PRIVATE EQUITY PERFORMANCE IMPROVEMENT

Risk, Reality and Reward: A Navigation Playbook

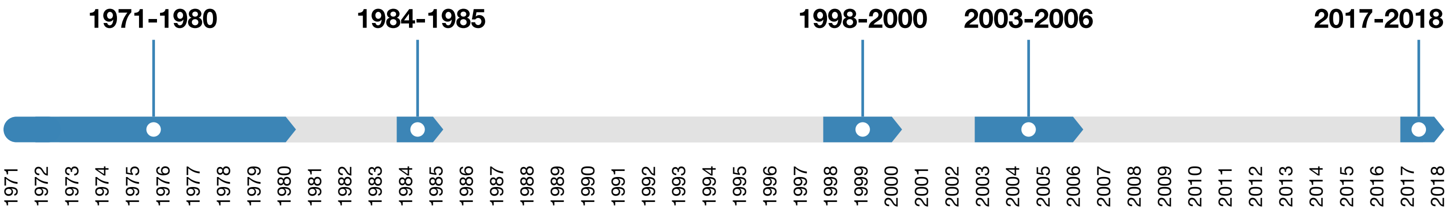
Preparing Organizations in the Midst of a Storm

A Gathering Storm

The private equity industry has been facing challenges from the pandemic with travel restrictions, labor shortages and supply chain issues disrupting the global economy for two years. More recently, the attention has shifted to managing inflationary pressures and assessing potential risks associated with global uncertainty. While many private equity firms and their management teams continue to maneuver through the inflation surge, now is the time to look further over the horizon to consider additional actions to be taken in advance as preparation for additional inflation and economic pressure will soon be signaled by Federal Open Market Committee (FOMC) rate hikes.

While no one is breaking news to note the Fed's recent turn to tighten the money supply and reduce liquidity from an overheating economy, the pace of inflation and the accelerating hawkishness of the FOMC members have caught many by surprise. Last November, the Fed was attributing inflationary pressures to "transitory" supply chain disruptions.[1] By December, markets were predicting three rate hikes in 2022. More recent expectations indicate up to five hikes.[2] What follows this near-term inflationary period could be a significant economic downturn in late 2022 or early 2023.

