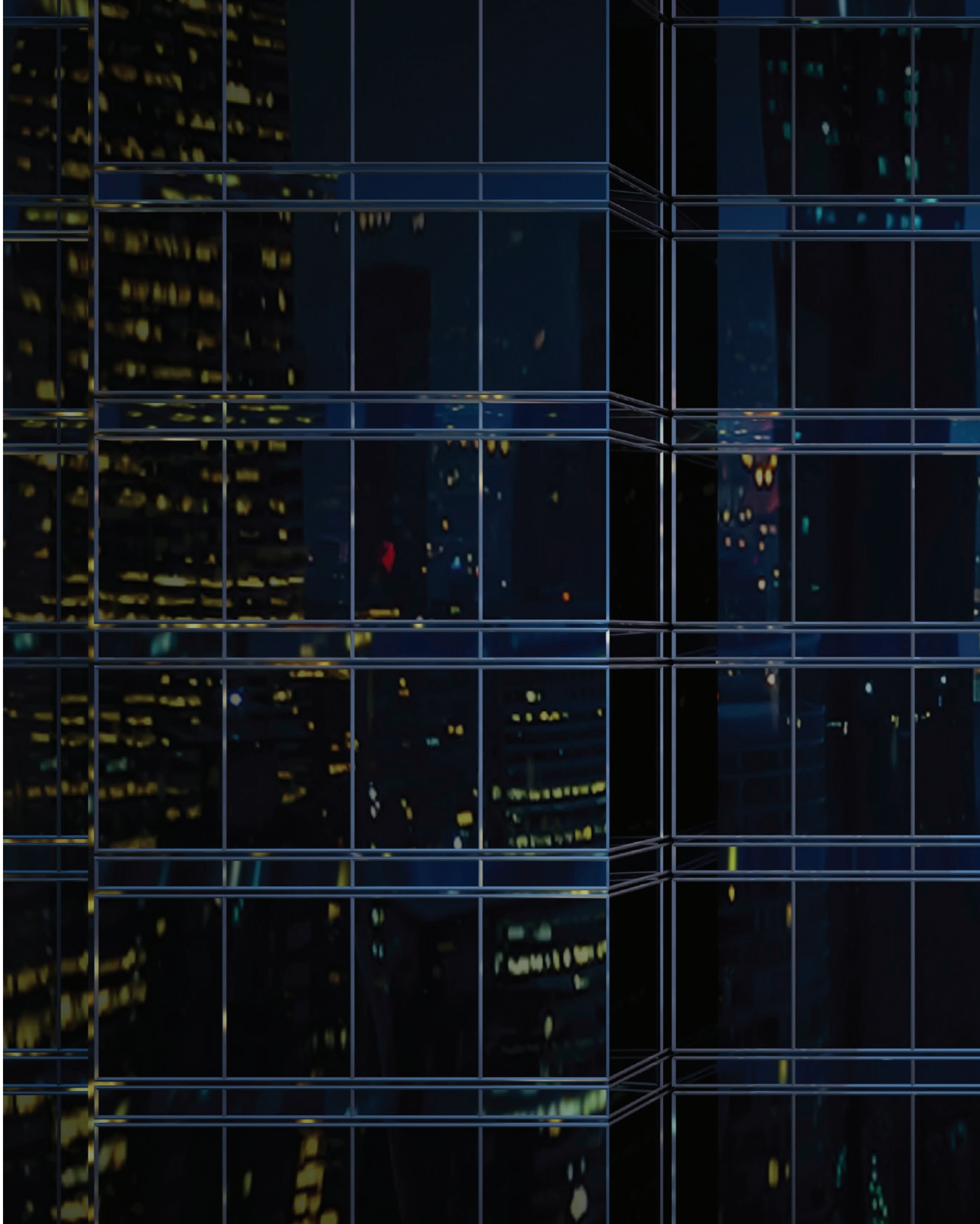
Private Equity Ate My Customer

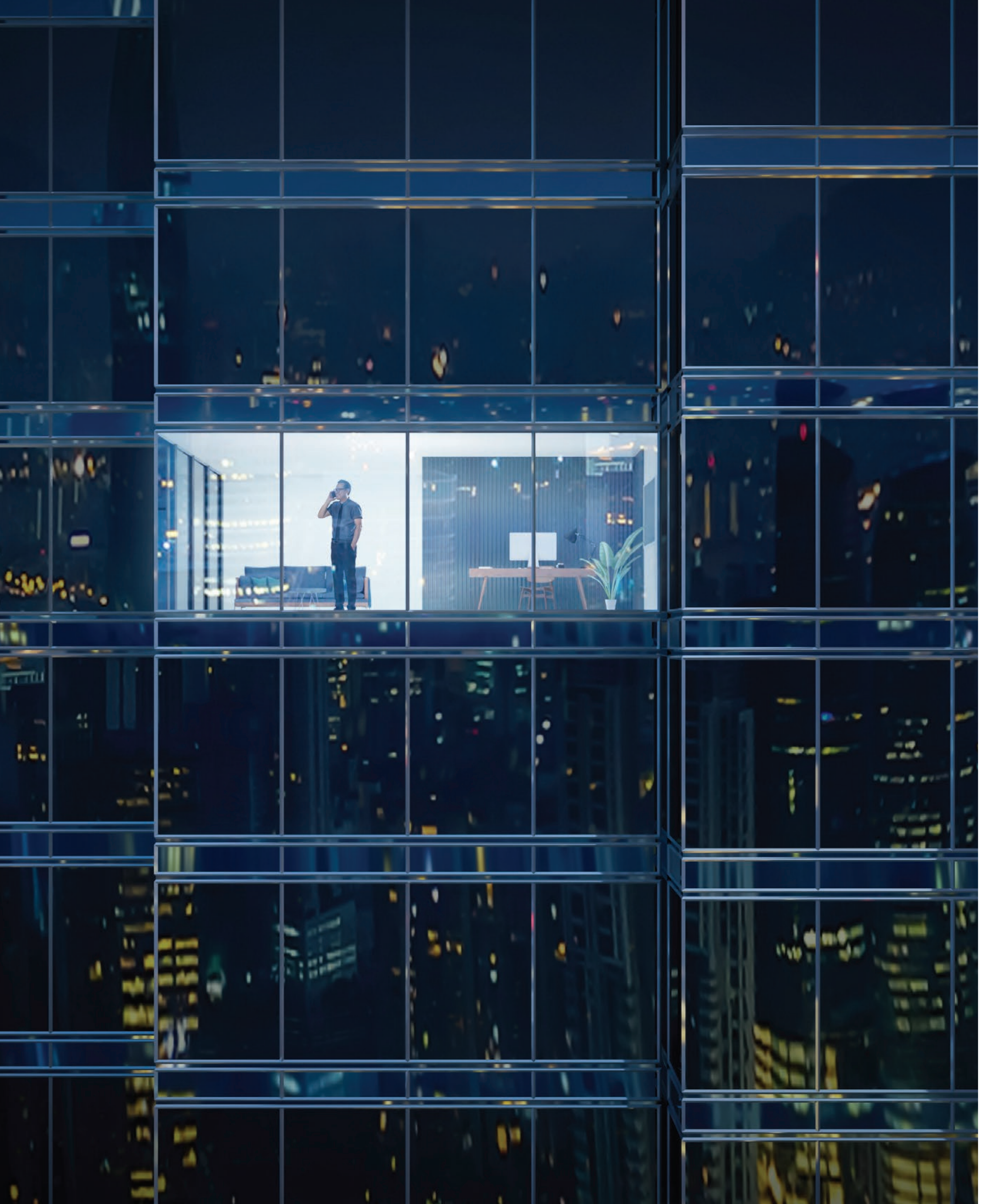
UNDERSTANDING THE PRIVATE EQUITY MINDSET TO BUILD EFFECTIVE PARTNERSHIPS

By Brittany Christian, Ryan Parker, and Seth Baldock

jābian consulting

Contents





Private equity unlocks and creates value by identifying untapped potential in markets, business models, and industries. With a favorable environment for alternative investments, PE activity is on the rise with more investment dollars waiting to be deployed. This trend is particularly important for business-to-business companies to watch and plan for, with an eye toward the possibility that their current and future customers could be acquired.

B2B companies should be familiar with the ways that PE could disrupt their customer base and be prepared to reconsider their customer strategy. The primary goal in this scenario is to be an effective partner in the PE value creation process.

In this market perspective, we give a brief overview of the current environment for PE activity in the US, and describe how B2B companies can better work with an acquired customer by understanding the typical mechanisms of sponsor-led M&A and some potential value creation playbooks. Then, we introduce three success factors for effective partnerships with customers acquired by a PE firm. Finally, we share some takeaways for what you can be doing now to be positioned for success in the face of this disruption.

Introduction

Private equity activity has accelerated over the past few years, reaching all-time highs in total deal value with more available capital on deck to be deployed. The COVID-19 pandemic has created opportunities for private investors to source a greater number of opportunities, pick favorable platforms that align with now expanded strategies and deeper expertise, and create value through transformation that capitalizes on the current environment. Mid-market B2B companies should pay particular attention to these trends, as the probability of customer involvement in a private equity transaction will continue to increase for the foreseeable future, particularly in healthcare, technology, and growth opportunities.

