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Value Through Operations

Maximizing Operating Value to Generate Superior Returns

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The private equity industry has gone through a massive change in recent years, one that has brought portfolio company operating performance to the forefront of successful investments (see Exhibit A). Historically, private equity firms created value by finding great deals through their proprietary deal flow and utilizing creative financial engineering techniques to extract value from portfolio companies. With today's higher competition for deals, auctions have supplanted proprietary deal flow. As a result, fuller prices are being paid, with financial engineering capabilities no longer a differentiating factor. In the current, more mature private equity world, assumptions about potential opportunities to improve operating value are often the key differentiating factor among bids—bids with the highest operating value improvement assumptions tend to be the winner.

In this deal environment, it is not surprising that financial engineering levers (multiples and financial leverage) are no longer sufficient to generate historic ROI. A recent General Partners survey confirms the growing importance of operating value in achieving targeted ROIs (see Exhibit B).

PRIVATE EQUITY FIRMS MUST BE ABLE TO ACCESS OPERATIONS EXPERTISE

With operating value taking center stage in ROI generation, private equity firms have to revisit their capabilities and ensure they have or can

Exhibit A

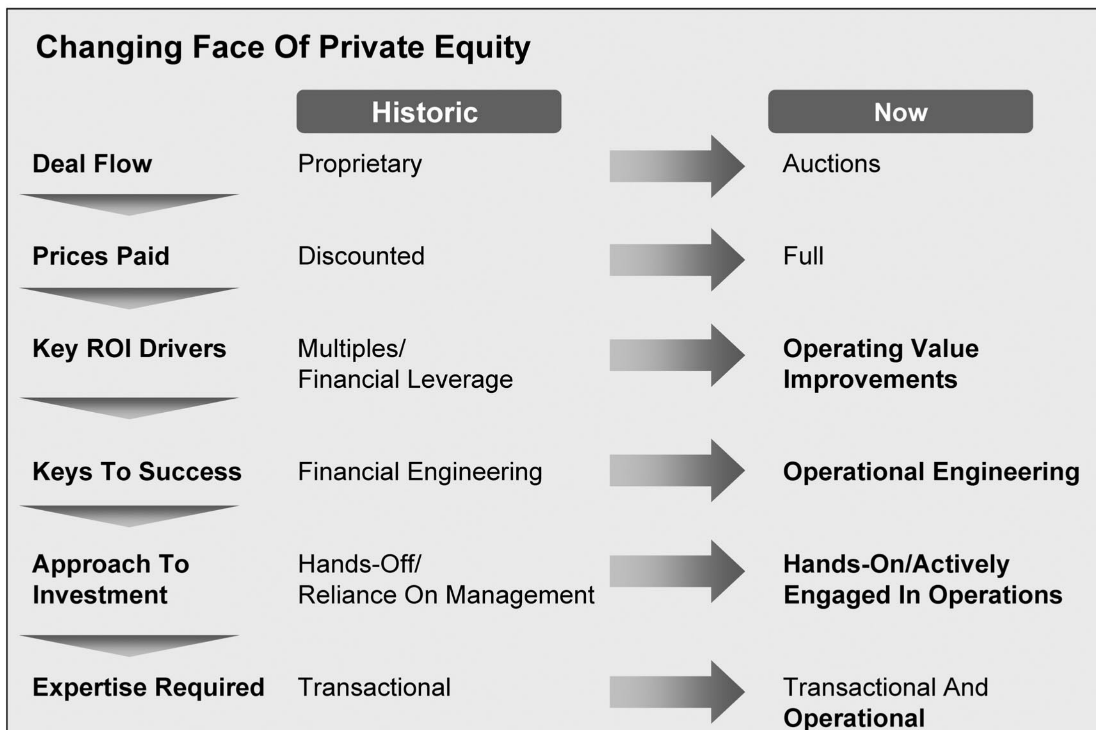
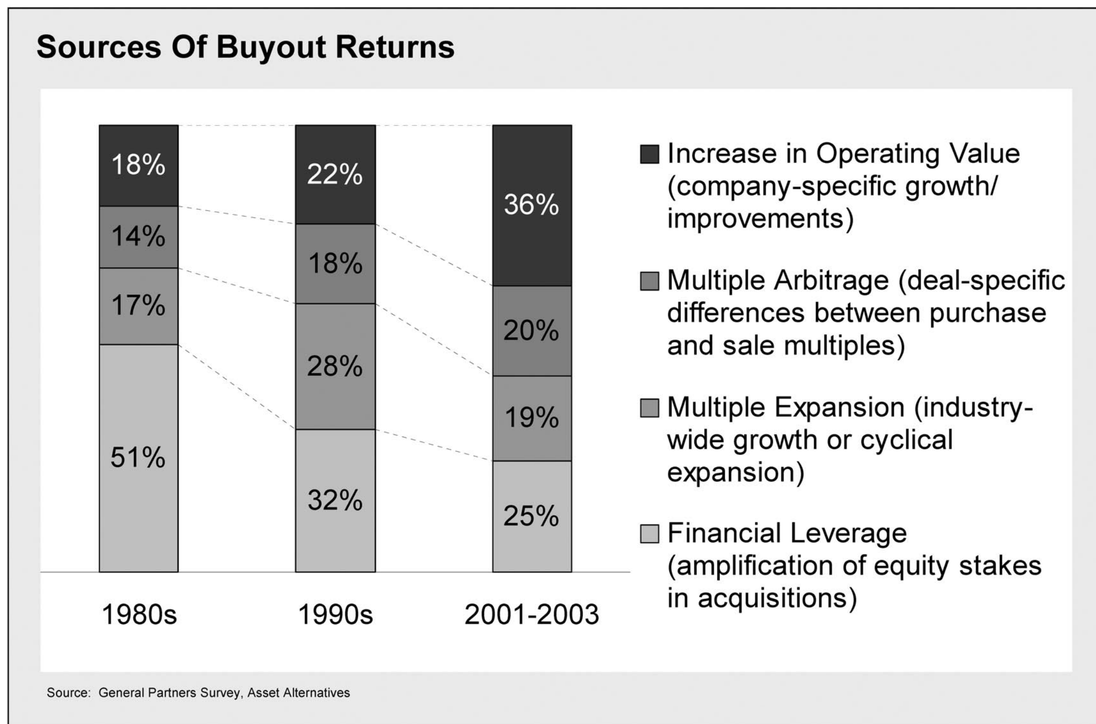


