# PRIVATE EQUITY'S SPRINT TO VALUE CREATION

## 14 strategies to move faster toward boosted profits and returns

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# SPRINT TO VALUE CREATION WELCOME

The private equity ownership horizon is short, and the goal is clear: Create value for the firm, the portfolio company, and investors. Finding the fastest and most reliable route to value creation is key.

While a value creation plan should always consider the entire lifecycle of an investment, we've found that the best results can often be obtained by focusing on the distinct parts of that greater whole: Implementing a series of value creation "sprints" that result in more immediate top-line, bottom-line, and operational impacts. Sprinting to value creation offers a practical, results-oriented approach to improving portfolio company performance.

This guide contains insights shared by experienced, accomplished professionals from across our private equity value creation team, representing the various facets of our approach to accelerating growth. We hope they are a valuable resource for identifying and acting on the most important elements of the value creation process.

Feel free to reach out to us for more details, or for help getting started. Whether pre-transaction, mid-transaction, immediately post-close, or at any other point in the investment lifecycle, we're ready to offer guidance and assistance in building first-class value creation plans and implementing the strategies needed to succeed.

## OPTIMIZE RELATIONSHIPS FOR SUSTAINED SAVINGS

Sourcing and procurement practices have evolved significantly over the past decade to such a degree that many consider them to be a major driver of EBITDA. For private equity firms, enhancing sourcing and procurement practices has opened up a new opportunity for value creation that has the potential to span an entire portfolio, and to produce large savings throughout the lifecycle of an investment. Because procurement spend represents a significant percentage of revenue for middle-market companies, improving the efficiency of procurement practices can exponentially enhance EBITDA growth while solidifying supply chain operations. A dollar of procurement savings often represents as much as three to four times the financial impact of a dollar of incremental revenue.

Especially in times of heightened inflation, supply chain disruptions, and the uncertainty brought on by climate change, sourcing and procurement should be put at the very center of a value creation plan, even before a term sheet is in place. Optimization should begin during the due diligence process with an **initial examination of operational spend data**. With many middle-market target companies lacking the proper analytic tools to measure the impact of their procurement decisions, this may require **a deeper dive into specific agreements with major suppliers**, with a distinct focus on the length of key agreements and the number of suppliers engaged in a specific area of spend, as well as the overall financial health of the suppliers.

> Sourcing and procurement should be put at the very center of a value creation plan, even before a term sheet is in place.

**Key vendor agreements**, especially long-term ones, can reveal a great deal about how a company conducts its business. The following can be signs that management may be purchasing goods or services at sub-optimal pricing – and thus indicate opportunities for PE firms to implement value-creating changes with long-term impacts, such as renegotiating terms and pricing or even switching vendors altogether.

- Major vendor relationships that have not been competed in the prior 12-24 months
- Evergreen agreements with no explicit expiration date or option to terminate
- Pricing structures that contemplate automatic annual price increases
- Lack of contractual provisions tied to specific supplier performance metrics
- Non-arm’s-length supplier agreements

Some sophisticated PE firms have moved to **hiring specialists in procurement** to conduct detailed diagnostic analysis and drive operational improvements in order to create a systematic approach to EBITDA growth that can be deployed across an entire portfolio.

**Including key suppliers** in the value chain can also have positive benefits: PE can often accelerate the implementation of a new process improvement, such as optimized billing and invoicing, by working alongside both internal procurement leaders and key suppliers.

An increasing number of PE firms have taken the approach of **consolidating** the sourcing and procurement of products and services common to all portfolio companies, such as benefits and certain insurance offerings, office products, cybersecurity, transportation, and many others. The consolidation and centralization of this purchasing allows each PE firm to maintain increased pricing power over the suppliers and obtain key products and services at significant discounts relative to solely purchasing at the portfolio company level.

While these sourcing and procurement improvements can rapidly yield significant benefits in the short term, they are not the end of the job; it’s important to maintain a consistent sense of urgency in this area throughout the lifecycle of the investment, and continuously re-evaluate. This will require **defining key performance indicators** – contract terms, spend data, billing trends, competitive pricing, and other points – and securing and deploying the **analytical and tracking tools** needed to monitor them. With active and ongoing management oversight, savings can be sustained, and potentially even grown, all the way through to the point of exit. ■

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# CHAPTER 2: SUPPLY CHAIN

## BUILD RESILIENCE AGAINST SHIFTING CONDITIONS

Risk mitigation should be a central theme for private equity firms at every point in the investment cycle. While it's no surprise that **supply chain weaknesses** can be a main source of vulnerability, the resilience of the supply chain has taken on a new level of importance in the wake of widespread disruptions caused by disease and conflict, and in the face of climate change. The result has been a strategic effort to aggressively build stability and efficiency into a portfolio company's supply chain as part of the value creation plan.

While closely linked with the procurement function's goals around cost optimization, supply chain efficiency is differentiated by its focus on planning, distribution, logistics, and operational efficiency. Operations managers dedicated to supply chain resilience concern themselves with mitigating risk related not only to inventory, but also to the physical movement of goods.

Supply chain optimization begins with improvements to overall forecast accuracy. This is the Achilles heel for most companies. World-class forecast accuracy can reach about 80%, but the benchmark is typically a 50-60% accuracy rate. Improving forecast accuracy can automatically smooth out an entire supply chain and avoid a bullwhip effect, where a minor change at one end of the process becomes exponentially larger by the time the impact is felt at the opposite end of the chain. It can take at least two to three quarters to recognize any meaningful impact of a change to supply chain processes.

While closely linked with the procurement function's goals around cost optimization, supply chain efficiency is differentiated by its focus on planning, distribution, logistics, and operational efficiency.

Once confidence is established in the forecasts, companies should work from those baselines to plan for a range of acceptable performance, so that they are prepared for any fluctuations in market conditions – especially important in today's unpredictable environment. Whether delivering goods or services as their product, it's a unique and ever-changing balancing act to determine what investment in product inputs is sufficient to satisfy projected demand, and also not too much. This step is key to the ultimate goal of building resilience in a company's supply chain.

Within the bigger picture, PE firms should strive to analyze and strengthen each distinct aspect of the supply chain. Closely examining each link, creating or revising business continuity plans for all key inputs, and working to alleviate potential disruption can produce significant EBIDTA growth and value creation upon exit. For example, consider:

- **Warehouse locations.** A portfolio company that manufactures and ships goods across the U.S. from a single warehouse in Los Angeles should raise multiple red flags in today's environment. If there is a problem in the local market, how do you continue providing a predictable supply of raw materials to that one factory? If that supply is disrupted, how do you still deliver finished product to the customer, on time? In this example, adding more facilities in strategic locations can boost supply chain continuity.
- **Reducing distribution and shortening freight distances.** A portfolio company with 65 distribution centers, on the other hand, may function more efficiently with just 10, depending on the strategic locations of the facilities. Consolidating a company's distribution footprint

has the potential to reduce both cost and risk simultaneously, with fewer touches to the product, plus better utilization of warehouse space and key freight assets.

  - A freight utilization analysis may also be helpful as part of this process, for businesses with relevant freight usage. The ability to consolidate Less-Than-Truckload (LTL) moves to maximize Full Truckload (FTL) shipments can erase cost, complexity, and risk from the supply chain. Additionally, there may be opportunities to team up with suppliers to move freight on their contracts where they possess additional leverage in certain markets or shipping lanes.

