TURBOCHARGE PRIVATE EQUITY VALUE CREATION WITH INDIRECT PROCUREMENT

FIND THE MONEY, GET THE MONEY, KEEP THE MONEY

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Introduction

This report focuses on how to use indirect procurement to turbocharge private equity (PE) value creation. Indirect procurement (third-party spend on areas such as IT, facilities etc.) is often seen as the unglamorous and unloved cousin of direct procurement. But this needs to change.

Why? Simple: well-planned and executed indirect procurement transformations can turbocharge value creation within a conventional PE ownership period, potentially delivering significant margin and EBITDA improvements. Because indirect procurement has historically been under optimised compared to direct procurement, it is a 'rich' area for savings in multi-national and de-centralised businesses. It can also rapidly unlock trapped value and do so much faster than performance improvement initiatives based around streamlining headcount.

PE firms pride themselves on creating operational value faster than their corporate counterparts. However, executives and investors in PE-backed companies still have to contend with the perennial challenges of limited spend visibility and muddy P&L attribution from procurement initiatives.

As a result, only a few large-cap PE firms have made progress in unlocking cross-portfolio value by leveraging sector-agnostic 'spend aggregation' for multiple portfolio companies. Most PE portfolio management teams still struggle to build detailed spend visibility and exploit the extraordinary promise of indirect procurement.

In our latest report, we focus on indirect procurement opportunities within mid-sized companies (i.e. Net sales of >£200m). We highlight emerging procurement trends through the PE investment cycle and then outline a structured approach to turbocharge value creation based on our experience working with PE companies, management teams and financial sponsors.

If you are interested in discussing how we could help you through a rapid diagnostic or implementation, please contact one of our experts.

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Executive summary

Almost without exception, PE firms are looking to carefully manage portfolio risk and build robust investment theses in the wake of the COVID-19 pandemic. Indirect procurement represents an untapped opportunity for many PE firms and portfolio companies. Whether pre-deal or post-close, a deliberate focus on indirect procurement guides the new wave of value creation thinking of an increasing number of PE firms. Here are five key insights from our report:

01

Indirect procurement presents big savings opportunities for PE firms and management. Indirect spend accounts for between 5% and 25% of revenue depending on scale, geographic footprint and complexity of the operating model. Indirect procurement savings can uplift EBITDA by between 0.4 and 2.0 percentage points. Which can equate to circa £20-25 million in savings for a £1 billion revenue company. PE firms typically target between four and eight points of EBITDA margin improvement under their ownership, making indirect procurement a meaningful lever for portfolio investments.

02

Too often, indirect procurement is neglected in favour of direct procurement. Many Chief Procurement Officers (CPOs) focus on direct procurement optimisation at the expense of indirect procurement. Few CPOs are capitalising on simple indirect procurement tools and technologies (e.g. spend analytics, P2P process mining, e-auctions) that can impact the bottom line.

03

Many PE firms are behind the curve on managing indirect procurement. Given that operational value creation can account for >50% of some funds' internal rates of return (IRR), indirect procurement should be a strategic consideration at the fund level. Some top-tier funds are leveraging advanced portfolio-wide internal procurement capability; this represents a competitive differentiator with the rest of the pack.

04

The benefits of indirect procurement are sustainable and quick to deliver. Ability to rebase expenditure in line with a 'new normal' post-COVID-19 will be crucial for many PE portfolio companies. In our experience, all indirect procurement savings can be realised within 24 months post-close, with up to 70% achieved during the first year and up to 20% in the first 100 days. Portfolio companies restructuring indirect spend as part of their annual planning cycle typically outperform peers on EBITDA margin and revenue growth metrics by 2.0 to 5.0 percentage points.