Private equity entry into a B2B buyer's customer base means relationship dynamics will change and requires nimble adaption to new buyer priorities. Suppliers cannot rely on a status quo understanding of the customer in this scenario, and they cannot manage through the change with sales talent alone. To enable success in the face of this disruption, it pays to consider how best to align incentives, justify the existing relationship (or a new relationship), and capture opportunities for mutually beneficial growth.

An effective sales relationship with a new private equity-backed customer requires:

- Understanding the customer's business model and cost structure to better understand how current offerings impact its business
- Discernment of the customer's new goals, and ways to best partner and help achieve those goals
- A consistent, clear, and concise conception of competitive advantages and why continued business is the most valuable option on the market

The following visual represents the impact that PE has on a target acquisition and the partner B2B businesses that supports them.

The target business' suppliers will experience implications of the PE acquisition, as the mechanism of the transaction and the PE firm's value creation thesis will change how the target operates and how it makes decisions.

PRIVATE EQUITY

B2B BUSINESS → **TARGET BUSINESS** ← **DOWNSTREAM CUSTOMER**

The target business' customers typically experience a much smaller impact than upstream businesses, because PE value creation strategies tend to focus on improving the business rather than exerting power over customers.

A common misconception is that PE targets are fixer uppers or in need of saving. However, most attractive PE targets have a solid market position, multiple avenues for growth, stable cash flows, and low capital requirements. The threat of new entrants, substitutes, and competitors is likely well understood.