- **Supply chain redundancy.** As many companies experienced during the pandemic, supply chain disruptions can have a severe negative impact on business operations. In the same way that companies must develop business continuity plans for other areas of their business, they must do so for their supply chain. Companies should have purchasing contracts in place with secondary suppliers that have the capacity to ramp up should the primary supplier suffer a disruption. The selection of the right base of suppliers is almost as critical as the pricing from those suppliers.

- **Vendor managed inventory (VMI).** With the uncertainty of today's supply chain, more companies are needing to hedge risk through added inventory investment, reversing prior benchmarks aimed at "just in time" (JIT). Working with key strategic suppliers to produce and hold stock on the company's behalf, only billing as items are actually consumed, can help address the need for added inventory coverage while also bringing working capital improvements to the balance sheet.

In many instances, especially for any kind of manufacturing or distribution business, supply chain challenges can often be exposed during the due diligence process, but portfolio companies in technology or other service sectors may require a deeper look to avoid a supply chain issue going unnoticed until later in the investment lifecycle.

Finally, coordinating a portfolio company's supply base footprint with its production and distribution footprint can unlock substantial value through Total Cost of Ownership (TCO) analysis, taking into account factors such as supplier lead-times and Order-To-Delivery (OTD) timing tied to the various network design alternatives available. Looking for alternative sources of supply or localizing manufacturing and distribution to shorten shipping times are among the many avenues PE firms can take to optimize supply chains and create long-term value. ■

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## MINE DATA FOR DECISION-MAKING GOLD

Across the business landscape, in all corporate functions, state-of-the-art analytics have changed the state of play. The time where private equity firms could succeed with limited data collection and analytical insight about the operations of their portfolio companies has long passed.

The impact and importance of analytics on the journey to value creation cannot be understated. Analytics offer *the* competitive tool to help PE firms make smart decisions and add value at every stage of a portfolio company lifecycle. Firms are sitting on a treasure trove of potential value creation in the form of gold mines of data across their portfolio companies' value chains.

- **Early stage:** Analytics help build cases for smart decisions based on data, not feelings. With bad data – or worse, a lack of data – a firm may invest in the wrong things, and never achieve their value creation goals. Data-driven decision-making tools help reduce risk and complexity.

- **Throughout:** PE firms and their portfolio companies face a variety of key operating and reporting requirements: to investors, regulators, other stakeholders. Audited financial statements may be required. Analytics keep the data necessary to fulfill these obligations right at their fingertips.

- **Late stage:** If measured and tracked correctly throughout the hold period, key performance analytics and demonstrated ability of portfolio companies to transform insights into action can help create an attractive narrative theme for a potential buyer.

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For various reasons, there has been a reluctance across the private equity industry to stand at the forefront of digital transformation. Fortunately, many of these reasons are easy enough to mitigate.

- **Hurdle:** Significant upfront costs and a rapidly changing technology lifecycle make the investment and deployment of large-scale analytics a challenge.
- **Solution:** Engage external data engineers, information architects, and systems integration specialists to complement and augment internal teams in a build-operate-transfer cycle.

- **Hurdle:** These investments may be less appealing because there may not be an immediately quantifiable return or result.
- **Solution:** Use an agile, iterative approach, and recognize immediate benefits from implementing these solutions in the form of better decision-making in various aspects of company optimization and operations based on specific hypotheses.

- **Hurdle:** One of the most challenging, often-overlooked hurdles is largely cultural: Working with portfolio company leaders to create a business ethos built around data. Senior leaders and entrepreneurs may have operated successfully for decades without tracking and managing data as part of their day-to-day operations, relying instead on instinct and gut decision-making. Embedded management resistant to change mandated by new leadership can cause lengthy delays in the value creation process.
- **Solution:** Begin the process of becoming a data-driven organization as early as possible by including stakeholders from all levels of the organization in the process for identifying, building, and celebrating analytic wins. During the due diligence process, assess the management team's willingness to adopt a data-driven culture, and use early discussions to lay the groundwork for doing so.

Once alignment in perspective has been achieved, setting baseline values and target benchmarks is essential for managing the value creation plan. Making measurable actions, investments, and experiments in analytics encourages directional value.

### Cracking the code to embedding analytics and reshaping the business

Start with these four steps to building or boosting analytic capabilities for a portfolio company.

1. Align on a strategy tied to specific income statement or balance sheet actions.
    - Build a focus on hypothesis generation that comes from the strategic decisions the business needs to make both every day and on key actions.
    - Embed all levels of the business into the analytic building and enablement process.
2. Build the right foundations of data, people, and technologies.
    - Bring the cross-functional, integrated talent required together to put analytics into action.
    - Use an established adoption method for analytic introduction, including building and bringing a single source of truth and trust to a portfolio company's data.
    - Build a strong, transparent governance and management function from the start, so that stakeholders can trust the insights generated across the organization.
3. Focus the foundations on the highest-impact problems to solve for both business outcomes and adoption enablement.
    - Create a "flywheel" of both easy and challenging problems to solve for, and introduce both descriptive analysis and elements of advanced, predictive analysis to the organization.
4. Embed analytics-driven decision-making into all aspects of process with management and line employees.
    - Empower decision-making based on the insights at the lowest levels to realize and obtain the real value of embedding data and analytics into the organization.

Analytics has a deep, central role to play in every part of value creation, whether in optimizing inventories or supply chain planning; establishing how to measure and monitor sustainability efforts; determining the right prices to set, customers to distribute offers to, and stores to invest in; or any number of other initiatives. It is the foundational but most overlooked and under-deployed mechanism that has the opportunity to have the most lasting, pervasive, and deep impact on a firm's effort to identify and create value, for better financial outcomes. PE firms shouldn't delay in evaluating how to give analytics a more prominent role in their toolbox. ■

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## BOOST VISIBILITY TO IDENTIFY EFFICIENCIES

It's easy to dismiss the function of cash management as overly technical and unexciting. But working capital is the engine for the growth of a business, and taking deliberate steps to tighten cash management and increase the transparency of the cash conversion cycle can reveal numerous opportunities for value creation.

The due diligence process is likely to reveal shortcomings in a target's cash management procedures, practices, staffing, and systems, with additional intelligence bubbling up during the first few months of ownership.

### Getting ahead of cash management challenges

Know this: When assessing the health of a company, working capital is a key indicator.

Gain transparency around the cash conversion cycle. Probing the portfolio company's management team about how they have managed cash to date may reveal gaps that need attention to reduce cash leaks – or worse, the unpleasant task of injecting additional funds into a company after closing just to keep it afloat.

Elevate working capital as a key value driver across the business. It is typical for private equity investors and portfolio companies to focus on increasing revenue and optimizing costs. Managing working capital rarely receives the attention it deserves until there's a shortage of cash. Instead, creating a standard cash management template, and making cash management a priority across the company, may yield favorable results. Additionally, focus on upstream processes to improve working capital in the shortest time. Examine the quality of sales and the reliability of vendors and suppliers to maximize throughput resulting in steady spending levels.

Consider utilizing a standard cash management template for all current portfolio companies and new acquisitions. Even for those with a thorough, adaptable blueprint, the task of working with the CFO and senior leadership to adapt new formats or schedules for reporting is many times easier said than done.