05

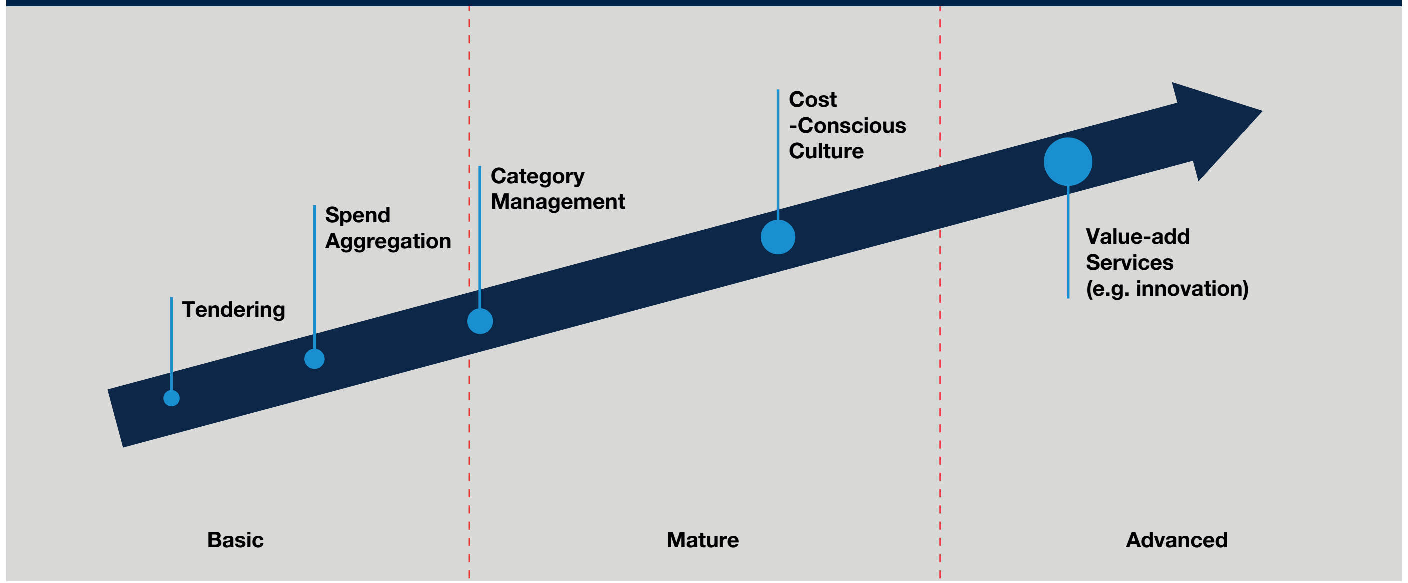
All these factors combine to de-risk an investment thesis. As the financial stresses of COVID-19 begin to impact markets, PE firms need levers like indirect procurement to de-risk portfolios and manage volatility wherever possible. Objectively and realistically scoping procurement savings can provide an advantage in competitive sales processes. Detailed pre-deal diligence on indirect procurement can improve the pace at which deals can move as well as the subsequent path to value creation.

We will also highlight A&M's experience working with PE firms and management teams to realise indirect procurement opportunities right through the investment lifecycle, reducing cost while creating earnings and margin improvements.

Emerging trends

The role of procurement is changing fast, and COVID-19 has only intensified the pressure on organisations to leave 'business as usual' behind. The following trends and technologies are likely to become more relevant to procurement, operations and finance professionals in the coming months and years, making procurement a more central pillar of operational and strategic change (see Figure 1).

Figure 1: Characteristics of maturity journey for a typical indirect procurement function. New trends enable rapid transformation for forward-looking procurement teams.

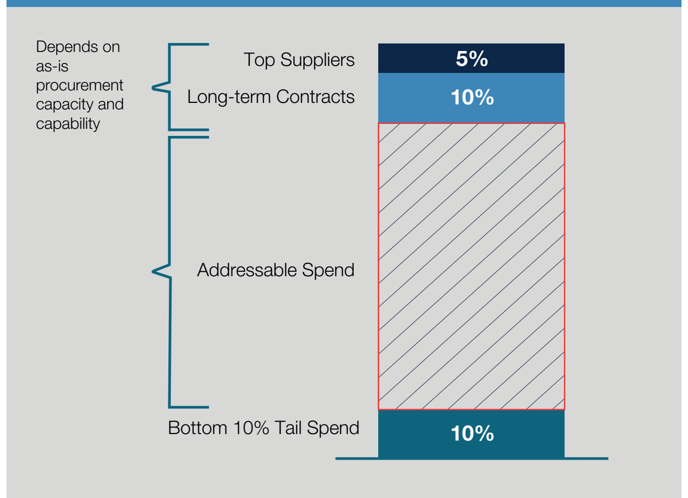


Adoption of cloud and AI-based spend analytics

Obtaining third-party spend visibility has become less onerous with the rise of deep data analytics and data visualisation applications. Too often, spending data is tangled up in complex enterprise resource planning (ERP) systems. Today, affordable AI-based tools help stakeholders collaborate effectively and optimise indirect spend rather than getting lost in spreadsheets. Increasingly sophisticated 'analytics as a service' providers like The Smart Cube can also accelerate value creation. In all, around 75% of indirect spend can be positively impacted (see Figure 2), making regular spend assessments led by Zero-Based Budgeting (ZBB) methodologies a strategic imperative..

Figure 2: A&M's 'Topping and tailing' methodology is critical to sizing 'addressable spend' in M&A situations

Addressable Spend Analysis Methodology



The disruptive rise of digital procurement and e-marketplaces

Employees use slick e-commerce platforms like Amazon in their personal lives, but this is not often the case when it comes to procuring on behalf of their employers. Most procurement processes are still geared around compliance and use old and rigid frameworks, slowing down businesses with excessive bureaucracy. 'Plug-and-play' buying platforms with 'digital by default' content and processes are transforming the procurement experience for early adopters, building cost-conscious culture while improving employee experience. Services buying focussed E-marketplaces like Globality, which standardise the requirement-gathering process for services such as IT or marketing, have started to gain more traction with corporates. Besides connecting buyers and suppliers, these marketplaces are delivering 'win-win' outcomes by standardising the requirement gathering process, speeding up sourcing timelines and avoiding giving sub-conscious preferential advantage (via excusive but unnecessary requirements) to a specific supplier.