Background

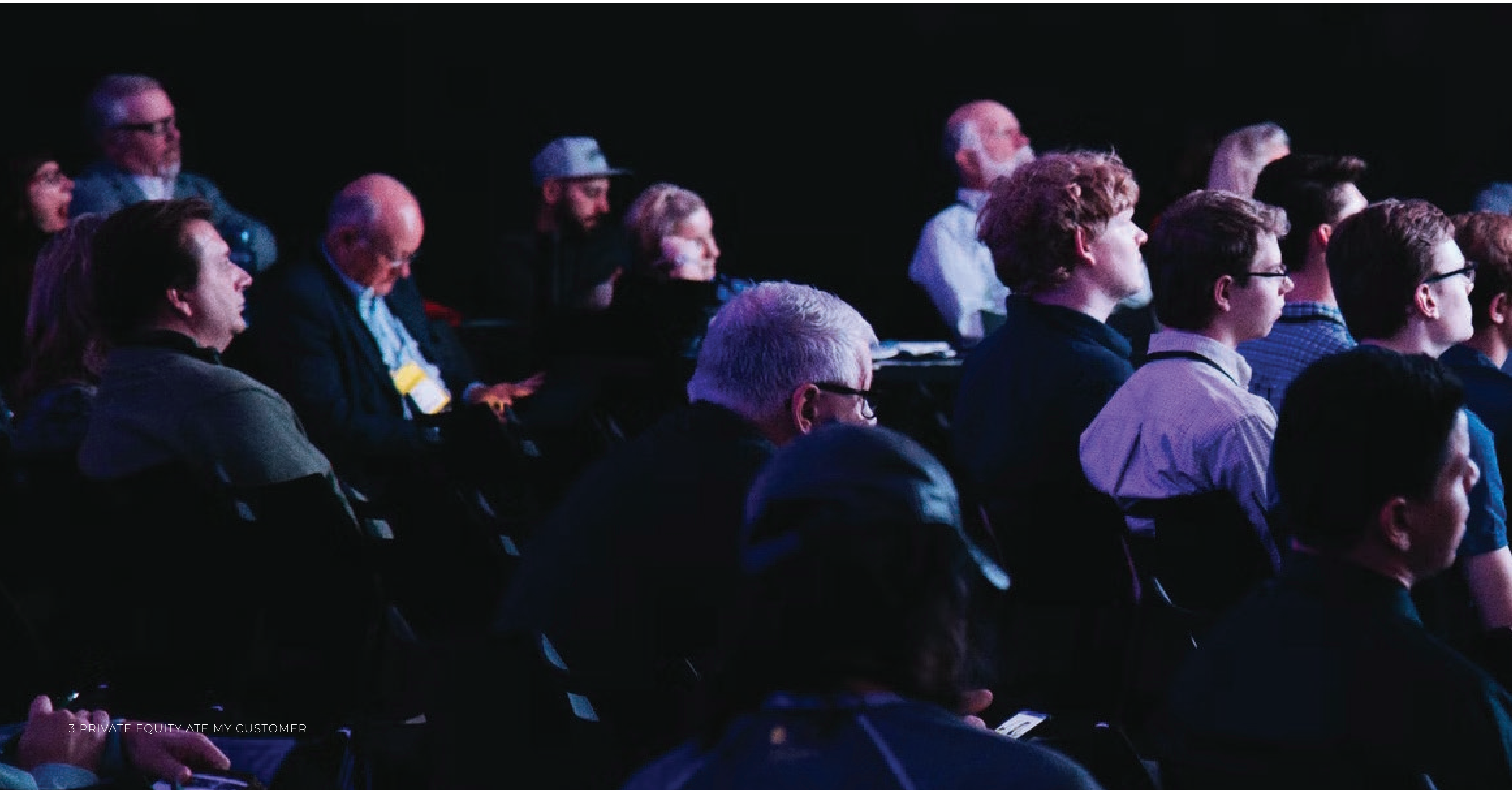
In 2021, private equity deals in the US exceeded $1 trillion, with significant increase in the number of large funds (greater than $5 billion raised) compared to zero large funds raised in 2011. This has led to an evolution in the creativity and diversification of PE portfolios and their value creation playbooks beyond targeting asset-heavy platforms in the firm's primary domain expertise.

The increasingly active M&A environment is attractive to acquisition target firms as well. Increasing multiples over the past few years means that sellers can target favorable exits by virtue of industry dynamics, forecasts, and positioning as much as or more so than firm performance. The increase in the number of firms, the amount of capital ready to deploy, and the number of deals means that a particularly attractive acquisition target will have multiple options for partners and deal terms.

It's worth noting there are some headwinds against these trends. Rising inflation will likely lead to rate hikes from the Federal Reserve and other central banks, increasing the cost of capital and slowing the frenetic M&A pace. Supply chain pressures and labor challenges also inhibit growth prospects in certain sectors, dampening private investors' appetites. However, subdued performance of public markets may prompt investors and PE limited partners to continue allocating more resources to alternative investments and maintain an active environment for private equity.

Some Common Mechanisms of Private Equity Disruption of a B2B Customer Base

There are three primary mechanisms by which private equity could enter a market and cause disruption for a mid-market B2B supplier.



MECHANISM 1: BUYER CONSOLIDATION

The first kind of mechanism is buyer consolidation, where a private investor makes multiple acquisitions of smaller players with the intent of rolling them up into a single and more powerful organization. This is possible when there are lots of small, disparate players with little to no economies of scope or scale on their own. By combining the small firms into a bigger organization, the private equity firm could look to create value by sharing costs, centralizing certain functions, bringing the best parts of each firm to the broader network, and exerting its newly created power throughout the value chain.

MECHANISM 2: ACQUISITION & TRANSFORMATION OF SINGLE LARGE PLAYER

The second kind of mechanism is the acquisition and transformation of a single large player in the market. This might come about because the acquisition target is going through a transitional event such as the exit of family ownership and/or management or could be because the target firm has underperformed and needs a capital infusion to maintain operations and enable change. Either way, the acquiring sponsor would look to make a leveraged buyout with a value creation playbook in mind depending on the investor, its domain and operational expertise, and the deal economics.

