Measuring a Company's Digital Competence

Sector-specific scorecards give private equity firms a critical edge in digital due diligence and value creation.

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No investor today can afford to overlook a target company's digital competence. The harder question: How do you actually build that critical perspective into due diligence?

Digital innovation moves so quickly, and has such a pervasive impact on virtually every aspect of doing business, that determining where to look and what to ask is a constantly moving target. Measuring threats and opportunities can feel like trying to map a genome: While similarities exist across species and subspecies, every individual is different.

The most effective firms approach the problem as an extension of the rigorous, individualized approach to due diligence that they already use to size up a target company. What's different is the recognition that developing a full understanding of digital competence requires a deeper layer of inquiry, this one aimed specifically at evaluating the impact digital innovation has on value.

That means filtering the noise to identify the most relevant areas of impact for a given sector or subsector, and then producing a detailed measure of a target company's capabilities in those key areas relative to competitors. Where in the value chain, for instance, are companies in that sector using technology to improve performance? How is digital technology changing customer expectations, market size or growth prospects? Is the target company a leader with a sustainable advantage in key areas of impact, or is it a laggard? And given this assessment, is there potential to boost value post-acquisition, or is it too late to catch up with the rest of the industry?

Scoring digital competence

One effective way to frame the issues is through a sector-specific digital scorecard that helps investors answer a critical set of questions. The right framework can bring structure and clarity to the diligence process in two ways: first, by defining where digital technology has the greatest impact in that sector and, second, by providing a clear method for assessing how a given company compares with the competition in capability areas that will be essential for success in the face of digital change. This is especially valuable at a time when private equity firms are facing asset prices that have soared to record levels. A fact-based assessment of a company's digital competence can provide investors with the conviction to pay up for an asset in a highly contested auction or take a pass when the diligence process raises red flags.

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A key challenge in assessing digital impact is that no two sectors are alike. Even raising the right questions requires extensive knowledge and experience working in a given industry. In retail markets, for instance, the paramount priority may be creating highly relevant omnichannel customer experiences that build strong relationships with a target demographic. For an auto supplier, on the other hand, the key issue may be how well it meets customer needs in areas like infotainment and assisted driving, or how effectively it deploys digital tools in its own business to manage its supply chain, inventories and product development. Defining where digital contributes the most value in a given industry is the first step in assessing where a company falls on a spectrum of excellence and leadership. It also helps identify where insurgents are disrupting the status quo and how quickly.

Figure 1: Digital technology is transforming the beauty products sector in six key areas

Customer-focused

	Area	Description
1	**Marketing/customer engagement**	Using proprietary and third-party platforms to acquire and maintain customers
2	**Omnichannel/online sales**	Engaging customers with a seamless, cross-channel buying experience
3	**Merchandising/localization**	Optimizing product price, volume and range across channels
4	**Fulfillment/back-end operations**	Deploying digital tools to streamline and enhance a company's operations
5	**Product development**	Using customer data in product development and packaging
6	**Digital infrastructure/capabilities**	Deploying digital systems internally to enable organizational effectiveness

Internal operations–focused

Source: Bain analysis

What good looks like: A digital leader in beauty products

In the beauty products sector, for example, the marriage of e-commerce and data analytics has completely transformed the relationship between customers and brands. Digital technology has had a major impact on six key aspects of the business (*see Figure 1*). In marketing and customer engagement, what counts is how a company uses proprietary and third-party platforms to acquire and maintain a customer base. The best-in-class companies are creating seamless, omnichannel experiences that allow customers to research thousands of products, buy them online or at retail stores and keep track of their purchases. In merchandising, digital tools help companies optimize their product and price mix across channels and geographies. Digital analytics also helps streamline fulfillment and back-end operations while sharpening product development and enabling product personalization. To make it all work, leading companies invest heavily in the new talent and capabilities needed to manage digital effectiveness.

