PRIVATE EQUITY PERFORMANCE IMPROVEMENT

No Regret Moves: Actions PE Leaders Must Take to Optimize Portfolio Company Value in the Face of High Interest Rates

Doing Nothing in This Environment Is Exactly What Not to Do

The Private Equity (PE) industry finds itself in a very dark place after experiencing unprecedented highs in recent years with record deals, volumes and fundraising activities. Interest rates have risen precipitously with no expectation they will retreat from their current levels for some time to come, leaving liquidity strained, debt difficult to acquire and firms facing lower returns.

For the PE sector, this is a new environment. Following a boom of deal and fundraising activities in 2021 and early 2022 and the cheap money that enabled it, the rate hikes in 2022 had an almost devastating impact on deal activities, exits and exit valuations:

- Fundraising is at a significant low. The second quarter of 2023 was the worst for raising capital since 2018, reaching a mere $106 billion.[1]
- Unrealized value is at an all-time low with exit activity virtually at a standstill.[2]
- Limited partners are now cash-flow poor.

For many general partners, such uncertainty may lead them to adopt a “wait and see” approach, but that has never been a good strategic plan and is one of the worst things they can do in the current environment. While PE firms should not stop fundraising efforts, now is the time to turn their gaze inward, toward operations and liquidity management, rather than outward toward dealmaking.

Liquidity and margin management are the tools needed for the day — skills most management teams don’t often wield effectively. Their comfort zone is scaling deals for growth with an exit window in mind.

Smart PE firms will take the opportunity in the face of industry headwinds to manage and optimize cash burn now.

Take Action — With No Regrets

Without the traditional formula for acquiring, growing and selling portfolio companies to realize returns, PE firms need to direct their attention to operations and data-driven forecasting. Traditional arbitrage and consolidation approaches won’t work now. A new plan is needed.

Cash management is one answer, but it can’t be the only solution in this environment. Organizations can fix about 20 percent of their cash problems through management, but when most cash in the company is consumed in operations (as much as 60 percent) it won’t be enough. This means the focus must be on cost containment, such as reducing cost of goods sold (CoGs) to improve margins and selling, general and administration (SG&A) costs.

1. https://www.wsj.com/articles/private-equity-fundraising-falls-to-lowest-level-in-five-years-b4998705
2. Bain & Company Stuck in Place Private Equity Midyear Report 2023

Finance and better cash flow planning can't fix the problem alone. Until the weather breaks in the industry, It's an operational challenge first and foremost.

Time is not on the side of PE organizations. Making no decision is worse than a bad decision at this point.

With the potential to remain in this interest rate environment for a longer period of time and the subsequent malaise, PE firms must reset the baseline for their portfolio companies. For some, it's too late. For many more, taking action now can not only preserve investments but also offer an advantage in the marketplace.

The more proactive PE firms have a view into their liquidity and cost problems. This makes more options available to them, potentially allowing them to move ahead of competitors in the marketplace when the economics change.

Moves to Make Now

Here are four actions to take to ease the pain now.

1 *Focus on Liquidity*

In such an unfavourable interest rate environment, pivoting to cash preservation is paramount. The first step will be accurate forecasting. Developing a rolling 13-week cash flow forecast is essential but venturing to predict cash needs as far out as possible, preferably up to four years out, is even better. Why that long? Interest rates are a two- to four-year problem at minimum, so firms need to forecast for the long term to weather the storm. A longer term cash forecast that leverages an indirect model may help to plan out the liquidity impacts and capital needs down the line.

The second step is ensuring the data serving the forecast is accurate, as the output will only be as good as the input. That requires the Chief Financial Officer to work closely with operations to ensure data quality and predictability, find opportunities for data improvement and challenge historical and data-driven assumptions.

In essence, cash flow should become an organization-wide concern. It means going beyond Accounts Payable and Receivables to unearth opportunities in the middle of the business — reducing cost to serve customers, optimizing billing times, reimagining inventory management and procurement and manging CapEx.

2 | *Cost Management*

Not all costs drive value. The key to managing costs is transparency. As with the effort to drive liquidity, quality data will help leaders make decisions on cost management. Do firms have the data and tools to determine total, direct, indirect, fixed and variable costs? Does the data indicate which costs will drive value?

With data in hand, it's time to go back to square-one and begin planning with a new sheet of paper. Know what each category costs. Areas to look at are CoGs, overhead and, in particular, fixed costs that can be turned into variable costs.

An often-overlooked cost reduction method is to renegotiate vendor and customer terms to better sustain a healthy level of cash flow, which was particularly useful during and after COVID when supplies were hard to come by and customers were asking for a break. Changing the game with vendors and customers alike will prevent companies from getting squeezed leading to negative working capital.

In a recent client example, a $500 million revenue portfolio company was able to generate more than $50 million of cash flow by renegotiating terms with their vendors and making sure that customers were adhering to pre-Covid terms, which had gone significantly off-track during and right after COVID.

3 | *Shrink to Grow (It's About the Margin)*

There's good revenue and bad revenue in every company. Which customers provide the best returns? Which actually cost more to maintain? Which cost areas are not yielding expected outcomes? What are the true "costs to serve" for a particular customer, product, channel or business unit?

Create value by increasing the former over the latter. A customer may look profitable on the outside, but when everything's added up, the total cost to serve can end up being negative. Take the time to determine which customers, products, channels and other revenue dimensions you want to support.

Recently, a $1 billion revenue client uncovered more than $80 million in margin opportunities stemming from a combination of pure pricing actions, consolidating a long tail of customers by moving a large portion of them to a distributor and streamlining costs to serve in areas like customer service, logistics and sales commissions.

4 Change the Culture

The organization's culture toward cash is important and likely will need to change. Is it biased toward taking smart actions or taking a wait-and-see approach? PE-owned companies must be pro-cash under these economic circumstances.

A cash culture starts at the top, beginning with the board and being driven through the entire organization. The degree that an organization is focused on cash from top-to-bottom will determine a company's drive to profitability. KPIs, compensation plans, communication of goals and announcing the achievement of metrics all serve to support a cash culture. Companies that seek to continuously take out costs and focus on good revenue will survive the current environment and build value for a future return on investment. Those that don't risk succumbing to the pressure.

Treading Water Leads Nowhere

This is the time to act. Indecision will not help and potentially jeopardize the survival of a portfolio company. While cash is king, true and comprehensive performance improvement is required to move the needle.

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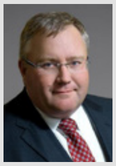

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