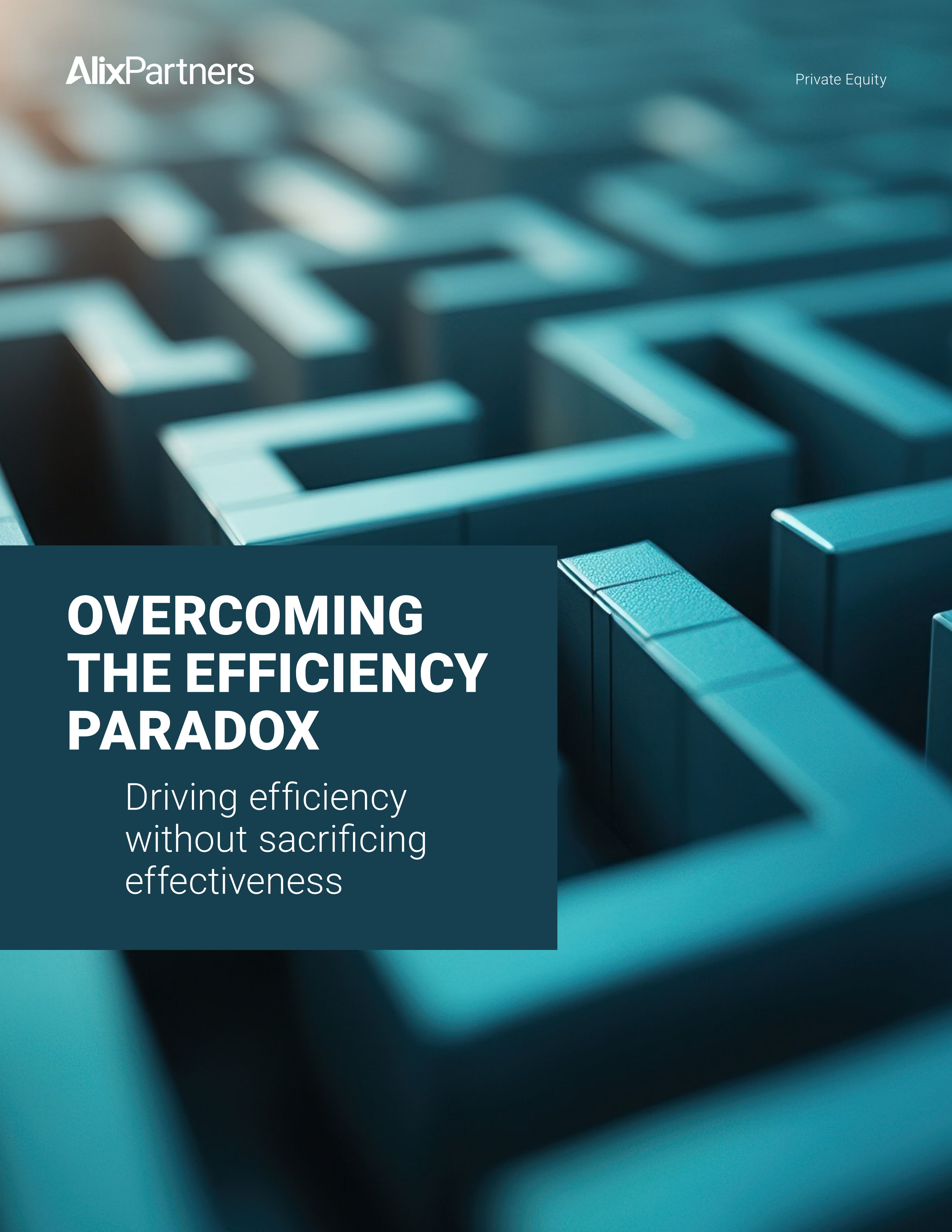


AlixPartners

Private Equity

OVERCOMING THE EFFICIENCY PARADOX

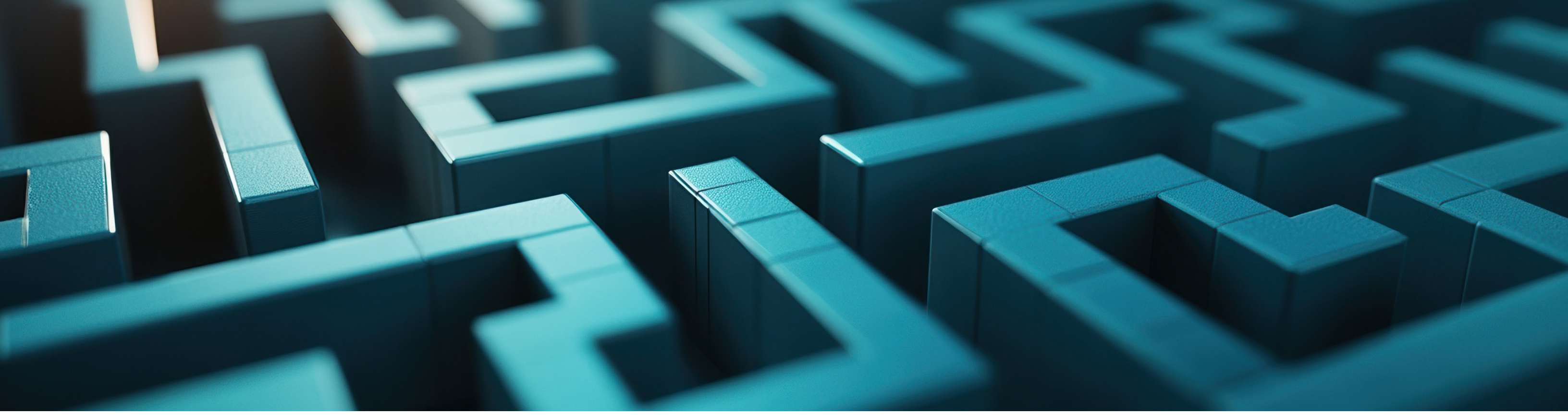
Driving efficiency without sacrificing effectiveness

How can you cut costs without gutting capabilities?

How can you make sure short-term fixes don't short-circuit strategic options?

Every executive faces those challenges. For public companies it is often expressed as the need to make the numbers Wall Street expects while making the investments that the future demands. We think of the issue as the efficiency paradox:

A company must be hyper-efficient to make profits that will fund growth, but misguided efforts to raise productivity levels can come at the expense of long-term efficiency and the value of the enterprise.



Nowhere is such tension stiffer than in private equity (PE). When PE firms take over a company, the situation almost invariably includes a deal thesis predicated in large part on reducing costs. The cost-cutting muscle was built when most PE acquisitions were stand-alone deals and thus could not deliver positive synergies the way corporate M&A could.

Today, however, three out of four PE deals are rollups or add-ons—meaning, companies acquired to be merged with others. In such deals, although there are indeed costs to be cut, substantial revenue growth is almost always an important part of the plan.

