Unlocking the Hidden Value in Portfolio Holdings

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– Tom Klebeck, USCCG
Director of Finance and Administration

Private equity firms have been a significant driver of the economy in the past few years and have made billions of dollars from shrewd acquisitions in virtually every industry. However, with competition for deals rising, PE firms are challenged to achieve higher returns from ever more costly investments. To do so, they will need to make substantial improvements in the operations of the companies they hold in such key areas as productivity, asset utilization, cycle time, quality improvement, SG & A reduction, and supply chain optimization. This will not only be the case with poorly performing companies, but also, and especially, with those that are seemingly meeting their targets. By seeking improvement opportunities across their portfolios at every stage in their lifecycles – and working with their holdings' management teams to implement new operational practices and tools – PE firms can generate more cash from their holdings and make them operationally stronger to ensure they become even more attractive to prospective buyers when the time comes to monetize the assets.

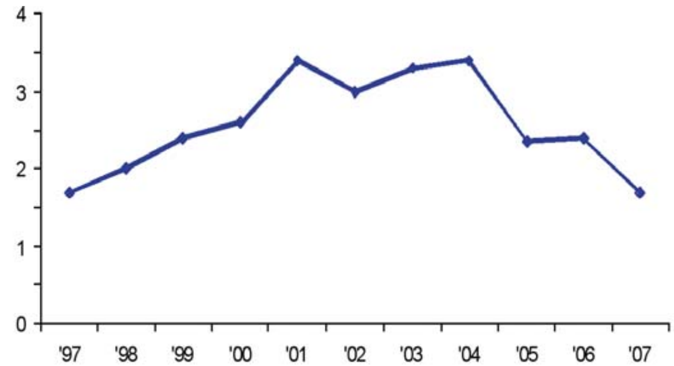
Today's more challenging PE environment requires a different approach to managing portfolio holdings, regardless of industry sector. A more detailed, disciplined, and adroit hands-on approach to operational improvement can pay handsome dividends at every stage of a firm's investment.

Historical Returns Will Be Harder to Sustain

As a whole, the private equity way of running businesses has proven to be hugely successful, both for investors and the growing number of companies PE firms have added to their stables. Over the past ten years, returns on investments in PE firms outpaced the S&P 500 index by more than 70%,[1] a track record that until recently, attracted vast sums of capital. In the first five months of 2007 alone, the value of companies acquired by PE firms has more than doubled from the same period in 2006, accounting for nearly half-a-trillion dollars in deals.[2] Some $281 billion in deals have been done in the U.S., more than triple from the year before and representing more than one-third of all mergers and acquisitions.

Until recently, liquidity had been plentiful, spurring greater competition for deals and boosting acquisition prices. Increasingly, this has ratcheted up the economic returns PE firms needed to achieve from each investment to reach targeted or customary ROIs. In fact, many of the more recently acquired companies carry a greater risk that their cash flows won't cover their debt service. S&P says companies bought by PE firms have watched cash-to-debt ratios fall 50%, from 3.4 to 1.7, in the past three years, a ten-year low.[3] Now, the problems in the mortgage market may squeeze buyout financing, which would require PE firms to slow new acquisitions and/or hold on to some companies in their portfolios longer. That further intensifies the pressure on PE firms to provide better support to the management of their portfolio companies to maintain performance for investors.

Interest Coverage Ratio



Cash flow divided by interest expense
Source: S&P's Leveraged Commentary and Data

Both scenarios imply that PE firms will have to dig deeper into the operations of their portfolio companies. We believe that PE firms have substantial opportunities to generate more cash from their holdings and make them operationally stronger, thus ensuring they become attractive buyout or public offering candidates when the PE firm decides to part with them. But doing so requires making operational improvements of the type that many, perhaps even most, PE firms have traditionally shied away from, preferring instead to focus on "structural" improvements that can have a huge (although one-time) impact.

- Strategic improvements — Selling off business units and/or divisions of a company that are not necessary for its parent company (and the PE firm) to own (e. g., Cerberus selling off Chrysler's financing division).

- Asset consolidations — Consolidation of plants, distribution and sales routes, data centers, and other costly assets; pooling purchasing power across a company's various divisions or multiple companies in the PE portfolio; and other moves that require little or no revamping of the operations that remain.

