



Maximum Value Creation: Creating a Competitive Advantage for Private Equity

In today's challenging environment, PE funds are turning to innovation to create value.

While incremental innovation increases earnings by keeping product lines fresh, disruptive innovation increases the multiple at exit by broadening the range of suitors.

One group has been honing a method of commercializing innovations quickly and successfully. It's a technique that can help PE managers get the returns they seek.



INNOVATION TRANSFORMERS LLC
Transforming Inventions Into Commercial Success

Creating a Competitive Advantage for Private Equity Portfolios

Returns for private equity funds are being squeezed.

As investors seek strong returns despite weak economic growth around the world, private equity funds are in a new, more challenging era. The easy deals have all been done and there are too many funds chasing too few targets.

Funds have high levels of uninvested cash or “dry powder.”¹ This is true even for funds that are well along in their life spans. Bain & Company estimates that there is enough dry powder to support 3.1 years of investment activity.² All this money continues to push up acquisition prices, with multiples reaching above eight times EBITDA in some sectors.

This often extends the holding time for an investment while the fund waits for the company’s performance to gradually improve or for equity values in the market to catch up with an acceptable valuation. According to Preqin, funds are now holding onto investments for an average of 4.9 years, up from 3.9 years in 2008 (Figure 1).³

It has never been harder to develop a viable investment thesis.

Moving beyond operational and financial techniques.

There are two main levers to impact the return on an investment in a company: improve its **earnings** (EBITDA) or improve the **multiple** that acquirers are willing to pay upon exit. Management techniques have historically focused on the earnings lever:

First, companies are managed for operational excellence: managers watch all key performance indicators on the sales and revenue side while closely managing gross margins, G&A expenses, and CAPEX.

Beyond this, managers make acquisitions to bolster earnings—often successfully: EY says that bolt-on acquisitions accounted for 26% of EBITDA growth in private equity portfolio companies from 2006-2012.⁴ But these efforts generally stay close to the company’s core markets.

As private equity matures, the next strategy for improving a company’s earnings is to use innovation to fuel growth. Everyone *wants* innovation, but it is notoriously hard to pull off. Accenture recently described the two most common innovation pitfalls: focusing only on conservative line extensions, or “renovation;” and the “invention trap.”⁵ Renovation brings small improvements and correspondingly small returns. Companies caught in the invention trap place too much emphasis on generating new ideas without creating the supporting processes that enable new ideas to become commercial realities. As Kodak found in digital photography, the right new idea still won’t fly if the company does not provide the right ecosystem to roll it out.

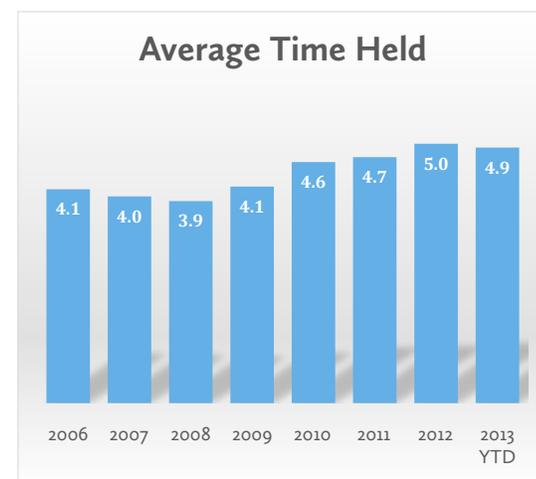


Figure 1: Average Holding Period for Private Equity-Backed Portfolio Companies by Year of Exit (Source: Preqin)

¹ Duong, Jessica, “Too Much Dry Powder, Too Few Deals?” *Private Equity Spotlight*, Preqin Ltd., September 2013.

² *Global Private Equity Report 2013*, Bain & Company, Boston, February 2013.

³ Parker, Jonathan, “Private Equity-Backed Portfolio Company Holding Periods,” *Private Equity Spotlight*, Preqin Ltd., May 2013.