Exhibit B



access the requisite expertise to foresee realistic operating value improvements (during the buy process), to plan for and capture improvements (during the ownership period), and to have optimized EBITDA and demonstrated further prospects for operating value improvements as they prepare to exit the investment.

In short, the historic reliance on portfolio company management teams to identify and capture operating improvements is no longer sufficient. These teams are often new to the LBO environment where effectiveness requires focus on new dimensions not found in normal corporate set-up—namely, cash generation (beyond the conventional focus on earnings and growth). As a result, they may struggle to come up with a comprehensive and credible value creation strategy on their own.

Today's most successful private equity firms are actively engaged in the operations of their portfolio companies. This involvement goes well beyond board membership, and is made meaningful by strong operational expertise that supplements the private equity firm's traditional transactional expertise and avoids over-reliance on the portfolio company management team.

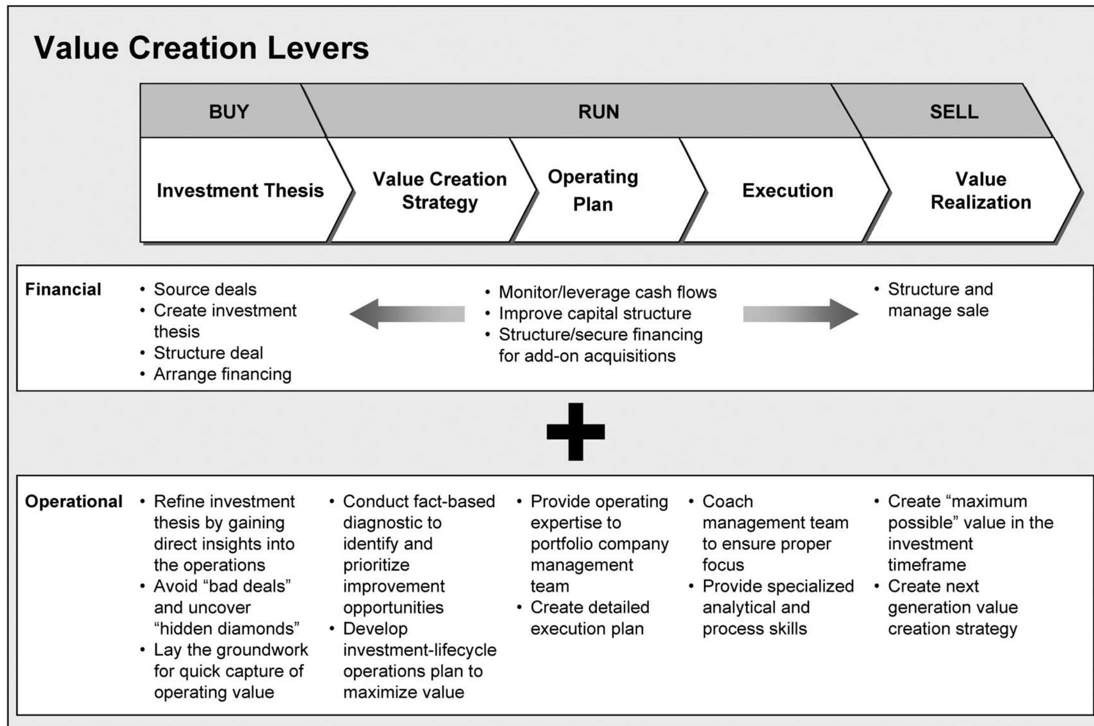
Know The Key Levers For Increasing Operating Value