### Start here

No matter the situation, there are three top steps PE firms can take to improve cash management efficiency and rapidly create value:

1. Look closely at **receivables** and, if possible, discuss where things stand directly with the sales team. Asking for data and probing for historical analytics about the size of the sales funnel can reveal tremendous opportunities to secure working capital. Looking further up the sales funnel to explore the quality of the customer may reveal important trends that go beyond quantitative sales.
2. Review the current **payables** and the existing systems being used to pay vendors. Does the company have a set policy or a programmatic approach? Could a new system yield results in a timelier fashion? For small and mid-sized businesses, it is unusual to find automated tools and controls coupled with a sophisticated purchasing order system for invoices, so implementing those solutions may be a clear early improvement for PE buyers to execute. Another may be the consolidation of vendors and developing consistent terms. Many smaller businesses don't have the leverage to enforce their own payment terms, but can leverage the power of the sponsor.
3. Analyze **inventory days** and calculate the number of days of inventory on hand. With the rise of global supply chain disruptions over the past few years, many businesses have moved from a "just in time" approach to managing inventory to a "just in case" mindset. This shift is expected to dominate business for the foreseeable future and could open up new pathways to value creation in the years to come.

Portfolio companies with improved working capital ratios and other performance metrics in line with industry benchmarks will be better positioned for healthy growth. ■

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# ADD MUSCLE FOR MISSION-CRITICAL CAPABILITIES

For private equity firms racing to create value in their investments, the introduction of a new technology solution can serve as an accelerator of growth. When properly implemented and managed, technology systems and solutions can add significant value to a portfolio company during the time it is held, and again at the point of exit, as technology systems are playing an increasingly large part in exit valuations.

While the benefits of utilizing leading technology may seem obvious – better management, sales, and financial controls – the costs of *not* doing so will appear as the company grows. The underlying operating model capabilities and technology systems are typically evaluated during the diligence process, likely following examination of a company's financial health and management expertise.

Making the decision to upgrade or change key operational systems should be carefully considered and conducted with an unflinching focus on what drives value for the company.

### How to improve – Business goals first, technology second

Technology is foremost a central part of the organization's operating model, representing a key enabler and muscle for mission-critical capabilities.

Before any technological investments are put into motion, the first step is to establish **what capabilities are being sought**, or how the technology will help drive value in the portfolio company. Is the goal to increase customer willingness to pay (e.g., personalization), or lower company cost to serve (e.g., greater efficiency)? If the goal is to increase the top line, target capabilities and their supporting technology investments may include:

| Capability | Technology investment |
|---|---|
| New products | Tools for research and development (R&D) |
| Enhancements to margin | Data and analytics tools to better understand thresholds |
| Sales team enablement | CRMs and marketing automation |

This need to hone in on the purpose of a change is true of any area of value creation, but it's particularly important for technology because of the tendency to go for widgets – easy, seemingly handy tools that are less aligned with the firm's goals. Without a true business case for how an improvement will provide necessary value, companies may end up just implementing technology for technology's sake, or to try to keep up with other businesses. There should be a clear, integrated, top-down roadmap for all changes, with leadership driving the vision.

Because some target companies may be less developed when it comes to the key capabilities needed to spur growth, identifying and upgrading processes and applications can provide a relatively fast way of creating value. Common improvements may include stronger CRM (customer relationship management) or ERP (enterprise resource planning) systems; new customer portals or commerce capabilities; sensor/IoT networks; marketing automation and intelligence solutions; and the deployment of a modern insights platform composed

of a data repository (or "lake"), integration layer, and reporting capabilities. As organizations become more technologically mature, automation through bots and robotic process automation (RPA) are other capabilities to activate in support of growth and competitive advantage.

With so many possibilities, PE firms may wonder where to start. While it may seem obvious, speaking directly with business function leaders and other team members about their needs is a critical first step in this process, one that is often overlooked by PE deal teams who may instead focus only on dealing exclusively with senior management. Similarly, speaking with a representative group of stakeholders about the capabilities that serve them best can potentially help streamline and simplify purchasing and other processes.

### When to improve

Investing in technology can be a challenge for any business, no matter their level or technical maturity or the stage in the investment lifecycle. For a PE firm, the decision-making calculus is especially complex, demanding a detailed analysis of both the importance of the system(s) and its potential impact on the performance of the business, as well as the overall value of the portfolio company upon exit. A central question revolves around timing the investment(s) and deployment of technology-related initiatives.

From an internal perspective, calculating the return on investment for any technology outlay must be balanced against the holding period for the company. Significant technology shifts should typically be made in the first two years of ownership; after three or five years, it is likely too late in the value creation cycle for any technology to make a significant impact on EBITDA.

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Keep in mind, too, that talent is an important factor in the success of new technology and capabilities. Preparations to launch an improvement should include putting the right team in place to support it. Look for seasoned people who know the nuances of the business and how the technology should be tailored to best meet its needs; then, once any customizations are ready, make sure there are sufficient people to stand up and maintain the new systems. And as early as possible, make sure that the organization is ready to accept the technology and the associated process changes. Clear communication of the technology's benefits for both the overall organization and for employees themselves may be helpful in that regard.

The deployment of technology solutions plays a critical role at every stage of the sprint to value, from back-office optimization to growth initiatives. Strategic and timely investment in technology can make or break the valuation of a portfolio company. Assessing the company's capability needs, developing a plan to meet them, and executing against that plan to achieve the desired goals is critical in a competitive market. ■

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## ACCELERATE GROWTH WITH STRATEGIC, SMOOTH INTEGRATIONS

Sometimes, optimizing organic growth within a business isn't enough. Strategic deployment of an M&A strategy to accelerate growth has been proven to speed value creation for stakeholders, and can successfully be used as the cornerstone of a PE firm's investment thesis. There is little doubt that value creation plans focused around a "buy and build" strategy create the fastest route to growing a platform. These strategies typically work best:

- In highly fragmented industries where the acquisition of a new company can quickly add geographic reach and an expanded roster of customers with minimal disruption.
- With founder-owned businesses that can be purchased at reasonable multiples.

As always, quicker doesn't necessarily mean easier. Employing a "buy and build" approach demands that both PE investors and the management teams at portfolio companies maintain a dual focus on not only advancing their own core business objectives, but also completing acquisitions and integrating people, systems, and cultures across multiple businesses. Without a well-oiled and experienced operational team, value and opportunity may be left on the table.

### Targeted acquisitions

A focused pipeline of acquisition targets is essential when using M&A as a value creation strategy. Consider these suggestions to build a healthy pipeline of potential acquisitions:

- Assign someone at the portfolio company to work in tandem with the PE deal team to lead corporate development activities.
- Create a profile for prospective acquisitions, including size, industry, product/service offering, and geography, and communicate the strategy across the organization.
- Communicate your interest in add-ons to vendors and current service providers.
- Engage directly with industry-specific professional associations.
- Develop industry-specific relationships with investment bankers, independent sponsors, and venture capital firms.

In more unstable market conditions, M&A activity may be impacted by changes in the targets' revenue streams, margins, and customer retention and engagement. Additionally, potential fluctuations in current and near-term market conditions may cause both buyers and sellers to approach pricing and valuation differently. Both items could cause headwinds to a successful M&A strategy. The benefits of action in an unstable environment should always be balanced against the risks.

### Integration planning

One of the most commonly overlooked challenges with a "buy and build" strategy is failure to plan for integration early enough in the process. Proper integration planning should be included in the diligence process to fully understand how the plan will be executed. This should include everything from finance, technology, and HR to real estate

and accounting. In some instances where a firm is acquiring tangential businesses, it may make sense for the PE firm to acquire the company and operate it separately for a short time to identify potential pain points; still, the parameters of that "trial period" should be laid out in advance (e.g., how long it will last and what will be assessed, by whom).

