Private Equity's Value Creation Secrets, Herb Engert, EY, June 2014

Imagine if your largest stakeholder knocked on your door and demanded that you make operational changes because your back-office strategy was lagging behind that of your peers.

What would you do?

Perhaps the better question to ask is, what would a private equity (PE) firm do?

In this situation, a PE firm would likely:

- Conduct a short assessment of spending and resource allocations
- Use zero-based budgeting or other techniques for longer-term alignment of the business cost structure
- Identify and prioritize opportunities to eliminate redundant and inefficient activities, outsource non-value-added operations, optimize essential operations and adjust management talent

These approaches are worth considering, given PE's performance track record. According to a recent EY study of 230 PE-backed portfolio company exits executed between 2006 and 2012, PE-backed companies exhibited EBITDA growth of approximately twice the rate of their publicly traded peers.

Creating value, the PE way

PE firms focus relentlessly on value creation throughout the entire investment life cycle, even before their initial investment is made. Their insights are formed based on identified issues and upside opportunities, such as margin enhancement and revenue growth.

Those insights, in turn, are used to develop a handful of targeted performance improvement initiatives, such as improving margins by strategically sourcing key commodities.

Building a road map

PE firms develop a road map that details key activities; highlights expected results; assigns responsibilities; identifies key milestones; and develops key metrics and dashboards for tracking performance. Quick wins are accomplished as early as possible to gain stakeholder confidence for the mission ahead and to generate cash to fund longer-term investments.

Developing a value-creation framework

Value is created by leveraging a comprehensive framework to translate the investment thesis into results. This may consist of:

- Developing plans to address strategic requirements
- Determining, prioritizing and implementing key value drivers
- Establishing key enablers (i.e., people, processes and systems) to make a permanent shift in performance

Key value drivers include high-impact operational improvement initiatives to drive revenue enhancement, margin improvement and capital efficiency.

Enhancing revenue

Revenue growth can be achieved either organically or through strategic add-on acquisitions. For sustainable revenue growth, product strategy and capital strategy need to be tightly aligned.

Once a company has defined its key business strategy drivers (such as market trends and growth regions), it needs to assess current product line profitability and growth and decide on future investments or rationalization opportunities. The company must also evaluate its sales approach, whether it uses a direct-sales model or a third-party distributor.

Improving margins

PE firms know how to cut excess costs and improve margins. They focus on reducing non-value-added processes (such as accounts payable/receivable); simplifying core processes (such as supplier qualification and cash management); and optimizing high-value-added processes for competitiveness (such as product-pipeline management).

From a profit-and-loss standpoint, a combination of plant rationalization, strategic sourcing and logistics cost reduction can improve cost of sales, while outsourcing or moving to a low-cost shared services model for back-office operations can improve operating margins.

These measures can take time, and PE firms typically make short-term investments to achieve longer-term objectives.

Creating capital efficiency

PE firms focus on improving working capital, releasing cash and quickly optimizing the capital structure of their businesses. For example, they try to carefully track inventory throughout the supply chain to reduce disconnects between sales, manufacturing and supply chain.

They also consider opportunities to sell and lease back fixed assets to free up valuable cash flow.

Achieving the ultimate goal — performance management

Companies can adopt a value-creation strategy based on industry dynamics, company size, global presence, resources, governance, quality of business processes and shareholder expectations. While non-PE businesses do not have some of the built-in advantages of PE, they can still learn from PE practices.

Ultimately, the goal is to manage performance instead of having to react to shareholder activism.