

Private Equity & Principal Investors Practice

Seeing the savings: Toward transparent management of portfolio companies

Early in the COVID-19 crisis, sponsors and portfolio companies collaborated to find ways to conserve cash. The next step, delivering the savings, requires heightened diligence and discipline.

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In April 2020, we wrote that private equity (PE) firms were consistently partnering with the leaders of their portfolio companies to identify potential actions to preserve cash and ensure liquidity. At the time, the decisiveness of those initial actions was reassuring. Yet today, many PE firms are questioning whether their portfolio companies will deliver the promised savings.

One concern is that, in most markets, the COVID-19 pandemic is the first major economic crisis in a decade. A steep learning curve is to be expected as portfolio companies navigate it. Further, PE-firm leaders have often had the experience in which “big savings programs” do not translate into real results in P&L.

A number of PE firms are taking a more forward-leaning approach. They are recommending process and behavioral changes to help their portfolio companies better measure and manage the work of saving cash and managing liquidity—work that can be critical to survival. Two approaches can support that goal.

A “spend control tower” (SCT) offers a pragmatic way for companies to ensure that they are spending the right amount, no more and no less. And an approach to track the “delta and absolute” makes sure that savings (the delta in performance that a company expects) are real and are fully realized when P&L absolute values are calculated. The combination is the “unlock” that many companies are missing to ensure that the savings proposed

in meetings find their way to the bottom line. Not only does the approach help deliver the savings, it also promotes the culture of ownership, agile ways of working, and fact-based discussions that will continue to help management teams deliver greater impact over time.

The spend control tower

Typically deployed in a time of crisis for a finite period (six to 12 months), an SCT is both a team and a process. Every day, managers propose expenses to a central decision-making body. They make a case for those expenses, saying why they are needed. The SCT hears them out, then approves or rejects the proposal that same day.

An SCT focuses primarily on general and administrative spending, as well as some indirect costs of goods sold. It reviews all spending, including point-of-sale purchases, invoices, expense reports, and recurring expenses, such as subscriptions. (It doesn’t manage direct costs of goods sold.)

The SCT process temporarily supersedes all current spending-approval processes and the mechanisms many companies have installed to ease purchasing, such as blanket purchase orders and purchasing cards. An SCT tracks all its decisions. In our experience, using the SCT approach can quickly reduce non-direct-cash expenditures by 10 to 15 percent.

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While the SCT approach can seem simplistic, disengaging, and time consuming—particularly during a crisis—a closer look reveals the power embedded in a process that’s focused, deliberate, and disciplined:

- **Focused.** While the SCT approach isn’t particularly complicated, it can be very effective. It begins by addressing the fundamental premise that too much spending is on autopilot and that mindsets around spending must be reset. At most companies, a delta-prior-year approach to budgeting rarely allows for that change—detail is lacking, and budget owners often don’t know where to look for opportunities. A renewed focus on fundamentals can help companies prioritize critical expenditures and reset their spending bases accordingly.
- **Deliberate.** Executives often worry about whether the approach will alienate their workforces. When an SCT is supported by strong communication, with a clear case for change, we have found the opposite. As Byzantine, multilevel review processes are replaced by a streamlined approach that results in accelerated approval, line managers come to appreciate SCTs. Employees often find the speed and agility of the approach for justifiable spending to be energizing. Some team members, however, will likely find it intimidating or frustrating, so making a compelling case for change is particularly critical.
- **Disciplined.** While a daily process can seem time consuming, many leaders are surprised to find that the volume of issues isn’t as significant as expected. Maintaining discipline is key: most organizations can effectively manage the SCT process in 30 minutes per day with the right procedures, roles, and preparation.

Initially, the biggest difficulty an SCT faces can be in making the tough decisions—in saying no. It’s changing not only processes and behaviors but also mindsets and culture around budgets and expenditures. That’s where an SCT team needs a clear mandate from the top and the initial engagement of senior leaders to model the desired changes.

Another problem is lack of time. While reviewing all invoices individually requires incremental effort at first, the workload reduces dramatically over time as employees adjust and adapt to the new culture. Once an SCT establishes expectations about what will and won’t be approved, it isn’t uncommon for those operating in steady state to spend fewer than 30 minutes a day on SCT work.

The delta and the absolute: How savings get seen

As managers of cost-cutting programs know, even well-designed initiatives are subject to leakage. Most commonly, managers will siphon off savings from the programs and reallocate them to other parts of their budgets.

