

Offshore Insights

Market Report Series

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RESEARCH SUMMARY:

Private Equity Firms Turn to Global Sourcing for Returns

Private equity firms are increasingly turning towards global sourcing as a tool to drive additional returns from portfolio companies. Apart from simple cost reduction, global sourcing helps streamline the operating model without putting undue strain on cash flows. The enterprise value created by global sourcing is several fold that of specific project savings.

While global sourcing is not without risk, it is sufficiently proven that the risk can be managed and calculated. Private equity firms cannot haphazardly venture into global sourcing and expect savings. Firms must align with industry best practices and leverage market expertise if they expect to realize near-term results.

Key Topics Covered

- Private equity prerogatives
- Suitability of global sourcing for private equity
- Sourcing do's & don'ts for private equity

Leading private equity firms are leveraging global services as a tool to improve portfolio performance.

Industry Landscape

Private equity (PE) or 'buyout' firms have been in the news a lot, though not always for the right reasons. While different groups may have their own reasons to love or hate PE, the success of the industry, especially in recent times, cannot be disputed. Worldwide, PE firms raised a record \$432 billion in 2006 and the leveraged buyout business provided over two-thirds of the US capital raised! The industry, as a whole, generated about 13% average annual return for the last decade and the top private equity funds earn over 20% in annual returns.

The leveraged buyout business is not new. What is new is the proliferation of fund sources and the size and scope of deal making. In 1988, when KKR bid \$31.4 billion for RJR Nabisco, the PE industry was thrown into harsh limelight and the audacious move even captured the attention of Hollywood! Today, multi-billion dollar deals are common and even Fortune 100 companies are legitimate private equity targets.

Table 1: Recent Private Equity Acquisitions

Company	Acquirer	Price	Year
Equity Office Properties	Blackstone	\$38.9b	2007
Hospital corporation of America	Bain, KKR, Merrill	\$32.7b	2006
First Data Corporation*	KKR	\$29.0b	2007
Harrah's Entertainment	Apollo, Texas Pacific	\$27.4b	2006
Clear Channel Communications	Bain, Thomas H. Lee	\$25.7b	2006
* Pending close			

Generating Private Equity Returns

The power of debt leverage, coupled with basic house-cleaning, was the primary vehicle for PE returns in the 1980s and 1990s. As the industry matured, sophisticated capital restructuring and favorable bank rates helped maintain high yields on deployed capital. In fact, one cause of indignation among business owners and operational managers has been private equity's ability to generate wealth through financial engineering – i.e. without having to fundamentally improve the business operating model.

Institutional private-equity investing in the USA began in 1946, but the industry acquired traction only in the 60's and 70's. The industry grew modestly in the late seventies until the reduction of the capital gains tax in 1981 spurred the private-equity market. Except for brief pauses in 1990 and 2001, the industry has grown steadily.

As the size and maturity of private equity acquisitions increase, the industry inherits operating companies that have already tried or implemented many of the capital restructuring models in the private equity toolkit. PE firms have realized that traditional models of creating value alone will not be sufficient. Forward-thinking PE firms are already looking at the other option to increase the portfolio company's value; **improve the operating model.**

Operations Leverage

The most logical step after restructuring capital is to address the operations of its portfolio company. This is easier said than done. Most of the 'low-hanging' opportunities in process optimization, rationalization of general and administrative costs, supply chain optimization, etc. have likely already been leveraged. Aggressive reductions in workforce introduce associated business and revenue risks. Many times, companies struggle to launch or continue their operational improvement initiatives within the constraints stipulated by its private equity owners.

It is important to appreciate that both a regular board and a private-equity-controlled board have the same objective – increase the market value of its portfolio company. The primary difference is the time period in which they want to achieve this and the trade-offs they are willing to live with towards meeting this objective. This seemingly minor distinction can lead to vastly different – in some cases, diametrically opposite – approaches to investment and operations.

Private-equity boards are reluctant to invest in long-term operational improvement projects that consume current cash flows. Capital purchases are avoided unless they are critical for the company's survival. Efficiency tools and process enhancement exercises are viewed with skepticism unless a quick and unambiguous value-add can be demonstrated.

In this ever-morphing landscape, however, the global sourcing model seems to address most of the major requirements of the operating company and its private-equity owner.

Key attributes of global sourcing, favorable to private equity include the following.

- **Convert from a fixed to a variable cost model:** Services outsourcing helps convert fixed and upfront investments in people and technology to a 'pay per use' model that is cash flow friendly.
- **Improve the operating model:** Global sourcing help reduce cost of operations through efficiencies and/or labor arbitrage. Also, downstream savings inherent in such projects can help finance the initial project costs of set-up and transition.
- **Predict cash flows:** Predictability of cash flows is a key requirement in the private equity environment, given its commitments to limit partnerships and financial institutions. The availability of precedents and experienced vendor

partners can help forecast future cash requirements to a reasonable degree of accuracy.

