" can be a

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powerful transparency enhancement tool to communicate to investors and/or prospective investors exactly how value was created, on an investment-by-investment basis.

To that end, the "deep dive" results can be grouped and aggregated by what we consider to be the four fundamental sources of value creation: (1) Industry/Sector; (2) Capital Markets (Beta); (3) Deleveraging; and (4) Unique (Alpha).

(Capital Markets (Beta) reflects value changes resulting asset inflation/deflation as required market rates of return fluctuate over time. Unique (Alpha) is the net value creation not attributable to the other sources and represents the best indication of operational and/or strategic value-add.)

By attributing created value to its four fundamental sources, GP's can provide meaningful insight into the valuation creation process to investors and prospective investors on an investment-level basis. The GP can present the amount of value creation in each of these categories, both in absolute and percentage terms, and the investor can then get an indication of how much of the created value may be due to GP efforts and industry selection vs timing, deleveraging, and post-acquisition operational and strategic efforts.

Annotated results of the "deep dive" analysis can complement attribution to fundamental sources by providing detail and narrative support. And attribution to fundamental sources can provide a reasonable basis for comparison across investments. As the analysis can be aggregated in a variety of ways, it also has the potential to provide meaningful comparisons across funds, vintages and geographies, as well as across GPs.

As investors demand greater transparency into value creation, it is a challenge to present the required detail in an insightful manner. By separating out industry and capital market movements and historical debt repayment, the alpha value creation that remains may provide telling evidence of GP value-add.

PJ Viscio is a managing director, and George Pushner is a director, in the New York office of Duff & Phelps, a valuation services provider.