

A Private Equity Value Multiplier

Reducing indirect costs increases the enterprise value of private equity portfolio companies

Any private equity firm's chief goal is to enhance enterprise value by helping its portfolio companies increase top line revenues, reduce costs and realize profitable growth. Reducing the costs of their indirect expenditures is an often overlooked part of the equation.

Indirect costs are externally-purchased goods and services not directly related to the manufacture of a company's product or provision of its core services to customers. They are typically general and administrative expenses such as office supplies, insurance and telecommunications expense, or indirect costs of goods sold, such as freight and factory consumables.

From the standpoint of the private equity investor, the business case for reducing indirect costs is obvious: enterprise value is increased by the investor's EBITDA valuation multiple times every dollar saved. Indirect costs represent an untapped gold mine and present a real opportunity to significantly enhance the profitability of portfolio companies.

Reasons for overspending on indirect costs

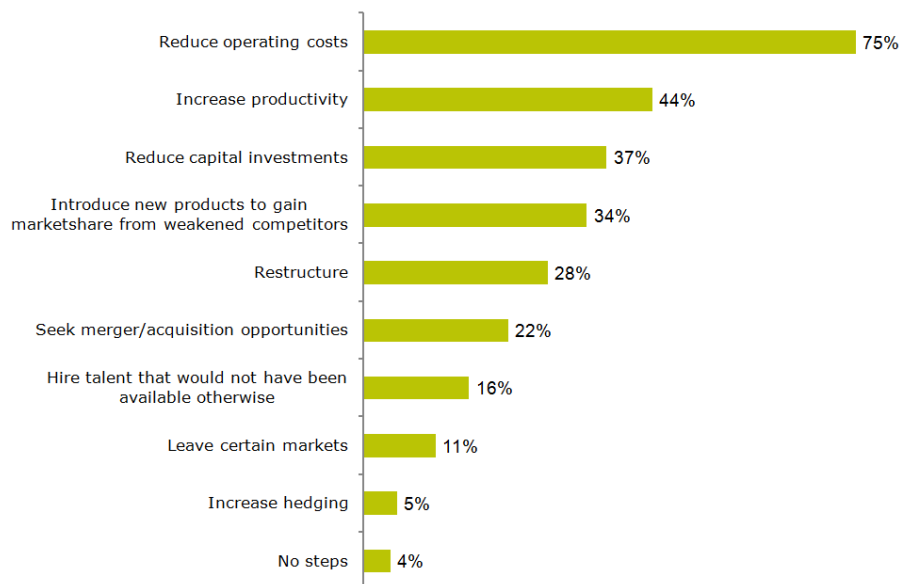
The typical mid-sized company applies disciplined strategic sourcing to only about one-third of its total spend. A study by the Aberdeen Group showed that in the U.S., ineffective sourcing by mid-sized companies results in \$134 billion annually in missed savings opportunities. Middle market companies typically overspend on indirect costs for a variety of reasons:

- Senior management does not believe that controlling indirect costs is strategic;
- Staff and management have limited time to address non-strategic costs;
- Employees have limited purchasing experience or expense category knowledge;
- There is insufficient data, including internal spend data and external benchmark data, to do an adequate spend analysis and leverage purchasing power;
- Management has a misconception that suppliers are looking out for the portfolio company's best interests;
- Companies believe they are doing a good job of cost control on their own;

- Multiple suppliers and/or multiple order points prevent cost-bundling or leverage;
- Management is not sure where or how to begin a strategic sourcing initiative; and
- Companies lack a formal sourcing or procurement department.

Cost Reduction Drivers

Even without private equity oversight, companies often try their own hand at cost reduction. The recent recession has made cost reduction a must, rather than a luxury, for most companies. According to the McKinsey Global Survey from the fourth quarter of 2008, 75 percent of companies surveyed planned to reduce operating costs in response to the economic climate. In fact, this was the number one measure reported as a way of weathering the recession. But in many cases, companies lack the leverage or internal expertise to be truly effective, and are better served hiring external cost reduction experts. Other responses for how companies planned to react to the economic climate are shown in the table below.



Source: McKinsey Global Survey

How Private Equity Firms Can Help

Private equity firms are in a very good position to help their portfolio companies reduce indirect costs, given their overall mission of helping management better run the company by providing expertise and oversight.

One benefit that private equity firms can bring to a cost-reduction process is leverage. They typically own multiple portfolio companies, and can pool purchasing power to better negotiate prices. Cost reduction experts know how to leverage this purchasing power.

However, managing indirect expenditures such as insurance or fleet management expense is not a core competency of the private equity firm, just as it is not a core competency of their portfolio companies. In many cases, it is more effective for private equity firms to establish partnerships with third-party cost management experts that will negotiate deals on behalf of their portfolio companies, with an understanding of the service, quality and cost the portfolio companies expect.

External cost reduction experts can:

- Bring procurement experience and expense category knowledge to the table;
- Have insights into and leverage with the suppliers;
- Have access to external cost benchmarking data; and
- Perform cost reduction projects with minimal time required of the portfolio company management and staff.

Avenues for Cost Reduction

Within each portfolio company, there are several common avenues for maximizing profitability:

Spend Analysis

Performing a spend analysis in the relevant cost categories produces a detailed map showing the money being spent, goods and services purchased, typical pricing per item, and vendors used.

Vendor Analysis

Ordering from multiple vendors is a common area of overspending – consolidation creates competition and can lead to far better rates. Offering vendors the opportunity to compete for a larger share of business compels them to provide better rates. Consolidated billing reduces purchasing and accounts payable transaction volumes, lowering processing costs. It also gives the purchasing department a far greater perspective on its spend, when personnel can examine one invoice instead of 200. Many vendors can offer consolidated purchasing reports and analytics.

Consolidation of Ordering Points

Centralizing the purchasing process so all purchases of a given product or service happen in one place significantly improves the efficiency of the ordering process. Many vendors provide online ordering portals that employees can use at multiple company locations, while having their access controlled and purchases authorized based on their user profile.

Ask for the “Best Deal”

Ask suppliers for their ideas on reducing costs—this is a simple cost-reduction tool that is typically not employed. Many suppliers will offer discounts for online orders or volume rebates.

By examining the ordering process, companies realize both hard and soft savings—they typically see a cost reduction in per-item cost, but also see reduced manpower devoted to purchasing and payables.

Facing Objections to Cost Reduction Efforts

While reducing costs sounds like a win-win, the objections or obstacles companies most often raise include thinking the process will be time consuming, that it is too good to be true, or that they'll receive recommendations that they aren't willing or able to implement.

Private equity firms can play a significant role in easing those fears by advocating for their third-party cost reduction partner and sharing past experiences of cost-reduction success. In extreme cases, it may even be in their best interests to mandate cost-reduction efforts.

The payoff can be significant. In our experience, companies realize average savings in indirect costs of about 20 percent, and that 20 percent can represent anywhere between half a percent to 5 percent of revenue.

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