PRIVATE EQUITY PERFORMANCE IMPROVEMENT

Transforming Branch-Based Business Operations in the Face of Recession and Beyond

While every industry will feel the effects of the current bumpy, recession-like market, branch-based businesses will be disproportionately negatively impacted.

Disseminated labor-intensive service businesses, or branch-based businesses, are businesses with many (many times hundreds) locations all conducting the same service locally. Examples include a $600M revenue home services business with 300 company-owned and 250 franchisee nationwide locations providing HVAC, plumbing, electrical, and lawn care or a $3B building products and industrial supplies company with 500 locations across 40 states. These businesses are excellent investments for private equity funds as they are most often for EBITDA improvement regardless of market conditions. They are typically a great investment strategy for an industry roll up of smaller businesses or to make a transformational change to professionalize the business with investments in people, process, systems and tools to drive scale and sophistication in both the commercial and operational components of the business. However, an extended economic slowdown will exacerbate their operational weaknesses of having inherently high fixed cost and having a low level of process excellence and standardization. Technology and AI will change the industry leader landscape with first movers in applications using it for AI-powered customer service inquiry responses, predicting inventory demand patterns, predictive maintenance, more robust customer segmentation to aid in dynamic pricing, and automating operational and financial repetitive tasks for less reliance on labor force.

Leaders should act now to transform their operations to: be more resilient, minimize the impact of a downturn and position the business for growth.

This series will cover the three steps private equity (PE) funds need to take to transform the operations of the branch-based businesses in their portfolios. This first article will detail how to identify and build an ideal operational and pricing model. The second article will outline how best to migrate to the new model, while the third article will detail how to make the changes sustainable through market swings.

This first article outlines both key questions that PE deal teams should ask during diligence, and the ideal operating design that PE operating teams should use as a guide to transform portfolio companies post-acquisition.

Why Are Branch-Based Businesses Especially at Risk?

Disseminated labor-intensive service businesses often operate with each branch acting as a separate business, do not take advantage of scale and so are inherently high fixed cost. Each high fixed cost branch becomes a significant cost issue during economic slowdowns as volume declines.

Limited standardization of their organizational structures, functions and processes also hinders their ability to adjust cost structures to deal with economic volatility.

As a result, many of these businesses have locked cost structures as well as utilization and overhead inefficiencies that cause them to run at much higher costs than needed. Lack of standardization makes company-wide changes risky and hard to implement in a short time period, limiting the ability to adjust operations as markets change.

Addressing these operating model restrictions can enable businesses to become more agile and, hence, lessen the market downturn impact.

What is the Purpose of a Branch?

PE Fund managers should be defining the purpose that the branch serves in the future model. Is it to allocate sales territory, a physical site for local distribution of product, a method to drive local P&L accountability, a means to manage local labor or a hybrid of all? A clear branch purpose defined will drive clear design principles for the network and resulting ideal business model.

What are PE Funds Asking?

- *“What is the purpose of the branch in my future model?"*
- *"How do I manage through market swings and seasonality?”*
- *“Why do my branches operate well only when I have a top talent general manager?”*
- *“The business is a result of a series of acquisitions. How can we develop a more sophisticated and standardized operating model that takes advantage of the scale of the business?”*
- *“How do I determine a turnaround plan when EBITDA declines?”*
- *“How can I enact change from executives to the field when the frontline has significant variance in operating procedures?”*
- *“How do we improve our pricing when our customer interface is not optimized?”*
- *"How can we build an optimized network inventory model to extract cash from inventory?"*

What Goes into Building an Ideal Branch-Based Model?

There are five elements to consider when creating an ideal model:

Network
Improve the infrastructure and health of assets, including the adequate number and type of branches, the most profitable geographies and the right equipment for the customer requirements.

Pricing and Contracts
Pricing approach and contract terms need to be standardized and there is governance in place ensure gross margins are maintained through market swings and cost changes.

Frontline Processes
Processes must be simplified, streamlined, standardized and measured.

Metrics
Business performance is managed through leading and lagging key performance indicators (KPIs), allowing clear transparency to frontline behavior and enabling management to adjust behavior by changing metric goals.

Organizational Structure
Optimize organization across field, regional and central functions. Clear ownership and processes should exist between each of the three organizational structures and across all functions.

How Can Branch Network Infrastructure be Restructured?

Key Questions:

- *After all overhead costs are allocated correctly to each branch, business service, SKU category and customer segment, do they all make the required return on capital?*
- *Are there geographies, branches, service segments or customer segments that could deliver a positive return with operational improvement?*
- *What network elements most likely will not make a positive return even with significant operational improvement?*

Network optimization results in the right branches in the right locations, products that are profitable at the SKU level, services are offered at the right levels with the right resources and support to maximize profitability.

