Virtual Analysts

Next Generation Deal Sourcing

udu

PE STACK

Foreword

In recent years, innovative technology products have transformed many elements of private equity deal-sourcing.

Key channels such as intermediary relationships, referral networks and marketplaces can be tracked, managed and assessed through a combination of market data sources and front-office platform tools. By operationalizing key processes in the sourcing process, forward-thinking firms constantly monitor performance and proactively implement strategies to maintain a robust stream of investment opportunities.

However, when it comes to the more open-ended “proprietary” channel, the significant variation between approaches taken by different firms has made it more challenging to achieve the same levels of efficiency and oversight.

We were therefore excited when our friends at udu asked us to examine the value that emerging “Virtual Analyst” technology is adding to deal-sourcing processes in terms of efficiency, consistency and competitive advantage.

Happy Sourcing!

Tim Friedman

Founder, PE Stack

Q&A - Rett Crocker

CEO, udu

Can you give us an overview of what your technology does?

udu uses innovative technology to generate tailored data and intelligence for private equity deal-sourcing teams. We work closely with our clients to establish granular, specific search parameters for their strategy and define what represents a good or bad match. We then apply this criteria to our engine which combs thousands of data sources including websites, APIs and obscure databases to deliver deal-sourcing targets. The results are updated in real time and we work to refine the model until desired results are being achieved.

We use the term Virtual Analyst because our platform can replace and vastly improve upon the human processes currently being used to build and maintain proprietary deal-sourcing databases.

But you're not talking about analysts losing their job to a robot, right?

We hear this a lot! Analysts are actually our biggest advocates because udu allows them to spend less time on mundane and menial tasks and more time developing their pipeline and actually analyzing data.

How are your clients using udu during this period of uncertainty caused by COVID-19?

Firms are understandably spending time focusing on supporting their portfolio companies and communicating with LPs, but the smart money is also seeing this as a time to breathe and prepare so that when this is all over, they can take advantage of compelling opportunities quickly and confidently. In addition to the core activity we typically see on our platform, we've seen numerous instances of clients using udu to build knowledge of new areas as strategies are adjusted and new theses built in the wake of COVID-19. There is a lot of preparation going on behind the scenes because things could get very competitive once the outlook becomes clearer.

I hear comments about incredible opportunities, but then there is a record amount of dry powder and managers will be under pressure, right?

In a scenario where activity has unexpectedly been reduced, there is a danger that unprepared firms under pressure to put capital to work could make bad decisions. It's really important that firms maintain a strong understanding of the landscape and dynamics that underpin their area of focus as the world today looks very different to six months ago. One benefit of udu is that we can help firms track the changing environment and achieve a strong understanding of new areas quickly.

And there are benefits to understanding the exogenous environment when it comes to existing portfolio companies too, right?

Absolutely, and this is actually an area where I think there will be a lot of opportunities for firms with an advanced deal sourcing engine to make some really smart investments. One of the core use-cases for udu is to identify very specific targets for add-on investments. I believe we will see a lot of activity in this area once conditions improve as firms seek to strategically support their portfolio and invest in areas which they already know well.

That's an interesting use-case, I would have assumed that the portfolio companies would be aware of the key companies in their individual competitive landscape?

You've just described one of our biggest challenges, and this is why we encourage potential clients to let us do a pilot search so the results

“A lot of opportunities are missed due to a lack of data”

can speak for themselves. One of our biggest sceptics insisted there was no way we would find companies in the chemicals industry he was not aware of, but to his surprise udu identified a prime target located practically in his backyard.

Proprietary deal flow is still alive!

