

# How to Manage Portfolio Companies When the Economy Is Down

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*Strategies to Turn an Economic Slump to Portfolio  
Companies' Advantage*



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## Management summary

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The current U.S. economic environment has profoundly hurt companies of all sizes and ownership structures. Rising raw material costs, driven by volatile commodity prices and rising supply chain costs, have crippled EBITDA margins. Adding to the pain, companies in many industries are struggling to maintain sales volume in the face of decreased downstream demand.

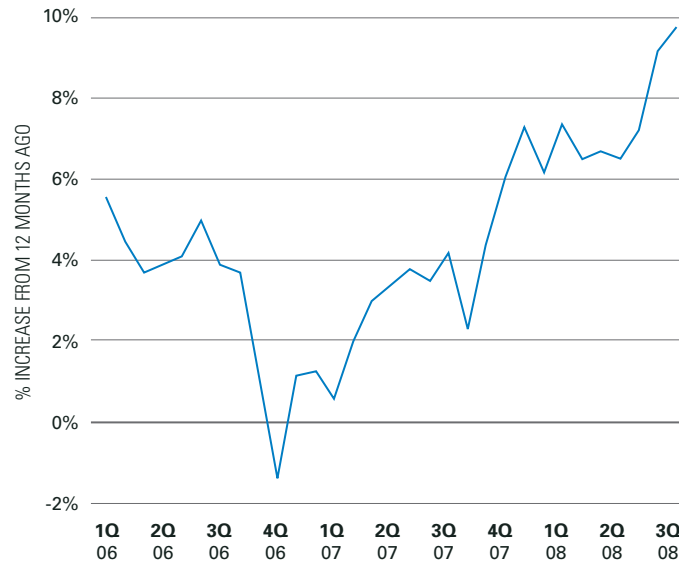
The private equity professional feels the downturn directly. Companies capitalized in an attractive environment are squeezed both on sales and on cost control, resulting in a reduced EBITDA margin and lower operating cash flow. The latter inhibits a company's ability to service its debt and restricts re-investment of retained earnings in value creation initiatives. With a lowered EBITDA, valuation suffers and the ability for a private equity firm to make a profitable exit is threatened. However, there are several strategies a private equity firm can initiate to achieve "quick wins" without a large capital expenditure.

In difficult economic times, many firms are reluctant to make large capital expenditures to overhaul the operations of portfolio companies. Often, implementing capital intensive or comprehensive improvement projects such as process automation, CRM, BPO, lean manufacturing or Six Sigma are put on the back burner until the operating cash flows return to acceptable levels. In downturns, Arthur D. Little recommends private equity firms to focus on immediate impact and low capital expenditure projects such as overhead cost reduction, sourcing excellence and revenue optimization.

Arthur D. Little, the world's first management consulting firm, has extensive experience and proven methodologies for scoping and implementing projects centered on protecting EBITDA margins and cushioning the impact of a difficult economic environment. In challenging times it is crucial that a project's impact is measured by the effect on EBITDA. By investing in EBITDA preservation projects, a portfolio company sets the foundation to survive the difficult times and emerge from the downturn better positioned in the marketplace, financially stronger and operationally smarter.

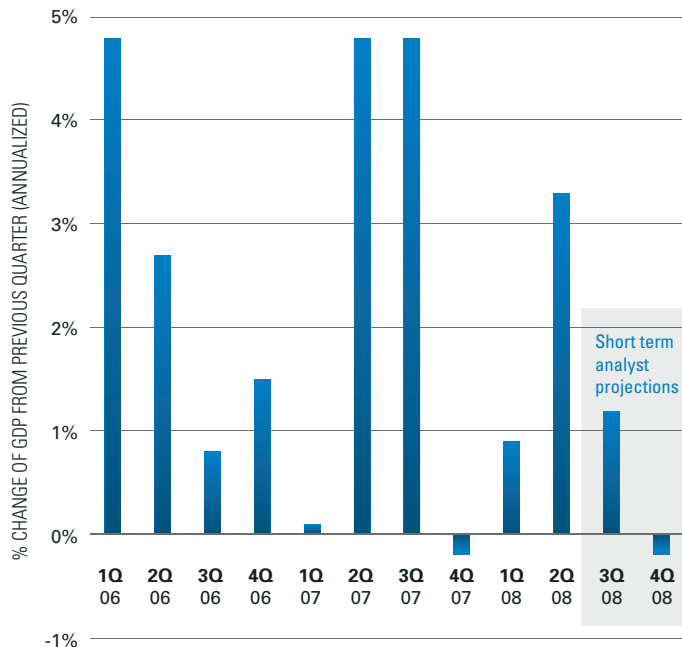
**Figure 1**  
**Producer Prices, change from previous year (not adjusted for seasonality)**  
 Soaring commodity prices are shrinking EBITDA margins

