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Portfolio Companies in Distress Need Special IT Intervention

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Troubled companies got that way for a reason. Often inadequate, misaligned, or under-resourced IT played a role. That's when private equity firms should call in an IT turnaround specialist.

Information technology typically makes up two to five percent of a company's total revenue, with private equity investors often looking to drive Information Technology (IT) costs below two percent. Yet IT's impact on total performance is likely to be far greater than those percentages suggest, and far greater still in distressed companies — including those in a private equity portfolio. After all, distressed companies got that way for a reason. It is not unusual that inadequate, misaligned, or under-resourced IT played a role. Portfolio companies, especially those in the middle market, often lack IT leadership that has the required blend of architecture experience and business perspective needed to drive strategic IT initiatives. That's when the private equity firm should call in an IT turnaround specialist.

*So what does an IT turnaround specialist do? **Two things:*** First, it helps get IT's house in order — driving the IT spending down while making sure that IT dollars are spent efficiently. Second, it helps align IT expenditures with business priorities — so that IT not only does “the job right” but it also does “the right job” to get the distressed company on track.

IT turnaround specialists are thus experts in two worlds — IT and turnarounds — in partnership with the private equity firm. They know how to keep the IT lights on through difficult times such as by renegotiating service contracts and tapping underutilized functionality in existing applications. But they also have the skills to fit into the private equity firm's team. Just doing the same things over again only better doesn't work in distressed situations. Private equity firms know this as they fight the challenges of today's environment: tight credit, capital overhang, a tougher IPO market, and the commoditization of financial engineering skills. They need the special operational leverage IT can provide — from an IT provider who knows how to do things differently.

A Double Whammy

Private equity firms are getting hit hard from two sides. In the marketplace, they face more competition for credit, investment opportunities, and buyers. But firms are also being challenged operationally since more value is now locked up in troubled companies. In a recessionary economy, there is simply a greater proportion of companies in that category. But this is also where the greatest upside potential lies. Under-performing companies offer greater opportunities to add value, and larger paybacks from turnarounds. Of course, a more distressed company is also one that is harder to turn around.

In distressed situations, there is less margin for error. Private equity firms can't add more value than they'll get back in a market that only rates exceptional performance as good enough. A distressed company may be underperforming, or it could be performing at its full, albeit inadequate, potential. Some turnaround attempts should be aborted before they begin. The rest will require as much operational leverage as possible to be successful, which these days can mean replacing debt with expertise in information technology. By its nature,

information technology substitutes insight and innovation for two commodities that are typically much more expensive: brute force labor and money. To the extent you can stop doing things inefficiently (or stop doing them altogether) and instead do things competitors haven't yet thought of (or in a way they haven't thought of) then the greater will be your operational leverage and your return on investment.

Companies invest billions every year on IT — so the point of whether IT can in fact deliver enormous operational leverage might seem moot. However, as a recent Bain study found, more IT spending does not automatically mean better company performance overall.¹ Much depends on: 1) the state of the IT organization itself (whether, in Bain's words, it is "well-oiled") and 2) the alignment of IT with corporate strategy. Private equity firms in particular should consider these factors, faced as they are with the perennial question of how to match IT spending against their own strategies for growing portfolio companies.

Bain surveyed senior business and technology executives at more than 450 companies. They were asked to rate their firm's IT departments on effectiveness and alignment. Effectiveness measures were such things as whether executives felt their IT departments did a good job on IT projects. Alignment includes things like whether executives thought that good solutions were in place to support functions they identified as critical to corporate growth. Executives' ratings were then compared against: 1) their company's IT spend and 2) its rate of growth.

Companies whose executives rated highly for both effectiveness and alignment had the best three-year compound growth rate (35% on average). They also spent 6% less on IT. Companies that were "IT effective" but not "IT aligned" also outperformed those that were the reverse — i.e., "IT aligned" but not "IT

effective." They spent 15% less on average on IT and grew 15% faster. This simply says that companies should get their IT engines running first before they can expect to steer them. That does not diminish alignment's importance, of course. Alignment is especially critical in turnarounds where private equity is likely to impose new strategic objectives.

These results further indicate companies pay a growth penalty if they do not make the IT turnaround part of an overall turnaround — a penalty private equity firms can ill afford now.

