AlixPartners

Private Equity

OVERCOMING THE EFFICIENCY PARADOX

Building scalable and sustainable business operations

When a private equity (PE) firm pursues a platform or roll-up strategy, it embarks on a series of acquisitions by adding one company after another, with the goal of building up a sizable market player.

Rolls-ups are now the dominant strategy among PE firms and have altered the competitive landscape in industries as different as home services, business and professional services, software and software as a service (SaaS), healthcare and health technology, and more.

Invariably, the architects of these serial deals plan to eliminate duplication as they bring companies together, and back-office functions are the first places they look, asking, What do we need with two—or more, as a roll-up progresses—human resources (HR), finance, legal, and other teams? Surely, we will need just one facilities team, one employee benefits team, and one cybersecurity team. And surely, we can reduce head count in every department, eliminate redundant systems, and achieve economies of scale across the entire spectrum of general and administrative activities.

Improving margins by cutting back-office costs seems easy. But doing it right is surprisingly hard. Time and again, we have seen PE firms and their portfolio companies (portcos) create cut-and-paste back-office functions that save money at first but that are less efficient, less sustainable, and less scalable, which makes them more costly over time. The efficiency paradox—short-term cost-cutting that leads to long-term *inefficiency*—is a common outcome of poorly designed general and administrative costs (G&A) rationalization.

WHY IT HAPPENS

What goes wrong?

In our experience, portcos and PE firms have a heightened risk of running afoul of the efficiency paradox for one of four reasons.

1. The first is the imposition of ***formulaic cost targets*** on the organization without considering the organization's unique aspects or, crucially, its growth plans.

2. The second risk is the rolling out of ***incomplete solutions*** to problems involving organization design, which leads to an increasingly unmanageable patchwork of workarounds.

3. The third risk is ***suboptimal outsourcing***, which fails to exploit opportunities created by one or a series of acquisitions.

4. Finally, ***proliferation of shadow roles*** and functions in the organization as a result of inefficient integration and chaotic hiring practices.

EACH OF THESE DANGERS IS ESPECIALLY TROUBLESOME WHEN…

1 PORTCO LEADERSHIP is new to PE by having only little experience in ways of working with operating partners

OR

2 MIDDLE-MARKET PORTCO LEADERS lack experience of what it takes to manage back-office functions as the shop becomes significantly larger.

FORMULAIC COST TARGETS

This risk arises when a portco is given a number and simply told to reach it. The target number usually comes out of the due diligence process, and it's particularly problematic. A target number is typically a product of benchmarking—that is, when the acquirer or its advisors apply an industry standard cost (e.g., legal should be X% of revenue, finance Y%, HR Z%, etc.) and expect management to achieve it. Benchmarks are indeed valuable tools, and a deal that has to be done quickly usually leaves little time to perform a detailed, bottom-up analysis of the target's cost structure. But benchmarks can become straitjackets if management takes them literally or sees them as an analysis's end points, not start points.

Formulaic cost targets are problematic for three reasons:

1. first, because they ignore unique attributes of a company itself;
2. second, because benchmarking-derived targets rarely account for anticipated growth and further acquisitions—indeed, as we have written, a deal thesis predicated on significant top-line growth often underestimates the infrastructure needed to support it as the company lays a foundation for transformation;
3. and third, because formulaic cost targets may actually overlook opportunities for much higher cost savings and greater productivity gains.

INCOMPLETE SOLUTIONS

Within many companies, each G&A function—legal, finance, real estate and facilities management, HR, IT, and so on—have developed as independently run departments, with its own individual technologies and specific processes and with little coordination when it comes to purchasing or the design of processes' interactions. When those decentralized function groups encounter gaps—for example, between order processing and payments—the gaps get papered over. That can work in a small shop, but as one acquisition follows another, ad hoc solutions become inefficient, expensive, and error prone. The same thing can happen within functions; for instance, one company we worked with was operating three different accounts receivable processes that had been holdovers before three companies came together as one.

