SURVIVING THE SQUEEZE: PRIVATE EQUITY'S RESPONSE TO ECONOMIC HEADWINDS

Introduction

For more than a decade, private equity (PE) funds thrived in a low interest rate environment, achieving strong returns for investments made at high valuations at the top of the market. Active value creation was not prioritized since investors could rely on steadily rising multiples, abundant capital and stable operating costs to guarantee a good exit.

But these tailwinds have reversed over the past 18 months as new macroeconomic realities set in. Long gone is the plentiful (and cheap) credit that allowed businesses to fund multiple expansions and undergo debt refinancings. Operational costs have increased due to high inflation and a tight labour market, putting pressure on margins across portfolio companies. These new forces are pulling down corporate valuations across the board.

All the while, the outlook for growth is dimming as economic activity slows. Eurozone retail sales fell more than expected in September[1] amid weaker consumer demand, while services and manufacturing activity in the region also contracted in October[2]. In a slowing economy, using volume growth as a value creation lever is no longer as effective as before.

Indeed, more and more we see PE clients experiencing this situation and switching their advisory requests from M&A support to transformation to address some of these issues.

This article explores how many PE funds are moving away from the traditional levers of the last ten years, making interventions at several levels and areas to offset inflationary pressures and continue to deliver above-market returns to their investors.

Achieving high-impact transformation **through rapid improvements in 9 areas**

In our work with PE clients, we see fast improvements coming from the following levers:

1. **Inflation pass-through:** Historically, pass-through terms on direct material costs have been partly negotiated, whilst labour cost inflation was expected to be absorbed by productivity improvements. However, with disproportional increase in labour costs more recently, corresponding pass-through terms are required to avoid margin squeeze.

2. **Shrinking to grow more profitably:** With increasing costs that cannot be entirely passed over to customers, portfolio companies should closely evaluate their entire portfolio. The portfolio optimization process should include reviews and development of strategic plans for product and customer portfolio, as well as for the divisional and subsidiary structure with their manufacturing footprint.

3. **Market proposition optimization:** As volume growth is becoming more difficult to achieve, portfolio companies should focus on (profitable) market share gain by growing the share of wallet with existing customers. As part of that, they should explore opportunities to stretch current product/service propositions to enter adjacent products, different channels and/or customer segments. This requires a thorough understanding of market and channel trends as well as customers' key purchasing criteria. To capitalize on this, portfolio companies need to be agile in new product development as well as in their sales and marketing approach.

[1] https://www.reuters.com/markets/europe/euro-zone-retail-sales-fall-much-more-than-expected-aug-2023-10-04/
[2] https://www.ft.com/content/7d6015f9-3282-42a6-a3a9-192ec68458a0

4. **Mitigate cost inflation with ZBB and procurement transformation:** With increasing supply chain costs, portfolio companies should provide detailed action plans to mitigate direct and indirect material cost inflation. They must put tight controls on spend management and push zero-based budgeting (ZBB) initiatives to reduce costs. Well-planned indirect procurement transformations can also deliver significant margin and EBITDA improvements. Our A&M's rapid diagnostic assessment allows companies to determine the maturity of their procurement set-ups and identify quick wins.

5. **Liquidity control:** With higher interest rate and inflation driving operational costs, PEs must push portfolio companies to increase their liquidity transparency and control. Some of the options to better manage liquidity include the introduction of cash offices, capital expenditure (CAPEX) prioritization and the establishment of 13-week cashflow forecasts.

6. **Working capital enhancement:** Rising inflation and high interest rates are buffeting companies' liquidity levels. PE funds should demand working capital improvements from their portfolio companies to release trapped cash and improve companies' ability to weather the financial challenges that could lie ahead. This includes initiatives regarding demand and inventory management as well as the optimization of payment terms.

7. **Increased labour productivity:** Improvement of labour productivity is an evergreen topic for PE firms, however, with labour inflation at rates more than 5% per year, it becomes more and more important. With higher rates currently limiting major capital expenditures, less capital-intensive initiatives – including shopfloor optimizations, lean management as well as utilization and efficiency reviews – should be prioritized.

8. **Digitalization as enabler:** Companies are expected to increase their level of automation to mitigate labour cost inflation, but investments in this area are being delayed due to higher capital costs. Many management teams have also experienced costly and lengthy Enterprise Resource Planning (ERP) projects in the past, making them cautious about new digital investments. However, with the introduction of artificial intelligence driven technologies, digital transformation becomes more efficient and effective, leading to better and more immediate result-on-investment (ROI).

9. **ESG:** Developing a comprehensive ESG assessment can help PE firms optimize businesses' growth potential by addressing ESG-related risks and capitalizing on value creation opportunities. This includes preparing a roadmap of identified ESG value creation actions and risk mitigation strategies with implementation timeline.

How Can A&M Help

By activating these levers, PE funds can lead high-impact, cost-based transformation that will rapidly improve the performance of portfolio companies, allowing them to deliver on their growth plans despite the current macroeconomic headwinds.

Alvarez & Marsal (A&M)'s comprehensive approach to performance improvement leverages our firm operational heritage and bias towards action to positively impact portfolio companies' revenue, cost and margin drivers, as well as working capital, in a compressed timeframe. Our Rapid Results Program stands out from other performance improvement approaches by focusing on:

Results and Speed: energy/intensity levels and proven results in a compressed timeline.

Relevance: specific industry and functional expertise alongside availability of comparative data and benchmarks.

Risk Management: always operator-led and execution-focused, extending a company's management capacity to address KPI drivers.

A&M's strong working capital management and liquidity expertise ensure PE clients can drive transformation programs in a cost-effective manner, by directing just a fraction of the cash released in EBITDA savings towards funding these projects.

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With over 8,500 people providing services across six 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, leverage A&M's restructuring heritage to help companies act decisively, catapult growth and accelerate results. We are experienced operators, world-class consultants, former regulators and industry authorities with a shared commitment to telling clients what's really needed for turning change into a strategic business asset, managing risk and unlocking value at every stage of growth.

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