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Business Intelligence: Critical Insight for Private Equity

By John Stiffler

In a challenging economic environment, managing at both the general portfolio and operating unit levels has taken on greater importance. Private equity firms and management teams must look at every possible avenue in order to streamline company operations and improve performance.

Business intelligence (BI) is a system for analyzing collected data, with the purpose of providing a better view of an organization's operations to ultimately improve and enhance decision-making, agility and performance. Contrary to popular belief, implementing or improving BI isn't necessarily expensive or time-consuming. It isn't only about tracking financial metrics, and it doesn't have to involve a wholesale replacement of existing systems and processes.

Regulatory changes, such as FAS 157 and the Dodd-Frank Act, are putting pressure on PE firms to manage themselves and their portfolios more effectively and efficiently. Focusing on leading and lagging metrics across portfolios can provide the insight necessary to do so.

But many firms struggle to develop timely and accurate metrics because they don't have the tools and processes in place to draw real-time data from across their portfolio companies and consolidate it into a forward-looking view of investment performance.

Keys to Better Performance

One of the keys to effective portfolio management is insight — in particular, establishing metrics and collecting and organizing information that enables private equity firms to make timely, effective decisions with respect to portfolio company operations, value creation opportunities and transactions.

Most PE firms use a simple application (such as Microsoft Excel) combined with manual processes to track financial performance. However, compiling and synthesizing data can be difficult and time-consuming and often produces reports that, by the time they are completed, are out of date.

In addition to understanding a single portfolio company's performance, PE firms also need to draw information from across companies in order to assess overall investment performance.

Despite their inherent need for performance data, many firms have not expressed the same level of interest in establishing the same BI capabilities as the corporate world at large. According to West Monroe Partners' research, more than 70 percent of private equity firms have not invested in BI solutions.

Benefits for Private Equity Firms

Private equity firms actually have many good reasons for improving their reporting and analytics capabilities, starting with the ability to pull data from disparate sources and create a consolidated view across portfolios or industries. Recent BI trends that facilitate these views suggest that PE executives may want to take a fresh look at its capabilities.

The marketplace for BI vendors and solutions has matured significantly in recent years. Robust offerings from vendors now focused on the middle market have helped reduce the hard cost of implementing a true BI solution. Additionally, today's BI solutions can reduce staff time required to build manual reports, which in turn allows private equity firms to eliminate positions or redeploy resources to activities that will generate greater value.

PE firms that adopt BI and performance management practices can gain a significant competitive advantage, including:

- **Financial and cost management benefits:** Through mechanisms that enable them to monitor and understand portfolio companies' costs and compare results, while at the same time minimizing manual reporting processes.
- **Operational improvement benefits:** Through the capability to analyze operational costs, identify process inefficiencies and streamline key processes throughout their portfolio companies' supply chains.
- **Sales and marketing benefits:** By establishing the ability to track sales effectiveness, identify new sources of revenue and protect portfolio companies' customer bases.
- **Consistency of metrics across the portfolio:** By using a common "single version of the truth." A BI solution uses agreed-upon measures that can be stored and reused to ensure continuity across reporting periods.
- **Better leverage of analysts:** By defining a common reporting approach and providing a consolidated database of reporting data. Analysts can spend more time actually analyzing the data rather than pulling, consolidating and building the reporting solutions each time.

To Maximize Benefits, Start Small

Most private equity firms already have some useful tools in place that can help minimize capital investment and ongoing maintenance. Look carefully at existing reporting systems, including those established within portfolio companies — with an eye toward understanding which systems could play a part in developing "through-the-windshield" view of performance.

Next, complete a simple audit and assessment of the metrics that are relevant to the various portfolio companies. Is there evidence of performance that's visual, up to the minute and can be acted on immediately? A scorecard or dashboard can be a powerful way to garner insight in a matter of minutes.

Finally, keep the initial effort small and focused. Business intelligence should evolve constantly to meet the needs of an ever-changing business. By keeping it simple, a quick-win can be established on which the organization can build.

To focus efforts and maximize the benefits, define a small set of five to seven key metrics that define and evaluate how successful the company is, and how it is making progress against its overall corporate goals. In addition to portfolio-level financial/operating metrics, consider these fund-level key performance indicators:

- **Vintage year and analysis:** This is the first year in which a project or company receives capital from the private equity firm, and it provides investors a way to assess returns — particularly if the investment occurs during a peak or low point in a business cycle. Firms investing at the peak generally pay a premium and have higher expectations for return than those investing at the bottom of the cycle, when companies are often undervalued.
- **Auction successes:** Some companies use investment banks to represent their intentions through an auction process. Others work on a proprietary basis, selling directly to the PE firm without the help of an investment bank. Insight as to how well the PE firm has done in the auction process will help determine if the auction process is producing expected results or if pursuing proprietary deals is a more effective approach.
- **Debt multiples individually and across the portfolio:** Debt multiples are the ratio of total outstanding debt balance to operating cashflow. This is one of the most telling and accurate ways to look at the financial health of a company. Thus, it is of keen interest to private equity investors. Furthermore, debt multiples across a fund's portfolio are important indicators of the fund's performance against the principles around which it was created.
- **EBITDA trends across the portfolio:** EBITDA (earnings before interest, taxes, depreciation and amortization) is the standard financial metric by which firms are judged. Strong EBITDA numbers both individually and across the portfolio indicate that the private equity fund has been successful in picking solid, strong-performing companies.
- **Internal rate of return (IRR):** Think of this as the rate of growth an investment is expected to generate. The higher the number, the better. Looking at IRR throughout the course of an investment is a common practice across the equity community.
- **Seasonal trends in specific industries:** As a private equity fund invests in similar industries, developing an understanding of seasonally affected numbers such as EBITDA will help to manage troughs in expected earnings across the portfolio.

In the current environment, effective reporting and portfolio management can drive investment performance and competitive advantage, regardless of an organization's size. Insight and agility — the products of a sound BI solution — are vital elements of operations and portfolio management. While BI solutions may not have met needs in the past, much has changed in today's maturing offerings. For organizations that haven't considered their BI capabilities recently, now may be the time to reap the benefits a truly intelligent solution provides.

John Stiffler (jstiffler@westmonroepartners.com) is a director in West Monroe Partners' Private Equity & Alternative Investment practice where he has been building and implementing business intelligence solutions across a number of industries, including PE.

Metrics that Matter

Companies considering opening their business to private equity investment could learn a few lessons from recent BI successes. An organization that can produce key metrics easily and rapidly and has the ability to provide data on demand will be able to meet the significant demands of the PE diligence process. Traditional financial markers of a company's health, such as common income statement and balance sheet metrics, are critical for a BI solution:

Income Statement	**Balance Sheet**
Gross Revenue ($)	Accounts Receivable
Gross Profit ($ and % margin)	Inventories
Net Sales ($ and % growth)	Property Plant & Equipment
Cost of Goods Sold	Goodwill
Selling, General and Administrative ($ and % of net sales)	Intangibles
Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) ($ and % margin)	Accounts Payable
Capital Expenditures ($ and % of net sales)	Accrued Expenses
Day Sales Outstanding	
Inventory Turns	
Working Capital (% of sales)	

Additionally, other financial and nonfinancial metrics might be of interest:

- Compound Annual Growth Rate (CAGR)
- Clients (Top Ten and % of Net Sales)
- Customer Satisfaction (Net Promoter® score)

Companies that hope to attract private equity investment should seriously consider developing an easy, flexible method to generate these — and derivations of these — metrics.