PRIVATE EQUITY PERFORMANCE IMPROVEMENT

THREE-PART SERIES ON COST OPTIMIZATION

PART II: NOT EVERY DOLLAR IS A GOOD DOLLAR

ALVAREZ & MARSAL

INTRODUCTION

The second article in A&M's three-part series on cost optimization, entitled "Not Every Dollar is a Good Dollar," is written for investors and executives in private equity portfolio companies that have historically increased shareholder value through revenue growth, but are now facing challenges and lower levels of profitability. In A&M's experience, portfolio companies in these situations cannot simply cut their way back to profitability, and while chasing incremental volume is a common response, that response could lead to a greater negative impact on profitability. Portfolio companies in these situations need to change how they operate, and that change often starts with the realization that Not Every Dollar is a Good Dollar.

There is no debating that organic revenue growth creates value. Organic growth provides regular increases in cash to support capital investments and higher debt loads, and companies that have demonstrated an ability to grow organically typically command a higher premium in terms of valuation. With 75 percent of private equity transactions last year exceeding multiples of 10 times EBITDA, portfolio companies are under increasingly high pressure to deliver organic growth. In fact, a recent Forbes article highlighted a survey where "over two-thirds of private equity funds are pushing their portfolio companies to grow at faster than 10 percent a year to justify the price premiums they have paid."

In our experience working with private equity funds and their portfolio companies, we see an increase in situations where businesses that have historically delivered growth are now beginning to face challenges and lower levels of EBITDA. In most of these cases, the historical emphasis on growth over profitability has led to a significant build-up of cost and complexity throughout the business. Reducing this complexity must be the number one priority to avoid further EBITDA deterioration.

For companies in these situations, chasing additional revenue does not create value. What it does create is a potential trap to move into unprofitable business. Falling into this trap is especially problematic for portfolio companies that are in highly leveraged situations, as these companies may be the equivalent of a ticking time bomb. Solving the problem through growth may temporarily extend the fuse, but the clock is still running and eventually the bomb will explode.

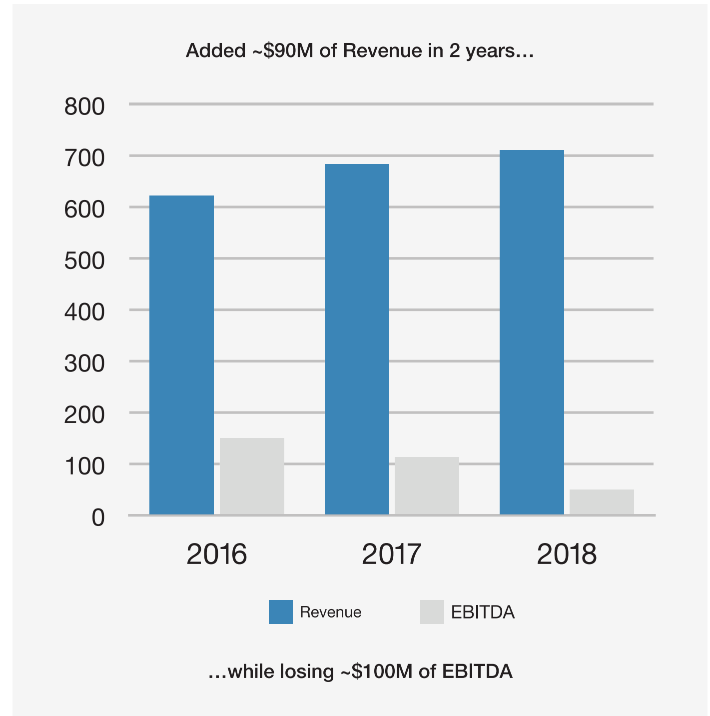
NOT EVERY DOLLAR IS A GOOD DOLLAR

Revenue growth solves a lot of problems. When portfolio companies that have historically emphasized year-over-year revenue increases over profit begin to face declines in profitability, the common refrain is “we will grow our way out of the problem.” Companies that follow this approach tend to not only lose focus on whether incremental revenues are profitable, they risk adding more cost and complexity which amplifies the problem. Revenue growth does solve solves a lot of problems, but it does not solve this problem, as illustrated in the sample case below.

