



PRIVATE EQUITY PERFORMANCE IMPROVEMENT

# SHOW ME THE MONEY, BUT THE RIGHT MONEY PLEASE!

PART 1: WHERE IS THE MONEY?

ALVAREZ & MARSAL

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*In our three-part series, “Show Me the Money, But the Right Money Please!” A&M Private Equity Performance Improvement Managing Director, Cliff Hall, discusses the framework behind an effective commercial strategy that drives profitable sales, margin improvement, and cash flow.*

*In part I, we discuss how understanding cost-to-serve and creating transparency on margins and the market are the foundation. This informs product and pricing strategy, and sales organization structure and process to create an effective commercial strategy that drives profitable sales and cash flow.*

## THE CURRENT LANDSCAPE

Given the current global economy – markets and customers in turmoil, shifting business models, and cash strapped vendors and customers - it is time to reset to drive profitable growth integrated with operations to reduce cost and working capital. The recent turmoil that COVID-19 has created, forcing limited face-to-face interaction with customers, offers a prime example that it makes sense to always be reevaluating your go-to-market strategy and to be almost “clinical” in terms of understanding where the money is being made and not made.

Poor or non-existent margin management (the tendency to say “yes” to every customer dollar regardless of profitability and payment terms) also needs to be addressed. Consider giving up some top line by consolidating or eliminating customers, products, or channels, because EBITDA, cash, and working capital can actually see a positive effect from it.

For years, we’ve seen numerous companies feeling squeezed and trimming costs. But, in reality, you can’t cost cut your way to sustainable growth. Though there are often opportunities to spend sales and marketing dollars more effectively, the focus must be on profitable sales, liquidity management, responsiveness, agility, and connecting with customers—not just on cost reduction. In our experience with privately held companies, many are missing opportunities to drive profitable top-line revenues using an effective commercial strategy.

When top-line revenues are increasing, it can be easy to ignore the opportunities for commercial improvement. However, when revenue and/or profitability begin to level off or fall, inefficiencies in the commercial structure and processes are exacerbated and can be a significant drain on cash that should be preserved or more gainfully deployed elsewhere. Carefully managing the cash conversion cycle can be critical to preserving working capital. Often, lenient payment terms given to high growth customers during the growth phase come back to haunt when revenue levels off, putting further pressure on operations and making revenue turnaround even more challenging.

For companies where growth has plateaued or is declining, Sales may be one of the last departments to come under scrutiny due to the fear of upsetting the delicate revenue stream. The commercial strategy is a challenge to the C-Suite professionals, who may have limited insight into how it is performing beyond the typical lag measures such as revenue. When a company begins missing revenue or profitability targets, the first instinct may be headcount eliminations to drive cost reductions. The risk is that if this is done without an in-depth analysis of customer needs and the cost to serve the customer base (including working capital costs), it can lead to share loss, losing the wrong customers, low employee morale, and customer discontent. These risks to maintaining a fragile revenue stream rightfully cause a hesitancy to make dramatic headcount cuts.

So how do you thoughtfully make the right short-term decisions without causing customer churn? The best approach is to focus on performance improvement that transforms the commercial function productivity (sales, marketing, customer services, etc.) and improves cost-structure and working capital. Bottom line – this means harnessing the dual power of Margin Management and Sales Team Effectiveness to maximize the growth of realigned resources. Achieving this requires:

- Taking an unbiased, candid view of the current organization and management process with a willingness to eliminate long-standing habits and practices that provide minimal value to customers.
- Executing the plan, through the perspective of “fresh eyes” and bringing industry best practices and processes to leverage the way world class sales departments operate to help guide decision making.

## HOW DO YOU IDENTIFY THE OPPORTUNITIES?

Leaders driving change need to focus on the following commercial execution-focused questions:

- Do you understand the true cost you are incurring to serve each customer?
- Do you understand your market and where it is heading?
- Is your Sales department leaving margin dollars on the table?
- Can you measure the productivity of your sales team beyond lag measures (financials)?
- When was the last time you reviewed your sales territory loading?
- Do you align your channels to maximize profitability?
- Is your sales team's incentive structure aligned with company priorities?
- Has your sales cost structure outpaced your competitors?
- Are commercial and operations functions linked through a robust Sales, Inventory and Operations Planning process to drive operational efficiencies and manage working capital while delivering cost and service levels to the customer?
- Do you have the right product mix and new product pipeline to fuel future profitable growth?
- Are support functions properly equipped to handle a high performing commercial strategy?
- Do you have effective leadership that can manage change and make it stick?

