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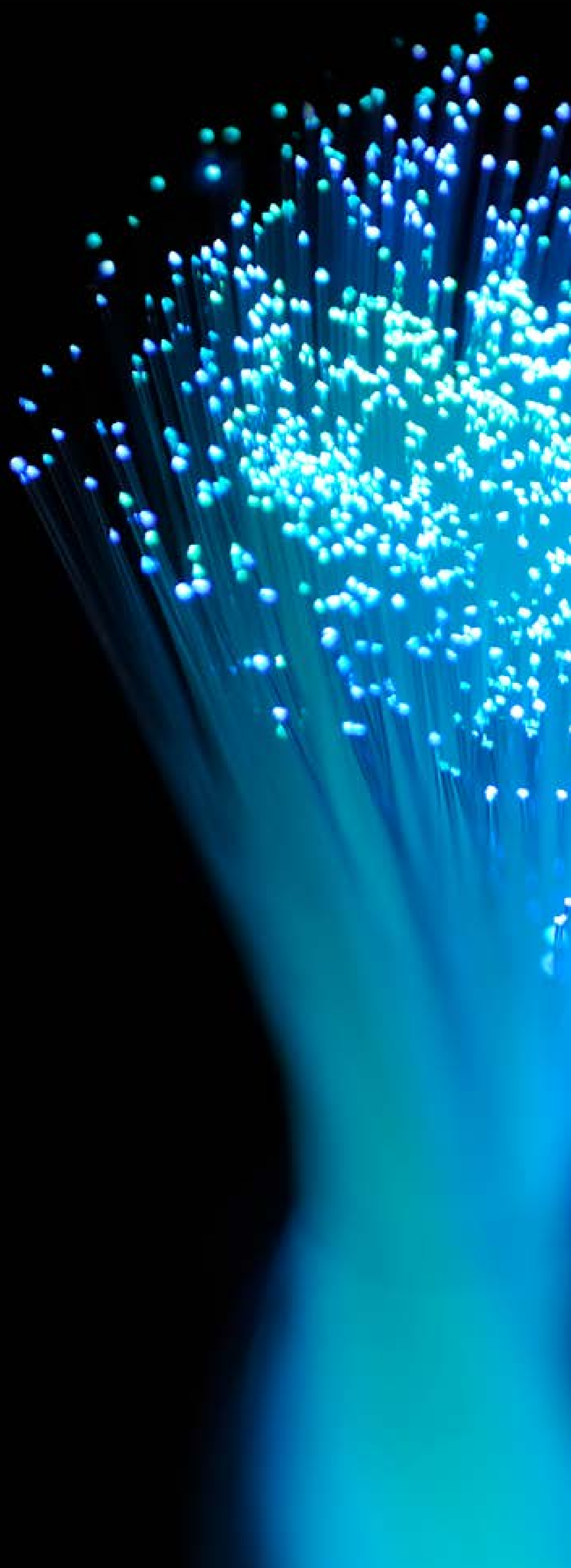
The digital transformation imperative

Why private equity firms must digitally transform to compete



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About the authors

Gavin Geminder

KPMG National Sector Leader, Private Equity

As the U.S. National Sector leader responsible for KPMG's Private Equity practice, Gavin brings the full complement of firm resources to bear to help our clients. This includes intelligent automation and other innovative, industry leading technology tools, as well as specialists from around the globe with the experience and talents to suit our client's individual needs. Gavin also serves as the Global Lead Partner for one of the firm's largest and most well-known private equity clients.

With more than 20 years' experience advising on private equity, alternative investments and other financial transactions, both domestically and internationally, he has worked in KPMG's London, Hong Kong, New York and San Francisco offices. A passionate supporter of many charitable activities, Gavin currently sits on KPMG's Executive Leadership Team for the Bay Area Heart Walk, part of the American Heart Association.

Jeff Kollin

KPMG U.S. Advisory Lead Principal, Private Equity

Jeff serves as the lead Advisory partner for KPMG's private equity group. He also is private equity's liaison with KPMG's Insight Center, the firm's center for innovative technology and intelligent automation capabilities designed to serve our clients. Jeff also acts as relationship manager for many of the firm's premier private equity clients, delivering our audit, tax and advisory resources to them and their portfolio companies.