Source: Bureau of Labor Statistics,  
 Arthur D. Little analysis



**Figure 2**  
**Real Gross Domestic Product, annualized rates (adjusted for seasonality)**  
 Slower economic output in 2008 has influenced revenue streams

Source: Department of Commerce,  
 Arthur D. Little analysis



# Impact of a downturn on financial performance

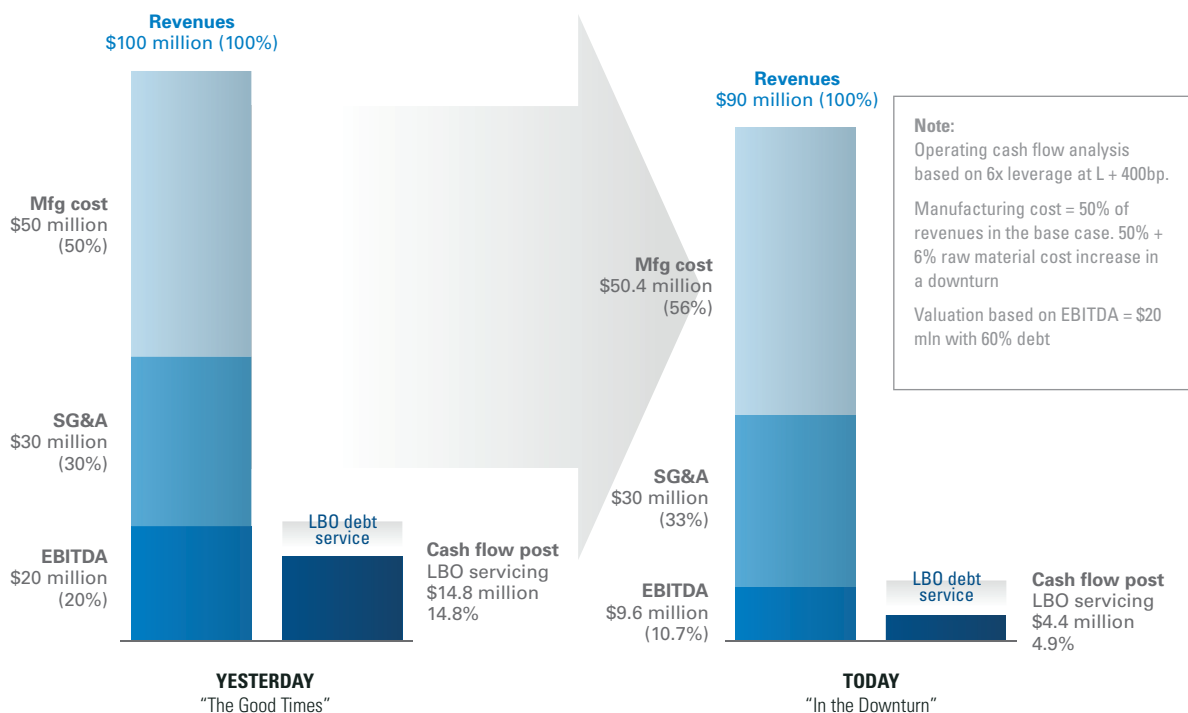
The United States is currently embroiled in a credit-market-driven economic downturn that is affecting companies of all sizes and capital structures. Companies feel the strain both in revenue growth and effective cost control. Revenues can suffer due to downstream pressures on customers to reduce inventory and adjust to changing appetites from end users. As top-line pressures increase, sales force performance can suffer, especially if adequate structure, performance transparency or resources are not in place. Fixed general and administrative costs add to the burden, absorbing underperforming resources and straining profit margins.

In downturns, struggling companies may reduce costs through decreased input costs. However, in most cases, these realizations are offset by higher raw material costs and pressure from financially strapped suppliers, resulting in a net increase in manufacturing costs as a percentage of revenues

and a decrease in EBITDA. In the example shown, assuming a 10 percent decrease in revenues, a 10 percent increase in manufacturing costs and a static SG&A expense, EBITDA could drop from \$20 million to \$10.5 million as a company is affected by a downturn.

