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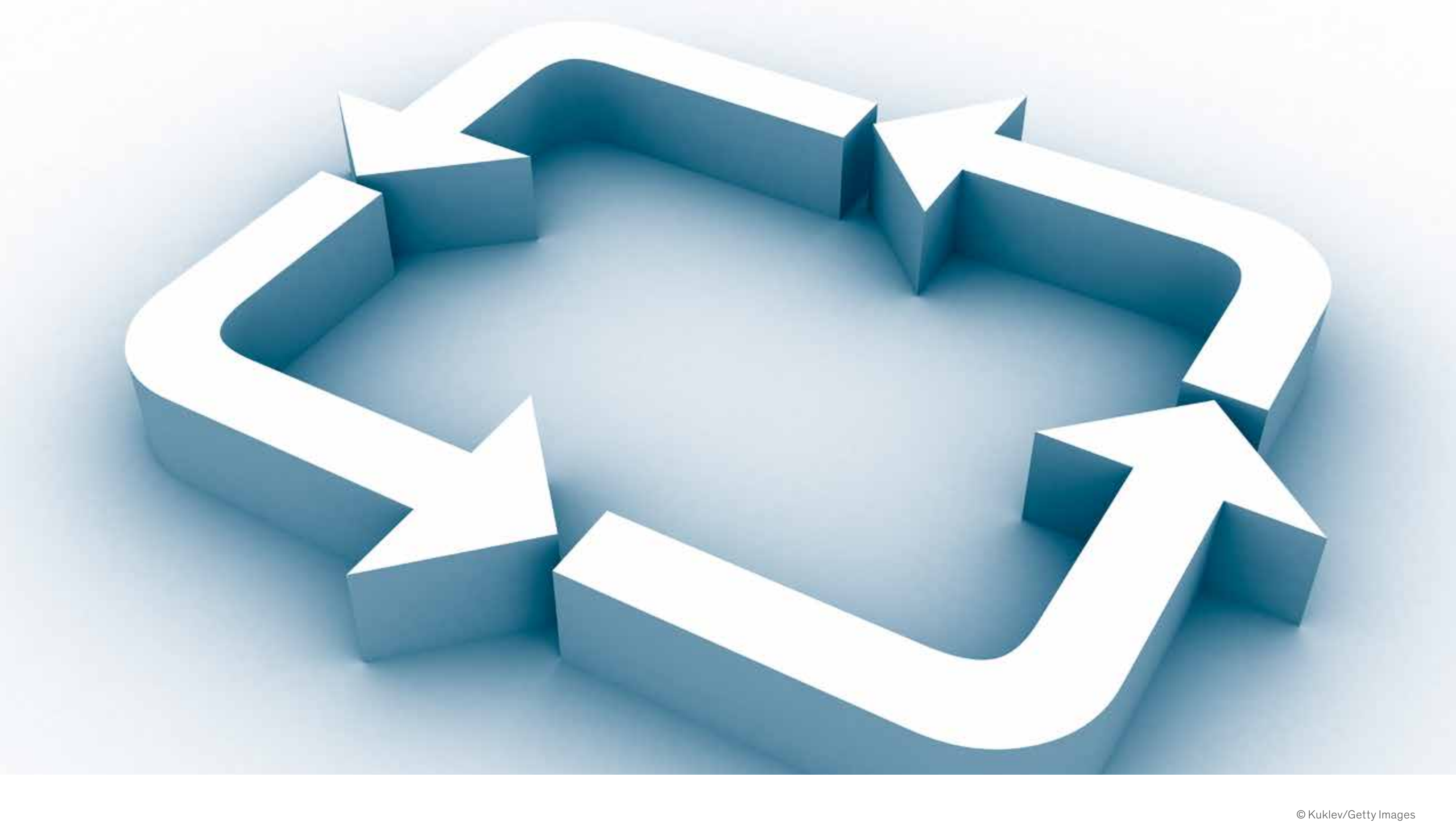
Pricing: The next frontier of value creation in private equity

Few PE firms systematically focus on pricing transformations, though such programs can create substantial value. Here's how pricing value can be captured at any stage in the deal cycle.

by Walter Baker, Manish Chopra, Alexandra Nee, and Shivanand Sinha



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Over the years, private equity (PE) firms have mastered the art of creating value for their portfolio companies through cost reduction, talent upgrades, and financial engineering. Moreover, they have built valuable experience in recognizing patterns that allow them to spot and invest in the best portfolio targets. In contrast, most PE owners do not display the same level of fluency or confidence in commercial productivity—especially in pricing.