More Diligence is Due

These days, however, the most common reason private equity firms engage an outside consultant to look at IT is not to improve either the IT department or IT's corporate alignment — but rather to carry out due diligence projects. Like a house inspection, the goals are to identify and mitigate risk prior to closing, and to develop cost estimates for addressing risks. Typically IT due diligence services are offered as add-ons by the financial due diligence partner, and are often performed by individuals with no IT operational expertise or special expertise in IT turnarounds. They look to see if disaster recovery plans are in order, if the company is in compliance with software licenses, and whether internal controls exist. However, they may completely overlook what could be the biggest hidden risk private equity firms face. That's being saddled with an IT organization that dooms the corporate turnaround before it starts. Before committing themselves, private equity firms need answers to questions such as:

- Where do opportunities exist to streamline, consolidate, and optimize IT operations?
- Which IT expenditures are aligned and which are not aligned with business objectives?

- Which pending projects and expenditures are of questionable value?
- What's the order of priority of pending projects and expenditures?
- How do IT costs benchmark against industry standards — can they be driven below benchmarks to levels more appropriate for the turnaround period?
- Are investors paying too much for IT assets?
- Are non-tangibles (like data repositories) properly valued — can they be monetized?
- Are service-level agreements and contracts with vendors adequate and enforced?

After the deal closes, there will be new opportunities to improve the effectiveness and alignment of IT operations — improvements any future buyer will likely view as table stakes in evaluating corporate value. One example is management dashboards for better performance visibility and fact-based decision-making. Just the sheer presence of such tools says much about the quality of the management. But what they enable management to do has an even greater bearing on corporate value — monitoring key performance indicators that show how well management's initiatives are actually succeeding day-to-day. Such tools are also valuable when the time comes to demonstrate how those initiatives perform to a prospective investor.

“We're all in distress now.”

Of course, answers to questions like these would benefit any company in a private equity portfolio, even those performing well. But distressed companies would benefit more. Not only is the need greater when companies are in distress — the need is also different, for four reasons: **1)** Money is tighter; **2)** Time is short; **3)** IT has disproportionate impact; and **4)** Different performance metrics are in play for a

distressed company and will likely change as a company gets healthy. Furthermore, as one private equity firm manager recently remarked, “We're all in distress now.” The current environment has forced all private equity firms to become more operationally focused — in light of these four factors — and focused on those things that count most in operations.

Take efficient use of funds. No one disputes that credit is now tighter and that therefore the timeframes in which to demonstrate operational results are compressed. A July 2007 *Economist* article with the ominous subtitle, “A Storm Is Coming,” noted, “creditors around the world have started questioning the easy money offered to private-equity firms.”² It cites a laundry list of high profile deals that collapsed in 2007 thanks to high debt costs or banks' eleventh-hour decisions not to lend at all. Tight credit, combined with “record amounts” of capital has driven up prices for acquisitions putting more pressure on portfolio companies to perform.

By August, the private equity “party fizzled abruptly” reported the *Wall Street Journal's* Lauren Silva, who predicted “megadeals will be replaced by small-to-midsize buyouts.”³ The result, she says, will be that 2008 “could usher in a rat race for those whose expertise lies in restructuring and turning around troubled companies.”

Other experts agree. Nicolette Davey, also writing in the *Wall Street Journal*, noted that today's environment favors midmarket private equity firms already accustomed to using less leverage — and thus are better able to get deals done in an uncertain debt market.⁴ The manager of one such firm is quoted as saying: “no one expects that firms will be able to invest and then refinance six months later to take money out. It is not about financial engineering or securitizing assets — we focus on growing earnings and sales, and this strategy is unlikely to change.”

