

WHITEPAPER

Unleashing Digital Transformation in PE-backed Middle Market Companies



Digital Transformation – Opportunity or Threat?

Digital transformation has become a hot topic. Startups continue to disrupt traditional industries. Incumbent big businesses are investing billions to acquire digital startups, build digital capabilities and digitize internally and externally facing business processes. Legions of consultants are engaged to assist, leveraging some pretty sophisticated and expensive technology tools. But where does this leave middle market companies – many of them private equity backed – that don't have the skills or budget to compete? They are increasingly being squeezed between new age startups and deep-pocketed big company competitors who have jumped on the digital band wagon. And the pattern keeps repeating itself industry after industry. If middle market companies are not able to understand, embrace and react to these changes many will be squeezed into oblivion. Yet mid-market companies in particular have some unique challenges they must overcome to realize the promise of digital transformation.

The Promise of Digital Transformation	The Challenges – Especially in Middle Market
❖ Deliver insight by connecting data across silos	❖ Takes too long
❖ Drill down & drill across for actionable insight	❖ Costs too much
❖ Ensure accountability and fact-based decision making	❖ Slow end user adoption
❖ Automate business processes & repetitive decisions	❖ Steep technology learning curves
❖ Leverage algorithms, and AI to improve decisions	❖ Requires highly specialized skills, resources
❖ Deliver step change in cost, quality & speed	❖ Consumes too much management bandwidth
❖ Transform the customer experience	❖ Too inflexible: difficult to modify, iterate, evolve
❖ Create new sources of revenue	❖ Even with right tools, hard to extract real value
❖ Change the competitive game	

The Impact of Digital Disruption

Digital disruption has already had massive impact in several industries and that impact is quickly spreading to almost every sector. In some extreme cases, digitization will wipe out whole classes of products and services. Consider for example that 18 months after the introduction of the Google Maps Navigation app for smartphones in 2009, as much as 85% of the market capitalization of the top makers of stand-alone GPS devices had evaporated. However, in many other cases digitization may not completely blow up existing industries but it is putting downward pressure of revenue and profit growth rates, usually to the benefit of the customer. Think Uber and AirBnB.

According to a major McKinsey study in 2017, then current levels of digitization had already taken out, on average, up to six points of annual revenue and 4.5 points of growth in EBIT across all industries. As digitization spreads McKinsey estimates the long-term impact across industries to be a reduction in average revenue and EBIT growth rates of 12 and 10 points respectively, a sobering thought indeed. The good news is that the impact will not be spread evenly. The effects clearly vary by industry, but the reach and impact of digitization is rapidly spreading to even the most traditional industries. Digital disruption hurts slower-growing companies the most. The bottom 25% of companies in terms of growth are experiencing three times greater reduction in annual revenue growth at the hands of digital disruption as do companies in the fast growing top quartile. Most importantly, digital leaders will benefit at the expense of laggards in almost every industry.

The same McKinsey study projects that digital leaders, across all industries, will enjoy revenue and EBIT growth rates 11 and 7 points higher than their current industry trajectory. According to surveys 49 percent of leading companies are investing in digital more than their counterparts do. This compares with only 5 percent of the laggards, 90 percent of which invest less than their counterparts do. Bold, tightly integrated digital strategies will be the biggest differentiator between companies that win and companies that don't, and the biggest payouts will go to those that initiate digital disruptions. The more aggressively companies respond to the digitization of their industries—up to and including initiating digital disruption—the better the effect on their projected revenue and profit growth. Today many successful incumbents are carefully watching tech start-ups to identify the winning plays and then quickly imitating them at their own bigger scale. Fast-following and great execution are the next best thing to leading disruption and carry significantly lower risk, provided a company has the right technologies and capabilities in place to respond.