Money Left on the Table

Financial gains that can be reaped from improving work flows, reducing costs, and other aspects of the remaining operations, i.e., from creating efficiencies in company operations that are not sold off or consolidated out of existence, are often left on the table. For example, after PE managers consolidate the work of ten plants into six, the next questions should be: How could we design the operations within these six plants to make their manufacturing processes much more efficient? How can we lay out the plants differently to increase throughput and reduce costs to free up working capital? We routinely see savings of three to four times investment in operations improvement initiatives, which, with an asset valuation multiplier, means there is significant hidden value waiting to be seized.

One private equity firm we worked with saw an opportunity when it purchased three familiar, but somewhat neglected, food brands out of bankruptcy and formed a new company to revitalize them. It felt they had recently been under-managed, and offered a potentially lucrative return on investment if they could be turned around.

Following their investment, the new owners brought us in to improve operational effectiveness, in this case, productivity, throughput, and material yields. In short order, we mapped their production process from end-to-end, identified and attacked leading causes of capacity erosion, reviewed equipment settings, established optimal run parameters, and, finally, developed and implemented management systems to provide enhanced production control, throughput, and yield management. We then identified and eliminated nonvalue-added activities, streamlined processes, and defined and displayed key performance metrics at the point of execution. Asset utilization and material yields were improved and labor savings captured through the installation of a time-phased, capacity-balanced planning and scheduling system. This freed up working capital that was re-deployed in the holding to drive further improvement.

As a result, the food company was able to handle additional volume of current products, as well as incorporate new SKUs into an existing facility – delivering its private equity parent a substantial premium over its purchase price less than two years after acquisition.

Certainly, such gains can be hard to achieve. But PE firms can achieve them — and can do so in relatively short order — if PE managers are willing to think somewhat differently about their portfolio companies. In particular, they will need to seek operational improvements not just in their poorer-performing companies, but also in their newer acquisitions and well-performing assets, which they often leave alone if they are hitting their financial targets. But because such targets often are set based on past experience or historical performance, this approach can result in gains that fall far short of what the holdings could actually achieve. The financial possibilities are not fully understood until one determines what improvements could be made in a company's plants, distribution routes, warehouses, and other operations. They only become possible with acute visibility into the health of such operations, i.e., details about where waste, extra steps, errors, and process problems exist in a company's core operations.

Looking Beyond Structural Improvements

Sources of Cost Savings and Revenue Increases

PE firms' ability and willingness to make rapid structural improvements in their portfolio companies' strategies, operations, and management compensation have fueled enormous returns for investors and PE managers over the past decade. But the gains are becoming harder to get, and thus pulling the third lever -- operational efficiency -- is now a necessity for many PE firms.

However, this is far from easy. Four barriers typically stand in the way of many PE firms gaining operational efficiencies:

- Difficulty of identifying opportunities;
- Not wanting to interfere with the managers they've appointed to run their portfolio companies (whether new or existing) after setting their financial targets;
- Inherent complexities and risk to outcomes of achieving process improvements; and
- Extra headcount and cost of achieving desired outcomes.

To be sure, selling off divisions and combining operations in most instances entails less risk than pursuing operational efficiencies. Many PE managers we have spoken with say they don't have the knowledge they need to determine the extent of possible operational improvements, especially before they make an acquisition. As a result, they cannot identify — or don't know how to identify — those opportunities. Yet all deal-makers know that the more information they obtain before the deal about a target acquisition's financial health, the more successful the deal is afterwards (both in the price they pay and the structural moves they make).

PE firms need to know what operational information to request that will provide insights into potential operational efficiencies. And they need the right relationship with the target acquisition's management to obtain that information. Such information is obtainable, especially if management of the target company is in favor of the acquisition. But, information of this kind can seem foreign to many PE firms because of their financial orientation. PE managers are comfortable when operational indicators are aggregated, especially when that summary is attached to a dollar figure. But when operational indicators are rolled up to an aggregate level, they can hide significant variances in operating performance.

For example, a transportation company can report a 95% on-time performance across its divisions — i.e., shipments arrive on time to customers 95% of the time — and yet have much poorer on-time performance in one or more of those divisions, or in regions of those divisions. A great amount of operational reporting of variances (and thus identification of operational improvement opportunities) is hidden because of the way reports are aggregated and variances calculated. This is why it is absolutely essential to know where to look and to delve into the details underlying the macro-numbers.