⁴ *Clear Direction, Focused Vision: How do private Equity Investors Create Value? A Study of 2011–12 North American Exits*. Ernst & Young, 2013

⁵ Koetzier, Wouter and Adi Alon, *Why “Low Risk” Innovation is Costly: Overcoming the Perils of Renovation and Invention*, Accenture, 2013.

When it's done right, innovation can succeed in PE timeframes *and* improve the exit multiple.

A successful innovation can bring new revenue and profits. A successful *disruptive* innovation takes a company even further, changing its competitive profile and causing many more companies to be either interested in, or threatened by the new development. This brings more suitors at the time of exit, extending all the hard work on EBITDA performance by applying a higher *multiple* to the exit transaction.

But organizational issues can impede the launch of disruptive innovations. These initiatives represent either a new business model a new market segment. Core businesses are managed very tightly; there is no slack left in the modern company. People don't have time or incentive to go beyond their prescribed goals—their annual MBOs. To make disruptive innovations work, businesses need a new technique.

Innovative Acquisition

The state of the art in disruptive innovation has been evolving.

William V. Hickey, CEO of Sealed Air through 2013, has had a long history of encouraging innovation. He championed and cultivated a freelance team of external innovators to “generate platform or *breakthrough innovations*.”⁶ It was in this external team that the process of Innovative Acquisition was developed.

Several pressures caused the evolution in this team's core activities from simply developing products to creating and executing new business strategies. First, Hickey and VP Larry Pillote mandated that all new innovations should focus on a *service business model*, rather than on the sale of products or equipment. Second, while the goal was to create breakthroughs, the existing business units were managed to be very tightly focused—too focused to support or sustain these novel initiatives. And the third pressure was the universal need to make innovation happen more quickly.

In 2009, one of Pillote's external innovator teams found itself trying to get traction with new business models but unable to count on existing resources within the company to launch the new offerings. They had to find a new way.

Enter the acquisition strategy.

The “outsider” status of this team gave them a unique and useful position. They were accustomed to forming relationships with contributors and suppliers. They enjoyed considerable autonomy and an ability to move around in the market without arousing much notice, so they were much more nimble than any company personnel could ever be.

Team members realized that the best way to launch an innovative new business for their client would be to acquire a small company in a space close to the new idea. Small size was important because the new business idea was going to be “implanted” into the acquired company. Nobody expected to find an exact match; the target company's connections and capabilities were the important things.

But would the entrepreneurs at the target company embrace the new idea? Surprisingly, the innovation team found that to the extent that the new idea made sense, people at the target were ready to get on board with it. They were in fact energized by the prospect of getting the resources to grow in their market.

Following this path, the team added **acquisition** to its already robust **innovation** process. Innovative Acquisition also addressed the speed-to-market pressures by minimizing the inventing and instead relying on the “10,000 hours” of experience already built by the entrepreneurial target companies.

The team described above is now working with Innovation Transformers, applying these principles with private equity funds and their portfolio companies. It takes a unique combination of experience, vision, creativity, customer insight, and relationship building to accomplish the critical steps of the process.

⁶ Ofek, Elie, “Sealed Air Corporation: Deciding the Fate of VTID,” *Harvard Business School Case #9-512-0259*. Harvard Business School Publishing, Boston, 2012.

Innovative Acquisition Described

Discern the Company's Core Identity – The portfolio company's identity and position in the market are the starting point for developing a breakthrough business idea (rather than focusing on its core technical competencies, which pulls thinking backward toward the past).

Innovate a New Business Model – This is the heart of improving exit multiples. A new, disruptive approach in the market will draw the attention of competitors. Today, this often involves switching from a product sales model to a service model, with recurring revenues secured by high-value, proprietary activity at customer sites. This takes companies away from pressures of commodification and keeps them connected to the pulse of customer needs. Business models also include innovative revenue structures such as pay-per-use.

