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The S.M.A.R.T. Playbook for Achieving Superior Returns With Portfolio Companies

The buyout market is very competitive, which has led to higher prices for buyouts and shorter hold periods. Today, private equity (PE) firms need a focused and accelerated path to value creation for their portfolio companies.

In the first installment of this *Executive Insights* series for PE firms, "Six Smart Ways PE Firms Are Mining Profits in a Challenging Environment," we discussed six strategies to generate superior returns by creating advantaged deal flow. While advantaged deal flow may lead to a lower purchase price, PE firms will want to increase the value of their portfolio companies during their hold periods regardless of purchase price.

To address this leg of value creation, we introduce the S.M.A.R.T. playbook in this second installment of the series. S.M.A.R.T. is composed of:

- Strategic focus
- Management & organization
- Asset alignment
- Revenue growth
- Total cost alignment

We created the S.M.A.R.T. acronym to describe a systematic approach to portfolio company value creation that we observe PE firms utilizing to face the demands of the ROI clock.

Let's take a closer look at each component of the S.M.A.R.T. playbook and how successful PE firms are utilizing these components.

Strategic focus. However successful a portfolio company's strategy may have been, shrewd PE firms look to refocus priorities and/or grow into new areas by making changes, such as:

- Focusing on faster growth or more valuable customer segments
- Expanding into new channels
- Integrating forward or backward in the value chain
- Adding new products that align with the company's capabilities or with customers' needs
- Adding new services to business lines as described in L.E.K. Consulting's *Edge Strategy: A New Mindset for Profitable Growth* (Harvard Business Press, 2016)
- Entering new geographies
- Performing "tuck-in" acquisitions to accomplish the above or gain scale where beneficial

Determining which growth vector to pursue involves forming a fundamental understanding of the opportunity set available while

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simultaneously deciding how the company's assets or capabilities can provide a differentiated product/service to exploit new opportunities.

Oftentimes, middle-market companies have not been as thorough in finding new vectors of growth or may have faced constraints that new owners can unlock. It takes time to identify and redirect a company's strategy, but the payoff from exploiting these new opportunities is substantial.

Consider the example of a client's portfolio company that sold its performance parts for passenger vehicles exclusively to avid performance drivers. These target customers purchased the parts through the do-it-yourself (DIY) channel and installed the parts on their own. However, L.E.K. identified a population of latent enthusiasts who were willing to purchase these parts when they were offered through a "do it for me" channel. Not only did this enable the company to gain more customers, but it also created a new channel through which to sell its product.

Management & organization. PE firms must often operate as if they are talent scouts. They carefully assess the company's existing management team and make the necessary changes to drive company performance. In addition, PE firms will often reconfigure the organizational structure and management systems to facilitate growth and improve the company's effectiveness.

We frequently see PE firms refresh the talent in a portfolio company and build out the management systems. We have also seen the addition of new senior-level functions, such as chief commercial officer, chief business development officer, chief technology officer and chief digital officer. Adding this talent helps drive the desired strategy by putting in place the skill set required to achieve it.

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Asset alignment. Many portfolio companies are noticeably either underresourced or overresourced. At one extreme are companies that have been starved for cash or denied investments that would yield high returns. At the opposite end of the spectrum are companies that have overinvested in people, property, plant, and equipment and/or working capital.

We also see portfolio companies with the wrong assets, such as poorly located plants or other facilities, a situation that may have arisen with a change in products, distribution channels or the supply chain. As an example, one client acquiring a packaging company with multiple divisions found during diligence that some of the divisions had lost their leadership positions and were in decline but had great PP&E because they had been the historic cash cows, while other, faster divisions were starved for investment because they required investment in new substrates for the company.

Successful PE firms ensure that costs are truly aligned to the needs of the business and aggressively challenge how a given activity or cost contributes to the strategy.

