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## Back to basics: Creating value through superior products

Revitalizing product development is an unexplored lever for most private-equity firms.

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Some analysts argue that private equity has run out of steam.<sup>1</sup> It's true that some of the traditional ways that firms have created value—notably buying undermanaged companies and modifying capital structures—are getting harder to accomplish. There are fewer companies available that are susceptible to these kinds of improvements. That's not news, though. Private-equity firms have recognized this and learned new techniques, such as improving operations, optimizing pricing, and making sales forces more productive. Many firms believe there is still plenty of value to be tapped through these and other approaches.

At the same time, however, the frontier of value creation is shifting, in ways that not every private-equity firm recognizes. All of the traditional

techniques aim to improve the denominator of the multiple—that is, the intrinsic value of the company. Today, some farsighted firms are moving in a different direction, seeking to expand the numerator and achieve a higher multiple for their portfolio companies. Strategic buyers are willing to pay a higher multiple for faster-growing companies with products that excite customers. Private owners are responding by retooling their product-creation skills.

It's an idea whose time has come, as product development is a basic lever of value creation. Every privately owned company has cut costs, both in direct operations and in selling, general, and administrative expenses. Product development has only been addressed in blunt ways, when R&D budgets have been slashed for short-term cash flow.

Today, new tools can be applied to address the accumulated inefficiencies in operating companies. Portfolios of new-product ideas are rarely well managed and are often clogged with expensive, low-value projects. When these ideas do come to market, they saddle the company with the problems of managing too many SKUs. And few companies can say, hand on heart, that they have the insights needed to create new blockbuster products.

These problems can crop up anywhere but are most often found in smaller established companies, businesses that have been run for cash, and businesses that have become “unstrategic” and have been neglected—exactly the companies that are most likely to fall under private-equity ownership.

In this article, we will examine four ways that private owners can increase efficiency and accelerate revenue growth through creative changes to product development. Firms that embrace these techniques may approach their next auction with more confidence than their rivals, and go on to extract more value than others could. In our experience, companies can free up to 30 percent of their product-development capacity. They can then spend the savings in various ways: some of it can be used immediately to lift margins, and the rest can go to reinvigorate the product-development process—and the company’s fortunes.

### **Rapid portfolio review**

To begin, companies should review the R&D portfolio. Typically, about a quarter of all projects can be cut without sacrificing any value. Review criteria should include financial strength, alignment with product platforms, and the ability to meet or exceed customer features and needs. Mitsubishi Fuso Truck and Bus Corporation, the Japanese maker of trucks and buses, set up a cross-functional team (R&D, sales, product planning, and finance) to analyze the product portfolio. Top management set

high thresholds for the review, looking in particular for projects that had been overtaken by market developments and those that an influential executive had kept afloat. As a result, the company stopped development of two major product lines, which represented nearly 350 potential SKUs. In another case, a diversified specialty-chemicals manufacturer systematically evaluated its R&D projects; it pruned the projects that had fundamental economic issues—a stunning 70 percent of the portfolio. In both cases the teams on the canceled projects were reassigned to other projects, with the aim of accelerating commercialization.

### **Redesign products for value**

Another important use of liberated resources is to improve margins on current products. The design-to-value (DTV) approach uses market insights, competitive intelligence, analytics, and engineering know-how to challenge a company’s design paradigms. By breaking through these norms, DTV changes products in ways that are sometimes large (such as eliminating unused functionality) and some small (such as spec optimizations). Redesigned products command higher margins, in our experience—between 5 and 30 percent higher, depending on the industry and the original design. And companies nearly always go on to greater market share, as redesigned products provide opportunities for pricing and promotion actions. A medical-device company deployed DTV to improve margins across its portfolio of products, from electrotherapy machines to ultrasound equipment. The company started by interviewing customers and sales teams, to understand how products were used and the parts of the experience that worked well (or not). It compared features with competitors’ products, putting the top four products through “teardowns” to understand their engineering. It scoured supply markets to arrive at the “should cost” price for the most expensive components (circuit boards, displays, and so on). All this information was

used to fuel a two-day workshop to generate ideas with a cross-functional team. The team suggested adding some new features and dropping others, to better align products with customers' unmet needs. A touch screen was added to one product and laser therapy to others. After DTV, one product cost 23 percent less to make, even as the company was able to price it effectively 5 percent higher.

