PRIVATE EQUITY PERFORMANCE IMPROVEMENT

THREE-PART SERIES ON COST OPTIMIZATION

PART I “GROWING INTO DISASTER”

ALVAREZ & MARSAL

INTRODUCTION

Alvarez & Marsal (A&M) is introducing a three-part series on cost optimization. The first release of this series entitled “Growing into Disaster,” is written for investors in portfolio companies that have historically increased value through revenue growth but are now delivering lower levels of profitability and facing challenges. Private equity investors often find themselves in situations where portfolio companies need to realize meaningful and sustainable improvements in cost structure. Companies in these situations cannot simply cut their way to efficiency – they need to change how they operate.

We are not saying don’t grow, we are saying grow smartly. Expansion and growth lead to increases in complexity, and with complexity comes additional cost. Without an efficient cost structure, continued prioritization of growth over efficiency can lead to situations where urgent change is needed to avoid “growing into disaster.”

GROWING INTO DISASTER

Each year, Inc. Magazine releases the "Fastest Growing Companies in America" celebrating the 5,000 businesses with the highest growth rates in the country. An article in Fortune highlighted a study of what happened to these businesses five to eight years after making the list and found that about 2/3 of the companies were either sold at unattractive valuations, shrunk or were no longer in business.

Over the past 10 years, many companies have focused on growth and expansion boosted by positive momentum of the general economy. These businesses have pushed the top-line higher through expansion of geographies, development of new products or services and acquisition of companies in similar or adjacent markets. In the push for continued growth, many companies have prioritized growth over cost and efficiency – and in more extreme cases, have followed the mantra "growth at all costs." In A&M's Private Equity practice, we are seeing similar trends in the portfolio companies of our performance improvement clients.

Fast forward to the present, and, many of these companies are growing themselves toward disaster.

We have written this series for companies and their investors who have historically increased value through revenue growth but are now facing challenges and delivering lower levels of profitability. We are not saying "do not grow." We are saying grow smartly. Growth from expansion, new products and services, or through acquisition, leads to increased complexity, and with increased complexity comes cost. To do it right, companies must recognize and manage that complexity, build platforms and maintain an efficient cost structure to generate incremental EBITDA from incremental volume. Without these platforms, the pursuit of growth and expansion above efficiency can lead to situations where urgent change is needed, as these companies may be … GROWING INTO DISASTER.

As predictions for the economic environment grow dimmer, the potential downturn may have a significant impact on private equity portfolio companies that have historically delivered incremental profits. Businesses that have grown through acquisition or consolidation of smaller companies seem to be particularly susceptible. In addition, companies that have grown organically but have not yet demonstrated an efficient platform and cost structure may also be at risk. If and when growth rates begin to soften, the business loses a top customer, or market conditions and competitive headwinds begin to strain the top-line, companies that have not looked after the cost that comes with increased complexity will struggle to generate incremental EBITDA.

An increasing number of portfolio companies are finding themselves in this situation. Once the low-hanging fruit is gone, these businesses will face some tough questions in an environment where private equity valuations and leverage are at an all-time high.

Below are three examples from recent consulting assignments. In all three cases, the business went from high growth and incremental year-over-year EBITDA to high risk for growing into disaster.

Portfolio Company Examples	Example 1	Example 2	Example 3
Size	<$500 million	>$500 million < $1 billion	>$1 billion
Background	• Data center and managed services provider with 40 data centers and ~1,000 employees • After initial period of rapid expansion through acquisition, sales growth was limited, and costs were increasing, leading to decline in margins and EBITDA • Broader industry experiencing price and profit increases driven by overall increase in demand • Acquired companies included smaller data centers, and often came with long-term leases, limiting flexibility and scalability • Cumbersome organization structure with overlap in responsibilities across core functions in the business	• National importer and wholesale beverage distributor operating in 20+ states with ~1,800 full and part-time employees • Initially formed by merger of companies with two different business models (import and wholesale distribution) • Initial period of high growth driven by acquisition of smaller regional business, each with a unique product portfolio • Product portfolio included ~46,000 SKUs across ~5,000 brands from ~1,200 vendors • Combination of functional, geographic and line of business leaders with unclear separation of duties and roles and responsibilities across teams	• Global technology and communications business with over 4,000 employees • Complex, three-tier distribution model including value-added resellers, distributors and owned / captive sales force • Over 38,000 active SKUs with high degree of variation; ~9 percent of SKUs contributing 80 percent of contribution margin • Significantly high R&D cost structure, developing products without common platform / configuration • Nearly 58.000 annual orders processed manually, with over 50 percent of orders reflecting non-standard pricing and discounts
Symptoms	• Decline in EBITDA margins, followed by loss of EBITDA dollars • Cost increases are outpacing revenue increases • Loss of high-volume customers and decrease in competitiveness • Attrition of talent and increases in employee turnover • Short-term, marginal cost cutting and management uncertainty		

While the backgrounds of all three situations are very different, the symptoms and root cause of the issues facing those companies are the same. In all three cases, top-line growth was pursued with little to no consideration for the cost and complexity that comes with it. When the headwinds started blowing, the businesses doubled-down on growth strategies and began cutting costs to meet their profit goals without addressing the fundamental issues within their respective cost structures. As a result, their individual cost cutting efforts only delivered a marginal, short-term impact to profitability.

