Private equity and digitization

The hidden equity story
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For private equity funds, the days of buying stakes in companies at a low price and selling high are over. Prices are high across markets, competition is fierce, and opportunities for multiple arbitrage are scarce. More than ever, private equity managers need special insights to find value where others can't. They also need the skills to take a fairly priced asset, implement hands-on management, and create value that will boost their returns.

There is still a largely untapped area that offers extraordinary opportunities for value creation, but most private equity firms — in fact, most investors — aren't fully aware of the potential here and therefore aren't yet asking the right questions: To what extent has the target company digitized its services and products, operations, and back office? How does the level of digitization compare with that of its competitors? How much more can be done, and what's the best way to do it? These are some of the questions that should be a big part of any private equity investor's due diligence. But except for technology-focused funds, many private equity investors are neglecting digitization's importance and may need additional expertise in recognizing and developing a strong digitization strategy.

Digitization has by now made its way into nearly all industries. It isn’t just about tech companies, or sales channels, or a little more cost savings on the margins; it’s also about creating new products and services, new production methods, and new ways of collaborating with customers and suppliers. It’s about the revolution of the industrial sector under the banner known as Industry 4.0, and beyond; though few people associate such sectors as natural resources and chemicals with the latest technologies, digitization can change every sector of the economy — and it is. All of a company’s physical assets and all of its partners along the value chain can become part of an ecosystem in which data moves seamlessly throughout. In a fully digitized company, production and supply chains will be lean and flexible. Marketing will be omnichannel and responsive to customer needs. The company’s
internal structures will be efficient and integrated. Product and service offerings will be digitized and expanded. The company will have, in sum, much greater potential for growth and profitability.

Understanding this big picture is just one piece of the puzzle. Private equity managers also need to be able to assess precisely where individual target companies and their competitors stand in this ongoing movement. They also must have the ability to provide hands-on management when needed so that they can help their portfolio companies develop comprehensive digital strategies and build necessary capabilities.

When private equity firms have this knowledge and this ability, their view of potential acquisitions will change, sometimes dramatically. In some cases, paying a premium is justified because the target company is digitally advanced. Other companies lag so far behind digital leaders that they’re not worth buying regardless of the price.

Still other companies, digital laggards in sectors with no clear leader, have enormous value that can be unlocked. For that, private equity managers must have the capabilities to guide a digital strategy and the implementation of new technologies. With some companies, these technologies can do far more to improve performance than traditional cost-cutting methods can.

In this report we provide an overview of how a private equity manager should start assessing a company’s digital capabilities. The investment due diligence process should include a “due diligence on digitization” component; to that end we’ve formulated a (by no means exhaustive) series of important questions that private equity investors should ask, along with a look at how companies typically evolve into digital maturity, a briefing on core digital capabilities that a company should have, and strategies that private equity funds can use to maximize returns.
Private equity and digitization today

The investment environment is challenging. Plentiful capital and cheap debt have driven up companies’ prices. Private equity firms and corporations are buying more businesses than they’re selling. Adding to the competition for attractive assets, more and more Chinese strategic investors are making acquisitions abroad, further increasing the pool of capital competing for targets. Since most private equity firms have learned from the financial crisis and refuse to overpay, many deals are failing or becoming very drawn out.

In this environment, private equity funds need every tool they can get to screen the markets and develop portfolio companies. It’s no longer enough to look at the usual factors such as market position, historical performance, industry trends, cash flows, and capital expenditures. It’s also not enough to marshal the traditional tool kit for cutting costs and improving processes. To judge a company’s position and prospects, an investor has to know where the company and its competitors stand in the digitization journey.

The answer will determine whether a company can prosper. In some cases, it may even determine whether the company can survive. Product life cycles are getting shorter, and a seemingly solid legacy product can become obsolete suddenly. But the speed with which digital technology can change a business also provides opportunities. PwC’s 2015 Global Digital IQ Survey found that companies in the top quartile of digital sophistication were twice as likely to achieve rapid revenue and profit growth as those with lower scores.\(^1\) For private equity firms, digitization offers many ways to create value within portfolio companies by improving their processes, as well as upgrading and expanding their product and service portfolios (see Exhibit 1, next page).