That means that investors, operating partners, and portfolio companies (portcos) all have to plan integration and operations with both the top and bottom lines in mind. For some PE leaders, this runs contrary to decades-old instincts and habits. Portco executives, for their parts, typically underestimate potential savings, or perhaps they cling too tightly to activities that will not actually be productive. Other times, they accept cuts too readily, and they don't speak up either strongly or effectively in the face of pressure from ownership.

Wrestling with the efficiency paradox can damage relations between investors and portco management—especially when the management team is new to PE. When things go awry, PE leaders say it's because execution by portco leadership was unfocused (52%; only 15% of portco leaders agree), or lacked urgency (45% versus 15%), or was inflexible (30% versus 19%). Portfolio company executives say tensions in the relationship stem from the level of debt they must carry (31 to 20%) or because their goals and incentives are not aligned with those of their owners (31 to 22%). As a result, the impact on value creation can be severely negative. As our colleagues Jason McDannold and Yale Kwon wrote in Harvard Business Review, "You can't cut your way to prosperity."

How should a PE–portco team address the efficiency paradox?

IN OUR EXPERIENCE, THE GAINS AND PERILS ARE GREATEST IN THREE AREAS:

1. **Rationalizing and optimizing commercial activities**
2. **Improving the effectiveness of general and administrative functions**
3. **Funding and managing an innovation pipeline.**

Each of those areas offers more efficiencies than executives usually think they do, but each also carries hidden dangers in the form of tempting opportunities to cut costs that could cause long-term damage.