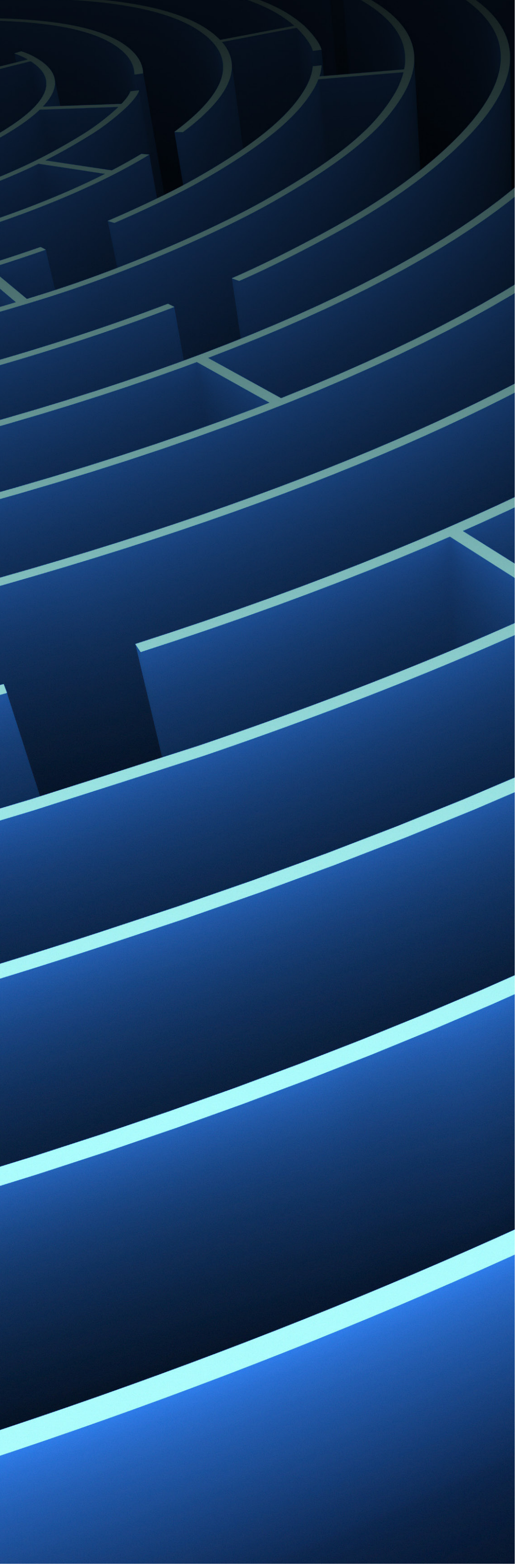
The most common solution for such an organization is to recruit new employees or hire contractors to manage the workflow—a band-aid that works for a while but becomes increasingly dysfunctional through time and as an organization grows.

SUBOPTIMAL OUTSOURCING

We often find that a client has created a patchwork of outsourcing arrangements for G&A functions. Sometimes the assortment is an outgrowth of the decentralization described earlier, with each function in it acting independently and hiring vendors that the function is familiar with. These deals might save money in the short run, but they eventually become costly and inefficient as the company grows, as it then adds more acquisitions, and as it ultimately loses the ability to adapt scale and volume for its outsourcing needs across the business.

SHADOW ORGANIZATIONS

Shadow functions and shadow platforms are not uncommon within a company. Under such a system, functional leaders hire employees to do similar work, or the leaders invest in platforms that do similar or sequential tasks but without seeing the larger picture. In a recent engagement with a vacation rental business, we saw three so-called training groups in the client's organization: one each within HR, operations, and sales and marketing.



THE SOLUTION

These issues have two things in common:

First, they single-mindedly focus on cost and have short time horizons, and second, they have the wrong kind of governance: either too top down—as in the case of mandated cost targets—or too decentralized.

What's needed is a top down/bottom up combination that focuses on enterprise value and takes into account both costs and the company's growth plans and acquisition strategy.

Critical change lies in the growing company's needs for both a vision and a change process from decentralized functions to centralized ones. Fulfillment of those needs combines deft cost management with a design for future growth. If G&A functions remain untouched or get managed in a balkanized way, then through the course of time, they cause confusion about what to do next and who is accountable; and it will become harder and harder to achieve efficiencies, because every initiative—every growth initiative, every cost initiative—has to be done several times.