- **Escalate executive sponsorship:** Most global sourcing projects face several process, technology and emotional roadblocks in its early stages. A lack of executive involvement can often undermine such initiatives even before the company begins to realize the returns. In the private-equity environment the board actively tracks the progress of the project and will ensure that internal hurdles, if any, are addressed in time.
- **Partner in business:** Services outsourcing or global sourcing helps build a deep relationship with the provider organization(s) that can potentially extend to newer products and markets.

For the private equity firm, the business value created through global sourcing far exceeds the bottom line impact of the specific project. Apart from the 5X-10X multiple on project savings (EBITDA multiples) that any divestiture event returns, some strategic buyers may show more interest in the acquisition if the overall operating model is attractive!

The leveraged impact on company value brings in board level attention and solves the 'lack of corporate sponsorship' problem such projects suffer from in the non-PE world. The increased attention, however, demands greater discipline and the following section overviews the key requirements for sourcing success in such an environment.

Sourcing in a Private-Equity Controlled Environment

A phased approach, starting with smaller sourcing projects is an obvious preference in a PE-controlled environment, given its dislike for long gestation periods before realizing returns. Sourcing consultants can provide greater value by customizing their standard 'assessment' methodologies to identify and prioritize projects better suited for the PE environment. Some PE firms even retain in-house expertise to leverage the learning across its portfolio. Apart from the need for a custom filter to evaluate sourcing opportunities, a nuanced sourcing approach in the following stages will help ensure success.

- Timing of Assessment
- Deal Structuring
- Project Monitoring
- Supporting Divestiture
- Vendor Management

Timing of Assessment

As the song goes, 'the very beginning - a very good place to start'. Maximum value can be generated if global sourcing analysis is part of acquisition due-diligence. The output of such analysis can be incorporated into the financial model and can have an impact on both the negotiating power and the future operational model. Information available at this stage may predominantly be financials, but an experienced global sourcing analyst should be able to provide high-level inputs to the modeling team.

'Sign to close' and 'post-close transition' are the best times to assess and validate global sourcing opportunities. Projects can be launched at this stage, as long as a major restructuring is not envisaged.



Key Takeaways...

- Evaluate opportunities for global sourcing even before acquisition
- Seek advice and assistance from experienced sourcing analysts
- Launch projects during or immediately after transition

Case Study

A running case study is used to highlight these unique aspects of planning, launching and monitoring of global sourcing projects in a private-equity controlled environment.

Line of Business:

Claims administration and payer services

Stage:

Post transition

Private Equity goal:

Identify areas where cost can be rationalized through global sourcing

Company goal:

Better cost model and address retention problems in transaction processing staff

Timing of Assessment

Launch process:

The PE firm deputed its global sourcing consultant to help the operating company identify areas of opportunity. After an 8 week study, the consultant outlined the scope and called in external experts including potential vendor organizations to further define specific processes and expected savings. An RFQ process followed and 2 vendors were short listed to provide services.

Opportunity size:

Out of a total cost base of about \$40.0m, close to \$7.0m could be addressed through the series of identified projects and expected steady-state annual savings were projected to be \$3.0m. The initiative expected to reach its steady-state within 18 months of the start date.

Deal Structuring

Global sourcing projects require a robust and detailed transition process for success. The transition process can drain significant cash through a variety of start-up activities including training, dual-processing and severance. Project sponsors should forecast negative cash flows and work with the global sourcing partner to underwrite cash requirements. Creative deal constructs can engage the partner to finance the negative cash flows of 'transition' completely or help even-out the cost spikes.

It is important to consider the overall cost of the project and not just vendor billing when financing options are negotiated. Most of the transition cost is internal and, more often than not, poorly forecast. Open discussions with the outsourcing partner can help structure the deal for cost optimization without the associated cash-flow surprises. Many of the top-tier global sourcing vendors are cash-rich and are able to design deals with minimal cash-flow impact to the buyer.



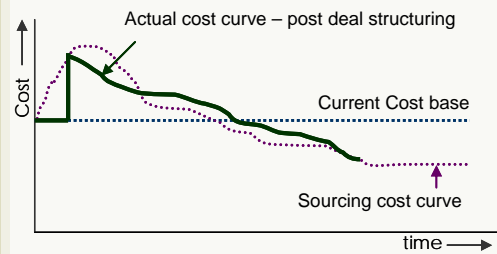
Key Takeaways...

- Forecast negative cash-flows and get the vendor to underwrite them
- Consider overall cost, not just vendor billing

Case Study (continued)

Deal Structuring

Contract negotiations helped reduce several vendor charges for transition, but internal 'technology' and 'severance' expenses required significant up-front investment. Also, since the project was identified and launched in September, no specific budgets were available in that calendar year. Therefore, the deal construct required the vendor to not only defer billing till the end of the calendar year but also invest, on the operating company's behalf, in start-up technology. The vendor recovered the same over the next 12 months moving the date for operational break even by 6 weeks. This model helped avoid the painful process of seeking cash late in the year and also provided practical insights into project budgeting for the following year.