The impact on cash flow post-LBO debt servicing is equally unnerving. Assuming a 6x leverage ratio and a Libor + 400 basis point interest rate on financing, the company's cash flow post-LBO servicing would drop to \$1.9 million from \$11.4 million. The reduction makes it increasingly difficult for the company to cover its interest burden and to reinvest retained earnings in value creation initiatives. The private equity owner feels the tight cash position in the carried interest gained and subsequently upon exit, when a weakened EBITDA drives down valuation. The result is a cash-strapped company in need of cost reductions and revenue optimization initiatives.

**Figure 3**  
The downturn decreases profitability of portfolio companies



# Impact of implementing cost realization and revenue optimization opportunities

Economic downturns are often the best times for cost reduction and revenue optimization initiatives. The dire situation a company finds itself in presents a clear need for change, which should neutralize many political obstacles that often threaten cost reduction and revenue enhancement.

Arthur D. Little’s proven program targets three main levers:

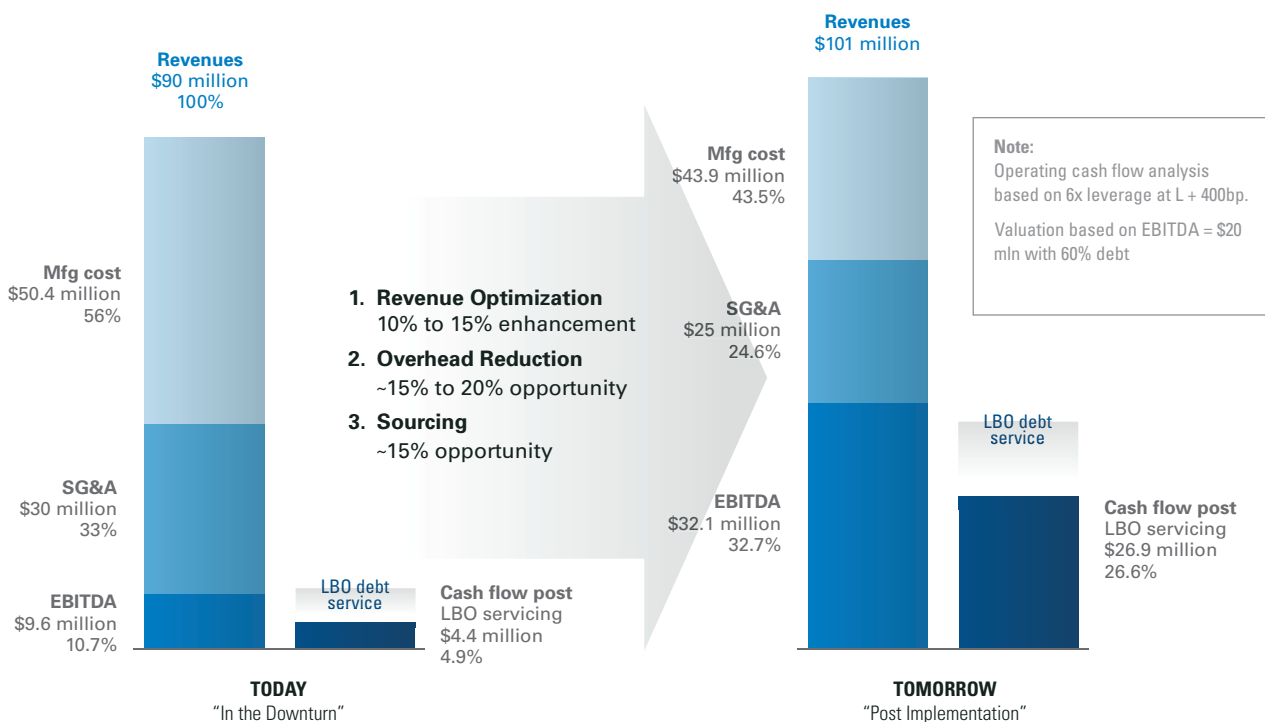
1. **Overhead reduction** (15% – 20% savings on overhead spent)
2. **Sourcing excellence** (10% – 15% savings on total spent)

3. **Revenue optimization** (5% – 10% increase in sales; 10% – 15% increase in GM)

Implementing these strategies in a downturn often results in a transformation that can incrementally improve EBITDA margins beyond pre-downturn levels. These initiatives are readily adoptable because they require minimal capital expenditure compared to more labor-intensive process-related improvements.