Notable Recessionary Periods

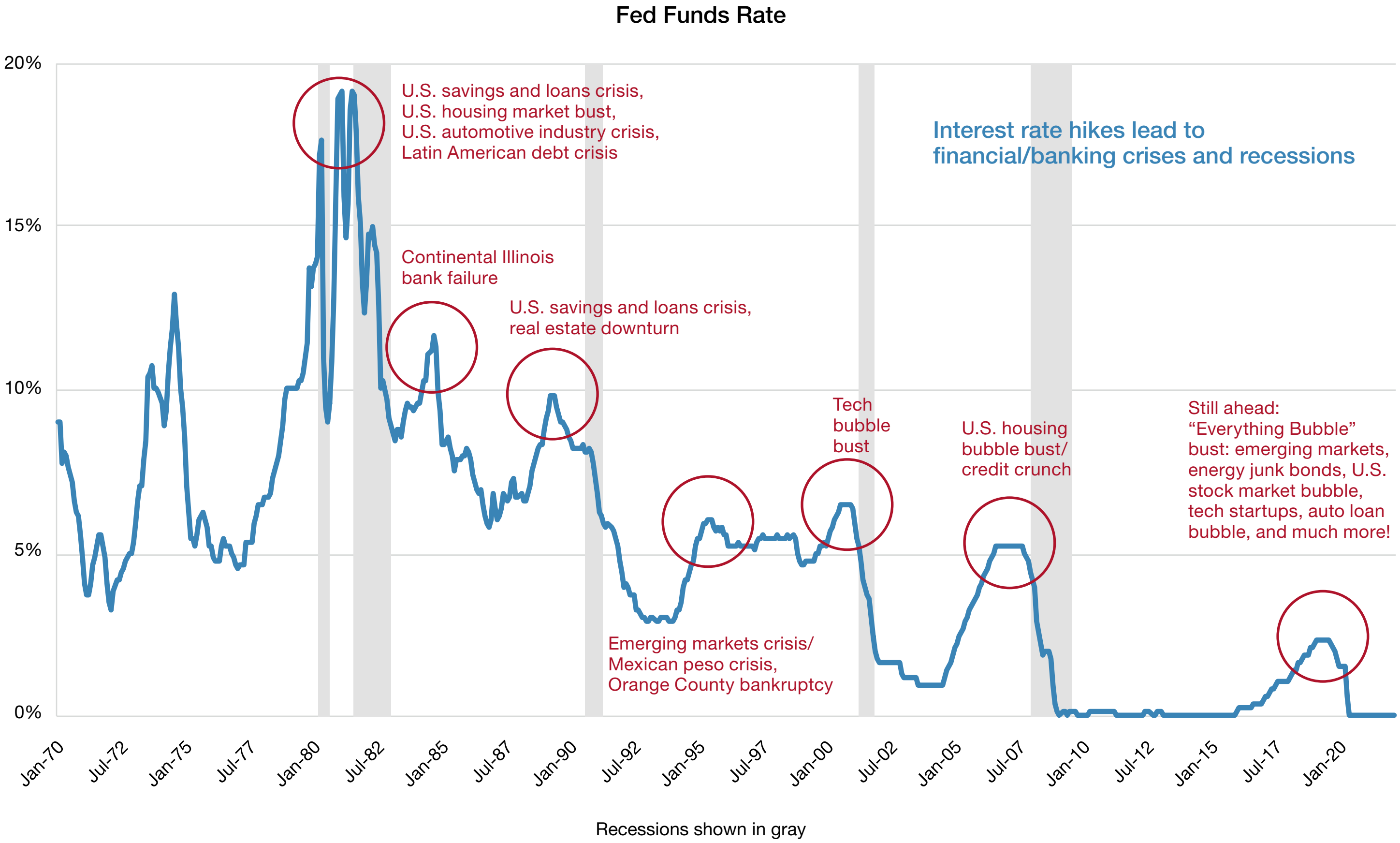


If the last 40 years of rate hikes are any indication of what lies ahead, a recessionary environment could be imminent. Since 1971, there have been 20 periods of rate hikes by the FOMC, each of which has been driven mostly by inflation and geopolitical uncertainty. Out of these 20 periods, 11 of them included three or more specific increases in rates and, out of those 11, eight (or 73 percent) led to recessions and bear markets.

[1] "Transcript of Chair Powell's Press Conference", November 3, 2021, https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20211103.pdf

[2] Countdown to FOMC: CME FedWatch Tool (cmegroup.com)

In other words, using the last 40 years as a proxy, there is about a 75 percent likelihood that multi-incident rate increases trigger recessionary events — most notably were the rate hikes from 1971 to 1980, 1984 to 1985, 1998 to 2000, 2003 to 2006, and 2017 to 2018, which are highlighted on the graph below:



Source: St. Louis Fed

Counteracting The Storm

This roller coaster of interest rates was last seen in the 1970s, well before private equity and its related leverage was such a significant part of the global economic picture as it is today. Over the past 50 years, the private equity industry has contributed a great deal to the energy and dynamism of our modern economy. Arguably, the rapid rise of private equity since the 1970s has been one of the primary forces driving increased competitiveness and productivity across all major sectors of the U.S. and global economy.

However, many of the attributes that drive value in this space can leave portfolio companies uniquely exposed once the Fed starts to take action. The direct and indirect costs of leverage will increase. Higher cash flow volatility driven by a combination of revenue headwinds, rising input costs and supply chain disruptions pressure debt service capacity and increase the implicit impact of financial distress.

The onset of an inflationary cycle coupled with collapsing liquidity and elevated recession risks are likely to put even more pressure on companies with higher leverage, fixed costs, and aggressive growth plans. Considering where we are in the inflationary cycle and upcoming rate hikes, the focus must now pivot towards the next phase of actions to counter these economic conditions.

