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Five success factors for turnarounds of private equity-owned businesses

For private equity (PE) investors, discovering the early warning signs of a struggling business – and successfully turning it around – largely hinges on the PE firm’s relationship with the portfolio company’s management team. A troubled relationship between these two parties can lead to drastic measures that solve near-term liquidity problems, but leave the business increasingly challenged and ill equipped for the long term. By focusing on key success factors, both PE investors and management teams will be better poised to resolve a distressed situation and build a business that is sustainable long past the PE fund’s exit.

Early warning signs

In some cases, PE firms know they have to turn around a business before they even buy it. In fact, the business’s issues may be the reason it was for sale in the first place, and core to the investors’ deal thesis.

But in many cases, the business runs into trouble only after it is acquired. Consistent financial underperformance, including stagnating revenue and compressing margins, is an obvious warning sign. A set of traditional KPIs, such as revenue growth, gross and net margins, and earnings before interest, tax, depreciation and amortization (EBITDA) provide critical metrics for a portfolio company’s performance. But there might be some less obvious red flags that investors can combine with the KPIs to help uncover issues earlier, providing more time to turn around a troubled business. These include:

- Increasing customer churn as early adopters turn to newer solutions
- Management suggesting that poor performance is driven by “short-term events,” not permanent shifts in technology, the market or competitive landscape
- Increasing turnover among the management team, especially key executives who report to the CEO

“Once the warning signs are spotted, PE owners must act quickly to resolve issues to preserve value and place the focus on the growth trajectory,” Andres Saenz, EY Global Private Equity Leader, said.

Defining the key success factors

So how can PE owners work with management teams to enact a turnaround plan that results in a viable business with growth potential? Based on EY study of turnaround situations and interviews with business leaders, five key success factors have been developed.

Intellectual honesty

Management teams often have a blind spot about what is really causing distress in their business. It is human nature to assume actions that led to success in the past will continue to deliver success in the future. The key to instilling intellectual honesty among the management teams and boards is objective analysis and a willingness to directly confront uncomfortable issues. "Often a management team really knows why their business is faltering but they are afraid to face the core issues, especially with their PE investors. Getting them to accept and openly address the issues without feeling blame is critical," says Greg Schooley, Value Creation Leader, Ernst & Young LLP.

PE firms and management teams have a range of models for monitoring portfolio company businesses, including weekly calls with stakeholders and quarterly board meetings. Ultimately, a more robust and objective feedback loop is required among key stakeholders, including management, the deal team and the operating partners, to understand customers' changing needs, and analyze key business drivers and evolving market dynamics.

Operating partners can play a critical role in identifying early warning signals, but they also have a tightrope to walk. Initially, management teams can be wary of their involvement, viewing them as potential "spies," or as second guessing major decisions. Therefore, operations teams have to be mindful of their interactions with management to be viewed as trusted collaborators, not "note takers" for the PE firm.

Insisting on KPIs that are specific to the industry will help operating partners see warning signs that management needs to address. Advanced analytics, meanwhile, can help PE owners and management teams develop better insights about competition and the current state of the industry and to understand what best practices look like. The goal is to make sure there are no surprises.

The need for objective analysis is exemplified in one case of a PE-owned distribution business facing financial challenges, still run by its co-founders. Sales had been declining at 5%-10% per year for three years and margins were being compressed as it battled more efficiently run competitors. But the co-CEOs remained confident that the full-service, high-cost business model that they built 20 years earlier would succeed into the future.

To change management's views, the PE owners and their advisors presented an objective, fact-based analysis that demonstrated the root causes of the financial challenges. There were four primary issues that the business faced. First, the business's product mix had shifted to lower-margin commodity products that were heavier and more costly to distribute. Second, as a result of a merger, the business operated twice as many distribution centers across the country than previously used. Third, the competitive landscape had radically changed with the growth of mass online resellers who offered the same products at lower prices. And fourth, the company had introduced a new sales compensation plan that rewarded salespeople for revenues irrespective of gross margin. Armed with a new view on reality, management, working with their advisors, agreed to cut the number of distribution centers by half; employed new, cheaper technology platforms; reduced overhead by streamlining the organization; and redesigned the salesforce compensation plan to drive higher profit margins.

As a result, annualized EBITDA tripled within 12 months of implementing the turnaround program.

Simplification

PE firms often acquire companies that have built layer upon layer of complexity over the course of many years. These layers include businesses that were acquired and perhaps poorly integrated, non-core product lines, multiple management teams and lines of reporting, and a host of irrelevant policies and procedures.

Refocusing on core competencies is typically a first priority for deal professionals and operating partners with an underperforming business. If the enterprise continues to struggle, PE owners should look to see if further operations can

be simplified and then, using objective evidence, encourage the management team to take further action.

