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Value Through Operations

Operational Improvements

Time To Leverage This Often Overlooked Value-Creation Driver

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Several persistent trends in the buyout industry – increased competition for deals, equity overhang, broad economic slowdown, weak capital markets, and decreasing leverage – are squeezing buyout firms' margin for error. Buyout firms must understand and act on the critical implications of these trends if they are to operate successfully in this environment.

What Are The Critical Implications Of Today's Trends?

- **The path to buyout returns is increasingly through operational improvements:** Of the three value-creation drivers – leverage, multiples, and operations – portfolio managers can only control operations. A recent survey of general partners conducted by Asset Alternatives indicated that over 36% of the buyout returns are now being driven by company-specific operational improvements. Compare this figure to the 80s and 90s when less than 20% of buyout returns were attributable to enhanced operational performance. Contributing to the emergence of operations as a key value-creation mechanism are: the inability to rely on top-line growth in a poor economy and continuing margin pressure from the overcapacity resulting from dampened demand and expansion in the late 90's.
- **Successful exit strategies demand proof of a successful operating history:** Companies are now valued on hard performance numbers, not on promises. Further, many strategic buyers are shying away from acquisitions while they focus on their own margins and protection of their own balance sheets/share prices. If a buyout firm wants to ensure a successful exit, it must provide irrefutable evidence that its portfolio company has a history of solid operational improvements and a proven management team.
- **Smart, capable buyout firms can position themselves well to benefit from eventual economic upturn:** The operations-savvy buyout firm can "leverage the moment" to: ferret out (for a good price) those acquisition targets where operations will drive premium returns when the economy turns around; and/or make fundamental operational fixes to its existing portfolio companies so they will be off and running in an upwardly trending economy.

What all of these implications underscore is the power of strong operational expertise (either through internal capabilities at the buyout firm or through partnerships/alliances with external sources). To ensure that the proper operational expertise is developed internally or accessed externally, buyout firms need to first recognise what it takes to create value through operations.

What Does Creating Value Through Operations Mean?

Creating value through operations requires achieving a state of excellence in terms of cost, service, quality, working capital management, and capital expenditure. This in turn means: *costs* that are more than competitive, reflect the lifecycle evolution of the product/service (e.g., commodity vs. non-commodity), and encourage the transition of end-user segments to the portfolio company's products; *service* that consistently meets customer requirements for timely delivery and easy, cost-effective interactions from order through invoicing/collection; *quality* that is consistently high, where the portfolio company "gets it right the first time"; *working capital management* that generates/ minimises cash tied up in receivables, payables, and inventory; and a *capital expenditure plan* that focuses on and prioritises opportunities that provide the highest returns in the shortest time period.

What Are The Key Levers For Achieving This State Of Operational Excellence?

A discrete set of levers opens the door to operational excellence. While traditional levers (e.g., productivity improvements, waste reduction, cycle time reduction, inventory reduction, purchasing savings, headcount reduction) are still useful mechanisms to quickly capture "low-hanging fruit", these conventional approaches alone will not deliver quantum leap improvements in operations, and hence, full capture of the operational value of a given portfolio company. A jump in EBITDA growth requires that the buyout firm also attack operational problems from a top-down, global perspective in order to address new requirements from customers (e.g., customisation, quick response time) that often imply the need for more widely dispersed manufacturing and distribution capabilities.

The key levers for delivering operational improvements that drive EBITDA growth include:

1. Segmented Operations – Analyse and structure operations in a segmented fashion (rather than taking a monolithic approach). This means: product segmentation based on service requirements and competitive realities; manufacturing segmentation based on process type and volume requirements; and market segmentation based on channel and customer importance. Justifiable, meaningful segmentation along product, process, and customer dimensions enables cost- and service-effective operations decisions – for example: move high-volume manufacturing to low-labour-cost locations while keeping low-volume manufacturing close to the demand; outsource non-strategic operations to third parties.
2. Extended Supply Chain – Leverage and manage the extended supply chain (from

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supplier to customer), not just what is owned. This requires: synchronising outsourced operations with what is owned; working effectively with a global sourcing base to take advantage of lowest costs worldwide; leveraging vendor capabilities, expertise, and working capital; and creating stronger linkages with/ensuring proximity to customers to enable a fact-based understanding of their demand, facilitate cost-effective VMI, etc.