After a merger or acquisition, managers naturally resist attempts to change what they see as an organization's profit engines: the sales and marketing teams and, in some cases, commercial functions like customer success and support. The managers' hesitation is valid because clumsy or hasty changes can damage established processes that work well or they can upset customers at a critical moment. Entrepreneurial companies in particular usually have deeply personal relationships with key customers. At the same time, however, in a rollup or platform acquisition, two companies are coming together to become one—one that will be more profitable as well as bigger. NewCo will want to present a single face to customers in order to drive sales and growth, and surely it makes no sense to operate duplicative sales and marketing organizations. The needs to (1) preserve—and expand—customer relationships and (2) increase profitability make commercial functions ripe opportunities for the efficiency paradox to show up—meaning that unfortunately, efforts to achieve efficiency end up boomeranging and doing long-term harm.

COMMON PITFALLS OF COMMERCIAL ORGANIZATION TRANSFORMATIONS

In commercial transformations and integrations, organizations frequently struggle to separate signal from noise. They can become so focused on select productivity metrics that, upon further review, may be misleading (the noise), as opposed to focusing on metrics that truly influence future performance (the signal). In our experience, the most common mistake is to make decisions based on metrics that measure volume or activity but do not necessarily measure profitability.

Following are examples.

SALES TEAMS

Sales teams often track volume-based metrics such as total bookings generated, number of units sold, or pipelines created. And even though those activities are important facets of a given rep's performance, they are myopic. Reps respond to the incentives laid before them, and if volume is all that gets measured, reps will reduce prices or add service packages to close deals, or they'll sell low-margin products if those products are easier to move than more profitable items, or they'll sign up customers they know are not likely to remain with the company. Cutting selling costs by ranking reps by volume alone is quick and easy, but it can hamper profit in the long term.

MARKETING SPEND

Marketing spend presents a different but related set of problems, because attributing revenue to marketing activities has been historically difficult and notoriously flawed. As legendary retailer John Wanamaker remarked,

> "Half the money I spend on advertising is wasted; the trouble is, I don't know which half."

As PE firms and portcos evaluate marketing spend after a deal, we often see them, say, adding up marketing-qualified leads (MQLs) or sometimes using the more sophisticated measurement of how often turn into sales-qualified leads (SQLs). Those measures are incomplete. As with sales, the number of fish that wind up in the net or in the boat matters less than how valuable the catch is. A company that resets its marketing budget based only on volume usually finds itself a victim of the efficiency paradox: finding savings today that are costly tomorrow.

CUSTOMER SUCCESS AND SUPPORT

Customer success and support: These groups may be the most prone to misinterpretation of activity-based metrics.

> "Our customer service managers cover X number of accounts, our call center reps close Y many tickets, and our average speed of answer is below Z seconds."

But those measures of efficiency say nothing about effectiveness or about the value of the customers being served. Deeper analysis might reveal that coverage is too thin to provide meaningful support, that tickets are being closed before resolution has truly been achieved, that low-value customers are being served in high-cost ways, that high-value customers are not getting the service they expect, and, generally, that breadth of service is being prioritized over depth of service. Any of those drawbacks can lead to decreased customer satisfaction, reduced customer retention, and limited account expansion opportunities.