Understanding your market and where you are truly making money is the basis for addressing each of these questions and identifying the levers to create value. Develop a deep understanding of market trends, competitive dynamics, growth opportunities, and customer and end-user behavior and purchasing decisions. Determine where money is being made at the customer, market, channel, product category, and SKU level by unpeeling margins and applying cost-to-serve where it is incurred. These steps lay the foundation for building an effective commercial strategy by understanding how to apply the levers of:

- Product portfolio optimization
- Pricing and margin recovery
- Segmentation and channel optimization
- Sales force and market coverage
- Sales process and operations
- Integration with operations in sales, inventory and operations planning

## A&M COMMERCIAL EXCELLENCE APPROACH



### Product Portfolio Optimization

Ensure the product portfolio and new product pipeline maximize profit opportunity



### Pricing and Margin Recovery

Ensure that costs to serve are recovered and pricing captures maximum value



### Segmentation and Channel Optimization

Understand the market drivers, how to differentiate by segment/channel to optimize the sales organization design



### Sales Force and Market Coverage

Optimize the size and structure of the sales force and ensure it is properly incented to grow profitable business



### Sales Process and Operations

Ensure leads are efficiently generated and converted into profitable sales, and sales is held accountable to KPIs and metrics



### Margin Transparency

Determine where money is actually being made at the customer, market, channel, category, and SKU level by unpeeling margins and cost-to-serve



### Market Transparency

Understand market trends, competitive dynamics, growth opportunities, and customer and end-user behavior and purchasing decisions

## MARKET TRANSPARENCY: DO YOU CLEARLY UNDERSTAND HOW MARKET TRENDS ARE IMPACTING YOUR COMPANY AND CUSTOMERS?

Almost all executives have a deep and instinctive knowledge of the markets and customers they serve, which is built around years of experience in an industry. However, when companies are experiencing a declining topline, it is difficult to know if the cause is a one-time market event, poor execution, or deeper structural problems (caused by changing market and industry trends) that need to be addressed through fundamental changes.

When external market conditions change rapidly and companies are under financial stress, it's critical to develop/refresh the company's views about how these external trends will impact their customers, competitive positioning, and revenues so that the company can avoid:

- Simply hoping for a recovery and postponing needed restructuring actions.
- Overcorrecting—by cutting capacity and product lines that may be well positioned to grow.

If your company is under commercial stress requiring significant structural changes, relying on anecdotal or “the latest headlines” type of market information is not conducive to good decision making. Systemically understanding the underlying market trends; how your customers and their spending with you will be impacted; competitive opportunities and threats that may emerge; and how those trends will impact your company's revenue and competitive outlook is the starting point to consider any operation or structural changes.

