

DIGITAL TRANSFORMATION: REALISING THE POTENTIAL

EIGHT TAKE-AWAYS FOR
SUCCESSFUL ADOPTION
IN VALUE CREATION

SEPTEMBER 2022

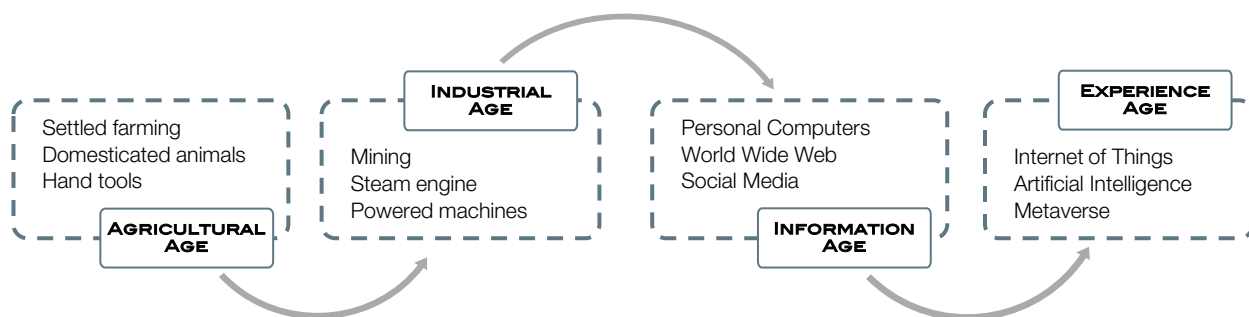
DIGITAL TRANSFORMATION

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FOREWORD

As a concept, Digital Transformation has been around for decades. Right from the onset of the Information Age in the mid-20th century, companies have strived to 'digitalize' and automate processes and practices. Technological advancement continues to create new industries and profoundly alter existing ones. As a result, business models are being disrupted across all sectors and customer expectations are forever changing. Organizations, therefore, require ongoing transformation to keep abreast with technology and thrive.

More recently, the term 'Digital Transformation (known as DX)' has been associated with a paradigm shift from the Information Age to the Experience Age. Where the Information Age dealt with the creation, capture, and processing of information, the Experience Age deals with the immersive experiences that dictate what, where and how information is consumed. Connected devices and network effects are by-products of the Experience Age.



Forecasts suggest that by 2025 there will be more than 75 billion Internet of Things (IoT) connected devices in use, a threefold increase from 2019¹. Businesses and industries too are becoming more interconnected and interdependent than ever. Though this can dramatically improve communication and collaboration, the network effect also increases cybersecurity risk. Furthermore, increased turbulence in the geopolitical and socio-economical landscape demands greater agility from organizations to innovate and respond to disruptions.

While the need for and benefits of DX are clear, successful and sustainable DX is not easily achieved. To understand why this is, we will go "back to basics" and explore DX and its relevance today for PE portfolio companies:

- What exactly is DX?
- What are the key challenges in running a successful DX program?
- Why is DX even more important in today's volatile socio-economic and political landscape?

Finally, we offer some examples of DX and outline our approach to successful DX that begins with the Value Creation Plan.

[1] <https://www.statista.com/statistics/471264/iot-number-of-connected-devices-worldwide/>

DEFINING DIGITAL TRANSFORMATION (DX)

The term DX is a buzzword that has been around for over a decade now. In fact, many technology practitioners and business leaders feel that the term has been so broadly used that it creates confusion and is therefore useless at conveying an intended meaning. Perhaps the reason for the confusion is that DX looks different from company to company and across industries.

From the perspective of Private Equity Operating Professionals, we provide the following two-fold definition of DX.

1. DX is the iterative application of new or emerging information technology capability to improve operating efficiency or commercial effectiveness and thereby create value
2. DX is a cultural change that requires the continuous challenge of the status quo to leverage the new capability

Given the evolving nature of the innovations that enable DX, it can be challenging to quantify benefits and plan them over the life of a typical Value Creation Plan. But to build a case for change, we need to be able to set targets and measure success. This means that an iterative approach will be more successful. This brings us to our first Key Take-away:

Key Take-away | 1/8

DX benefits can be hard to estimate initially. However, DX objectives should be identified during due diligence and quantified during value creation to ensure that value is delivered.

