In the third in a four part series examining how private equity creates value within its portfolio companies, Real Deals looks at the changing face of management consultancy.

Value creation: External consultants

not even management consultancy, a sector which regularly posts double digit annual growth rates, is immune to the consequences of private equity’s maturation process.

The links between the two industries are well established. Along with investment banking and accountancy, management consultancy has provided the lion’s share of private equity’s talent pool. Bain & Capital, one of the largest global buyout houses, was formed when a group of consultants from Bain & Co. felt they could derive much greater profits by implementing their expertise directly.

It stands to reason that buyout houses should seek out executives who have enjoyed operational insight during a spell with McKinsey, BCG or LK Consulting – there are fewer other ways of gaining an in-depth knowledge of a range of companies in various sectors. But even when finally brought on board, there are still plenty of occasions for these converted dealmakers to call upon their former colleagues. Originating new deals, executing transactions and managing the portfolio require an abundance of time and energy, and some tasks will inevitably need to be outsourced.

Private equity can turn to consultants for any number of tasks, from training management teams to improving procurement to providing industry analysis. Typically, a brand name consultancy would provide the full suite of products, which may even stretch to pre-deal due diligence. However, this is no longer the case.

“The traditional consultancy model can often result in a very large budget requirement,” says Daniel Callaghan, founder of MBA & Company, which matches up more than 30,000 consultants with corporates on a project-by-project basis. He launched his business with the aim of delivering premier consultants without the top shelf price tag.

The appeal for private equity is evident, particularly in the mid-market. A well-run business is likely to need to optimise a few functions in order to achieve growth rather than undergo a complete strategy overhaul. Instead of bringing in a generalist for a company-wide assessment, firms are increasingly turning to experienced freelance consultants with demonstrable knowledge in a particular niche.

“Ultimately it comes down to getting the right person in to do the task,” says Callaghan. “£25m a year is spent on strategy consulting, but only £7m of that is spent on the staff. There is a lot of money being wasted on offices, overheads, lower utilisation etc. For both parties there is a better operating model.”

By the number of people it can deploy, MBA & Company claims to be the ninth largest consultancy in the world. It has achieved this position by capitalising on dissatisfaction with the all-too-common phenomenon of paying for the partner and getting the analyst.

“Lack of transparency is what leaves professional services open to disruption

“The average margin on a consultancy project is 70 per cent,” says Callaghan. “That’s six times the salary day rate. That is why alternative models are becoming more prevalent. That lack of transparency is what leaves professional services open to disruption.”

Simon Havers, head of the private equity practice at Odgers Interim, notes another criticism frequently levelled at the traditional consultancy model. “There is an impatience, and this is part of a trend of more than a decade now, with receiving reports rather than receiving delivered action,” says the former chief executive of Baird Capital Europe. His organisation has also sought to remedy this expectation gap by placing senior executives, typically for six to 12 months, to enact changes within a business, rather than just recommend a course of action.

There are compelling arguments to be made for interim managers over consultants in the mid-market. Instead of bringing in a team with a range of experience levels, expertise and outside commitments, the interim approach allows a company to fill a particular gap with a proven veteran. An interim financial director’s day rate may be considerably higher than that of a full time employee (and, for its part, Odgers takes a flat 25 per cent), but it still compares favourably to the margins taken by the bigger houses.

“It’s not that consultancies are cramming it and making ridiculous net profits,” says Havers. “The problem they have is when their people are on the bench with no useful client work to do they are still on the payroll. We don’t have that, and that transforms the whole economics of this.”

Furthermore, the interim will lead the recruitment process for a full-time replacement, who will benefit from the changes already established within the business, but come with a lower price tag. Of Odgers’ 200 or so interim managers currently out on assignment across the public and private sectors, Havers says around ten per cent are in private equity-backed companies.

BUYING SUCCESS

Many consultancies will use the aforementioned strategy reports to push ancillary products – for example, identifying weaknesses in procurement could lead to an internal specialist team being brought in. This area is a particularly pertinent one for private equity.