Digital development of portfolio companies requires additional capital, but our latest research indicates that digital investments tend to pay off quickly. The PwC 2016 Global Industry 4.0 Survey\(^2\) found that companies that have put a full digitization strategy into effect expect to increase their revenues by an average of 2.9 percent over the next five years and reduce costs by an average of 3.6 percent per year.
Exhibit 1
Impact of digitization on value chain and value creation

Digitization
(illustrative technologies)

1. Business model, products, and services
2. R&D and innovation
3. Purchasing and production
4. Supply chain and logistics
5. Marketing, sales, and customer service
6. Enabling functions (HR, IT, finance)

Value creation

↑ Sales
↓ Opex
↑ EBITDA
↓ Working capital
↓ Capex
↑ Cash flows
↓ Risk
↑ Growth
↑ Multiples

Source: Strategy& analysis
A significant minority has even projected total revenue growth of more than 50 percent over five years.

In the following pages we look at questions and capabilities that private equity firms should consider for both target and portfolio companies — in six key areas:

1. Business model, products, and services
2. R&D and innovation
3. Purchasing and production
4. Supply chain and logistics
5. Marketing, sales, and customer service
6. Enabling functions (HR, IT, finance)

1. Business model, products, and services

Digital business models are increasingly important throughout the global economy.

The following questions and discussion points will help private equity investors measure a company’s digital capabilities and provide guidance on how to help a company develop a fully digitized business model and portfolio of products and services:

• Does the company have a digital strategy and business model? Companies with strong digital business models will have strong product and service portfolios, or they might have a wholly digital ecosystem (see Exhibit 2, next page). These portfolios will increase revenue and growth, and justify higher valuations.

• Does the company have a digital organization, including a chief digital officer or equivalent? PwC’s 2016 Global Industry 4.0 Survey and Digital IQ research found that the biggest implementation challenge is not technology, but a lack of digital culture and skills within the organization. Companies need a visionary C-suite leader to drive the changes that digitization brings.

• Which products and services are threatened by digital disruption, and which are less at risk? We’ve all seen how quickly new technologies, and new ideas for existing technologies, can turn markets upside down. Asset-light business models allow disruptors to enter new markets quickly, resulting in global competition even in markets (such as taxis and movie rentals) that everyone once thought were
Exhibit 2
Digital business models typically focus their value proposition on one digitization layer

- **Core product**
  - **Physical**: Traditional base offering, which can be “digitized” by adding digital layers around it (e.g., a German company offers physical sensors for internal climate control that connect to Wi-Fi and allow users to create apps without having to develop hardware).
  - **Digital**: Data and technology define the product’s value proposition and generate stand-alone revenues (e.g., media companies that sell information).

- **Digital augmentation**
  - Digital customer interfaces, touch points, and channels augment the core product and allow a variety of interaction models (e.g., sporting goods manufacturers equip running shoes with sensors so that users can evaluate their performance on a smartphone or computer).

- **Digital service**
  - Digitally enabled services that in combination with a physical product can provide an end-to-end solution to a broader customer need (e.g., a traffic app provider that supplies traffic information and uses the data it gathers to help customers choose locations for opening a business, measure results of marketing campaigns, or plan transit systems and roads).

- **Digital ecosystem**
  - With interfaces to suppliers, partners, and customers, the product is embedded in an ecosystem for co-creation and additional value capture. Online retailers such as Amazon are classic examples: They sell products directly, create new products and services with partners, and provide a marketplace for other retailers.

Source: Strategy& analysis
A target company’s leaders should have an eye on trends in the making and a plan for taking innovations to market.

- **How will the trends toward increasing digitization affect the overall business model?** In more traditional industries, can any of the company’s products be digitally enhanced? In all industries — sometimes even those with technology products — to what extent does the company have digital ecosystems, components, or add-on services? Can it develop new digital products, services, and ecosystems?

### 2. R&D and innovation

A company that has the right strategies and capabilities to address a rapid demand for new products will be able to lower costs and increase sales. It will also be a lower-risk investment, since if disruptions arise, the company will be able to move swiftly to safeguard its existing business or establish a new one.