Navigating The Storm

What actions can private equity firms and their operating companies take now to help manage this cycle? This confluence of impacts is largely an unprecedented situation for the private equity industry and requires responses by portfolio company management teams that are deliberate and decisive to place a greater emphasis on nimble, cross functional management.

From a risk perspective, there are three areas directly tied to inflation or interest rate hikes that management teams can focus on as they steer through the current and near-term economic environment:

- **Manage or Reduce Leverage:** Rate hikes will drive important first- and second-order effects. Higher interest and debt service costs will strain cash flows. Short-term, floating rate debt is a clear risk factor that many companies have already moved to address. Consumer-facing firms with products funded with discretionary spend must consider the impact of price elasticity on reduced sales volumes and resistance to price increases. Combined with higher input costs, these companies may see significant gross margin pressures. Many credit facility agreements that were amended in 2020 to provide companies with sufficient flexibility (e.g., PIK'd interest, covenant relief, etc.) during the pandemic start to unwind and tighten or mature during 2022 or 2023.

  Proactively entering lender amendment conversations now can secure a path forward for operating companies. Deleveraging ahead of rate hikes is one of the more obvious moves. Floating rate debt should be hedged where it cannot be eliminated. Debt covenants must be carefully evaluated and tested to identify high-risk scenarios. Be proactive in your communications with lenders and other creditors. Ensure that your liquidity forecasts have sensitized scenario analyses and that 'hope is not baked in' to these looks, but a sober view is instead shared and acted upon.

- **Manage Balance Sheet:** The short and long ends of the balance sheet will be pressured. The implicit carrying costs of inventory and working capital will increase substantially. Critical suppliers may present unexpected risk. Companies must strike the right balance between carrying safety stock to survive supply chain issues, and maximizing inventory turns to reduce working capital costs. Address order-to-cash processes, cross functionally, quickly. Mining this data will allow for a good situational understanding of the health of accounts receivable and collections' velocity, providing for better action steps. Re-evaluate customer credit arrangements, attack contract or customer differences that drive collections performance differences and make this a focus of management.

  All of these measures must be taken with a sharp-penciled, near-term view towards inflation and a very watchful eye towards a looming recession shortly thereafter. Developing and implementing a plan proactively to manage the balance sheet can provide stability through any economic environment.

- **Manage Margin:** Executive teams will be managing this inflationary cycle for the foreseeable future. Again, the margin performance data associated with customers, markets, products, regions, cohorts and possibly others must be understood. Companies must quickly determine if the underlying market conditions related to customer pricing strategies and vendor pricing are temporary or permanent. Sales, operations, and finance must manage seamlessly, cross-functionally to create a unified, deft approach towards margin management. Standard costing should be employed as well—particularly, for companies where material and labor inputs dominate the cost structure.

  Standardized input costs achieve several important goals during an inflationary cycle. For example, they force managers to think more clearly about the composition of different input costs; they are a useful tool for adding discipline to vendor agreements and for managing relationships with suppliers; and they facilitate tighter and faster assessment of variances. Track performance closely and make it part of the weekly or monthly reporting. To the extent market performance is available, leverage it for comparative analysis.

Batten Down the Hatches

Riding out this upcoming economic environment will demand tighter alignment between operations and finance, requiring improved visibility and tools to accelerate decisions and response times, and thoughtful risk management.

Operational Alignment

- Companies must explicitly strengthen and improve the linkages between operations, finance and sales to survive.
- Budget cycles should be accelerated, with rolling monthly or quarterly forecasts to drive continuous focus on cost drivers. The traditional once-a-year budgeting cycle will be outdated before the first quarter is completed.
- Rolling forecasts and more frequent cycles also force managers to give closer attention to the inputs that drive outcomes.
- The accounting team must work to accelerate closing cycles to provide managers with more relevant information. Formal processes must be established and implemented, with checklists and accountability.
- Organizations should look to reassess and retool their procurement organizations. Centralizing functions into a shared services model along with enhanced use of Artificial Intelligence (AI) and Business Intelligence (BI) tools to gain insight and alignment across the enterprise provide opportunities to find margin improvements.
- The sales organization must be brought into the fold and employed as a force multiplier to drive financial performance and maintain customer relationships in an inflationary environment. Customer quotes should be based on input prices at the time of delivery where possible. Pricing must be carefully considered and planned, with a focus on understanding the factors that drive value to customers. Eliminate or reduce elements that are not core value drivers to enhance margins.

