

THE BUSINESS OF WEALTH

FAMILY OFFICE MAGAZINE

SPRING ISSUE 2021

ART & MUSEUM MAGAZINE INCLUDED



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WEALTH & INVESTMENT MANAGEMENT

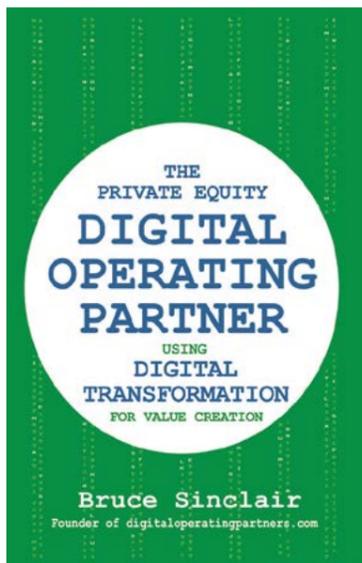
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THE "SMART" VALUE CREATION OPPORTUNITY IN PRIVATE EQUITY



This article was adapted from, *The Private Equity Digital Operating Partner*

It's inevitable. It's coming. It's already here. All companies will become digital companies. I don't mean all companies will use digital (technology), because they already do. And I don't mean all companies will have internal tech projects under way or even a digital product, because many already do. I mean, given time, all companies will become data driven, using data to improve their physical operations and, more importantly, using customer data to improve every

aspect of their products' customer experience. Given time, technology as a stand-alone sector will disappear as it permeates all other sectors.

If you're like most people, your first experience with a smart product came in 2007. At the time, I was living in Montreal and was the CEO of a networking company. We were developing a smart building platform but didn't have a good way to control it. We wanted a mobile solution, so we bought all the top-of-the-line phones to test, including the reigning Nokia N82. The browsing experience for all of them was terrible. Then, on a business trip to New York City, I bought the iPhone 1. It wasn't yet available in Canada, so I had to have it "cracked" to make it work on our networks. I must say, it was a thing of beauty. Whereas the N82 was a phone with computing and networking capabilities, the iPhone was a computing and networking device with phone capabilities.

The iPhone was the first smart phone and, for many of us, the first smart product we ever saw or owned. Think back to the first time you used an iPhone or competing smartphone. Remember how it was better in almost every way than the traditional phone you used before it, and the feeling you had when you used it. That's the difference between a smart product and a traditional product, and that's the opportunity we have in front of us today for every kind of traditional product. Smart is so much better.

	TRADITIONAL COMPANY	DIGITAL COMPANY	DIGITAL TRADITIONAL COMPANY
CREATE VALUE:	Offline	Online + sometimes Offline	Online + Offline
PRODUCTS MADE OF:	Mainly atoms	Mainly bits	Bits + atoms
CONNECTED TO CUSTOMER:	No	Yes	Yes
DATA DRIVEN:	No	Yes	Yes

Even though we already have smart watches, smart speakers, smart homes and smart cars, this is just the beginning. Eventually all companies will sell smart products and have smart operations. Though that future is a little ways off, we are now witnessing the emergence of the smart megatrend that we can capitalize on as private equity (PE) investors.

Smart companies outperform the broader market, independent of sector. All the reasons that make private equity successful as an asset class are the same reasons that make it best suited to digitally transform companies into smart companies.



$$DIGITAL TRANSFORMATION = \sum_{i=1}^n d_i$$

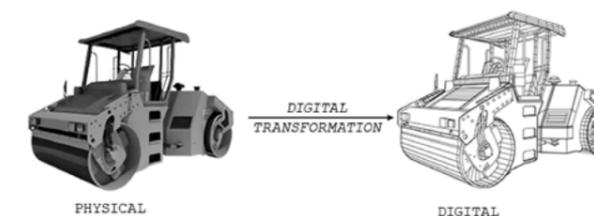
where d_i = digital initiative i

Transforming a traditional company into a digital-traditional company (Figure 1) is a clear example of where the active management ethos of PE can do a better job than the average company left to its own devices. The desire for change, quick decision making, and the rapid alignment of resources and incentives are hallmarks of private equity and what's exactly needed during digital transformation.

