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ADDING VALUE

Through Technology

/ Leveraging Portfolio Data

WITH EXPERTS FROM:

Partners Group

Sentinel Capital

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About Privcap
Privcap is a digital media company that produces events and thought-leadership content for the global private capital markets. Privcap offers communications services to market participants.

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Knowledge Is Power

The most popular jargon in the private equity industry may be "the dashboard"—the array of indicators that track portfolio company data, allowing the private equity investor to properly steer the value-creation flight.

It's so important to hit the ground running at the outset of a deal that many PE firms have a fully operational dashboard before a deal closes.

This report looks at the differing approaches that private equity investors take to creating and using the dashboard. Even where private equity ownership does not include majority control, the financial sponsors usually have guaranteed access to information, making the asset class unique in its ability to deeply understand the performance of its assets. The report asks the questions: What kind of information do the most sophisticated investors want, and how do they use it?

One of the case studies you'll read about involves a private equity firm— Partners Group—that took a deep dive into the sundry expenses of one of its portfolio companies and discovered a significant spend on pagers, those relics of 1980s telecommunications. The lesson here is that Partners Group undertook this analysis not out of a need to cut costs at a struggling portfolio company. In fact, the company was growing quickly and in fine financial health. The effort was part of a portfolio-wide strategy of financial fine-tuning designed to eke out points of return—a performance-enhancing endeavor for which a well-designed dashboard is essential.

A dashboard can indeed be useful in discovering "rogue" expenses. But more importantly, it helps a private equity investor determine the extent to which a painstakingly crafted plan for value creation is being properly executed.

Enjoy the report,

David Snow
@SnowsNotes

‘Paging’ Mr. Cost Savings

Although its portfolio company was growing strongly, Partners Group didn’t hesitate to realize extra value by scrutinizing relatively small expenses

Lane McDonald
Global Head of Business & Financial Services, Partners Group

Private equity investors are fond of saying they “get their hands dirty” working closely with portfolio company management to improve operations. And yet, in reality, all are happiest when the companies seem to grow themselves and the job of creating value is, shall we say, easy.

It’s not surprising, then, that a private equity firm may forget to reach for its full value-add toolkit when growth is robust. After all, who wants to squeeze out nickels and dimes when dollars are flowing in?

Partners Group does, says the firm’s global head of business and financial services for its Industry Value Creation team, Lane McDonald. In an interview with Privcap, McDonald tells the story of a portfolio company that greatly benefited from a cost-savings plan, adding precious points of return to an investment that was already a home run.

Privcap: Can you think of an example of a deal that benefited from a careful analysis of expenses and a resulting plan of action?

Lane McDonald, Partners Group: I’ve never seen a company where there wasn’t an opportunity to pick up a few pennies and dimes on the ground; you can always run a little tighter, a little more efficiently. We had one world-class, top-line focused leadership team whose revenues had grown extremely quickly through organic and acquisitive growth. Typically, managing such growth usually takes up the bulk of management’s bandwidth, meaning there may be even more of an opportunity to tighten up. The pace of growth in this case was a signal to all of us that there was probably at least a point or two of efficiency or integration EBITDA that we were leaving on the table.

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>
> –Lane McDonald, Partners Group

The Database of Destiny

Partners Group tracks its many value-creation plans across its global middle-market portfolio in a custom-built system called the Primera Database. According to McDonald, the firm has as many as 150 separate projects being tracked at any one time.

Members of the firm's Industry Value Creation team are primarily in charge of updating Primera and tracking the many company-level initiatives and KPIs.

The most important indicators vary from industry to industry. McDonald gives the example of early-childhood education, a sector in which Partners Group has invested.

"Employee engagement, teacher churn, and parent scuttlebutt—for lack of a more technical term—are really the first signs that something weird is going on at a center. Our job at IVC is, per company, per geography, to identify what the leading indicator is, because financial performance is very much a lagging indicator, and you've missed some signs along the way by the time that EBITDA starts to fall."

During our onboarding process, we decided to bring in an entry-level, right-out-of-college expense expert just to focus on field expenses. Within the first week, this person found that the company had been spending $30,000 a year on pagers.

Pagers? Was this in the '80s?

McDonald: This was two years ago! We were shocked. What? We're spending $30,000 a year on pagers? And, with a fine-toothed comb, we discovered a few things like that. Not inappropriately, the company had just paid its bills and focused on growth, but with a little extra effort, the expense professional found $400,000 worth of redundant expenses within his first year. The company had been moving so quickly that it hadn't had time to really stop and breathe and take a look.

