Accelerate Growth with Business Performance Management

Anand Divekar

2010

The recession has caused significant deterioration in the financial performance of many businesses. Preliminary signs of improvement in the economy now raise a new set of questions for all executives - viz. what actions should they take to return to growth. An additional question for business owners who wish to exit in the near future is how to accelerate business valuations prior to sale. This article provides an overview of Business Performance Management frameworks and methodologies which can help.

Eco-Bridge LLC.
206 - 174th Place NE,
Bellevue, WA 98008
M: 425-894-3776
O: 425-747-0055

Eco-Bridge LLC

BUSINESS CONSULTANTS, M&A ADVISORS

IMPACT OF THE RECESSION ON BUSINESS PERFORMANCE & M&A

Through the third quarter of 2007, US business valuations, multiples and transactions generally maintained an uptrend. Business sentiment reflected confidence based on access to easy capital and strong markets. M&A activity in the public markets and the midmarket was healthy.

Valuations began to retreat in the fourth quarter (deviations from this trend occur to varying degrees across different geographies) confirming the official start of the recession on Dec 2007 (per data from the National Bureau of Economic Research). From 2008-2009, businesses valuations and transactions generally shrank due to a lack of buyers and deteriorating business performance triggered by capital shortages across the business ecosystem. M&A activity in the public markets disappeared almost completely. Although smaller transactions were not affected as significantly, this was only because highly qualified buyers were able to bottom fish on price and either finance transactions with internal funds only, or borrow cash through regional lenders, in spite of increasingly restrictive lending terms.

Guidance from Bloomberg, BlackRock and other economic observers in late 2009 indicates that the path to economic recovery could take as long as 12-24 months, although expectations for the '*new normal*' (a phrase coined by the industry), emphasize a slowdown in future economic growth rates.

So what should businesses do in 2010?

2010 is shaping up to be a recovery year as owners and executives focus on improving markets. Although the flow of capital is picking up, business owners and executives are finding that the loan process is not as fluid as in past years. Lenders require proof of performance and confidence in future growth plans to release funds. Establishing formal performance management techniques can help businesses accelerate future improvement and convince banks of their viability.

BUSINESS PERFORMANCE MANAGEMENT

Business performance management is an umbrella[1] which tightly integrates various existing business improvement and analytical methodologies (summarized later in this paper). These serve to tie together strategy, operational and financial information into a single decision support and planning framework. The benefit is to set the stage for performance improvement while reducing uncertainty. Its results are measurable in the form of milestones and quantifiable metrics, including ROI.

Performance management is important for several reasons, the most important being to enable the business to better serve its shareholders, employees and the environment. It also plays an increasingly important part in the months leading up to a major liquidity event such as bringing new shareholders into the company through an M&A transaction, private equity investment, or IPO.

Valuations generally rise when a business has predictable, growing revenues. In the public capital markets for example, Accenture research[2] on enterprise software vendors shows that future growth prospects account for 50-80% of the company's stock price, while the balance comes from past performance.

Performance management targets planning, execution and measurement of specific, consecutive business benefits, in the context of a changing environment. These changes result from external and internal challenges. External challenges include changes in the national and global economy, regulatory trends, industry trends, etc. Internal challenges include coping with growth, competition, product strategies, etc. The executive team must therefore constantly monitor execution of its strategies to

[1] Gary Cokins, "Business Performance Management", Wiley, 2009.

[2] "The Future of Enterprise Software – How software companies can achieve high performance in an era of disruptive change and uncertainty", Accenture, 2005.

successfully steer the business in the right direction.

For a business which utilizes performance management techniques as a part of its repertoire, a growing economy will likely provide additional lift and accelerated realization of the targeted business benefits. In a deteriorating economy, the same business can expect to perform better than competitors utilizing an ad-hoc approach and overtake them in profitability, market share and customer satisfaction.

FORMAL METHODOLOGIES AND TOOLS

Strategy and Execution

Ninety percent of all businesses fail to successfully implement their business strategy, even though executives generally do a good job on strategic planning[3]. The reason is that the strategic plan is not well communicated to operational managers who end up focusing on localized process improvement without understanding the critical success factors which form the basis of the entire plan. Another reason for failure is when the strategic initiatives budget is not clearly separated and protected from possible cuts in operational and capital budgets.

Tools such as strategy maps, balanced scorecards and KPIs (key performance indicators), dashboards (for operational metrics), incentives and analytics help formalize and document the causal relationships between the strategies, the projects and initiatives the organization must undertake to execute the strategy and achieve the vision. They help executives communicate their goals and vision to middle management, while KPIs (key performance indicators) help measure progress toward those goals.

The formal approach used in implementing these tools makes it easier for all participating business functions/departments and individuals to clearly understand roles and responsibilities, milestones and metrics associated with success. Deviations are easier to detect and correct.