INCREASED URGENCY FOR DX

Over the last two years, DX has taken on a new urgency. The disruptions and restrictions of COVID-19 resulted in the higher use of digital channels. Though restrictions have eased considerably, data suggests that behaviors may have permanently changed. According to the office for national statistics in the UK, “the proportion of retail sales online fell to 26.6% in May 2022 from 27.1% in April but remains substantially higher than the 19.7% in February 2020 before the coronavirus pandemic”¹.

Similarly, the disruption to global supply chains, which began at the start of the COVID-19 pandemic and had a significant knock-on effect on businesses around the globe, looks set to continue through 2022². Any recovery from the pandemic has been slowed by the war in Ukraine which has triggered much more than a humanitarian crisis. The economic damage from the conflict has contributed to a significant slowdown in global growth in 2022 and adversely contributed to inflation. Fuel and food prices continue to increase rapidly.

The challenging macro-economic environment has accelerated the adoption of DX. Several businesses have had to accelerate the deployment of e-commerce platforms during the pandemic just to survive, these businesses are now forced to invest further in digital marketing. Others, who have already progressed their DX journey with the foundations of reliable data architecture and DX culture in place, have been able to leverage artificial intelligence and machine learning to thrive in seemingly unpredictable times. AI especially has proven to be helpful through demand optimization, inventory management, network optimization models, and catastrophe modelling.

DX has become integral to organizational ability to respond to external macro-economic challenges. In uncertain times, organizations need to be prepared for different scenarios and digitally-enabled businesses are quicker to respond. Consequently, DX objectives and ambitions need to be prioritized to prevent value erosion in portfolio businesses. This leads us to Key Take-away number 2:

Key Take-away | 2/8

Companies that adopt DX have been faster to adapt to external shocks. Therefore, DX needs to be prioritized to prevent value erosion in portfolio companies.

[1] <https://www.ons.gov.uk/businessindustryandtrade/retailindustry/bulletins/retailsales/may2022>

[2] <https://logistics.org.uk/media/press-releases/2022/june/uncertain-conditions-continue-to-put-pressure-on-s>

DX CHALLENGES AND RISKS (1/2)

From a PE perspective, a key factor to maximize value from DX is doing the right deal in the first place and then following through quickly. Industries or niches that have not typically benefited from "digitalization" are likely to offer good candidates.

However, these companies are likely to have underinvested in technology, and there might be unforeseen pitfalls. The same is true of a non-core asset being divested by a corporate. This brings us to Key Take-away number 3:

Key Take-away | 3/8

Do the right deal to be sure of value creation from DX. Non-core assets can benefit from DX but value creation opportunities must be validated through operational and technology due diligence.

The right balance between risk and opportunity must be struck during diligence and measures identified to mitigate risk. A business with historical underinvestment in technology is likely exposed to cybersecurity vulnerabilities, but it also presents an opportunity for market-leading transformation that can disrupt a yet undisrupted industry. In addition, ramping up a DX programme can expose more data interfaces to cyber risks, leading us to Key Take-away number 4:

Key Take-away | 4/8

DX can drastically increase the 'cyber impact surface' of the business. PE buyers need to get on top of cybersecurity risk during due diligence and stay on top of it post-deal.

DX CHALLENGES AND RISKS (2/2)

Perhaps the most common pitfall in implementing DX is ineffective cultural change that results in a failure to adopt new practices. DX programmes traditionally tend to be management-led (top-down). Employees are often apprehensive of objectives and internal resistance quickly develops. Like with any major change programme, a lack of buy-in from employees results in behaviors not being changed, slowing down payback and value realization.

From a PE portfolio perspective, a workforce that has recently undergone divestiture, acquisition, or merger with another portfolio company is likely to be experiencing apprehension or change fatigue. It is therefore important to incorporate DX into the wider change approach. Understanding this can help inform the overall DX approach, particularly the communication strategy.