MECHANISM 3: VERTICAL INTEGRATION

The third type of mechanism for PE-led disruption of a market is through a vertical integration play, where a major B2B customer and a key supplier are merged. This is a longer developing scenario and would be a possibility whenever the B2B customer is in an industry with a few prompting characteristics. Its suppliers may have increased power, resources could be scarce, it could lack the capabilities to efficiently manage its supply chain, or there may be opportunities to increase market share with a captive supplier by enabling greater diversification, pricing, or other competitive advantages. As with all these characteristics, the fastest and most promising option is to vertically integrate with a supplier – a current competitor – to create value.

In all three of these mechanisms, the target acquisition firm will be faced with some combination of a few operational mandates common to investment-fueled transformation:

Growth acceleration, where new strategies and hypotheses are deployed to increase revenues

Cost cutting and/or restructuring, where inefficiencies are identified and improved upon, and opportunities to better protect and grow margins are a priority

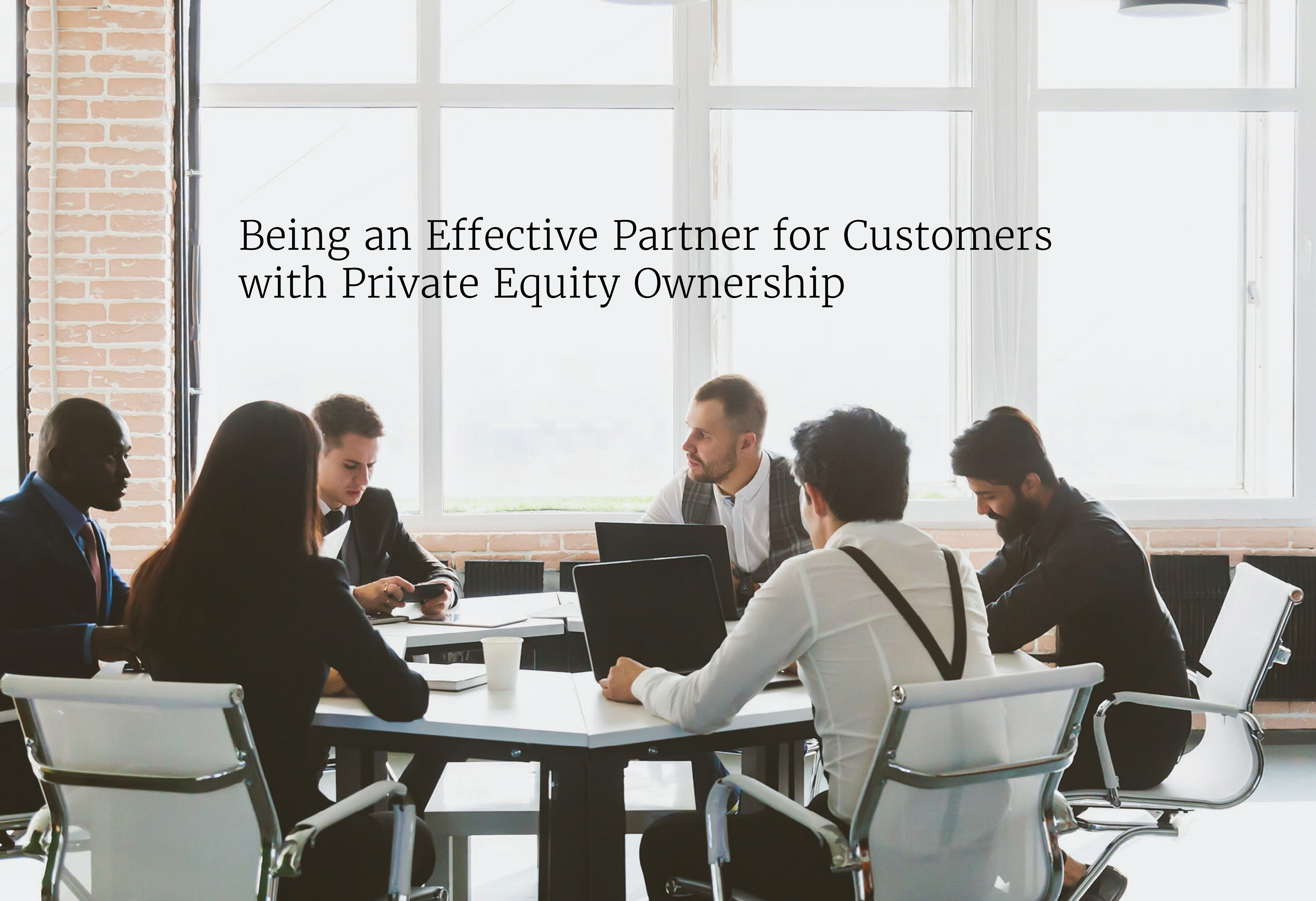
Leadership change, where the target company's leadership is augmented through key additions or transitions leveraging the PE firm's talent network

Additional investment, where the M&A transaction provides additional capital to the acquired business and enables new initiatives, such as further M&A, technology or capability investment, or market expansion