In our experience, commercial improvements—such as those in a company's pricing, customer and product mix, or sales volume growth—can create tremendous value for both the portfolio company and the PE owner. Specifically, when PE firms tackle pricing in their portfolio companies, we typically see margin expansion of between 3 and 7 percent within one year. Factoring in potential pricing improvements can allow PE firms to be more confident in potential upside and differentiate themselves in competitive deals. The direct and rapid margin expansion from pricing transformation creates more value for portfolio companies and investors alike during the holding period. And highlighting a track record of both successful pricing improvements and additional pricing opportunities can result in a higher exit valuation.

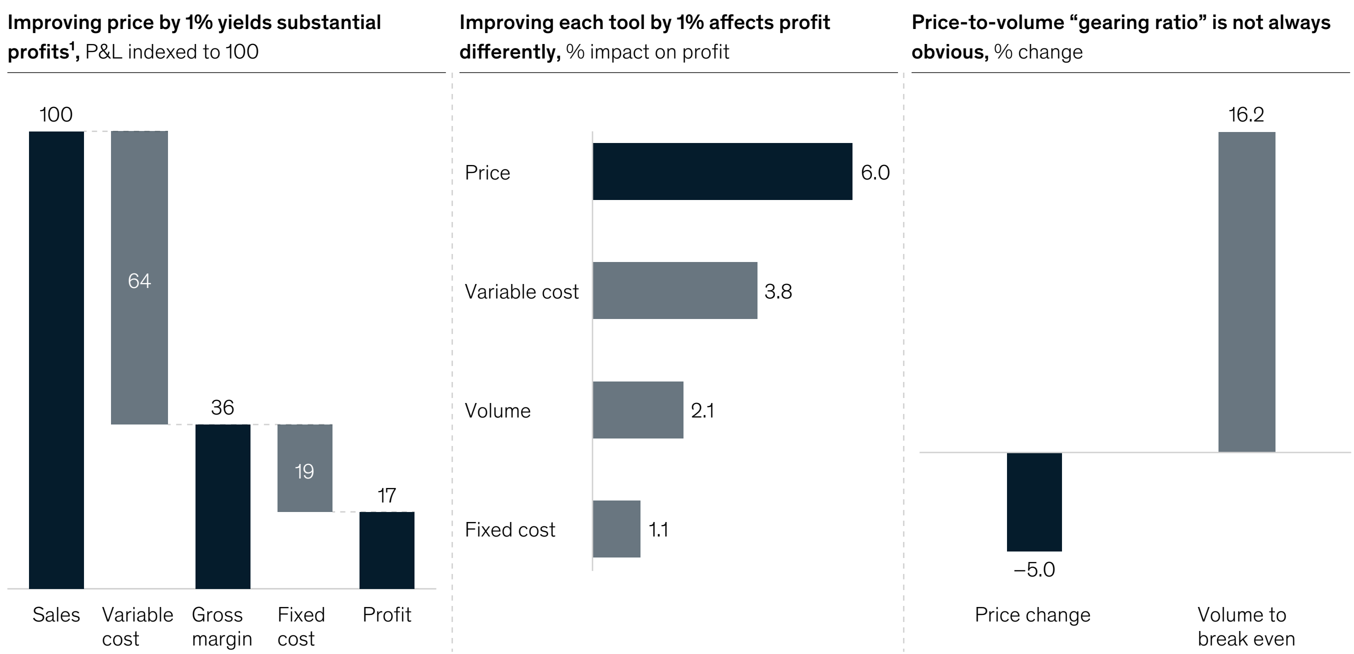
To better understand the barriers that prevent deal and operating partners from using pricing to boost earnings, we recently surveyed more than 100 senior leaders from PE firms and their portfolio companies across Europe and the United States.