Some people dismiss the idea as impossible in this day and age, but we have seen numerous examples of proprietary deals which were sourced by our engine. That said, it’s about more than generating unique deals, and truly uncontested investment opportunities are rare. But you can have a proprietary relationship. You can be the first private equity firm to speak with a company owner. You can be the first to track a company and achieve a superior understanding of the business leaving you better placed to make a smart investment decision compared with your peers. That’s why many of our clients set triggers to help them determine when targets enter their sweet spot. Maybe it’s when they hire a VP of sales or expand their warehouse to a certain size. These are the things that humans struggle to track, and certainly it’s impossible to do in real-time.

So it’s about better, faster intelligence.

A lot of opportunities are missed due to a lack of data, and this makes sense when you consider the process for maintaining a traditional database. Whether it’s a commercial product or an internally maintained resource, databases are populated by placing data points into defined fields. If the data point can’t be found, the field normally remains blank, which is actually what many private companies want. In addition to the granularity which we can employ to better isolate relevant results, our engine is also looking for analogs where data doesn’t exist. Take software as an example: the engine might look for the number of online reviews within a set time frame and predict company size by cross-comparison with entities where both metrics are known if the correlation is shown to be strong. All of this is done automatically and will improve over time based on user feedback. This helps our clients to identify opportunities which do technically exist in traditional databases but are impossible to filter.

Like filling in the gaps?

We see it as problem-solving. In the absence of data, how can we identify opportunities and rank them effectively? And even if there is a reasonably comprehensive data source for companies in a specific industry, how do you work out which ones to examine first if there are thousands to go through? A lot of what we do is around efficiency, helping firms to maximize their existing resources and helping them spend more time on the most valuable tasks.

That seems to go hand in hand with the trend we’ve been seeing lately towards operationalizing key tasks in the deal-sourcing area.

Absolutely. Maintaining consistently high standards when it comes to managing operations is vitally important, and I believe this technology is helping managers achieve a higher level of understanding, performance and efficiency. I like to compare it with the hedge fund industry when quant engines were first being introduced. As more firms engage with the technology and realize how much value it can add to different facets of their deal-sourcing operation, the conversation will quickly move beyond whether or not to implement a virtual analyst and onto how to best configure it.