Visibility

- All businesses use some type of dashboards or reporting system. Most fail to understand and measure the critical few indicators that drive success. Output or result indicators such as revenues, earnings, and cash flows are lagging. By the time these are reported, there is no ability to make changes. Leading indicators must be tracked and understood by all functions with a frequent, consistent cadence.

- Metrics must be carefully tied to the plan, distilled into the critical few elements that drive success and must be cascaded down throughout the organization. High-performing companies will incorporate strategic metrics as part of normal weekly and monthly reporting, with detailed business-segment metrics tightly linked into the strategic objectives.

- Supply chain disruptions and the impact of higher cost of capital place a premium on purchasing, receiving, and inventory metrics.

- Critical cost inputs must be closely monitored in this environment. Management teams with a clear, real-time view of major cost drivers will be positioned to quickly adapt and respond ahead of competitors. This may be securing critical inputs in a supply-constrained environment, planning for lower-cost substitutes, or preparing customers for price increases.

- Business Intelligence (BI) systems are ubiquitous. However, they are useless without careful attention to the design, definition, and governance of key performance indicators (KPIs).

Risk Management

- The balance sheet should be cleaned as much as possible. Cash is king during these situations. Therefore, conserve it. Capital investment plans may be delayed or scaled down as hurdle rates and return targets are reconsidered.

- Cross-functional, seamless management will be critical. Equally important will be the strategic management between the board and management. More frequent communications may be required. Clear, prioritized actionable plans must be created so that response to a changing economic view can be quickly addressed. Many private equity-sponsored companies operated similarly during the height of the pandemic and this close-knit approach worked well in their favor.

- Working capital management will be critical in this environment. Vendors and customers may be much more highly exposed than managers expect. Customer accounts and credit terms should be carefully analyzed and rated. Companies must invest in initiatives to accelerate collections and monitor major accounts in real time. The vendor base should be assessed to identify and rank exposure. Vendor concentration should be remediated with alternative suppliers.

- Firms must also implement rigorous risk management processes. Liquidity should be monitored with a 13-week cash flow forecast. Debt covenants and cash flows should be subjected to rigorous scenario testing. Businesses that are exposed to foreign exchange rates with international operations must consider the potential impact of large changes in exchange rates and evaluate whether that risk should be hedged either through financial instruments or by rebalancing expenses and revenues between countries.

A Port in the Storm

Passing the second anniversary of the pandemic's start and now entering a tightening rate cycle unprecedented in the modern era of private equity investment, the pressures are higher than ever. There has been no end of shocks: collapsing demand, supply chain constraints, labor shortages, travel restrictions and rising inflation. In many cases, this has forced firms into a reactive, myopic approach as managers have dealt with one crisis and then another. High liquidity and cheap money have eased these impacts.

As available capital retracts and becomes more costly, we will see higher pressure on operational performance. Companies should be situationally prepared, aware, nimble and coordinated. To prepare, companies should focus on:

- Integrating finance and operations to ensure a close alignment across the enterprise;
- Improving the situational understanding of the company's health, metrics, likely performance vector and its governance to accelerate response times; and
- Implementing actionable and thorough risk management plans now to identify and manage exposures.

No one can fully predict the extent or duration of the coming economic downturn. Proactively addressing the potential impacts today, while managing the ongoing challenges and distractions of the current cycle may further stretch management, already exhausted by the last two years. However, time can be an ally for those who are willing to invest the effort now to get ahead of the curve. It harkens back to a 1970s advertisement for Fram oil filters which indicated that you could pay a little bit for oil filter now or a lot for the rebuild of a neglected engine later. Prudent planning and effort today will be more effective and less costly than waiting for the inevitable to occur.

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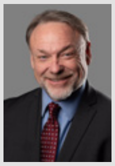

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