New products and services are coming to market more and more quickly, and customers are demanding faster responses. Change is rapid, and disruption due to technology is a constant threat. This faster pace of business means that the old models for private equity investors to optimize portfolio companies are no longer enough. Questions an investor should ask and digital capabilities a company should have include the following:

- **How innovative is the company?** Companies may have to develop new products and services if they want to increase or even just maintain their market share and profitability. Digitally enabled innovation is increasingly needed in every sector, not just in technology companies. If a company has been innovative without much digitization, it’s likely that it can do even better with digital support.

- **Is the company using digital prototypes, 3D printed prototypes, and simulations to create new products?** These advancements facilitate innovation and get new products to market more quickly; they are faster, cheaper, and more flexible than physical prototyping. The auto industry, for example, can now use 3D printing to make an intake manifold prototype in less than a week for around $3,000; previously, it would have taken about four months and cost approximately $500,000 to make the prototype.

- **Are products and services co-created with customers, suppliers, and partners?** Co-creation leads to innovation and faster product development, since it makes a company more responsive to demands and more flexible in meeting them.
• **How effectively is the company using data and analytics?** Although harnessing and analyzing data quickly is a challenge for most industries, a company that has a strategy in place for using sensor data from products in the marketplace is in a better position to identify problems and provide insights to improve performance, quality, and design. The data can be shared with suppliers so that they, too, can use it to improve their products.

### 3. Purchasing and production

Even if costly investments are needed in the beginning to take advantage of digitization in purchasing and production, the investment will pay off quickly. Operating expenses will drop while output and earnings will keep growing.3

The following questions and capability considerations will help assess and develop a company's purchasing and production processes:

• **How automated are tenders and the evaluation of suppliers?** Tenders should be automated, and companies should be using B2B platforms for purchases. Offers and suppliers should be automatically and constantly evaluated. The automated evaluation should be multifaceted, taking into account macro variables such as currency exchange rates and raw materials prices.

• **How integrated are production processes throughout the company?** Which digital technologies are supporting these processes, and what gaps still exist between the current operations and the systems needed to provide value? Companies should use integrated planning and scheduling systems, ranging from the sensor level to ERP. These systems provide real-time visibility of the status of ongoing production. Costly investments may be needed up front to take advantage of digitization in purchasing and production, but they often pay for themselves more quickly than expected. Check to see if there is a plan for operating expenses to drop and output and earnings to grow over time as a result of these investments.

• **How flexible is production?** In principle, digitized production is modular and flexible, making it easier to tailor products and packaging to customers’ needs. Production through 3D printing is on the rise. Digitization can connect far-flung assets and operations, increase flexibility, identify bottlenecks, and optimize workflows. But in practice, not every company has realized these benefits.
• How extensively has data analytics been incorporated into sourcing and operations management? Data analytics and quality controls allow for the permanent monitoring and prediction of deviations, and for integrated responses. Processes can be optimized with big data. Moreover, the monitoring of equipment and performance permits predictive maintenance: Maintenance schedules will be defined automatically, and problems will be solved before they actually happen. To set all this up, however, requires a high level of expertise and some investment.

4. Supply chain and logistics

Most companies have emerging opportunities to digitize their supply chain and make big gains in efficiency. The following considerations will guide the investor in assessing and improving a company’s supply chain:

• How well integrated are the company’s suppliers, customers, and logistics providers? Digital transformation of industrial companies can yield large gains in efficiency and increase flexibility. For example, by connecting its suppliers, production processes, customers, and logistics, the German industrial group Thyssenkrupp was able to boost output by 30 percent within two years without building new factories.¹

• Does the company have end-to-end logistics visibility? Digital capabilities can be used in every link of the supply chain, to maximize integration and optimize inventory levels. Cloud-based platforms permit end-to-end planning and horizontal collaboration with suppliers and customers. These platforms can automate most planning, in real time. Data-driven analytics and communication across the supply chain can improve forecasts and performance.

• Does the company use smart warehousing? This makes order management more efficient, with nearly real-time order confirmation, a “touchless” order process, and full transparency. Inventories can be lower, with autonomous packing, augmented picking of the right products, and logistics systems integrated throughout the warehouse network.

