

On the radar

Here are the top five ways private equity firms are using technology to track portfolio company performance.

By Greg Woolf of Vantage Reporting

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A growing number of general partners are looking for new ways to leverage technology to provide more flexible yet sophisticated portfolio performance monitoring.

Among the drivers of demand are recent changes in the credit markets. Firms that were once doing high-valued deals when cheap financing was easy to come by are now finding themselves under closer scrutiny as to how those deals are to achieve positive realizations for their funds.

At the same time, the private equity markets continue to grow in both volume and complexity, exacerbating the challenge GP's face in calculating, analyzing and reporting operating performance of their portfolio companies to limited partners and other stakeholders.

Given these factors, GPs are seeking more robust ways to monitor and report on operating performance, not just within and across underlying portfolio companies, but at a fund level as well. They are looking to software solutions to provide standardized performance analysis across the portfolio, specialized analysis for certain industry sectors, analysis of the debt, both pre- and post-acquisition, and for early stage investors, a means to gauge performance when traditional metrics aren't available. Finally, GPs use such technologies to apply valuation models across the portfolio to capture the true value of the entire fund. Here's a closer look at the top five ways firms are using technology to monitor portfolio company performance.

1. For standardized analysis across the portfolio

As PE firms turn closer attention to their portfolios, many are looking for new ways to standardize performance measurement across their portfolios. A typical analysis that pertains to all portfolio companies is a comparison of operating results against prior periods or annual budgets. Most firms scrutinize at least revenue, gross profit, and EBITDA at their portfolio companies on a quarterly basis (or monthly, if available) from each company's profit-and-loss statements.

A further analysis of the financial stability of a company's balance sheet includes key assets, liabilities, working capital and capital expenditure. Firms that proactively grow their portfolio compa-

nies through acquisition may monitor current performance against pro-forma results to show the effect of acquisitions on the resulting performance. A growing number of firms are looking to implement operating company "dashboards," which provide a snapshot of the financial performance and position of each portfolio company for use at internal investment team meetings and to streamline quarterly reporting processes for limited partner communications.

There is a wide range of non-financial portfolio company information that firms monitor and update routinely for internal purposes and investor reporting as well. This includes company profile, such as investment tranches and amounts, syndicate investment partners, capitalization and valuation; business address locations, description and strategy; management and board of director contact information; due diligence teams and consultants; key action items, such as strategy, product, marketing and staff changes; management discussion and analysis for quarterly investor updates; recent news and events; and key company deal documents, which may be stored in a central repository.

2. For industry specific analysis

Many firms invest in diverse industries and sectors. While all companies have certain standard financial metrics, each industry has specific metrics that provide the best measure of the company's performance. Some firms track unique financial metrics specific to individual companies. These analyses can be vastly different depending upon the industry sector, such as same-store sales for retail companies or subscription rates for media companies. Some firms extend their analysis to compare portfolio company statistics—not just against previous results for the same company, but against similar portfolio companies or recognized industry benchmarks, if available.

Finding a single solution that can be used to access data from all portfolio companies is virtually impossible, especially for GP's invested in diversified industries and sectors. That's largely because each industry has its own back-office solutions that are appropriate for the given vertical market. For example, banking software is different from retail software, etc. Moreover, mandating a change in software systems at the portfolio companies could disrupt operations and put at significant risk the operational efficiencies the GP is striving to achieve. Consequently, even some of the industry's leading PE firms continue to perform many of their performance and portfolio management functions manually, relying on spreadsheets that track the monitoring/valuation data, particularly for specialized analyses.

Given the recent industry pressures to support higher volumes and more complex processing demands, there is strong and growing interest in finding a more flexible, automated alternative. Ultimately, the desire is to produce analyses of company financial performance (revenue, EBITDA, debt covenants, etc.) across sectors, strategies, funds or the entire firm's portfolio. Many GPs are looking to implement a flexible data warehouse platform that can import data from disparate formats, standardizing the data to produce, scalable, streamlined analysis and reporting. This allows firms to create powerful performance dashboards that can import variegated data from underlying portfolio companies using standardized templates.

3. For early stage evaluation

Venture capital investors pay special attention to the cash positions of their portfolio companies. In early-stage companies, cash-burn rates, cash flow projections and cash balance restrictions are typically monitored. Equally important is a continuously updated narrative plan about alternatives for when the company may run out of cash.