## MARGIN TRANSPARENCY: DO YOU KNOW YOUR TRUE COST-TO-SERVE?

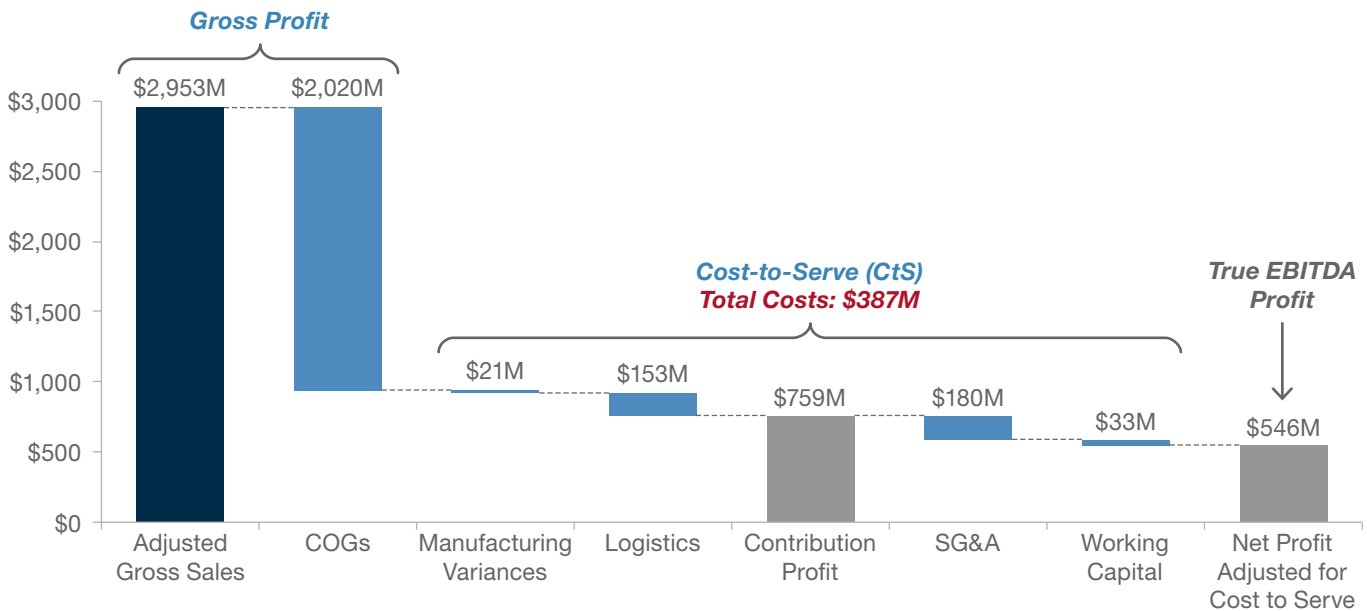
Building a cost-to-serve model is critical to inform proper changes to go-to-market strategy, organization structure, and pricing strategy. Without this, a significant loss in revenue can cause a company to double-down on the bad habits that were formed to grow the company. This is the time that a company needs to pivot towards a culture centered around profitability and cash generation. On a recent assignment, a company of approximately \$3 billion revenue had a tail of customers (16 percent of total revenue) that contributed negative \$12 million in profitability. By focusing on top-line results, the company had lost sight of the cost-to-serve. Many sales organizations struggle with identifying good customers, instead focusing primarily on growing the top line. Not every dollar is a good dollar and not every customer is a good customer.

To change the culture in your company, the area that needs immediate attention is improving financial transparency by market, product line, SKU, customer, channel, and plant or location. Once you have good data and an understanding of operations to more accurately allocate operating costs, you can build a cost-to-serve model that provides insight into true customer and product profitability.

In most cases, companies stop at the gross margin level without understanding the true net margin of their product portfolio. Thus, weekly decisions on pricing and marketing strategy may be flawed. Digging deeper into additional costs such as product customization, customer service, expedited freight, returns and warranties, and special terms and conditions may be necessary to develop an accurate picture of a customer's true net margin.

By reviewing the company's costing methodology, you may identify improvements for future product costing that will improve the accuracy of evaluating profitability. Without a true sense of how much it is really costing the organization to support each customer, your go-to-market strategy (and associated organizational structure supporting the strategy) may be flawed.

**P&L Walk, Adjusted Gross Sales to EBITDA Margin**



*Tip: Work with your Finance department to outline the key costs that should be allocated to serving your customers, and work with operational functions to identify the right cost drivers to build a cost-to-serve model that can be used to measure true profitability. This model can then be used by the Sales department to inform future organization changes and to build a sound day-to-day pricing strategy. While the initial analysis is likely to be done off-line, investigate how to incorporate the cost-to-serve and cost transparency model into the business systems and incorporate into standard operating procedures for Sales, Finance, and Management.*