In the private equity world, operating value is a function of EBITDA and working capital management. With the sale price tied to a multiple of EBITDA, even a small increase in EBITDA—from margin improvement and/or top-line growth—can bump up the value of investment. Tighter working capital management frees up cash that can be used to pay down debt, re-invest in the company, or recover some of the original cash investment in the deal.

Thus, there are three key levers available to increase the operating value of portfolio companies:

1. **Margin improvement**—Margins can be increased by improving price realization and/or reducing costs. Considering the competitiveness of today's market, opportunities to improve margin through pricing are relatively limited. This leaves cost savings as the primary means of improving margins. Untapped savings opportunities often run the full gamut of the cost structure (material, labor, overhead, and SG&A expenses), with operational cost excesses often as high as 20-50 percent of the total cost of goods sold.

Exhibit C



2. Working capital management—While typically a company's Accounts Payable and Account Receivables situation can be improved to reduce working capital, significant reductions can only be achieved by dramatic cuts in inventory levels. Manufacturing and distribution businesses have changed drastically in recent years because of more complicated supply chains with multiple facilities and global sourcing, as they seek to meet increasingly demanding customer requirements. Absent streamlined, efficient management and proper configuration of these complex supply chains, inventory levels can build up quickly—with cash tied up in the 30 to 50 percent of inventory that is excess or avoidable.

3. Top-line growth—Certainly the age-old ways to achieve top-line growth, such as aggressive sales and marketing approaches and acquisitions, are still options. However, for most companies, the greater, more enduring growth opportunity comes from creating a lasting competitive differentiator that enables pricing power gains, promotes customer retention, and attracts new customers. Capturing the bigger opportunity requires a broad understanding of the external business environment, creative thinking, and new operational capabilities.

Take Full Advantage Of What Can Be Accomplished Operationally Throughout The Investment Lifecycle

Those players who understand and have the expertise to capitalize on the relationship between operations and ROI are ahead of the game throughout the life cycle of the deal (see Exhibit C).

Buy Better

Astute private equity players validate and refine their investment thesis by gaining important insights into the operations of the target company. They conduct robust operational due diligence to uncover both problems that may be masked by standard financial reporting and hidden operational potential that may justify a winning bid. Beyond ensuring the potential buyer is not blindsided by egregious operational flaws, rigorous operational due diligence signals when to persist in the purchase of a target and lays the groundwork for quick capture of operating value after the purchase goes through.

To quickly uncover both showstopping operational issues (i.e., we shouldn't buy it because the "wheels might fall off") and operational opportunities

that can over-deliver on return targets (i.e., maybe we should place a higher bid because we don't want this one to get away), a "freestanding" model is required. In order to be "freestanding", the model must be focused on key operational metrics, incorporate as much objective actual data as possible, and correctly weigh and interpret the impact of assumptions leading to various scenarios of operational outcomes. Finally, the model must translate these operational outcomes into financial measures and implications.

While routinely bringing in specialists to address legal, accounting, environmental, and other aspects of due diligence, private equity firms have tended to rely on finance people (transaction staff and accounting firms) and the existing management team for operational assessment. Such assessments are "top-down" in nature, failing to "get under the hood," thus missing out on critical front-line data and first-hand observations. Further, they may be biased. Successful firms recognize the high risk of not doing rigorous operational due diligence and build such expertise as one of their core capabilities, either through additions to their staff and/or alliances with outside operations experts.

Run Better

The private equity firm that has conducted robust operational due diligence as part of the buy process has a jump start on effecting operational improvements as soon as the deal is closed. This advantage is important because, while the targeted ownership period varies, time is always of the essence in the private equity world. The trick is to create and execute a value-creation strategy that aligns with both the portfolio company's operational performance situation and the private equity firm's target exit date.

To fully realize the value of operational improvements typically requires three to five years—this timeframe may exceed that targeted for the investment holding period. If the goal is to exit the investment within two years, the value-creation strategy should not focus on "long payback" operational initiatives. If, on the other hand, the plan is to hold the investment for three years or beyond, the private equity firm wants to avoid a singular focus on "incremental" opportunities at the expense of "bigger impact" opportunities.