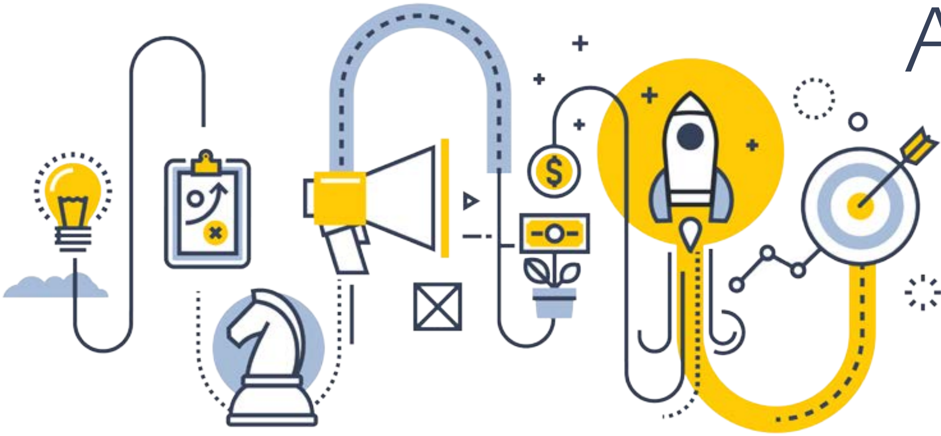
Did the cost savings have an impact on the performance of the investment?

McDonald: Our job in the Industry Value Creation team is to constantly be looking for that next level. And frankly, for the companies that are doing better, the efficiencies you can gain are that much more powerful, because quickly that $400,000 in cost savings that you found will multiply by eight, nine, 10, etc. when you exit, depending on your multiple. We ended up putting a larger program in place before we exited, and we found around $11M of cost savings all told, which, when you multiply it by the multiples that companies are going for these days, quickly becomes "real money." So that's the benefit of having a playbook of tactics that have paid off with other types of companies.

Beyond expenses, what's another example of a value-enhancer that can be applied across portfolio companies?

McDonald: Pricing. With the advent of big data, the knowledge of customers has changed dramatically—be they B2B or B2C. There's a lot of interesting things that you can do to flip the pricing equation on its head, to really make it a conversation about value rather than just a conversation about "Here's how much it costs to make and here's my markup."

We've done a lot of projects around the efficiency of pricing, to pull that more through the revenue side. In partnership with the management team, we figure out what will be most impactful, what a company can digest, and what the field will adopt.



Adding Value at Sentinel: An Operating Partner Perspective

Building relationships with the portfolio management is crucial for adding value

At Sentinel Capital Partners, complexity is an opportunity to add value.

To do so, Sentinel, a private equity firm that invests in lower-middle-market companies, deploys operating partners to help drive performance improvements within the portfolio. Steve Cumbow is one of them.

"As an operating partner, the only way to make a difference is to be out there [with the portfolio company]," he says. "To create value, you need to partner with management, establish capability and trust."

Sentinel focuses on eight industry sectors, including aerospace/defense, businesses services, consumer, distribution, food and restaurants, franchising, healthcare, and industrials. Whatever the industry, one of the primary ways Cumbow and other operating partners create value is by streamlining operational processes.

"It could be that purchasing functions aren't synced with planning, leading to shortages or excess inventory," he says, "or that a company's sales force needs to be better aligned to service key markets, or it needs to upgrade its IT infrastructure. It could take many different forms."

Sentinel utilizes a dedicated third-party forensic and accounting team that helps new companies on board and standardizes their financial reporting to ensure it's compliant with the firm's standards. A process that often needs improvement, especially in challenging situations, is working-capital management. The firm's operations team works with the portfolio company to cut the collection times, assess inventory, and renegotiate vendor agreements to improve cash flow.

The dedicated third-party forensic accounting team issues monthly portfolio performance reports that pull together portfolio-specific metrics, such as restaurant sales, as well as financial metrics, such as EBITDA, free cash flow, and balance sheet metrics. Sentinel also uses this data to benchmark one portfolio company against another.

On the expense side, the firm uses customized ERP solutions—and the forensic team—to consolidate expenses, compare trends, and secure volume discounts on a variety of spend categories including communication, health and property insurance, and technology.

Each portfolio company is free to use whatever software provider it deems best. Sentinel itself mostly relies on custom-made software and Excel-driven techniques to track the spend.

For industrial businesses, Sentinel looks to optimize manufacturing utilization and capacity. This can involve rationalizing facilities and either on- or offshoring. Sentinel is seeing a resurgence of interest in U.S.-manufactured items. A lot of customers are now eager to buy products made in the U.S.A.—whether or not it's the lowest cost, says Cumbow.

Another way to help the business grow is through acquisitions. Before acquiring another firm, a company needs to have IT and management operating systems in place that can easily integrate with a target company's existing infrastructure.

Chase Doors is a good example. Under Sentinel's ownership, the company completed two add-on acquisitions. In August 2011, it bought Chem-Pruf, the gold standard in corrosion-resistant doors. In November 2012, Chase Doors purchased Eliason, the leading provider of impact traffic doors to the restaurant industry. The company integrated these acquisitions prior to Sentinel selling Chase Doors in 2014. ■

Is Your Plan on Track? Use a Dashboard

Middle-market GP Argand Partners uses customized data to track whether its portfolio companies are headed in the right direction

Having spent decades investing in private companies, Howard Morgan knows the winning feeling when a plan is well-executed. He also knows the sinking feeling when it isn't.