Our findings suggest that while respondents view pricing capabilities as highly valuable, they do not effectively build and use those capabilities to design and implement pricing programs. We also found that PE firms can maximize value by addressing pricing early, but value can be derived at almost any point in the deal cycle, from pre-deal diligence to the eventual exit.

Exhibit 1

Pricing is by far the biggest tool for earnings improvement.

Economic sensitivity analysis for ~1,000 midsize ($100 million–$1 billion) US public companies, 2017



[1] EBITDA used for profit; cost of goods and services used as proxy for variable cost; fixed cost represents difference between EBITDA and gross profit.
Source: D&B Hoovers; McKinsey analysis

Understanding PE's approach to pricing

For a typical midsize US company, a 1.0 percent improvement in pricing raises profits by 6.0 percent, on average (Exhibit 1). By comparison, a 1.0 percent reduction in variable costs and fixed costs yielded an increase in profits of 3.8 and 1.1 percent, respectively. In practice, a midsize company acquiring a business approximately 30 percent of its own size with a similar P&L structure would have the same impact on its bottom line as a 5 percent improvement in margin.

Another reason that pricing is an attractive way for PE firms to create value is that any improvement flows almost entirely to the bottom line, net of any volume changes or investments made in tools and resources. Pricing has an outsize impact on valuations given the EBITDA multiple view that investors apply, and in many cases, it can also lead to increased multiples and therefore further competitive differentiation.

To create value in their portfolio companies, PE firms and operators often start by gaining efficiencies through cost control, which has a lower perceived risk. PE leaders cite multiple reasons for traditionally putting less emphasis on pricing to create value (Exhibit 2). Notably, the top concerns are competitive responses—that is, competitors would change their pricing behavior to capture more of the market—and customer defections. From experience, we know that when pricing improvements are implemented in the right pockets of opportunity, the risk of customer loss is widely overestimated and investments in pricing capabilities typically have a high and quick return.

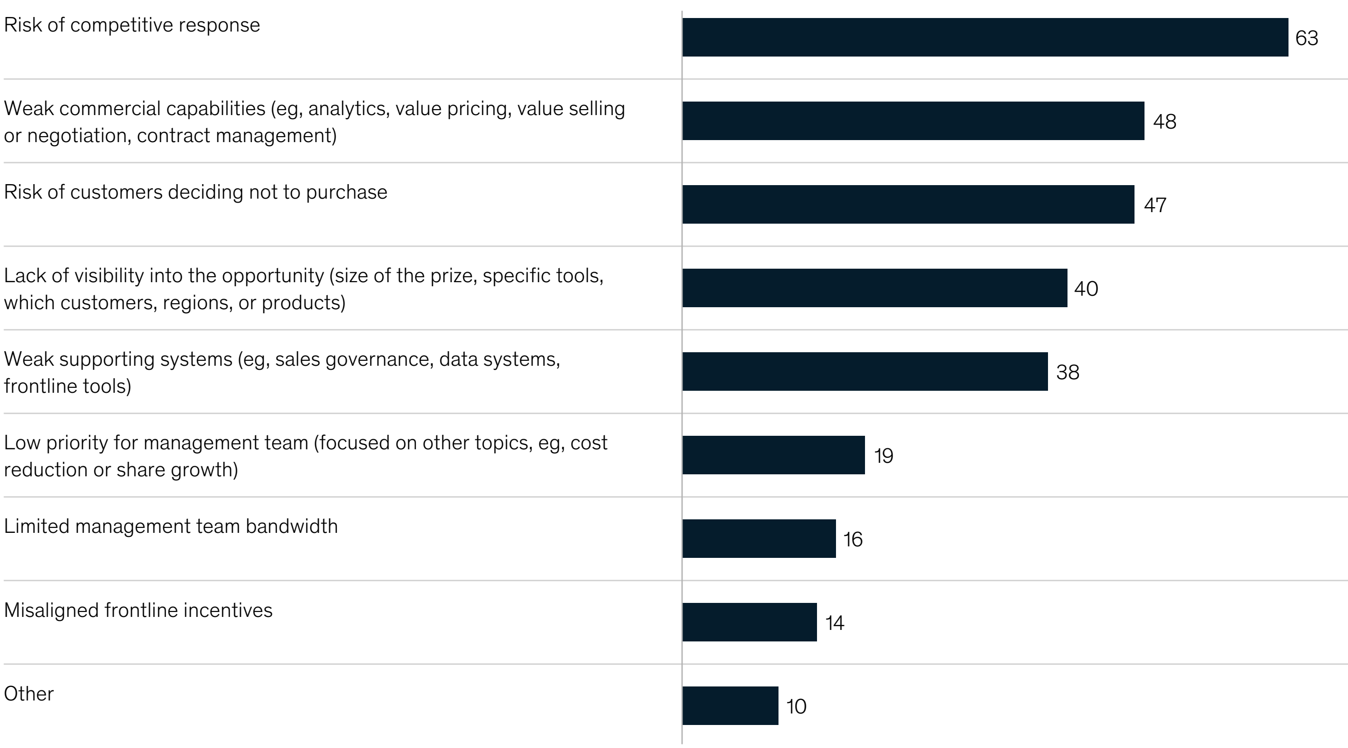
Even among deal and operating partners who broadly believe in the opportunity and view pricing