PE LEVER	POTENTIAL PE ACTIONS	IMPLICATIONS TO B2B SUPPLIER
Growth Acceleration Target acquisition undergoes a shift in strategy to expand revenues over a short time horizon	• Diversification • Change in customer segmentation/prioritization • Deeper market penetration • Invest to grow (sales force expansion, new tools, etc.)	• Orders will increase; don't get in the way of growth by not being able to meet greater demand • Opportunity to share – and take credit for – downstream customer intelligence and marketing efforts
Cost Cutting/Restructuring Inefficiencies identified and stripped out of the target acquisition to expand margins and improve operations	• Inventory reduction • Reduction in force • Footprint reduction • Operational improvement	• Orders in the interim won't increase and may decrease, making share the most important metric • Buying decisions will be scrutinized, which means you must make sure your customer clearly agrees with your value proposition – and that it's compelling
Leadership Change Key management and operational leadership turnover at the target acquisition leveraging PE firm's talent network	• C-suite & executive turnover • Hands-on involvement • Strategic operational hires	• Hard-won relationships may be shifting to different people – or go away entirely – meaning a diverse networking plan is essential • New partnerships with the right people could mean an opportunity to earn more support with decision makers
Additional Investment Target firm infused with the ability to make additional investments as a part of the PE acquisition	• Operational footprint expansion • Further M&A • Vertical integration • Systems & capability upgrades	• More M&A might mean that you will face added pressures as the customer grows in power, increasing the need to emphasize win-win sales approaches • A bigger and more sophisticated customer could be a blessing (more maturity, agility, etc.) and a curse (greater ability to scrutinize, more demanding priorities, etc.)

PE FIRMS TYPICALLY PRIORITIZE OPPORTUNITIES BASED ON THEIR INVESTMENT TIMELINE (TYPICALLY 3-5 YEARS), SO CONSIDER YOUR INVESTMENTS ON A SIMILAR HORIZON.

Being an Effective Partner for Customers with Private Equity Ownership



When a mid-market B2B company's customer base undergoes disruption via PE activity, there may be a tendency to rely on the skill and talent of sales professionals to navigate the changes and successfully protect or grow sales. However, to paraphrase Sun Tzu, it is better to win via strategic advantage rather than demanding it from personnel. Being an effective partner with customers under new ownership essentially boils down to knowing what the customer's new ownership is looking to accomplish and positioning offerings and relationship benefits to capitalize on that knowledge. It would be unwise to expect individual talent to be aware of the changes, understand their implications, and succeed in the face of such disruption.

Instead, consider these three success factors for being an effective partner for customers with private equity ownership:

SUCCESS FACTOR 1

UNDERSTAND THE BUSINESS MODEL

SUCCESS FACTOR 2

DISCERN THEIR GOALS AND WAYS TO BEST HELP ACHIEVE THOSE GOALS

SUCCESS FACTOR 3

ESTABLISH A CONSISTENT, CLEAR, AND CONCISE CONCEPTION OF YOUR COMPETITIVE ADVANTAGES

SUCCESS FACTOR 1

The first success factor of being an effective partner for new PE owners requires understanding the customer's business model and cost structure, to have a better grasp of how current offerings impact its business. This means going beyond a market-level understanding of current pricing relative to competitors, and instead knowing the impact products and services have on customers' ability to generate profits. This is critical knowledge because articulating the value proposition to potentially more cost conscious buyers will become a lot easier. It's likely there won't be any public resources to understand the customer's business; it will require gathering more on-the-ground-intel. The easiest way to understand a customer's cost structure is to just ask. This is relatively easy to accomplish if strong relationships have been maintained with key contacts at the customer who did not move on after the acquisition.

Take for example a customer selling relatively low margin products, for which a B2B business is the primary supplier. The B2B supplier enjoyed this relationship because the customer's main priority was continuity and trust in supplier relationships. Suppose that the customer's ownership changes in an acquisition, and now there are new private equity stakeholders in the picture. Those customer buying priorities are very likely to shift eventually, especially given the implications of any debt added in the transaction, and the business will need to justify its relationship on different terms. With new debt service obligations and dividends siphoning cash flow, the customer will scrutinize the economics of each business relationship. The value-price-cost framework is a simple way to think about how to manage a more financially focused buyer. It is critical to have a clear perspective on the value created by current offerings and the partnership, and to be willing and able to speak plainly in those terms.

It is also essential to have an intimate understanding of where pricing stands in relation to the value being delivered; can prices be justified in the context of the customer's margin and the value added to the customer? This means having a perspective on the real and perceived value of current offerings before the acquisition, and what has changed (or might change) after the acquisition. Consider scenarios where prices are held constant, raised, or lowered. How do those scenarios play out pre- and post-acquisition in terms of the value the acquired customer receives both economically (its ability to generate profits) and intangibly (ease of doing business and other synergies, alignment with corporate social responsibility strategies, etc.)? Having insight into the financial detail of the customers' business grants the ability to have better sales conversations and more easily align on economic value. Understanding how offerings effect perceived value after the acquisition reveals a more holistic picture of the customer's value proposition.

UNDERSTANDING THE BUSINESS MODEL

DrillCo Gets Smart About XYZ's Business

THE SITUATION

XYZ, a manufacturer that makes and sells widgets and gadgets to the military and industrial technology companies, is acquired by a PE firm. The firm's thesis relies on increasing operational efficiency to protect margins as products become even more commoditized. DrillCo is a parts supplier who has enjoyed a long-standing sales relationship with XYZ based on trust with key contacts who are now exiting the business as part of the transaction.

THE CHALLENGE

XYZ is reducing parts inventory levels as part of a broader mandate to bring costs in-line, and DrillCo is being called in to compete for XYZ's business with other widget manufacturers. In preparation, DrillCo assessed XYZ's deal economics with its downstream customers using DrillCo parts vs. competitor parts.

