Four key areas for cost reduction and value creation in private equity (PART 1)

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Against a challenging landscape, the ability to identify and execute the right cost optimization strategy can be a game changer.

Three questions to ask

- What optimization strategy is ideal for achieving the firm's true cost potential?
- Are the cost reduction solutions focused on developing resilience and not eliminating resources critical for future growth?
- Has increased complexity hijacked the cost structure impacting the ability to retain and recruit talent?

The current business environment presents private equity management teams with an opportunity to holistically address their cost structures while building resilience. Managers are under renewed pressure to control costs, despite delivering savings in recent years by either streamlining or restructuring. Against a challenging landscape of economic uncertainty, high inflation and geopolitical headwinds, identifying and executing the right cost optimization strategy (COS) can be a game changer. While most manage costs for stability, the winners will be those that manage for both resilience and future growth.

For private equity funds and their portfolio companies, the pressure is arguably even greater, as their organizations also face falling price multiples and higher financing costs. EY teams estimate that US$530b in debt is coming to maturity for portfolio companies by the end of 2025, propelling a need to maintain EBITDA levels and adding greater urgency for further cost improvements.

Wider benefits of cost optimization

Many business leaders tactically manage costs without seizing the wider opportunity to build strength into cost structures. Business management and information systems are typically designed for control — for instance, to deliver a budget — and less geared toward providing transparency on processes and the improvement potential within them. As a result, businesses making tactical top-down cost restructuring decisions run the risk of eliminating resources that may be critical for future growth.

When the process of identifying and executing the right COS is done effectively, the increased operational leverage delivers short-term profitability. This lays the foundation for companies to overcome adversity and maintain a competitive advantage over the long run.

Setting the right approach to an effective strategy

There are three questions businesses need to ask to successfully deliver COS:

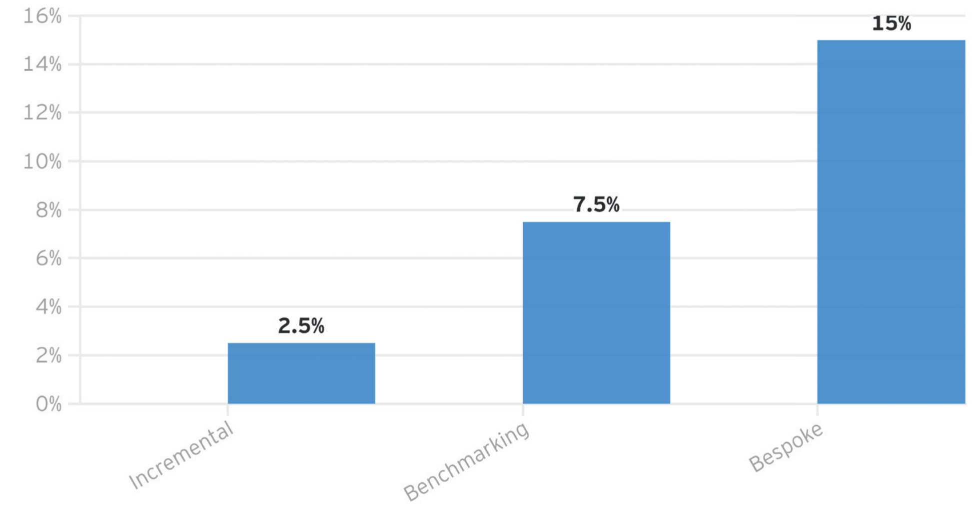
1. Is there a true understanding of the real cost drivers of the business?
2. What could or should the cost be to effectively serve the customer base, and is this sustainable?
3. Does the business demonstrate the right competencies and mindset to rapidly deliver on genuine cost savings?

The next steps are to decide on the scope, intensity and timing of COS. Leaders typically take one of following approaches:

- Incremental approach: Many businesses employ what can be referred to as an incremental approach. The usual starting point here ranges from budget-cutting strategies to adopting lean approaches. This is typically designed to offset pressures in a low inflation environment while delivering a few percentage points of cost optimization, at best.
- Benchmarking approach: A more tactical, top-down approach is benchmarking, comparing a business to its peers to identify opportunities. While this may achieve 5-10% of incremental savings, the risk is that benchmarking acts as a band-aid and fails to exploit the greater efficiencies that can be fully extracted from the business. Additionally, wider company buy-in can be a challenge for some organizations.

Setting the right approach

Typical projected cost savings in three optimization strategies



A chart showing the typical projected cost savings in three optimization strategies. The incremental strategy shows 2.5% growth. The benchmarking strategy shows 7.5% growth. The bespoke strategy shows 15% growth.

- Bespoke approach: In contrast, this approach is business-driven. Such a strategy typically focuses on the key value drivers, scrutinizing all business operations from the bottom up and revealing the ones that have the biggest impact on profitability. The approach often leads to better internal acceptance given the collaboration required throughout the process. Done well, a step-change approach can improve margins by more than 15%. As one CFO commented to an EY team: "It provided the transparency to deliver cost savings, while safeguarding key growth lever."

Identifying the cost base

Private equity-owned firms, and corporates considering the future of a business unit or division, increasingly want to know the true cost-base potential for those assets. What level of performance could be achieved if all realizable cost-saving opportunities were realized?

Carrying out a rapid value creation diagnostic will set the framework for considering costs in relation to other levers, such as pricing, working capital, capital allocation, tax optimization and ESG. A diagnostic will drive the necessary unbiased cost transparency and lay the foundation of a short-, medium- and long-term value creation delivery plan. It will also inform crucial business decisions on whether to focus on fixing underperforming assets, pursuing sale options or partially winding down an operation.■

(CONTINUED IN NEXT EDITION)

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