It is essential to identify the roles and responsibilities of key executives and know who will actually manage the integration workstreams. Far too often, a deal team will complete a transaction and assume that every other aspect of the combination will be managed following the hand-off after closing. Underestimating integration planning can cost a management team weeks or even months to resolve, simply because issues were not addressed in a timely fashion.

### Communication

The communication piece of a transaction can easily get overlooked by executives focused on the financials of the transaction. Or, because add-ons tend to involve smaller, owner-operator businesses, sophisticated communication may have never been a core component of their operation. But given the fast pace of an M&A transaction within a PE environment, the importance of communication cannot be overstated.

Be sure to consider:

- **Internal communication to employees** to clarify the path forward. Bringing people into the loop is crucial in gaining their support for a transaction, and waiting too long can build mistrust and lead to unanticipated departures of key staff. At the least, employees should be told before a deal hits the news or gets announced publicly.
- Ensuring that **customers** understand how they will benefit from a transaction. Firms that do this well will time any announcement so that customers are finding out as the deal is closing, but before it is publicly announced. A poorly timed communication strategy opens the door for gossip and rumor, which may derail key customer relationships. (Employees should also be filled in on how and when customers will be informed about the change, particularly if the process involves rolling up multiple businesses at once.)
- **Suppliers** may have questions and doubts about how a merger or acquisition will impact their own business.

M&A is a core competency of most successful private equity firms. A "buy and build" strategy is likely to deliver value faster than an organic growth strategy. Private equity firms that scale up their talent, focus on pipeline management, and implement seamless integration plans will be in the best position to achieve their value creation goals in the shortest time possible. ■

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# CHAPTER 7: MANAGEMENT AUGMENTATION

## FILL IN EXTRA SKILLS AND EXPERTISE TO SUPPORT LIFT-OFF

Business owners joining up with a private equity firm do so with the understanding that their organization will probably go through changes on the path to (hopefully) becoming more valuable. One of the first things a PE investor should assess when acquiring a company is the talent of the current management team. Quite honestly, most private equity investors are attracted to acquisition targets with proven management teams. But do they have the insight and experience needed to make good on the investment thesis? The leadership skills to actualize the value creation plan? Are there any gaps? If so, a good solution may be hiring interim members for the executive team to augment current management during initial lift-off.

### How to determine whether (and where) management augmentation is needed

Unless critical to the business, most private equity investors will wait to replace a member of a company's leadership team, unless precipitated by a specific event or infraction. Most would rather retain and develop the current management team. Entering into an investment with the intention of immediately conducting drastic changes is likely to create disruption, result in a high degree of skepticism and distrust among both the impacted executive team and the broader workforce, and possibly even signal a lack of respect for the company itself.

Still, before and during diligence, PE investors may notice signs that a member of a company's leadership team may be unsuited for a role in the future of the company. Typical red flags can include:

- Requested information is slow to come, and/or incomplete
- A history of poor reporting
- Financial information does not correspond with inventory or sales data
- Inability to communicate clearly

> If handled correctly, the ROI when bringing in outside assistance can be substantial. Some may be able to find and create value within an organization that may not have existed before.

Some of these deficiencies can be improved as the private equity parent professionalizes the business, but others may require changes.

More than anyone else, the CFO and their work should come under direct significant scrutiny, as they can give PE investors deep insight into the performance and structure of the company's finance department. As a result, the office of the CFO may quickly become a candidate for transformation.

Finally, it is not unusual for a member of the executive team to leave voluntarily following (or even leading up to) a transaction. As details of the value creation plan unfold, they may come to realize that they simply may not possess the capabilities to drive the business forward.

### Why employ management augmentation?

Augmenting management during the early stage of the investment lifecycle can be a prudent solution that produces a significant return on investment. Interim executive management can:

- Provide access to industry professionals with functional expertise without long-term commitment
- Help the current management team support integration activities while managing the business
- Fill gaps left by any departing leadership while a search is conducted for a long-term replacement
- Act as a communications ambassador for the private equity parent
- Build trust with the current management team and employees
- Focus on the implementation of a specific set of objectives
- Build a strong foundation for good decision-making and action

### Get the most from interim management

All this said, just bringing in interim leaders is not enough to give lift-off to the value creation plan. The right approach to hiring and working with them is critical. Consider these must-do's:

- Set clear goals, objectives, and scope of work for each interim executive.
- Develop a communication process that includes the current management team, interim executives, and the private equity parent.
- Identify specific KPIs to measure the impact of each interim executive.
- Assess the going-forward needs of the business when the interim executive transitions out.
- Create a hiring process in the event a permanent solution is required.

Failure to communicate properly with new team members of the portfolio company about retaining consultants is one of the most frequently cited reasons for transaction failure. Often, consultants are retained and brought in without the proper internal communications or directions, creating an uncomfortable situation that can quickly lead to employee disengagement.

However, if handled correctly, the ROI when bringing in outside assistance can be substantial. Some may be able to find and create value within an organization that may not have existed before. The best consultants will track their own performance in financial terms and be able to demonstrate that the changes they identified and implemented had a specific impact on the income statement.

The process of augmenting management should be undertaken with care and appreciation for its impact on the larger organization. Identifying specific areas to be addressed, along with a detailed plan for implementing change, is crucial to long-term success. ■

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# CHAPTER 8: OUTSOURCED OPERATING PARTNERS AND OUTSIDE ADVISORS

## EXPAND INDUSTRY AND SITUATIONAL KNOW-HOW

In a race to create value, one of the most effective tools a PE firm can have is a team of business specialists who can assist in the due diligence process, craft a post-closing plan, and hit the ground running immediately after a transaction has closed. Similar to the pit crews of Formula One racers, these specialized operating partners can quickly assess areas of concern, formulate a strategy, and implement necessary changes without significant oversight.

Outside operating advisors are typically executives with deep expertise in one or more specific areas, such as procurement, systems technology, accounting, marketing, sales, or human capital. Some have skills distinct to a particular industry, such as biotechnology, aerospace, or agriculture. With the value creation clock ticking, outsourced operating partners add both talent and industry-specific knowledge that can be effectively transferred to a portfolio company's current management team for long-term success.

Beyond bringing instant expertise, outside advisors can expand a management team's bandwidth to address issues that may have been on the back burner, enabling the existing management team to remain focused on day-to-day operations. Where the existing internal management team might need a full year to solve an issue due to stretched bandwidth, an outside advisor solely dedicated to the problem may be able to correct it in a few months.

PE firms with the resources to do so may benefit from keeping these specialists at the ready and deploying them as needed on site at portfolio companies over and over again. Others can retain outside advisors who can fill the role of operating partner at varying points in the investment lifecycle.

> With the value creation clock ticking, outsourced operating partners add both talent and industry-specific knowledge that can be effectively transferred to a portfolio company's current management team for long-term success.

### Optimize your outsourced operating partners

Outsourced operating partners can help lift some of the work of moving a portfolio company forward from the private equity firm's shoulders – if the PE firm creates for them the right structure in which to do so.

Utilizing outside advisors *without proper oversight* can pose a significant downside to a PE firm. In some instances, having a multitude of consultants operating without proper management can create new issues and thus an undue burden for the firm and the portfolio company. To achieve a positive outcome, management must make sure that each outside advisor has a clear plan and mission, as well as a timetable for deliverables, prior to deployment.

Consider these best practices.

