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The Role of Innovation in Private Equity

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Introduction

Middle market private equity faces a conundrum. All portfolio companies must innovate to execute their investment theses. However, innovation takes money—sometimes speculative money. Innovation also entails the potential for failure en route to the reward of success. This reality does not appear to jibe with a highly leveraged capital structure. Eric Ries, author of *The Lean Start-up: How Today's Entrepreneurs Use Continuous Innovation to Create Radically Successful Businesses*, imparts, "If you cannot fail, you cannot learn." The paradox of setback tolerance toward the pinnacle of success somewhat mirrors the crux of Genrich Altshuller's TRIZ: solving seemingly incompatible design challenges. For example, how may a substance be both stronger and lighter? Creative genius figures out these challenges and drives innovation resulting in products like Tensar International Corporation's geogrids for soil stabilization benefitting the construction industry. The product actually gets stronger as it is drawn and stretched—a completely counterintuitive concept. Are there innovative alternatives for private equity that come without casino-caliber risks? In response to this question, this article attempts to address practical approaches to the necessity of portfolio company innovation.

Innovation in Context

The argument should begin with an understanding of the nature of innovation. Innovation does not necessarily have to be the next Apple virtuosity. This type of innovation is product innovation. Product innovation may sustain or expand product lines. For example, fuel injection was sustaining technology. It did not replace the car, but rather modified its features. Product innovation may also yield new products in pursuit of a different type of customer. This is disruptive product innovation. An example of this innovation is drone surveillance and weaponry. Another one is oil patch hydraulic fracturing, or fracking.

There is plenty of room in organizations for another type of innovation: process innovation. Process reengineering gurus like Michael Hammer assert that the predominance of business model process steps are non-value add. Consequently, a strong argument exits for reducing costs without compromising quality. Toyota elevated this to an art form with its Total Quality Management discipline. Lean manufacturing is a kindred spirit for tuning the supply chain.

Process innovation is both a great opportunity and a common trap. Of course, it is tempting to reduce costs and beat the budget. In some situations, the savings may be big enough to warrant a recapitalization to take at least part of the initial investment out of the portfolio company, jolt the internal rate of return, and re-leverage the balance sheet. This, however, may be shortsighted. The real opportunity may be taking advantage of this wave of process innovation to fund additional innovation—both process and product innovation.

Whether innovation is of the process or product variety, the objective is favorable impact to the business model. More than mere creativity, innovation turns ideas into cash flow. This is the essence of value creation. The impact must commence and end with customers. In reality, the cycle never ends. Customers must be sufficiently enamored to make an initial purchase, but the benefits only accrue to the innovator with repeat purchases. Such purchasers may indeed be internal customers.

Process Innovation

Robust scalability is a common portfolio company objective. Automation is a typical means of accomplishing this objective. However, portfolio companies should first weed out non-value added tasks. Otherwise, true efficiency opportunities are squandered. Automating processes laden with non-value added components results in wasting money more efficiently.

Consulting firm Middle Market Methods observes that portfolio company technology systems are among the chronic scalability deficiencies in the small business community. How is the edifying question framed to affirm this condition? An example may look like this: Could the business function smoothly tomorrow morning at three times yesterday's size? The stock answers range from a boisterous "No!" to "Yes, but we (the portfolio company) would have to hire a horde of people to digest the growth." The latter answer may sound rational, but is typically a signal of process ineptness. Good processes, complemented by robust systems, mean that economies of scale are justified by metrics substantiating lower unit cost and higher per capita productivity.

Systems upgrades are expensive—maybe seven digits. This is a substantial investment for companies with EBITDA (earnings before interest, taxes, depreciation, and amortization) below $10 million. However, Moore's Law is making the possibilities cheaper. Moreover, the cloud is an increasingly popular option to avert server purchases and maintenance overhead.

Earlier in this article a point was made that internal customers also benefit from innovation. Now is the time to expound on the point in context. Finding better processes for the business model and the systems to support them are relatively easy. Getting employees to buy into the change is not so easy. John P. Kotter's must-read, *Leading Change*, presents an argument tantamount to humans being hardwired to perceive all change as evil until there is a clear personal benefit to eschewing the deceptive comfort of today's status quo. Performance management systems may exacerbate this phenomenon. Consider a manufacturing vice president's incentives based on productivity. Process innovation tends to drive a J-curve beginning with negative slope, i.e., lost productivity, before the benefits gain traction. Consequently, the boss may have to adjust the incentives to disarm the manager's resistance to change. Despite apparently obvious benefits, associates sometimes just cannot embrace change. This does not mean that they are bad people, but it may mean that they need to find their smile in another venue. Indulging sabotage is akin to nourishing cancer cells in the body.

One of the angles private equity deal teams should consider is evaluating a technology investment vis-à-vis the hold period and eventual exit. Deal teams should not lose sight of the value of robust scalability to the next purchaser. If the acquirer does not have to resolve the scalability problem, the acquirer may rationalize a purchase premium. This argument assumes a stand-alone acquisition by another financial investor. However, strategic investors may also value the technology. Indeed, they may adopt the acquiree's process in reverse integration. Stated another way, the acquisition might be primarily motivated by the buyer's desire to resolve a technological impediment. This is a version of the classic build versus buy. The occurrence is not rare either. Microsoft, Google, and Apple regularly buy proven technology to complement their business platforms.