THE PARTNERSHIP

DrillCo was able to offer a creative solution that enabled XYZ to reduce inventory holding costs and articulate the superior margins the deal would generate for XYZ. DrillCo was able to establish a dominant share position at XYZ as a result of its efforts.

SUCCESS FACTOR 2

The second success factor of being an effective partner for new PE owners is to discern their goals and ways to best help achieve those goals. In the acquisition, the private equity firm will have a thesis for the investment that will serve as the basis for new organizational goals. This will likely be a goal shift from previous ownership, as the PE firm is likely making the acquisition to enact some change in strategy to create value. Adding to that goal shift is the element of time. Previous ownership may have taken a long or even generational view of some business goals, especially if family owned. That will change with private equity ownership, as many firms will look to create value and exit within a relatively short time horizon that aligns with fund goals (usually 3-5 years). Added to the shift in goal horizons is a new, relentless focus on quantification of value that customer may not have had before.

Many firms are explicit in what they look for in acquisition targets and publish those on their website or other materials, which can be a good starting point in understanding the new goals. But like Success Factor 1, it pays to build relationships and ask questions to gain insight into the investment thesis and what goals the new ownership is looking to accomplish. Establish a picture of what the customer's new goals are and think strategically about the role to be played in achieving those goals. If the customer now has ambitious growth goals, it will be most valuable to the customer if it has help achieving that growth through marketing efforts rather than just another member of their value chain. The PE firm's value creation methods may also have long-term implications for the target's strategy and vision; B2B firms need to gather intelligence on the changes and play out the implications as they seek to understand how best to partner. This is the opportunity to creatively examine the value brought to the relationship and the possibilities for contributing to the PE firm's value creation strategy.

DISCERN THEIR GOALS AND HOW YOU CAN HELP ACHIEVE THEM

Dentist Source Adapts to New Reality at SW Dental

THE SITUATION

SW Dental is a collection of dentist's offices acquired by a PE firm and brought under one single regional network entity. SW Dental is looking to become the top dentist network in Texas within the next few years. Dentist Source is the second largest supplier of dentist office consumable supplies in the US.

THE CHALLENGE

Pre-acquisition, Dentist Source managed sales relationships directly with the dentists themselves and often relied on the best-in-class quality of its products as well as the occasional golf game. However, sourcing and procurement are now handled by a shared service at SW Dental, and it declines all traditional business development activities as a matter of policy.

THE PARTNERSHIP

As a part of its supply chain capabilities, Dentist Source tracks end consumer trends so that it can forecast demand from dentist offices. Dentist Source shared its business intelligence with SW Dental, giving it a better sense of growth opportunities to achieve its goals. As a result, Dentist Source earned the primary supplier designation at SW Dental.

SUCCESS FACTOR 3

The third success factor of being an effective partner for customers now backed by private equity is to establish a consistent, clear, and concise conception of competitive advantages within this new context. The goal of refining a competitive advantage "elevator pitch" is to enable sales and marketing teams to be able to succinctly explain to the customer why continued business is the most valuable option on the market, including a perspective of that value in plainly understood terms. Having a quantifiable answer to "what you get out of the partnership" will strongly resonate with PE-owned customers.

This success factor also goes beyond self-knowledge of strengths and weaknesses, to include how remaining partners create a competitive advantage for the target firm. Sales conversations will be more impactful when the advantages created for the target firm can be explained easily and concisely. This competitive advantage success factor is a natural extension of the first two success factors; if the economic value of the partnership is well understood, if prices are justified by the value added, and if continued partnership plays an important role in the target firm's value creation strategy, then competitive advantages should become clear. Once the dust settles on the transaction, the customer will likely move quickly to begin creating value for its new shareholders. B2B suppliers can demonstrate a strong alignment to their customer's new operating environment by having a decisive, plainly understood competitive advantage statement that addresses its new cost structure and goals.

ESTABLISH A CONSISTENT, CLEAR, AND CONCISE CONCEPTION OF YOUR COMPETITIVE ADVANTAGES

Boltwork Clearly Makes the Case to HSS

THE SITUATION

Horizon Space Systems (HSS) is a specialty component supplier for space-focused aerospace and defense companies. HSS was acquired by a PE firm in part due to the tremendous growth prospects in the industry and is looking to invest in its operations to improve quality and efficiency. Boltwork is a SaaS solution that tracks operational compliance, audit signatures, test data, and recurring tasks in one cloud-based application, and it is responding to an RFP from HSS for a new operations solution.