Project Monitoring

Outsourcing projects that have the attention of its private-equity board usually have a bottom-line goal. As priorities, processes and technologies change, project leaders must make appropriate modifications to meet the dollar objective.

It helps to ensure goal congruence by having the project manager track the global sourcing initiative on the same yardstick used by the PE parent – projected savings and cash flow. It is also important that the vendor organization has visibility into the bottom-line goal of the project and is an active participant to ensure its success. In cases when the internal cost loading is not significant, the vendor's performance can be pegged to overall cash flows.



Key Takeaways...

- Track cash-flow adherence and “realized” savings as key metrics of project progress
- Provide visibility to your vendor into your bottom line goals and involve them to help meet those goals.

Case Study (continued)

Project Monitoring

Project monitoring: The monthly cash-flow statement from the cost benefit analysis (initially prepared by the sourcing consultant) was discussed with the vendor and adopted as a key review document for the project. The same document was also used to report on project's progress to the private-equity parent. This ensured that the stakeholders focused on managing overall project costs, irrespective of whether they were company-driven or vendor-driven. A team-oriented approach to meeting cash flow projections helped the project jointly implement creative solutions to address cost spikes.

An example may help highlight this:

In the early stages of transition, the project had to pull back one of the processes from the offshore center to meet certain compliance guidelines. This move, while cash flow friendly in the immediate term, resulted in an overall loss of savings in the long run. A joint team was deputed to explore options to address this short-fall. After detailed analysis at both functional and individual process levels, this team identified areas where the offshore team can be expanded to catch up with savings projections. The skill of this team in unearthing valid opportunities in such a short time was so attractive that it was retained on a permanent basis to assist the program management office.

Supporting Divestiture

Divestiture or acquisition opportunities do not always align with sourcing projects' lifecycle. Merger or acquisition events can interrupt the project at any stage. In such cases, the project team should be prepared to establish the correct future value of the initiative, including an assessment of forward-looking risks of non-completion. The discipline of meeting or exceeding savings projections will be key and project leaders should build strong contingency plans to ensure this. Firms will also be required to show a history of realizing the projected savings through headcount reallocation or retrenchment.



Key Takeaways...

- Be ever prepared to assist M&A with project's cash-flow and savings projections
- Additional information, if any, on how the project will change the operating model will help

Vendor Management

Most private equity firms leverage the power of cooperative buying in the areas of travel, insurance, payroll processing etc. The same model can be extended to services outsourcing too. PE firms will benefit by consciously cultivating a core group of preferred services vendors to ensure preferential pricing and support. While individual service contracts are still entered into with the specific operating company, the private equity firm can leverage its buying power across its entire portfolio. Long term partner organizations are also able to pass on the savings in their sales and marketing costs.



Key Takeaways...

- Invest time and effort in building vendor partnerships and 'returns' in reduced risk and preferred pricing will more than offset the cost

Case Study (continued)

Supporting Divestiture

Divestiture: Sixteen months into the project, the M&A team announced that due-diligence activities by a potential acquirer would commence. Even though the sourcing project was 2-3 months away from steady state – i.e. the new cost model – the operations group was able to project financials on the new cost basis.

The history of close adherence to the pre-project cash-flow projections helped the team stand behind its numbers. One of the aspects that attracted the acquirer, an insurance company, was the overall efficiency and cost model the operating company had for claims processing. With this acquisition, they hoped to replicate the same model over their much larger claims processing organization.

Conclusion

As funds proliferate and debt costs rise, private equity firms will increasingly look for operational improvement in its holding companies. Global sourcing is a powerful tool that can improve the operating model and, if managed well, provide returns several fold the investment. Most PE boards also realize that while individual projects may have modest 'savings' projections, the multiplier effect on divestiture can significantly enhance company value. The inherent attributes of global sourcing – fixed to variable, predictable cash flows and the ability to finance the investment – make it an attractive option for PE controlled environments.

The keys to success in managing global sourcing within private equity are slightly different from traditional project management. Global service providers and operational companies will benefit from aligning individual project objectives with the company's board level goals of cash flow and savings.

Attributes of Global Sourcing

- **Convert:** Classic model for moving from fixed to variable costs.
- **Improve:** Better operating model without the need for significant investment.
- **Predict:** Predictability of future cash flows – a key requirement in modeling.
- **Escalate:** Board level attention to smooth inter-departmental conflicts
- **Partner:** Leverage organizations that can assist in working capital management and, in some cases, even revenue enhancement.

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More information about the offshore outsourcing industry can be found within neoIT's research center at www.neoOffshore.com. For more details about neoIT's offshore advisory and management services, please contact:

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