Proprietary Channels: More Important than Ever

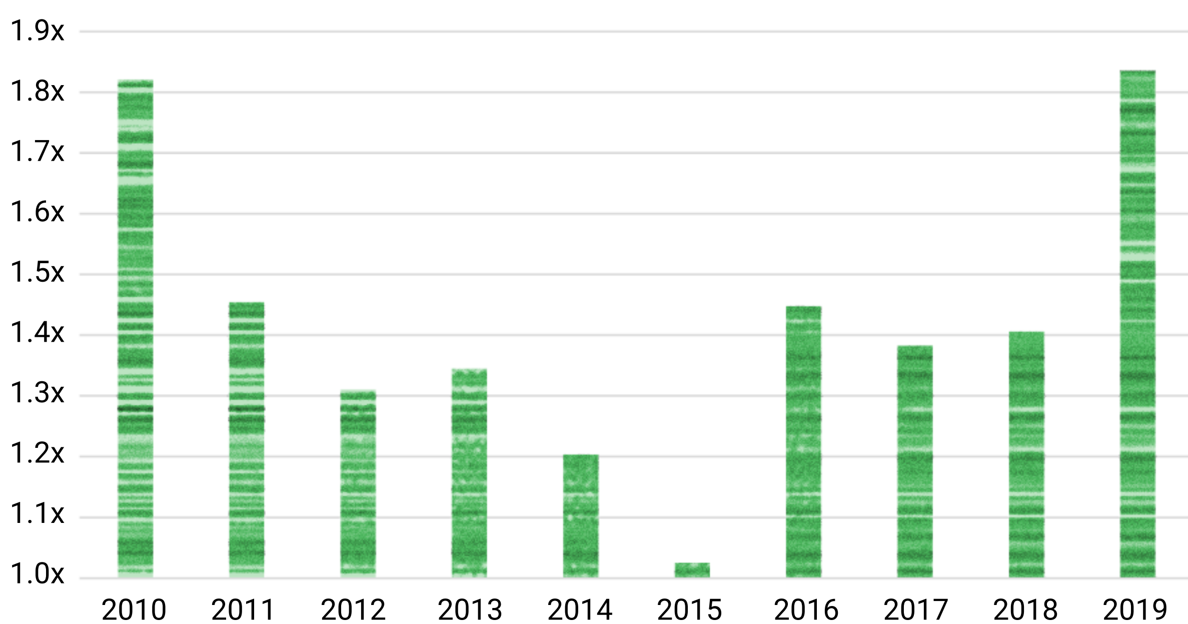
Competition for Assets is Intense

Buoyed by an enthusiastic limited partner community, the private equity asset class experienced consistent, significant growth since the last major downturn, entering the 2020s with record AUM and an unparalleled level of dry powder. Preqin's latest figures show a total of $758bn in uncalled capital available to buyout funds, an increase of 57% over the past decade. Without the right context, such figures are difficult to truly appreciate. If we consider what dry powder is for, and make some simple comparisons, the results highlight the changing dynamics of the asset class.

Fig. 1 shows the ratio between the amount of dry powder at year end and the total value of completed deals. In other words, how many dry powder dollars are there for each completed deal? The trend is clear – in recent years there has been a significant increase in dry powder dollars per dollar invested, with 2019 even exceeding the ratio experienced in the uncertainty-fuelled post-GFC environment of 2010.

As the Coronavirus causes deal activity to contract significantly, this ratio is certain to increase. Adding further fuel to the fire, many firms placing activity on hold will emerge from the crisis with the end of their investment period looming.

More Dollars Chasing Deals - Ratio of Global Buyout Dry Powder : Total Completed Deal Value



Source: Preqin Pro

“we anticipate competition for individual assets to be intense even if overall volumes are muted”

Wait, Isn’t this a Buyer’s Market?

As deal volumes contract significantly as a result of COVID-19, some commentators have suggested that opportunities for attractively priced assets await brave firms willing to make investments. However, low volume does not necessarily indicate a lack of competition – asset owners, which more than ever include private equity firms themselves, will not be so motivated to sell at a reduced valuation unless there are specific factors at play. As we emerge from the COVID-19 crisis, we anticipate competition for individual assets to be intense even if overall volumes are muted. In such an environment, gaining an edge from effective proprietary channels is set to be more important than ever before.

What does ‘Proprietary’ really mean in 2020?

Although firms we spoke to when preparing this paper have generated proprietary deals as a result of effective data and technology strategies, the value of powerful proprietary channels is not defined by its ability to generate uncontested deal opportunities alone. The real value of an effective proprietary channel is to better understand the landscape and create as many opportunities for competitive advantage as possible. For example, a process which identifies companies likely to enter a firm’s sweet spot in future years might yield a long-term relationship and deep understanding of the business, creating competitive advantage should an opportunity for acquisition present itself down the line – even if the process itself enters a more traditional bidding phase. Furthermore, expertise in a chosen industry and region built through knowledge of the specific ecosystem and market dynamics is key to making smart investments – another area where building knowledge of all participants over a long-timeframe can lead to competitive advantage.

Traditional Sources for Proprietary Sourcing

A major challenge in building a robust proprietary channel lies in sourcing, prioritizing and maintaining the target list. When we consider the source for this intelligence, two broad categories emerge:

Market Data

Market databases covering private company intelligence have long provided a valuable resource for deal origination teams and we do not see this changing any time soon. In addition to providing details for potential targets, including sponsor to sponsor deals which are bound to make up a significant proportion of deal-flow in coming years, market databases help teams to price assets effectively and access comparative metrics to build an investment case.