THE CHALLENGE

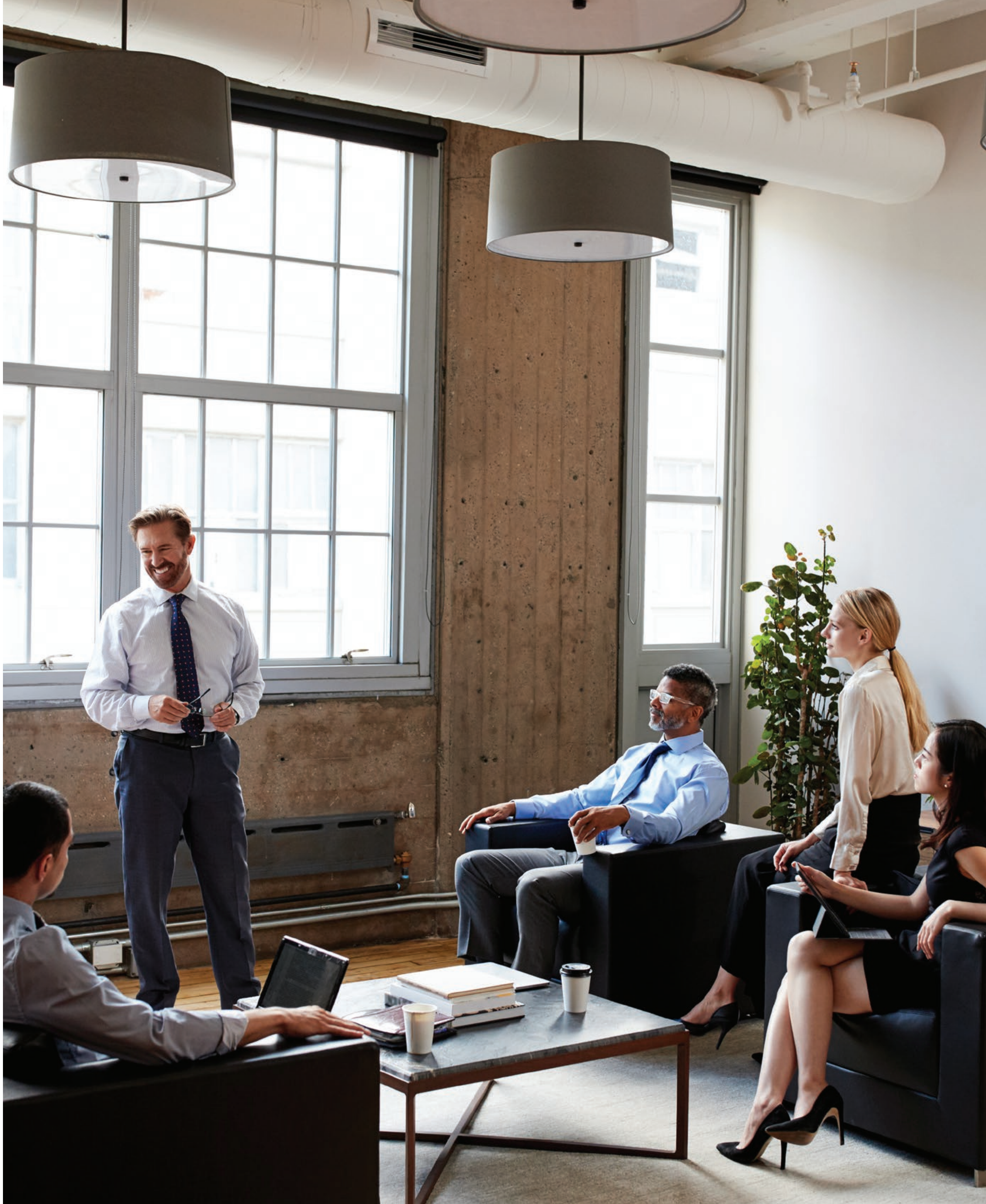
In preparation for the RFP, Boltwork analyzed competitor offerings in context of HSS' business model and HSS' statements about needing to minimize rework and lost time confirming key metrics.

THE PARTNERSHIP

Boltwork positioned its sales pitch to focus on three key competitive advantages: that it is a mobile-native application designed for field use; that it integrates with test instruments to log data directly in the application; and that its price per license was not the most expensive. Ultimately, HSS selected Boltwork.

What is missing in the equation is a solid understanding of competitors' offerings in this new context. Competitive intelligence will be important: about competitor share at the customer, its value propositions, positioning, and ways its offerings could win with a shift in buyer behavior. This is important because competitive advantage statements should always be comparative ("better than alternative x because…") and ideally superlative ("the best on the market"). The key is to be explicit about why offerings are comparatively better, or why they are the best. Those competitive advantages can be because of some key differentiator in the offerings, or pricing, or value-added services; what matters is that those advantages are well understood and are the focus in each conversation with the customer. This will help messaging be more effective with a customer who will have different priorities and may be more savvy in how it makes buying decisions. One final consideration is the dynamic environment the customer will be operating in; be ready to evolve and adapt differentiators in the event of further PE disruption.

While having a tailored competitive advantage statement for different customer types is not controversial advice regardless of the situation, it is doubly true in this PE disruption scenario. If the competitive advantage statement to a disrupted customer has not changed in the wake of a PE acquisition, then it's worth questioning if the new business realities and goals have been fully considered.



What Can You Be Doing Now?

In 2021, roughly $1.2 trillion worth of deals were announced compared to less than $600 billion in 2020. If you have not already felt the impact of this deal activity, consider that those investments are just now beginning to execute on value creation playbooks, and will continue to transform over the next few years. With more investments on the horizon, it's time to act.

If this is already happening to you: All is not lost. You can still pivot and win. While disruption is real and needs to be addressed, you must assume you will be operating and selling in a hybrid landscape of traditional customers and PE-acquired customers. This means you will need to continue to manage your existing customer relationships and protect your core business, while building the capability to address a new type of customer. As an organization, you can plan for both realities and operate within the tension of differing customer expectations.

As a team, focus on:

1 How you identify new disruptions early.

This requires having an "ear to the ground" mentality, a nimble way to get this information to leadership and an approach for vetting and assessing information (e.g., Is it real? What would it mean? How big of a disruption could it be? Who else could we ask?)

2 How you prioritize customers and customer experience.

Operating in a hybrid customer landscape, it will be critical to determine relative importance and value for these customers compared to your other customers, and the downstream implications of investing in one over the other. Considering that they also have different underlying values, evaluate the total value proposition, including customer experience, offerings, programs, discounts, etc.

