

ARTICLE

Middle-Market Value Creation Opportunity: Driving Margin Growth Through Operational Improvement

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Key Takeaways:

- With traditional value levers fading, PE firms are prioritizing operational improvements like cost controls and AI adoption to drive margin growth organically.
- Middle-market manufacturers benefit most from operational enhancements, focusing on margin expansion to overcome resource and capital challenges and attract buyers.
- Longer holding periods demand stronger operations, including change readiness, navigating geopolitical risks, and addressing talent gaps to stay competitive.

The value creation formula for PE firms and their portfolio companies, particularly those operating in the middle markets, has been permanently altered over these past few post-pandemic, high-interest rate years.

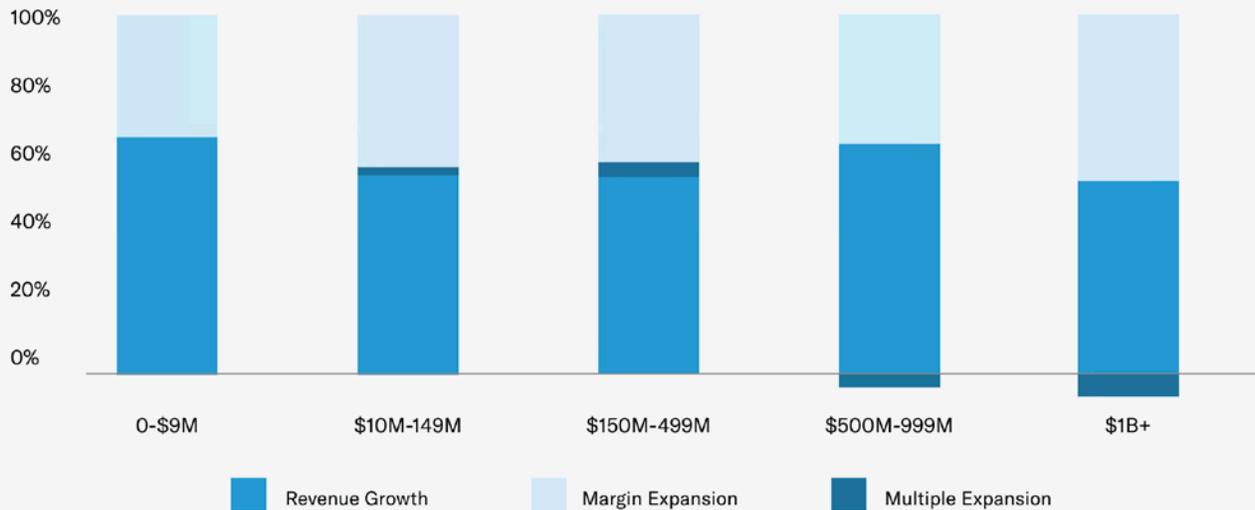
The days of being able to rely on arbitrage or other arbitrary tailwinds to boost growth have gone the way of the ill-fated Edsel. The most popular value creation vehicle on the road now is your portfolio company's operational footprint, where investments and enhancements can help fill the void and then some.

Why an Operational Focus?

With these traditional value levers now muted, a focus on making operational improvements to drive margin expansion—essentially optimizing operations to grow profitability—has taken hold. This mindset shift has been a popular talking point at the different industry conferences we have attended recently that have focused on factors driving the next chapters of both PE strategy and value creation.

For a variety of reasons—narrower selling markets, the soaring cost of capital and longer pre-exit holding periods—more general partners (GPs) are putting operational matters higher on their improvement priority checklists—focusing on areas such as growing margins, stabilizing cash flows, and other ways to inject long term growth. This is the new way forward. Or, as the co-head of equity at Apollo recently said more colorfully: “What’s the purpose of investing in private equity if it’s just levered beta on steroids?”

What Drives Value Creation for PE Deals in North America?



*Margin expansion contributes 4.04% to the value creation for midsized PE deals, according to data from DealEdge
As of: Oct. 28, 2024*

Middle Markets: Fertile Grounds for Operational Value Creation

Manufacturers across the middle markets, quite simply, have more room to grow than their larger-sized counterparts. This is evident in looking at the correlation between transaction sizes and margin growth appreciation, which shows that smaller and medium-sized deals depend considerably more on profit growth to generate value than larger companies. [From 2010 to 2024, buyout and growth investments ranging from \\$150 million to \\$500 million in size generated 4.04% in value from profit margin improvement.](#) Conversely, larger deals experienced margin erosion due to a growth-focus tilted to reinvesting cash flows into R&D or sales.