- Outside advisors are most successful when brought in **early during the diligence process.** Working with specialists to identify areas of need prior to closing enables the advisor to build a rapport with the management team and create a smoother working relationship post-acquisition. Outside operating partners brought in during the diligence process can help address commercial and operational business assumptions that may not hold up post-acquisition.
- Without **clear communication channels**, PE firms that deploy outside advisors at their portfolio companies run the risk of disrupting

the normal course of business and slowing the value creation process. Because they typically report to the deal team at the PE firm, outside advisors often maintain no formal reporting relationship to portfolio company management, which can sometimes create a challenging environment for executives accustomed to having complete control of their operations. To alleviate this, look for seasoned outside advisors skilled at communicating with both sets of management and quickly gaining the confidence of existing management teams. When all of these groups work together properly, the advisor is best positioned to present a solution-driven, action-oriented approach to addressing the most pressing needs of the company, which will help put everyone at ease.

- To be successful, outside advisors must **drive action**, rather than simply develop plans and recommend strategies. An outside operating partner will create the most value if they are put in a position to drive implementation rather than simply offering advice or counsel.

> Outsourced operating partners can help lift some of the work of moving a portfolio company forward from the private equity firm's shoulders – if the PE firm creates the right structure in which to do so.

Bringing in outside operating partners can be an expensive undertaking, but the ROI can be significant. PE firms that engage outside advisors throughout the value creation process tend to achieve an exponentially higher return than those who do not.

(Do, though, make sure to have a system in place for properly measuring ROI during the investment lifecycle. Being able to capture a tangible return on the investment will help ensure that everyone at the firm and company level understands the value that an outside operational manager brings to the table – and build the trust needed for their recommendations to succeed.) ■

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## BUILD A HIGH-PERFORMANCE TEAM TO PROFESSIONALIZE AND TRANSFORM THE FUNCTION

Finance sits at the core of every business and should be one of the first corporate functions to be assessed by a private equity investor. Examining a portfolio company's financial picture includes an in-depth review of the business's existing finance structure, processes, systems, teams, and leadership. While the existing finance and accounting functions at a portfolio company may have worked exceptionally well in the past, history is not an adequate predictor of future success. Under the new pressures of a time-sensitive value creation plan, they may not be able to deliver similar results. Founder-owner organizations, in particular, often do not have defined finance and accounting processes and operate utilizing spreadsheets. This is not conducive to scale or integration.

Because the finance and accounting function is a cost center, many PE firms may be reluctant to make the investment necessary to build a high-performance operation in the early stages of ownership. While this approach may work in the short term, any business on a fast track to growth and expansion will need a sophisticated, state-of-the-art finance and accounting function. Indeed, investing in the necessary people, tools, and technology is integral to the success of a value creation plan.

### Identifying what to improve

A comprehensive diligence process will typically uncover weaknesses in finance and accounting. In addition to the standard quality of earnings and tax due diligence, PE firms should consider conducting finance process due diligence, which looks at the processes, infrastructure, and team under the CFO's domain. A thorough understanding of key areas such as order to cash, procure to pay, treasury operations, etc., will provide deeper insight into risks as well as opportunities for improvement within the finance function. Appropriate due diligence should expose top-level issues, such as financial reporting failures, incomplete document management, poor staffing, or outdated technology, prior to the close of a transaction. If it does, improvements can be incorporated into the broader value creation plan.

As an organization takes on outside investors and finds itself facing additional reporting and compliance requirements, the finance function will need to respond quickly. However, some weaknesses may not be apparent until performance improvements are implemented in other areas, such as sales, logistics, or production. This is frequently the case when a target company is part of a larger platform within a PE portfolio. In an effort to create synergies, the PE firm may not identify shortcomings in the target company's finance and accounting function until they are integrated.

Investing in a highly sophisticated finance and accounting function can help achieve a number of important value creation goals, including:

- Streamlining processes throughout the organization.
- Decreasing inefficiencies and redundancies.
- Creating financial modeling systems to support decision-making.
- Reducing the cost of capital.
- Providing timely and accurate reporting to the private equity parent.
- Identifying and recommending incremental investments to increase revenue and optimize costs.
- Automating repeatable processes.
- Utilizing forecasts and sensitivity analyses to prioritize resources.
- Upgrading technology systems, including enterprise resource planning (ERP) and general ledger functions.

> Any business on a fast track to growth and expansion will need a sophisticated, state-of-the-art finance and accounting function.

### Building the right team

Any performance improvements to a business will place additional strain and responsibility on finance and accounting. For this reason, the CFO is among the first executive members to be closely scrutinized. In many cases, the role of the legacy CFO is not scalable because they cannot grow or adapt to new expectations. Although they may have done an exceptional job to date, the added reporting and structural functions of a newly funded portfolio company are likely to require a change in financial leadership.

In order to minimize disruption to existing business functions, some PE investors may elect to install interim management to focus on the future state of the business. These temporary advisors can identify potential areas for process and staffing improvement necessary to achieve the larger goals of the value creation plan. Outside advisors can be tasked with long-term planning and analysis, such as conducting a comprehensive review of financial, accounting, and strategic planning systems. Making recommendations for enhancements to key financial systems, such as ERP, is often best outsourced to consultants who can offer deep insight without disrupting internal staff operations.

Because financial management sits right at the hub of a business, investing in a high-performance finance and accounting function can have numerous tangible benefits that extend far beyond process improvements and streamlined operations. Chief among these is enhancing a portfolio company's exit narrative, ultimately leading to a higher valuation. ■

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## CREATE AN INCLUSIVE, EQUITABLE FOUNDATION FOR ALL TO THRIVE

The success of a private equity firm's value creation plan generally assumes that most performance improvement goals within a portfolio company can be realized within a three- to five-year time horizon. **Corporate culture** and **diversity, equity, inclusion, and belonging**, or **DEIB**, present a unique improvement challenge, as they tend to take longer to show measurable change. But there are ample opportunities for PE companies to start or advance progress in these areas that can continue to create benefits and value leading to an eventual exit.

Culture and DEIB have been attracting increased attention over the past several years as attitudes within the labor market have shifted and stakeholder focus has grown on environmental, social, and governance factors (ESG; read more in Chapter 14). Especially amid the rise of remote work, what has been done in the past to create and maintain corporate culture is no longer sufficient; businesses must find new frameworks for employee and customer engagement.

Culture is the foundation upon which successful businesses build trust with their most important constituencies, both internal and external. It often enhances and accelerates the success of a business, impacting revenue, share price, and sales.

And while culture may seem to be a less quantifiable topic, its impact on the value creation process can be measured through data points such as productivity, attrition, and retention rates, which illustrate the impacts of employee churn. Every employee lost means not only the loss of institutional knowledge, but also the potential for lost revenue, as holes in the workforce stop or slow client work, plus the cost of recruiting and onboarding a replacement.

### Culture

It's important to start observing a target company's culture and leadership team right away, and then more thoroughly during the diligence process. While the idea of pursuing two identical cultures is impractical – and likely not even ideal – PE firms should keep their eyes wide open for potential challenges that might derail a deal or require extra planning post-integration. It used to be that a keen observer could walk into a company and watch how a receptionist deals with customers or a manager interacts with a subordinate to get a clear understanding of the culture. Today, when so much interaction is virtual, gaining a well-rounded perspective can be difficult. In whatever setting possible, things to watch for include:

- How decisions are made – hierarchy vs. autonomy vs. collaboration, who needs to be involved by name and position
- How management influences decision-making, and how tightly they control information
- How the organization communicates with its employees and customers – the level of corporate transparency, how is feedback is managed, circular vs. one-way communication
- What is valued in the company, vs. what is practiced; who are the organizational heroes?
- Any red flags in the types of clients/businesses they serve or represent
- Any instances where the company says one thing but does another when it comes to DEIB or other priorities – often a sign that a much deeper issue is at stake

The goal of all this should be to determine:

- How do the target companies' cultural beliefs, values, and practices differ from ours?
- What would be involved in changing or adapting to them?
- Are there any problematic leaders – or problematic customers – to let go, replace, or retrain?
- What would be the timeline for such changes?