Given the nature of buyout portfolios, it is logical that private equity firms should be able to leverage the cumulative bulk of their assets to improve purchasing power across the board. Even in a generalist fund spanning many different sectors, there will be common costs incurred by all businesses, such as stationary, vehicles, and IT and telecommunications deals. A
number of firms have attempted a portfolio-wide procurement strategy, but few have succeeded.

Bridgepoint has taken the model further than most. In 1999 it launched the Bridgepoint Affinity Purchasing Scheme, which sought to combine the heft of around 120 portfolio companies to achieve cost savings on group purchases. The model subsequently developed to the extent that Pepco, a new company which provides procurement services and consulting to a number of mid-market firms, some of which some of which have included CBPE, Dunedin Capital and Graphite Capital, was spun out in 2003.

"In the mid-market, our experience is that the core products are generally being run very well by executives within the business. On the indirect side, such as insurance, facilities management and office products, there may be less experience as they don't negotiate these deals very often. That is where we can help by either accessing our aggregation or using our specialists to review the best approach," says Kate Gulliver, managing partner of Pepco.

Gulliver says that the average savings on such indirect costs can range from ten to 30 per cent. The use of e-auctions, which work in the reverse format, allowing companies to drive down prices aggressively, can be key to this. These typically deliver 14 per cent savings over traditional tenders.

"When we started procurement was seen as a back office type function. Now you can make a significant impact on the bottom line, in many cases running to millions of pounds or euros, and it is seen as a great success - but it has to be sustainable," she says.

DIGGING DEEPER

Bridgepoint's success is a rarity, however. According to Declan Feeney, director in the private equity practice at procurement specialist Efficio, the challenges of bringing multiple companies under one purchasing plan are daunting. "Trying to get 100 managers to agree on one deal is a nightmare," he says. "It is much easier to get one manager to agree 100 deals."

While Pepco will largely target the indirect costs, which may account for around 25 per cent of total spend, Efficio seeks to address all levels of a company's outgoings. In a manufacturing business that may drive down into the raw materials, as well as contracts, equipment, and the like. It targets typical savings for each spend area of up to 15 per cent, which it claims cumulatively can turn a decent exit into an impressive one.

Again, Efficio believes that this narrow focus allows it to deliver the kind of results that are not attainable with a larger generalist consultancy. To put this confidence into practice, it will tie its fee on a project to the savings gained by the client.

The London-based company has worked on projects with the likes of EQT Partners, KKR, CVC Capital Partners alongside their internal consulting partners and consulting units, and the benefits of efficient procurement are well established among these firms. "The best private equity investors will have between five and seven points in their value creation plans, and procurement will always be one of them because it's a relatively easy win," says Efficio founder and chief operating officer Alex Klein. However, that isn't always the case in the mid-market. "There can be an element of pride. They say that they are growth-orientated so they don't need to look at this," says Feeney. "Some firms can be too focused on growth when it comes to value creation. The reality is in the current economic climate, that is hard to come by. Procurement isn't an emotive issue - it's not about firing people - and it can make a significant difference to an exit multiple" Mainstream consultants will rightly argue that they offer a breadth of knowledge which specialists simply cannot. There are certain projects, such as those in larger companies that require board-level or lender approval, that will require the assurances an established brand name consultancy brings, and they will always have a steady flow of top young talent. Furthermore, the rise of upstart specialists is not breaking news, and the bigger players are reacting accordingly by pushing their capacity to enact, rather than just lay out, strategic improvements.

However, there are many cases where it is possible to achieve performance gains and avoid painful bills. "In the mid-market you do not need a big five year strategic plan," says Callaghan. "They are investing in the management team - their vision and their strategy." The success of many challenger specialists is testament to the viability of this alternative path.

Both models have their place in driving value creation, which is good news for private equity. Firms are now spoilt for choice when calling on outside help.