Diagnosing Potential Impact From Digitization

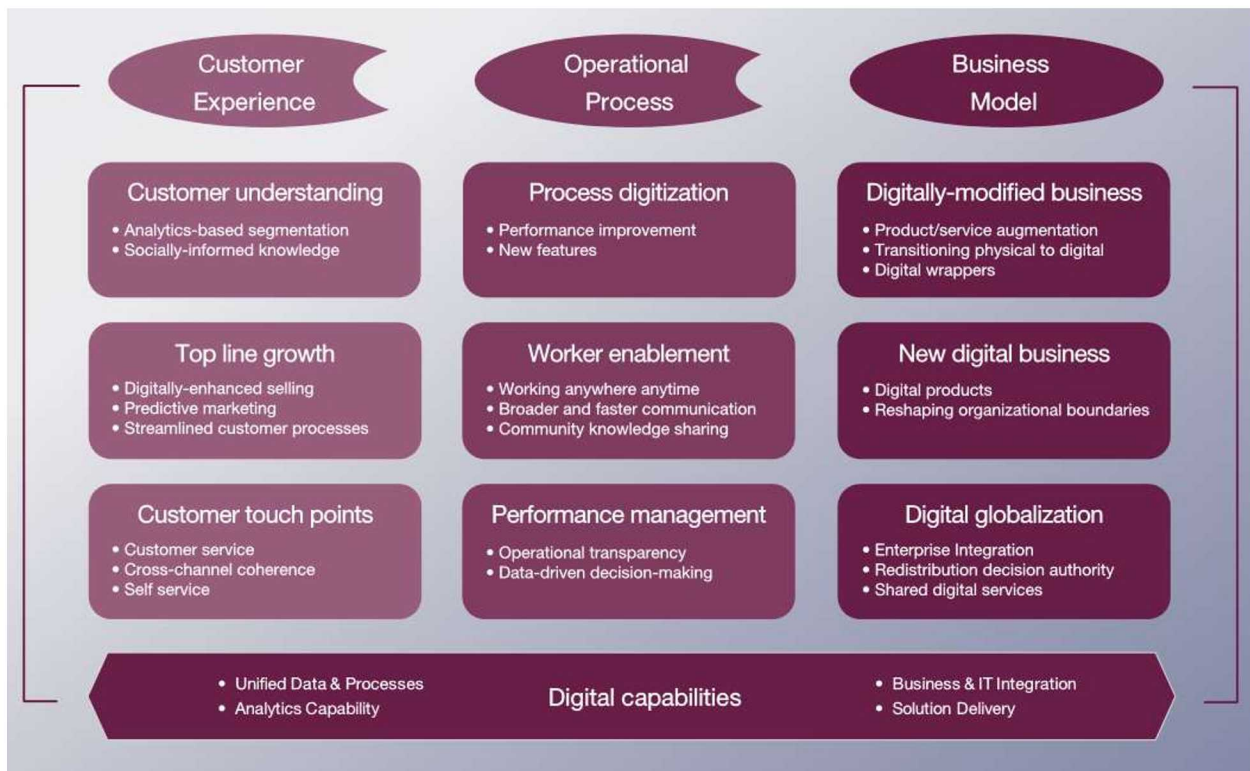
We think about this from two perspectives: understanding and quantifying (1) your degree of vulnerability and (2) your potential points of impact from digitization. Your business may be most vulnerable/have most opportunity if your customers:

- ❖ Buy virtual rather than physical products where costs are largely from processing and servicing
- ❖ Have to cross-subsidize other customers or are burdened by fees and layers from intermediaries
- ❖ Have to buy the whole thing for the one or few parts they really want or will use

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- ❖ Can't get what they want where, how and when they want it.
- ❖ Get a user experience that doesn't match consumer grade expectations for speed, transparency, simplicity and effectiveness
- ❖ Have to wait to receive, or physically go get, your product or service
- ❖ Use social media in relationship to your product or service
- ❖ Are open to upselling and cross selling of related products or services
- ❖ Want to rapidly flex their consumption yet your capacity is costly and inflexible
- ❖ Would derive value from connecting/monitoring your unconnected physical product, e.g. thermostats

There are a number of competing frameworks available for thinking about how digital can impact your business. One we find especially helpful came out of extensive research conducted by the MIT Center for Digital Business. Researchers identified 3 categories and 9 types of impact from digital transformation together with 4 critical enabling capabilities, as depicted in the figure below. Which and how many of these types will deliver the most value varies by industry, company and competitive set. Systematically brainstorming opportunities for each type is often a helpful starting point to frame your digital opportunities.



Source: MIT Center for Digital Business

Category 1 - Customer Experience. A great starting point in this category is to map, in detail, each touchpoint within a typical customer-experience journey. Think about how digitization of that journey can achieve a step change improvement in the customer experience. Rather than simply automating existing processes push your teams to rethink each interaction from the ground up and from the customer's perspective. When designing new customer interaction pathways build these guidelines into your thinking for maximum impact:

- ❖ Work through bad experiences early so that customers recollect the positive ones that come later
- ❖ Disaggregate pleasure and combine pain so that the pleasant parts of the journey form a stronger part of customers' recollections
- ❖ Finish on a strong, upbeat note, as customer final interactions will have a disproportionate impact on their memory of the experience
- ❖ Provide customers choices to give them a sense of control, even if you design those choices to draw people to the ones the company favors
- ❖ Reinforce habits and avoid surprises, again giving customers more peace of mind and sense of control