Our experience tells us that efficiency-paradox traps can be avoided if a company organizes itself so that each G&A function has one single controller with the explicit authority to bring together the merging companies' various vendors, the companies' different ways of working, and the companies' disparate performance metrics. It doesn't matter whether a function's controller comes from the acquiring entity or the acquired one; what matters is that the controller have authority as well as the support of senior management. Ideally the controller should have both functional knowledge of and experience with change management. Those are not common skills at middle-market companies, but they have to become capabilities at portcos that are expanding through continued acquisition.

Consider how that controller role might work in the area of, say, procurement. Especially in a small to midsize organization, a decentralized procurement function or a team focused on tactical tasks like spot buys and basic vendor management might miss crucial, organization-wide resource allocation opportunities. That tactical, suboptimal approach doesn't just go away when two teams become combined; if it's not managed, it multiplies.

Establishing a robust procurement team, giving the team strong leadership, and empowering the team to be the gatekeeper for all non-personnel expenses can ensure thorough vetting of both new and existing providers, thereby facilitating a comprehensive business case review before the hiring of a new vendor or before a consolidation of providers.

Generative artificial intelligence (Gen AI) can play a major role in helping companies integrate vendor management following an acquisition.

More important, a central team with a strong charter can manage both existing and new relationships in the context of a plan to create a scalable, less-expensive, integrated function that supports growth. With a lean organization in place, a business can then find efficiencies in its organizational structure—and achieve efficiencies more effectively than if the business made tactical cuts in a decentralized function.

Similar benefits accrue from consolidation of financial processes into one system that offers visibility into how a business performs, establishes standard metrics for tracking performance, and that enables real-time analysis of cost-saving initiatives.

Centralization also leads to better uses of technologies, thereby saving money in the long run and implementing scalable processes that require less manual labor. For example, a PE firm recently acquired a human capital services company that was operating three different financial reporting systems for the main divisions and corporate. Each system relied heavily on manual processes, and therefore even more labor was required to roll the numbers up to the enterprise level.

By implementing a revised, integrated financial system, the company could streamline activities, reduce overall team sizes, and improve the timeliness and accuracy of its monthly reporting—a perfect example of the use of technology to improve efficiency and effectiveness in the management of reporting and data.

That, we believe, is the right way to find and optimize efficiencies in the back-office functions, whether the issues involve payables, facilities management, procurement, or HR. We have seen that with the right foundation in place, a company achieves up to 15 to 20% efficiencies in its G&A organization without disrupting day-to-day operations. And the gains are more than financial. Such solutions can produce true centers of excellence that will support a company as it grows and that will create career paths for employees at every level while also helping ensure that the enterprise is operating at levels of efficiency and quality that will make the organization more attractive when it comes time for the PE firm to sell. By addressing the aforementioned issues and implementing the proposed solutions, portcos can optimize their G&A functions and effectively manage their growth so as to clear a secure and efficient path forward.

AlixPartners

CONTACT THE AUTHORS:

Saurabh Singh
Partner
ssingh@alixpartners.com
+1 919 809 4556

Joe Centlivre
Senior Vice President
jcentlivre@alixpartners.com
+1 773 585 9756

Aditya Eswar
Senior Vice President
aeswar@alixpartners.com
+1 312 989 6779

Jason Estriga
Vice President
jestriga@alixpartners.com
+1 248 607 2189

ABOUT US

For more than 40 years, AlixPartners has helped businesses around the world respond quickly and decisively to their most critical challenges – circumstances as diverse as urgent performance improvement, accelerated transformation, complex restructuring and risk mitigation.

These are the moments when everything is on the line – a sudden shift in the market, an unexpected performance decline, a time-sensitive deal, a fork-in-the-road decision. But it's not what we do that makes a difference, it's how we do it.

Tackling situations when time is of the essence is part of our DNA – so we adopt an action-oriented approach at all times. We work in small, highly qualified teams with specific industry and functional expertise, and we operate at pace, moving quickly from analysis to implementation. We stand shoulder to shoulder with our clients until the job is done, and only measure our success in terms of the results we deliver.

Our approach enables us to help our clients confront and overcome truly future-defining challenges. We partner with you to make the right decisions and take the right actions. And we are right by your side. When it really matters.