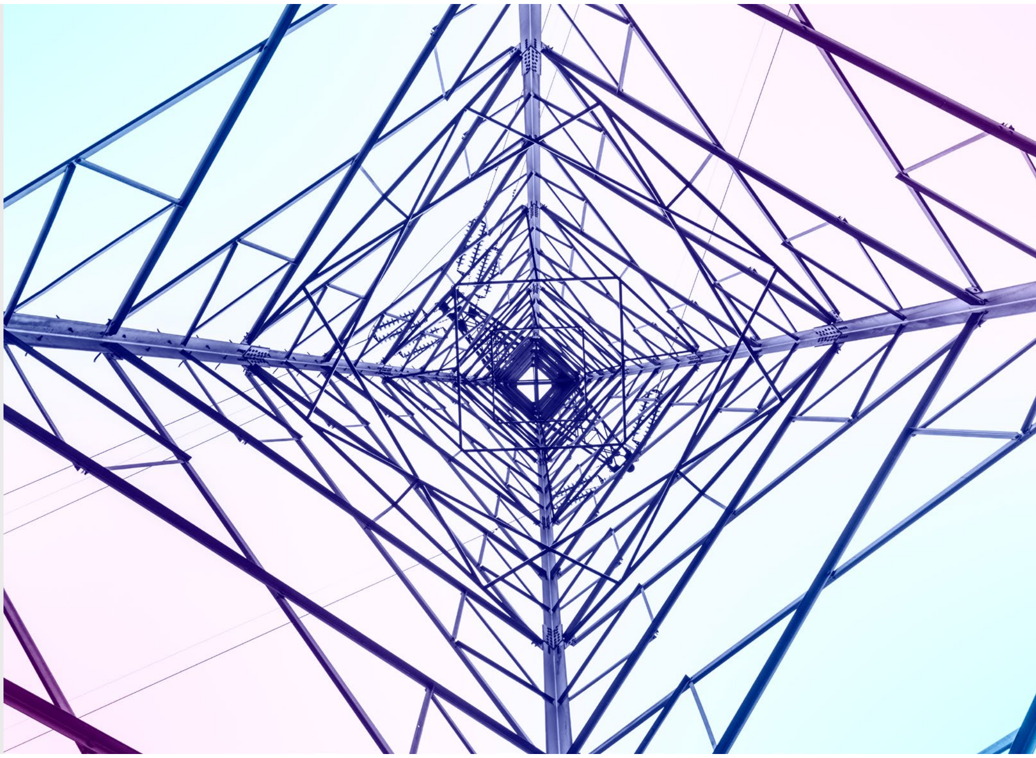
Businesses should take tough actions to decide whether lower-performing branches, SKUs or services should be consolidated, rationalized or closed. Some customer segments will not be worth continued support without increasing prices or reducing the services provided. In less profitable markets and geographies, a satellite branch might have a better cost-to-serve than a full range branch. This establishes a healthy, profitable base business network.

The network of support resources also needs to be optimized when building the ideal model. Significant variances in metrics, systems, tools, applications, processes, roles and responsibilities can hinder operations and complicate management. Aligning the resource network reduces costs and allows the network of branches to react more quickly to both seasonal demand fluctuations and longer-term downturns.

The more advanced businesses collaborate as a network of branches, services and assets — at least regionally — to optimize local markets or clusters of adjacent markets. They also constantly evaluate the investment return on the network and if there are other geographic markets, services or customer segments that are better investments of resources. That way, focus can be put on growing the most attractive markets with the largest opportunities for penetration.

Finally management can be focused on growth vs 'fixing' the base business issues caused by a suboptimal network resulting in better return on assets and overall EBITDA improvement.

Network Example: A Client with $1.4 billion in sales and 300 branches lost 30 percent of EBITDA the previous year. A&M led a transformation program to restructure its network. The team shut down 10 percent of the branches that didn't make a profit when all overhead costs were allocated and added branches in more attractive markets. The team then restructured the Client's organizational model to bring executives and supervisors closer to the frontline and developed processes to optimize resources across the network. As a result, the business regained the 30 percent of EBITDA within the fiscal year of the transformation.



How Can Frontline Processes be Used to Drive Productivity?

Key Questions:

- *What level of variability exists in the key processes across geographies, branches, service segments and customer segments?*
- *Does management use Standard Operating Procedures (SOPs) to drive productivity?*
- *Is the business managed by metrics?*

Streamlined and standardized processes for frontline employees improve productivity by bringing all employees to the optimal model and removing all unnecessary tasks. This is especially important for branch-based businesses due to the disseminated nature of employees working many times by themselves, in a truck, on a job site without direct supervision. We often find significant variance in processes and protocols across branches leaving the branch manager to define their own best method of management.