**Figure 4**

Emerge from the downturn better positioned in the marketplace, financially stronger and operationally smarter



**Overhead reduction**

Cutting overhead costs in an economic downturn is one of the most tangible ways a company can maintain and improve overall profitability, although this can be time consuming and challenging. Arthur D. Little uses proven methods to identify and realize SG&A reduction opportunities with these distinct tools for both management and staff functions:

**Management Savings Toolkit**

- Span of Control Analysis helps users understand the appropriate number of departments, regions and staff individual managers can effectively support.
- Exception Analysis further refines savings potential identified by the Span of Control Analysis by examining various factors affecting the ability to cut management

staffing, such as geography or functional or domain expertise required to supervise activities.

- Organizational Redesign defines the new organization that captures savings from optimized span of control and develops a blueprint for a smooth transition of roles and responsibilities.

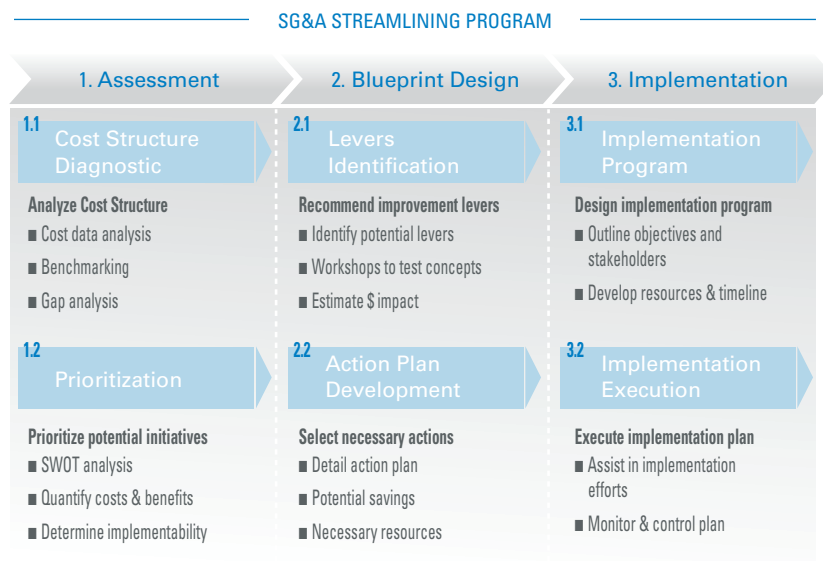
**Staff Savings Toolkit**

- External Benchmarks give indications of appropriate staffing levels. Benchmarks must be selected carefully and based on the necessary granularity of activities to be meaningful to a specific company.
- Internal Benchmarks provide an alternative to external benchmarks when staff functions are split across organizations while performing similar tasks.

**Figure 5**

Arthur D. Little SG&A Streamlining approach follows a comprehensive and structured methodology