Collaborative sourcing and spend aggregation across portfolio companies

Collaborative buying consortiums, such as Group Purchasing Organisations (GPOs), can enable more effective management of indirect spend. Firms like Blackstone, KKR and TPG have saved millions through GPOs such as Core-Trust, harmonising prices and terms on cross-sector categories such as hardware and office supplies. Investors such as 3G Capital and Danaher have unlocked value with leveraged procurement, creating a 'capability stack' including on-demand spend visibility, volume aggregation, ZBB policies and IT-enabled end-to-end buying processes. In-house procurement teams are essentially paid for by supplier rebates at no cost to portfolio companies, and – if aided by a robust PE mandate and management buy-in – can deliver double-digit return on investment (ROI).

'As-a-service' business process outsourcing (BPO)

Sales, general and administrative activities are by definition not core to revenue-generating operations, which has made BPO a mainstream choice since the discipline's emergence in the 1980s. In general, PE firms don't aggregate spend and contracts across portfolio companies, to avoid untangling messy contracts that can slow down transactions and make exits more complicated. However, outcome-based outsourcing deals can help deliver on value creation targets while mitigating the risks of in-house centralisation. Three- to five-year outsourcing arrangements can help PE firms capture full profit and loss (P&L) potential during their ownership period, and as with so many other areas of business, 'as-a-service' BPO infrastructure is making the outsourcing process easier than ever before.

Whether or not to outsource indirect procurement is a nuanced debate with different pros and cons, but indecision can result in stagnation or actually erode significant value. If the business case for internal indirect procurement improvements appears unconvincing, PE firms should be bold and push management to outsource spend to BPO players specialising in indirect procurement, such as 4C Associates, which can deliver benefits on gain-share basis besides faster capability build.

Procurement value innovation is increasingly on the executive agenda

As we enter 2021, procurement is being discussed in more boardrooms than ever before. Forward-thinking PE firms and management teams are keenly aware of the connection between procurement and other top-table agenda items like sustainability and corporate social responsibility. As COVID-19 continues to bring about financial and operational disruptions, procurement's contribution to supply chain resilience and broader risk management is likely to continue to grow.

Value innovation (see Figure 3) is key to building high-quality procurement capability. Careful examination of supplier contracts is just the start: actively managing supplier relationships and seeking greater collaboration on mutually advantageous performance indicators can deliver significant added value. Thinking creatively about software assets and evaluating whether per-user license or enterprise-level licenses will deliver better value is just one example of this kind of process.

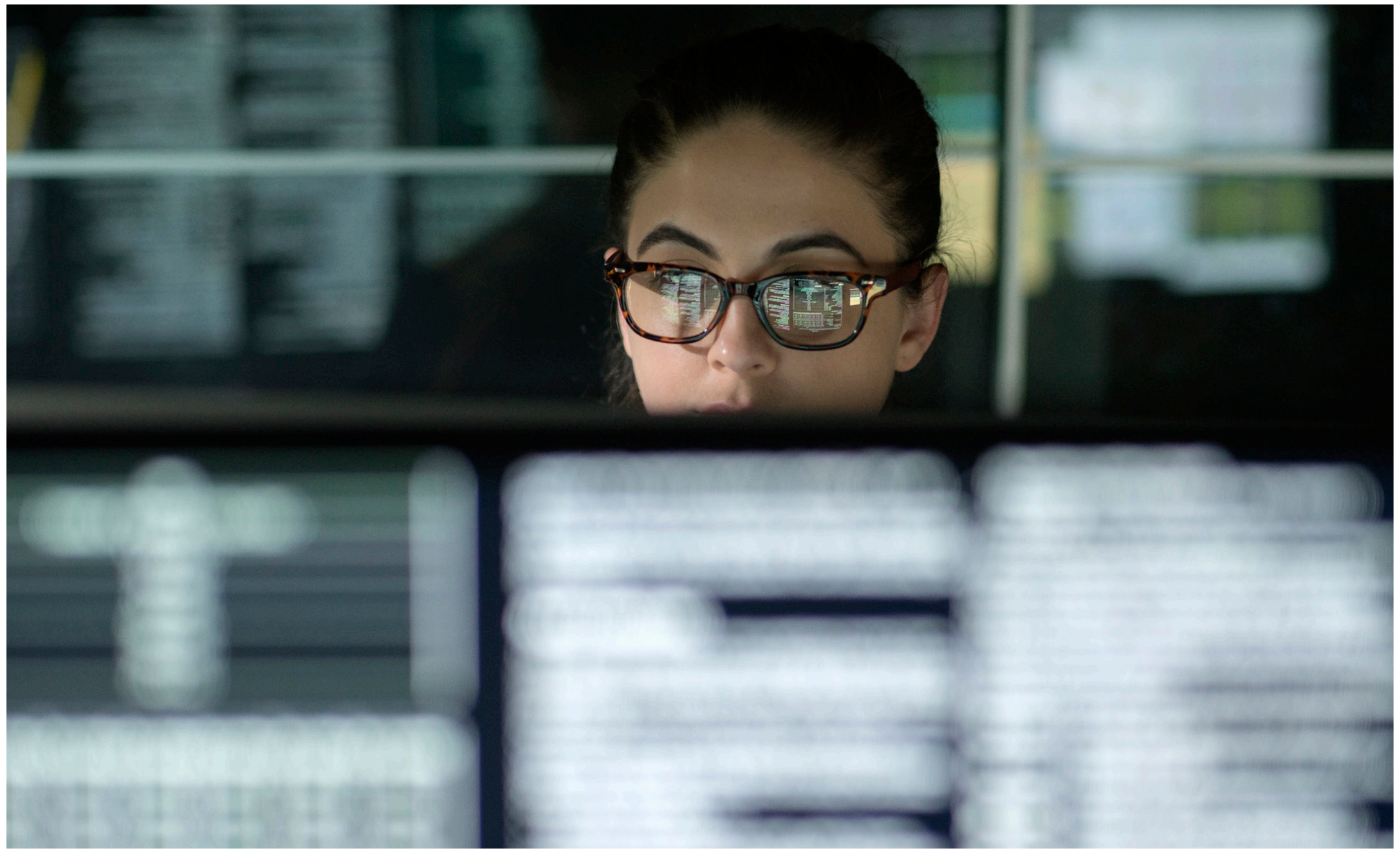
A variable cost base can be a valuable hedge against volatility, and procurement functions have an important role to play in creating increased cost variability within contracts. A&M has worked with many PE-backed companies to renegotiate and optimise complex supplier contracts.