The structural elements of an ideal operational model include:

- Simplify, streamline, standardize and potentially automate daily and weekly work activities. Make the frontline as simple as possible by driving standardization at the local level. Critical to this effort is to challenge and eliminate non-value added tasks throughout their day.
- A standard "Day-in-the-Life-Of" (DILO) for frontline employees with a standard operating procedure (SOP) playbook. By activity decide the rough amount of time each activity should take and the metrics and goals of each activity.
- A strong, metrics-driven frontline employee workforce through having SOPs and playbooks will free up time for frontline supervisors to focus on operations, coaching, retention and customers.
- A process or team continually evaluates how to continiually further simplify operations.
- A standard branch layout and set of best practices that drives efficiency and safety at each location.

Standardized processes drive productivity and increase capacity and improve EBITDA. Higher productivity also enables more of the business to be operated by higher performing employees, which reduces the need for hiring and training additional labor during peak seasons.

Sophisticated operators facing significant seasonality should develop a flex labor model that drives capacity and utilization decisions proactively to optimize gross profits through market swings. Core aspects of this model include scenario planning, agility to adjust capacity up and down, strategic use of overtime during peaks vs. adding capacity, and a proactive process to manage the adjustments.

Frontline Processes Example: A&M built playbooks with lean principles and detailed standard operating procedures for a Client with 8,000 frontline employees across 300 branches. The team built separate playbooks for the 8,000 frontline employees, the frontline supervisors and the general branch manager. The playbooks detailed the specific activities to be completed, how to complete them and how much time each should take. The Client had an excellent culture of execution which enabled the playbooks to be installed quickly across the network. This resulted in a 20 percent increase in productivity which enabled a greatly reduced hiring requirement during the peak summer season and increased revenue per frontline employee.

How Should the Organizational Structure Differ for Central and Field Functions?

Key Questions:

- *Does the company utilize the scale of functions that don't directly impact branch operations?*
- *Are the branch managers focused on operations, and do they have the proper tools and resources to manage the branch?*
- *Are the central and regional functions effective and efficient, and communicate well with local branches?*

The ideal organizational structure for branch-based businesses creates efficiency and effectiveness for scale-intensive functions, focuses branch management on frontline operations and maintains the connective tissue across local, regional and central functions. This is key for branch-based businesses, due to the requirement of needing the branch managers to focus solely on frontline operations vs. the functions to support the business which can usually be done more efficiently outside the branch.

A key factor in branch-based business' organizational structure is delineating what activities can be, and are better served by being, centrally or regionally managed rather than field managed. In the best organizations, the field only runs frontline operations, providing input to central functions where needed. Keeping non-frontline operating functions centrally managed allows them to operate at scale, realizing cost efficiencies and productivity improvements.

Key resources shared across branches (e.g., fleet and equipment) should be owned and managed by central functions vs. branch management. Key personnel in a center of excellence function can perform at-scale, centralized roles such as data analytics.

Defining the organizational structure considering the majority of activities that drive commonality reduces complexity in the business. Some businesses allow outliers, non-core business lines and special circumstances to dictate operating models, resulting in a suboptimal model.

Business executives should organize to become close to the activities of frontline employees. This can be accomplished with strong dashboard metrics, adjusting spans of control and layers of management.

Finally, businesses should install their own Management Operating System (MOS). The MOS is the connective tissue consisting of roles, activity ownership, support, communication service level agreements and metrics that bring together all activities between the field and central functions.

Leading companies build their organizational structure and MOS tailored to archetypes. Archetypes are defined as similar business groups. For example, branches by market size, the services being delivered or the customer profiles being served. Different archetypes may have variances in service levels, standard operating procedures or organizational structures.

The main benefit of getting the organization correct is being able to scale non-frontline functions while focusing local management on operational excellence. This drives a nimble and more flexible cost structure to partially alleviate the market downturn impact of the fixed cost nature of branch-based businesses.

Organization Example: One Client with over 500 branches had the local branch manager doing most tasks needed to run the business. As a result, the local branch managers were not effective. In response, A&M centralized, professionalized and standardized tasks not directly related to the daily operations of the business. Though some activities had to remain local, managers were given tools and training to run those activities effectively. Second, the business was restructured to create optimized operating procedures. Third, other activities that could be done more effectively with central functions were stood up and enabled local input only as needed. This resulted in local branch managers now being able to succeed in the daily operations while being supported with central functions which operated much more efficiently.

How Can Pricing and Contracts be Optimized?

