AlixPartners

Enterprise Improvement
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The new operations playbook part one

WITH VALUE CREATION GETTING HARDER, NEW TACTICS COME INTO PLAY

It’s time to revise and expand the operations playbook for private equity (PE). PE sponsors have long applied a familiar set of operational moves to realize their investment theses.

Ever since the PE community’s turn toward a focus on EBIT in the 1990s, those moves have remained in wide use. They include renegotiating sourcing agreements, reducing head count, streamlining processes, closing or turning around inefficient plants, and instituting zero-based budgeting—moves that in the past reliably created value for PE sponsors and their portfolio companies, and facilitated timely exit once the companies had achieved their financial and operational objectives.

But those plays no longer predictably yield the expected results. Many commodity prices have curved upward in recent years, adding difficulty and uncertainty to attempts to reap sourcing benefits. New tariffs are prompting many companies to reconfigure supply chains and look closer to home for inputs. Labor costs have climbed sharply in the past five years amid shortages of both skilled and unskilled workers. Many plants are operating at or close to capacity, making closures counterproductive. Zero-based budgeting has in many cases generated cost savings but at the expense of productive investment. And to add another layer of complication, prior owners of many PE assets have already applied their favorite plays—such as automation, procurement improvement, and technological transformation—to their portfolio companies, leaving the new owners to devise new approaches to create value and prove their investment theses.

The changes in business conditions—from overcapacity to under capacity and from labor surpluses to labor shortages—are spurring PE sponsors to seek new plays designed for value creation to add to their tried-and-true repertoires of cost-reduction moves. Those moves may still work as designed, but today’s environment requires additional approaches—ones aimed at generating EBIT improvement through operational enhancement. Those approaches don’t relax the reins on strict cost control but place cost-reduction efforts within the larger context of improving enterprise value by tightening up the operational seams where value leaks out.

As a first step, sponsors are re-framing operations into a core source of competitive differentiation, not just a collection of cost centers. Following from that change of perspective, the wider focus on value creation itself takes many forms, such as the following:

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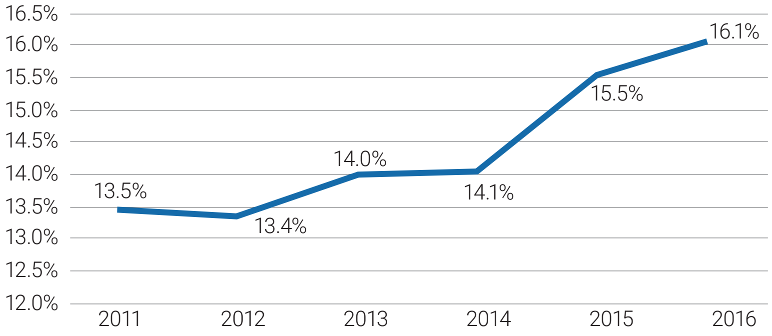
1 MANAGING OPERATIONS TO BETTER MEET THE NEEDS OF KEY CUSTOMERS AND DRIVE INCREMENTAL GROWTH

Rather than attempting to serve customers by way of a one-size-fits-all approach, companies are beginning to tap the profit-enhancing potential of segment-specific strategies by reserving the highest service levels for customers with the highest lifetime values and disciplining themselves to avoid over-serving lower-value customers. In a similar vein, some companies are trimming their stock-keeping units (SKUs) and product lineups by clearing out low-selling, low-profit offerings.

For example, one company we worked with had long focused on minimizing labor inputs and extending production runs as a way to reduce unit costs. The approach made sense when the company's core business was struggling with overcapacity, price-based competition, and slack demand. But as costs increased and the industry swung to under capacity, management recognized that the focus needed to change as well. With ready buyers for as much as the company could produce, each additional unit of production essentially went straight to incremental earnings. Of necessity, the company looked to operations as a source of value creation and shifted to maximizing production of goods that were predictably in high demand and that delivered the highest margins.

PE firms face rising headwinds, including rising costs...

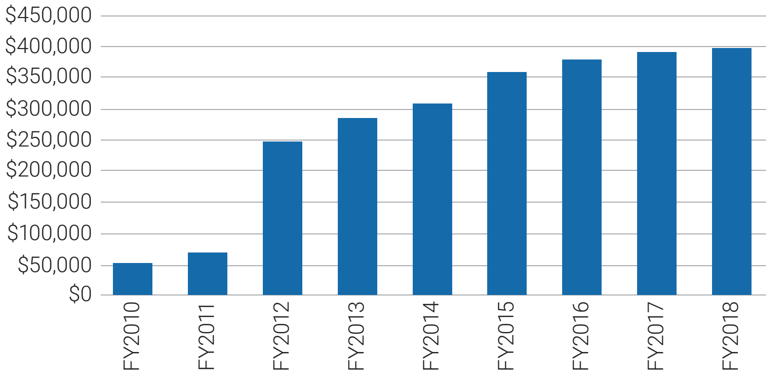
FIGURE 1: LABOR EXPENSES AS PERCENTAGE OF SALES
(%, United States, 2011-2016)