The second barrier is one of management autonomy versus management effectiveness. Typically PE firms motivate the management team with incentives aligned to those of the PE firm by shifting greater parts of management compensation from salaries to ownership stakes. Sometimes this requires hiring new managers to run an acquired company (e.g., Cerberus Capital bringing in GE and Home Depot veteran Robert Nardelli to run its newly acquired Chrysler business). Other times existing management is left in place and new incentives and new measures are used to encourage new behaviors. As a result, PE firms believe the management teams they put in place to run their portfolio companies are the best ones to make operational decisions. For the most part, this is true. But, despite new incentives, those managers often are not equipped with new tools and information for identifying new ways of running their operations – whether those are plants, warehouses, sales offices, or other operations. Simply giving management some (or greater) ownership in their business is not likely to help them see their operations in whole new ways. PE firms want to keep their relationships with acquired companies supportive, but "hands-off." However, that leaves money on the table.

The perceived difficulty in capturing value from process improvements is the third barrier to gaining operational efficiencies. Most deals are underwritten with some degree of operational change baked in. But, because they often lack in-depth operations experience, many PE firms believe cost savings and other benefits from rethinking processes, as opposed to making structural changes (operational risk vs. capital structure risk), too problematical. They are concerned that the changes, and therefore the cost savings, will not be sustained or that costs will simply shift elsewhere and never materialize on the bottom line.

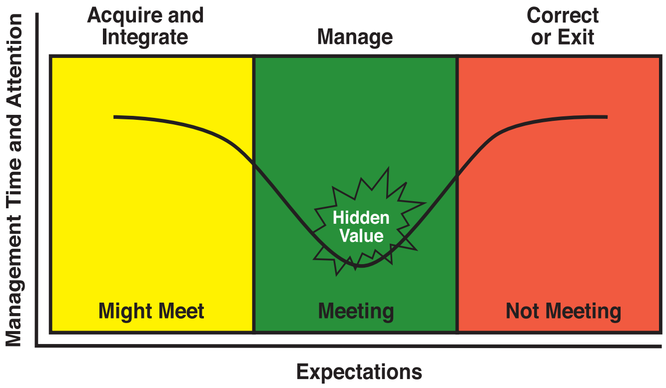
Working in partnership with one PE firm, we identified three ways to save $9 million in one of its companies. One way was closing excess plants, which would cut $3 million in costs. Another was in pooling purchases, which would ring up an additional $3 million in savings. The third opportunity involved making operational improvements in the surviving plants through reducing scrap, boosting throughput, and reducing the frequency of equipment changeover. Those moves had the potential to save another $3 million. But the PE firm was very unsure of whether the operational improvements could be generated and, so, passed on that opportunity and settled for the "more easily attained" $6 million.

The last barrier to operational efficiency is PE firms' reluctance to add headcount and cost to their operations to help ensure that the desired outcomes are achieved and sustained in their portfolio holdings. Many PE firms have limited operational expertise on staff. Some place an industry-experienced resource into the deal or on their acquisition's board to look after their interests, but, in our experience, there's no substitute for having "boots on the ground" – intensely focused, highly trained subject matter experts who know how things should or should not work and who have the ability, tools, and people skills to set them right. In our view, anything short of this is false economy leading to lost opportunity. Recognizing this, many PE firms are aligning themselves with outside management consulting resources to help them execute strategic initiatives or realize promised synergies without adding to overhead.

Targeting Operational Gains at the Outset

The pursuit of operational efficiencies doesn't have to be risky. The efficiencies can be secured without undermining the executive teams PE firms put in place to manage their

P/E Holding Life Cycle



portfolio companies. And they can generate some surprising benefits, both in the form of cost savings and new revenue that comes from accelerating manufacturing output and improving product and service quality. Unlocking value hidden in their holdings should complement structural moves (strategy, financial, consolidation, etc.) and give PE firms the tools they need to sustain their robust performance of the past ten years in today's challenging market.

Identifying operational improvements in their portfolio companies at each stage in their lifecycles will not only create greater returns from the existing portfolio, it also will enable PE firms to have much broader portfolios. By bringing operations improvement expertise into their acquisition due diligence process, private equity firms can reduce the risk of acquisitions — especially when acquiring companies outside of industries the PE firm knows well. This is particularly true of acquisitions whose historical performances are attributed to favorable market conditions rather than strong operations. If their market becomes more competitive or if market growth wanes, operational efficiency becomes a key competitive factor.