The scale and impacts of differences will vary. If Company A prides itself on a hybrid or work-from-home model and Company B requires on-site work, that presents a relatively simple integration challenge; but a history of enabling abusive leadership or questionable business dealings may be a reason to kill the deal altogether.

### DEIB

When companies talk about DEIB – if they talk about it at all – it's easy to focus on the D, Diversity. It's true that a company should not be demographically homogenous, and that it should reflect the community it serves. Anything less is likely a red flag to consider in diligence. But representation alone isn't enough. There must be conversations and action around justice, equity, and inclusion, both internally and on a broader societal level.

Some have tried to draw a one-to-one correlation between diverse leadership and success, but it's not necessarily the case that organizations with diverse leadership are inherently successful because of that diversity. Rather, it's that successful organizations are ones that have created environments that help all employees be successful, where everyone is aligned on the company's purpose and mission and what they're doing for their customers, and all employees can thrive and rise into leadership. Companies that focus on attracting, supporting, and retaining the best people possible should find that along the way, they start to have more diversity in background, experience, and other measures.

It's also important to be wary of tokenism. It's easy to say, "Let's find a woman to join us in this discussion," or a person of color, or an employee with a disability. But people, organizations, and communities don't want to be made to feel like they're in the room for the wrong reasons, or being touted as different or unique. That doesn't create belonging, inclusion, or culture; that's box-checking, and can lead back to attrition, if those employees feel marginalized, alone, or even afraid.

Instead, start by fully rethinking how the company brings in new talent. Where does the company recruit? What do the recruiting team and interview panel look like?

Then, think about how employees are supported. Treating everyone the same is **equality**; considering and meeting individual employees' unique needs is **equity**. Instead of making policy decisions around the majority, make them around the most underrepresented person. Don't think about what the average employee needs; think about what a single parent of color with a disability needs. This is important in everything from leave and remote-work policies to those social norms so critical to advancement; happy hours are less accessible to a parent working from home, or an entry-level employee who has to plan around public transportation schedules. All of this adds complexity to every conversation but is critical to ultimately building equity and inclusion.

### In conclusion

There's an entire cottage industry around solutions to "fix" DEIB and culture, but in reality, this progress must be created from within. While training can be helpful, this isn't a "to-do" on the way to value creation. It's a multifaceted, long-term leadership activity – and one where everybody within the organization has to do the work. ■

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# CHAPTER 11: CUSTOMER PREFERENCES

## DEFINE WHO THEY ARE AND HOW BEST TO SERVE THEM

The speed at which customers change their buying patterns has never been faster, due to the rise of e-commerce, remote work, financial pressures, and countless other factors. And so it has become more important than ever for portfolio companies and their private equity buyers to fully understand the company's clients and their preferences, and to shape the organization around their behavior. Defining the customer and how they buy, engage, and interact with a portfolio company is an essential starting point for every investor.

### Step 1: Who are the customers?

In the absence of good customers, there is no value proposition for a firm. Private equity investors seeking to build resilient, growth-oriented portfolio companies must have a clear and deep understanding of the customer and their dynamics to evaluate the attractiveness of an industry and segment. Diligence of a company's consumers should generally begin with a broad market scan to evaluate the sales dynamics of key players in the industry or industry subset. This is typically followed by more extensive research that may involve deeper commercial diligence, evaluating the composition of existing or potential customers in a given or target addressable marketplace.

For deal teams and operating teams, this means first establishing an understanding of the factors and drivers influencing overall market growth, decoupling and understanding each layer of demand. To further establish and evaluate preferences, firms must deeply contextualize the target's value chain to understand where preference drivers emerge: at the end-user customer level, or upstream. Finally, evaluating the channels and mechanisms that are used by various customer segments is critical to understanding the right ways firms can connect value propositions to target groups.

In the absence of good customers, there is no value proposition for a firm.

After this wider market analysis, conduct a detailed examination of the company's current customers, the stickiness of those relationships, and the elasticity of customer demand in the face of evolving macroeconomic environments. A significant revenue concentration in a few customers can indicate undesirable risk, as top-line value creation strategies (or even the deal itself) may stumble if new ownership cannot gain access to a particular customer or secure an agreement with a key buyer. Deals can also underperform if the investor cannot identify ways to offer new or better value to that customer set and the sustainability of the core customer is lost.

While data and records will be key, insights and perspectives from company executives are also critical at this step – to learn about both the customer and the company itself. Depending on the organizational structure, responsibility for customer preference and engagement typically rests with a chief marketing officer, chief revenue officer, or VP of sales. But in certain instances, the CEO may be heavily involved in the customer acquisition and retention process, which can serve as a strong indicator that the business maintains a customer-driven focus.

### Step 2: Which customers are the most valuable?

Once they understand who the target company's customers are, which channels they use, and the dynamics and levers of sustainability, private equity firms must then focus on the customers that are most valuable in order to align value creation principles. To identify these key customers, firms can employ an understanding of traditional measures, such as understanding a customer's willingness to pay (and how to increase it), or focusing in on how to improve the costs to serve profitable customers. This prioritization can unlock tremendous value-

creating potential.

There are a variety of tactics that firms can employ in assessing and prioritizing customers, such as:

- Focused analytic boot camps with portfolio companies to mine customer insights
- Rigorous segmentation exercises to increase the likelihood of matching customers with products (and prices) that yield the most valuable results for the firm

Firms may also take a keenly strategic lens to evaluating customers' value, such as identifying those that influence churn or attrition or those that may serve as key channel partners and provide market signals that are not otherwise available.

### Step 3: How can they best be served?

Improving customer engagement to increase stickiness and sales demands a deep understanding of the sales funnel and the customer journey. Look for friction points and work to smooth them, with a focus on optimizing technology, inventory management, logistics, procurement, personalization, or a host of other tactics to make sure that sales are swift and seamless. Develop strong customer connections by bolstering feedback and loyalty programs. Rather than focus on a single lever to expand customer interaction, leading customer-centric organizations pursue multiple angles.

It will be important to note that the buyer process and how to improve it will vary significantly from company to company, depending on factors such as whether the company focuses on serving B2B or B2C customers or if the customer is the end user of a product. For example, a distributor or OEM manufacturer that sells through wholesale networks will have a very different approach to measuring customer engagement than a consumer product manufacturer. At the same time, this may also provide a strong indication of where firms can seek to enhance product and customer offerings – expanding from durables into consumables and developing more consistent, recurring revenue streams.

All this will depend on instituting tactical programs to provide better and more meaningful product and sales data. The ultimate goal should be to develop and deploy a "real-time" system for measuring customer behavior, buying patterns, market trends, etc., to help ensure that the company is meeting customers' needs while avoiding excessive inventory holding costs and write-downs.

If the target company does not yet have sophisticated analytic capabilities, start with more firsthand approaches like customer interviews, surveys, or focus groups. Talk to sales teams and others who work with customers directly to identify trends in requests and pain points.