Management Accounting

Most organizations use accountants to manage their books, file tax returns and (for public companies) maintain compliance with Sarbanes Oxley. While these are important, this form of accounting does not give the management team enough information on how costs are actually allocated in their production processes, thus hampering a full analysis of the profit and losses incurred by individual products.

Management accounting is a term which refers to detailed cost allocation which provides an accurate picture of how costs are allocated to different products and services, thus facilitating a focus on growing profitable lines while putting the unprofitable ones under a microscope. Pricing optimization requires price elasticity analysis of customer demand, along with competitor pricing analysis. Activity based costing techniques can help properly allocate costs across product and service lines, allowing management to base its decisions on a real understanding of where money is being spent and the returns. This in turn, provides a robust foundation for product (or service line) strategy and pricing decisions, which ultimately determine product and business profitability.

Risk management

Various sources of risk - internal and external, exist. Identifying risks, prioritizing them, implementing mitigation plans and monitoring them on a regular basis should be a part of normal business practice but few businesses devise policies and business processes or allocate the budgetary resources to do so. As a result, there are consequences when unexpected events occur.

Risks and opportunities often go together. Every business must strive to leverage opportunities while mitigating the impact of associated risks. Given the interconnected nature of the world's global financial markets, labor and materials

[3] David Norton, *The Balanced Scorecard: Translating Strategy into Action,* at the BSCol Summit on Nov 7, 2006.

supply, and customer distribution, both internal and external risks should be periodically monitored. An example of a recent external risk was the 2009 EPA ruling that carbon dioxide is a major source of global warming. This puts all US businesses on notice that they are now potentially exposed to legislation and resulting taxes on carbon dioxide generating activities.

An example of an internal risk is ascertaining stakeholder buy in when implementing a new initiative. Resistance to change of any kind is a well documented risk and can occur at both senior and junior levels in the organization.

Some corporations now appoint a Chief Risk Officer (CRO) to manage the risk process and budget. It is this individual's job to maintain a historical database of past risk events and associated mitigation plans and their costs, assess all current sources of risk on an ongoing basis, ensure that the appropriate budget is in place to support mitigation plans and ensure that the appropriate mitigation plan is executed when specific risk events occur.

Customer Lifetime Value (CLV)

Since different customers contribute varying amounts of revenue and costs to the financials of an operating business, it is important to manage customers based on their contribution to shareholder wealth. This requires segmentation into high and low value customers based on their historical and anticipated future spending patterns. This analysis allows the business to categorize customers based on profitability (which can differ from revenues due to subsequent support costs) which helps determine CLV based on net present value calculations of customer profitability.

Conventional accounting techniques mask cost data (examples of costs include distribution, selling, credit, payments and marketing costs as well as any product customization demanded by the customer), making it a challenge to identify the cost of serving various customers. Activity based costing facilitates analysis of profitability by customer and provides the cost of serving each customer, including not just the cost of building the product (or providing the primary service), but also the cost of ongoing support based on items such as help desk calls and warranty support.

Availability of such data enables a business to make decisions on customer retention (loyalty program offerings), choice of distribution channels, pricing, support, additional customized services, etc. For example, low CLV customers may be provided access to self service tools over the internet, while high CLV customers get personalized services.

Human Capital Management

People are critical to the success of any business. Skilled employees, especially those with skills in short supply are often wooed by competitors, especially in a recovering/growing economy when the competition is looking to backfill gaps due to prior layoffs.

An effective HCM system is more than just an automated personnel database. It helps with employee selection and retention, by using analytics to correlate historical employee turnover to the existing workforce to predict which of the current employees might leave, enabling management intervention. Additionally, an aging workforce increases the risk of knowledge leaving the company.

Predictive Business Analytics

Businesses gather a lot of data as a part of normal operations, especially if they use ERP or CRM systems to manage customers, suppliers, human resources etc. Unfortunately, the value of this data is hidden due to a lack of business analytics. Functionality provided by predictive business analytics can open a window to customer, supplier and other kinds of intelligence which can help the executive team improve their strategies and help operational managers better manage the business.

Predictive analysis is mainly used to attract, retain and grow the value of customers, manage inherent risks in dealing with customers and to detect and prevent fraud. Examples of intelligence gained include correlating cross selling of specific products to customer retention, building profiles for customers with the greatest value potential and eliminating customers likely to engage in fraud.

Environmental Performance Management

In April 2009, the EPA (Environmental Protection Agency) issued a ruling which has the potential to change the entire US economy in the near future: "*greenhouse gases threaten public health and the environment and that science overwhelmingly shows greenhouse gas concentrations at unprecedented levels due to human activity*". With this ruling, the EPA has set the stage for the Federal Government to regulate emission reduction by issuing policies which are widely expected to include the taxation of businesses that emit carbon dioxide.

