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EVALUATING PRICING IN DUE DILIGENCE FOR VALUE CREATION IN PRIVATE EQUITY

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In today's hypercompetitive deal environment, value creation is critical for acquisition strategies. By formulating the right pricing strategy during due diligence, PE firms can incorporate the potential for significant EBITDA increases into their investment theses and, ultimately, into their bids. BCG's unique approach to assessing potential pricing improvements during due diligence, together with our expertise in executing pricing improvement programs, helps firms capture this upside after acquisition.

GLOBAL PE FIRMS HOLD nearly $1 trillion in dry powder—capital yet to be deployed—in their funds, and acquisition multiples have risen to approximately 11x in 2017, up from 9x in 2013. These factors, among others, make it increasingly necessary that PE investors achieve operational value creation to generate the required returns on investment. In the 2000s, 36% of returns from PE deals resulted from value creation. In the 2010s so far, that percentage has climbed to 55%—and continues to rise.

Pricing is a key means of creating value, and all the gains achieved through pricing accrue directly to the bottom line. Understanding the potential upside from pricing improvements, in turn, gives investors the ability to bid higher, with confidence, for desirable assets. By taking a unique diagnostic approach to pricing during clients' due diligence efforts, BCG routinely identifies significant upside—from 150 to 400 basis points of EBITDA—in due diligence efforts lasting 3 to 4 weeks. For longer efforts, the potential upside can actually be as high as 800 basis points.

Improvement through Pricing—There for the Taking

Room for improvement through pricing almost always exists in a PE context. BCG classifies pricing maturity into five levels: reactive, foundational, analytic, strategic, and dynamic—illustrated on BCG's Pricing Maturity Curve. The opportunity for upside from pricing improvement depends on the target company's level of maturity on the curve. In our work with many of the world's largest and leading companies, and our analysis capturing data through the joint BCG/Professional Pricing Society cross-industry assessment of more than 300 major corporations, we have found that very few companies rank particularly high on this pricing maturity curve.

It is not surprising, then, that a majority of companies targeted by PE investors and examined in due diligence efforts with which BCG has assisted have achieved only a basic level of pricing maturity, which we call foundational pricing. This suggests that most target companies offer as much as 500 basis points of potential gain through pricing transformation, should their businesses lend themselves to dynamic pricing.

Estimating the Opportunity for Pricing Improvement

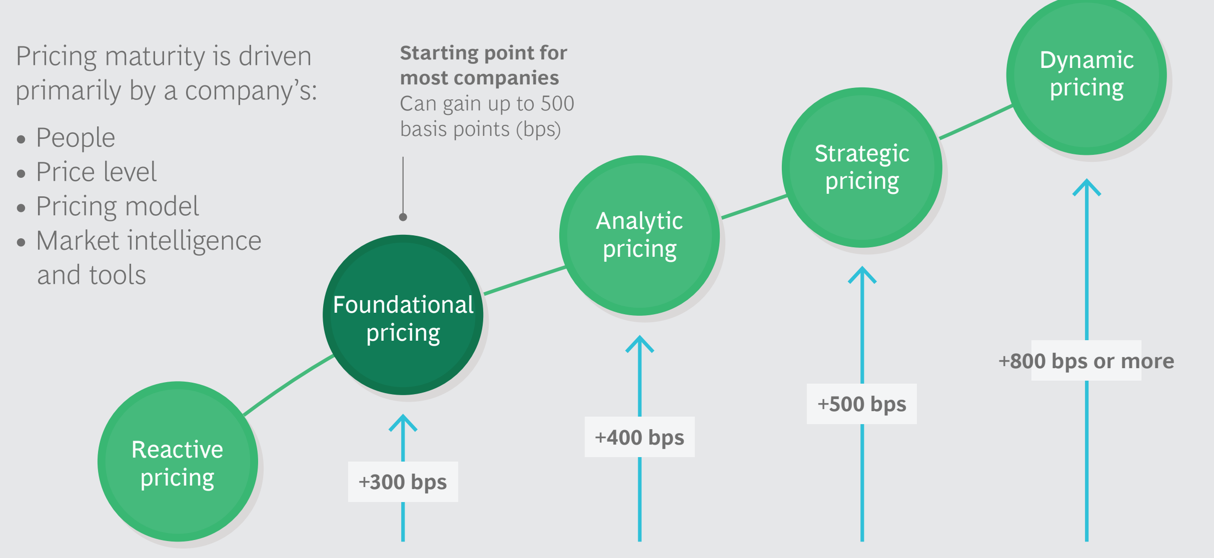
BCG uses three approaches to assess potential pricing improvements that can boost EBITDA in a target company. This three-part toolkit takes into account the unique nature of due diligence processes, which vary both in length and in required access to management and company information.

When all three approaches are combined in the due diligence process, they deliver a very precise and actionable assessment of the scope for pricing improvement in a target company. These three approaches—ranked from the least to most intrusive and the least to most dependent on access to target company information—are:

Outside-In Assessment. This assessment uses means such as market research and interviews with customers and industry specialists—and possibly former employees of the target company. As part of the assessment, BCG evaluates how well the target's existing pricing model meets customer needs while offering the proper flexibility for responding to competitive threats. This analysis allows us to develop hypotheses about where the target could do better.

Capability Benchmarking. This benchmarking process makes use of a limited number of interviews with senior management at the target company. The questions are based on the BCG Pricing Maturity Model, a tool for gauging existing organizational capabilities and comparing them with those of similar companies in BCG's proprietary benchmarking database. This benchmarking first helps identify approaches and processes in the target company that fall short of best practices. It

EXHIBIT 1 | BCG's Pricing Maturity Curve Shows That Most Companies Have A Significant Opportunity for Improving Ebitda Margins



Source: 2015 BCG/Professional Pricing Society Maturity Assessment survey of more than 300 major corporations.
Note: EBITDA equals the median of the self-selected EBITDA range.

can then be used to form a preliminary estimate of how large the potential pricing opportunity might be if a concerted pricing effort is undertaken following acquisition.