Figure 3: Various value innovation dimensions of procurement beyond cost reduction

Indirect procurement through the investment lifecycle

PE firms can leverage procurement opportunities through the pre-deal process, as part of an operational performance improvement during the ownership period, or when preparing for exit. A few key trigger events should be viewed as catalysts for a fresh look at indirect procurement (see Figure 4).

Figure 4: Trigger events and subsequent value creation pillars.



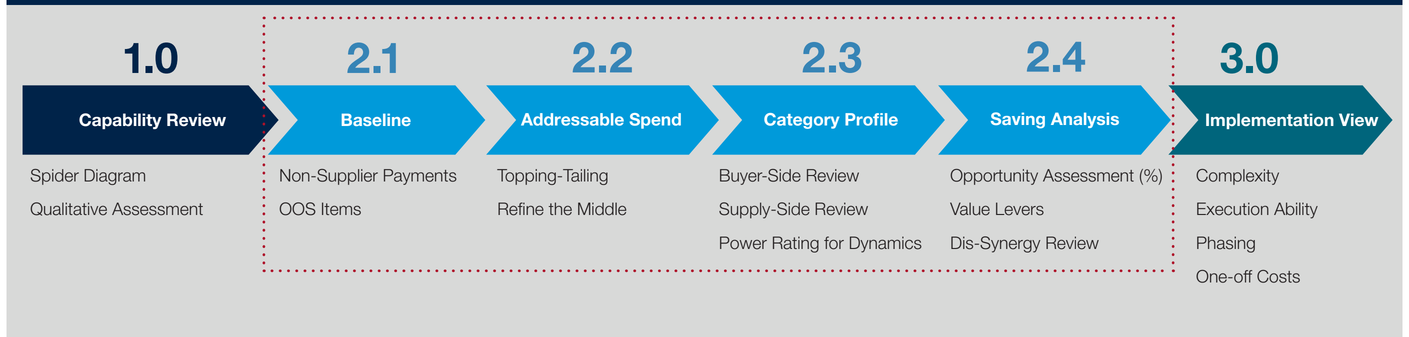
Pre-deal procurement due diligence

Given both speed and quality are critical to a due diligence process, 'one size fits all' approaches don't work, especially when PE firms are concentrating on winning competitive auction processes. Indirect procurement is often a secondary priority for sell-side management, and a proactive approach on this front can be a powerful differentiator, particularly when dealing with mid-size targets (see Figure 5).

Comprehensive procurement due diligence should assess:

- **Spend** (getting a cost-centre view of who spends how much, on what, can be challenging and is a key gap in many analyses)
- **Maturity** of as-is capability (including organisation, process and systems)
- **Contracts** assessment (i.e. supplier performance and high value/low risk contracts)

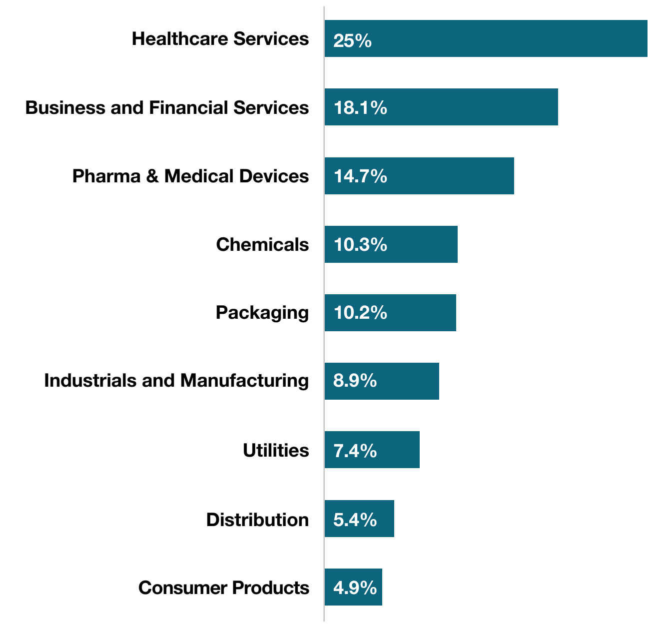
Figure 5: Our procurement DD is optimal blend of quantitative capability and quantitative spend assessment.