In helping the portfolio company craft an appropriate value-creation strategy, it is useful to think of opportunities as falling into one of three categories, each with a different capture timeframe:

- **"Quick-hit" opportunities to streamline operations (immediate to 1 year capture timeframe):** Such opportunities are applicable when there are fundamental issues with and excess costs in basic operations or individual functions at the portfolio company and the private equity firm does not plan on holding the company for long. The operational value these opportunities deliver comes from such "quick-hits" as purchasing savings (via vendor consolidation, non-strategic spend consolidation, accessing low-cost materials); inventory, waste, and overhead reductions; productivity improvements; and product portfolio optimization. Capturing these "quick-hits" begins with a rapid, but rigorous diagnostic to identify and prioritize improvement opportunities based on level of effort required vs. likely return, followed by speedy execution of "low pain/high gain" initiatives.

- **Opportunities to gain cost/capability advantages (one to two year capture timeframe):** These types of opportunities are pursued when portfolio company operations are functioning smoothly but tougher opportunities have yet to be tackled and/or existing cost/capability advantages have yet to be leveraged, and the private equity firm is not targeting an immediate turnaround. Capturing these opportunities entails benchmarking today's cost performance and capabilities relative to best-in-class performance and ensuring full leveraging of advantages in the marketplace, while strengthening capabilities as necessary via quick-payback (<two years) capital investments and other harder initiatives. What can be expected from these opportunities is maximized marketplace performance as a result of strengthened capabilities and honed cost advantages (from, for example, facility closures/network rebalancing; leveraging of low-cost global manufacturing opportunities; automation/technology upgrades; distribution strategy overhaul; organizational restructuring; and SKU, product design, vendor, and customer rationalization/-complexity reduction).

- **Opportunities to achieve break-away growth from new operational capabilities (three to five year capture timeframe):** When a private equity firm is looking for dramatic growth in the value of its holding and

is willing to make the necessary investment in time and money, this last category of operational opportunities is relevant. That is, assuming the portfolio company in question has already milked the value from its existing capabilities and has the management strength to commit to aggressive growth targets. Success here means that the portfolio company is well on a path to break-away financial performance from new, industry-leadership capabilities (e.g., value-added services, market-making capabilities, pioneering in new geographies, innovation capabilities, specialized/customized manufacturing and distribution capabilities) that are developed organically and/or the result of targeted strategic acquisitions. Pursuing these type of opportunities requires in-depth market intelligence (market and industry trends, new channel and customer opportunities, competitive landscape) coupled with a visionary mindset in order to identify new opportunities for growth, the sweet spot for long term competitive advantage, and the operational capabilities required to capture these opportunities.

Sell Better

The most successful exits share the following characteristics: the maximum possible value has been created in the portfolio company given any constraints imposed by the investment timeframe; and a next-generation value creation strategy is laid out to help interested buyers with their own operational due diligence effort and allow them to clearly see the value they can get from acquiring the company. Any buyer is willing to pay the full (and maybe a premium) price for a company that is well-run and has clear plans for where to go next.

Key Success Factors For Maximum, Rapid Capture Of Operating Value

Those private equity firms who properly pull the operations lever to maximize EBITDA and optimize working capital do so by:

- Ensuring a strong, fact-based understanding of the financial implications and potential of the portfolio company operations before the deal is closed

- Creating an actionable operating plan that is prioritized and phased and relevant to both the portfolio company's situation and the investment horizon

- Putting in place rigorous performance tracking/ meaningful Key Performance Indicators (KPIs) that measure internal and external performance

- Being actively engaged in setting direction for and monitoring portfolio company operations

- Bringing in outside expertise as necessary to supplement and challenge the portfolio company management team

- Securing buy-in from/ownership by all stakeholders at the portfolio company (from CEO down to the shop floor) and "external" stakeholders as appropriate (e.g., vendors, third parties that complete the supply chain, key customers), thus solidifying the likelihood of rapid, successful execution.

While the above may seem challenging, it is both doable and necessary in today's world. And many private equity firms are beginning to recognize the need for a stronger focus on operations. When asked to rate itself on its performance vis-à-vis maximizing operating value at its portfolio companies, one of the largest private equity firm gave itself a "three" out of a possible "ten". This firm went on to say if it could achieve a "seven" on that scale, its IRR would probably reach 30 percent from its current 20 percent. Said another way, those who can maximize operating value hold the key to the difference between superior and industry average returns.

Deepak Agrawal is a co-founder and the managing director of Gotham Consulting Partners LLC (www.gcpny.com), a specialist in helping private equity firms create exceptional value through operations in manufacturing, distribution, and service companies. He has extensive experience in achieving superior and lasting financial performance and operational capabilities improvements for clients ranging from multi-national Fortune 500 companies to middle-market buyout portfolio companies. He can be reached at 212-497-9201 or dagrawal@gcpny.com.

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