With over 25 years of experience in the financial services industry, Jeff has worked with a variety of alternative investment structures, including private equity funds, venture capital funds, hedge funds, funds of funds, and hybrid products, as well as family offices, investment banks and fund administrators. Jeff participates in many community, religious and charitable activities, including Cycle for Survival and Summer Camp Opportunities Promote Education (SCOPE).

IDC Recognizes KPMG

KPMG is THE ONLY BIG FOUR professional services firm to be named a leader in the new IDC Marketspace: Worldwide Digital Transformation Consulting and Systems Integration Services 2017 Vendor Assessment. "KPMG has not created a digital practice, but rather, a global digital community of resources with a broad set of capabilities. Digital plays a role in almost every project KPMG delivers."

—Ali Zaidi, Research Lead, U.S. IT Consulting & Systems Integration Services, IDC

Does your firm have an expiration date?

Let's cut right to the chase. If you're running or working for a private equity firm and you haven't taken bold steps to integrate the latest digital tools and data and analytics (D&A) technology into your business, you may be working with a built-in expiration date.

Too strong a statement? We don't think so.

As you've undoubtedly witnessed over the past few years, the private equity game has gotten tougher and more competitive. More capital has poured into the field of play, leading to higher prices for fewer deals. Currently, global assets under management (AUM) stand just shy of $3 trillion, and firms are buying more businesses than they're selling.

This competition has been accelerated by all the dry powder available—reportedly an all-time high of $954 billion as of September 2017—a significant portion of which is being held by foreign players, for example China and Middle Eastern countries. And the private equity arena is only likely to get more challenging.

This is why a growing number of private equity firms are utilizing and/or looking to digital transformation and the effective use of D&A to give them an edge in terms of making portfolio acquisition decisions, driving revenue growth, and also streamlining and enhancing internal operations, record keeping, and regulatory reporting. The speed and accuracy that comes with digital transformation can help give your firm a competitive advantage in this increasingly competitive environment.

Private equity firms for the most part have been slow to the party in terms of automation and innovative technology, with most still just familiarizing themselves with digital innovation (see Exhibit 1). Instead, the majority of private equity firms rely on traditional manual processes to analyze deals and for back-office processes. However, there are a handful of larger PE firms that have already implemented or are currently exploring the use of digital tools and D&A to provide them edge in this competitive PE market segment.

The transformation to a digital world may represent a significant cultural and operational change for your firm, and also require an infusion of new talent. It may not come easy, but is essential if your firm is to compete in this new world.

In this whitepaper, we will examine digital transformation from the perspective of a private equity fund:

— Finding, valuing, and pricing investments (predeal assessment),

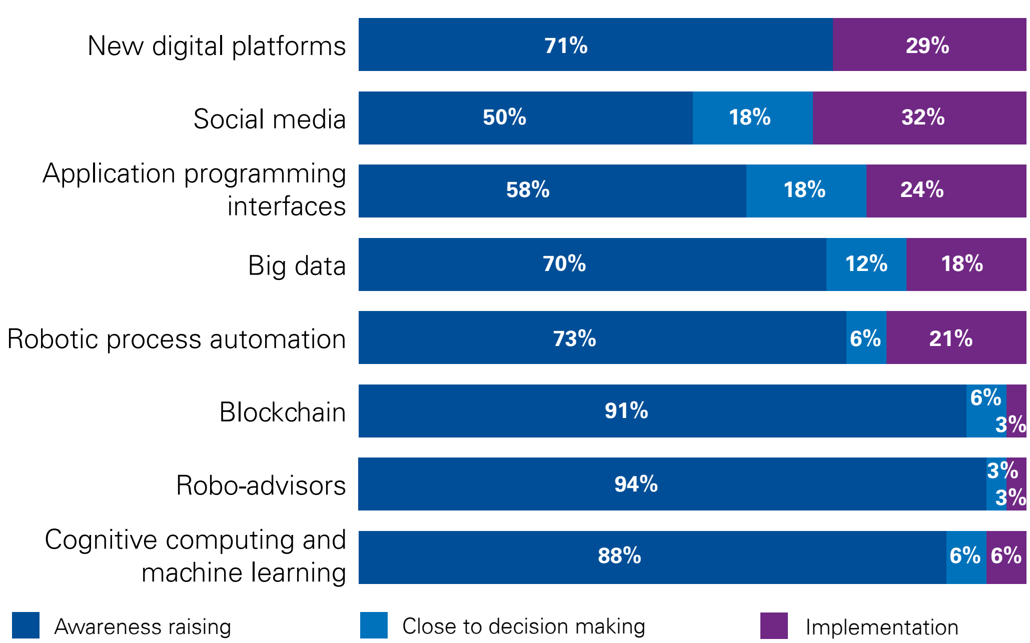
— Managing, optimizing and/or merging portfolio companies (postdeal),