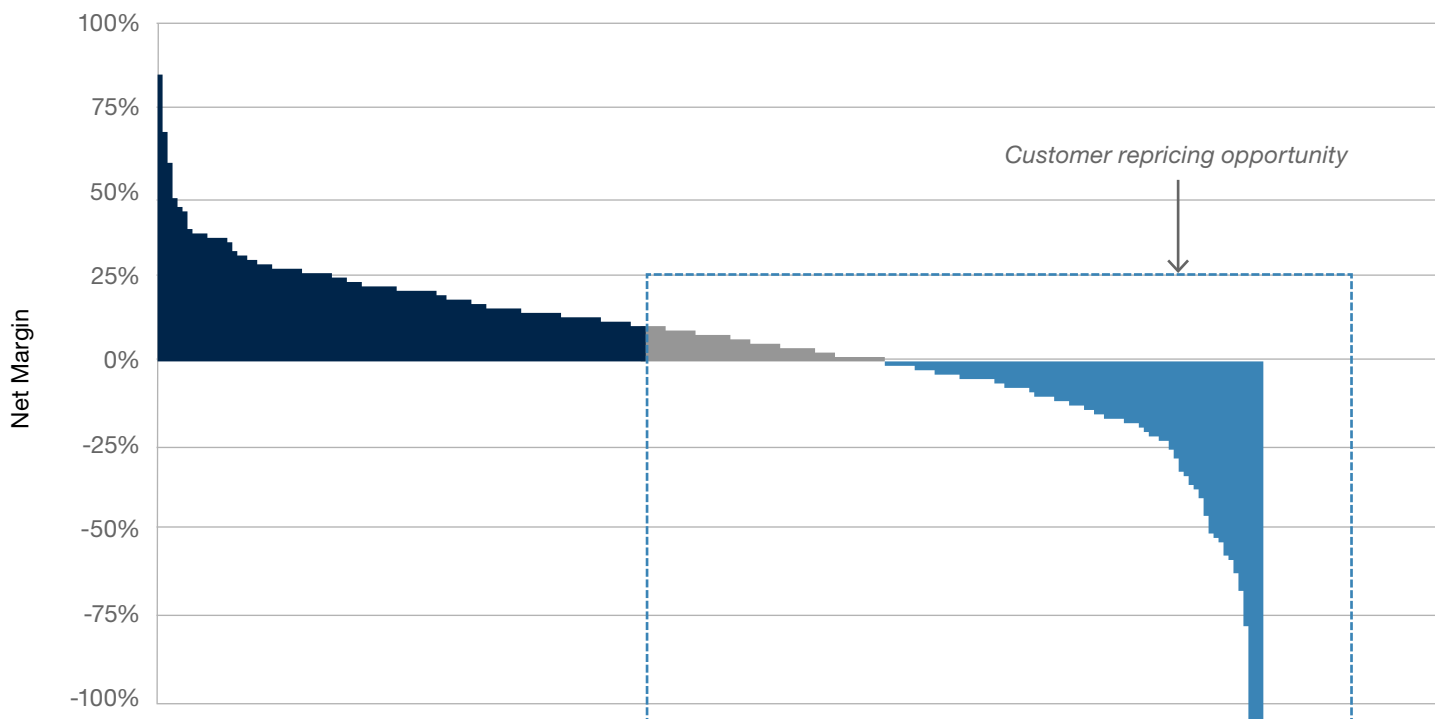
## PRICING AND MARGIN RECOVERY: IS YOUR SALES DEPARTMENT LEAVING MARGIN DOLLARS ON THE TABLE?

It is logical to say that not having visibility into customer or product profitability can lead to a flawed pricing strategy for your goods and services. Unfortunately, this is true for many companies that do not track customer profitability accurately. This may lead to underpricing your product and leaving profit on the table, or conversely, overpricing your product putting share at risk. This can lead to poor discounting discipline by your sales department and to “price selling,” and not “solution selling,” contributing to lost sales and margin loss. To compound matters, legacy customer contracts with outdated terms can also lead to business that causes stress for the organization to serve these customers.

To address these issues, begin with a reset of your cost allocations by teaming with Finance to create a profitability model for Sales with true costing that gives instant feedback on pricing that is above or below the target profitability line. Next, consider a price increase for your “product tail” for SKU’s that are low volume, difficult to make, or unprofitable. In many company product portfolios, 20 percent of the product SKUs make up 80 percent of the total revenue at the company, with a significant number of SKUs exclusively sold to customers contributing negative profitability.