For example, a company we worked with manufactured and sold a high-end, high-margin product for home renovation. Its operations were inefficient, but that wasn't a problem at the time. After several years of strong financial performance, the company was purchased by a PE firm, which paid a premium for those stellar results, inefficiencies and all. But after the acquisition, the market for the product eroded and the company's financial performance suffered. Had the PE firm uncovered in its due diligence the operational shortcomings, it could have helped its acquisition boost efficiencies and better prepare itself for the eventual market downturn.

Missing the Forest for the Trees

It is easy to think that focusing on operational improvements will help PE firms primarily boost performance of the lagging companies in their portfolios. In fact, we have found that operational improvement initiatives stemming from detailed analyses can boost the financial performance (EBITDA) of better-performing companies by as much as 10% to 20%.

Take the example of a heating systems company owned by a PE firm. Company management knew they had an operational problem – customers received their orders full and on-time just 59% of the time. Believing the problem stemmed from a manufacturing throughput issue, the company (with advice and support from the PE firm) was considering a major expenditure to purchase a new paint system that would increase the availability of inventory. However, when they examined the operational problem more closely, they found a high frequency of partial order shipments that in itself was adding cost. When a customer put in an order for eight products, the company would ship available products even if all eight were not ready. That added to shipping costs — and increased the delay between the time the customer placed the order and the time it received the entire shipment. That lead time was unacceptable given that competitors offered much faster turnaround. As the company continued to investigate, it got to the source of the problem: plant supervisors preferred not to change over manufacturing lines frequently. That meant if the line for one product was running its course, the switchover to make another product had to wait.

The solution was instituting a factory program that made switching over to manufacturing other products far easier. It was done cost effectively and increased customer fill rates to acceptable levels. For sure, the PE firm had limited plant knowledge and would not have discovered the problem and solution on its own. But had managers in the heating system company chosen the route of equipment investment versus getting to the source of the problem, the result would have been significant capital outlay for new equipment, even greater inventories, and a decline in market share from continued customer dissatisfaction. Even portfolio companies at the late stage of their lifecycle (i.e., are close to being sold) can put more money in their parent company's hands through operational improvements. This flies in the face of many PE firms' philosophy, which is to avoid investing anything in long-held and soon-to-be-sold assets. Yet some operational improvements can generate short-term boosts to EBITDA.

The case of one PE firm, albeit unusual, is instructive. The company was trying to sell a small holding, a firm valued at $20 million. A $500,000 process improvement project identified an opportunity with significant payback. After the project was completed, the PE firm was able to sell the company for $24 million based on trailing 12-month earnings.

The Six Efficiencies that Lead to Operational Effectiveness

Private equity firms can unlock hidden value in their portfolio companies in six ways: productivity increases, asset utilization gains, cycle time reductions, quality improvements, SG & A reduction, and supply chain optimization. All of these can free up working capital, a result of achieving operational effectiveness. We'll explain each opportunity and where to look for it.

Six Key Sources of Operational Effectiveness

- Productivity increases
- Asset utilization gains
- Cycle time reductions
- Quality improvements
- SG & A reduction
- Supply chain optimization

Productivity gains come from many operational improvement initiatives, including process improvement, better asset utilization, and improved planning. Often a productivity initiative is a good companion project to consolidating excess capacity. In this case, productivity gains result from identifying and eliminating such semi-variable costs as maintenance, shipping and receiving, or from reaping process improvements from consolidated operations. One manufacturer consolidated its plants and generated major cost savings. However, it would have missed an additional $2.5 million in annual savings had it not pursued these process improvements in the surviving plants: reducing variations in equipment run speeds, set-ups, and raw material changeovers, in addition to improved plant capacity planning.

Improving asset utilization comes in two forms: equipment and inventory. By improving the way a piece of manufacturing equipment is operated, throughput can be accelerated. Rather than produce 1,000 widgets a day, it can now produce 1,300, which boosts revenue. Better plant equipment utilization can reduce the need for major investments in new equipment. For example, one window manufacturer was ready to spend about $4 million to improve four manufacturing lines. Instead, the company improved the productivity of each line at far less cost. It was able to produce more than enough capacity to meet demand — and without having to spend that $4 million.