— Exiting investments,

— Enhancing internal operations (tax reporting, regulatory compliance, investor communications).

Exhibit 1: Where do private equity firms stand in their journey?

Most surveyed firms are still in the "awareness raising" phase with respect to the eight key digital innovations.



All figures add to 100%

Source: © KPMG/CREATE – Research survey 2018.

The key digital innovations

Radical changes to the private equity industry—and the alternative investment industry as a whole—will be led by leading digital innovations, including the following:

For purposes of this paper, when we refer to digital transformation through the use of innovative technologies, we're not talking about "digitization."

Digitization simply is the process of converting physical information, like paper documents, photos, microfilm, etc. into a digital format that can be used in computers. But digital transformation is much more than that; it's about revolutionizing a company's operations and business models/processes with innovative technologies that may include the following:

Application programming interfaces (APIs): generating new business via mobile apps and the cloud

Big data: availability of data with vastly enhanced volume, velocity and variety

Blockchain: a distributed ledger that disintermediates payments and settlements

Social media: social networking to help increase brand exposure and broaden customer reach.

Cognitive technology and machine learning: capabilities that facilitate alpha generation

New digital platforms: platforms that can reconfigure the producer–distributor–client relationship

Robo-advisers: algorithms that disintermediate fund distributors and facilitate Direct to Customer (D2C) business

Robotic process automation (RPA): software tools that automate labor-intensive processes

Technology in action

In fact, private equity firms that have jumped on the digital transformation wave have witnessed improvements in their deal-making process as well as increased operational efficiencies in their portfolio companies.

For example, these leading firms have introduced sophisticated data analytics into their pre-due diligence process to increase deal speed and enhance accuracy in deal pricing. They're also using D&A to perform scenario and growth analyses on financials, which enables them to develop growth models and strategically plan for the future growth the firm as well as newly acquired portfolio companies. Firms have also capitalized on innovative technology to gather and analyze market and social media signals in order to learn about unique investment opportunities.

Many private equity firms have also implemented platforms that offer virtual data rooms where limited partners can access data in real time, check risk positions, and do scenario analysis. In some cases, the data from these platforms are fed into models that analyze both internal data and publically available market data to help generate alpha, or even mitigate risk.

A number of private equity firms have applied robotic process automation to mechanize routine mid- and back-office manual operations, which may include fund accounting, CRM, and trade and settlements matters.

Leading private equity firms have also benefited from technology that makes addressing risk and compliance issues (regardless of jurisdiction) more cost-effective. This includes making the on-boarding of clients more efficient and user friendly, or streamlining regulatory or compliance reporting.

Finally, more private equity firms are developing in-house digital capabilities to help improve the "digital fitness" of companies they invest in. Through this model, they're moving away from simply providing capital and becoming strategic partners, affirmatively interacting with their portfolio companies to accelerate value creation.

Finding, evaluating, and pricing a target

Going digital doesn't mean you can or should discard the traditional criteria needed to find, assess, and price potential acquisitions for your portfolio. You're still going to have make judgments based on market position, historical performance, industry trends, cash flows, and capital expenditures.

But new digital tools and D&A technologies will help make the process significantly faster. What's more, judgments will be based on far more data (structured and unstructured) and objective analysis than ever before.

As a result, private equity firms with digital capabilities may be more efficient and timely in:

- Locating potential targets
- Assessing their value and how they stack up against the competition
- Determining the parameters for making an offer that will generate an acceptable return.

> "We leverage proprietary data analytics tools to derive enhanced and actionable insights at deal speed."
>
> — Rick Wright, Advisory Principal, Digital Transformation Lead, KPMG

The power of data

A private equity firm was interested in buying a chain of branded automotive service facilities. It engaged KPMG to assist it in arriving at the right bid price, implementing a more effective operating strategy, and potentially relocating some offices.