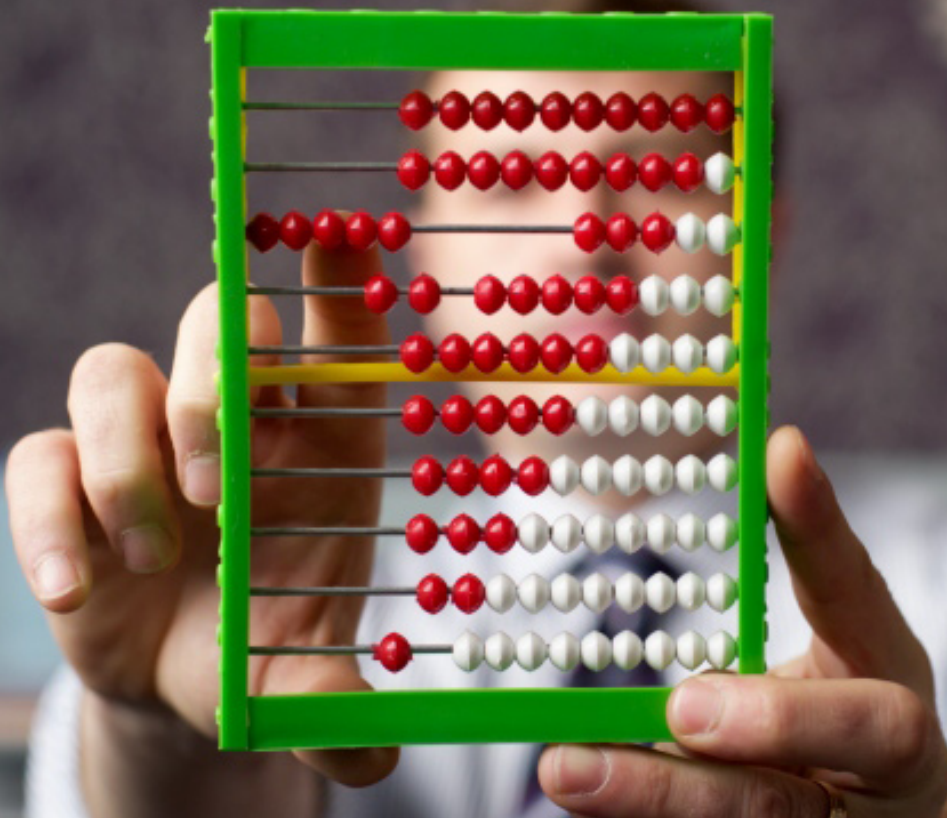
Source: Arthur D. Little analysis



- Activity Analysis helps discover inefficiencies that can be corrected to reach best-in-class internal or external benchmark productivity levels.
- Efficiency Levers address the identified inefficiencies and opportunities. These levers can include:
  - Increasing utilization levels by smoothing workload
  - Reducing errors and reworking through standardized processes
  - Training and reorganizing to improve productivity
  - Upgrading automation or technology to reduce manual tasks
  - Changing customer processes to reduce complexity

Each lever determines specific actions and steps to reach savings potential. The efficiency levers are applied with concrete actions defined in blueprinting. Implementation can vary significantly in time due to the level of complexity of the levers (e.g., process standardization may take several months while a technology upgrade could take much longer)

SG&A cost reduction programs typically deliver cost savings of 15 percent to 20 percent of targeted costs, with some savings available almost immediately. These results directly affect EBITDA, with portfolio companies able to improve EBITDA five percent to 10 percent in the first 12 months after implementation.





### Sourcing Excellence

Sourcing Excellence is one of the most effective strategies to reduce costs and improve profitability quickly. Typically, portfolio companies are rich with opportunities to drive costs out of their supply chain by implementing a Sourcing Excellence program. Traditional procurement efforts tend to focus on two areas: price negotiation and vendor consolidation. This is particularly true for smaller, mid-market companies that are usually not exposed to world-class sourcing initiatives.

Arthur D. Little's Sourcing Excellence program goes beyond price and vendor consolidation. Our program reduces Total Cost of Ownership (TCO) in key spending categories. TCO is a holistic approach to impact EBITDA positively in collaboration with suppliers to drive up profitability. There are multiple focus dimensions to our TCO approach, such as:

- Raw materials specifications – Reviewing materials specifications with potential suppliers, operations and

marketing executives uncovers cost savings opportunities by addressing issues like substitute products, waste, quality, and yield.

- Inventory costs – Improving capital tied in inventory has great potential for most portfolio companies. Raw materials, unfinished and finished products along the supply chain can be optimized to reduce inventory costs when working collaboratively with suppliers.
- Logistics and transportation – When fuel and freight costs rise, the percent of TCO represented by logistics and transportation steadily increases over time. Integrating supply chain operations with suppliers results in savings by driving out inefficiencies.
- Transaction and overhead costs – The amount of resources employed in processing routine purchasing transactions, which typically add little value, is another area for improvement. These costs impact the supply chain twice,

**Figure 6**

Sourcing Excellence program follows comprehensive and structured methodology

Source: Arthur D. Little Methodology



from the vendor and customer sides. Collaboration optimizes these costs quickly.

- Pricing and strategic planning – Creating a transparent and interactive process allows innovation and open communication with suppliers, and creates the appropriate conditions to receive fair and predictable pricing. As a result, companies can project costs and plan production, market strategy and operations to increase their profitability.

Improving on these dimensions not only drives down costs, but also impacts revenues by reducing stock-outs and improving pricing and quality. Arthur D. Little has adapted world-class practices used by leaders of many industries to develop its Sourcing Excellence program.