3. Simplification – Simplify operations to reduce complexity and uncertainty and make day-to-day management easier. This means standardising equipment, eliminating process variations and non-value-added steps, and rationalising products, suppliers, and customers.
4. Product Optimisation – Establish a product development process that ensures unnecessary, costly uniqueness/complexity will not be built in. This means: shared and standard components to capture volume savings and reduce inventory and obsolescence; modularity in design to optimise production; postponement of differentiation to provide choice to customers without creating complexity in manufacturing; and design for manufacturability to reduce labour and capital costs and to improve quality and lead times.
5. Flexibility/Responsiveness – Set up operations to meet changing market and customer requirements quickly and effectively. This means: short changeovers to enable smaller batches and facilitate production switches; short lead times to enable quick response to changes in demand; and low inventories to facilitate quick transition to new product designs.
6. Continuous Improvement Program – Establish a continuous improvement program, such as six-sigma, to ensure excellent execution of and performance improvement in day-to-day manufacturing, supply chain, and business process activities that will allow the portfolio company to continually improve.
7. Key Performance Indicators (KPIs) – Implement and monitor KPIs to provide early warning of issues and enable timely, fact-based decision making within the portfolio companies. Buyout firms have to ensure that decisions are being made based on facts, not on "status quo" experience or "gut-feel".

How Can Buyout Firms Maximise The Impact Of These Levers At Their Portfolio Companies Within The Shortest Time Period?

Typically, buyout firms rely on the management teams of their portfolio companies for operational improvements and, hence, focus on shoring up the quality of these teams. While capturing operational value requires strong management at the portfolio companies, the most successful buyout firms don't stop there – they also become actively engaged in the operations of their portfolio companies (beyond board meetings). Such involvement includes holding periodic operating reviews with portfolio company management to: get a first-hand assessment of/regularly monitor operational performance; evaluate the management team; and communicate their objectives to ensure that portfolio company operations are aligned.

Further, successful buyout firms ensure that operational improvements at their portfolio companies are undertaken in a manner that maximises value within the shortest time period without overwhelming the organisation or interfering with the effectiveness of daily operations. Because a buyout firm's time horizon for exiting an investment does not always align with the time required to fully realise the value of operational improvements, a 3-phased approach is recommended. While it typically takes 3-5 years to fully leverage opportunities and make that quantum leap in EBITDA growth, many benefits can be captured quickly (in Phase 1), while laying the foundation for longer-term, more strategic improvements (in Phases 2 and 3).

This phased approach is described below:

Phase 1: Streamline Operations (Immediate: 0-1 Year): The first phase of a successful operational improvement program starts immediately after the close of the deal and requires heavy participation from the buyout firm. This phase kicks off with a rigorous diagnostic to quickly identify and classify improvement opportunities based on level of required effort and likely return. From this opportunity classification, a plan is created for prioritised, rapid value capture. The most rapidly capturable opportunities typically include purchasing savings, inventory reduction, waste reduction, overhead reduction, and productivity improvement, and are undertaken immediately. The key during this phase is to rapidly capture bottom-line benefits of and maximise return from "easy" initiatives without either compromising core capabilities or precluding longer-term, more strategic opportunities. In summary, Phase 1 delivers maximum return from "quick-hit" opportunities, while building necessary organisational momentum to tackle the portfolio company's harder operational challenges in the subsequent phases.

Phase 2: Develop Cost/Capability Advantage Within "As-Is" World (Short-Term: 1-2 Years): Once the portfolio company starts delivering immediate bottom-line results, the buyout firm needs to move on to capture the next level of opportunities within the "as is" world. Building on the momentum developed during Phase 1, Phase 2 begins to challenge the portfolio company's "sacred cows". The initiatives during this phase may include facility closure, organisation realignment, automation, worldwide sourcing, and distribution strategy.

Phase 3: Put In Place New Operational Capabilities For Growth (Medium Term: 3-5 Years): Once the portfolio company is on a path to elevate its operations to a significantly higher level, the buyout firm needs to start conducting broader external industry and market analysis to identify growth opportunities and bring new ideas to table. With a clear understanding of the market/competitive situation and required operational capabilities, missing capabilities can be developed and properly leveraged to drive growth. Key to this phase is defining the "sweet spot" for longer term competitive advantage and understanding how that translates into operational capability requirements.

In summary, a buyout firm needs to be a catalyst for rapid change/improvements at their portfolio companies. This means being actively engaged in setting direction for and monitoring the operations of their companies, rather than being an "absentee" owner who relies solely on the management team to make operational improvements. ■

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