Using our proprietary software and industry-leading D&A capabilities, we examined available internal financial data from the target along with external data, both structured and unstructured, from a variety of sources. Our analysis revealed, among other findings, that its facilities performed best in certain locations where certain demographics existed.

This information allowed our client to better forecast how existing stores would perform and, equally important, guide it in choosing future locations.

We also used our D&A capabilities to explore customer sentiment regarding the potential target's brand as compared with leading competitors. We discovered that customer sentiment for the target's brand was more favorable than other competitors—in some cases twice as favorable.

These insights provided our client with a greater understanding on how much to offer for the target and also guided its future marketing efforts.

Upgrading portfolio company operations

Once you've acquired a portfolio company, possessing digital capabilities like D&A opens the door to mining greater amounts of data in order to make it more productive and efficient.

Here's why: Prior to acquisition, you're typically limited with regard to the amount of internal data you're allowed to access. But once you own the company, you can do a 100 percent value capture and really drill down into information that enables you to enhance efficiencies in the way that it operates and markets itself.

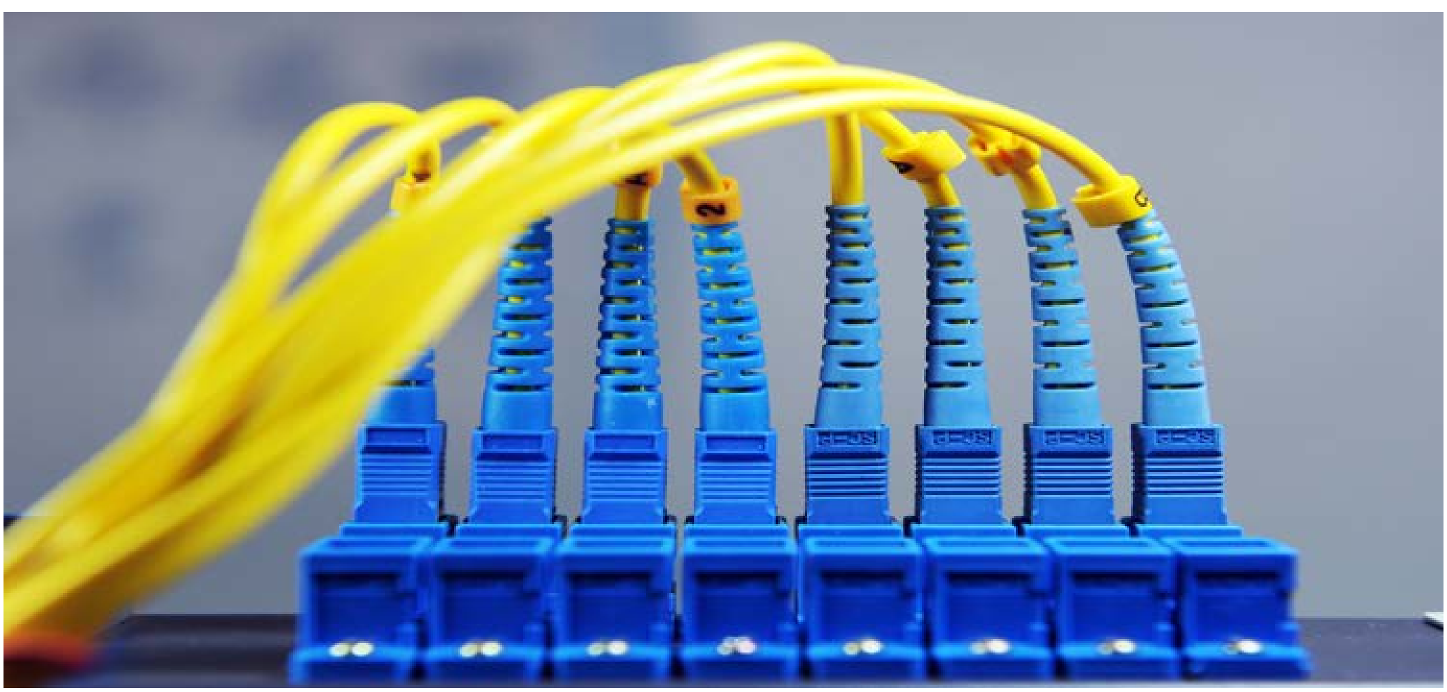
Following an acquisition, another consideration is whether to equip the portfolio company with extensive digital capabilities. These capabilities can offer many ways to create value within a portfolio company by improving its processes, as well as upgrading and expanding its product and service lines.