Background	▪ PE-backed company in the consumer goods sector operating in the United States ▪ Current sponsor is in latter stages of investment, having held the company for over five years ▪ Historically, the company has delivered consistent year-over-year growth in revenues
The Record Year	▪ Company achieves a record year, delivering the highest annual EBITDA level since inception, but no growth in top-line revenues ▪ Since the investment is in late stages of sponsor’s holding period, the record EBITDA is overshadowed by the lack of growth in revenue ▪ Capturing incremental volume becomes the sole organizational focus with a mantra of ”growth at all costs”
The Ticking Bomb	▪ Company rapidly enters adjacent markets and opens new channels to capture additional volume ▪ Limited consideration is given to the capabilities needed to efficiently support this expansion ▪ Added complexity strains operations in the core business; orders are late, key goods are out of stock and high-volume customers are increasingly dissatisfied ▪ Simultaneously, the core business faces headwinds with key customers demanding both price concessions and customization, as complexity grows exponentially ▪ Management becomes consumed by fighting fires and plugging the leaks; meanwhile the business loses more than 60 percent of its EBITDA in two years

In this sample case, as with other portfolio companies facing similar situations, the root cause of the EBITDA decline is not a lack of additional revenue, but a lack of profitable revenue. In these scenarios, the lack of scalable platforms to ensure growth initiatives are accretive to the bottom line is a common problem. Revenue is "acquired" at the expense of increasing complexity, and ultimately profitability declines. Revenue growth can often mask increases in complexity and issues such as SKU proliferation, dilutive customers or products and lack of margin management discipline. These problems only rise to surface when added costs and complexities start dragging down profits.

In our experience, there is no one specific root cause for this situation. It is, rather, a symptom of multiple issues spread across the commercial aspects of the business. The chart below outlines the most common factors that lead to added costs and complexities negatively impacting profits.



NOT EVERY DOLLAR IS A GOOD DOLLAR

Lack of Transparency	▪ Limited understanding of where the company makes money, e.g., understanding the most significant sources of margin dollars across the business, inclusive of direct and attributable overhead costs ▪ Limited visibility into the actual Cost-to-Serve ("CtS") across customers, products and channels, including the impact of indirect costs such as customer service, expedited shipments and other directly-attributable costs ▪ Lack of reasonable top-line expectations in addition to revenue forecasts that are based on hope versus market realities
Jumping the Gun on Growth Strategies	▪ Expansion into new or adjacent markets without the commercial discipline and operational capabilities to efficiently support those incremental sales ▪ Entering new markets or channels outside of the business' core competency with the hope of capturing additional volume, but without recognizing critical operational and financial realities ▪ Launch of product extensions and derivatives to boost the top-line without careful consideration of the cost and complexity required to support increasing variations in the core business
Lack of Discipline to Say No	▪ Significant customer "tails" that contribute little profit yet receive the same level of focus as major customers ▪ Margin and associated pricing expectations that are not clearly-defined, leading to dilutive pricing and discounting practices and an emphasis of volume over profit ▪ Lack of ability to say "no" to customer requirements or requests that add costs which are absorbed, not recaptured, which further depresses margin and profit levels
Commercial Chaos	▪ Sales teams are focused on volume at all costs with incentives designed to drive volume, not profitable volume ▪ Redundant sales coverage models where "everybody sells everything" across products, customers and channels ▪ No connectivity between sales and operations processes (S&OP), leading to product or services sales that require high operations cost and bring added complexity
Culture of Revenue at all Costs	▪ Company culture that prioritizes sales and volume above cost and efficiency

PREREQUISITES TO PROFITABLE GROWTH

Addressing these situations requires a shift in how the portfolio company thinks about revenue and profit. Saying no to perspective revenue that does not make sense for the business can be difficult. Right-sizing the existing business to shed customers and products that are not profitable is often even more difficult. However, both actions need to be taken to get the business back on track.

In addition, the business needs to first recognize that it cannot “grow itself out of the problem” and initiatives to re-start growth must take a back seat, at least initially, to initiatives that reduce cost and complexity. The immediate priority is to develop the right platforms to deliver both scale and efficiency so growth re-starts can be smartly achieved.

Shedding unprofitable business and having the discipline to “say no” goes beyond concepts. It requires the discipline to drive a fundamental overhaul of the major commercial functions, as well as improved connectivity between sales and operations. Tactically speaking, the critical first step is to take a hard look at where the business is making money and where cost and complexity are dragging down profits. After all, not every dollar is a good dollar, and in many cases returning the business to acceptable levels of profitability means that first the business must shrink before it can grow.

The blueprint for companies in this situation is not just about ripping out cost. Improving the company’s go-to-market effectiveness and instituting the margin management discipline is critical to ensuring the business grows the right way. In our work with private equity investors and their portfolio companies, we apply the following principles to help management teams right-size their business and establish the platforms necessary for future profitability.