THE HOUSE OF CARDS

So, what led to these situations? How can a business pivot so quickly from consistently delivering growth and incremental profits to teetering on the cusp of disaster?

When growth is pursued without consideration for the organization's ability to efficiently support that growth, it can bring dramatic increases in complexity across the business. Combined with enough leverage, that complexity can lead to a situation that requires urgent intervention.

Based on our experience in dealing with these situations, there is no one root cause behind growing into disaster. Rather, it's multiple issues that have a compounding effect resulting in an accelerated deterioration of profitability. Once the business reaches the point of inflection, there are limited options. This fact pattern is a trend that we are seeing time and time again on consulting assignments.

TRENDS THAT INCREASE POTENTIAL FOR GROWING INTO DISASTER

Growth at all Costs	• Sales incentives are purely driven by volume without consideration for the contribution margin, leading to prioritization of revenue over profit. Sales resources operating under this model tend to sell what they can to hit their volume and/or bookings target, not what they should to support healthy profitability of the business. • In addition, growth strategies that ignore the company's ability to efficiently support that growth lead to a culture where cost and complexity go unchecked, e.g., pursuit of growth strategies before platform development. • Unrealistic top-line forecasts and growth expectations based on hope over reality can lead to situations where the cost structure is built to a level that is not appropriate for the current size of the business.
Increased Complexity	• Whether they are generated from acquisition or expansion, increases in product complexity and high variation in the product and SKU portfolio can lead to high build-up of fixed costs. • When every dollar is a good dollar, companies lose focus on the key customers that drive the majority of contribution margin across the business. Over time, significant "tails" emerge in the SKU and customer portfolios that bring added complexity and cost. • Cumbersome organization structures and managerial layers lead to unclear roles and responsibilities. Without clear processes and accountability, resources and headcount are needed to fill the process cracks.
Lack of Platform and Lack of Transparency	• Lack of scalable processes within and across key functions leads to headcount and cost increases to address specific issues, and lack of scalable organization structure. • Performance metrics and/or KPI's are not in place for the major drivers of profitability. Without the right level of visibility into profitability and performance metrics, management is relegated to the role of simply reporting. • Limited transparency on product and customer profitability, including true costs to serve that accurately reflect the actual contribution margin of products and customers often leads extensive product and customer "tails" and further increases the overall cost structure.
Build-up of Corporate Back-Office Costs	• Once the customer feels the impact of increasing complexity, the business responds by adding resources to address lack of process, e.g., customer orders are not being shipped on time, so the business adds a corporate coordination function to get a handle on the specific issues. • Increases in corporate cost structure and headcount is often a leading indicator that a company may be headed for trouble, especially when resources, costs, and capabilities are moving further away from the operations. • Consolidation of resources and costs across a company's footprint is an obvious way to create efficiency, and with proper planning and execution, it works. However, some businesses take it too far and lose sight of the fact that corporate functions exist to support the business, not operate the business.
Leverage Begins Crushing the House	• The historical focus on growth requires investment for acquisitions and expansions, etc. resulting in the company now having moderate to high leverage, given this investment capital. Discussions on growth strategy quickly shift to topics around debt covenants and potential "tight quarters" in upcoming year. • Lack of a reasonable top-line expectation puts further pressure on cash flows as revenue forecasts are missed. It takes cash to reorganize and create efficiency, which puts further pressure on cash flows. • *High leverage accelerates the deterioration* and time becomes a critical factor. Without a high sense of urgency to implement meaningful cost structure changes, the business quickly runs out of options.

CHANGE, DON'T JUST CUT

Without an efficient cost structure, incremental growth and expansion adds complexity and cost. Once the growth begins to stall, companies are forced to look at cost structure, but only marginal improvements are possible given the high complexity. Low hanging fruit is typically the first to be addressed but does not provide the level of improvement needed in these situations.

These companies cannot cut their way to efficiency – they must change how they operate. And that is not an easy task. In fact, during an A&M Private Equity Operating Partners (PEI) event in October 2018, we surveyed the audience and asked how many of these situations end up in disaster. The answer was about two-thirds of the companies that get into this situation are not able to get out.