It can enable them to compete more effectively against businesses in the same space. It may also offer opportunities for you to increase prices on the back end when you decide to exit.

But digitally transforming a portfolio company may not always be the right strategy. For example, if you're a private equity firm that's more interested in a quick turnover, it might not be worthwhile. Revamping an acquisition's IT infrastructure is something that typically takes significant time and money to get right, and it may extend your holding period.

"Technology allows you to better monitor and analyze the volume and value of portfolio company operating data in real time."

— Bradley Fisher, Partner, Data & Analytics Lead, KPMG



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Linking portfolio companies: Digital transformation offers private equity firms that own or manage portfolio companies in the same or similar fields an unprecedented opportunity to improve efficiency and profitability. Depending on their digital maturity level, you may be able to link all of the portfolio companies' systems together and have them feed into your own system. Then you can monitor them in real time, like a hospital monitoring patients in an ICU.

The traditional approach would be to get monthly management reports from the various portfolio companies and then try to figure out manually or with spreadsheets who is or isn't performing well, where and how performance can be improved, and so on.

But, by digitally transforming the companies, inventory levels, production efficiency, ordering/ purchasing data, sales statistics, and hundreds of other relevant measures can be digested and analyzed for patterns.For example, KPMG has built apps that allows private equity clients to transfer knowledge they learn from one portfolio company to all of them. The analysis of the data they receive from these companies and the insights they gain allow them to make objective, data-based decisions that result in better performance.

As a result, information gathered from one company can help boost operations for some or all of the other portfolio companies. The analysis of all of the data may suggest that merging one or more of the companies is the right move or creating a completely new entity incorporating a best-of-all-world's approach is the optimum path to success. "With our innovative technology, we can gather and analyze huge amounts of data in a matter of weeks or even days; this wasn't possible before," noted KPMG Tax Principal Kevin Valek.

Another benefit: As the ultimate owner of a portfolio company, you can lead your management team to change the way it operates, its production process, or its sales strategies. But you may find that you will meet with more success if you can present them with hard data that shows how other similarly situated companies have achieved better results by doing things differently.

Upgrading a portfolio company's digital capabilities may not lead to exiting the investment more quickly as it may take time to transform the acquisition and get it running up to speed. But it should help you develop the portfolio company to its fullest potential so that it either performs better and increases returns, or fetches a higher premium or multiple when it is eventually sold.

> "Because of our innovative technology, we can gather and analyze huge amounts of data in a matter of weeks or even days; this wasn't possible before."
>
> — Kevin Valek, Tax Principal

Portfolio companies with digital capabilities:

A positive or negative factor?

We've discussed the beneficial impact that digital transformation can have on a private equity firm. But does the same hold true for a potential portfolio company?

During the due diligence and valuation phase, you need to find out where the target company is in its digital journey. And say you find that it is, or is well on its way to becoming digitally transformed. Does that fact make it a more or less attractive acquisition?

There's no right or wrong answer to these questions. There are many

variables to consider before deciding whether it's worth paying a higher price for company that's partially or fully transformed in terms of digital capabilities.

For example:

- In an industry or sector with a low level of digital maturity, a portfolio company with little or no digital capabilities could have greater upside potential if you go in, help develop it, and make it a technology leader.
- If the industry as a whole is too far ahead in terms digital transformation, the target may not be a worthwhile investment at any price.
- Will you need to make a significant investment so that the portfolio company's technology is compatible with yours or with other portfolio companies' technologies?

Improving compliance, regulatory reporting, and communications

For private equity firms, developing digital capabilities is an effective—and increasingly necessary—strategy for streamlining and boosting the efficiency of their compliance and regulatory reporting processes and procedures, as well as its stakeholder communications efforts.

It can help firms (1) gather information from multiple internal departments and also from portfolio companies, (2) organize and analyze the data, and (3) complete and file required forms, including Form PF, more quickly, more accurately, and cost-effectively.