Increasing Focus on Margin Expansion

Margin expansion is one of the more powerful value creation tools for middle market companies, which typically face challenges around resources, competition, and access to growth capital.

While difficult to combat all three, a focus on growing margins – improving profitability by widening the gap between revenues and costs – can be a transformative thread that courses through the entire business.

By improving margins through smarter cost controls, pricing adjustments, or operational enhancements, companies can unlock significant long-term value without relying heavily on traditional, top-line revenue growth. Common examples of operational, margin-focused initiatives include optimizing legacy IT systems, cutting back on raw materials and waste, adopting new technologies such as AI or automation, and the always-tough decisions involving longer-tenured staff.

Companies that can generate margin growth on a consistent basis tend to stand apart from the crowd, and middle market companies generally are in a margin growth “sweet spot” in that many are in the midst of transitioning from a growth at all costs mentality to a sharper focus on operational efficiency.

Challenges, Opportunities and Solutions for 2025

While the value creation tactics may have changed, the opportunity set around making operational enhancements – and the associated challenges and solutions – remain intact. Let's touch on several key factors and considerations.

Navigating Macro/Geopolitical Uncertainty

- One theme that has come through in client interactions recently is a seeming sense of acceptance. The election has come and gone, rates are still high, and capital is expensive, and to paraphrase renowned investor Harry Markowitz, most GPs and companies today understand that “there is no free lunch” when it comes to value creation.
- A wild card, which some of our clients have already been planning for, is the possibility that President-elect Trump will install tariffs on China and other US trading partners. Some companies will be affected more than others based on their mix of business geographically, but we are seeing lots of pre-ordering and stocking up before the potential storm hits. The flip side of this is that the cost impact of the tariffs could force some companies to explore new opportunities or markets. If tariffs do materialize, we also could see some type of new legislation supporting the U.S. manufacturing sector.

Longer Holding Periods/Fewer Exits

- Another challenge is the ongoing dynamic of PE firms holding onto their best companies for longer and extending their runway to an eventual exit. Over the last 20 years, the average age of companies at time of IPO has risen from 4.5 years to more than 10 years.

- This considerable rise has brought a whole new set of challenges for companies and their investors to navigate. Most companies prepare for specific needs and demand projections, but the majority are not prepared to weather prolonged periods of market softness – making it all the more important to focus on ways to get stronger operationally and margin-wise.
- Operating partners need to be more engaged; portfolio companies need to learn quickly how to prioritize around atypical volume activity and know when to ask for external help, and companies need experienced talent and leadership to pull it all together.

Private Company Landscape

Exhibit 7: Median Age at IPO for US Companies has Increased to 11 Years

Median Age at IPO for US Companies



Source: University of Florida, Morgan Stanley Research

Change Readiness

- [A recent study found that up to 80% of all mergers fail to deliver the expected value due to integration issues.](#) For middle-market companies, these challenges are often exacerbated by a lack of sufficient integration planning and execution resources, and the myriad challenges that can come when different cultures merge. This culture shock often has a bigger impact on smaller firms.

Talent & Expertise

- Success begins and ends with talent, both at the top of the house and across the operational footprint. Middle-market companies especially need to continually focus on ways to keep their best talent happy and engaged, and senior leaders need to be good at knowing what they do and don't know and looking internally or externally to fill the void caused by the latter.
- Not having the right people in the right positions happens and should be fixed immediately, but delays occur too often and can cause real damage. We have seen companies, for example, fail to put milestones and goal posts in place, which causes delays and deflates morale.

Explore & Embrace New Technologies

- AI continues to be a much-discussed topic and while we have not seen any compelling business use cases, [more companies are taking it for a spin](#), with many using AI to either organize information or to analyze past data.
- The state of AI might be compared to the development of the search engine. When search got faster, information became widely and readily accessible. In that same way, AI could help companies get increasingly better at making strategic decisions around improving processes and driving margin growth.

What's Your 2025 Value Creation Resolution?

As we roll into a new calendar year, margin expansion and operational improvements have become entrenched as essential components of value creation that fundamentally strengthen companies. While operating partners are holding onto companies longer, the day for exit will come and those companies able to build value organically, and consistently, year after year will be in stronger competitive position.

The opportunity for portfolio companies is to candidly assess where their businesses are, including the supply and demand projections, and make the necessary adjustments to manage. This could mean re-allocating resources internally or partnering with external experts to fine tune operational improvement plans to ensure optimal results.

The goal, or rather the New Year's value creation resolution – don't leave any value on the table in 2025.

Meet the Expert



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