This program is proven to be effective not only in large multinational corporations, but also in smaller mid-market portfolio companies across a wide spectrum of industries. Our methodology uses a rigorous approach in four phases: Procurement Assessment, Sourcing Strategy, TCO Workshop & Negotiations, Monitor & Control.

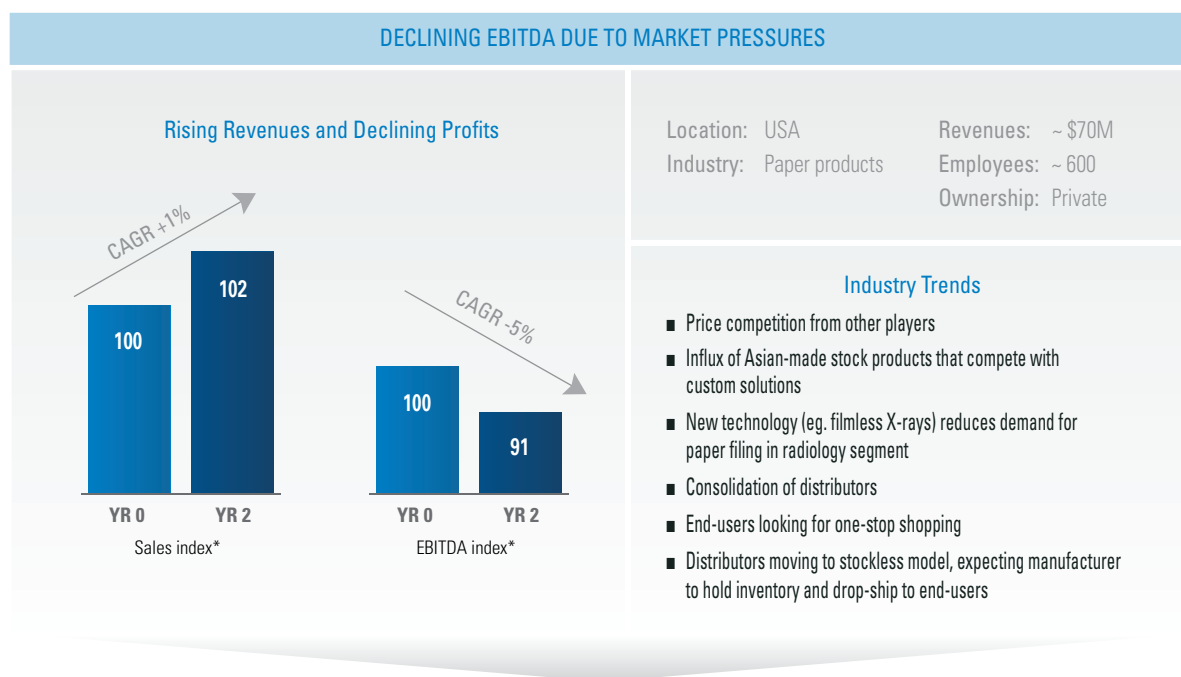
Our methodology applies to a broad range of areas, and its implementation in multiple spend categories helps develop a set of corporate competencies that allows the company to continuously drive efficiencies and cut costs out of the supply chain.

The world-class experience of our team, combined with our methodology, has delivered cost savings in the range of 10 percent to 15 percent per category, in as little as 90 days.