As private equity firms become more complex and own portfolio companies operating in multiple countries, digital transformation becomes even more essential. They may have to take into consideration laws and regulatory requirements from a number of jurisdictions, such as Europe's Alternative Investment Fund Managers Directive (AIFMD), then file reports and forms, pay taxes, and send out communications, such as K1s, to limited partners and other investors. (Note that many of these same tasks may apply to your portfolio companies as well, which is another reason for helping them digitally transform.)

Digital capabilities, such as D&A, RPA, and cognitive learning, can also be used to make the on-boarding process for new acquisitions much faster, and more accurate and efficient. To do these tasks manually, or even on a partially automated basis, can be incredibly time-consuming. What's more, they can drain money and resources that would be better put to use growing the business, working on deals, or helping portfolio companies improve their operations or increase sales.

Boosting investor confidence: Digitally transforming can help private equity firms distribute their K-1 forms and other required communications to investors, limited partners, and other stakeholders more quickly. And because these forms are based on more complete data, they're less likely to need corrections.

What's more, these are the types of details that can paint your firm as being a buttoned-up operation in the eyes of investors. This can be a deciding factor that gives your firm the edge over a similarly situated and performing private equity firm.

Start your digital journey now – before it's too late

The competition in the private equity sector is more heated than ever. There are more firms getting in on the action, and there is more money available for investment. Plus, deals and decisions are being made at ever-increasing speeds.

If you want to keep up, your firm is going to have to take advantage of digital innovation, both internally and also in the selection and management of portfolio companies.

Private equity firms have been slow to embrace digital transformation. But soon they will have no choice. And those private equity firms that are early adopters will have an edge. (See Exhibit 2 for areas most suitable for digital transformation,)

So whether you decide to start your digital journey on your own or by aligning with a strategic partner who can help you, the time to act is now

Since 2014, we've helped:

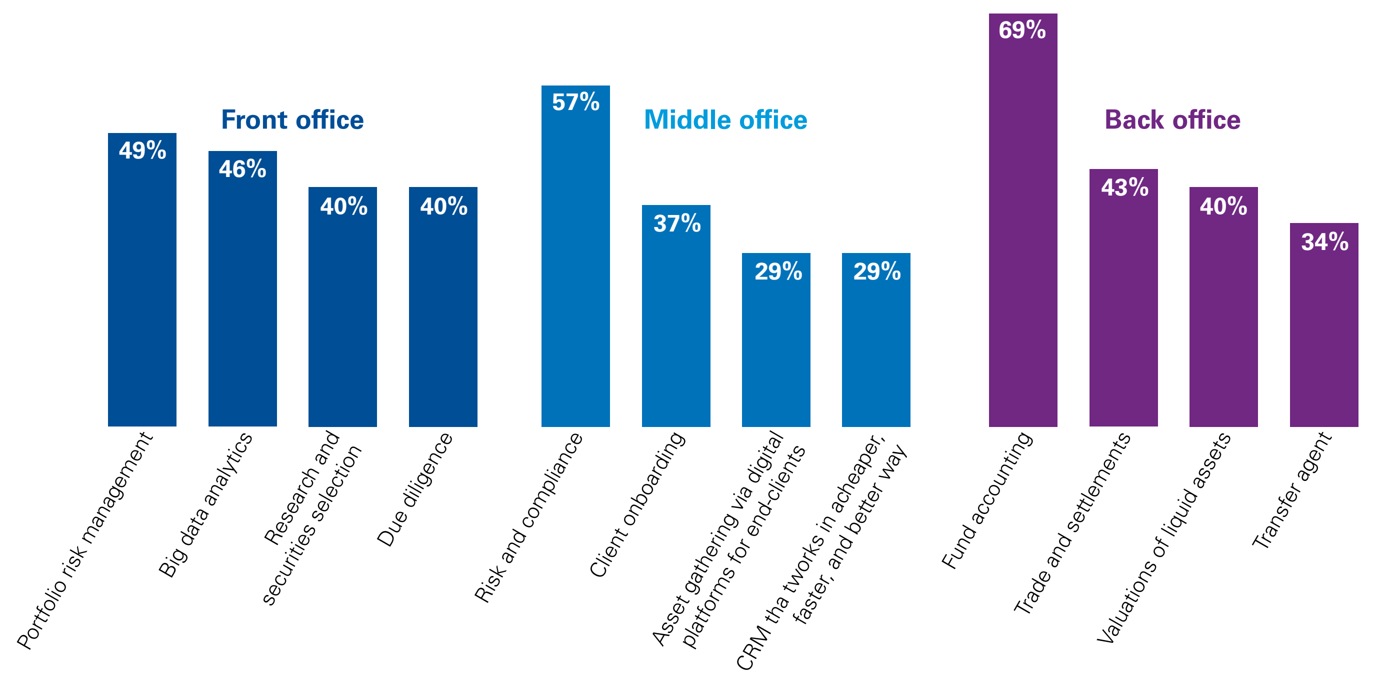
Over 650 clients

Including 250 private equity firms

in their transformation journey with our technology and D&A tools.

Exhibit 2. Which activities could benefit the most from digital innovation?

The chart below lists the areas in the front, middle and back offices that survey respondents felt would be most amenable to digital transformation.



Source: © KPMG/CREATE – Research survey 2018.

Digital transformation checklist

Here are some digital capabilities questions a private equity firm should consider before acquiring a potential portfolio company. It should also be asking itself these same questions with regard to its own operations.

- ☑ Do you (or the target company) have a digital strategy and business model?
  - Will trends toward digital innovation impact your (or your target company's) business model? If so, how?
- ☑ Do you (or the target company) have a dedicated digital department?
- ☑ Do you (or the target company) have the right culture and digitally sophisticated personnel to make the most of digital opportunities?
- ☑ Does the chief information officer (CIO) have a seat at the management table?
- ☑ Does the CIO's opinions and advice influence decisions regarding IT and IT's interaction with other areas of the business?
- ☑ Are the target company's products and services threatened by digital disruption?
- ☑ How effectively are you (or the target company) using data and analytics (D&A)?
  - Has D&A been incorporated into the target company's (1) sourcing and operations management, and (2) supplier evaluation process?
- ☑ Are digital technologies integrated into the target company's production, warehousing, and inventory processes?
- ☑ Are the target company's suppliers, customers, and other third-party providers connected digitally?
- ☑ Are digital technologies integrated into your (or the target company's) marketing processes?
- ☑ Does the target company allow customers to purchase products or services via multiple digital sales channels?
  - Do these sales channels enable the company to gather and analyze customer and competitor data?

Five steps to help you digitalize

Whether you're new to the possibilities of digital innovation, have been contemplating digital transformation, or have taken some steps to implement digital capabilities, here's a framework to follow to for making the most your efforts:

1 **Assess where you are on the digital spectrum and develop a digital strategy:** A strong first step here is to hire a CIO and/or form a committee to formulate a digital strategy. The end goal should be to digitally connect your front, middle and back offices and, ultimately, your portfolio companies. A key decision will be determining whether to build, buy or otherwise acquire the necessary digital tools and capabilities.

2 **Upgrade your private equity firm's core functions with digital capabilities:** As increasing amounts of data become available and need to be digested, digital tools, like RPA, and D&A capabilities can be used by your firm and your portfolio companies to upgrade core functions. These tools can be employed to streamline and boost the efficiency of your internal operations, including tax reporting, onboarding, regulatory compliance, and investor communications. This will become even more essential if or when you expand globally.

3 **Embed digital capabilities in your process for choosing target companies:** Utilize D&A and cognitive capabilities to help you become more efficient and timely in (1) locating potential targets, (2) assessing their value and how they stack up against the competition, and (3) making a reasonable offer that will generate an acceptable return.

4 **Employ digital capabilities to help manage, optimize and/or merge portfolio companies:** The ultimate goal here would be to link all of your portfolio companies' systems together and have them feed into your own system. This may take time and resources, and may not be feasible to do now or all at once. But ultimately, the data/information you will gather can help you maximize the development of your portfolio company(ies) so they either perform better and increase returns, or result in a higher premium or multiple when they're eventually sold.

5 **Develop a talent strategy:** You'll need a team with digital and analytical skills. Assess your existing personnel to determine if they have the appropriate digital expertise. Can they be trained, or are you better off recruiting new talent? Or should you retain the services of a firm that already possesses appropriate tools, technology and personnel? You should get input on this decision from all key stakeholders, including human resources, IT, operations and so on.