Employees should not feel that DX is being done to them, instead, they should be empowered and incentivized to drive DX. An effective way to do this is to see the DX adoption journey as natural entrepreneurial growth, progressing in manageable stages. Learnings can be taken at each step and can be used to inform and improve the next stage of the process. This helps to address the complexity and risk of large-scale implementation and minimizes disruption to the business.

We believe that the right culture and communication strategy is the most important factor for successful DX. Our iterative DX approach, outlined in subsequent sections delivers cultural change through an employee-led change network. This brings us to Key Take-away number 5:

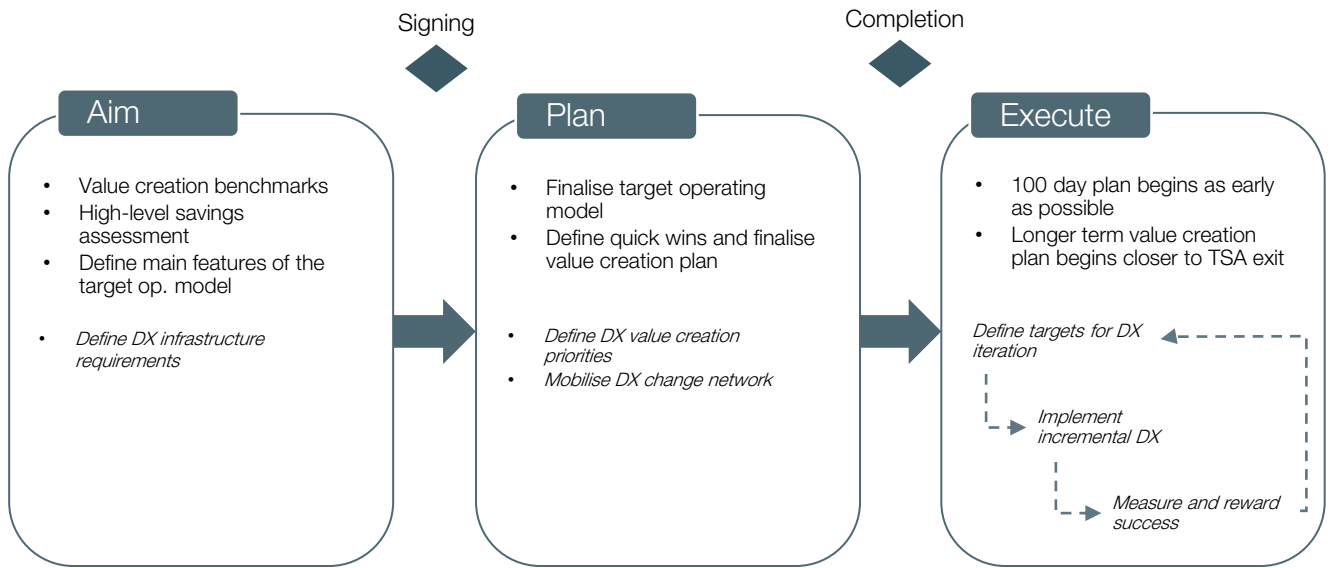
Key Take-away | 5/8

DX programmes that are driven top-down tend to fail. DX needs to be employee-led and delivered in manageable increments in order to be effective and achieve value creation objectives.

THE EIGHT ADVISORY APPROACH TO DX 1/4

As we have explained, DX is not a destination, but a journey triggered by a change in culture. Any approach that a PE operating team may take to set a portfolio business on the DX journey must be sustainable and supported by the workforce to be successful. We advocate an integrated Value Creation Plan (VCP) that catalyses the DX journey.

The following diagram illustrates at a high level how our DX agenda is embedded within the three phases of the VCP. We will focus on the key DX elements of each phase below:



Key:

DX element of Value Creation Plan

THE EIGHT ADVISORY APPROACH TO DX 2/4

Aim

During the “Aim” phase of the VCP, it is important to outline not just the value creation potential associated with DX but the required DX infrastructure as well. This infrastructure can be thought of as the scaffolding that supports and enables the delivery of structural change and transformation. It typically includes a central data warehouse or “data lake” with connectors to information systems and other information sources already in use across the business. As organisational DX capability matures, platforms that feed on the data repositories to deliver artificial intelligence and machine learning solutions will be built.