Pre-deal due diligence is a mix of science and art. If quantitative benchmarks are the science, expert judgment on value creation potential is often the art. For benchmarking to be most effective, PE funds must adopt a standard category taxonomy on procurement spend. Be aware: comparing within a given sector may encourage management to rest on their laurels. Comparing best-in-class performance across different sectors is the key to understanding 'what good looks like' for indirect spend (see Figure 6).

Figure 6: Intra-sector comparisons can be deceiving. Indirect spend is sector agnostic and cross-sector offer best view of as-is gap and potential opportunity

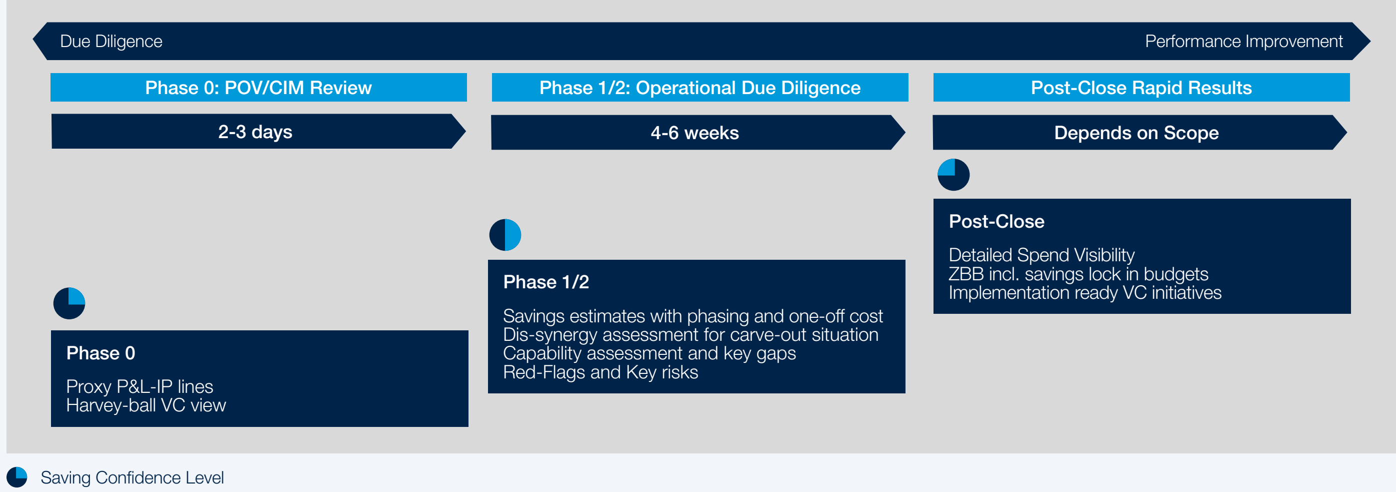
Average Indirect spend by sector (% of Revenue)



Post-close value enhancement

Confirmatory due diligence post-deal can help move the Value Creation Plan (VCP) from the deal room to the real world. In A&M's experience, the first 100 days post-close is perhaps the most important stage in the value creation cycle: locking VCP targets into functional budgets during this time period can deliver as much as 20% of all indirect procurement benefits. A successful first 100 days lays the groundwork for subsequent months and years in which organisations can realise the full potential of any procurement optimisation plan. See Figure 7 for a detailed overview of procurement activity milestones through an investment lifecycle.

Figure 7: Key indirect procurement activity milestones through the deal process and investment cycle.



Exit readiness and preparation

Managing procurement spend through an ownership cycle has widespread beneficial effects across the organisation (see Figure 8). Using savings to fuel an agenda that prioritises talent and digital can serve as a growth and margin multiplier for the procurement function as a whole. In the months before exit, A&M has supported many PE firms to deliver zero-based spending reviews, making sure that efficiencies can translate into strong EBITDA multiples on exit.

Figure 8: Indirect procurement across PE Investment lifecycle

Key challenges for PE operating partners

Although procurement is a fast-moving space, delivering productive change in indirect procurement is more complex than simply relying on existing teams and processes to get the job done. Existing dynamics within organisations can make it difficult for PE firms and management teams to find the required bandwidth to focus on the potential of optimising indirect procurement.

Elevate role of indirect procurement

Some CPOs and procurement teams focus predominantly on direct procurement, as spending that drives new business and impact can appear more 'business critical'. If indirect procurement is being neglected by internal teams, a balance needs to be struck.