And, take the case of Ford's sale of car-rental company Hertz to private equity in 2005. Within the first year of ownership, the Carlyle Group; Clayton, Dubilier & Rice; and an investment arm of Merrill Lynch brought in Mark Frissora as the new CEO. One of his first initiatives was to send a team of operations managers to O'Hare for a "waste walk-around." The group evaluated every aspect of the rental operation. By changing the layout of cleaning stations and streamlining the steps in the cleaning and refueling processes, Hertz doubled the number of cars it could process per hour – thereby improving asset utilization and reducing the overall number of cars needed in the fleet.[4]

Inventory also can be less of a burden. Companies can reduce inventory costs by accelerating inventory turns or using less inventory to achieve the same volume of sales. There are numerous examples of companies that are "operationally" out of balance, where excessive investments are made in inventories whose volumes are too low, as well as too little investment in inventories whose products are in short supply. Balancing inventories to match demand can free up 20% to 40% of inventory investments and shift working capital to other areas of the business.

Cycle time reductions are the third type of operational efficiency. These can come in the manufacturing and distribution processes. An appliance manufacturer, for instance, may have 500 SKUs that it sells to a big-box retailer like Home Depot or Lowe's. The retailer requires a very high in-stock position on all 500 products. If improvements in manufacturing and distribution can cut an average cycle time from, say, 17 to 10 days, huge amounts of costs can be extricated from those processes by accelerating order-to-cash velocity. These are the costs required to make the product and the cost of keeping excess inventory (i.e., "buffer" stock) on the shelf to please customers and the retailers.

The fourth type of operational efficiency is quality improvement. Reducing process variation leading to over-fill and other forms of giveaway improves material yields. Reducing the number of product defects cuts warranty costs and claims. It also reduces rework and scrap in the factory. Further, poor-quality products erode a company's brand equity, which means the company has to spend more on marketing to reassure consumers that its products are good. The best places to identify quality improvements are not at the end of the manufacturing line, but, rather, in the line and in the engineering and design of products.

Reducing sales, general, and administrative (SG & A) expenses, along with manufacturing overhead, is the fifth key area in which to improve operational results. Organizations evolve over time and layers of duplicate or unnecessary management grow roots that are hard to eliminate. A company can add considerable cash to its bottom line by identifying and quantifying opportunities for reducing indirect labor, duplicate structures, and overhead, and institutionalizing best practices with technology. Often times, the relationship of manufacturing overhead plus SG & A to such direct costs as materials and labor shows that these nonvalue-adding areas provide a significant opportunity to improve profitability. However, cutting for the sake of cutting or mandating across-the-board reductions, for example, might damage important functionality. Rather, carefully applying the same disciplines of process measurement and evaluation of waste can target areas for reduction without harming the core business.

Finally, optimizing the supply chain to increase supply chain velocity (order to cash) and overall enterprise throughput can be accomplished by rationalizing supply chain requirements; improving procurement (spend management) practices; optimizing cycle and lead times across the supply chain; implementing systems and processes to help manage and control work; developing effective linkages between each of the supply chain nodes; streamlining logistics; improving customer service; and developing meaningful metrics.

Achieving Operational Efficiencies

Clearly these operational improvements can have a solid impact. But all require the PE firm to have the ability to drill down into the operational details of the holding, know what to look for, prioritize and quantify the opportunities, and implement change.
PE firms must be able to look into their businesses at multiple levels: plants, manufacturing lines, SKUs, and so on.
This requires establishing and using a set of key operational metrics that will provide real-time visibility to the state of operational performance. These metrics could include such things as "attainment to schedule" (adherence to manufacturing, shipment, and other schedules), labor productivity, downtime, and scrap volumes.

But setting the metrics is not enough. Executives also must put into place the discipline for reaching those metrics and hold management accountable for attaining the goals. Having the PE firm and company managers jointly create such a dashboard of operational metrics will encourage the right behavior and discourage the wrong behavior, which is hitting financial targets by taking shortcuts in operational performance.
When one PE firm was trying to sell one of its companies, the buyer agreed to a price (a multiple of earnings at the end of the fiscal year) and a time: one year out. The PE firm and the management of its holding were obviously motivated to rapidly improve earnings, but the PE firm worried that its holding might make cost reductions that could erode product quality, customer-order fill rates, and customer satisfaction. So, it brought in a third party to help set up an operational metrics dashboard to ensure product quality and customer satisfaction while pursuing operational improvements. The work cut $1.7 million in nonessential labor and material. The company's earnings rose and its customer performance improved. Based on the company's increased earnings, the buyer wound up paying 20% more than originally offered.