AT THE OUTSET, MARGIN TRANSPARENCY MUST BE THE NUMBER ONE PRIORITY:

- Understand the hidden costs of serving customers, including expedited freight, split or rush orders, inventory hold concessions and other similar costs that may seem necessary to book the sale. But also acknowledge and realize that these additional costs can quickly add complexity and erode profitability;
- Do not just talk to sales. Involve operations at the outset, as operational leaders typically know a thing or two about where a company has idle capacity and potential for scalable platforms;
- Establish a granular understanding of where the company makes money and where the company does not make money – by product, customer and channel. Without this level of transparency, the business will continue flying without a parachute.

TAKE A RUTHLESS APPROACH TO SKU AND CUSTOMER RATIONALIZATION, AND RE-PRICE PRODUCTS AND CUSTOMERS OFTEN AND CONSISTENTLY:

- In many of these situations, the portfolio company historically builds a significant "tail" of customers that deliver minimal volume yet require substantial cost and resources to support. When properly managed, these customers typically require markedly different pricing from larger customers. Pricing variations of 30 percent to 50 percent are not that unusual depending on the specific industry;
- Break the myth of "fixed cost absorption." In most situations, the theory that fixed costs are being absorbed by the customer tail is typically an excuse for taking on business that doesn't make money and therefore doesn't make sense. Fixed costs should be cut if there is no profitable business, not the other way around;
- Many companies are faced with the business reality that 80 percent of the customers generate 20 percent of the revenues. As long as higher margins are compensating for added complexity, there is no problem. Overall, particularly for consumer products businesses, mass customization has become a condition to do business and exist. Addressing these trends often requires more flexible platforms and pricing strategies.

FOCUS ON WHERE YOU CAN WIN AND LEVERAGE EXISTING PLATFORMS TO DRIVE GROWTH. IF THOSE PLATFORMS ARE NOT IN PLACE, TAKE THE REQUISITE TIME TO DEVELOP THOSE CAPABILITIES BEFORE CHASING GROWTH:

- Every company should clearly understand its value proposition. Challenge it while being conscious and deliberate about where you make money. Too often, our clients perceive that particular products or services are their "bread and butter." However, in the light of transparency, the facts can show a very different picture;
- Do not fall for the "let's try something new." Our experience is that it can take up to two years to get traction in new markets / channels, and more likely three to four years before you reach profit margins that are comparable to the company's "core" business. Add-on acquisitions may help but can also yield complexity and hidden costs as well;
- While customers and end-users should be involved in new revenue generation, do not fall for every little nugget or idea. If allowed, your customers should bear a significant portion of risks and costs of new revenue generation and expanded offerings that support their bottom line, not the other way around.

INSTILL A CULTURE OF MARGIN MANAGEMENT DISCIPLINE THROUGHOUT THE BUSINESS. USE INCENTIVES TO DRIVE THE RIGHT BEHAVIORS ACROSS THE COMMERCIAL FUNCTIONS:

- Maximize volume and revenues within the core competency of the business and avoid chasing business that is beyond a company's core competency. Many clients have gone after adjacent markets only to realize that the competencies required are completely different from the core business, and the actual cost and complexity of entering those markets erases the benefit. For example, in the food and beverage businesses, it is a known but not always recognized fact that fresh, frozen and canned business segments are completely different animals;
- Focus Sales on executing sales. When Sales becomes the product manager, margin manager, customer service rep or product expeditor, businesses start building complexity and lose control of profitability. An effective Sales force with a clear focus on executing profitable sales is key;
- Establish proper incentives, processes and controls throughout the go-to-market and commercial functions. This means incentives are linked to clearly-defined KPIs so that sales managers can maximize opportunity and identify areas that are falling off-track;
- Force connectivity between sales and operations through comprehensive S&OP processes. When sales and operations are not coordinated, it can cause massive negative customer reactions. Companies with strong S&OP processes will always be stronger and ultimately win in their respective markets;
- Cultivate a company culture that puts profits above revenue. Organizations with a "yes, we can do everything" culture tend to take on business that does not make sense. A healthy "yes, but" or "no, sorry this is not for us" culture helps drive the right behaviors and ultimately the right outcomes.

CONCLUSION

When portfolio companies that have historically increased value through revenue growth begin to face challenges, attempting to "grow out of the problem" is often not the right answer. These companies need to change how they operate and focus on profitability rather than chasing more of the top-line. The path forward typically involves shedding unprofitable products and customers, improving sales force effectiveness and establishing scalable and efficient platforms so a business can re-start growth in order to grow profitably. Many businesses need to shift the way they think about revenue and profit and instead, instill the type of margin management discipline necessary to "say no" to unprofitable volume. Remember, not every dollar is a good dollar.

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