Indirect procurement is challenging and matrixed: indirect spend can sit across multiple P&L lines and can be fragmented across sites and functions. If indirect procurement decision-making is delegated to functional or country heads, a disconnect can emerge between the CPO's agenda and that of other budget-holders. Generally speaking, the more functional stakeholders taking procurement decisions, the more value is left on the table. However, bringing best practice techniques to Chief Marketing Officers, Chief Information Officers and SVPs of Supply Chain can help them attack their spend categories whilst letting them retain ownership.

To remedy this, the Chief Procurement Officer (CPO), and potentially the Chief Financial Officer (CFO), should act as champions of the indirect procurement cause. Top-down steering from senior management can make a significant difference, including reducing 'shadow procurement' where budget-holders take decisions outside the permitted purchasing structures and thereby creating enterprise value.

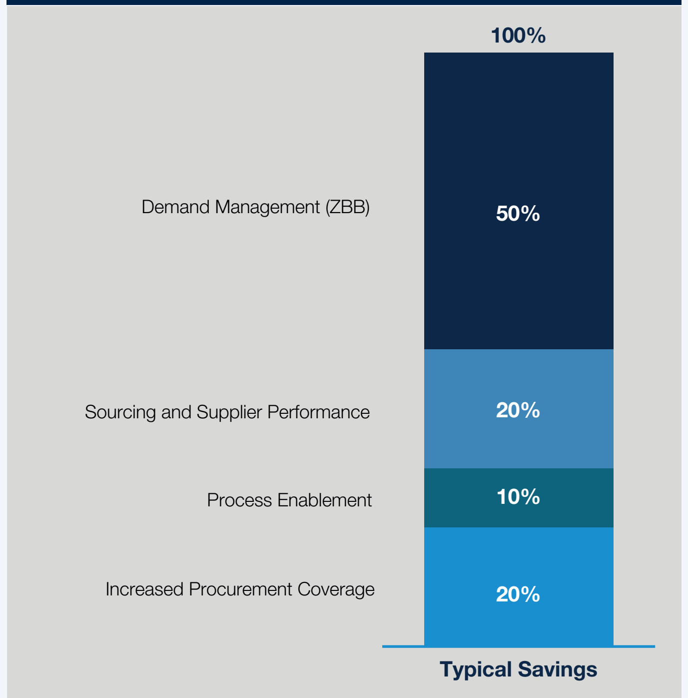
Demand: a reservoir of untapped potential

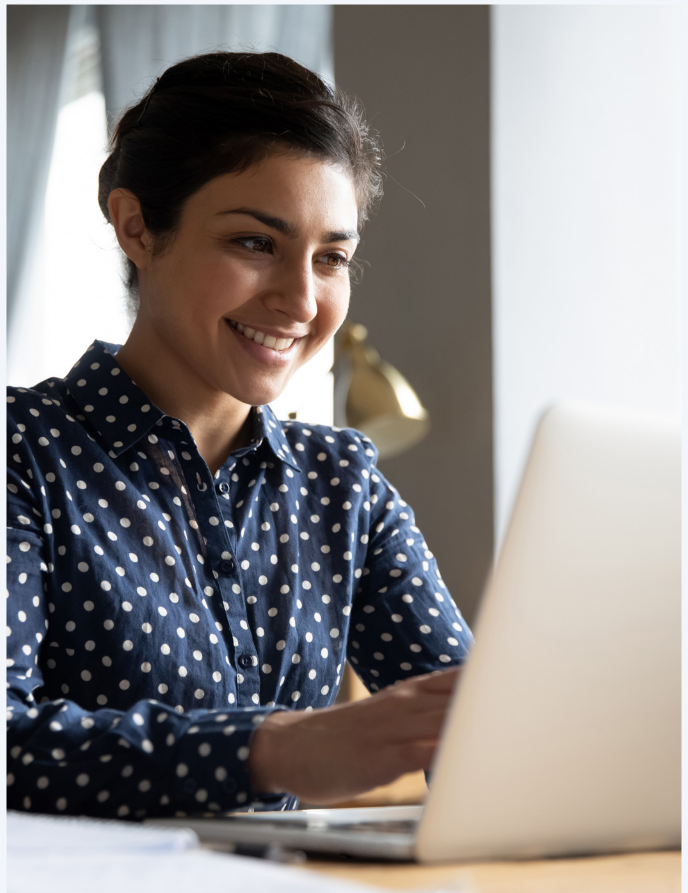
The supply side of procurement often captures most of the attention of procurement teams, but as much as 50% of all indirect procurement savings can stem from effective demand management (see Figure 9). Despite these rich opportunities, though, effective indirect demand management is almost non-existent or weak in most PE portfolio companies due to the following notable deficiencies:

- Low spend transparency in terms of unit price, volumes and specifications
- A disconnect between individual spending decisions and the overall strategic plan
- Inability to challenge spend drivers because of existing organisational dynamics and hierarchies

Most PE firms confess that ZBB is a game-changer to elevate their procurement game and is a best friend to CPOs who have adopted the category management framework. ZBB elevates CPO roles to the Executive Board and enables the CFO to drive spend transformation effectively. (Our white-paper on 'Pragmatic-ZBB' led cost transformations contains much more on this subject.) A&M's indirect procurement toolkit, tailored to the needs of PE firms, can deliver significantly faster & sustainable results with double digit ROI while building resilience against further shocks.