• With what level of inventory (vendor products, intermediate products, and final products) is the company operating? With digitization of external logistics, companies can track and trace supplies, identify problems, and respond quickly and effectively, thereby reducing inventories to a minimum.
5. Marketing, sales, and customer service

Digitization offers many opportunities to increase revenue and customer satisfaction, especially since so many customers now are “digital natives” who have grown up with technology. Many companies outside the technology sector now lag behind in these areas. A private equity investor might need to bring in its own team of experts to close any digital marketing, sales, and service gap and add value quickly. In judging and improving a company’s digital sophistication in the areas of marketing, sales, and customer service, investors should consider the following:

- **What marketing channels is the company using?** Companies that use omnichannel and personalized marketing (websites, mobile apps, and social media in addition to traditional channels) will reach the new generation of digital natives. The emphasis has to be not on B2B or B2C, but on B2P: reaching people, whether those people are individual consumers or buyers for companies.

- **What percentage of the marketing budget goes to each channel?** Industrial companies are often especially far behind the current marketing and sales trends, even when they’re market leaders. But almost all companies, whether they sell to businesses or to consumers, have room for improvement.

- **How integrated is marketing?** Digitization permits joint marketing with suppliers, business customers, and other ecosystem partners, while digital customer journeys enhance the customer experience. Customer journeys should include not only marketing, but also sales and customer service.

- **What digital sales channels are offered?** Offering several digital sales channels gives customers the choice of their preferred way of buying. Digital sales interfaces should include customers’ reviews and suggestions and allow customers to configure products themselves, thereby enhancing customer experience. Algorithms that integrate and analyze data about demand, supply, and competitors’ prices will let companies automatically adjust prices, as airlines do with tickets.

- **What percentage of customer interaction goes through digital channels? Which of these channels are also used to manage customer relationships?** Digitized customer service gives customers the quick response times and multiple options for contact — including through social media — that they are demanding. Companies can also integrate their digital customer service offerings with suppliers’ and even customers’ own systems.
• **What data is gathered, and how is it used?** Digital interactions with customers make it easier to gather data about customers and about the broader market. The data collected from customers can be integrated with data from sensors on products, from partners, from transactions, from digital search tools, and from social media. Using this data helps improve marketing, sales, and customer service — e.g., by tailoring marketing to specific customers. Advanced analytics of this data also provides valuable insights for improving the products and services offered and for creating new products and services.

6. **Enabling functions (HR, IT, finance)**

In a company taking advantage of digitization's potential, the human resources, information technology, and finance departments will support the company’s transformation. These departments will also use the technology to run themselves efficiently.

In *human resources* departments, these considerations will help map out a company’s status and improve it:

• **Is there sufficient talent to take advantage of digital trends? How easily can the company meet new staffing needs?** Good HR departments attract and retain digital talent. They use analytics to predict future staffing needs. If necessary, they also rethink the company’s branding, to make it easier to recruit digital-savvy talent from all over the world.

• **Does the company hold training sessions to cultivate digital skills? How is knowledge sharing and collaboration managed throughout the company?** Digitally aware HR departments hold training sessions so employees can take advantage of the latest trends, and they supervise systems for collaboration.

• **How digital is the overall culture?** A digital culture with its flexibility and flat hierarchy encourages fast, responsive decision making.

Just how well *information technology* departments can support a company is shown by these discussion points:

• **Does the chief information officer have a leadership role in the company’s digitization strategy?** PwC’s 2015 Global Digital IQ Survey found that 40 percent of CIOs globally were leading all digital efforts, including operations, market-facing efforts, and innovation.\(^5\)
How well is IT supporting business functions and processes? The best IT departments fully integrate collaboration and knowledge management tools with all business applications.

To what extent are data and applications in the cloud? The best IT departments also take full advantage of cloud computing and ensure cybersecurity. Workplaces should be fully digital.

A digitized finance department gathers and analyzes data to support every other part of the company — and should help lead the company’s overall efforts. Key considerations include the following:

How well is the finance department integrated with other business functions? When a digitized finance department is fully integrated with the rest of the company, fewer costly reconciliation efforts and manual adjustments are needed. The department can then also provide tailored, on-demand financial reporting. The rapid, automated analysis of financial data lets management better judge the feasibility and likely profitability of new products and business models. Digitized finance departments can also better connect financial planning with operational and sales planning.