It is important to distinguish the data entry and upload mechanism between an early stage and a mature company. Early stage companies tend not to have sophisticated in-house financial reporting systems or deep bench-strength on the finance team. Consequently, quarterly financial data may be easily obtained via an easy-to-use web-page, often, comprised of less than 10 lines entered directly by senior management, possibly a founder or CEO. Contrast this with a \$100 million dollar mature portfolio company that provides monthly financial data with possibly 100 lines of P&L, balance sheet and performance data across multiples divisions and departments. Mature company data is typically generated from global enterprise accounting systems, and would be too cumbersome and voluminous to enter via a web-page. Hence this data is often provided in the form of a spreadsheet.

The metrics that drive valuation of an early stage company also differ from a latter stage, mature enterprise. The value of a mature company is generally calculated as an industry-specific multiple of earnings (usually prior year or trailing 12 months' EBITDA) from which any debt or outside equity positions are subtracted to arrive at the firm's valuation position.

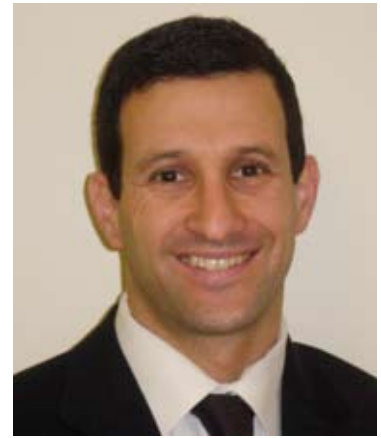
However, an early stage company generally has no earnings to show and is more likely in a cash-burn position. Thus, valuations of early stage companies are driven by different metrics, such as product development or regulatory approval stages (e.g., clinical trial approval by the FDA), forecast profitability or valuation metrics vis-à-vis a strategic acquirer. The ability to track these diverse properties and changes to them over time is essential for assessing a successful exit from the company.

4. For debt analysis

Many investments in mature companies are achieved through a combination of equity and debt investments. Given recent pressures in the credit markets, investment teams as well as their lenders and limited partners are paying a lot more attention to the portfolio company's ability to service acquisition debt that may have been used as a mechanism to close the deal. For leveraged positions, firms tend to analyze the composition of debt as well as its terms and rates based upon prevailing market conditions. Companies are continuously scrutinized to ensure they remain in compliance with debt covenants as well as debt service indicators such as cash flows, interest coverage and debt coverage ratios.

Some firms also monitor the performance of their lenders. For each portfolio company that uses debt as part of the deal, these firms track

which lenders are most frequently used along with a summary of the terms being offered, such as rates and rate structures. In addition to lenders, firms may include ongoing analyses of their acquisition and post-acquisition consultants, such as due diligence experts, to determine how effective they were in the initial acquisition process by measuring their assessments against subsequent company results. Firms that implement programs to improve efficiency and purchasing across the portfolio (e.g., negotiating bulk-rates from service providers) often monitor the effectiveness of those programs from a quantitative and qualitative perspective.



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5. For fund valuation

With valuation methodologies coming under greater scrutiny by investors and regulators, PE firms have been paying more attention to calculating and documenting a defensible valuation methodology on an ongoing basis. The aforementioned industry forces have driven firms to find new technology-enhanced ways to standardize and document their valuation process and methodology. As portfolios grow, the firm's valuation process needs all the more to be timely and scalable.

Many firms base their valuation models on the performance of the portfolio company, such as a multiple of EBITDA or revenue. The ability to quickly obtain and review portfolio company financial performance data in a reporting system is critical to justifying valuations, especially when valuations published to investors are based on trailing 12 months instead of outdated audited financials from prior years.

Early stage company valuations are even more tricky to achieve since financial performance is often not indicative of current value. Valuation is often based upon discounted external financing rounds, comparable public company stocks, proposed acquisition terms and write-down methods.

Some PE funds are extending their analysis of portfolio companies beyond individual company analysis to performance across an entire fund or all funds as a whole. When combined, the aggregate portfolio company revenue for a significant portfolio may equal that of a Fortune 500 or even Fortune 100 company that employs tens of thousands of employees across disparate industries.

Firms with substantial portfolios may view themselves as comparable to a conglomerate or parent company by reporting consolidated operating performance, not just as a purely passive investor. This is especially true for buyout funds that may have a control position in their portfolio companies, either through the majority of stock ownership or control of the Board of Directors.

PE firms continue to wrestle with a plethora of systems and solutions to monitor performance across growing volumes of diverse sets of data. With clients and regulators pressing for more visibility into private equity portfolio performance, GPs are well-advised to streamline their operational environment such that the software they use conforms to the way they work – and not the other way around.