Successful PE firms conscientiously review whether there are high-NPV-investment opportunities or whether capital needs to be pulled out to make a company run more efficiently. Taking out unnecessary investments in fixed or working capital releases more cash that can be set aside or used for other purposes, including strategic investments that yield high returns.

Revenue growth. All companies want to beat industry growth rates. We observe PE firms systematically looking for new areas of growth for portfolio companies to pursue, such as:

- Identifying new target customer segments to pursue
- Expanding into new channels and/or acquiring new customers
- Developing new products and services
- Redefining the customer's journey and finding opportunities at the edge of their business to better meet customers' needs
- Culling product lines to remove those that yield low returns for the resources they consume
- Reviewing pricing policies that may have been neglected in the pursuit of top-line revenue growth
- Running advanced analytics on customer or other data to reveal insights that enhance the company's value proposition
- Realigning the sales force to better exploit customer opportunities

For example, one client selling healthcare services was originally focused on selling to a declining market segment, small community hospitals, in part because that segment had a short sales cycle. After the company was purchased by a PE firm, L.E.K. helped reconfigure the sales function. First, the sales focus turned to larger hospitals and hospital systems. Second, a well-supported outside sales organization was created. Third, an inside sales organization was formed to support the sales function and target medium-sized hospitals. These changes put the company on a solid long-term path for growth.

Total cost alignment. Individual decisions to grow costs, typically in the name of developing capability or enabling growth, are almost always rational. However, it is common for overhead costs to grow beyond the true needs of the business. Successful PE firms ensure that costs are truly aligned to the needs of the business and aggressively challenge how a given activity or cost contributes to the strategy. This challenge can take multiple forms — from a strategic sourcing review through to comprehensive bottom-up approaches such as zero-based budgeting.

Regardless of the approach taken, functional/cost categories are examined, and both operating expenses and capital expenditures are assessed. Although an array of cost-reduction techniques can be applied, L.E.K. believes that successful cost alignment includes:

- Setting aggressive top-down targets that create focus and urgency, as a "best endeavors" effort rarely results in a cost effort achieving its full potential
- Addressing strategic and structural solutions, not just tactical solutions (the biggest cost-reduction opportunities typically lie not in incremental process improvements, but rather in making strategic and structural choices, e.g., what markets to exit, insourcing versus outsourcing choices)
- Operating at a fast cadence, which helps decision-making and avoids stalling and delay
- Measuring real outcomes by following the cash

Conclusions

L.E.K. developed the S.M.A.R.T. playbook through our work with more than 150 PE firms that are fiercely determined to generate superior returns. Applying the S.M.A.R.T. framework provides a systematic approach to grow the value of portfolio companies. The framework is applicable to companies of all sizes, in all economic conditions and at any time in the ownership tenure of the portfolio company. It serves to develop an effective plan to grow the value of the business to yield superior returns upon exit.

About the Authors

Peter McKelvey is President of L.E.K. Consulting's Americas practice and is responsible for directing the firm's strategy and operations in the Americas region. He also chairs L.E.K.'s Americas Regional Management Committee and serves on L.E.K.'s Global Operating Committee and Global Leadership Team. Peter has more than 25 years of experience with L.E.K. and specializes in corporate strategy development and M&A advisory services for private equity firms and their portfolio companies. He has broad expertise both in evaluating new investment opportunities and in providing strategic enhancements for portfolio companies.

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About L.E.K. Consulting

L.E.K. Consulting is a global management consulting firm that uses deep industry expertise and rigorous analysis to help business leaders achieve practical results with real impact. We are uncompromising in our approach to helping clients consistently make better decisions, deliver improved business performance and create greater shareholder returns. The firm advises and supports global companies that are leaders in their industries — including the largest private- and public-sector organizations, private equity firms, and emerging entrepreneurial businesses. Founded in 1983, L.E.K. employs more than 1,200 professionals across the Americas, Asia-Pacific and Europe. For more information, go to www.lek.com.