Figure 9: ZBB-led demand management can typically deliver as much as half of all indirect procurement savings.





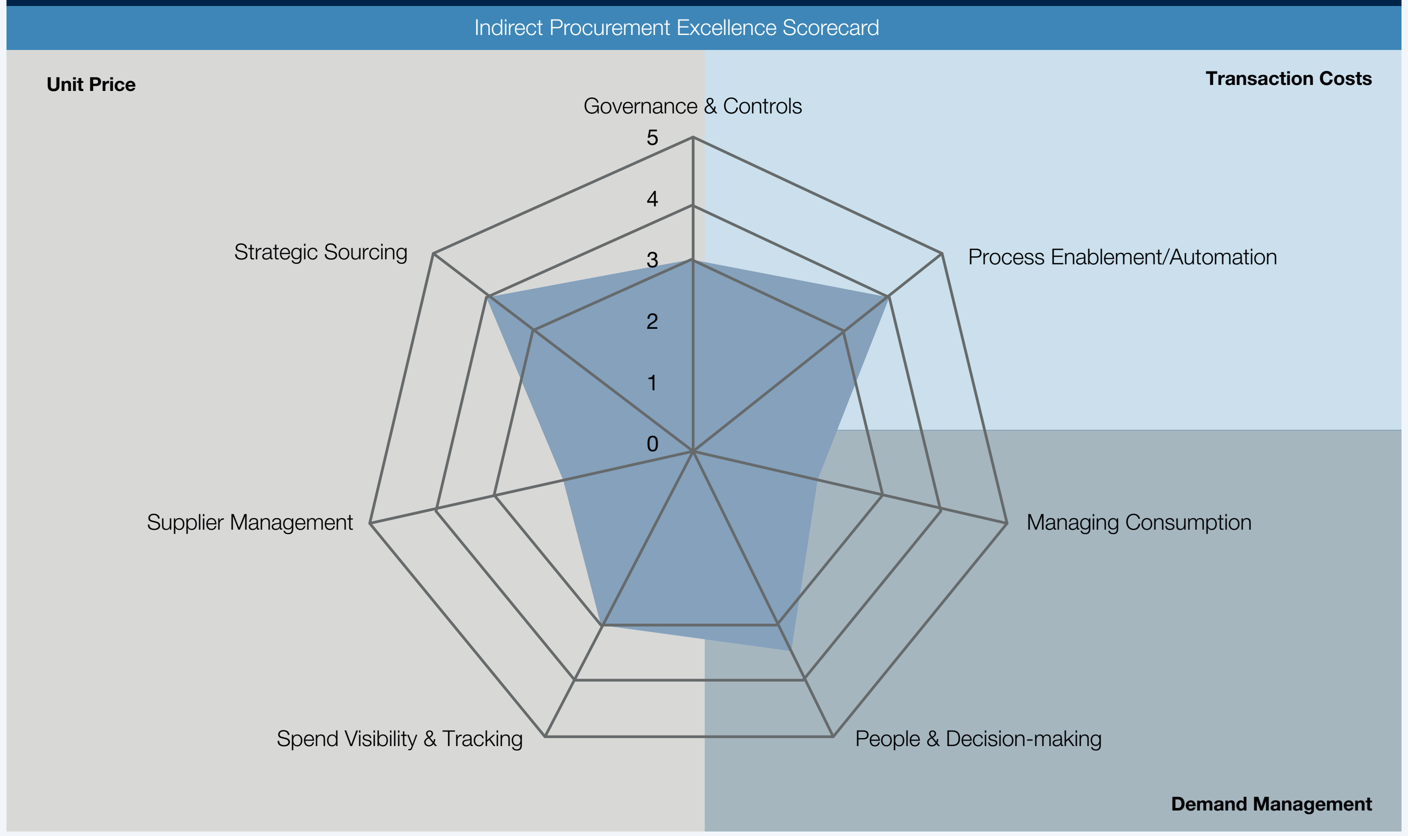
The PE operating partner's playbook

Indirect procurement is potentially a key lever for PE firms scoping value creation opportunities. However, several issues could define the degree to which PE firms can expect true transformation within the procurement function. The following insights are taken from conversations with PE operating partners:

- Hiring procurement 'A-players' can make all the difference. Many PE firms have begun to hire procurement operating partners or advisors who can identify the best route to manage spend for portfolio companies and act as trusted business partners to management
- Being able to understand the specific quirks of indirect procurement at a granular level is one thing, but achieving this across a portfolio can be exponentially more complicated.
- When approaching a deal pre-close, a lack of operational and category benchmarks can make it difficult to understand the true value creation potential from an indirect procurement transformation.
- Segmenting portfolio companies' suppliers into supplier relationship management tiers is another key indicator of advanced procurement. Most companies often have a few key partnerships with strategic suppliers and a 'long tail' of less business-critical, commodified relationships. In those situations, adopting technology enabled tail spend management tools such as Ariba allows category managers to focus on sizing and realising value.

