# ADOPTING PRIVATE EQUITY'S PLAYBOOK

## RAPID EBITDA IMPROVEMENT

Private equity firms rely on several levers to create value in their acquired assets, the most important being operational improvement. As a result, the industry has enjoyed significantly higher shareholder returns than other private and publicly traded companies. With economic recovery taking hold, manufacturers should consider implementing some of private equity's proven practices to spur growth.

The levers available to improve operating profitability in manufacturing are well known, yet deploying these levers in a holistically successful way and delivering significant impact remains challenging. Understanding this, anyone who reads the business press can admire certain CEOs or certain transformational programs that have dramatically increased a company's performance. These successes are rarely based on a new set of profitability levers, but rather on the acumen, discipline, resources, urgency, and transformational agenda brought to the profitability improvement program. Eliminating the "business as usual" mindset – by shaking up priorities, organizational structure, or governance – is the key ingredient in these cases.

The private equity (PE) industry has long enjoyed the benefits of such shake-ups, using their new ownership as a catalyst for change in their portfolio companies. In addition, the full-court press they apply through the use of dedicated teams of internal and external industry-specific operations experts, together with a "leave no stone unturned" mentality, creates the right environment for big changes to take hold.

Using as many levers as they can uncover, including sourcing cost reduction, product cost down, manufacturing improvement, overhead reduction, pricing enhancement, etc., it is rare that a PE firm doesn't significantly improve a company's EBITDA (earnings before interest, taxes, depreciation, and amortization) – often to levels that surprise the incumbent management team. For the PE firm and its shareholders, each dollar of sustained EBITDA improvement is worth \$8-\$10 in equity increase – a clear incentive to move fast and make major changes. PE firms clearly understand that the investment required to make transformational programs happen is insignificant at these return levels.

**\$8-\$10**

What each \$1 of EBITDA improvement at a portfolio company is worth to the equity holders in a PE fund in 2014.

## LEVERS FOR RAPID EBITDA GAINS

Historically low interest rates in today's financial markets have created a valuation boom in the PE sector. Whereas the bulk of purchase multiples in the manufacturing sector were in the 6-8x range a mere three years ago, today's deal multiples are gravitating toward the 8-10x range, largely due to the low cost of leveraged financing. Thus, PE firms must extract more value from post-acquisition operations improvement to ensure that they recapture their investment at exit. Oliver Wyman has developed a "Rapid EBITDA Improvement" playbook that is being used by a number of PE clients; it comprises a set of proven levers for generating both sales growth and cost-out in a rapid and sustained manner:

- **Sourcing cost reduction:** Gaining leverage over incumbent suppliers of both direct and indirect materials and services, often utilizing synergies with other portfolio companies or purchasing consortia, can be a critical source of value. Understanding where to find quick wins and expertise in each commodity is key.

- **Product cost down:** Using a network of industry experts to provide engineering and materials expertise, together with the most sophisticated design tools available, manufacturing companies are revisiting legacy designs and practices to determine where costs can be reduced or eliminated.

- **Pricing strategy and service parts pricing:** Linear regression-based pricing using competitive data sets and real-time market feedback is helping manufacturing companies find the peak of the marginal demand curve for each of their products.

- **Manufacturing operations and value chain improvement:** A "clean slate" approach to manufacturing assets and make-versus-buy often results in tough decisions for the management team. A holistic, transformational agenda is necessary to establish the case for change.

- SG&A optimization, sales force effectiveness, headcount reduction, and MRO improvement are other levers of equal importance.

## IMPROVING EBITDA: NOT JUST A PRIVATE EQUITY PROBLEM

What about manufacturing companies that aren't PE owned? A hasty reaction might be that their financial structures, incentives, and risk profiles are different and, therefore, PE-like transformations aren't applicable. However, the similarities with private equity far outweigh the differences: Both types of firms have shareholders seeking growing returns and a desire to outperform the market. Both have enterprise values that the market calculates by applying a ratio to profitability. And both have the resources and availability of expert partners to help them execute large scale change. Once the starter pistol is found – an appetite for change – the transformation can begin.

**Rapid EBITDA improvement framework**

13 specialized tools impacting each area of the value chain

**Suppliers**

Tier 2 sourcing

Direct materials sourcing (Tier 1)

Indirect sourcing

**Enterprises**

**SG&A reduction**

**Product development**
Product cost down

**Sales and marketing**
Sales force effectiveness

**Manufacturing**
Facilities consolidation
Operations improvement
MRO optimization
Labor/headcount reduction
Make/buy rationalization

**Customers**

Pricing and customer profitability
Service parts pricing

Kevin.Hauser@oliverwyman.com
+1 248 906 7935
Tobias.Eichner@oliverwyman.com
+49 89 939 49 774