While market data sources serve certain vital functions well, the same attributes which make them so powerful can prove to be a hindrance when considering the deal-sourcing use case. In particular, market data must employ rigid classifications for companies which are often aligned with industry codes such as SIC and NAIC. This allows users to perform analysis and filter the database according to familiar, standardized groupings, but makes it impossible to reliably search by criteria which are more granular or misaligned with industry codes – as we will discuss later in this report, this is especially applicable to the more laser-focused searches which are required to identify add-on opportunities for existing portfolio companies. Even if the right companies are there, the risk of missed opportunities is still high.

Another characteristic of market databases is that all users have access to the same dataset, making it challenging to identify truly unique opportunities. As a result, many firms will utilize additional research methods and sources to bolster their pipeline.

Analyst-Generated Intelligence

In addition to commercial databases and marketplaces, firms use various other sources to uncover opportunities falling into their area of focus. This might include data gathered from public filings, web searches, referrals, media and more. It is this area in particular which is receiving a lot of attention from mid-market firms seeking to create competitive advantage through implementing a more structured, technology-based approach.

Historically, proprietary databases have been built and maintained using inefficient and inconsistent manual data collection conducted by analysts. Today, firms are increasingly seeing the potential to utilize the latest technology by adopting services like udu to power their proprietary database and market monitoring capabilities. By implementing a scalable and proven technology to automate and iterate the process of building and maintaining the data source, deals teams are able to reap the benefits of better coverage while freeing analysts from engaging in menial, inefficient data collection tasks.

Introducing...
The Virtual Analyst

How Does it Work?

The primary value-add of a virtual analyst service like udu is to provide a high-quality, proprietary stream of company data by combining a technology-based approach to scouring thousands of data sources alongside the application of machine learning to iterate on a client's model until well-aligned results are delivered consistently.

In addition to looking for specific data points, the technology overcomes an inherent weakness of traditional databases by looking for analogs - cases where established correlation between data points allows for accurate predictions to be made even if certain inputs are missing.

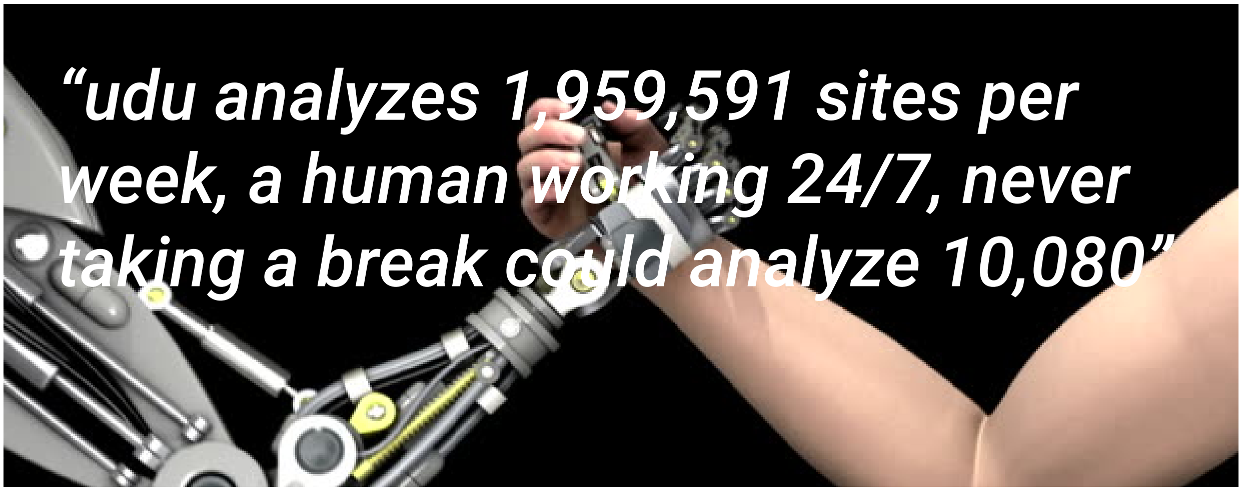
As the platform's engine is always running, the output is constantly updating as a result of both market and individual company performance. As users provide feedback on the results, the model utilizes machine learning to enhance future performance and constantly improve the relevance of the results.

