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Value Through Operations

Second(ary) Generation

by Deepak Agrawal

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Over the past several years, the once relatively rare practice of transactions between buyout firms has become more common. In 2003, $18 billion worth of these secondary buyouts took place, and the market is on a pace to double that in 2004.
There are two key reasons.

First, traditional exit strategies have become less viable. Strategic buyers remain reticent, the initial public offering market continues to be sluggish and Sarbanes-Oxley Act requirements have dampened enthusiasm for going public.

Second, the maturing buyout industry itself — 1,000-plus firms and more than $450 billion in capital in 2003 versus 637 firms and $187 billion in 2000 — has driven increasing stratification and specialization as firms strive to differentiate themselves.

But while there are good market reasons behind this trend, buyout-to-buyout deals create a new set of challenges that demand strong operations capabilities to extract value from "higher pain, but higher gain" operating improvement opportunities.

The traditional buyout approach was to provide a company with capital and clean it up to generate improved operating performance that would command higher valuation at exit. Thus it is safe to assume the seller has already captured easy wins, such as savings in purchasing, labor and overhead, simple product and marketing initiatives, and enhanced accounts receivable/payable management.

The next generation of value creation — margin improvements, working capital management and growth — can prove to be very difficult to achieve.

For sellers, meeting these challenges means aggressively marketing the company's future operating value potential to prospective buyers to whet their appetites.

For buyers, it means conducting rigorous operational due diligence to understand the true value, untapped financial opportunities and associated timeline-requirements for capture. It also means having the capabilities and being prepared to take a hands-on, proactive approach in the creation, the execution and the monitoring of the next-generation value creation strategy.

Creating value through operations is a three-stage process: Streamline operations; develop cost-capability advantages within the "as-is" world; and put in place new operational capabilities for longer-term competitive advantage.

In a typical secondary buyout, Stage 1 of the process is generally well under way. The real opportunity lies in going beyond surface-level fixes and undertaking more structural, complex changes in such areas as post-merger synergies, cost structure, inventory management and customer service.

For deals where the seller has used acquisitions to grow the company or the buyer plans to combine it with an existing portfolio company, the key to fully leveraging post-merger synergies is truly combining the companies to create a single

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culture; an integrated, rationalized and optimized asset base; seamlessly linked information technology capabilities; and a rationalized organization structure.

Absent this, it is virtually impossible to reap the benefits from synergistic acquisitions and build off the marketplace promise.

On the cost structure side, ensuring competitiveness in today's global economy often requires that manufacturing, distribution and even service companies leverage low-labor-cost locations. Here the challenge is to be holistic, not merely opportunistic. A holistic global sourcing strategy understands that a company is a collection of distinct segments determined by product, manufacturing and market requirements — with each segment warranting a tailored sourcing approach.

Finally, the requirements for success in today's environment (particularly global sourcing) have created vastly more complex, extended supply chains than those managed historically by middle-market companies. Traditional management skill sets and methodologies are no longer sufficient, as evidenced by high inventory levels and poor customer service levels at many companies today.

The challenge is to put in place a fact-based, agile distribution and replenishment strategy that will meet both current and future customer requirements while minimizing the inventory levels required. Such operational enhancements not only improve customer satisfaction — and hence the top line — but also free up working capital tied up in inventory.

Buyout firms that maximize value are those with access to strong operational capabilities that are fully leveraged throughout the investment life cycle — from due diligence through exit. Only by taking a hands-on approach and bringing the necessary expertise to the transaction early on can the buyout firm ensure rapid, proper execution of a fact-based value creation strategy that tackles the "harder" but higher-return operating improvement challenges.

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