So when evaluating investments for his relatively new private equity firm, Morgan crafts painstaking 100-day and medium-term strategic plans. This discipline includes tracking a mountain of data about the underlying operations and looking for evidence that goals are being met. It also helps in understanding when operational intervention is in order.

Morgan, the former president of Castle Harlan, who, along with former colleagues Tariq Osman and Heather Faust, founded Argand Partners in 2015, says the best private equity investors start tracking key performance indicators early. "We would want to start to work with management… even before we're given the keys," he says.

Like many firms, Argand creates customized dashboards for each portfolio company. Portfolio management reports core data on a monthly basis and more comprehensive data quarterly.

"Too often financial reports are forensic, so we try to develop reports about what is happening on that day and what actions can be taken in the weeks following to improve, even if the company's beating budget," says Morgan. "We monitor cash and liquidity, for sure, but also backlog, unused capacity, plant loading, sales activity, sales calls. It's quite customized."

Howard Morgan
Partner & Senior Managing Director,
Argand Partners

Morgan says he focuses on some granular day-to-day activities that public company reports would never include. "One of the unusual practices, but which we feel is a best practice, is tracking direct cash flow, which is literally receipts and disbursements. Accrual accounting can hide a lot of things, but it ought to always reconcile back-to-cash accounting."

PROMOTING GROWTH, TRACKING EXPENSES

Outside of distressed investing, private equity investors rarely say they focus first on cutting costs at a portfolio company. Instead, they focus on growth strategies that can transform the fortunes of the company. Argand falls into the growth camp. "More often than not, we are adding resources to sales and marketing," says Morgan.

That said, carefully tracking budgeted and actual expenses can help an investor better understand strategic priorities and how well value-add plans are being executed.

Says Morgan: "I can recall an instance where management was recommending a new advertising program. We were very, very enthusiastic. But their numbers seemed conservative. When we asked them why…they bluntly said that if it was any more, it might negatively impact their bonuses. We said, 'Okay, well, we can fix that. We'd like you to double the program.'"

Once a plan of action has been set, Argand will use its dashboard to track whether the desired goals are reached. It's not as simple as one metric or one cost cut. Tracking travel spend, for instance, can be useful, but does not necessarily act as a leading indicator of sales.

"Certainly, you know, there have been instances where cost containment is penny-wise and pound-foolish. You need to see the client and put that in a travel budget. And if travel costs start falling and you also see fewer quotes, less activity, and a declining backlog, then you know there's really a problem." ■

What You Can Do to Cut Down on 'Rogue Spending'

Companies that adopt cloud-based expense trackers often see a reduction in overspending in certain categories

Spend of all types—travel, employee out of pocket, vendor-related—too often involve opaque, antiquated, cumbersome, and time-consuming processes. Even many of the best companies have yet to adopt cloud-based systems for tracking and analyzing expenses, says Rebecca Sheehan, senior director for business development at SAP.

Resistance to the adoption of dedicated software is often related to the perception that doing so would be too expensive.

"Companies often think that it's too cost-prohibitive to adopt a software solution to address this need," says Sheehan. "They may be on a manual system, using spreadsheets and taping receipts to a piece of paper and submitting it to finance. And for that manual process, it's often perceived as free. But if you tally the time it takes for employees to go through the effort of actually pulling all of their expense documentation together and filling out a manual expense report, it's not free."

While focusing on T&E and vendor expenses may not be a top priority for growth-minded private equity investors, the fact remains that these are the second-most-controllable expenses, behind payroll. In the particular case of travel expenses, the price points are so varied, and the methods for booking travel so heterogeneous, that companies without strong controls often suffer from a culture of employees constantly bending or ignoring company guidelines.

One telltale sign of a chaotic travel expense system is "employees spending inordinate amounts of time just trying to research the fares, the hotel rates, and not necessarily making the right decisions," says Sheehan, who manages the Concur Private Equity partnerships for SAP. "Without proper tools and software, it's really challenging to know what your risk is, what people are spending, where it's being spent, if it's the right spending. That lack of visibility can really hurt a company."

Rebecca Sheehan
Senior Director,
Business Development,
SAP

Adds Sheehan: "When companies are more efficiently and effectively capturing spend through an integrated cloud-based system, they gain greater visibility into that spend. These insights can then drive broader improvements across the company—from increased compliance and operational efficiencies to streamlined, accurate management of working capital and better overall financial health."

And if you believe time is money, the time-saving benefit of an online expense solution which connects to mobile devices is warmly regarded by those who adopt them.

"Your finance team can be focused on more strategic initiatives," says Sheehan. "There's less time being spent on, for example, getting an expense report approved. You're not having to shuffle it all over the office—it goes through an online approval. And that is super time-saving."

As online expense tracking systems proliferate, it is unlikely that there will be nostalgia for the days when employees needed to tape receipts to paper expense reports. (But there may be nostalgia for rogue spending.) ■