Of course, it is possible for an in-house development team to utilize the same technologies and approach of third-party providers such as udu. This may be feasible for the biggest firms with the right developer resources, but as with other technology products in the space, most firms will find third party providers delivering Virtual Analyst services at scale to be far more cost-effective.

Proprietary Relationships lead to Proprietary Deals

One user of the udu service we spoke to was only partly joking when they expressed dismay that the focus of this report would alert competitors to a data source which had already yielded proprietary acquisition opportunities.

If that sounds hard to believe, that is perhaps unsurprising given the skepticism which users we spoke to initially expressed toward the platform's ability to generate intelligence on potential targets which they were not already aware of. Such attitudes were dispelled only upon conducting a pilot search to see the results for themselves, which is why conducting an effective demonstration of any platform is so important.



Add-ons for Existing Portfolio Companies

When we consider the limitations of market databases and strengths of the virtual analyst service, this is perhaps most applicable to cases where firms are proactively or opportunistically seeking add-on opportunities for existing portfolio companies. In such cases, search criteria is likely to be very narrow and the need for quick, reliable results may be pressing.

As Doni Perl, Principal at Charter Oak stated: “It can be hard to parse all the noise... These tend to be small companies with highly technical specifications that make them attractive, or not.”

We have seen the proportion of dealflow attributed to add-on investments grow considerably in recent years, and we expect many managers will achieve a lot of value from virtual analysts when applying the technology to this use case in particular.

Real-Time Updates and New Opportunities

Maintaining a data source requires a lot of work if there is a manual process at play. Realistically, many firms have a lot of stale data within their proprietary channel. A Virtual Analyst works 24/7 at machine speed, constantly updating the database as inputs change and evolve. The benefits here go even further when the tool is set to trigger alerts when tracked companies fall within desired parameters which align with the firm’s strategy for initiating contact.

Real-time alerts and tracking can also help maintain coverage of the wider environment which existing portfolio companies are operating in, providing additional intelligence for firms on the relative market position of their assets and potentially highlighting add-on targets.

Another major benefit of the Virtual Analyst is the ability to examine and understand new industries and regions with far greater speed and depth, allowing firms to uncover new areas of opportunity plus the confidence to better understand and act on incoming leads in areas which are less well-known to the firm.

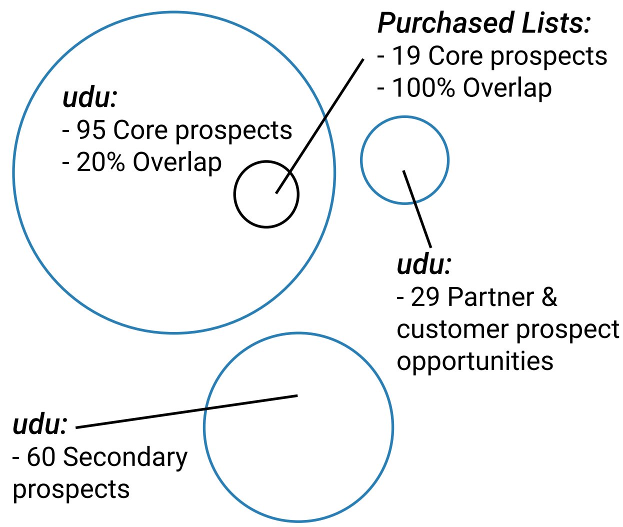
One user described how they were able to produce “a list of leads that our team could not have identified, screened and catalogued in any reasonable amount of time”

Case Study: Charter Oak Equity

Mid-market private equity firm Charter Oak was seeking to identify potential add-on targets for a portfolio company.

The conditions required for a target to be attractive were based on highly technical specifications specific to the portfolio company's industry.

