The Value Creation Imperative:

Shifting Market Dynamics & Playbook Essentials

Shifting dynamics in the Private Equity (PE) market have led to the consensus that the past decade's returns through existing channels, primarily driven by multiples expansion, will not be replicable in the coming years.

According to McKinsey's 2024 Global Private Markets Review, approximately two-thirds of the total return for buyout deals executed between 2010 and 2021 (and exited before 2021) can be attributed to market multiple expansion and leverage. However, with declining multiples and interest rates remaining higher for longer, this trend is unlikely to persist.

Shifting Market Dynamics

Three major factors are contributing to the emergence of a new value-creation paradigm shift in PE markets.

1. Valuation Expectation Gaps: There's a significant valuation gap in the current market between buyers and sellers. As multiples have decreased, the enterprise value of portfolio companies (PortCos) has also declined. Consequently, even if a company is performing well, its value may erode over the holding period.

   On the other hand, there are buyers with substantial funds who are interested in making acquisitions but are unwilling to pay a 10x multiple when the market is trading at an 8x multiple. As a result, transactions are only occurring with the highest-quality PortCos that can still command a 10x multiple. However, multiples aren't anticipated to rebound quickly, perpetuating a cash cycle characterized by fewer transactions and less capital available for investment.

2. Higher Cash Costs: Interest rates are projected to remain higher than historical averages for an extended period. Despite ongoing speculation about potential rate cuts from the Federal Reserve, the last rate change occurred in July 2023, and the last decrease was in March 2020, over four years ago.

   These rates have been steadily increasing since 2022, contrasting sharply with the significantly lower rates of the previous decade, which made it easier to use leverage to acquire PortCos without requiring a high multiple. However, the current federal funds rate of 5.25-5.50% presents a significant challenge in generating the necessary returns.

3. Macroeconomic Instability: Macroeconomic trends and instabilities, such as an election year and political instability, add another layer of complexity. These factors make it even less likely for the PE market to revert to its state a few years ago, and we can't expect valuation multiples to jump back to previous levels. Without the ability to use financial leverage as effectively as in the past, the path to portfolio growth becomes more limited.

So, without the ability to rely on multiple expansion or financial leverage against low interest rates, what options remain? If PE leaders expect to achieve returns similar to those seen historically, value creation is the only path forward.

The value creation imperative

Value creation is the new foundation of successful PE strategies. As the window for leveraging market conditions narrows, the focus must shift towards making significant improvements within PortCos through revenue growth and margin expansion.

> **"To ensure that distributions are flowing back to limited partners (LPs), businesses need to be on track for margin expansion. Multiple expansion isn't something we're seeing in the market right now. The only other viable option is to ensure margin expansion that aligns with the equity story. Private equity firms must do everything possible to support their portfolio companies."**
>
> \- Joshua Maxey
> *Co-Founder, Third Bridge*

There are three ways to grow margins: cutting costs, selling more, or raising prices. Each method can add value to the bottom line, but not all are created equal. According to the renowned McKinsey study cited in Harvard Business Review's article Managing Price, Gaining Profit, pricing is the most significant profit lever a company can pull. A 1% price improvement yields an average 11.1% increase in operating profit.

Strategic pricing

Price increases can be challenging for a company to execute, especially in a softening economy. However, achieving a 1% price improvement doesn't mean raising every customer's price.

There are likely subsets of the business that are less profitable than the rest. Finding and addressing these trouble spots can improve profits by 1% or more. Actions can range from targeted price increases and selling a more favorable product mix, to more aggressive measures like firing unprofitable customers.

Additionally, industrials often give sales reps significant pricing autonomy to close deals. This can lead to reasonable average selling prices but significant price variations at the individual deal level, causing companies to lose potential profits.

Listed prices may not show the whole picture. Favorable discounts, terms, and rebates can lower realized prices and profitability. Eliminating excessive concessions can easily yield a 1% improvement.

What lies ahead

While holding periods traditionally provided for multiples expansion, they now serve as a limited window to execute value-creation strategies. As a result, PE firms must prioritize initiatives that will have a rapid impact.

Strategic pricing is a pivotal value-creation strategy for PortCos, directly impacting their profitability and market competitiveness.