Exhibit 2

There are myriad perceived obstacles to expanding margins through pricing.

Select your top three obstacles in promoting margin expansion through pricing

% of interviewees that selected option as a top three obstacle, 2019, n = 106



Source: 2019 interviews with 106 operating and investing partners of private equity firms and CFOs/COOs of portfolio companies as a key promoter of earnings, many underestimate its potential impact. Thus, their investments in pricing opportunities continue to be low compared with procurement and other cost-saving measures. Given that, it is not surprising that most management teams feel their organizations are underprepared and lack the resources to capture the pricing opportunity (Exhibit 3).

How to create pricing value throughout a deal life cycle

Firms can maximize value by addressing pricing early, but value can be derived at almost any point in the deal cycle. More sophisticated PE firms and portfolio companies maximize value creation from pricing by focusing on different tactics throughout the deal cycle—before the deal, early in the holding period, midtenure, and pre-exit.

Before the deal: Sizing the opportunity

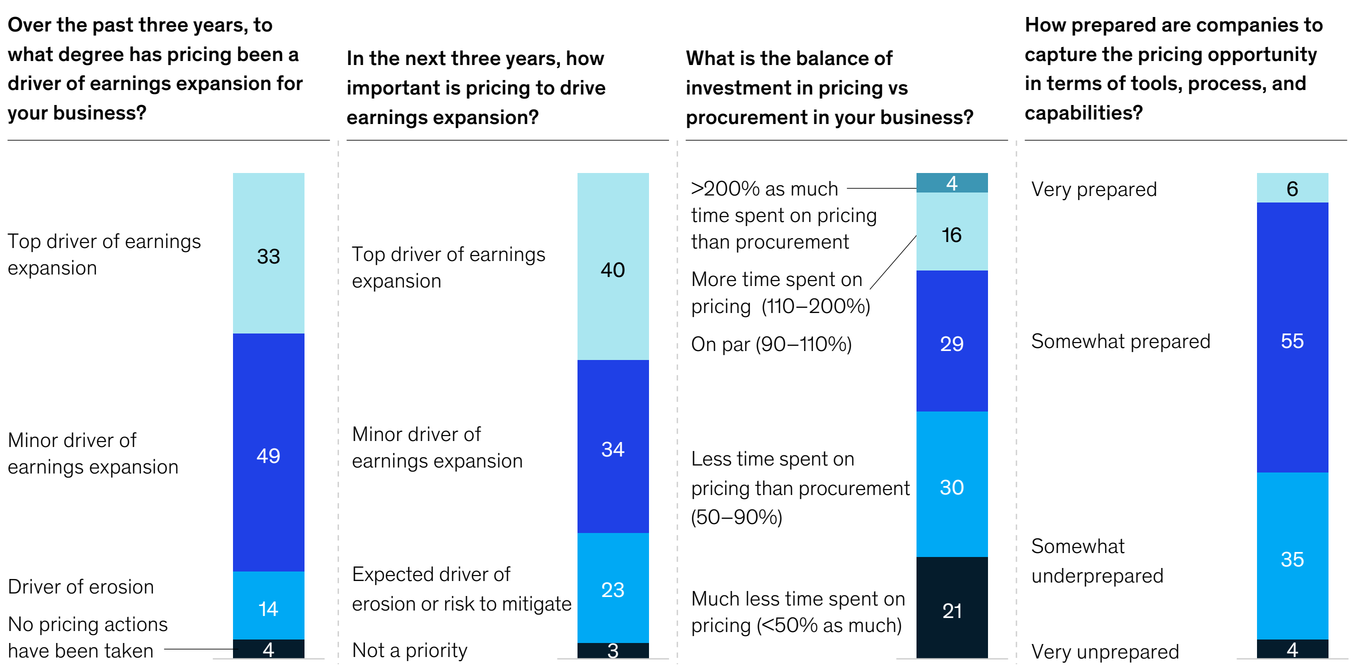
The first step is to assess the potential opportunity from pricing and build it into the upside case in a way that inspires confidence that value can be captured. Firms often have less-than-ideal data and compressed timelines, however, to assess potential opportunities. To formulate a robust perspective, experts need to hunt for patterns showing indicators that might help estimate potential value. Although these predictive indicators vary by industry, combining them with whatever limited data are available in the diligence stage and insights from management reports and interviews can help differentiate an investment case and allow investors to bid more accurately and competitively.

For those opportunities where a pricing program is likely to succeed, we typically see a 3 to 7 percent margin improvement for PE portfolio companies (Exhibit 4).

Exhibit 3

Despite the anticipation that pricing will be important to boost earnings, a majority admit underinvestment in pricing.

% of respondents, 2019, n = 106



Source: 2019 interviews with 106 private equity professionals and management teams of portfolio companies

The extent of the impact ultimately depends on industry dynamics as well as significant factors such as market structure, business model, the breadth and complexity of a company's product line, or its existing level of pricing sophistication. While it can be a complicated exercise, getting a sense for pricing upside during target diligence is important because it allows the PE firm's investment committee to reliably approve higher bid values with confidence that the team will be able to deliver on that value over the holding period.

For example, a PE firm in the diligence phase for a fast-growing healthcare business was assessing whether a pricing transformation might be a viable value-creation strategy. Beyond the confidential-information memo—which typically only includes summary information—the firm did not have access to financial or customer data. The deal team had to determine from the outside whether there was room to improve pricing and what potential value could be at stake. The deal team conducted a competitive analysis; expert interviews; and a survey of patients, payers, and providers, and used the results to assess the nature of pricing opportunities across different market segments. This assessment included identifying value-creation opportunities on both price point and bundling services.