Key Take-away | 6/8

Data is the foundation of DX. Identify the key data sources critical to the business and identify the infrastructure that enables the access and exploitation of that data.

Plan

The second DX-related agenda item delivered through the VCP is the mobilization of a DX change network that is composed of business process owners who drive DX across functions. We differentiate our DX change network from a top-down traditional governance model where objectives are defined and driven by management. Instead, we see Management's role as facilitating progress and incentivizing workforce behaviours appropriately.

Our experience tells us that business process owners already have an idea of what digitalization needs to be delivered within their respective areas. Ideas must be challenged to define a prioritized list of DX objectives. Ultimately, process owners across the workforce must be empowered to take ownership of the delivery of DX in their areas. Integral to this approach is an early stakeholder impact assessment. Not only will this aid in breaking down silos but it also informs the communication strategy and identifies the change network.

Key Take-away | 7/8

Drive DX adoption with “change networks” of existing business process owners. Management should facilitate DX progress and prevent silos by incentivizing the right workforce behaviours.

THE EIGHT ADVISORY APPROACH TO DX 3/4

Execute

Finally, during the execution of the VCP, the first DX increments are delivered through pilot iterations of our repeated process of defining DX value targets, implementing change, and measuring and rewarding success.

To support clients in setting meaningful, realistic, and relevant DX objectives for each iteration, we provide references to DX best practices based on industry and business functions. However, we also advocate the cross-pollination of DX practiced between industries and different functions within the business.





Businesses that have started the DX journey late in the game, tend to try to build capability to match the competition instead of seeking to get ahead. This is an opportunity to leapfrog the competition and start from what the competition could be doing and is not currently doing.

Key Take-away | 8/8

Execution should be iterative and bold. Start from “what are the competition not doing?” Borrow from other industries and business functions.

THE EIGHT ADVISORY APPROACH TO DX 4/4

Our approach to DX is always tailored to suit the context of the business and the transaction strategy. It is not meant to be a 'one size fits all' methodology for DX. Examples of recent projects where we have tailored the approach to suit client needs:

Project/Context	Results
Buy-side support to a PE client on the carve-out of a non-core asset from a global consumer giant. DX of the IT function was executed in parallel with the separation.	 Modernized the underinvested technology environment within the IT function which resulted in a 30% function cost reduction.
Turnaround plan for a European retail client.	 Created DX plan for the business through the implementation of ERP, CRM and B2C solutions which supported the successful turnaround of the business.
A global logistics client required support with DX of admin functions which were operating in silos.	 Assisted our client in the DX of admin functions, drastically improving operational efficiency. Success enabled through change network.
A global engineering consulting firm required support to define a DX-enabled operating model better aligned to business needs.	 Completed a DX maturity assessment of the business. Designed a new operating model and assisted the company to implement it.

EIGHT TAKE-AWAYS

In closing, here is a summary of our Eight Key Take-aways:

Key take-aways

- 1.** DX benefits can be hard to estimate initially. However, DX objectives should be identified during due diligence and quantified during value creation planning to ensure that value is delivered.
- 2.** Companies that adopt DX have been faster to adapt to external shocks. Therefore, DX needs to be prioritized to prevent value erosion in portfolio companies.
- 3.** Do the right deal to be sure of value creation from DX. Non-core assets can benefit from DX, but value creation opportunities must be validated through operational and technology due diligence.
- 4.** DX can drastically increase the 'cyber impact surface' of the business. PE buyers need to get on top of cybersecurity risk during due diligence and stay on top of it post-deal.
- 5.** DX programmes that are driven top-down tend to fail. DX needs to be employee-led and delivered in manageable increments in order to be effective and achieve value creation objectives.
- 6.** Data is the foundation of DX. Identify the key data sources critical to the business and identify the infrastructure that enables the access and exploitation of that data.
- 7.** Drive DX adoption with "change networks" of existing business process owners. Management should facilitate DX progress and prevent silos by incentivizing the right workforce behaviours.
- 8.** Execution should be iterative and bold. Start from "what are the competition not doing?". Borrow from other industries and business functions.

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