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

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EY
Building a better working world

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:

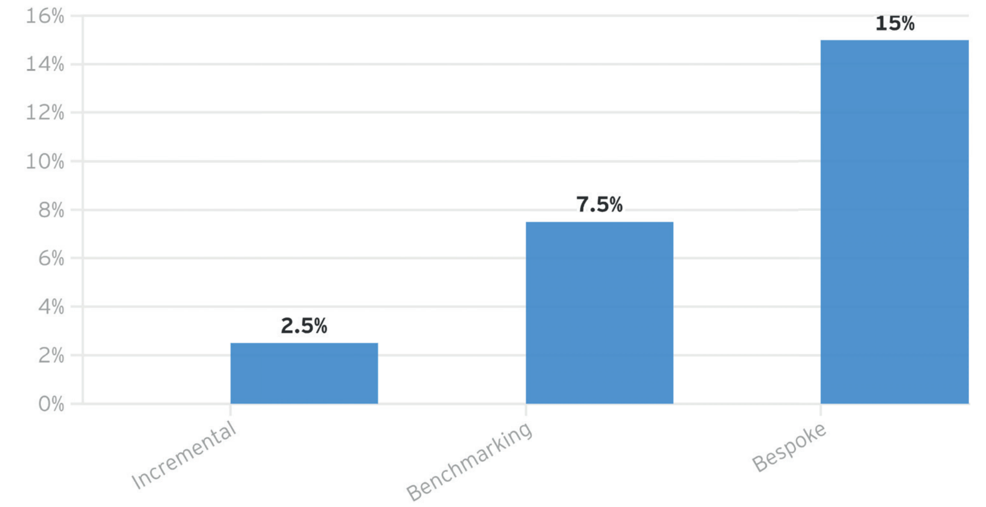
1. Is there a true understanding of the real cost drivers of the business?
2. What could or should the cost be to effectively serve the customer base, and is this sustainable?
3. Does the business demonstrate the right competencies and mindset to rapidly deliver on genuine cost savings?

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)

Private equity value creation services

Our hands-on value creation leaders work at pace to help PE companies and sponsors deliver their investment case by accelerating cash and profit improvements from ideation to results.

The better the question. The better the answer. The better the world works. For more information, please send an email to **isaac.sarpong@gh.ey.com** and copy in **kofi.akuoko@gh.ey.com**

Four key areas for cost reduction and value creation in private equity (PART 2)

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(CONTINUED FROM PREVIOUS EDITION)

Four key areas for cost reduction and value creation

Once the cost reduction approach — and its scope — have been determined, the next question is which areas of the business should be targeted for improvement. Here are four key areas being addressed by management teams:

1. Get a grip on spending

Consider and examine all forms of spending, not only the product, input and contractor costs, but elements of indirect spending as well.

- The employment of traditional procurement measures such as the consolidation of demand, rationalizing and developing closer cooperation with suppliers, reverse auctions, or employing necessary hedging mechanisms are likely to deliver cost avoidance benefits as opposed to cost optimization, especially in a high inflationary environment. The key here is to ensure that supplier side measures align with the working capital agenda. For more information on cash optimization and working capital, see our first article in the value creation series: Three cash disciplines to create value and resilience | EY - Global
- To drive further cost optimization, organizations need to focus on reducing the internal "demand" side. This can be addressed by working with sales, R&D and operations to harmonize product ranges and services or deploy value engineering to remove costly input materials or processes that don't deliver value.
- Similarly, scrutinizing indirect spend can prove highly effective: it is important to decide what controls and policies should be put in place to reduce the internal need for indirect spend (e.g., applying a zero-base lens) and drive sufficient value. These steps often require an abandonment of the "how it's always been done" mentality, and an external, disruptive challenge is often necessary – one that is typically easier to initiate in a high inflationary environment.

2. Simplify where you can

Complexity grows in businesses over time, which can reduce productivity and increase costs. This complexity makes it more challenging to fully grasp the businesses' true cost drivers. Business simplification enables sustainable cost optimization. Some key factors to consider are:

- Build an efficient operating model that can scale effectively, embracing productivity and back-office automation.
- Complexity is derived over time from organic growth, historical choices that may no longer be optimal under the current economic or regulatory environment, or acquisitions that weren't fully integrated. This can lead to duplication of roles or legacy systems and infrastructure that often tie up resources and increase costs. Focusing on operating model optimization allows for increased agility and an attention to the businesses' core markets, which is key in navigating a high inflationary environment.
- The push to drive more choice and offerings for products and services often drives supply chain, operational and overhead complexity. In a more recessionary environment, where customers curtail spending to more basic products, services and choices, eliminating low or negative margin products, services or geographies is critical. This paring down of products and services needs to include a right sizing of the operations and overhead. The true cost (of SKUs and services growth) beyond the direct cost lines are not often readily evident, which makes the selection process difficult when the impact on growth is uncertain.

3. Build an efficient and resilient supply chain — don't forget tax

Supply chain costs are crucial for any business, and from an operational standpoint, resilience is critical. The recent disruption, along with economic and geopolitical pressures have exposed various opportunities for cost optimization:

- **Remove excess spend.** In the past few years, many businesses have had to expedite shipments or ship partial loads to offset deficiencies. As this became the "new normal," the extra incurred costs did not always disappear as supply chain pressures eased. This provides an additional opportunity to integrate environmental, social and governance (ESG) agendas, further enhancing businesses' buoyancy against uncertainty.
- **Drive efficiencies.** Typically, zero-based efficiency reviews yield significant opportunities. When businesses were forced to change their operational approaches during the pandemic, they often rapidly set up new infrastructure that prioritized guaranteeing delivery over more cost-effective ways of supplying products and services. This offers two opportunities: 1) increasing the efficiency of the "sticky plaster" solutions; and 2) rightsizing and removing fixed cost in legacy supply chains with declining volumes.
- **Ensure resilience.** Some smaller suppliers are struggling with macroeconomic challenges. The urgency to swiftly replace suppliers often leads to short-term cost increased that need to be optimized. Greater transparency into which suppliers could put the business at risk is key to establishing both strength and cost avoidance.
- **Recognize that cost efficiency and tax efficiency go hand in hand.** There are several key areas to consider within tax. First, holistically examine the supply chain from a tax efficiency perspective. Second, consider the legal entity structure. Legal entities cost money and resources to hold and manage. A meaningful reduction in legal entities produces administrative cost savings, frees resources, reduces risk and increases transparency. Third, map the company's tax footprint and use this information to develop tax planning to reduce the total tax cost.

4. Focus on talent

Labor costs are key to any COS. To offset inflationary wage increases, focus on productivity and the removal of activities where there is low value add or duplication. Recruitment teams today face an ongoing battle for talent, where skilled employees are increasingly expensive to attract and retain, with rising hiring costs forcing the wider use of contractors. The retention and development of talent, combined with recruiting the right high-quality leadership, are core factors in creating a value-driven culture.

Looking ahead

The burdens business leaders face today are unprecedented, with inflationary pressures, energy challenges, the increased focus on ESG, supply chain disruption and talent shortages all coming together.

To survive and thrive in this environment, businesses need to rethink their approaches to cost reduction. While traditional focus areas and approaches still have value, they often result in short-term gains, where costs can creep back in 12 to 18 months down the road.

Leaders need to look holistically at business operations, bringing together a mix of competencies across commercial, finance, operations and data analytics to focus on the immediate priorities that deliver sustainable value.

Summary

Given demands on management's agenda, the C-suite needs clarity of thought around identifying, quantifying and executing on cost reduction priorities. The winners will be the ones that use this opportunity to manage costs for growing a more resilient business.■

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