Writing in *Forbes* at about the same time, Orit Gadiesh and Hugh MacArthur say that:

Now more than ever, these funds are sticking with their winning recipe, which enables them to generate big returns from dramatic improvements in operations. The results speak for themselves. The top 25% of U.S. private equity funds raised between 1969 and 2006 have earned internal rates of return of 36% on average, through good times and bad. That's close to 10 points higher than the equivalent S&P 500 top quartile. ... The approach calls for discipline — zeroing in on just a few high-value initiatives and matching talent to them.⁵

Even before the current credit collapse a McKinsey & Company survey of 60 private equity deals at 100 leading private equity firms found that:

The main source of value in nearly two-thirds of the deals ... was company outperformance. ... Successful deal partners craft better value creation plans and execute them more effectively. ... Once developed, the plan is subject to nearly continual review and revision, and the appropriate set of key performance indicators is developed to ensure that it remains on track. Firms implemented such a performance management system in 92 percent of the best-performing deals and only half as often in the worst.⁶

A distressed environment clearly provides extra incentive to apply exceptional operational and performance management skills. IT is a particularly sensitive point of leverage as confirmed by the Bain study cited earlier and by Edgewater's client experience working with portfolio companies. The ability to plan, execute off a plan within tight timeframes, and track Key Performance Indicators (KPIs) clearly speak to enhanced IT capabilities — which are likely to be lacking in troubled companies for obvious reasons. But IT has an extra burden to carry in the distressed companies simply because troubled companies must do something that successful companies don't have to do — which is to turn-around. Changing course is almost always harder than maintaining a straight line — so the visibility IT provides (or has failed to provide in distressed companies) is particularly relevant.

Staying on course is also harder given the changing state of the company as it emerges from its troubles. In a case of walk before you run and run before you fly, the plans, systems, and KPIs of distressed companies will change as companies evolve. Early in the game, the emphasis is on viability. Total customer value, inventory turnover, and revenue management are obvious KPIs. Later comes a greater focus on sustainability and growth, at which point metrics such as quarter-over-quarter revenue growth and cost reduction may require greater focus. That's one advantage of working with an IT turnaround specialist — knowing what to look as a turnaround unfolds and tuning performance management systems accordingly.

Likewise, it's not just a case of more IT intervention; it's a case of different IT intervention — depending on where the company is in its turnaround story.

What's So Special about Special IT Intervention?

In an environment where the four “distress factors” apply — tight money, tight timeframes, disproportionate IT impact, and evolving KPIs — it’s logical to think that what might work in “normal” circumstances won’t work here. When portfolio companies are in distress, private equity firms need IT experts that do four things well:

- Spend less
- Work faster
- Employ a richer talent mix
- Streamline requirements gathering

Precepts like “spend less” and “work faster” might seem obvious when time and money are both short. The key question is how to do that while simultaneously rebuilding IT and supporting strategic business objectives as they evolve from viability to sustainability to outperformance. Here are some ways that have proven successful for Edgewater in client engagements.

Spend Less

There are the things you can do without adding headcount or buying systems. For example, by outsourcing IT services you may simultaneously reduce headcount, facilitate upgrades, and take advantage of new technology. It’s also possible to renegotiate the contracts for IT services you already have. It’s often the case in distressed companies that service contracts are routinely renewed year after year without looking to see if the services still fit company needs or whether more competitive services are now available. Over time, every company’s requirements change and new vendors enter the market. And even if there’s no change in requirements or vendors, you may still be overpaying

relative to industry standards, which a practiced IT partner should easily identify.

There are other prime candidates for quick performance boosts as well — such as underutilized functionality of existing applications or hardware. Often applications are just sitting on the shelf, uninstalled, even though the company spends substantial licensing fees and — more importantly — incurs the opportunity costs of applications that could be doing useful work. Meanwhile, those applications that may be installed and running often have productivity enhancing features that simply go unused because no one knows they exist or how they might be relevant.

Virtualization is another way to boost IT performance quickly — especially in the data center — while bringing costs down. Virtualization is the practice of running multiple applications on the same computer as if they were on separate machines — and also running the same application across multiple computers as if they were the same machine. The productivity boost comes from mixing and matching software and hardware components so that hardware is used efficiently and only increased incrementally when more is needed — conserving cash outlays.

Work Faster

Just as some actions are very cost efficient, others are very time efficient (and some are both). In particular, by virtue of its industry experience an IT turnaround specialist can save the portfolio company huge amounts of time by quickly identifying the most relevant KPIs, technology vendors, and out-of-the-box software applications. As an example, Edgewater offers a “Business Intelligence (BI) QuickStart Program” designed to implement a business intelligence dashboard within six weeks. It focuses on the KPIs most relevant to the company’s current

situation and it also leverages whatever BI software the company already has in place.