How KPMG can help you

Since 2014, KPMG has helped 250 private equity firms in their digital journey. These firms and their portfolio companies cut across a host of industries and segments. We have helped our clients transform using both traditional digital technologies as well as disruptive digital and D&A innovations via our proprietary industry-leading technology programs and platforms, including our Strategic Profitability (SPI) and KPMG LINK PartnerTrack tools.

Our Private Equity practice is a fully integrated, cross-functional team of 1,500 professionals, including 250 partners. We focus on serving private equity firms and their portfolio companies. Our experienced professionals understand the dynamic nature of the private equity marketplace—domestically and in investment centers around the world—and its enormous growth potential. And we understand the issues that private equity firms face on local, national, and global levels.

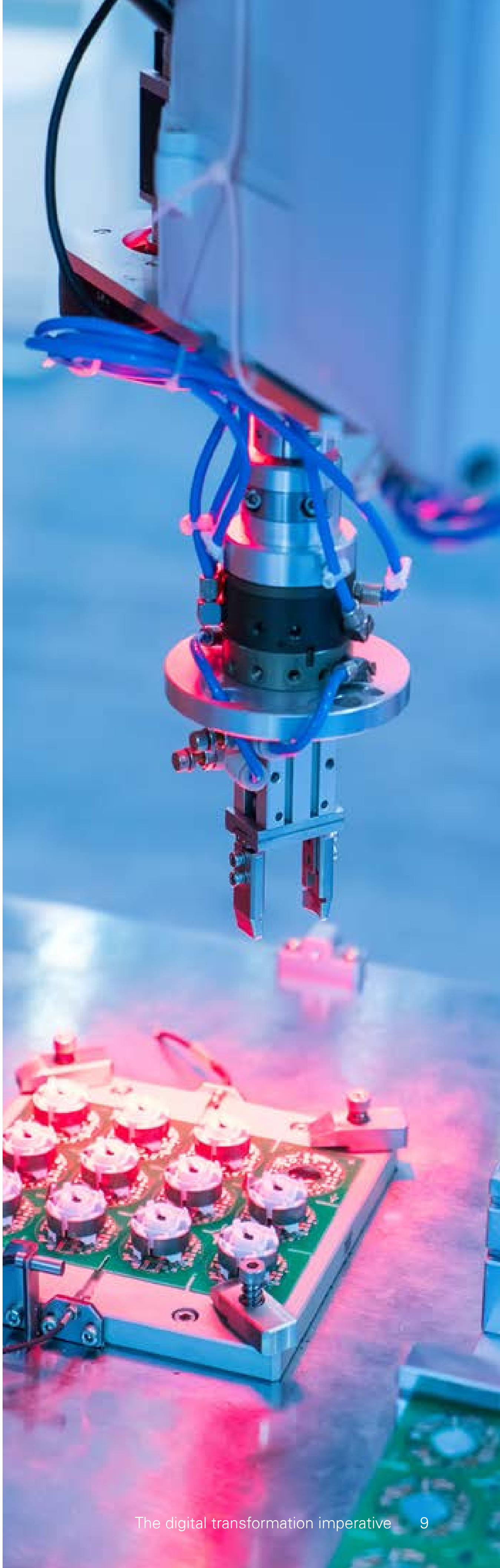
Our professionals bring passion and a fresh approach to the issues that challenge our private equity clients through their entire life cycle. They support the links between fund, managers, transactions, investments, and value realization. And our single-point-of-contact business model makes it easy for you to obtain the services you need, when you need it—whether it is raising capital and making investments, managing the fund and portfolio companies, or exiting and realizing value.

Through rigorous strategic analysis, ongoing discussions with clients, and frequent dialogue with regulators and policy boards, we stay well informed of the dynamics transforming the private equity sector and the industries in which they invest. This, of course, includes the digital revolution that the private equity industry is experiencing.

Where digital transformation can help

Digitally transforming can help private equity firms (and their portfolio companies) in the following areas:

- Business model, products, and services
- Marketing, sales, and customer service
- R&D and innovation
- Purchasing and production
- Supply chain and logistics
- Support functions (HR, IT, finance).



Contact us

For more information on how KPMG can help your private equity firm achieve business-wide digital transformation, contact:

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