Category 2 - Operational Processes. This is the least sexy and oftentimes most overlooked category. Yet digitizing these processes is oftentimes more straightforward and can have massive impacts on speed, cost and productivity while eliminating costly human error and in many cases preparing the necessary groundwork for future externally facing digital initiatives. Bringing greater visibility, measurement and control to internal business processes also creates much tighter goal alignment throughout the organization and helps build the data-driven, fact-based and accountable culture that is critical to the long run success of any digital change program. Modern digital tools such as data warehouse automation, visual analytics & dashboarding, financial planning & analysis platforms, no-code rapid application development tools and machine learning automation techniques are especially helpful in this and the customer experience category.

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Category 3 - New Business Models. This is the category that sometimes has the potential to disrupt entire industries. Yet in many ways is the most difficult to pull off with many risks, unknowns and potential for bad bets. In our view, most businesses should focus initially on attacking bite size opportunities in the first two categories to drive bottom line value creation quickly at the same time as building the “digital chops” the organization will require to successfully pull off a more full-blown digital transformation over the long run.

Critical Enablers

Two technologies above all others are critical to becoming a digital leader within your industry: a robust data platform and a development environment for creating software and analytics tools. Without these a company’s efforts at digital transformation may quickly stall and become mired in complexity. These technologies should be among the first investments that companies make to facilitate a successful digital transformation. Under private equity ownership it is smart to leverage these technologies across a portfolio of companies, especially for mid-market portfolio companies which are unlikely to have the skill sets inhouse or the budget and bandwidth to recreate the wheel at each company. Leveraging third party cloud platform solutions -- such as those provided by Halitics -- solves two critical problems unique to private equity ownership. Namely how to quickly bring the right skills and technologies to bear to make change happen fast and, secondly, how to efficiently and effectively spin out a portfolio company at the end of its holding period.

Common Obstacles & Solutions

In our experience there are several common roadblocks to digital success, independent of industry, that Operating Partners need to focus on to help catalyze successful digital efforts at their portfolio companies.

Obstacle	Solution
❖ Lack of clarity on biggest points of leverage or risk	❖ Operating Partners should explicitly diagnose vulnerabilities and opportunities for digitization to set clear priorities and align action
❖ Inadequate data infrastructure & measurement systems	❖ Invest early in a unifying data layer that sits on top of inflexible legacy systems. Brings visibility and accountability and greatly reduces downstream complexity of digital efforts. Avoid the allure and distraction of massive ERP replacement projects
❖ Weak data, analytics and process re-engineering skills & culture	❖ Develop/hire a few internal champions, supplement with trusted partners. The key is to combine “process” and “analytic” thinking and build “digital chops” over time
❖ Tendency to digitize existing processes rather than rethinking them	❖ Map the customer journeys that matter most, reinvent from customer experience perspective. Segment pleasure and combine pain. Provide customers choice, sense of control
❖ Traditional IT development approaches: Detailed project requirements = fixed scope project = custom code build = high cost of change	❖ Embrace agile approaches and flexible low/no code development platforms. Conceive, build and test applications with real users in a few days/weeks then quickly iterate to reach the killer solution, one manageable bite at a time
❖ Not knowing how or where to start, or getting sucked into a massive and overly complex end-to-end big-bang transformation program	❖ Start simple, move fast and iterate your way to success. Pick one or two high leverage processes and use tools like a no-code rapid application development platform to build and iterate on solutions in days not months. Transform your business over time in a series of typically self-funding bite size sprints

About the Author

Richard Spencer has been a private equity Operating Partner since 2006 working with lower middle market portfolio companies across many industries to drive change. Prior to his PE career Richard was a senior consultant with McKinsey & Company and a General Manager at Capital One. In early 2019 Richard founded HALitics to solve for the unique digital transformation needs of private equity firms and their middle-market portfolio companies. The HALitics platform brings together and integrates several well-proven technologies and was designed by private equity operating professionals based on decades of experience managing performance and driving change across a diverse portfolio of PE-backed companies.

Traditional approaches to these so-called Industry 4.0 technologies are expensive, time consuming, difficult to understand and generally apply only to large companies with a deep technical bench. HALitics changes this for middle-market companies and their PE sponsors by providing a more cost effective, shorter time-to-value digital transformation platform that encompasses: data warehouse automation, extensive pre-built visual analytics, business process automation, no-code rapid application development and AI-enabled decision support tools. All can be delivered in various deployment models including as a cloud subscription solution requiring no infrastructure and ensuring more rapid implementation and shorter time-to-value.

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