This benchmarking requires engagement from the senior management of the target company. It seeks to more finely hone the PE firm's understanding of the pricing opportunity and the level of investment that might be needed to implement the pricing improvements.

Data Analytics. In this approach, BCG uses transactional data—that is, customer-level data with detailed prices and quantities (PxQ)—to identify patterns in price realization relative to list prices. In combination with insights from the due diligence process about customers, competitors, and market dynamics, this information allows BCG to size opportunities quantitatively—and therefore most reliably.

Using one or more of these three approaches (depending on available time and the degree of access to the target company's management team), BCG not only estimates the overall potential for margin increase but also quantifies, in basis points, precisely how much of a margin increase can be gained by applying very specific pricing levers.

Armed with this information, PE investors can confidently incorporate value creation through pricing into their investment theses and valuation models, outbid the competition, and actually realize the projected gains after the acquisition is made. To gain such advantages, investors must build in the time and resources to conduct pricing analysis while devising the planning process for due diligence.

Realizing Pricing Opportunities after Acquisition

BCG's approach to the due diligence process involves identifying very specific areas for pricing improvement. These areas can be easily translated into a pricing improvement roadmap, which means that needed pricing work can begin very soon after closing.

Most often, BCG finds that the specific opportunities for value creation in a target company are associated with a subset of 33 pricing levers across the areas of pricing strategy and architecture, price setting and realization, and infrastructure and functional operations. In most cases, it is possible to identify a handful of tactical levers (that is, ones that can be implemented without changing the entire pricing model) that often account for a large part of the pricing

Exhibit 2 | BCG's Toolkit for Pricing in a Due Diligence Offers Three Approaches

		
OUTSIDE-IN ASSESSMENT	**CAPABILITY BENCHMARKING**	**DATA ANALYTICS**
Identify opportunities based on observation and research	Identify how to apply best practices to understand and size the opportunity	Size opportunities by analyzing data, such as price X volume clouds
Sources	**Sources**	**Sources**
• Expert interviews • Market research	• Interviews with target company leaders • BCG Pricing Maturity Database	• Transactional P×Q data • Price lists

Source: BCG analysis.

opportunity and can be combined with other levers to build pricing capabilities.

Depending on the nature of the business—B2B or B2C—and the pricing context, these tactical levers with short-term profit impact can include:

- Resetting prices for the long tail of products that are not critical for customers' price perception and contribute little to the overall business
- Driving customer-level price realization for smaller customers who are less profitable due to disproportionally high cost to serve
- Introducing or expanding price differentiation through zone pricing to fully capture differences in customers' willingness to pay
- Charging for giveaways or previously free services that provide tangible value for customers—for example, expedited order fulfillment
- Carefully reviewing trade-spend programs and clamping down on wasteful spend, or shifting spend to channels that can drive profitable growth

The greater the estimated increase in EBITDA that pricing analysis reveals during due diligence, the more important it is that PE firms treat the post-acquisition pricing work as a sustained effort. BCG can help ensure, after the due diligence, that the potential value is realized by doing what we call "organizing for pricing." This usually entails clarifying governance of pricing, establishing best-in-class processes and tools, aligning goals and incentives, and ensuring adequate resourcing with the right talent.

While every situation is unique, improving the profitability of a business by several hundred basis points through pricing usually takes a programmatic effort over a period of 6 to 18 months, depending on the starting point on the maturity curve, size of the organization, complexity of the business, and other factors. Typically, the work can be structured in a self-sustaining way—with quick wins early in the program helping to fund the entire journey.

PE investors should also be aware that many of the areas of opportunity identified at one portfolio company may also exist at others. Therefore, we encourage PE firms to systematically capitalize on potential synergies in one of two ways. Companies can sequentially take proven pricing levers,

Exhibit 3 | BCG Works with Up to 33 Pricing Levers to Advance a Company up the Pricing Maturity Curve

Pricing strategy and architecture	Price setting and realization	Infrastructure and functional operations
1 Pricing fundamentals: profitability by product / customer	9 Value pricing	26 Organizing by function
2 Market structure / Pricing power (large accounts, oligopolistic markets)	10 Competitive pricing	27 Roles & responsibilities
3 Value extraction	11 Price to elasticity	28 Decision rights by pricing lever
4 Pricing basis & structure	12 Price ladders/gaps / incentive curves	29 Processes (price increases, exceptions, cross-functional)
...and four other levers	13 Pricing by country / currency (macrozones)	*... and four other levers*
	14 Regional / zonal pricing (microzones)	
	15 Dynamic pricing	
	... and ten other levers	

Source: BCG analysis.
Note: Levers often transferable (with some adjustment) across portfolio companies

where applicable, from one company to the rest of the portfolio. Or they can bundle efforts and attack pricing opportunities for several similar companies concurrently.

Partnering for Optimal Value Creation

BCG's propriety tools and framework for formulating pricing strategy are strongly positioned to support PE investors and deliver ROI in an increasingly demanding and competitive deal landscape oriented toward value creation. To be able to take full advantage of these, it is usually helpful for PE firms to begin discussing pricing-based value creation before due diligence begins.

When BCG supports a firm in the due diligence process, we are best positioned to help that firm with the pricing work after acquisition. We bring from the due diligence an understanding of a portfolio company's economics, value, and competition—three elements that can be essential to the successful implementation of a pricing improvement strategy. BCG's large and capable network of global pricing experts has worked in virtually every pricing context, giving us broad and deep experience in structuring and executing pricing programs.

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