DIGITAL TRANSFORMATION

What is digital transformation? Let's break it down. The digital part is described consistently across the board: Digital is technology. However, to put a finer point on it, digital, in PE, should be high technology such as the internet of things (IoT) and artificial intelligence (AI), not, for example, IT (low tech) or automation (mid tech). The differential value has been squeezed out of these older classes of technology resulting in their commoditization, and for those looking for an angle, commodity rarely results in differential advantage.

The transformation part of digital transformation is a little trickier to nail down, because if you believe search results, every application of tech is transformational. Of course, it is, to SEO marketers, but for investors, not so much. So it's best to put digital transformation into context. In this book, *The Private Equity Digital Operating Partner: Using Digital Transformation for Value Creation*, the context is clear: Digital transformation for us is a value creation tool to increase the enterprise value of select portfolio companies by increasing their EBITDA and valuation multiple. For us, digital transformation is the transformation of a traditional company into a digital-traditional company by implementing one or more digital initiatives (Figure 2).



Roller Speed = f (asphalt density, HMA thickness, HMA temp, roller weight, drum vibration frequency)

So what is digital transformation? It's a new source of alpha for private equity. And who's responsible for making it happen? The digital operating partner.

DIGITAL TRANSFORMATION IS COMING TO ALL NONTECH SECTORS

Digital is transforming the companies and products in all nontech industry sectors. We're witnessing this first as consumers, in our pockets, on our bodies and in our homes. Smart speakers like Amazon Echo and Google Home are now in a quarter of U.S. households, and almost 20 percent of all homes have a second smart product. Smart cars, usually referred to as self-driving or autonomous vehicles, have been digitally transformed to be data driven—the definition of a smart product.

This is just the beginning in B2C and the very beginning in B2B (Figure 3), with the smart megatrend washing

over all traditional sectors, leaving behind new winners and losers in its wake. The winning companies will either lead or dominate their industries and will have been converted into data-driven companies—becoming part software and data science companies. Think about your portfolio companies. That’s where the opportunity lies. Read this book to be able to identify your digital winners.

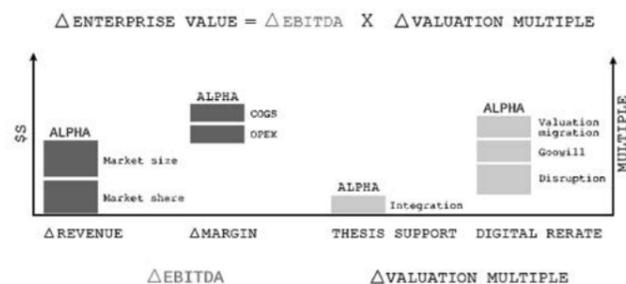
THERE’S A NEW WAY TO INCREASE ENTERPRISE VALUE

Digital transformation is a new value creation tool that enables your firm to capitalize on the smart megatrend leading to asset-light businesses in any sector. As a value lever, it’s long in capabilities. Not only can it reduce COGS and OPEX to improve margins; it is a platform for innovation that is primed to increase sales either by increasing market share through increased competitiveness or by entering new markets through disintermediation or other novel strategies. It can also ratchet up the valuation multiple (see Figure 4).

The quantification of value from being data driven can produce a product so competitive, like the iPhone, or a business model so compelling, like Uber’s, that data-driven companies can dominate or even disrupt their industry. Hyperbole aside, it certainly doesn’t need to be that dramatic to make a meaningful impact. The digital rerate, as you will learn, can justify a valuation multiple closer to the

valuation multiple range assigned to tech companies with the uplift characterized as goodwill.

DIGITAL MAY GIVE YOUR FIRM A COMPETITIVE EDGE
Aggregate returns will continue to be of primary interest to investors, but how COGS and OPEX



is increasingly important to LPs and GPs alike. Operational value creation has become private equity’s primary source of value. Digital transformation furthers that reality and is a value creation lever that creates alpha independent of any other operational improvement mechanism, making it accretive to any firm’s existing efforts.

Bruce Sinclair is an ex operating partner for a \$1.5B AUM private equity firm and is now the Principal Consultant for Digital Operating Partners. Read more about using digital transformation for value creation.

www.digitaloperatingpartners.com



Today,

I will pilot my boat out into the blue ocean,
practice swan dives off the bow
and say hello to a blue angel fish.

Then return to stroll off the dock
into my home that overlooks it all.

Live where every day is your best one yet.

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