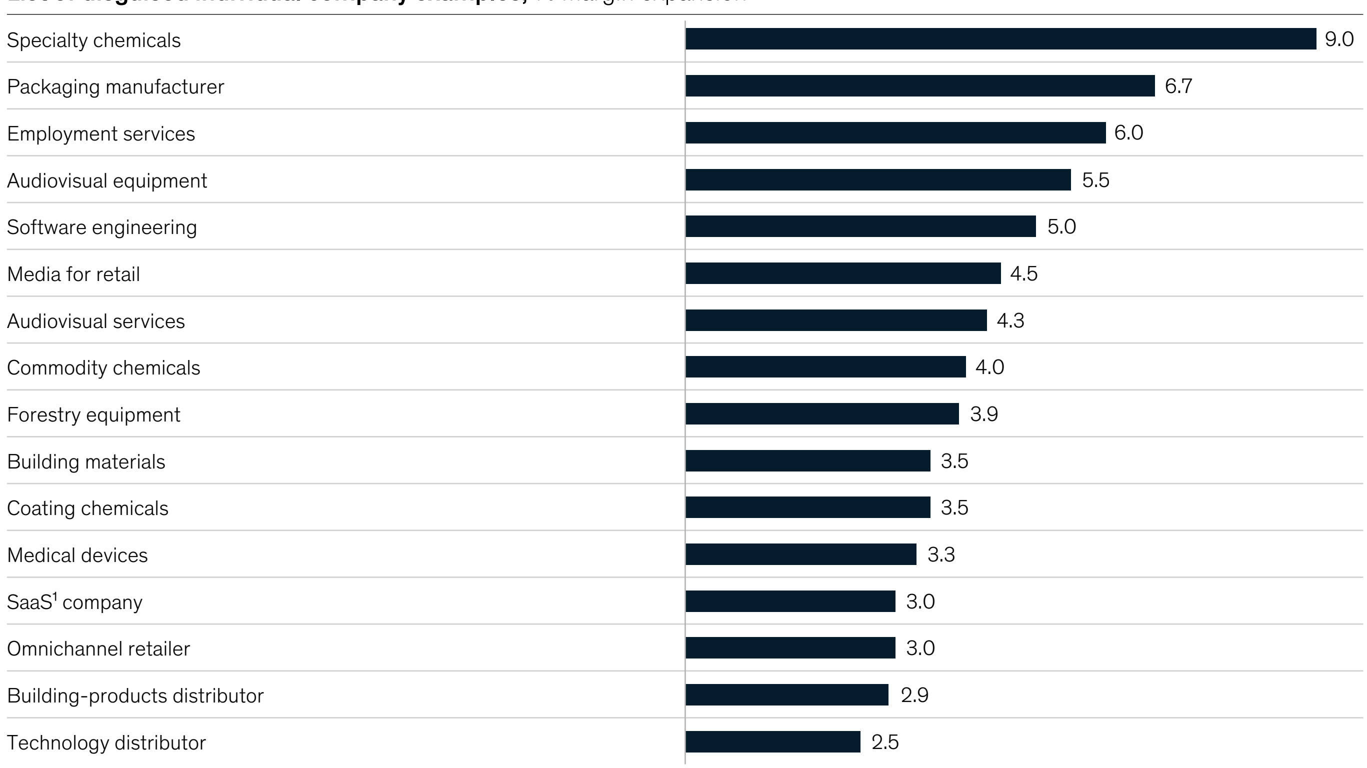
Ultimately, the deal team was able to get approval from its investment committee to incorporate into their bid a small portion of the upside from these pricing opportunities. These adjustments allowed the team to differentiate itself and retain most of the potential upside in the company's value-creation plan.

Exhibit 4

Pricing improvements can significantly boost margins.

Recent private-equity-owned pricing programs

List of disguised individual company examples, % margin expansion



[1] Software as a service

Early in hold period: Creating a 100-day plan
Our experience suggests that even though pricing improvements pay off, a company is more likely to invest adequate time and resources if the 100-day plan explicitly identifies pricing as a high-priority initiative. To weave a pricing-improvement journey into a 100-day plan, PE firms across industries should focus on getting a few important things right:

— *A perspective on industry-pricing dynamics and structural-pricing headroom.* This information can be quite important for midsize players, particularly midsize companies that often operate in a niche part of an industry.

— *A definition of business and commercial objectives.* This includes size of expected impact from organic versus inorganic growth and volume versus price targets on the organic growth portions of the business.

— *An assessment of how price is set today for all products and customers.* Typically we find either legacy price points that have not been updated at a regular cadence or a lack of consistent methodology for setting prices in various parts of the organization.