**Figure 7**

*A Case Study in Sourcing Excellence:*

Specialty paper converter facing industry pricing and cost pressures

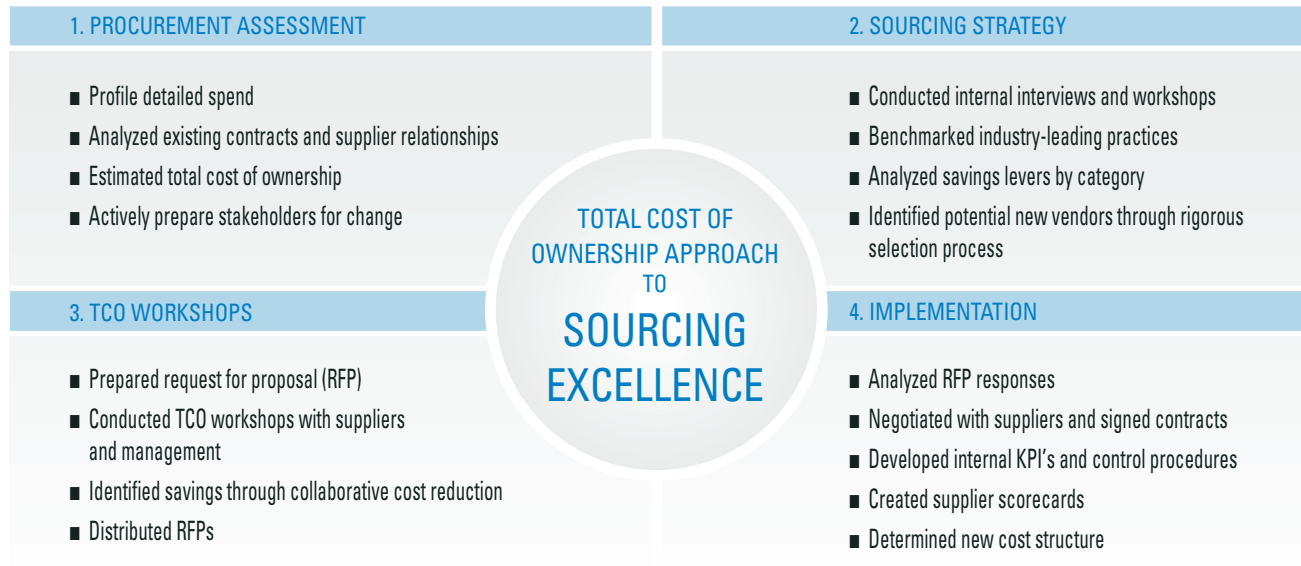


Management requested the team to reduce client's cost structure and meet market challenges

**Figure 8**

*A Case Study in Sourcing Excellence:*

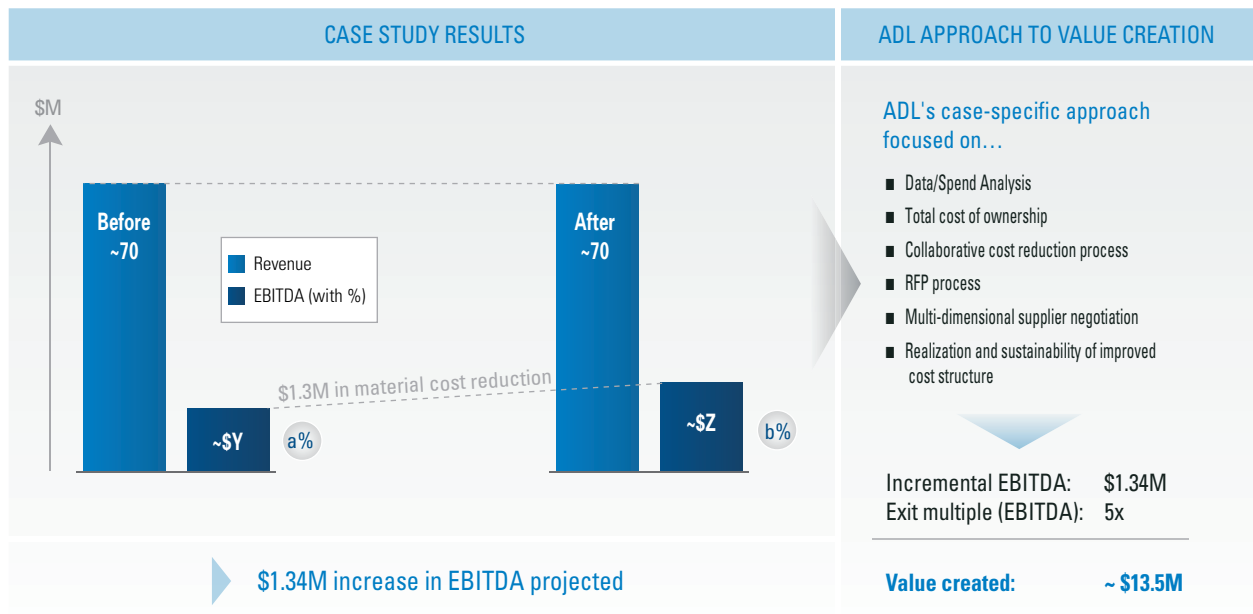
Team implemented a Sourcing Excellence program to reduce Total Cost of Ownership (TCO) and boost EBITDA



**Figure 9**

*A Case Study in Sourcing Excellence:*

Client's cost structure was reduced by \$1.3M in approximately 90 days



These results have a direct impact on COGS and EBITDA with portfolio companies being able to improve EBITDA in the three percent to five percent range over the first twelve months after implementation.

