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Value-creating Solutions in Private Equity

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An Oldie, but a Goodie, Value-creation Tool

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Introduction

We Baby Boomers love our classic rock-n-roll. In homage, I retain a marble-based Kenwood 2055 belt-driven turntable for enjoying the remnants of a once robust vinyl collection. A highlight of parenthood was our daughters learning that Dad had some cool beneath his square veneer. Their epiphany resulted from the discovery of my albums by their high school calculus study groups. Today, XM channels such as Classic Vinyl provide convenient access to my favorite bands. Ah, the oldies but goodies

What about oldies, but goodies, for value-creation? This installment taps into another nostalgic vein. Before GE became the Six Sigma posterchild, it utilized a tool called workout. For lenders in our midst, workout connotes a problem. Indeed, the workout technique for GE was agnostically aimed at problems, including and especially process problems. Workout doubled as a change-management tool. The workout technique leveraged employee tribal knowledge to harness 80/20 solutions. Materiality (of impact) over precision was vindicated by internal rate of return on results. In contrast to a sponsor community betrothed to virtuous—albeit tedious—empiricism, workout may be worthwhile for getting a jump on the proverbial low-hanging fruit among the portfolio company orchards. One of the most alluring attributes of the workout process is expediency. Leaders may need the workout option because conventional wisdom failed to produce the expected results. Only a day's investment of time produces executable solutions to "the problem." This article will outline the basic structure of the workout problem-solving methodology.

What's the Problem?

The first step in problem-solving is admitting that there is, indeed, a problem. The problem should generally come from one of three business model buckets: culture,

growth, or productivity. For example, a cultural problem might relate to turnover, a growth problem might entail returns and allowances, and a productivity problem might regard defects, respectively. Despite KPIs that called attention to such issues, a sustainable fix might not be obvious.

Aim workout at a succinctly worded problem that does not telescope “the” answer.

A problem statement is a simple declarative statement, e.g., “Our credit memos are twice the normal amount.” A good problem statement eschews embedding a telescoped answer which defeats the purpose of the exercise. The litmus test for violating this axiom is when the declarative clause is followed by another clause that commences with “because.”

What are the Ground Rules?

Good ground rules accomplish at least two objectives. First, the problem-solving team should possess cross-functional perspectives from participants closer to the action. I respectfully call these associates worker bees. My clients recognize this as axiomatic to my general process improvement work. Bosses do not typically make good problem-solving teammates. They enter the arena with heavy biases about right answers—and tend to dominate conversations. Moreover, bosses may lack granular perspective because they do not actually do the work. How do you error-proof this issue? Exclusion. Worker bees may already know what is causing the problem but may feel that their input is not valued. Workout provides the receptivity construct for worker bee practical wisdom.

Teams of cross-functional worker bees are the best problem-solvers.

The second purpose is change-management. Sustainable solutions require buy-in by those who must embrace the change. If those who need to buy-in are co-authors of solution(s), the odds of success improve. A team may be self-directed or facilitated. If facilitated, the facilitator should be someone disassociated with the chain of command, i.e., an objective mediator.

There are only two times when the chain of command participates. The first is sponsorship of the workout initiative. The leader sponsoring the event states the problem, frames the ground rules, and departs to let the team engage the problem without interference. The second participation by leadership is receptivity to the workout team’s recommendations, i.e., action items, couched in these terms:

- If the leader agrees with the action item, the team is immediately empowered to proceed with implementation.
- If the leader does not understand the action item, the team may be challenged for clarification before the leader responds.

- If the leader disagrees with the recommended action item, there is an appellate process to assure fair hearing, e.g., the peers, the leadership team, and/or the board of directors.

Context

The problem may be more clearly understood in the context in which it resides. Sticking with the credit memos example, the process scope might commence with production and end with collections. A Six Sigma tool called SIPOC comes in handy for contextual perspective. SIPOC is an acronym for suppliers, inputs, process, outputs, and customers. (See Figure 1.) The SIPOC is completed in this order:

- Focus first on the process that creates the perceived problem. When does it start and when does it end?
- Then, describe the process in a few high-level steps. This is a considerably more modest depiction of the process than a cross-functional process map.
- Next, identify what the process creates, i.e., outputs. Invoices would be an item for our example.
- Subsequently, ask “Who cares if it is done right the first time?” These would be customers of the process. Obviously, external customers are on the list, but there also are internal customers, e.g., the cash application employees in accounting.

