EXECUTIVE BRIEF

The economics of cloud computing in private equity

PRIVATE EQUITY RELATIONS TEAM

Why private equity should consider cloud computing as a major value creation element in portfolio company growth strategies

It may not be seen as a primary area for opportunity among private equity leadership, but cloud computing can present a major upside when implemented as a core element of value creation strategy and planning. While it comes with risks and can impact the business in multiple ways, a thoughtful approach can help organizations determine the real opportunity costs and value-driving elements of a cloud-first strategy.

In the past, private equity has tended to overlook the business impact and related value creation opportunities of moving to the cloud. This is because private equity economics has historically favored capital expenditure (CAPEX) versus operational expense (OPEX) as the investment source for IT infrastructure across their portfolios. Firm leadership felt this allowed them to better manage a fund's depreciation cycles and realize the associated benefits that came along with enterprise value calculations.

On-premises IT environments are usually associated with CAPEX costs like time, resource, and capital. The upfront hardware and software costs associated to support these environments need to be very thoughtfully planned based on business growth projections. The challenge is to accurately predict what the IT requirements will be based on complex external pressures like competition, market demand, and economic climate. Compounding this challenge, the capital used for on-premises IT environment investments cannot be redirected.

A cloud computing approach helps create a decision-making process that more accurately matches supply and demand, preventing over- or under-investment in IT. This "pay as you go" structure provides greater budget flexibility to manage costs at a line of business or subsidiary level with more efficient resource utilization.

As the cloud computing market continues to mature and scale, the economics offer a compelling value proposition that can benefit a firm's larger CAPEX investments in assets that are not central to their value creation strategy. Arguably, older and less flexible on-premises IT environments can be more of a liability than a benefit, as they drive little value while demanding greater resources to maintain.

IT environments' impact on growth, value return, and innovation

The rate of technology change continues to outpace most organizations' ability to effectively maintain on-premises IT environments. Many companies have legacy applications that lack the flexibility to be modified or upgraded to take advantage of the latest innovations. As a result, these companies get bogged down in costly maintenance efforts, which in turn can hinder their ability to grow. Cloud-based environments provide the flexibility to take advantage of innovation advances via upgrades, eliminating the sunk costs and inflexibility associated with the CAPEX heavy IT spend on legacy environments.

When to consider cloud migration as a value creation strategy within your portfolio

When considering a cloud migration strategy, it's crucial to consider your firm's growth and value creation thesis, as well as the firm's overall outlook on innovation through capital investment. If there are needs in a firm's portfolio that require capital investment in core product or service offerings, cloud computing can enable the firm to focus capital investments on these core value-creation activities.

Cloud-based environments provide the flexibility to take advantage of innovation advances via upgrades, eliminating the sunk costs and inflexibility associated with heavy IT spend on legacy environments.

Concurrently, cloud-based platforms also increase an organization's ability to make continuous enhancements as the business needs evolve, while eliminating the costly distractions that come along with managing an internal IT environment. For smaller portfolio companies, cloud-based environments provide a significantly lower cost-of-entry and total cost of ownership over time. They can enable companies to take advantage of best-of-breed technology throughout the business lifecycle on a cloud platform.

Cash flow is king

If there are capital constraints within the portfolio, cloud computing offers the flexibility to employ IT on an as-needed basis with monthly reoccurring expenses that align more closely with portfolio revenue and investment cycles. This delivers much more predictability from a cash flow management perspective. Managing a business on a cloud platform also eliminates the periodic need for unexpected spikes in capital investments that on-premises IT environments require due to sudden changes in the business. From a cash management perspective, business operations conducted on a cloud-based platform increase the efficiency of deployed capital by more effectively aligning IT expenses with the timing of revenue and receivables to keep cash flow strong.

Is information technology your core business?

To understand whether IT is central to your portfolio company's value proposition, you need to question its role in the context of the business itself. A cloud-first strategy allows operating partners to focus on the elements of the business that are truly at the core of value generation, resulting in the multiples and related returns a firm strives to achieve when exiting an investment.

At first glance, a cloud-first strategy may appear to create additional operating expenditures for a company. However, with careful consideration of all the opportunity costs of deployed capital, cloud-based economics will drive lower total cost of ownership and provide significantly more flexibility over a firm's planned investment horizon.

While cloud environments deliver beneficial financial and operational advantages, there are important considerations that need to be factored into a cloud migration strategy and plan. Private equity firms and their investment companies need to carefully consider business impact in the form of change and disruption, and plan accordingly. Done thoughtfully, with the right partners in the mix, the value of migrating to a cloud-first strategy can pay material dividends to both PE firms and the companies they invest in.

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