In a market landscape where traditional expansion strategies falter, strategic pricing provides a robust alternative, emphasizing operational excellence and targeted management of pricing structures to boost overall financial performance.

Untapped Value Potential

Many Private Equity firms are missing out on the most effective lever for creating value.

While it's true that some firms have already realized the benefits of strategic pricing — achieving significant profit growth and margin expansion — many, especially those with Industrials companies in their portfolios, have not yet capitalized on this opportunity.

By underestimating the power of pricing, firms may be undervaluing their assets and risk overlooking a proven strategy to enhance portfolio company performance and exit multiples.

Increase profit

There's no lever more effective for driving profit improvement than pricing. In fact, it's at least 50% more effective than traditional cost-out or share-gain strategies, according to a study published by the Harvard Business Review. Not to mention, it's measurable and fast to realize, making a focus on pricing a no-regrets decision.

Pricing has a direct impact on a company's bottom line, and even a small pricing inconsistency can significantly impact profits. This is because pricing isn't just about setting a number, but rather understanding the value of a product and how customers perceive that value. With the right pricing strategy, PortCos can capture more value from their products, increase their margins, and ultimately drive higher profits.

Pricing strategies can also be implemented relatively quickly, allowing PortCos to see a return on investment in a shorter amount of time compared to other value-creation strategies. This makes a focus on pricing a smart and effective choice for PE firms looking to improve their PortCos growth potential and performance.

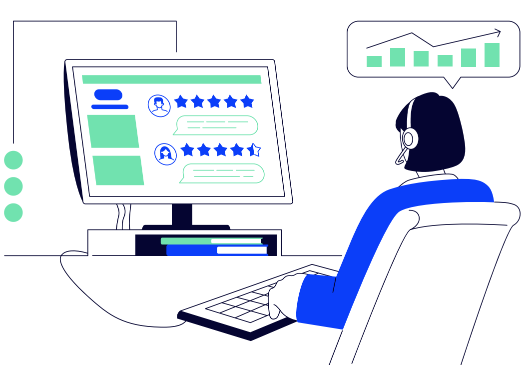
Build commercial maturity

When exits finally pick up, those best positioned to reap maximum valuations are those most able to demonstrate consistent, profitable growth. Yes, past performance is a big element of that equation, but more so is go-forward potential.

Companies with a robust pricing strategy backed by reliable capabilities and processes will be best positioned to support projections of continued, and more importantly consistent, profitable growth. However, PortCos that rely solely on a one-time pricing study or annual price increase to satisfy a pricing requirement are omitting the ongoing measurement and refinement of a comprehensive pricing strategy — and are likely leaving money on the table because of it.

Improve customer satisfaction

When sales efficiency suffers, the market-facing implication is concerning for customers. Poor pricing can mean it takes weeks to produce a final customer-ready quote. This frustrates customers — "How can you not know the price of your own product?" – not to mention putting many deals at risk.



It shouldn't be that hard, or that slow. To build trust, customers want to feel that the prices they're quoted are fair and consistent, rather than feeling like the sales representative or channel determines the price. If a PortCo serves customers across multiple channels, any disconnects in pricing can further erode customer trust.

Reduce manual work

Mid-market industrials businesses prioritize efficiency, but challenges with data handling and reliance on manual systems can complicate price setting and execution, especially for leaner companies.

For instance, consider an $180M polystyrene manufacturer where the senior vice president of sales and marketing manually sets prices. This requires them to spend a significant amount of time each month pulling multiple reports to monitor pricing trends, and can only be done at a high level given the scale of the business. For PortCos in this situation, having more automated processes and less manual work is crucial to freeing up the executive team's time so they can focus on strategy and execution to drive the business forward, rather than manually creating a Cost+ pricing model.

Mitigate business risk

Over the past few years, there's been an unprecedented level of uncertainty and volatility that most people can't recall in their professional lives. There's a general consensus that things won't "return to normal" anytime soon, whether it concerns cost stabilization, supply chain shifts, or macroeconomic and political factors.

However, having a robust pricing capability in place enables businesses to stay attuned to market dynamics and proactively adapt and respond over time. This empowers businesses to make pricing changes that drive growth rather than reacting to factors like cost reductions when customers request concessions.

Pricing is the value creation lever PE leaders can't afford to pass on for their industrials PortCos.

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