Pragmatic Zero-Based Budgeting in Industrials: A Private Equity Perspective

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Several intersecting trends are affecting the industrials sector at the same time. Margins are under pressure. Customer behaviour is volatile, for understandable reasons. Fixed costs remain high and production lines have generally been operating below capacity since the start of the COVID-19 lockdowns.

When revenues and earnings drop significantly in a short space of time, incremental cost reduction programmes are not suitable. Industrial sectors like aerospace and automotive have some of the highest fixed operating costs in any industry anywhere. This environment creates the need for more substantive fixed cost reduction programmes.

A lower-cost base is a competitive advantage in any sector and the COVID-19 pandemic has made management teams and private equity ('PE') investors urgently reconsider the costs and benefits of different transformation programmes. Zero-Based Budgeting ('ZBB') is at the core of many current restructurings and transformations.

Our view is that management teams should look to align any ZBB programme to the future target operating model of the enterprise, bringing rapid cost reduction targets in sync with forward looking strategic plans. With consolidation on the horizon, ZBB is also an important value lever in an M&A or a buy-and-build context.

Pragmatic-ZBB: it's about operations, not just cost!

Formulating a new operating model involves much more than reducing costs. Indeed, thinking about the ideal structure of a company's assets and operations can be an invigorating process. When executing a transformation, industrials management teams seek to understand a few key questions, usually in the following order:

- What is the overall business strategy to survive for now and thrive post-COVID-19?
- What is our roadmap for delivering new products and technology?
- What is the go-to-market ('GTM') strategy for our products?
- With our go-to-market strategy in mind, what is the optimal make-or-buy paradigm?
- How should we best structure our selling, general and administrative ('SG&A') functions and spend?
- In light of the above context, what are the enablers and investments required to deliver the new business plan?

In answering these questions, the quantum of pragmatic but ambitious top-down targets should make the scope of a Pragmatic ZBB programme clear. It is not about arbitrarily seeking to take cost out of a business – instead, it can and should be a catalyst for a productive reassessment of a business's key priorities by stopping 'non-working' costs and investing behind 'good and must-have' costs with a strong ROI.

Pragmatic ZBB from the investor point of view

Some investment firms tend to adopt a Goldilocks approach when appraising a potential investment – driving necessary organisational change, but being careful not to cut into the muscle when trimming fat. COVID-19 has forced PE firms to consider the effects on internal rates of return ('IRR') of investing further equity capital in portfolio companies. If possible, the ideal tactic is to fund any required investments from within portfolio companies' balance sheets, without requiring additional equity or debt capital.

As part of the due diligence process for any new investment, PE firms should take care to form a view on the ideal target operating model of the business. This is particularly important at this time: in a volatile dealmaking environment, it is reasonable to expect that a new portfolio company could face a very different operating climate in the months post-closing.

Accurately assessing gaps between the pre-investment situation and the target operating model scenario can help PE firms precisely price investments and deliver increased value. We have assisted several PE houses in quantifying the value creation upside during pre-close due diligence with our Pragmatic-ZBB approach. Our work typically accelerates the realisation of synergies, and can speed up time to payback by as much as one year.

Sustainable fixed cost restructuring is a typical value lever for PE firms, but there are different approaches to executing this kind of plan. Our view is that Pragmatic ZBB creates greater cost transparency more quickly and enables a closer link between on-the-ground cost reduction activity and the broader strategic plan. Pragmatic ZBB can deliver fixed cost reductions of 25-30% for industrials businesses, adding value for all key stakeholders.

More importantly, ZBB functions as the framework that moves the organisation closer to the end goal of a new target operating model to inherently create significant value.

Click here to download the full report on A&M's Pragamtic-ZBB approach.

If you are interested in discussing how we could help you through a Pragmatic-ZBB implementation, please get in touch with one of our experts Bob Rajan, Steffan Kroner or Naresh Kumar.

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A&M has worked with private equity firms in Europe and globally to stabilise financial performance, transform operations, catapult growth and accelerate results through decisive action. Our senior operators can rapidly assess and respond to challenging situations, delivering value for PE firms and other stakeholders.

Our professionals have extensive experience supporting sellers and buyers through carve-outs and divestments, helping guide businesses through tough, complex situations. To learn more about our expertise and to understand the full scope of our Private Equity Performance Improvement work, contact our team.

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