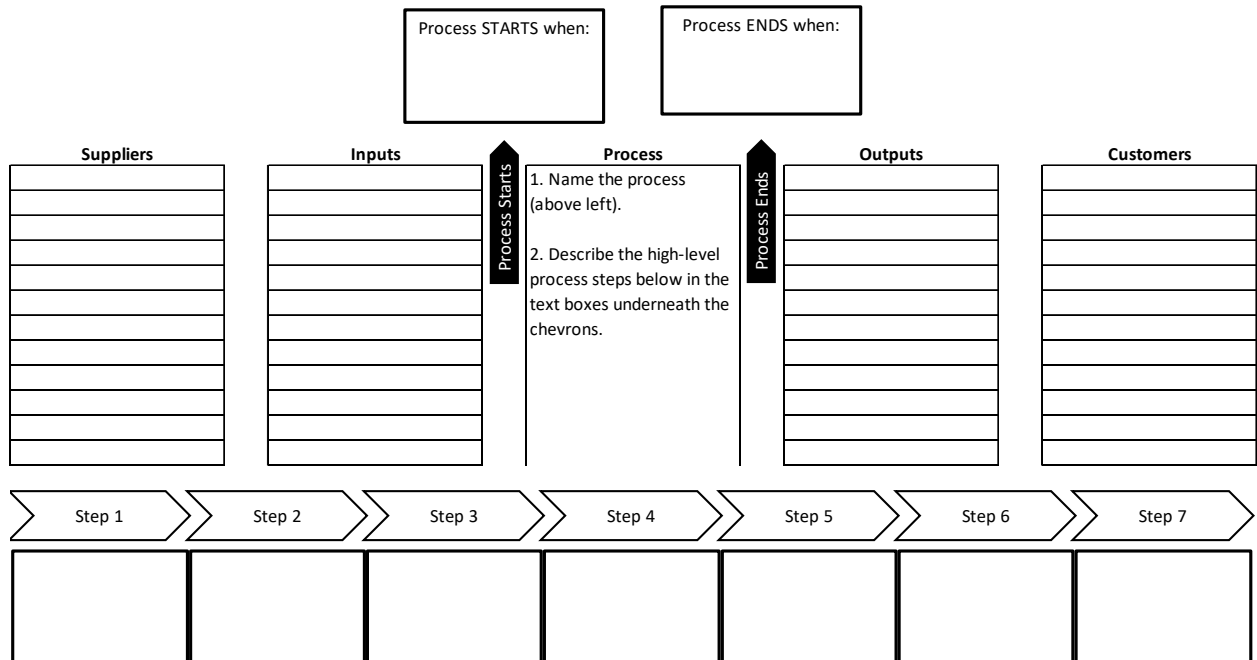


Figure 1: SIPOC

- Next, flip to the left side of the SIPOC, beginning with what inputs feed the process. Likely suspects consistent with our example include the work order, the bill of materials, the production router/traveler, etc.

- Finally, ask who supplies these inputs—the S in SIPOC. Suppliers may be internal and external.

Presto! The process ecosystem is thus depicted in which the root causes of eventual errors are germinating. The meaty and useful content in a SIPOC may surprise observers.

Major Root Causes

Benefiting by context and reminded of the problem statement, the team then leverages their tribal knowledge to brainstorm potential root causes. With the list in hand, mapping them to a fishbone diagram (see Figure 2) is a means of segmenting root causes into types. The fishbone diagram was invented by Kaoru Ishikawa as a quality improvement tool. There are six major bones branching from the spine: methods, machines, materials, measures, mother nature, and people.

