KEYNOTE INTERVIEW

Reaching beyond the low-hanging fruit

PE firms investing in manufacturing need to take a holistic approach to creating sustainable value through cost management, says EFESO

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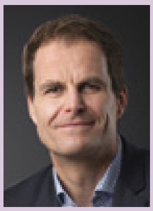

Andreas Dörken
Global leader for private equity

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Co-leader, North American private equity practice

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Q Why is a holistic approach to cost management so important for PE investors in the manufacturing sector?

Andreas Dörken: Many portfolio companies are now running through private equity cycles for the second or third time. The easy wins are gone, so as a PE owner you need to take a much deeper look into what you want to do to achieve value creation.

Making small improvements in siloed areas is no longer going to cut it. You need to look at everything at the same time to see how you can best combine the different levers between the processes and products and functions, such as purchasing or production.

Thomas Plasa: The cost of capital has increased significantly, and private equity firms only have the chance to spend their money once. Therefore, it's essential for them to make the right decisions about where they invest and how they invest over time.

The automotive industry started trying to work systematically on cost engineering around 20 years ago. At that time, we built up a team with industry experts and put together cost structures, systems and tools that we are still using today to help our clients simulate the impacts of different strategies and find an optimum way of managing costs.

There are a few key things to consider when it comes to total cost management in this sector. The first is to look at costs from the perspectives of the company's product, processes and carbon dioxide output.

The second is to recognise that every function in the company has a part to play in reducing total operating costs.

The final thing to consider is that firms should look to include the whole cycle of costs when evaluating an investment. This begins with measuring the company's top-down target costing, bottom-up product cost development and processing costs, and runs through to cost deployment through internal optimisation and supplier negotiation.

Q Do private equity firms appreciate the need to tackle cost management holistically, rather than incrementally?

Larry Keeley: Many firms still concentrate on low-hanging fruit. The opportunity to look at the holistic spend – to help the portfolio company leverage the spend in the best manner possible – is often overlooked.

For some PE firms, the instinct is to look at the opportunities and ask what is the easiest to grab. But if they are not careful, it's easy to slip into a silo mentality, as opposed to looking across the entire enterprise.

AD: Some firms are much more sophisticated than others in the way they look at operational improvements. It also depends on how long a fund holds onto a portfolio company. When they have a very short hold period, it's only natural to look first at the things that can be done very quickly and easily.

But, in this market, more and more private equity funds are holding onto their investments longer than the minimum three to five years. Once the owners have run out of ideas for incremental improvements, then it's time for us to say that they need to take a holistic view.

Fabian Rodriguez: Many firms appreciate that you can no longer only think about top line acceleration and margin growth. You've got to also pay attention to your multiple expansion, and that requires a longer-term approach.

However, even among the firms that understand this, most struggle with having the capabilities to work on all three levers – top line acceleration, margin expansion and multiple expansion – at the same time.

Q What are some of the key lessons to highlight from the automotive industry?

AD: One of the main things is the importance of flexibility when dealing with nascent technologies, as in the battery industry. Some companies are struggling today because of the technology choices they made. It's crucial to maintain flexibility for as long as you can, which may mean downsizing your expectations for one technology, but balancing it out with others. Those trade-offs and decisions are difficult to make, but you need to have transparency around the cost structures and the market potential to be able to decide.

What is important is total cost. If a company puts everything in one basket, it becomes hugely expensive to change course. If you run with multiple technologies, it is less expensive to change this.

Q How have inflationary pressures influenced attitudes to cost management?

AD: The easy way out of inflation is to pass on the price increases to your customers. In most cases, that's not possible. However, if you don't do anything, you can be stuck with contracting margins. When we support diligence processes, we often look at business plans where companies are making plans to improve costs to mitigate the impact of 2, 3 or 4 percent inflation. We always say, that's not enough!

You need to go beyond covering just inflation. You could probably cover inflation by squeezing your suppliers harder, but you need to make substantial and structural changes if you want see bigger reductions.

FR: Inflation is one of the reasons why you need to make a cost-management programme sustainable and cost optimisation a robust capability within the portfolio company. Identifying cost reduction opportunities and executing on them shouldn't be a one-time event. You need to do this on a regular basis. This is why it's vital to create the capability within a company so that they can make cost management sustainable.

Q At what point in the investment cycle should PE investors in manufacturing companies focus on cost management programmes?

FR: It makes most sense to put in place any such programme early in the hold period. If a PE investor has five to seven years to transform a company, they will need to take a comprehensive approach that involves multiple functions and suppliers. Starting early means they are able to see the results before they exit the company.

TP: We have to distinguish between companies. Investment targets that are taking a greenfield approach typically have very optimistic plans. With these companies, we evaluate the overall strategy and its premises. Things become more complicated when companies are working on both brownfield and greenfield projects.

This is why the German automotive industry is struggling, because companies have to serve brownfield operations in parallel with starting-up new technologies.

A holistic approach to cost management is vital, because we have to consider the strategy, the operational and functional approaches, and the implementation approach. We can simulate with our clients what the impact will be and what the best case, reasonable case or worst-case scenario will be.

Q What impact does a good cost management approach make on exit valuations?

LK: It's critical. As a PE owner, if you can demonstrate that a company is on a journey towards holistic cost management, you will be in a stronger position to get a better multiple when you sell the company. Even if the company is still part way through its journey, the owner can still get a large amount of credit for that at the time of the sale.

FR: We also participate in the private equity market as advisers during buyer due diligence, meaning that we help investors to put a valuation on a target. One of the things we look for is whether the company, relative to others, has a strong approach to cost reduction. Do they have the right data sets? Do they have the right processes in place?

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>
> **ANDREAS DÖRKEN**

Q How can private equity firms balance the need for investment to help companies grow with the need to control costs?

FR: The key is to look at the total future stream of cashflows. To maximise that, sometimes the optimal answer is to increase costs in the short term when it comes to quality, maintenance and new product development. The need to look for additional value creation is core to this industry, and investing in better tools and processes can help to add that additional free cashflow.

I'm very positive about the future because the industry is not going to stop looking for ways to improve value creation. Firms are always going to look for levers that enhance value creation opportunities in the short, medium and long term.

Q How do sustainability considerations factor into cost-management strategies?

TP: We can transfer our methodology around cost management to sustainability approaches. We work to make CO_2 consumption transparent and to show companies how to improve to avoid any penalties or carbon taxes. In this respect, we are not just optimising costs, we are also optimising the carbon footprint. We can simulate, from a supply-chain perspective, the best levers for sustainability and reducing emissions.

AD: We had a conversation recently with a company in the electric battery industry that originally decided not to invest in new battery cell plants. It intended to just source the cells from China. However, the CO_2 calculations around the product footprint made it clear that, with carbon taxes going up, importing from China would become a losing proposition. These kinds of decisions are strategic. Companies are liable to incur such high costs that they should look now at the sustainability considerations in order to make the right decision. ■