Below is an example of a company that recognized the reality, brought transparency into the financials and re-set the cost structure to create an ***efficient platform for profitability, not just growth.***

CASE STUDY: HOW ONE COMPANY TRANSFORMED AND PRIMED FOR A VALUABLE EXIT

Portfolio Company Scenario	Successful Turnaround and Exit
Background	• Industrial fibers company, with revenues that place them in the $500 million to $1 billion category. • Over 20 years of year-over-year revenue increases and growing at all costs, the company experienced a significant economic slowdown in their specific markets. • Dramatic declines in EBITDA, once the growth rate began to stall and the industry cooled.
Turnaround	• Recognizing the situation, the company changed the agenda to focus on profitability, and changed how it operates. • Developed scalable platforms across major lines of business. • Simplified the organizational structure with a focus on efficiency and accountability. • Overhauled sales force to optimize staffing levels, and incentivized sales to balance volume and contribution margin. • Established standard processes that would scale with the business, and performance metrics to manage vs. report.
Result	• **After a year-long turnaround program, the company had changed how it operates** • **EBITDA increased by 30 percent in the first year, given the focus on profitability and efficiency.** • **Successful sale of the business.**

IMPROVE YOUR CHANCES FOR A SUCCESSFUL OUTCOME

Our team of experts thinks you can significantly improve your portfolio company's chances of success by doing the following:

PRIORITY #1: FACE THE REALITY

Recognition plays a significant role in determining whether the company will make the pivot or continue growing into disaster. Given the historical emphasis on growth over cost and complexity, these companies often look to growth as the answer. However, there are no clear examples of companies that have "grown into their cost structure," and most private equity investors will not underwrite a growth-based improvement plan based on hope. In addition, to clearly recognize the situation, these businesses must also understand the magnitude of change that is required. They must change how they operate and establish a new culture that is focused on cost and efficiency.

PRIORITY #2: BRING FULL TRANSPARENCY TO MARGINS AND COSTS

Changing how a business operates requires a complete understanding of where the business is making money, and where complexity is driving too much cost. This frequently entails a significant analytical effort to understand the profitability levels on a product, customer and channel basis.

During a recent A&M assignment, we saw that once transparency was brought to the situation, management was shocked to see analysis showing that seven percent of current SKUs contributed to more than 90 percent of the company's contribution margin. Once this level of transparency is achieved, the business can focus on the products and customers that matter.

PRIORITY #3: RE-SET THE COST STRUCTURE (DON'T JUST CUT AROUND THE EDGES)

Typical cost reduction programs are limited to scaling back headcount and third-party spending under the current structure. Additionally, these programs focus solely on office and G&A spend. Traditional cost reduction programs are not appropriate when the business requires significant change, not simply cuts, and when the main driver of cost structure is high complexity in the business. Companies can realize three to five percent reductions in costs, without substantial change, by limiting their focus to traditional G&A reductions. However, successfully re-setting the cost structure requires addressing the fundamental drivers of cost and complexity in the business.

PRIORITY #4: REDUCE COMPLEXITY

Companies in these situations cannot simply cut their way to efficiency; they must change how they operate. Years of focusing on growth above cost often leads to massive build-up of complexity, which impedes the businesses' ability to flex its cost structure to maintain EBITDA and profit levels. Reducing this complexity through SKU rationalization, segmentation of customers and other similar strategies can provide a clear trigger to reorganize the business.

In addition, reducing complexity extends to organization and process. The litmus test is often a simple question: who is accountable for what in the organization? Implementing a simplified organizational structure with clear roles, responsibilities and accountabilities for execution can lead to significant reduction in complexity throughout the business. When a business and organization structure is simplified, it operates more efficiently and effectively, period.

PRIORITY #5: FOCUS ON THE "MUST HAVES"

Reduced complexity provides a trigger to evaluate the organization. The question to be addressed is simple: what are the "must-have" costs and capabilities that are required for the streamlined business? This tactic is especially important for corporate functions, and in situations where the business has expanded beyond its core set of products or customers. Once the business is re-focused, functions that are not required can be quickly identified as potential opportunities for reduction.

This approach is also useful for situations where the top-level organization structure needs to be simplified or otherwise restructured. By taking a "clean sheet" view of the organization structure and applying the "must have" filter, the cost structure can be built up based on what is needed to support the business, not what exists today.

CONCLUSION

Companies growing toward disaster cannot cut their way to success. They need to change how they operate, and that requires decisive action, leadership and a high sense of urgency to re-set the cost structure to sustainable levels that are in line with reasonable, not hopeful, top-line expectations.

In addition, getting the right cost structure in place today is a no regrets decision. If the top-line dips, the business can take it. If the top-line grows, that efficient cost structure will deliver higher levels of profitability and the incremental volume will be accretive to the business. The bottom line is businesses that consistently prioritize growth over efficiency tend to build up a cost structure that is not right for their current revenue base. We have yet to encounter a business that was successful at "growing into their cost structure," conversely, we have helped many businesses side-step "growing into disaster."

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ABOUT ALVAREZ & MARSAL

Companies, investors and government entities around the world turn to Alvarez & Marsal (A&M) when conventional approaches are not enough to make change and achieve results. Privately held since its founding in 1983, A&M is a leading global professional services firm that provides advisory, business performance improvement and turnaround management services.

With over 3000 people across four continents, we deliver tangible results for corporates, boards, private equity firms, law firms and government agencies facing complex challenges. Our senior leaders, and their teams, help organizations transform operations, catapult growth and accelerate results through decisive action. Comprised of experienced operators, world-class consultants, former regulators and industry authorities, A&M leverages its restructuring heritage to turn change into a strategic business asset, manage risk and unlock value at every stage of growth.

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