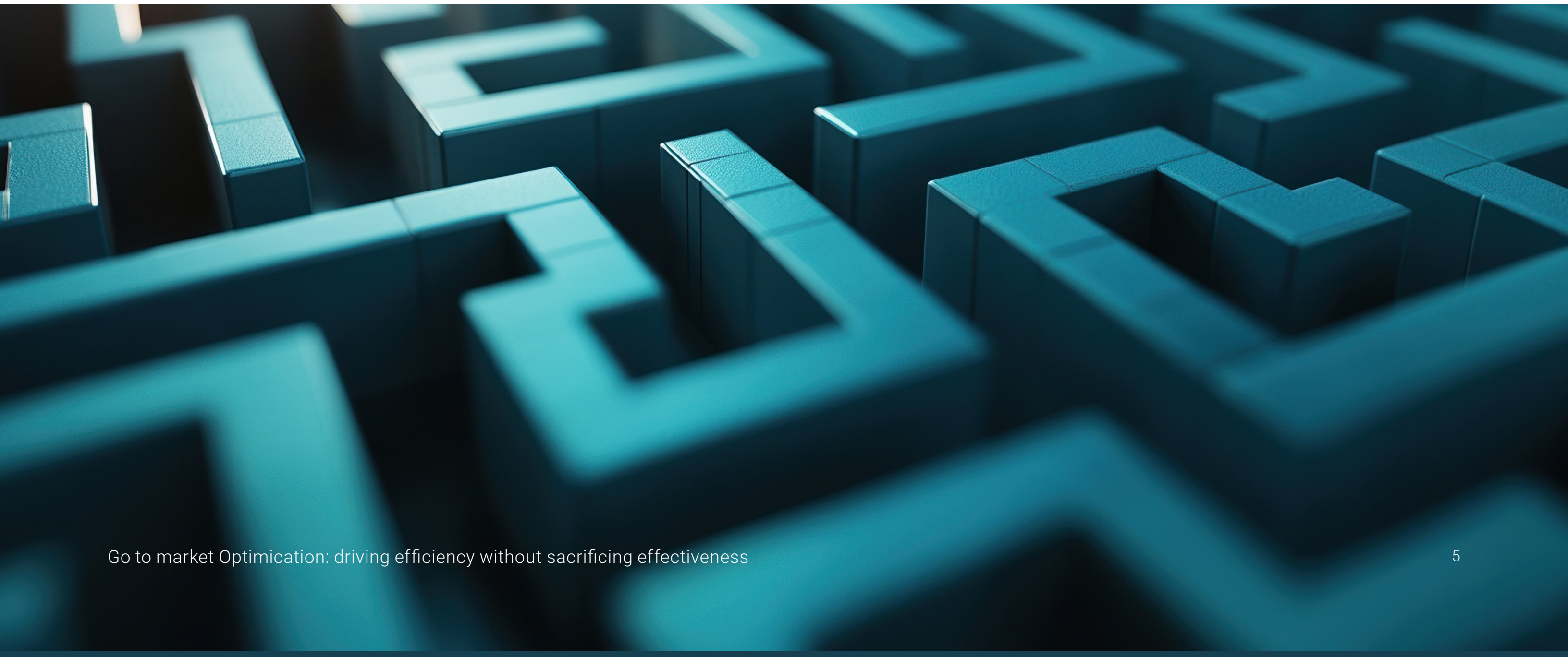
ALTERNATIVE APPROACH: CLV/CAC ANALYSES

These failures have two things in common:
They measure *amounts* of activity rather than its *value*, and they are siloed—meaning, they measure sales or marketing or service but not commercial effectiveness as a whole.

It is possible to fix the first problem by means of outcomes-based measurements, such as return on sales force, customer segmentation analysis, return on ad spend, and so on. But to avoid the pitfalls of the productivity paradox, a company should also develop an end-to-end view of commercial effectiveness. In our experience, such development begins by analyzing—and connecting—customer acquisition cost (CAC and customer lifetime value (CLV. Such analysis facilitates evaluation of the interdependencies of the entire commercial organization so that you can look for savings and synergies where they really matter: in the areas of acquiring and keeping your most valuable customers while avoiding overspending on customers or segments that are less profitable.

We saw that play out at a vacation property management company. After several acquisitions had expanded the company's geographic reach, the company found that EBITDA was plunging even as top-line revenue grew—in large part because the costs of sales and service were out of line. The Chief Financial Officer (CFO and Chief Revenue Officer (CRO)—both of them new to the PE environment—first thought they could solve the problem by cutting from the bottom: letting go of sales reps whose volumes were lowest. But that would have resulted in false economy. Deeper analysis uncovered wide variations in profitability by region and by market. One Florida city, for example, ranked in the 99th percentile for volume of rentals but only the 53rd percentile for profitability, whereas other markets showed the opposite: relatively low volume but high profitability.

A combined cost-to-acquire and CLV analysis showed that the company could sort its markets into three categories: it could *maintain* markets that were delivering solid combinations of net revenue and customer lifetime value; it could grow markets with attractive economics that made additional investments desirable; and it could optimize markets in which costs had to be brought down. The third group was soaking up 60% of marketing and sales costs but contributing only 30% of profit. The analysis enabled the company to identify greater cost savings than its previous cut-by-volume approach had found while it simultaneously found money to fund additional investments in markets that mattered more.