Does the chief financial officer play a leading role in determining the organization’s digital strategy? The finance department is ideally placed to provide data and analytical techniques, and to identify customers’ emerging needs and the company’s effective use of resources. Furthermore, a recent PwC study on finance in the digital age found that the finance teams that were most successful in leading change were operating at 40 percent lower cost than their counterparts that ranked in the middle tier. They were also playing a stronger role in winning business and providing insight into how to make new business ventures successful.

Has the finance department improved its own efficiency through digitization? Digital operations can cut the time spent on critical financial reporting and regulatory functions, freeing up resources and sharpening the company’s insights.
Since digitization is so valuable, it’s never too early or too late to start implementing it in portfolio companies. But investors need careful research and analysis to understand which particular strategy is appropriate to a particular company. Of course, as with any company requiring investment, digital or otherwise, the investor must measure the costs against potential returns, and the necessary capital has to be available.

For companies that are recent acquisitions, the evidence that digital investments often pay off within five years or less indicates that returns on digital investments will more than compensate for the reduced cash flows early on. Investors can then sell these companies, with increased cash flows and profitability, for much higher valuations.

For companies that have already been in a fund’s portfolio for some time, and for which a near-term exit had been planned, analysis may show that it’s worth postponing the exit in order to implement digitization. The value generated from digitization — even if the company is only partially developed — will compensate for the longer holding period. A good start down the path of digitization can be enough to increase potential acquirers’ estimates of the company’s growth potential and value. With this approach, a private equity firm creates the digital base for rapid future growth, and then leaves part of the equity story for the buyer.

If a firm can successfully brand a company as more digitized, technologically advanced, and “future ready,” buyers will almost always be willing to pay more. Strategic acquirers, for example, will usually pay higher multiples for successfully digitized companies, since they’re easier and faster to integrate. Similarly, other private equity funds may be willing to pay higher multiples for digitized companies when implementing buy-and-build strategies.
Due diligence on digitization has to be part of any private equity firm’s screening process. Existing or potential digitization may justify paying more for a company in a competitive auction. But a thorough analysis is needed to avoid pitfalls and find opportunities. Both overpaying and value traps are bigger dangers than ever in the digital age.

*Digitally advanced companies* may have a strong first-mover advantage, so they can often stay ahead of their competitors. *Exhibit 3, next page,* shows advantages that a company stands to gain as it acquires digital maturity in four of the key areas. But a careful analysis might reveal that such a company is overpriced and that a purchase may be unwise; the potential for value creation is probably lower. Careful assessments are needed, not just to understand how well a company is digitized, but also to judge whether the digitization level justifies paying the premium demanded.

*Digital laggards* are usually cheaper and have more upside potential when digitally developed. But here, too, careful assessments — of both the target and its competitors — are needed, with a focus on these questions:

- Is the discount compared with digital leaders big enough?
- How much upside can be realized through digitization?
- Is the gap between the laggard and the leader too big to be closed?
- Is the gap so big that a company should be valued as distressed?

It’s often a highly effective strategy to pick targets whose *entire industry is less digitally developed*. If an industry has no clear digital leaders, a well-managed digital novice can quickly become a technological leader and gain that first-mover advantage.
### Exhibit 3
Digital maturity model