The ability to show strong, sustained (and sustainable) growth, customer retention, and low customer churn is a key component in showing the overall sustainability of a company's revenue – which makes it extremely important and attractive to potential buyers. It's never too early to start evaluating a company's customer base and looking for opportunities to create value. ■

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## MOVE BEYOND ONE-SIZE-FITS-ALL: MATCH PRICES TO TRUE VALUE

Optimizing pricing and margins is the most obvious lever for private equity value creation – but also the most complicated. While performance improvements to pricing can have an immediate impact on a portfolio company's bottom line, they are intimately linked to enhanced customer experience, sales, marketing, sourcing, procurement, and supply chain management.

Pricing should be among the first things a prospective investor assesses during the diligence process, and one of the first items to be modeled. This process has taken on even greater importance in the post-COVID-19 environment, as many businesses have been challenged to modify pricing in response to supply chain issues and customer buying patterns. Thankfully, pricing information is relatively easy data to secure, and countless benchmarking studies exist to illustrate pricing by industry and geography. Any PE firm that is not accessing these data sets is ignoring a significant opportunity for value creation.

Typically, PE firms will support and encourage an emphasis on the pricing of the products and services of their portfolio companies. Many PE firms with strong operating partners will have a pricing strategy that they impress upon their portfolio companies and monitor closely. Others that do not have similarly structured operations executives may depend on the portfolio company management team to drive improvements.

Pricing strategies typically take on a few different forms:

- **Cost plus pricing,** which simply adds a margin to the cost of manufacturing a product
- **Value-based pricing,** which attempts to quantify the value that a client or customer derives from a product or service
- **Competitive pricing,** which attempts to match or beat the price of a competitor

Each of these strategies is linked directly to how well a portfolio company knows its own customer and the buying process.

In many instances, PE investors will engage outside consultants to develop pricing strategies that extend across their entire portfolio. However, it is important to recognize that one-size-fits-all pricing can be the downfall of a business in the long run. The pricing nuances of different products and services across a company's portfolio of offerings may mean that some more commoditized products or services would benefit from a competitive pricing model, while other high-value offerings may benefit from a value-based model.

Understanding price sensitivities and customer buying habits is central to the pricing process. Before adjusting pricing, it's important to first determine the elasticity of demand for the business's products or services; one of the most common mistakes a PE investor can make is overestimating a portfolio company's value to its customer. While some customers will be able to absorb a price increase, others will not, and the result of shedding unprofitable customers, as the 80/20 rule suggests, can sometimes reach a point of diminishing returns as profit goes up and volume decreases. (The discussion of increasing pricing in order to serve more profitable clients is generally centered around B2B companies. For a B2C portfolio company, pricing can many times focus on increasing sales volume, and any trimming of customers will be unacceptable.)

On the other hand, many middle-market or family-owned businesses may be underestimating their own pricing power and have not increased prices in decades. A company that is undervaluing itself offers a remarkable investment opportunity in the short run.

A last note: As is often the case in value creation, even after pricing analysis is complete and prices have been optimized, the process cannot stop. The dynamics of the market and ever-changing customer preferences demand that pricing be an iterative process built into the permanent culture of an organization. ■

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# CHAPTER 13: SALES FUNCTION OPTIMIZATION

## GET A HANDLE ON CLIENT CONCENTRATION FOR GREATEST IMPACT

Improving the performance of a portfolio company's sales function can be one of the fastest routes to value creation. With a proper assessment of the systems, routes to market, sales channels, and teams and individuals responsible for generating revenue, plus an accurate map of customer composition, private equity investors can rapidly enhance a sales function to build sustainable value.

### Right-sizing teams and engagement

Understanding a business's customer base and client concentration will reveal the initial intelligence necessary to enhance sales. During the diligence process, private equity investors should first determine if the business has a "Top Heavy" or "Long Tail" client dispersion structure. Top Heavy businesses will draw the majority of their sales from a handful of clients, while businesses with a Long Tail structure will draw small amounts of revenue from many clients. Both structures can be used to dictate how best to organize resources across sales and marketing.

For instance, a high-volume business conducting many small transactions where no individual customer is generating more than 5% of the revenue might make certain adjustments to jettison some low-revenue customers in an effort to add a few high-revenue customers to the mix. This can be accomplished by cross-selling more products or solutions to each client, or may require new markets to be developed.

And it would be inefficient for a business with a Long Tail customer concentration to have a large field sales force traveling to make sales calls. The expense of managing a large team to serve many low-revenue customers is likely to be less than optimal and will probably erode margins. Shifting some salespeople to leverage inside sales and increase the focus on higher-revenue customers and cross-selling may represent one solution. By moderating the sales strategy to better balance customer concentration, investors can better position the company for market changes and shifts in customer demand.

> A sales function that is both adding customer interactions and securing significant revenue from each interaction is coming closer to operating at peak efficiency and supporting sustainable growth.

Assessing and managing the allocation of existing sales and marketing resources is a critical step. Certain businesses might benefit from changes to compositions of the field sales teams and centralized call centers. The product mix, customer concentrations, buyer journey, and margin profile will inform the decision to right-size specific components of the sales function, including team orientation, industry alignment, or geographic coverage. The correct mix of sales and marketing resources is essential to expanding the business's revenue stream and improving the profit contribution.

Improving sales can best be achieved by increasing overall customer engagement without losing focus on growing revenue from each sale. A sales function that is both adding customer interactions and securing significant revenue from each interaction is coming closer to operating at peak efficiency and supporting sustainable growth.

### Sales and marketing: Separate, but not siloed

When considering changes to create a high-performance sales function, it is important to look beyond the people themselves to address the surrounding resources that contribute to their effectiveness. Because growing customer interactions is a priority of the marketing team, PE investors should work to ensure close collaboration between sales and marketing to grow revenue.

That said, while they are highly collaborative, it is critically important for a fast-growing business to maintain a clear distinction between teams dedicated to each specialty. It is not uncommon for a middle-market business to minimize the importance of properly defining the sales and marketing functions. Measuring how well senior leaders across sales and marketing are engaging with each other to create a co-dependent ecosystem can reveal a host of value creation opportunities.

Understanding the effectiveness of a marketing program – from brand awareness and market position to customer engagement and competitive intelligence – should be among the first tasks of any private equity investor focused on growth through enhanced sales. This can be determined by how accurately the marketing resources are allocated to support the existing sales effort. By contrast, a marketing effort that is poorly linked to sales may be indicative of siloed functions not working collaboratively. Having effective data insights and dashboards on their combined functions is imperative to making sound business decisions to accelerate growth.

> By moderating the sales strategy to better balance customer concentration, investors can better position the company for market changes and shifts in customer demand.

### Clear, consistent compensation

Finally, enhancing the performance of a sales function will frequently involve a discussion of compensation. This is typically one of the top items on a PE firm's to-do list following the close of a transaction. Ensuring that the compensation structure is both clearly articulated and easily understood by both management and the broader sales team is an important step when attempting to align individual performance with broader corporate goals. Compensation plans tend to work best when they are consistent and have no more than two or three elements that determine compensation. PE investors should work with senior management to determine whether compensation plans are achieving the desired outcome. ■

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## ALIGN STAKEHOLDER PRIORITIES TO CREATE VALUE AND DO GOOD

Private equity firms are in a unique position to influence both financial and social value creation through fund operations, investment decisions, and portfolio management. Thus, as attention to environmental, social, and governance (ESG) factors continues to rise, stakeholders have also come to expect PE firms to look at their investment and value-creation decision-making through a more focused ESG lens. Now more than ever, it's important for firms to know, meet, and exceed the ESG expectations of limited partners, vendors, customers, business partners, employees, and regulators. A well-defined and well-executed ESG strategy has the potential to drive value throughout the investment lifecycle.

