Middle Market Methods™

Value Creating Solutions in Private Equity

2017: 2nd Quarter

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The Simplification of Strategy

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Private Equity investors excel in identifying promising investments. This usually starts with keen ecosystem focus on a select few industry verticals. The gravitation of firms from generalists to specialists aligns with the argument posited by Adam Smith during the 18th century in *The Wealth of Nations*. Indeed, vertical specialization is one of the manifestations of Smith's "invisible hand."

Upon encountering investment opportunities, the firm reconciles the prospect's investment thesis with the firm's strike zone. The result can be a brilliant value-creation occasion. However (and presuming the transaction consummates), the deal team and portfolio company leadership team may find themselves a few months into the hold period inexplicably disillusioned by the lack of results. What happened?

A common misconception is that the portfolio company leadership team clearly understands and "owns" the investment thesis (i.e., the same way the firm understands the investment thesis). Consider these scenario possibilities. First, the owners of a closely held business may have minimally disclosed what all those strangers, e.g., diligence vendors, were doing at the company. This may include eschewing sufficient communication that an investor—majority or minority—had entered the picture. Consequently, the functional managers of the business model may understandably conclude—albeit erroneously—that the absence of the visitors corresponds with nothing impacting their daily duties.

Beware the assumption that the deal team and portfolio company leadership teams are on the same page regarding the investment thesis.

Second, the business model's functional managers may actually know about the advent of an investment partner, but no one told them that anything was going to change. Interestingly, absent any communication or engagement in planning, those functional leaders, as well as their employees via deliberate communication or gossip, might think something worse looms: they are going to lose their jobs. The vacuum of silence may lure all sorts of misinformation mischief into its vortex.

Third, whereas the CFO seems to be busy with a plethora of post-close activity, uninformed portfolio company employees may conclude that any change was limited to the Finance Department. Whew! Indeed, these and other scenarios—rooted in fiction or reality—abound for describing poor starts to hold periods.

Point One: *Within a month of transaction closure, portfolio company leadership should embrace the best practice of value-creation planning.*

What does value-creation planning accomplish? The ultimate objective is identifying the "vital few" initiatives that enhance enterprise value. Whereas this may seem obvious, a logical process for identifying the vital few undergirds the likelihood that the most accretive options are identified.

Each major process owner of the business model should participate in post-close planning. Indeed, they are the practical authors and change-agents of value-creation. Functional leaders who should participate in post-close planning are a byproduct of the business model. Examples of functional leaders include marketing, sales, product development, operations, supply chain logistics, customer service, billing, collections, accounting, human resources, and information technology.

The functional leaders of the business model should participate in post-close value-creation planning.

Appropriate planning emphasis is on customer touch-points. Post-close planning begins with the leadership team's introduction to the version of the investment thesis endorsed by the private equity firm's investment committee. Next is a structured reaction to the business model's ability to accomplish the SMART (specific, measurable, attainable, relevant, and timely) goals of the investment thesis.

In the lower middle market, stabilizing the business model's foundation is a common precursor to scaling in pursuit of enterprise value aspirations. Vis-à-vis diligence, planning participants may (i) confirm, (ii) clarify, (iii) refute, and/or (iv) identify omissions. Indeed, the latter two are most interesting—and more common than some investors may care to admit. These discoveries represent some of the most valuable business intelligence the private equity firm deal team may encounter.

The focus on competitive differentiation is among the major directional decisions the portfolio company needs to make. An old but useful tool offers guidance: the model promoted by Michael Treacy and Fred Wiersema in their book, *The Discipline of Market Leaders*. Similar to *In Search of Excellence*, the examples are dated, but the principles are timeless.

Treacey and Wiersema identified three things companies must do to exist: (i) engage customers with a relationship style, (ii) provide customers a product/service, and (iii) serve customers via some fulfillment methodology. A business must be "good enough"

in all three. In truth, most companies in the lower middle market have room for improvement in all three. However, the most important Treacey and Wiersema discovery is that the key to competitive *differentiation* is choosing one of the three to the exclusion of the other two. (See Table 1 below.)

Business Model Profile

Prerequisites	Good Enough	Differentiation
Product/service	Distinction	Innovation
Delivery medium	Operational competence	Operational excellence
Relationship dynamic	Responsiveness	Intimacy

Table 1

Businesses that pursue differentiation through product/service innovation create new markets. These companies tend to have large research and development budgets to accelerate remuneration within the finite exclusivity periods for intellectual property. Pfizer within the pharmaceutical industry provides such an example.

Businesses that choose operational excellence differentiation aspire to be formidable price competitors. These companies have finely tuned supply chains. Amazon.com is such a company and is inducing heartburn for another such operationally excellent pioneer of an earlier era: Walmart.

Businesses seeking differentiation by intimate customer relationships may earn margin premiums from customers as incomparable, holistic solutions providers. These models may be harder to sustain because recessions expose price elasticity of demand. Moreover, products tend to commoditize over time. Finally, these businesses tend to have smaller addressable markets. An intimate example is Herrods of London, a high-end retailer with an extremely broad product line. One particular item I recall from a 2007 visit was a cherry red go kart that looked like the 308 GTS Ferrari on the *Magnum, P.I.* TV show. The price tag far exceeded manufacturer suggested retail price for my sedan.