Recommendations may include simplifying the footprint of the business and divesting assets that are non-core. This review process should become a regular exercise, even after the business is put on sounder footing.

For example, in one industrial products company, management and owners built a national footprint with several manufacturing

and distribution sites across the US, believing that geographic proximity to local markets and large manufacturing capacity were sources of competitive advantage. It also considered the company's ability to offer highly customized products at no additional cost a key part of the value proposition. However, revenue stagnated and profits turned negative.

When the owner and its advisors looked deeper, it became clear that the organization was composed of three different businesses. Its largest line of business enjoyed attractive financial performance. Others performed horribly. To become more

sustainably profitable, the business needed to be pruned and streamlined. Four of five manufacturing sites were closed and production was shifted to the company's primary location. Two of the non-core businesses were wound down so the company could focus on its core offerings.

By concentrating on more volume of standardized products in one manufacturing site, the business was able to increase manufacturing efficiencies, reducing costs substantially. Profitability increased as EBIT margin went from -3% to 15% in roughly one year.

Experimentation

Encouraging management to experiment requires close, objective monitoring of success or failure to quickly modify strategy or kill unsuccessful options. There should be a clear definition of the baseline and high-level metrics to continually track progress of the target state of the company. Regular updates on both successes and failures should be communicated throughout the organization.

For example, sales at one PE-owned manufacturer fell 50% over two to three years after one of its two major retail customers went bankrupt and the other was acquired by a competitor. A new CEO came in and was eager to shift to new channels and products. The PE owner supported this exploration.

The company experimented with a direct-to-consumer online approach, traveling pop-up stores and a joint venture with a specialty retailer. The experimentation allowed the company to identify which new channels were viable. Despite being on the brink of bankruptcy, the company's growth in the new channels enabled the PE fund to exit the investment with a modest return.

It's likely that PE owners have other portfolio companies that have experimented in ways that management can learn from. Allowing management the freedom to experiment can lead to options for a successful turnaround.

Aligning stakeholders

A turnaround strategy always involves making tough choices. The previous examples include abandoning old business models, and streamlining and closing operations – choices that are likely to affect employees and external stakeholders.

As long as the PE owner is convinced that it has the right management team in place, it's essential to stay focused on problem solving while being willing to take on high amounts of risk

from time to time. In fact, in many cases, the risk was assumed when the PE owner bought the business. PE owners should own the turnaround plan and make certain that management incentives line up with the plan. Keep sight of monthly results, but place greater importance on progress toward key turnaround milestones.

Making the tough decisions

Once these steps are taken, if performance is still not turning around – as measured by KPIs and adherence to the turnaround plan – the question PE firms need to ask is, “do we still have the right team in place to execute on the challenges in front of us?”

Making a decision to change the management team midstream can be very difficult. It sets the time frame of the turnaround back and can also be seen as an admission of failure in deciding to back the management team in the first place. But it can also lead

to greater success, such as in the example above of a new CEO coming in and being willing, if not eager, to experiment with new strategies.

Just as data-driven analysis should point to the tough decisions that need to be made in changing the operating model, the same data-driven approach should be followed when deciding whether a change in management is needed.

Conclusion

A turnaround situation is uncertain by its nature. But when PE owners rely on objective data and analytics, and openly and honestly communicate with the management team, they can empower change that can stabilize a business and allow the PE firm to reap the greatest possible value from the investment.

By focusing on what matters most to the business and experimenting with strategic initiatives, PE owners can help create a culture with lasting impact on the organization's ability to evolve, compete and succeed amid market disruption, industry convergence and changing business models.

How EY can help

EY member firms have a team of dedicated professionals focused on turnaround situations across the globe, helping companies to identify their unique "DNA of success." The structured methodologies address companies' profit growth challenges, from rapid diagnostics to turnaround planning and full implementation across a wide range of areas. EY professionals leverage their industry proficiency and hands-on experience to see to it that effective turnaround plans quickly become reality. They can also take on hands-on execution roles in more urgent or extreme situations. The ultimate goal is not crudely cutting costs across the board to buy a company a short reprieve, but surgically redesigning businesses so that they can be successful over the longer term.



Andres Saenz

EY Global Private Equity Leader
andres.saenz@parthenon.ey.com
+1 617 478 4619



Gregory W Schooley

US Value Creation Leader
Ernst & Young LLP
gregory.schooley@ey.com
+1 212 773 5444



Jeffrey Ficks

Americas Central Restructuring Leader
Ernst & Young LLP
jeffrey.ficks@ey.com
+1 312 879 5761

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