— *A clear and detailed picture of surcharges, rebates, and discounts.* There should be guidelines for the whole organization around to what degree, by whom, when, and for which customer segments these terms and conditions are to be applied.

— *An understanding of what elements of cost to serve are included in the price versus charged separately to the customer.* These can include, for example, freight, rush orders, small-order surcharges, and raw-material cost changes.

— *An analysis of pricing tools and processes in place.* This assessment should also include gaps in the pricing feedback loop between marketing, sales, finance, IT, and customer service.

In addition to these six goals, PE firms should work to align the management team's incentives with pricing value-creation potential. This alignment helps encourage ownership of the business among team members, as well as behavior that supports the company's overall financial growth.

Midtenure: Solution design and midtenure tune-ups
For portfolio companies in their holding period, pricing can often be the right catalyst to spark margin and top-line growth. In these situations, after a four- to six-week phase to identify potential opportunities, management typically prioritizes a handful of pricing tools likely to generate the most value and explores how to capture that value sustainably. If the company at least started the process of developing a pricing road map as part of the 100-day plan, then midtenure becomes much easier. PE firms and management can then move right to determining the details of a pricing solution, calibrating, and accelerating the execution of that solution based on the existing road map.

Even portfolio companies that don't have a pricing road map in their 100-day plans can create value with pricing during midtenure. The timeline of designing a pricing solution varies greatly by the complexity and starting point of corporate capabilities, but it can typically take three to six months; another six to nine months of concentrated effort is generally necessary before the results of implementation are fully realized.

PE firms can improve the valuation of their companies at any point in the holding period by improving performance through pricing.

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However, while full run-rate improvement can take between 18 and 24 months to achieve on an ongoing basis, we typically see quick pricing wins that boost earnings in the first or second quarter after focusing on pricing improvements.

With the cooperation and initiative of management teams, PE firms can improve the valuation of their companies at any point in the holding period by improving performance through pricing. It is obvious that the pricing tools management and the investment team would prioritize this shift depending on where they are in the holding period. What is less obvious is that shifting priorities means PE firms should revisit the traditional pricing tools for a tune-up throughout the life cycle of the asset. These tune-ups will often result in new calls to action for marketing and sales teams.

Exit preparation: Demonstration of value

Starting 9 to 18 months before exit, the management and investment team should again review the pricing journey they have taken, documenting both the pricing tools they have used successfully and the opportunities that have not been fully utilized. As with any value-creation tool—whether cost optimization, sales growth, or pricing improvements—articulating a successful value-creation story demonstrates the management team's ability to deliver.[1] Management could even outline possible future value-creation opportunities for the new owners by studying remaining and new opportunities.

At an industrial machinery and components distributor, for instance, the management team conducted an exit diligence six months before starting the sale process. As part of the diligence exercise, the team checked up on its pricing program (which had been ongoing for about two years) to see where it had made progress and where it was lagging behind. The team also added some new initiatives to optimize margins within certain product categories (such as in-stock versus not-in-stock products), and they revised their 18- to 24-month pricing road map accordingly. This revised road map, combined with the management team's history of success in executing the initial pricing road map, gave potential new buyers confidence to bid aggressively for the company.

Pricing is undergoing a revolution fueled by advanced analytics, digital technologies, and the adoption of new models—such as dynamic pricing—across all industries. This creates new opportunities and challenges, as well as an imperative to double down on pricing as the next frontier for value creation in PE. While PE has historically not focused on or confidently pursued pricing to date, now is the time to break away from outdated mind-sets. Firms must embrace pricing as a primary way to create value. For despite perceived risks, substantial and sustainable value creation is often achievable. And the earlier it starts, the better. Irrespective of where a portfolio company is in the deal cycle, there are tangible actions it can take to capture this value.

[1] Guillaume Cazalaa, Wesley Hayes, and Paul Morgan, "Private equity exit excellence: Getting the story right," August 2019, McKinsey.com.

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