Although there has been immense public debate regarding the imposition of new taxes during a recession and the resulting impact on business health and jobs, there is universal acceptance in the business community that it is only a matter of time before carbon related policies and taxes become reality. For this reason, it is imperative that businesses start evaluating their sources of energy consumption and ways to reduce carbon emissions.

It is likely that future compliance reporting requirements will include measures and metrics to identify the sources and amount of carbon emissions from the business and its supply chain. Smart businesses will invest in identifying innovative ways to reduce emissions and contribute to improving the environment to earn tax credits against those investments as well as social goodwill for their green strategies.

VALUE ACCELERATION TECHNIQUES

The Value Acceleration toolset is a subset of the broader business performance management umbrella. Examples include due diligence checklist-based cleanup, deals & alliances, tax reduction strategies, internet related strategies (such as eCommerce portals, search engine optimization, social media integration, etc.) Two of these are described briefly below. Note that implementation of these techniques is greatly facilitated by an existing business performance management framework.

Due Diligence Readiness

Due diligence issues should be resolved prior to starting discussions with buyers, if the seller desires to get the highest price possible at sale. During the M&A process, buyers may make requests for detailed information in the form of extensive documentation and clarifications, which often slows down the M&A process, while shutting out other potential buyers and consuming time from the seller's management team. This can create an acrimonious relationship between buyer and seller. Planning for due diligence in advance of buyer discussions can help minimize this friction.

Due diligence preparation can be broadly categorized into 3 categories: operational, financial and legal. For technology companies, intellectual property must be included in scope.

Due diligence includes ascertaining the readiness of business documents including financial statements and tax returns (for at least 3-5 years prior to a transaction), financial forecasts, marketing and advertising information, lender information, leases, contracts, inventory, information on intellectual property, employee skillsets, customer information, description of intellectual property owned, etc. Any legal issues the company is facing should also be resolved.

Deals and Alliances

Partnering with other companies with the goal of exploiting identifiable synergies across products, services, markets, geographies, etc. is a powerful way to leverage each other's strengths and minimize risks and weaknesses, for mutual benefit. Such relationships can also be international in nature, allowing each partner to more easily access local markets and resources in another country. Examples of such alliances include joint ventures and licensing agreements and have been used successfully over the years in a variety of business relationships.

During a recession, this approach also has the advantage of providing each partner access to the other party's infrastructure, customers and processes at little or no cost. Additionally, partnering with another company allows the participating companies to build a trusting relationship over time along with knowledge of each other's infrastructure, which can ultimately result in a mutually beneficial and friendly M&A transaction.

Setting up such a relationship requires each party to have clearly defined goals for the alliance, along with well defined roles and responsibilities on either side, including arrangements for cost and revenue sharing. Negotiation and planning of such relationships, including their operation and eventual termination, as well as the ongoing management of milestones and goals is critical to the success of such partnerships.

CONCLUSION

This article outlines frameworks, methodologies and tools to help businesses manage and improve performance, which is directly related to business valuations and ultimately, sale price. The selection of a particular methodology or tool for deployment in a given business depends on business size and complexity. Smaller businesses may invest in a hybrid approach using a combination of techniques to overcome their most pressing issues. People, processes and technology are critical to the success of all areas discussed herein.

Tracking initiatives and the ROI they deliver is critical to ongoing management and improvement of business performance. The appropriate metrics must be identified – if they are too detailed, they deluge stakeholders with the wrong data, whereas if they are too abstract, they do not provide sufficient insight for either tracking or future improvement.

About the Author

Anand Divekar (MS, MBA) is Managing Principal at Eco-Bridge LLC., and writes and speaks on management topics in the technology & M&A industries. Mr. Divekar has worked with Fortune 500 clients in a range of areas including business strategy, technology initiatives, M&A advisory roles, governance and risk management.

Mr. Divekar is an alumnus of Bearing Point, Deloitte Consulting and Verizon Science & Technology. He holds a B.S. in Engineering from the Indian Institute of Technology, M.S. in Computer Science from Clemson University, S.C. and an M.B.A. from PACE University, NY. He is also a certified M&A Advisor.

Contact information:
Email: Anand.Divekar@eco-bridge.com

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Contact

Eco-Bridge USA
10900 NE 8th, Suite 900
Bellevue, WA 98004
Office: 425-747-0055

Eco-Bridge India
2 La Citadelle 99 MK Road
Mumbai 400020, India

Anand Divekar
Managing Principal
P: 425-894-3776
Email: anand.divekar@eco-bridge.com

Shankar Rele
Associate Principal
Email: sales@eco-bridge.com