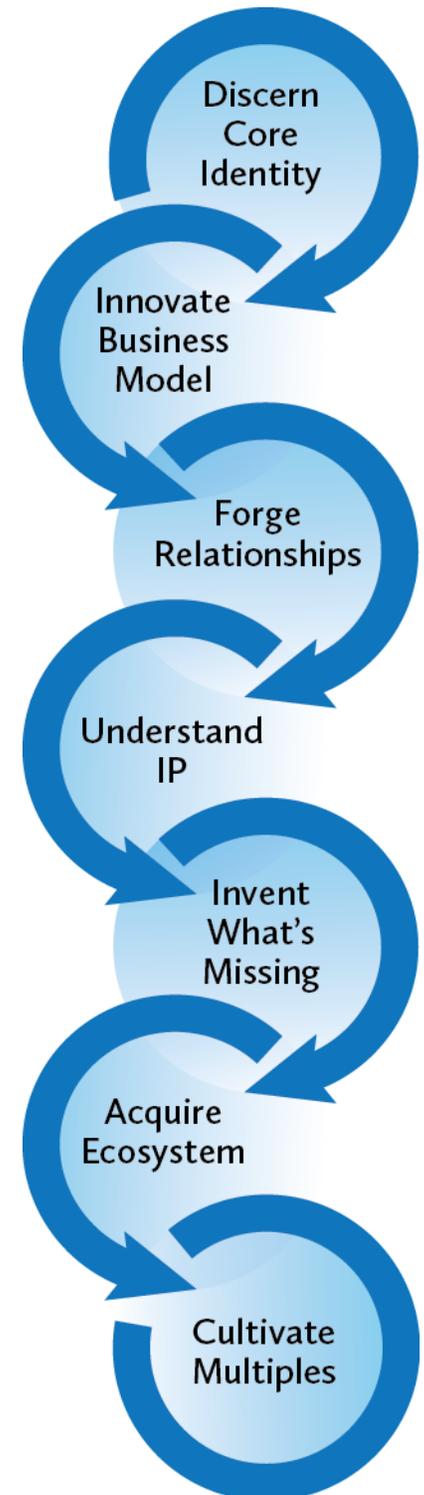
Forge Relationships with Partners – Commercial success requires a great relationship with acquisition targets and other partners. An external innovation team has a great advantage in building these relationships because team members can approach the target at arm's length from the client company. They can engage in a partnership to describe a value to the client along the lines of, "We're not sure if XYZ will go for this, but if we can describe a good business model, we can present it together and maybe XYZ will buy your company." The relatable size and the persuasiveness of the innovation team facilitate trust and ultimately make a transaction more collaborative.

Understand the IP Landscape – Since the external innovation team comes from a product development background, they have extensive ability to research, understand, and report on the IP surrounding an idea. Armed with a good understanding of the state of the art, they work around existing IP as they develop the idea. This also identifies potential competitors and partners. The strategy is to build an IP fence around the new ideas.

Invent What's Missing – (And *only* what's missing!) A key to speeding up commercial success is to avoid inventing new technologies as much as possible. The first focus is on finding the right complementary partner. But in the pursuit of a new business idea there is usually some part that needs to be created. This is not a problem for a seasoned innovation team.

Acquire Entrepreneurial Ecosystem – As mentioned earlier, an idea can't fly without a support system around it. The new idea is launched via the acquisition of a small company—one with which the innovation team has built a relationship. This provides the talent, focus, and market channels needed. The venture gets its support system and the client company finds itself up and running with a new business model or in a new segment.

Cultivate Multiples of Value – Disruptive innovation will attract interest in the market. The team works to cultivate this effect and enhance the exit strategy of the portfolio company.



A Path Forward

To increase success, private equity firms can leverage this learning.

Everyone employs operational and financial techniques to improve EBITDA, but those techniques just don't go far enough toward creating value in today's tough environment. Innovation is the next frontier for improving returns.

Moreover, disruptive innovation is desirable because it can change the competitive profile of the company thereby increasing the multiple paid on exit.

As described earlier, launching a new business or entering a new space isn't easy. Organizations lack agility and resources to move beyond their prescribed goals.

Innovative Acquisition offers a path forward. This technique infuses new, relevant ideas into manageable-sized acquisitions, minimizing risk and launching businesses in record time.

About Innovation Transformers LLC

Innovation Transformers LLC creates new value for its clients by bringing together the right people for each situation, including the teams described in this article. Larry Pillote founded the company to bring the business innovation experience he built inside a \$7 billion company to investors who are looking for an edge in creating value.

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