### Revenue Optimization

Private equity owners should seize the opportunity for structured and more efficient top-line growth of their portfolio assets during a downturn. Top-line growth, along with cost-cutting efforts, can be a powerful combination to protect and even strengthen profitability during difficult times. While the competition languishes or cuts costs that may hamper their growth potential when the economy rebounds, your portfolio companies can be driving towards smarter, leaner, more effective revenue execution.

With our Revenue Optimization program, we help companies reach their full sales potential through structured customer segmentation, optimized customer care programs and organizational alignment. Effective in favorable economic times, our Sales Optimization program is an especially vital tool when economic conditions become difficult because it allows for revenue enhancement in the face of shrinking resources.

Arthur D. Little's Revenue Optimization program helps our clients bring world-class sophistication and results to:

- **Customer Segmentation:** Internal sales staff and procedures often classify customers according to past success or comfort level, which can prevent aggressive and forward-looking sales activities. Our program helps companies move to the next level by segmenting customers based on overall market potential, revenue and margin contribution potential and strategic impact.
- **Customer Acquisition and Service:** Our program then designs a customer care program based specifically on optimal resource allocation and customer needs quantified through an ABC grouping.

- **Resource Alignment:** Building on previous steps, the program aligns resources – people, sales territories, organizational structure and processes – to maximize effectiveness, efficiency, transparency and cross-functional collaboration.
- **Tracking and Incentives:** The final step to ensure ideal performance aligns organizational incentive structures and tools, such as visual accountability, to promote motivation and performance transparency.

Our program is an effective, proven and structured tool not only for a domestic growth strategy but also for:

- International growth and diversification
- New product / market growth and diversification
- Channel management and new channel growth

In an economic downturn when sales growth is challenged and margins are threatened, a more structured sales and sales resource alignment approach means that top-line growth and margin growth do not have to take a temporary backseat to efficiency measures, but can work in harmony with them.

Arthur D. Little's Revenue Optimization program typically delivers revenue enhancements of up to 5 percent to 10 percent, and a gross margin improvement of 10 percent to 15 percent.

## Use these turbulent times to strengthen your portfolio companies

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Any measure to improve efficiency means change and therefore will result in some resistance. Our suggested activities specifically provide measures to reduce non-value-add activities in SG&A while increasing the output of existing value-add activities. Necessary actions like ours are easier to communicate when the company faces unfavorable circumstances. Additionally, external pressures on the sales force help to reveal which performers succeeded due to strong capabilities and which succeeded only because of easy economic times. Necessary strategic adjustments in the sales force become readily apparent.

Since not only the portfolio companies themselves are under pressure but also their suppliers, it is now easier to renegotiate contracts, terms and prices with them. When suppliers have been under pressure for a while, they will realize that they must act as well in order to retain their customers.

With an external expert, private equity firms can use this active approach of improving the portfolio companies as a means of positive communication to any additional stakeholders, such as

lenders. When the approach shows tangible results, it boosts the management team's credibility and presents a track record of cost consciousness and value creation, which leads to more favorable negotiations with lenders.

Improving business without adding complexity is key in economic downturns. There are many initiatives a mid-market company can embrace to improve results. In economically challenging times, it is important to focus on those initiatives that quickly deliver results and have an immediate and measurable return on investment.

# Key factors for improving your portfolio company

During the current economic downturn, Arthur D. Little is working with many portfolio companies on developing strategic frameworks. Several companies that have successfully implemented their framework have increased profitability despite difficult economic conditions.

Arthur D. Little has identified six key factors to create a successful platform for change:

1. **Quick Transparency:** Identifying the sources of costs, and how the company will be affected financially in the near term.
2. **Correct Doses:** Defining and segregating those costs associated with value generation and concentrating on reducing costs that do not add value.
3. **Management Commitment:** Providing management teams with a strategy they can buy into and fully own.
4. **Clear and Concise Objectives:** Brainstorming with management to allocate responsibilities and identify the resources necessary for success.
5. **Clearly Defined Milestones:** Developing a process to alert management of future goals, and creating a plan for potential pitfalls.
6. **Exact Sequencing:** Understanding what improvement measures are dependent on each other and the synergies that can be created through proper implementation.

**Figure 10**  
Portfolio companies must follow a logical framework for successful change



# Contacts

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## Arthur D. Little

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