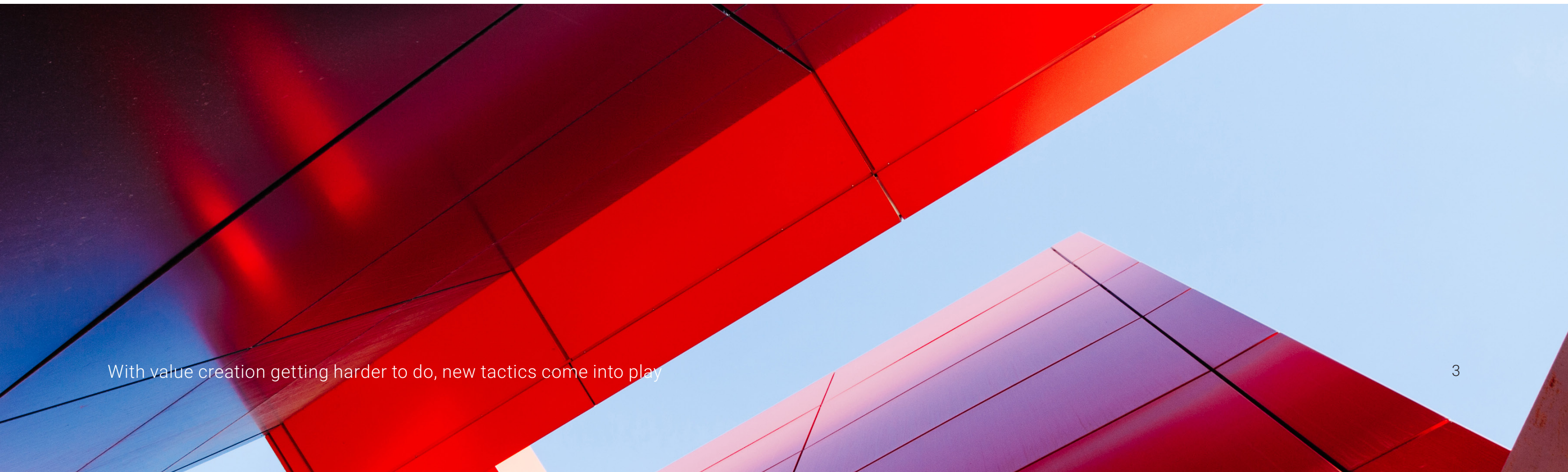
Source: US Census

...tightening plant capacity...

FIGURE 2: ORDER BACKLOGS OF MAJOR INDUSTRIAL COMPANIES
($M, 2010-2018, Select Dow Industrial Components)

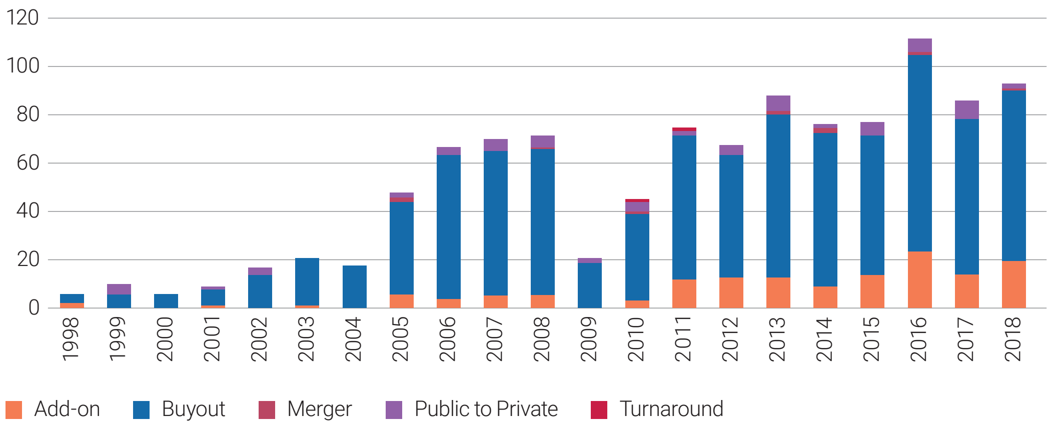


Source: Company Form 10-Ks



...and limited value-creation opportunities after successive improvement drives.