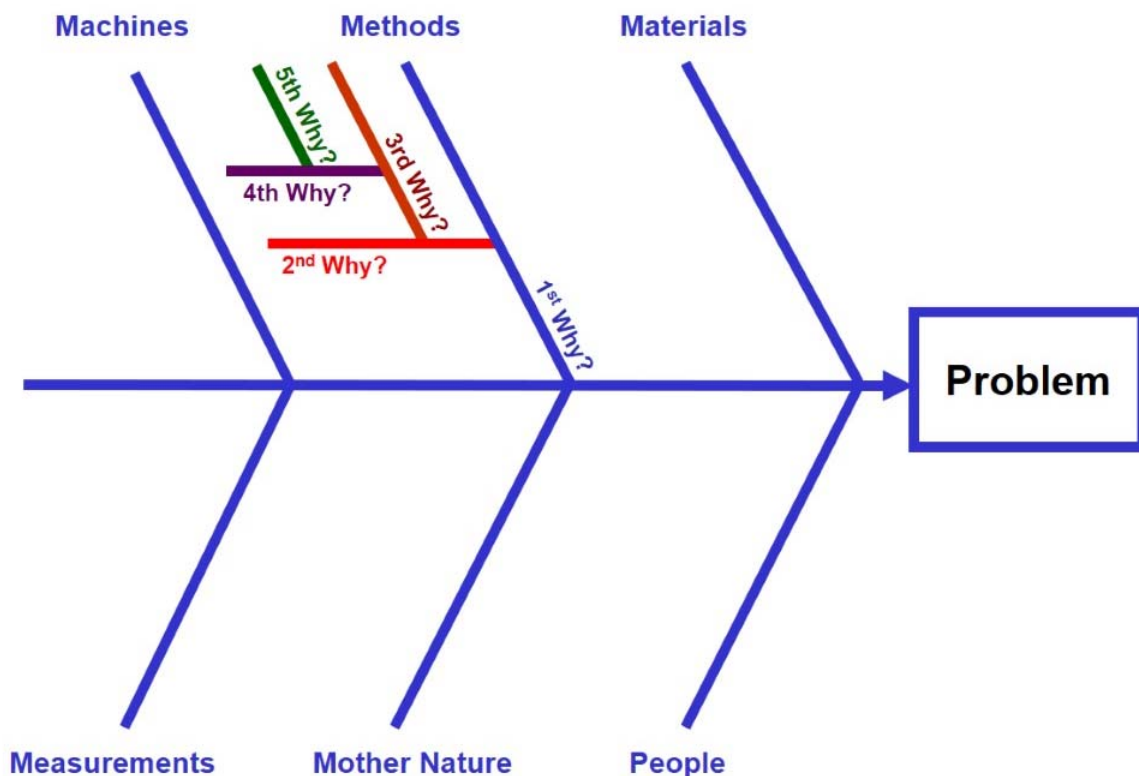


Figure 2: Fishbone Diagram

Some of the brainstormed potential root causes might benefit by further scrutiny. These become more detailed bones by abiding the 5 Whys technique. The best way to understand the 5 Whys traces to the precocious proclivities of two-year-olds who keep asking “Why?” until their curiosity is satiated. Five is not a magic number, but rather a precept. The point is drill-down until reaching a plausible explanation. This may be

accomplished in as few as three whys—or as many as 13. To understand the benefit, please indulge a detour through Six Sigma instructor folklore attributable to an unpublished 1993 report by Donald H. Messersmith for the National Park Service (which I cannot find to confirm outright attribution).

The monuments around the tidal basin in Washington, D.C., were experiencing decay. This is a problem statement at which the 5 Whys are aimed.

- Why were the monuments decaying?
 - Cleaning chemicals.
- Why were the chemicals necessary?
 - Bird droppings removal.
- Why were the birds fond of the monuments?
 - Delectable, juicy spiders whose webs adorned crevices.
- Why were spiders hanging out around the monuments?
 - Smaller, less succulent insects.
- Why were the insects teasing the spiders' palates?
 - The tidal basin made the insects amorous, and consequently, more plentiful.
- Why the romance among the insects?
 - There is something about sunset and water Coincidentally, it seems to work on humans, too.
- Why the insect tidal basin preference over other tidal pool locations?
 - Mood lighting that doubled as monument illumination.

Solution: Change the lighting timer.

Cost: None.

Benefits: Monument life extension, lower cleaning costs, smaller power bill, cleaner environment, and pleased park patrons—sans the annoying insects.

Note: My version of the story has more than five whys to prove the point of sufficiency. Attribute the variation to poetic license.

Not all root causes are created equally. A prioritization technique comes in handy. Nominal Group Technique (NGT) and N/3 are such examples. N/3 is explained here. Divide the number of root causes by three. That's how many votes each workout participant has for allocation across their perceived major root causes—only one vote per cause. The root causes with the most votes emerge as priorities for further scrutiny. This approximates the Pareto effect—and ties in to the 80/20 premise in the article introduction, i.e., 20 percent of the root causes account for 80 percent of the process errors. In practical terms, workout settles on two or three problems for acute focus.