While the underpinnings of ESG have been around for decades (previously referred to as "corporate social responsibility"), as a value creation initiative for private equity firms, ESG is still very much in its infancy. Historically, the practice of measuring and improving an organization's broader community impact has been a lower priority because of the perceived intangible impact on EBITDA.

But because ESG transcends an entire organization, developing, implementing, and monitoring ESG as a value creation strategy across an investment portfolio can take many forms and have profound impacts. From improving logistics and saving on materials, to building stronger relationships with customers and employees, to developing initiatives that advance human rights, the opportunities to create value using ESG are broad and deep.

> Because ESG transcends an entire organization, developing, implementing, and monitoring ESG as a value creation strategy across an investment portfolio can take many forms and have profound impacts.

### How to advance ESG

#### Start early

Incorporating ESG diligence as part of a broader diligence assignment helps to reveal ESG-related risks and opportunities. PE firms should establish an ESG workstream during the diligence process to create an ESG issues profile based on the target company's business model, industry, employee retention rates, geographic footprint, and a host of other measurable criteria. The investment team should then evaluate the existing design of the underlying ESG compliance programs to determine performance optimization opportunities that might ultimately contribute to enhanced EBITDA. With more potential buyers and investors taking decisive steps to establish ESG requirements for the companies they do business with, a comprehensive ESG program with a solid policy and reporting framework, and potentially even completed audits, should be table stakes in today's PE deals.

#### Focus on metrics, and knowing whose and what standards to meet

Taking a strategic approach to ESG metric-setting at the portfolio level can be a value-creation tool for private equity firms, even if those metrics are not initially demonstrating the desired impact. Merely having the ability to measure ESG can set a portfolio company apart and make an organization more attractive to a potential buyer. The specific metrics to track will vary based on the company's industry, geography, and goals, plus the given regulatory climate. However, it is likely that some market priorities will hold steady regardless of politics: clean, efficient, effective, and ethical operations, plus reduction of resource consumption.

When considering ESG strategies and initiatives, complying with state and local trends and regulations is a good place to start, but it's important to keep an eye on evolving global standards as well. Private equity firms should be prepared for opportunities

with global investors or buyers. For its own part, the PE firm should already be working toward the UN's Principles for Responsible Investment; for portfolio companies, consider frameworks such as the UN's 17 Sustainable Development Goals or the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD).

Consider the needs of potential large customers, and customers' own customer bases. As a variety of regulations are being developed by various jurisdictions – and as a host of standards are being developed by industry working groups – customers may also have their own standards to follow around the emissions or diversity of the companies they work with or buy from, or may have established their own ESG initiatives on the environmental impact of transportation or compliance with humane labor laws.

### Look for opportunities to save both costs and resources

Financially motivated improvements can also carry ESG benefits, and vice versa. For example, optimizing logistics so that no truck returns empty will boost the efficiency of transportation and save on fuel and labor costs – plus, it will help the company get the most out of every carbon emission and not emit more than is necessary.

A good place to start this process is breaking down exactly what goes into each sales unit produced, each customer sale, etc. Once that's defined, it will be clearer how to minimize those inputs – and thus improve margins and conserve energy and materials.

> Merely having the ability to measure ESG can set a portfolio company apart and make an organization more attractive to a potential buyer.

### Think creatively

Complying with ESG regulations keeps a company out of trouble with regulatory authorities, but also just keeps it on the same level as everyone else. Real value comes with looking further into what can set the business apart as a real ESG champion. Think outside the box when evaluating ESG credentials and opportunities; there's more to it than just conserving resources. For example, a company that repurposes old technology or reuses old parts isn't just being cost-efficient or resourceful – it's being sustainable, by diverting materials from landfills and reducing demand for new ones.

Help secure revenue-boosting deals by knowing what public ESG commitments potential customers have made, and how portfolio companies can help meet them. For example, a portfolio company operating entirely in the U.S. may be able to negotiate better deals because they can help larger companies meet "Buy American" requirements. (Smart pricing and good products will still be required, of course, as a baseline, but standout ESG factors can help provide that extra bump above the competition.)

### Rethink the 'intangible'

Beyond improving revenue and cash flow, committing to ESG can present an opportunity to build stronger relationships with broader investment groups and employee bases, as well as customer and employee loyalty – all of which seem like "intangible" impacts, but can be tied to real metrics. For example, matching employees' hours of community service with hours of time off can result in a service-minded workforce that contributes significantly to the communities where they live, which will help foster a sense of fulfillment in employees and goodwill for the company as a whole. This may translate to quantifiable results such as lower employee turnover and recruitment costs, higher local sales, and an overall enhanced market value of the portfolio.

### Watch carefully for 'greenwashing'

As market demand for ESG increases, companies may look to capture a share with marketing claims around sustainability, diversity, and more that are misleading or that they don't live up to. This can take many forms, from vague, toothless goals around "reducing carbon emissions" to misdirection like touting female leadership while sourcing materials from mines that demonstrate unsafe or illegal working conditions. Consider all claims carefully, and look for data and confirmed case studies to back them up.

### Mind the risks – and embrace the opportunities

While it would be a mistake to think of ESG as just another compliance burden, it is still important to note that there are risk factors to *not* prioritizing ESG. In addition to the financial and reputational risks tied to standards and regulations, inattention to ESG can also put deals at risk, from customer contracts to the eventual exit. Especially when large public corporations are involved, there is a high likelihood that the customer or buyer will have ESG requirements – and if the company is not prepared to meet these requirements, it may lose the deal, or at least face lower valuation or compensation. And when it comes time for the PE firm to raise its next fund, if the firm hopes to raise capital from limited partners with ESG mandates, they'll need to align their own ESG policies, procedures, and strategies to do so.

The issues that comprise a firm's ESG risk and opportunities profile wind through all functional and operational aspects of a business – cost optimization, top-line capital, human capital, and so on. Thus, on the whole, ESG can present a wide range of opportunities, drawing attention to items and ideas that hadn't previously been considered.

A strong strategic foundation can help leaders execute ESG initiatives that maximize ROI and preserve a firm's reputation in the eyes of stakeholders. With the window wide open for small and middle-market PE firms to embrace ESG, the time is right to consider conducting a comprehensive review of ESG strategies and to build value and conserve resources – and to help make the world a little better along the way. ■

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# CONCLUSION

Especially amid the shortened timeline of a private equity investment, it's important to leverage the time value of money by enacting your value creation plan as early in the investment lifecycle as possible. The "sprints" we've detailed here can help set you up for a series of early wins and ultimately the timely achievement of your investment objective.

Ready to get started? Reach out to our team to start building out – and executing – your value creation roadmap. Whether you're at the onset of an investment, dealing with barriers that are inhibiting your portfolio's performance, or fully ready to activate the components of an existing value creation plan, we're standing by with industry- and situation-specific expertise to help you find your best path toward the finish line.

When it comes to value creation, the needs of each portfolio company are unique – but as long as you know how to take them into account, there's also room to apply time-tested, proven solutions that lead to repeatable and scalable results. We look forward to taking that journey with you.

**Contact our team to get started.**

# TALK TO OUR VALUE CREATION TEAM

With comprehensive industry intelligence and situation-tested operational know-how, our Value Creation team helps both healthy and unhealthy companies overcome challenges and seize growth opportunities. Our professionals understand the unique relationship between private equity investors and portfolio company executives, and bring a wide range of deal, operations, and fund knowledge to each engagement. Whether you're looking to boost top-line results, reduce costs, or optimize efficiencies, we're standing by to help you achieve your goals, create value, and eventually exit profitably.

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