There are a select group of capabilities that can act as a shorthand for excellence in indirect procurement (see Figure 10). Replicating the 'scorecard' demonstrated in Figure 10 may give clarity to operating partners seeking a more thorough understanding of their positioning.

Figure 10: An illustrative look at a benchmarking exercise specific to indirect procurement

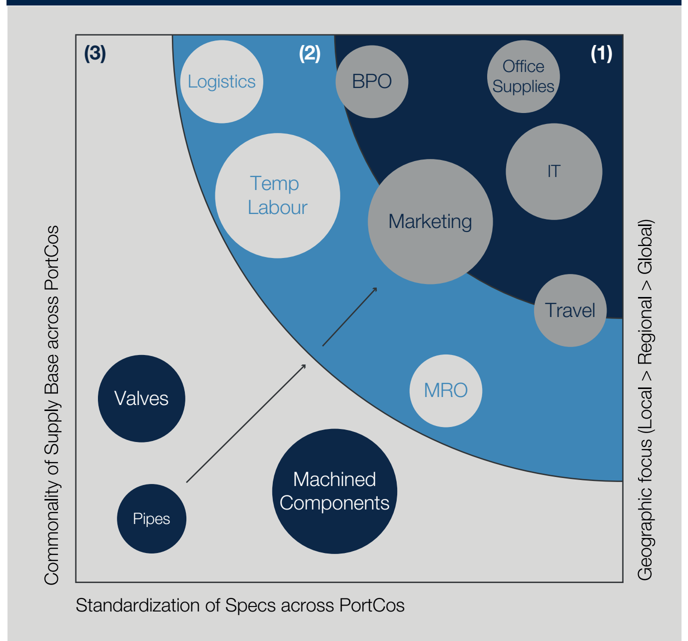


Conclusions

Best practice procurement comes down to finding money, getting money and keeping hold of money. As such, it can function as a central value creation pillar for PE-backed businesses. Optimising indirect procurement can help PE firms and their operating companies reap rewards and reduce portfolio risk. Although indirect procurement is sometimes seen as direct procurement's unglamorous cousin, EBITDA and margin improvements from well-planned procurement transformations are significant and – crucially – achievable within a conventional PE ownership period. Meanwhile, new tools and technologies make it easier than ever for organisations to obtain true visibility on spending and internal demand.

Cumulative portfolio market caps and revenues might put some of the largest PE players into the Fortune 100 on a hypothetical like-for-like basis. With the exception of some forward-thinking PE firms, few investors are currently focusing on portfolio-wide procurement efficiencies (see Figure11). We think that a deliberate emphasis on indirect procurement as a value creation pillar could deliver returns in what remains a highly volatile climate. We recommend that PE firms consider creating internal procurement teams to drive rapid adoption of 'cost-smart' mindset among portfolio companies.

Figure 11: Big opportunity for PE firms to size and deliver portfolio-wide indirect procurement gains



01 Portfolio-wide procurement value creation (global basis)

Typically "indirect" spend categories where all spend can be aggregated and sourced together. These opportunities are identified, quantified, and prioritized during the spend assessment.

02 Collaborative procurement in Targeted Companies (Regional basis)

Specific portfolio companies purchasing similar items can benefit from collaborating on leveraged sourcing.

03 Individual Company specific PI

Categories where the leveraged sourcing benefits are likely not enhanced by collaborating with other portfolio companies, yet significant opportunities for that company still exist.

A&M: Leadership. Action. Results.

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. We bring operating expertise to the table that helps PE firms and management teams rapidly build procurement capability and deliver sustainable savings, in and outside M&A contexts.

We place experienced operators (see Figure 12) at the core of all projects, bringing extensive experience as budget holders, functional leads, board advisors and strategic partners to PE firms across the whole investment cycle. Besides project led intervention, A&M also undertakes interim management roles, with practitioners simultaneously shaping transformation agendas as well as providing senior advisory leadership. This dual structure has delivered rapid P&L results at pace for PE investors.

Figure 12: Our procurement project teams are small but consist of senior operating advisors, who have proven 'Operator' credentials and deep expertise at each stage of PE investment lifecycle.

Key contacts

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ABOUT ALVAREZ & MARSAL

Companies, investors and government entities around the world turn to Alvarez & Marsal (A&M) for leadership, action and 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. When conventional approaches are not enough to create transformation and drive change, clients seek our deep expertise and ability to deliver practical solutions to their unique problems.

With over 5,000 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, leverage A&M's restructuring heritage to help companies act decisively, catapult growth and accelerate results. We are experienced operators, world-class consultants, former regulators and industry authorities with a shared commitment to telling clients what's really needed for turning change into a strategic business asset, managing risk and unlocking value at every stage of growth.

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