The following areas remediate several shortcomings of activity-based evaluations:

COMPREHENSIVE EVALUATION

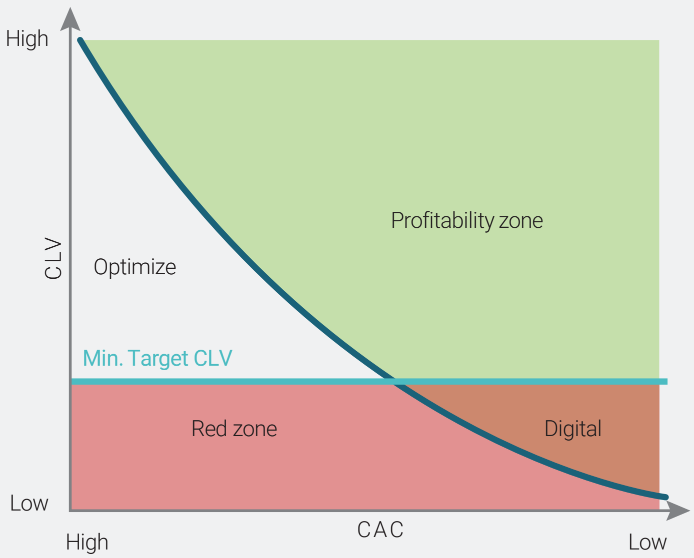
CLV/CAC models do not look at commercial teams piecemeal but, rather, evaluate an organization's overall health by considering operating profit—including costs of sales, marketing, and customer service—as opposed to only gross profit, which includes only cost of goods sold. That kind of approach enables each commercial team to prioritize its investments based on how attractive—or unattractive—a given customer or market segment is.

LIFETIME PROFIT CONTRIBUTION

Most of the activity-based kinds of metrics such as quotas leads created are short-term focused tracked monthly or quarterly, and they may ignore or discount the long-term value a customer may represent. The CLV approach demonstrates that chasing a big customer that is likely to leave might be less valuable than acquiring a smaller customer that will stay for years—or decades.

A LINK TO ACTION

Both measurements together have importance for leading to a decision about whether, as the saying goes, the juice is worth the squeeze. A few customer segments will be cheap to acquire and have high lifetime value, and those are ideal. Some segments may be costly but worth it. Some may produce low sales but also require very low cost—and are therefore also worth it. Others, however, will fall outside the profitability zone (See exhibit). Once you know the characteristics of each segment, you can make precise decisions about where to cut costs. You can also devise plans to improve profitability because marginal segments might become desirable if you can cut acquisition or service costs—for example, by automating activities—or if you can reduce churn. You can also direct your advertising toward high-performing segments and away from others.



RECONCILED INCENTIVES

Competing incentives can be one cause of the efficiency paradox. The conflict we see most often is between the CFO, who has a profitability target, and the CRO, who has a top-line revenue target. Without a mechanism to surface potential conflict early, incentives can lead to bad decisions that are expensive to fix later—for example, ill-considered cuts in service that lead to increased customer churn. Misaligned incentives can work the other way, too: They can cause sales and marketing leaders to chase growth regardless of profitability. We saw that in the form of a software-as-a-service (SaaS company that had lofty revenue targets coming out of a big COVID-19 downturn. After an acquisition, the company invested heavily to grow its sales team in the middle market, in which the recently acquired company had a significant market share that the parent company did not. At first, the strategy seemed to work: a significant amount of new revenue flowed in. Thetrouble was, the parent was using a high-touch, high-cost sales model—a Cadillac sales force for a market segment that could afford only a Chevy. When a CLV/CAC analysis uncovered the problem, the CFO and CRO became able to work together to reduce selling costs by $7 million—with no material change in revenue.

CONCLUSION

Most commercial organizations recoil from the idea of cost transformation programs. Their training and instinct tell them to go for growth, not to contract. That conflict expands when evaluations for cost reduction decisions are misguided by focusing on metrics that measure activity instead of productivity. Decisions made in that context can often lead to near-term cost reduction at the expense of long-term prosperity because companies that make such decisions are only working the revenue part of the equation and not also calculating profitability.

CLV/CAC models help incorporate a comprehensive revenue-and-profit consideration. When they're done well, such models show how the math works out— over a meaningful period of time—to ensure that a commercial transformation produces the right outcomes. But the models cannot be merely mathematical constructs, blindly applied. They must serve as pieces of the larger decision that considers qualitative inputs like market dynamics, the impacts of new products, geographic coverages, and idiosyncratic events—that is, inputs that reflect the insights and wisdoms of experienced executives.

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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.