Product Innovation

Compared to venture firms, product innovation for private equity portfolio companies may appear to be antithetical. Most middle market investors buy a proven "thing" that they intend to bolster with organic and acquisitive growth. Tinkering with something new in a three to five year hold period seems an anathema. Even so, some business models may suffer obsolescence in a seeming twinkling of an eye. Consider some examples. Private equity invests in apparel. However, and particularly in higher-end price points, the brand is no better than the notoriety of the last season's designs. Consumer electronics behave in a similar manner. Exacerbating the operating environment is the reality that every industry is threatened by something beyond their control. A chemical company may have its dominant product attacked by the Environmental Protection Agency. Fatty foods may be assaulted by the United States Department of Agriculture, Health and Human Services, and or the Food and Drug Administration for aggravating health risks such as obesity.

The core challenge is how a leveraged company budgets research and development money for innovation. Moreover, how might the process work without jeopardizing the business model? The argument is not advocating a grand slam—or even home run—approach to innovation. Even poet Earnest Thayer's mighty Casey struck out for Mudville in the clutch. Alternatively, the company may opt for a "several singles" approach, i.e., a measured and calculated methodology. Sticking with the baseball metaphor, something might get on base to manufacture a run.

What may a portfolio company do to make this work? The first step is philosophical. The challenge is not simple. Leaders have to promote innovation as a corporate value. Next, since innovation often threatens the status quo, leaders have to protect the new from the old. Organizational design is a useful tool. However, small companies may not have the resources to isolate in a single-purpose, developmental group. Alternatively, the boss may encourage each person to allocate a specific portion of their bandwidth. To make sure this gets traction, the boss might consider how the results of team creativity are nurtured toward marketable results. Regular meetings and celebrations for milestones are beneficial.

Leadership must resolve to address both unmet, overt customer needs and undefined, latent ones. There are techniques beneficial to this quest. One technique is to observe customers in what Adam Richardson, author of *Innovation X: Why a Company's Toughest Problems are Its Greatest Advantage*, describes as their "ecosystem," i.e., reality from the customer's viewpoint. This may lead to design changes for improved utility for product line extensions. Then again, such observation may lead to discovery of something radical and dramatic. Who knew they needed global positioning satellite (GPS) navigation for traveling? Now, applications may be downloaded to a smartphone that will talk drivers through their turns, obviating the need for retaining a car glove compartment full of maps.

The boss should prefer prolific producers to one-hit wonders. Abbie Griffin, Raymond Price, and Bruce Vojak argue in *Serial Innovators: How Individuals Create and Deliver Breakthrough Innovations in Mature Firms* that "serial innovators" do not desire attention or seniority, but rather the ability to work on "interesting" customer problems for a company that respects their talents. These people are relatively easy to manage. Leadership responsibilities include determining whether these prized employees are already on the payroll. Discovering and encouraging serial innovators is tantamount to establishing a value-creating annuity.

Interaction with customers is a proven methodology for innovative input. Innovators may see beyond customer complaints and discover root-causes to issues toward paradigm-shifting responses. Stated another way, the innovator may diagnose feedback as symptomatic of a problem awaiting an elegant solution. Since small companies might not be able to afford a product development staff, creative alternatives are necessary. A possibility may reside in the sales force. Jason H. Evans and William Greenleaf's *The Bright Sales Book on Closing* impart a disquieting version of the 80-20 rule: the overwhelming majority of sales people are untrained in a sales methodology. One of the available techniques is the Socratic Method. Socratic selling punctuates the approach with open-ended queries designed to reveal customer needs, among which may require innovative solutions. Whereas short-cycled commissioned sales may be problematic, long-cycled salaried sales might be ripe for training in this pursuit. Moreover, upon recognizing interesting problems, the sales professional might introduce one of the portfolio company's serial innovators to work with the customer to solve the problem. This is not only innovative, but also good customer service.

Conclusion: The Implications for Private Equity

Private equity firms have a fiduciary responsibility to provide attractive returns on the funds they manage. Innovation is an arrow in this quiver. Indeed, Gary Hamel features innovation as an integral element of *What Matters Now: How to Win in a World of Relentless Change, Ferocious Competition, and Unstoppable Innovation*. This article presented the argument for practical approaches to process and product innovation within private equity portfolio companies. However, there is another thing private equity firms might do within its own governance mechanisms.

Many private equity firms staff “operating partners” in support of their portfolio companies. Alternatively, some firms utilize a bullpen of vetted, external subject matter resources. In either case, the firm should prioritize for the benefit of its portfolio companies an approach that nurtures both process and product innovative endeavors.

Providing innovative support to portfolio companies from an external source circumvents the Biblical resistance axiom that a prophet is not respected in his own country. In this case, the “innovative prophet”—whether the firm’s operating partner or supplemental subject matter expert—provides a type of insular protection for the portfolio company innovators. At a minimum, the portfolio company is likely to become more efficient. This alone enhances enterprise value. However, the rigor may result in something differentiable—perhaps resulting in intellectual property—that dramatically enhances enterprise value. In either case, portfolio company innovation is a smart play to mitigate the risk of entropy and boost the veracity of the investment thesis.

About the Author
John A. Lanier is founder and CEO of Middle Market Methods™ (www.middlemarketmethods.com), a consulting firm serving portfolio companies of middle market private equity firms. Middle Market Methods™ mentors clients with a “value creation road map,” including strategic planning, acquisition integration, process improvement, and leadership solutions for “operationalizing” the investment thesis. Lanier earned Six Sigma Master Black Belt certification at GE. He holds a BBA in finance from the University of Georgia and an MBA from St. Leo University. Lanier is currently a third year strategic leadership doctoral candidate in Regent University’s School of Business & Leadership. Lanier is a member of the Association for Corporate Growth and The Society for Human Resource Management.