Primary Solutions

Beginning with the top root cause, the group should brainstorm solutions. Potential solutions for two root causes should be the minimum workout standard, with a third attainable as a stretch goal. The brainstormed solutions are then plotted in a pay-off matrix (see Figure 3). The order of execution is:

1. High impact, easy to implement
2. Low impact, easy to implement
3. High impact, hard to implement

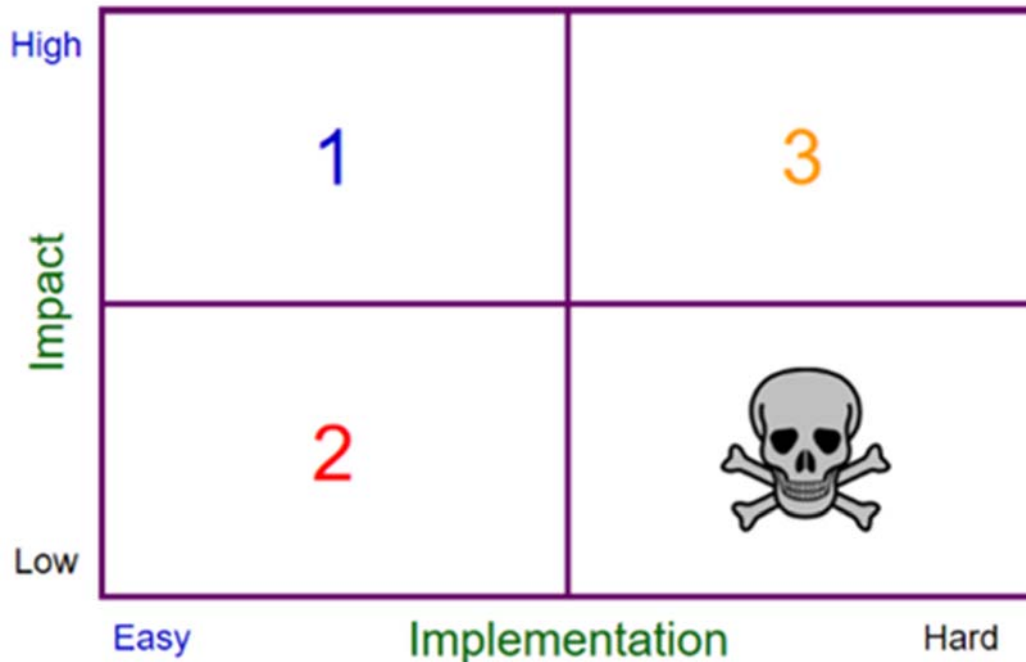


Figure 3: Pay-off Matrix

Stating the obvious, do not waste time on low impact, hard to implement. Why execute low impact, easy to implement (#2 in the pay-off matrix) before high impact, hard to implement (#3 in the pay-off matrix)? Because they are easy to implement. High impact but hard to implement action items may require project management rigor in response to their complexity. Moreover, leaders should avoid attempting too many of these simultaneously. Overwhelming company resources may mean that nothing gets done. Each itemized solution in the three acceptable quadrants should have owners and deadlines.

Report-out and Execution

The team is now ready to report to their sponsor relative to the framework in the “What Are the Ground Rules?” section above. Again, the options are (i) yes, (ii) clarification, or

(iii) no—but with a second look. The yeses pivot to immediate execution ahead of the possible subsequent yeses. Progress against execution should be appropriately tracked. Weekly is common.

Summary

Some GE veterans reflect that workout positioned GE to make the most of Six Sigma during the Jack Welch era. Workout solved the practical; whereas, Six Sigma solved the elusive. Good data are essential to Six Sigma. Unfortunately, the good systems required to produce good data tend to be problematic among lower middle market portfolio companies. Therefore, leveraging the tribal knowledge of worker bees via the workout vehicle seems the logical choice for expedited value-creation. Coincidentally, the results may self-fund the better systems essential to more sophisticated analysis.

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 investment hold period, resulting in higher exit multiples. Additionally, deal team time is liberated from operational surprises to invest in new transactions.