3 How you will need to operate differently.

Evaluate what, if any, operational and team changes you may need to make if disruption occurs. Consider how to equip your sales team to adapt their approach based on changing buyer motivations and roles. For example, some companies identify a handoff point, or threshold, when the relationship is transitioned to a different team. Some choose to equip the same sales force with the ability to manage multiple complex buyers. Also, consider how your internal processes and systems will need to adapt to view this new customer as an entity and create a seamless customer experience end to end.

4 How you evaluate pricing and margin decisions.

Scrutinize your past pricing changes and evaluate them through the lens of a different and informed buyer. At a small, single-location customer, sales conversations may have been less focused on the relationship between price, margin, and value, other than as a necessity in "doing business." At a PE-owned customer, the level of awareness and focus on the financial implications of buying from you will be exponentially higher.

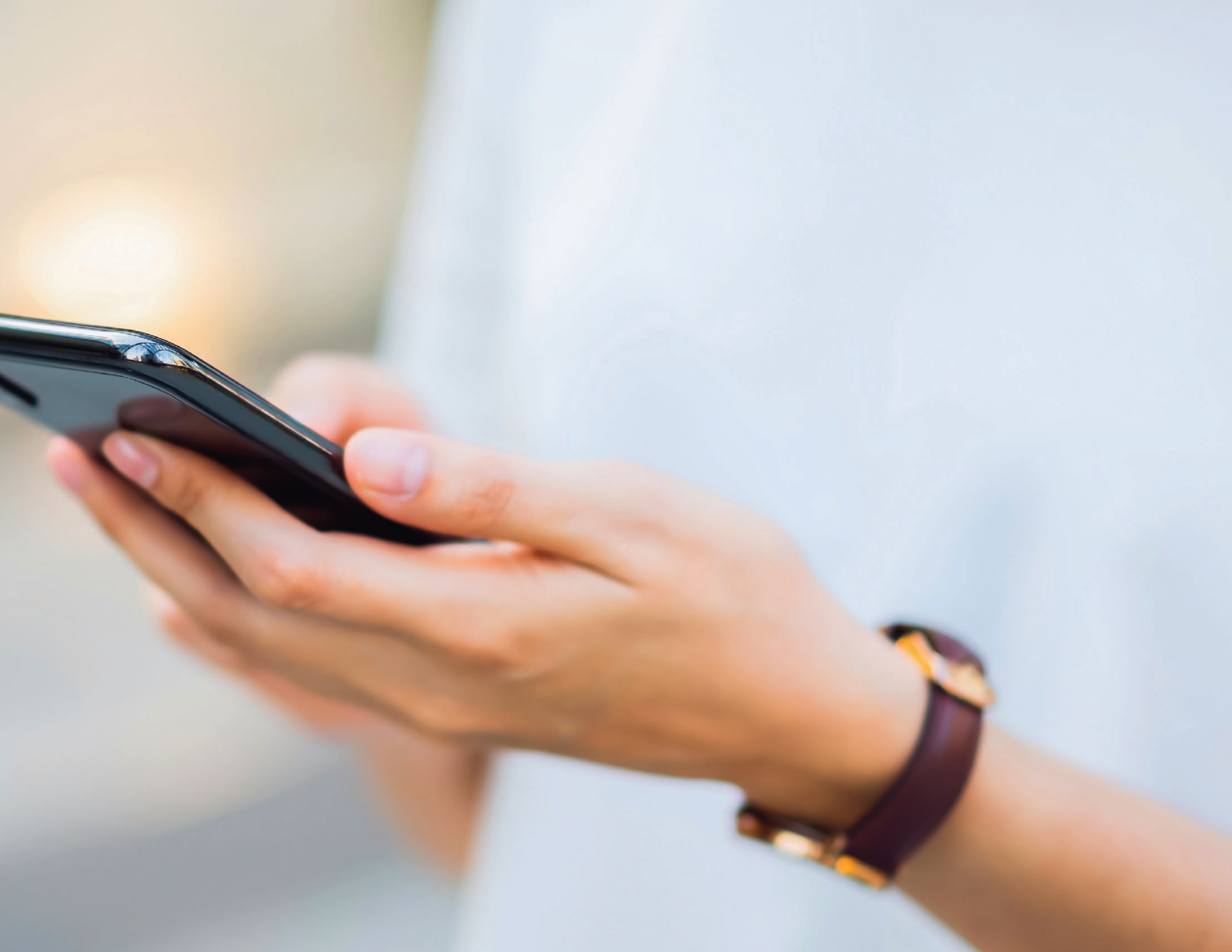
Partnering with Private Equity

One final takeaway is: Private equity is not the enemy. With good planning and thoughtful consideration of how things might change, you can create the path for a win-win situation instead of thinking of it as a zero-sum game. If private equity has not disrupted your customer base yet, it would be worthwhile to understand the prime opportunities for disruption now. Game plan the likely scenarios and what kinds of shifts to positioning you can make if an acquisition occurs. This way, you can best establish yourself as an exceptional partner to new private equity portfolio companies.

LET'S TALK

insights@jabian.com

FOR ADDITIONAL INSIGHTS, VISIT
JABIAN.COM/SERVICES/MERGERS-ACQUISITIONS



Jabian Consulting is a strategic management and technology consulting firm with an integrated approach to creating and implementing strategies, enhancing business processes, developing human capital, and better aligning technology – ultimately helping clients become more competitive and profitable. Jabian blends functional expertise, industry knowledge, and senior experience to think strategically and act practically. It's a Strategy that Works®.

Headquartered in Atlanta, with additional offices in Chicago, Charlotte, and Dallas, Jabian Consulting works closely with our communities and takes an active role through our 501(c)(3) foundation, Jabian Cares, providing financial assistance, volunteerism, and leadership.

For more information, visit www.jabian.com

jābian consulting