These six lenses work well to focus attention on broad capabilities. But taking the full measure of digital competence requires drilling down further by asking a key set of diligence questions specific to each area of impact: How effectively is the company engaging customers on social media platforms, for instance, or to what degree has it integrated fulfillment systems with supply chain partners? This analysis, in turn, leads to an assessment of relative rank in each area (best in class, at par or laggard). Applied across the value chain, the scorecard draws a picture of where the company demonstrates sustainable leadership and where it is vulnerable. It also helps determine where the target offers opportunities to create value post-acquisition.

Consider how the scorecard works in assessing two potential targets with very different capabilities. One is a large, regional beauty-products brand that has invested heavily in using digital technology to enhance its customer-facing capabilities. In marketing and engagement, it is clearly best in class. To help customers choose among thousands of SKUs, the company delivers a regular stream of relevant, high-quality content over multiple, integrated channels. It encourages ongoing conversations with its fans over social media by posting seasonal makeup looks to Instagram or offering video makeup tutorials and rich interviews with makeup professionals and other influencers. It also taps into new customers by using Facebook's Atlas platform to target online advertising precisely, and it has developed strong capabilities to gather and track the customer data flowing from its many platforms to both improve product offerings and uncover trends that can sharpen marketing.

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Less impressive is how it uses digital tools to localize its merchandizing efforts across geographies and provide customers with highly personalized experiences. It is also in the early days of optimizing its supply chain for its digital business. Given progress in these areas, however, and the fact that top leadership is focused on them, these issues may look more like opportunities than red flags for an aggressive new owner. More analysis will determine whether that opportunity is already reflected in the asking price and whether the company's digital competitive advantage is sustainable.

A second company presents a less clear picture. Although it has developed a strong retail-based following in the analog world, it trails its rivals in most areas when it comes to using digital tools to improve performance. Like the company in our first example, this one has focused its digital investment on the marketing and engagement capabilities that are so vital to generating interest among the target demographic: young, beauty-conscious women. It, too, has developed strong tutorial content and is making use of social platforms to increase awareness and engagement.

But in other areas, it lags its peers. Its website is serviceable but lacks critical functionality, such as the ability to filter research by product category or sign up for auto-replenishment. It also has inconsistent messaging across platforms regarding pricing and promotions. It has done little to tie together its strong retail presence and branding with the digital channels that are becoming the go-to resource for most of its target customers. It also has failed to invest in capabilities to gather and analyze customer data to use in product development and marketing strategy.

This combination of strong brand and following with relatively weak digital capability raises serious questions for a potential investor. The lack of investment in the tools, capabilities and talent needed to stand out digitally in a crowded beauty market is a major problem. What would it take in terms of investment and time for this company to catch up to its peers? Can it ever catch up? And what would be the cost to the business in the meantime, as competitors take share?

Putting a digital scorecard to work

Leading private equity firms know that answering questions like these with confidence demands true, microlevel insight. A general estimation of how companies are positioned with regard to digital competence will lead to a vague assessment of value. Imprecision can lead to major mistakes at a time when digital innovation can dramatically change a company's trajectory, for better or worse. The best firms use scorecards to develop a specialized understanding of digital impact in three ways:

- In the diligence process, they apply scorecards to gain an insider's appreciation for how digital innovation will change the competitive dynamic for every target company, and how quickly. This helps form a detailed appraisal of how well the company is positioned to succeed in the face of digital disruption and where digital can really transform its business to unlock value.

- Once they own a company, they use similar scorecards to assess the digital capabilities and competence of each of their portfolio companies as a starting point for creating a robust value-creation plan.
- Finally, they understand that the speed of digital information and change demands that both the scorecards and assessments have to be updated regularly to ensure that the firm itself stays ahead of the digital curve.

Staying ahead of the curve, of course, is becoming the central challenge for investors searching out value in the digital age. For each industry, it requires a deep understanding of both the existing competitive dynamics and how they are changing as digital technology redraws the landscape. It's not enough to know that digital technology is transforming industries. The right scorecard should focus attention on where, specifically, that transformation is taking place.

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