Beyond metrics, PE firms also must give their company managers the right tools, information systems, processes, and coaching to meet their new performance objectives. We refer to this as changing the management operating system. But this is not just about getting new information systems. It involves formal tools – computer systems, for example – for capturing, analyzing, and sharing information, as well as informal tools like meetings, sharing of methods, and so on. It requires reviewing and possibly changing all the tools through which managers understand and manage the flow of their materials and products – from the moment a customer places an order to the time he actually receives it – across their entire supply chains.

Upgrading a management operating system may require changing the physical layout of a manufacturing product line or redesign of an administrative process, e.g., how orders are taken. It always requires teaching people how to operate in a new process and use the new information and other tools they get to do their jobs. Too many companies focus only on training managers and supervisors on how to improve their performance without changing the fundamental work in their departments – the factory floor, the order fulfillment function, the warehouse, the customer service center, and so on. Training managers without changing their work environments and measurement mechanisms is largely futile.

Pulling the Third Lever

The business climate has become more intense for all private equity firms, such that they will need new weapons in their arsenals – strategic moves (selling off business units), consolidations, management incentives, and operational gains – to continue their stellar performance. Those that focus on making operational improvements, in addition to structural moves, may find their portfolio companies performing beyond their wildest dreams, boosting the returns they can generate during their stay and after they leave the PE fold.

1 According to Thomson Financial as quoted in an article in ***Fortune*** magazine, "Private Equity, Private Lives," Nov. 27, 2006.
2 According to ***Business Week***, "The Private Equity Effect," June 5, 2007, the value of companies acquired through buyouts in the first five months of 2007 has more than doubled [from the previous year] to $487.2 billion.
3 From Standard & Poor's Leveraged Commentary & Data, as quoted in a ***Wall Street Journal*** article, "Boom Aside, Not All LBOs Look so Hot," June 8, 2007. The article said the ratio is at a "10-year low and shows how the margin for error for companies is shrinking as their profit growth is slowing."
4 "Is Private Equity Giving Hertz a Boost?," ***New York Times***, September 23, 2007.

About the Authors

George W. Coffey,
President

George Coffey, in addition to his overall management responsibilities, works closely with the investment community, including private equity and investment banking, as well as seeking and negotiating possible acquisitions to enhance USCCG's product offerings and fuel its growth. He currently chairs the Strategic Planning Committee and is a member of the company's Executive Board with responsibility for policy matters.

George began his career with USCCG in 1978 as a project consultant in operations. His responsibilities grew with appointments to project manager, operations manager, business development executive, and regional manager/analyst. George became a partner in 1989, an executive partner in 1995, a senior partner in 1999, and president in 2006.

Tom Klebeck,
Director of Finance
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Tom Klebeck is responsible for broad financial oversight of USCCG's activity, as well as targeted financial analyses for specific clients.

Tom was most recently a financial consultant for VantagePointe Solutions in Orlando, FL. He also founded three successful companies, including a real estate development and investing company. Prior to that he spent 12 years with Equifax in Tampa and Atlanta, where he rose through various controller and vp-finance roles to become vice president of operations. He was also a founding officer of the firm's multi-billion-dollar information services spin-off, ChoicePoint. Tom has earned a solid reputation as a fierce cost controller and profit improvement specialist.

About USC Consulting Group

USCCG is an independent operations management consulting firm with nearly 40 years' experience in business performance improvement. It combines extensive subject matter expertise with enabling technology to drive and sustain superior results. The firm offers an array of services that include Six Sigma, Lean transformation, supply chain optimization, process improvement, project management, value stream mapping, training and facilitation, blended learning solutions, and modeling and simulation.
It includes many private equity sponsors among its clientele. USCCG is a Microsoft Managed Partner headquartered in Tampa, FL, and with offices in Chicago and Toronto.
For more information, visit www.usccg.com.

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