FIGURE 3: PRIVATE EQUITY DEALS IN THE MIDMARKET INDUSTRIAL SEGMENT
(Count of deals by type, 1998 through 2018)



Source: Preqin

That change in focus meant that certain long-standing practices had to be changed. The company had prided itself on serving all customers at the highest level—to the extent that it would interrupt a large production run to accommodate a small customer's request for a quick-turnaround custom order. Such orders required the company to shut down, change over a production line, execute the custom run, shut down the line again, and clean the equipment in order to resume the interrupted run.

But a customer segmentation analysis, conducted by feeding data from enterprise-resource-planning systems into an analytics engine, made clear that some customers, though loyal, delivered little in the way of EBIT once the cost of serving them had been factored in. When one such customer approached the company with one of those small-volume, quick-turnaround custom orders, the company's new management refused to accommodate it—an unmistakable signal that an aggressive profitability mind-set had become the new order of the day. And that change in mind-set delivered the additional benefit of reducing the need for safety stocks and excess inventory.

2 IMPROVING MARGINS BY MORE CLEARLY DEFINING AND MANAGING COST TO SERVE

A clearer view of costs enables PE sponsors to better align service levels with the profit potential of various customer segments. That's the approach we took at an industrial manufacturer that had historically delivered finished goods to end customers, charging a delivery fee based on the type of equipment rather than the distance and cost associated with executing the delivery.

The policy covering delivery charges belonged with the marketing function, whereas the costs of delivery were borne by operations. In an environment in which collaboration between marketing and operations was infrequent and usually ineffective, we brokered joint discussions to explore the ramifications and potential upside of cost-based delivery pricing. The discussions resulted in a more rational basis for executing delivery and in a significant rise in the delivery of finished products, which in turn opened up additional opportunities for collaboration between marketing and operations.

3 IMPLEMENTING GOVERNANCE PROCESSES THAT LINK ACROSS FUNCTIONS AND PROMOTE A SHARED OBJECTIVE OF IMPROVED OPERATIONAL RESULTS

Maximizing enterprise value requires implementing a system of Key Performance Indicators (KPIs) that work together to promote operational value rather than maximize one function over another, such as KPIs that promote manufacturing at the expense of logistics. Instituting such a value-focused governance system has a high degree of difficulty and an extended time to value, but the potential benefits can make the effort worthwhile.

One company we worked with adjusted its manufacturing KPIs to incentivize production of the most-profitable SKUs after finding that the KPIs that tracked volumes alone had led to overproduction of goods for which there was little demand. That overproduction in turn was impairing the company's ability to achieve its anticipated profitability and service levels. Management coordinated changes to the manufacturing KPIs by making policy changes that discouraged sales reps from unprofitable behaviors, such as offering customization options that added complexity but not value. At the same time, management instituted regular product-portfolio reviews and created roles empowered to eliminate unprofitable SKUs.

A new source of differentiation and high performance

PE sponsors' changing views of operational improvement—from seeing operation improvement through a cost lens to seeing it through a value improvement lens—are taking hold across a wide range of industries. But will it be an enduring change? And if it will be, what are the implications for PE sponsors?

Our observations across the PE landscape persuade us that as cost-based approaches become less effective and more difficult, sponsors' focus on broader EBIT improvement opportunities as a source of value creation will only intensify. That development will require PE sponsors to revise some of their routine practices. Among other changes, for example, they'll have to reorient their diligence assessments toward the identification of untapped sources of value. They'll have to define and prioritize new value-creation levers to pursue through the ownership period. And they'll have to periodically review evaluation criteria for operational leaders in order to ensure that such levers strike the right balance between cost-reduction and value-creation experience.

We believe that revising and expanding the private equity playbook to focus on new and different value-creating opportunities will differentiate PE sponsors. Those that update their processes to mine the full potential of the new sources of value stand to earn outsized returns over the life cycle of their assets—to the benefit of their investors and other stakeholders.

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ABOUT US

For nearly forty years, AlixPartners has helped businesses around the world respond quickly and decisively to their most critical challenges – circumstances as diverse as urgent performance improvement, accelerated transformation, complex restructuring and risk mitigation.

These are the moments when everything is on the line – a sudden shift in the market, an unexpected performance decline, a time-sensitive deal, a fork-in-the-road decision. But it's not what we do that makes a difference, it's how we do it.

Tackling situations when time is of the essence is part of our DNA – so we adopt an action-oriented approach at all times. We work in small, highly qualified teams with specific industry and functional expertise, and we operate at pace, moving quickly from analysis to implementation. We stand shoulder to shoulder with our clients until the job is done, and only measure our success in terms of the results we deliver.

Our approach enables us to help our clients confront and overcome truly future-defining challenges. We partner with you to make the right decisions and take the right actions. And we are right by your side. When it really matters.