Key Questions:

- *Is there a standardized approach to pricing products and services?*
- *Does pricing correctly incorporate dynamic market cost changes and competitive knowledge?*
- *Are the contract terms standardized across branches?*
- *Is the sales team focused on maximizing total contract value and have strong governance on pricing and service margins?*

Optimizing pricing of products and services needs a standardized approach to pricing across branches, driven by a comprehensive customer segmentation applicable to individual/group of branches. Pricing should include all cost-to-serve elements and track changes in material and labor costs and incorporate into dynamic pricing of deals.

Contract terms need to be standardized across branches to ensure consistent service levels as well as prevent potential margin leakage from under and overservicing. Contacts should have language to allow for cost increase pass throughs consistently.

Establishing robust data around transactions, customers and products, and building tools to drive data-driven decision making, would enable longer term revenue and margin expansion.

Lastly, strong governance with proper metrics and escalation processed needs to be established to drive consistent pricing and margin performance. Lack of governance on pricing and promotions, might attract and retain customers, but can also lead to price leakage.

Pricing and Contracts Example:
A recent client, a leading industrial distributor, had multiple branches across the country. While national account pricing was standardized and managed centrally, regional, local and smaller client pricing was managed at individual branches. Branches used inconsistent price setting for products and services and had varying levels of governance leading to inconsistent margin performance across branches.
Our team established standardized pricing approaches across branches, incorporating all cost-to-serve elements, standardized contract terms and service levels, and established governance to track margin performance by branch, sales rep, customer and product levels. This resulted in significant margin improvement across branches.

How Can Metrics Provide Insights to Improve the Business?

Key Questions:

- *Can the branches be measured with data consistent across the network that highlights the most important operational results and can flex with changing market conditions (e.g., seasonality)?*
- *Can management impact frontline employee behavior by adjusting the metric targets and SOP playbook?*
- *Is the data trusted and readily available at the right levels without significant manual intervention?*

Strong metrics programs drive leaders to manage through data, gaining better insights on improvement objectives and enabling the sustainability of strong operating discipline. Metrics are important in all businesses, but especially significant in branch-based businesses which are very difficult to manually manage frontline employees due to the disseminated nature of the operations.

The structural elements of an ideal, data-driven metrics model are:

- **Transparency** which allows businesses to understand and act on where profits are made.
    - Businesses with multiple services have a robust understanding of profits after all cost-to-serve models are in place and all overhead costs are allocated to the appropriate service lines.
- **Operations Frontline Management** that provides a mechanism to manage capacity, utilization and efficiency. This enables staff adjustments, ramp up or down hiring, develop training programs and incentivize frontline supervisors to dynamically manage field labor.
- **Sales** function that enables dynamic pricing knowledge. Sales has a nearly real-time understanding of cost changes, enabling them to adjust pricing appropriately.
- **IT** function that is integrated with all other business functions to develop concise and user-friendly dashboards that enable employees to access their metrics efficiently.
- **Leaders** that run the business based on metrics.

Ideal model metrics drive benefits across the operation, as they:

- Provide frontline employees with clear direction on job expectations and incentivize them to improve productivity.
- Direct frontline supervisors to effectively manage employee performance and provide coaching.
- Empower management and owners with the knowledge to invest in, shut down or change branches, service segments and customers based on profitability transparency.
- Inform organizational structure decisions with a template to follow, for the most efficient function cost.

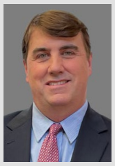
Metrics Example: At a national home services business the executives did not have a pulse on the labor utilization, local or national marketing spending level and impact, or service pricing changes at the local level. Executives could therefore not lead the branches through the flexing needed every few months due to the high seasonality of the business and impacts of the local competition. By installing tools to provide specific metrics on utilization, marketing and pricing, the Client was able to make better and quicker decisions to manage through the market swing periods, resulting in an EBITDA increase of nearly 50 percent.

How Can A&M Help?

PE funds have a significant amount of investment in the service sector. Over 50 percent of Alvarez & Marsal's top PE fund clients house service and disseminated businesses in their portfolios. A&M's Private Equity Performance Improvement group has deep, hands-on experience supporting pre-acquisition diligence assessments to create lower risk and higher value potential plan and post-acquisition EBITDA improvement programs to build the ideal model from assessment through execution.

We have developed a guide based on years of focused experience across US and European industries to help PE funds define, transform and sustain the ideal operational model.

Key Contacts:



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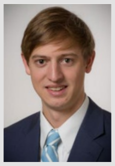

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With over 8,000 people providing services across six continents, we deliver tangible results for corporates, boards, private equity firms, law firms and government agencies facing complex challenges. Our senior leaders, and their teams, leverage A&M's 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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