Whether a company uses an SCT or other methods to rationalize its spending, it needs to ensure that savings stay saved and show up on its bottom line. In our experience, that requires two steps. The first is making sure that the designed savings are really there for the taking. The second, once the initiative is underway, is making sure that the savings are visible to managers as they are achieved, as part of the monthly reporting process. Cost cuts and similar performance initiatives are only successful if the delta is converted to absolute value at the year’s end.

Are the savings real? Verifying the delta

In our experience, three actions can form a systematic approach to making sure that the savings are there to be had. While they are common-sense moves for many managers, they aren't common practices.

A first move is to *build the right fact base to measure improvement*. In our experience, a company must develop a clear baseline of actual results rather than using traditional budgets or forecasts, both of which often contain broader assumptions that are more difficult to unpack at the same level of granularity. A baseline should be built in a way that will illuminate the drivers of a company's performance.

To then drive specific savings initiatives, a company must *identify a single source of truth* that houses all the values of planned initiatives, and their status, across all departments and functions. Most managers have experienced the pain of combining various spreadsheets, presentations, and valuation methods to come up with a board-level view of value creation and progress. That complexity inhibits speed, transparency, and accountability and, ultimately, makes it more difficult to track savings to the bottom line. A single source of truth solves the issue.

Third, in our experience, initiatives are often assigned a general value (such as \$1 million over two years). But few companies make it sufficiently clear where the value will show up in the P&L and how it will materialize over time. That makes it difficult to “find” the value later. In our view, a tracking approach

for each initiative must be mapped to general-ledger accounts, and initiatives' impact (monthly, quarterly, and yearly) must be anticipated in planning. When combined with a baseline based on actual results, those actions create the foundation for a company to “squeeze out” additional productivity by *using initiative plans to reforecast the business*. That removes the possibility of unintended leakage or reinvestment.

Are the savings realized? Converting to absolute

Companies know well that many factors influence published results. Business trends, the macroeconomy, production variations—all those and more routinely push results up and down. Finance teams know that better than most because they are asked to explain variance every month.

But few companies tackle the problem comprehensively. Most are content to calculate the net figures each month, and offer a few anecdotes to explain variance from plan. That's a problem: not only does it mean that the effect of savings initiatives is obscured by other factors, it also means that management doesn't have a solid understanding of the true influences on performance. What's needed is a more detailed look at the changes in several categories of change, including business growth, acquisitions, improvement and deterioration—and savings initiatives.

Consider a category we call “headwinds and tailwinds”—macrofactors, such as changes in accounting rules and unusual weather patterns, that are outside a company's control. Companies can

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calculate the effect of such factors on margins and expenses; in so doing, they remove one layer of the uncertainty masking the effect of savings initiatives. Similar work on other categories can pull back the rest of the curtains.

Achieving that kind of detailed understanding of the “hydraulics” inside the net numbers is both an art and a science. It can be done quickly, in an analog way, and doesn’t need to be 100 percent accurate. Simply going through the exercise can be revealing, as it informs a more precise management discussion on business performance.

Digitizing the tracking approach

Some analytically advanced portfolio companies have gone a step further, embedding their tracking systems as digital overlays to the financials of their enterprise-resource-planning systems by using either custom interfaces or a third-party solutions. That approach requires some initial effort to set up: companies must map general-ledger codes to a standard taxonomy to prevent “whack a mole” spending. Without a standard taxonomy, coding is discretionary. Too often, a reduction in temporary-labor costs, for example, is offset by an increase in office-services spending for the same expenditure.

Recognizing the power and value of such an overlay, some PE firms have deployed a consistent system across their portfolio companies to enable dynamic visibility from a firm level into the operating performance of their investments. While relatively rare in the pre-COVID-19 world, that cross-portfolio monitoring system has paid off handsomely in recent months for firms that had the foresight to build one.

Such firms were able to pivot the frequency of their performance reviews—from monthly to weekly or from weekly to daily—quickly, with minimal distraction of the portfolio-company finance teams that were focused on steering the businesses through the crisis. Those firms also were able to create standardized dashboards to track company performance against specific COVID-19-related savings initiatives to target areas of risk across the portfolio quickly. While such a portfolio-management model may have seemed time intensive and interventionist a few months ago, it may well become increasingly common in more PE firm playbooks in the coming months as the global economy begins the climb out of the current economic crisis.

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