<table>
<thead>
<tr>
<th>Business model, products, and services</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. Digital novice</strong></td>
</tr>
<tr>
<td>Physical products without digital functions; first isolated digital products, applications, and services; sporadic combination of products and digital services</td>
</tr>
<tr>
<td><strong>2. Vertical integrator</strong></td>
</tr>
<tr>
<td>Products become “smart” with additional digital functions and digital memory (sensors); product and service portfolios have software, network (machine-to-machine), and data as key differentiator</td>
</tr>
<tr>
<td><strong>3. Horizontal integrator</strong></td>
</tr>
<tr>
<td>Integrated customer solutions across supply chain boundaries; collaboration with external partners; transfer of product characteristics to the whole network</td>
</tr>
<tr>
<td><strong>4. Digital champion</strong></td>
</tr>
<tr>
<td>Digital services at the core; ecosystem with partners; development of new disruptive business models with innovative product and service portfolio; lot size of one; product and component identification</td>
</tr>
</tbody>
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<table>
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<tr>
<th>Purchasing and production</th>
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<tbody>
<tr>
<td><strong>1. Digital novice</strong></td>
</tr>
<tr>
<td>No systematic assessment of suppliers; focus on optimization of single production sites; production not connected with ERP system</td>
</tr>
<tr>
<td><strong>2. Vertical integrator</strong></td>
</tr>
<tr>
<td>Assessment of suppliers coordinated with logistics and production; production within a production site completely connected with ERP system; partial optimization of machine clusters/lines; quality management</td>
</tr>
<tr>
<td><strong>3. Horizontal integrator</strong></td>
</tr>
<tr>
<td>Production sites connected (e.g., dynamic routing of orders); production parameters, work plans, and allocation of machines managed dynamically</td>
</tr>
<tr>
<td><strong>4. Digital champion</strong></td>
</tr>
<tr>
<td>Automatic tenders and use of B2B platforms; dynamic, self-optimizing production network with flexible resources; optimization based on total cost of ownership</td>
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<table>
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<tr>
<th>Supply chain and logistics</th>
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</thead>
<tbody>
<tr>
<td><strong>1. Digital novice</strong></td>
</tr>
<tr>
<td>Manual planning in functional silos; traditional communication with suppliers; manual processing of orders and logistics; no monitoring of logistics</td>
</tr>
<tr>
<td><strong>2. Vertical integrator</strong></td>
</tr>
<tr>
<td>Internally integrated system-based planning; volume transparency established; internal optimization of logistics orders; internal monitoring of logistics</td>
</tr>
<tr>
<td><strong>3. Horizontal integrator</strong></td>
</tr>
<tr>
<td>End-to-end integrated system-based planning with suppliers and customers; IT integration with suppliers (e.g., ERP); automated order processes with suppliers; close, system-supported collaboration with logistics providers</td>
</tr>
<tr>
<td><strong>4. Digital champion</strong></td>
</tr>
<tr>
<td>Completely digitized, overarching, intelligent planning platforms; completely digitized communication with suppliers; real-time transparency of supply chain; total transparency with self-optimized routes; dynamic optimization of warehouses</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Marketing, sales, and customer service</th>
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</thead>
<tbody>
<tr>
<td><strong>1. Digital novice</strong></td>
</tr>
<tr>
<td>Online presence is separated from offline channels; product focus instead of customer focus</td>
</tr>
<tr>
<td><strong>2. Vertical integrator</strong></td>
</tr>
<tr>
<td>Multichannel distribution with integrated use of online and offline channels; data analytics deployed (e.g., for personalization)</td>
</tr>
<tr>
<td><strong>3. Horizontal integrator</strong></td>
</tr>
<tr>
<td>Individualized customer approach and interaction together with value chain partners; intensive use of partner data</td>
</tr>
<tr>
<td><strong>4. Digital champion</strong></td>
</tr>
<tr>
<td>Integrated customer journey management across all digital marketing and sales channels with customer empathy and customer relationship management</td>
</tr>
</tbody>
</table>

Source: PwC and Strategy& analysis
In the current investment market, it’s more important than ever for private equity firms to choose target companies wisely and to develop them to their full potential. But unless firms embed due diligence on digitization inside their standard commercial due diligence, they increase the risk of missed opportunities and unexpected losses.

In the acquisition phase, due diligence on digitization will look not only at target companies but also at their competitors. In the development phase, the concepts outlined above give an idea of the many ways digitization can create value and prepare companies for a profitable exit. And digitization is an ongoing process. A proper base for digital development, combined with effective communication, can add an extra layer to the equity story: Would-be acquirers that understand the potential for further growth may be willing to pay a higher multiple.

Experience and specialized skills are needed to take advantage of digitization's potential in both the acquisition and development phases. Private equity firms that don’t have these skills may have to invest to build out their own digital capabilities, or align with strategic partners that know how to assess target companies, support digital transformations, and capture the potential value.

With the right capabilities, a firm can use the lens of digitization to pick the right targets, avoid potential losses, maximize its portfolio’s value, and build a reputation in the markets for preparing companies for future success.
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Endnotes

1. “Are You a Digital IQ Leader?,” PwC 2015 Global Digital IQ Survey, pwc.com/digitaliq

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