After three iterations over one week, udu delivered 5x the core prospects compared with purchased lists, plus additional intelligence on secondary prospects and partner/customer opportunities.



Operationalizing the Proprietary Channel

The final key benefit which has been highlighted during our investigation into this emerging area is the way in which a more consistent process allows users to implement meaningful metrics to a channel which was previously more ad-hoc. It is possible to see set processes designed to manage Virtual Analyst generated results, with metrics and targets being applied to the channel as a means to ensure optimal performance is being maintained in similar ways to how a firm might analyze its relationship with intermediaries to ensure it sees opportunities aligned with its areas of focus.

The key enabling factor here is consistency – the results will keep coming regardless of shifts in priority from analysts, allowing for measurement in weekly meetings and targets for outreach to be applied. This same consistency also makes it relatively straightforward to measure and track the value which the tool provides, both in terms of the opportunities it creates and the analysts' time which is freed up to do more high-value, impactful work. As with any investment, users expect to receive a good return from the technology which they employ; we encourage clients to consider both the value of incremental opportunities and analyst time saved when assessing the cost of implementing a virtual analyst tool.

You Have a Robust Sourcing Process? Prove It

We started this report by examining the ratio of dry powder to deal value to show competitiveness when bidding for assets. If we take a similar approach to fundraising, the results are perhaps even more noteworthy. As we enter the second half of 2020, a total of $379bn is being sought by 476 buyout funds on the road globally according to Preqin, close to double the number of funds that closed in 2019 raising $358bn. Unfortunately for managers seeking capital, as cashflow slows, less capital is being returned to LPs and there is less pressure to reinvest distributions to maintain an allocation. Aggregate fundraising totals are

Procurement Considerations - Deal Sourcing Technology

Establishing a Baseline - Be Prepared

- What does the current process cost in terms of manpower?
- What is the value of each incremental opportunity?
- What additional strategic benefits can the technology deliver?

Demos and Pilots - Take Control

- Ensure that demos and pilots are tightly aligned with the firm's focus.
- Understand cost of ownership, implementation and ease of integration into existing workflow.

Pricing - Consider the Expected Return on Investment

- Consider pricing in the context of the value of additional opportunities and time-savings.
- Set expectations and targets for the technology which can be used to assess future renewals.

likely to drop significantly, with many of the commitments which are made going to the largest and most experienced firms or to existing GP relationships – a trend which has been gathering pace over the past five years.

With so many new funds to choose from, deep due diligence is becoming increasingly important in dictating where limited funds will be allocated. LPs are scrutinizing not only past performance, but also a firm's approach to ensuring that its operational processes are robust and equipped to deliver strong results for years to come. It is one thing to talk about deal-sourcing capabilities in general terms, quite another to back this up with real metrics showing the number of opportunities reviewed at each stage of the pipeline and the proportion of all completed deals in the sweet spot which a firm was able to bid on as a result of their deal-sourcing engine.

Even for managers not planning to launch a new offering in the immediate future, it would be a mistake to neglect the importance of continually demonstrating best-practice operations to existing LPs through regular high-quality communications.

Past Performance is not Indicative of Future Success: Final Thoughts for GPs and LPs

The results of a pre-COVID EY survey indicate that 43% of private equity CFOs saw technology as a top strategic priority for 2020. The recent surge in activity on our Vendor Profiles platform suggests that this figure has risen even higher since the crisis. The advances we have seen in private capital focused data and technology have transformed the ways in which forward-thinking firms are managing their operations via better data and analytics, plus improved efficiency. The operations underpinning successful funds from prior vintages cannot be expected to produce similar results in the future if they are not renewed and modernized to encompass the latest developments – something that LPs are increasingly scrutinizing as they face tough decisions in the fundraising arena.

We encourage GPs to consider current deal-sourcing processes in the context of advances in technology and advise LPs to include an operational assessment of this area when considering both re-ups and new investments.

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