Competitive differentiation is ultimately an either/or decision among product/service innovation, operational excellence, and customer intimacy.

The “differentiation” tipping point is an either/or—not both/and—decision. The differentiation options across product/service innovation, operational excellence, and customer intimacy are mutually exclusive. In substantiation of the either/or phenomenon, the Treacey and Wiersema research discovered that all research subjects which deliberately focused on more than one point of differentiation failed to accomplish their objectives.

***Point Two:** Choosing a point of differentiation—innovation, operational excellence, **<u>or</u>** customer intimacy—is the ultimate prism through which business leaders should view all "vital few" initiative opportunities.*

Deal teams and/or portfolio company leadership rarely commence the strategic differentiation discussion in perfect alignment. More commonly, within and across organizations, the opinions are passionately divergent. The reason is simple and understandable: the parties engage debate from different perspectives. However, the arguments, i.e., opinions substantiated by facts, are highly beneficial. Upon anchoring the singular differentiable focus, value-creation conversations invariably adopt a vernacular reflective of (i) "Does this initiative make us good enough in one of the two non-differentiable categories?" and/or (ii) "Does this initiative substantiate competitive edge in the differentiation category?"

The planning possibilities for value-creation are referred to as the "worthy many," and represent a mix of initiatives to be "good enough" in each of the three necessities (product/service distinction, execution competency, and customer responsiveness), as well as the truly strategic differentiators (see Table 1). The take-away is that foundational necessities preempt differentiation to assure sustainability. However, the approach to foundational initiatives requires an eye necessarily peeled for serving the strategic differentiation aspirations—executing each foundational initiative in a manner that undergirds product innovation, operational excellence, **<u>or</u>** customer intimacy differentiation.

The "vital few" subset of the "worthy many" invariably straddles the categories of culture, growth, and productivity.

Value-creation veterans realize that portfolio company employees had "day jobs" before the advent of the private equity sponsor dynamic. Thus, overwhelming employees with an avalanche of initiatives is counterproductive. The list of "worthy many" possibilities is usually plentiful and requires triage. Three at a time is the practical limit. This point was potently vetted in Larry Bossidy and Ram Charan's book, *Execution: The Discipline of Getting Things Done*. This shorter list (and subset of the "worthy many") is the "vital few."

Invariably, value-creation initiatives fall in one of three categories: *culture*, *growth*, and *productivity*. *Culture* pertains to all things people. Common examples include organizational architecture and performance management. *Growth* has two subsets: organic and acquisitive. Salesforce effectiveness is a common organic initiative. Acquisition integration is a chronic challenge, as some management teams underestimate their complexity by not having experienced one. *Productivity* regards efficient processes, typically undergirded by technology, that robustly accomplish productivity. Robust productivity is manifested in economies of scope and scale.

Point Three: *Deal teams may build value-creation bonds by supporting their portfolio company leaders with resources to accomplish the vital few.*

Knowing what the business aspires to do, i.e., the strategic intent toward differentiation, is the primary objective. How those objectives are accomplished is the next pivot: tactics. Four execution scenarios are common. First, the company may have both the skillsets and capacity for engaging the challenge. Second, the firm may need help with analysis, but is comfortable with execution. Third, the company is comfortable with analysis, but may need help with execution. Fourth, the company may require assistance with both analysis and execution.

Private equity firms accelerate value-creation when they tender pre-vetted resources to assist in the last three scenarios. Depending on the firm, these resources are provided in three scenarios. The first scenario is "operating partners." "Operating partner" does not possess a universally consistent definition. However and generally speaking, these are professionals employed by the private equity firm who, unlike deal team members, focus primarily on supporting portfolio companies with post-close value-creation endeavors. The second scenario is a pre-vetted, independent bullpen of subject matter experts, i.e., consultants, who may be deployed on short notice. The third scenario is a hybrid approach whereby some value-creation deliverables are supported by operating partners while others are supported by external resources.

Resources available for expedited execution of the "vital few" are essential to value-creation.

Value-creation initiatives of all varieties benefit by one of the most unheralded skills in business: project management. Particularly when initiatives entail numerous moving parts, some of which have dependencies on other parts, project management rigor helps keep things on track. Moreover, initiatives that enjoy "strategic" prominence should be integrated into other governance elements: dashboard metrics, performance management, monthly management discussion and analysis reports, and quarterly board agendas.

In summary, value-creation is most probable when (i) the right people in the portfolio company know what is expected, (ii) the private equity deal team listens to their input, (iii) prioritized value-creation initiatives are aligned with strategic differentiation, and (iv) execution resources are sufficient for accomplishing the objective.

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Middle Market Methods™ offers a value-creation toolbox of cultural, growth, and productivity solutions to portfolio companies of private equity firms. The premise is that best practice adoption correlates with a smoother ride during the investment hold period, resulting in higher exit multiples. Additionally, deal team time is liberated from operational surprises to invest in new transactions.