The combination of substantial product line proliferation and low volume customers can result in a highly complex business that drives cost higher through running a small-order job shop for a wide range of customers. With a recent client, an analysis of current pricing practices identified \$62 million of margin lift through repricing specific customers and tail products and implementing a workflow approval process to lock out poor discounting practices.

**Customer Profitability Summary**



You may also look at retiring old pricing agreements that are clearly one sided and do not provide a win-win. To execute this strategy, rate your customers A, B, and C on annual revenue and margin to pinpoint those unprofitable contracts to renegotiate. In many cases, you may have to make the tough choice to sever a contractual relationship with a “C” customer, pushing them to your competitor while strengthening your bottom line. In some cases, this strategy will lead to “C” customers that are willing to renegotiate higher prices after exploring other options. Another option is to lower cost-to-serve by removing all “C” customers from your outside sales team and reassigning them to a lower cost channel (e.g., inside sales).

For a business that is struggling to achieve profitability goals, pricing actions are inevitable. As you plan your price increases, take into consideration the impact on the entire company. A highly complex operating framework requires a coordinated effort across several functions for successful execution. For example, a price increase may reduce volume, and therefore requires sales support for repricing; supply chain management to properly adjust purchases and inventory levels for changing demand; manufacturing support to actively manage utilization and overhead; and the back office to properly adjust to the forecast. Work with Finance to create a sales pricing desk to scrutinize quotes before they are sent to a customer. This approval work stream can be integrated into a CRM platform with a profitability tool so as not to impact customer time to market.

## **PRODUCT PORTFOLIO OPTIMIZATION: ARE YOU SELLING THE RIGHT THING?**

Dovetailing with a price increase strategy, consider reducing the number of SKU's (rationalization) as a good way to reduce production complexity while concurrently improving profitability. To execute a tactical product rationalization, we first recommend increasing prices on low volume, low margin “odd-ball” products that are not strategic to your overall product portfolio. This will either raise profitability on these products or encourage your customers to simply stop buying them, with either of these choices resulting in a benefit to profitability. For more strategic portfolio optimization, a balance will have to be created between the obsolescing of older products facing declining volumes and margins with the new product development pipeline. Review your new product pipeline, stage-gate process, and new product development priorities to ensure that you are refreshing the product line with profitable growth.

## **SEGMENTATION AND CHANNEL OPTIMIZATION: WHO ARE YOU SELLING TO?**

As you review your profitability and product mix, one factor that you need to keep front and center is who your customers are and how you are reaching them. As you delve into profitability, it may become clear that you are not profitably serving certain customer segments. If you have not developed some differentiating competitive advantage with a segment of customers, you will likely find your lowest margins as they are treating you like a commodity and making their buying decision purely on price. If you cannot find a way to create a competitive advantage with this segment and capture premium pricing, the other option is to change your service model and lower your cost-to-serve. Perhaps this segment can be served by the distribution channel or perhaps it can be served through the online sales channel, avoiding the cost of sending an expensive direct sales force to their door to just take orders. Thinking about how to differentiate in selecting the right service model by customer segment should serve as a key design consideration for your sales force.

**With the foundation laid, an organization with a good understanding of the market and where the money is made can address issues with pricing and product portfolio to bring the right products to market at the right price. Now, the organization can examine how it is going to market to drive profitable revenue growth.**

**In part II of our three-part series, we will examine how the sales force is sized, structured, and deployed to uncover and capture profitable growth opportunities.**

## KEY CONTACTS



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## ABOUT ALVAREZ & MARSAL

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With over 4,500 people across four continents, we deliver tangible results for corporates, boards, private equity firms, law firms and government agencies facing complex challenges. Our senior leaders, and their teams, help organizations transform operations, catapult growth and accelerate results through decisive action. Comprised of experienced operators, world-class consultants, former regulators and industry authorities, A&M leverages its restructuring heritage to turn change into a strategic business asset, manage risk and unlock value at every stage of growth.

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