DTV is a vital element of the broader transformation, not only for these effects but also because of its speed: it generates immediate and lasting cash-flow improvements that can fund the effort to develop new products. In fact, we have seen that DTV can make the whole program EBITDA neutral within a year—and EBITDA positive after that.

### **Streamline new-product development**

As mentioned, companies can also put redeployed R&D teams on the product-development process, looking for efficiencies that can get the company's best ideas to market faster. In our experience, companies can trim both cost and development time by 15 to 30 percent through a disciplined lean approach to their product-development work. This means making a concerted attack on process steps that do not add value, improved resource planning, redesigned performance management and incentive systems, and a rejuvenated focus on project governance. Mitsubishi Fuso did this, and found that 40 percent of engineers' time was spent on e-mails, calls, meetings, reporting, and so on. By cutting down on these administrative activities, the company liberated 170,000 hours of engineering time in one year. The freed capacity was spread across the R&D function; but by reallocating resources, the company was able to launch many products faster and start new ones sooner.

Other companies have had similar results. Within 18 months, as this discipline becomes embedded, the product pipeline becomes markedly stronger, and

companies have a more credible value proposition for new products. Streamlining product development contributes heavily to higher valuation multiples.

### **Create an environment where breakthroughs can happen**

Few things are as compelling to investors as a track record of breakthrough products. That's largely because these skills are so rare: not many companies would argue against having more capabilities to see unique market insights and translate them into exciting new products. But these skills are within reach. New approaches to so-called design thinking are starting to bear fruit. And any company can learn the principles of unconventional market research, advanced analytics, rapid prototyping/revision, and strategic launch planning and develop a steady stream of breakthrough products.

As an example, General Mills used ethnographic techniques to gain insights for creating the first-ever yogurt in a tube. It studied families and saw that many parents had trouble getting sleepy kids to eat before rushing out the door in the morning. Insight generated: families needed an on-the-go breakfast option that could be consumed in the car or before lunch at school. Instead of trying to make the product better, General Mills developed dramatically different packaging that made consumption easier for young people on the move. Go-Gurt reached first-year sales of \$37 million, rejuvenating the yogurt category and helping General Mills capture market leadership from competitors.

Smaller, privately held companies often do not devote adequate resources or energy to new-product development. To innovate properly, several things need to happen. To begin, boards and management need to encourage different behaviors. The relentless focus on short-term profits is not conducive to innovation. Management must create slack in some core processes to allow R&D innovators some

creative space. At the same time, innovation must be strictly tied to corporate strategy. The concept of allowing engineers time to pursue individual projects is expensive and its benefits are uncertain. Companies must have a clear understanding of the businesses and geographies in which they plan to be active, and develop products for those opportunities.

With new products to talk about, the sales force is reinvigorated. New products create opportunities to revisit accounts, explore adjacent markets, and enter completely new ones. Our experience shows that growth is maximized when product-line transformations are accompanied by sales-force-effectiveness efforts.



When companies take all these steps, good things happen. Margins on current products jump by 15 to 30 percent. About 30 percent more products get launched, after the dogs of the portfolio are culled. One or two breakthrough products create a halo effect for the rest of the pipeline, which is itself much strengthened. And it is not uncommon to see growth accelerate by three to eight percentage points. That can boost the exit multiple one or two times—and provide an answer to those who doubt that private equity can continue to thrive. ■

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<sup>1</sup> See, for example, Andy Kessler, “The glory days of private equity are over,” *Wall Street Journal*, March 29, 2015, wsj.com.

The authors wish to thank Christine Decker Miller for her contributions to this article.

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