Another example is the RFP (request for proposal) process. Spending weeks writing “mega-million page” RFPs may add little actual value when the purchase decision ultimately rests on a few key factors. Within any service or product category typically only a handful of vendors will rise to the top of the review list. The IT turnaround specialist will know the key factors and will have probably worked with the relevant vendors on previous engagements — so the selection process is very efficient.

Out-of-the-box solutions are another potential timesaver. Tailoring business processes to align with out-of-the-box functionality of an existing solution almost always saves time versus building a solution from scratch. It’s also easier and less expensive to support down the road because there are no customizations to maintain across evolving versions of the software. The key, again, is in knowing where the right opportunities exist — what the turnaround priorities are — and what solutions exist in the market to fill them.

Employ a Richer Talent Mix

One sure sign of a soon-to-be-successful IT turnaround is its ability to leverage senior talent to reduce overall IT costs and boost corporate performance. For one thing, these high-octane individuals are simply better suited to work with private equity portfolios. They speak the same language and operate at an equally elevated level within their own practice domains. Easy and efficient communication is not to be underrated given the need to align operational imperatives with the private equity fund’s objectives. Private equity partners don’t have time to get IT people up to speed. At the same time, they’ll want partners who bring situational awareness — like which management proposals are doable from

an IT perspective or where the technology landmines are hidden.

Senior IT talent will know what’s actually implementable even before it’s proposed. They’ll understand the business implications — not just the IT implications — of technology problems. Both viewpoints are critical in distressed environments where every second, and dollar, counts.

Streamline Requirements Gathering

When selecting new systems, a seasoned IT partner knows where to focus resources during the requirements gathering process. There is little return on consulting dollars when every business process is documented in full detail. To find the real differentiators among various software solutions, the skilled analysis team knows to only focus on those areas that are high risk or high reward, specifically those processes that:

- The business does in an inconsistent or non-standard way
- Are not automated but that could be automated
- Are done poorly by the technology as currently implemented

Selecting the low-hanging fruit is also good for morale. Most troubled companies are excited about the prospect of winning for a change. Like most people, their employees prefer doing things in a productive way rather than just going through the motions. They like becoming more effective and seeing their skills improve. (And those who don’t should leave.) This is a more empowering environment than the alternative “do this because I say so” approach — and one more likely to achieve positive financial results for the private equity firm.

Brains Versus Brawn

Fundamentally, however, the game stays the same. Private equity firms have always made money by replacing brawn with brains. What's different now is simply the type of knowledge and expertise required. Insider connections and financial engineering have been democratized — thanks largely to information technology. On a flatter playing field you must work either harder or smarter to make money pay. It is no surprise then that information technology itself has become more of the brainpower private equity firms seek. The question is — how do they do that within the constraints of the distressed portfolio company (or the more distressed environment generally)? One answer is that they call in an IT turnaround specialist tuned to the unique requirements of troubled portfolio companies.

Footnotes

1 David Shpilberg, et al., "Avoiding the IT Alignment Trap," 12 December 2007, Results Brief Newsletter, Bain & Company, 5 March 2008 <http://www.bain.com/bainweb/publications/publications_detail.asp?id=26136&menu_url=publications%5Fresults%2Easp>.

2 "The Trouble with Private Equity," 5 July 2007, The Economist, 5 March 2008 <http://www.economist.com/opinion/PrinterFriendly.cfm?story_id=9441256>.

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4 Nicolette Davey, "Conservative Strategies Work Amid Uncertainty," 19 February 2008, The Wall Street Journal Europe, 5 March 2008 <<http://online.wsj.com/article/SB120338983408176165.html>>.

5 Orit Gadiesh and Hugh MacArthur, "Private Equity Lessons," 19 February 2008, Forbes, 5 March 2008 <[2http://www.forbes.com/2008/02/15/private-equity-bain-oped-cx_oghm_0219equity_print.html](http://www.forbes.com/2008/02/15/private-equity-bain-oped-cx_oghm_0219equity_print.html)>.

6 Joachim Heel and Conor Kehoe, "Why Some Private Equity Firms Do Better than Others," February 2005, McKinsey Quarterly, McKinsey & Company, 5 March 2008 <http://www.mckinseyquarterly.com/article_abstract.aspx?ar=1572&l2=5&l3=5&srid=6&gp=1>.



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