Don't Forget About Opportunities To Outsource

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Private equity leaders face undeniably complex challenges, primarily around a bleak deal outlook forcing attention toward maximizing returns on existing capital under management. While buying up undervalued assets and restructuring them for resale has in the past proven to be a highly effective strategy, today buyout firms frequently find themselves holding and operating these assets for longer periods of time.

In private equity today, we see this acutely with portfolio managers who, in the absence of an M&A rebound or IPO bonanza, are spread thin among numerous portfolio companies they are holding on to. Indeed, a recent report on the state of private equity compiled by the Boston Consulting Group and the IESE Business School at the University of Navarra in Barcelona concludes that private equity firms "should prepare all their portfolio companies for a long and deep recession, focusing on operational improvements. As the top-performing private equity firms have shown, operational value creation holds the key to success. This will be the most critical differentiator in today's recession."

Of course, when it comes to creating value in this recession, buyout firms' immediate challenge is that they, by design, typically do not have enough hours or other resources necessary for comprehensively guiding distressed companies waiting out the downturn. Crowded, long-haul portfolios also prompt greater concern around liability, overhead and operating budgets. The solution is to free up as much of a buyout manager's energy and abilities as possible, given competing demands. Strategic sourcing—carefully evaluating and optimizing whether business-critical functions are best performed inside an organization or by external service providers—offers time-tested methods and principles portfolio managers can adopt to reach this balance.

While strategic sourcing readily gives buyout-backed companies and others fueled by private capital a jolt of reinvention and competitiveness, it is becoming strategically appealing to their investors as well. A coinciding "buyer's market" for outsourced services in the current recession makes them even more attractive. Finally, outsourcing not only cuts costs at a time when interest payments need to be made, but also increases the value of the business when it can be spun out. Evaluated carefully according to private equity managers' risks, needs and operations, strategic sourcing is a logical means to optimize their focus and strategy as the industry navigates lean times.

Asking The Right Questions

When considering strategic sourcing for the first time, almost every client we meet prefaces the discussion with a list of their unique needs—attributes they feel set them far apart from most businesses. In short, many reflexively fear that transitioning services to an outside provider will come at the cost of quality and appreciation of their unique requirements. This initial hesitance is understandable, given the high degree of specialization in financial services. However, buyout firms should realize that not only can competent service providers quickly conform to their needs, but they often provoke beneficial reexamination of these needs in the process by offering outside analysis and best practices from other clients or industries.

The important principle to consider when contemplating outsourced services is that most organizations' mission-critical functions are simply carefully honed processes based on information and collaboration. Crucial data must be entered, reports generated, transactions executed and sensitive communications assured. Nuances between these critical functions from one organization to another are significant, but their delivery and enhancement is well within the sophisticated state of today's service providers.

One advantage private equity managers have in today's sourcing market is service providers' wider acclimation to "challenging" prospective clients' own habits and assumptions with respect to these critical functions and how they do business. Seldom content to simply "duplicate" work detailed in a project's RFP, talented providers will complement their responses with creative ideas on how the prospective customer could transform further toward the same objectives. This is a significant trend in providers' evolution as an industry. Whereas they initially looked to perform the same tasks a client performed internally for less, today that mindset has diminished as clients demand more and the providers' ranks grow increasingly competitive. Today's service providers want to bill themselves as helping clients refine their most cherished capabilities and free up resources from approaches that may be obsolete or vulnerable to disruption.

No Better Time To Buy?

The current economic environment is an unusually advantageous time for buyers and providers of outsourced services. Crises yield the clarity necessary for crucial decisions about an organization's future, particularly where their strongest resources need to be applied. There is also the buyer's market mentioned earlier to consider, and the fact that both providers and clients can work effectively in lean times to maximize shared success.

First, nothing beats a crisis for lending clarity to your strengths and strategy. In boom years, even chronically inefficient and out-of-whack processes persist unabated as long as profits are streaming in. In lean years, there is an immediate sensitivity to anything an organization does that seems uniquely expensive or "non-core" and might be best performed by an outside party's economies of scale or available expertise in order to free up resources.

The current climate is putting fund managers' role as coaches, accountants, strategic advisors, networkers and crisis counselors to the test, so initiatives placing managers and their staff in closer proximity with portfolios are critical. Second, even the most successful, reputable and well-led service providers' deal pipelines are softening. The down economy means providers are less likely to have conflict or capacity issues supporting all clients concurrently; they may even discover and propose opportunities to help customers break into new markets as part of deal terms. In short, the current economic climate affords reasonable creativity for challenging prospective service providers on winning the business and opening other value avenues.

Third is the impact this economy has on speed of execution. Put simply, clients and service providers in the current climate avoid a lot of the "gamesmanship" that can cloud sourcing arrangements in boom times. It may be counter intuitive, but sourcing deals struck in boom years can be prone to trouble compared to those crafted in down cycles. The former can suffer from objectives clouded by rhetoric, unrealistic expectations, and turf battles over assigned tasks if roles are not delineated clearly. Contrast this with the current market, where providers have more at stake when it comes to keeping clients, and clients want to focus solely on what gets them through what may be the most difficult chapter in their history, when failure is not an option. The latter is much more conducive to setting performance benchmarks and measuring progress.

More Options Equal Higher Stakes

With the broader array of service providers and outsourcing models available today comes the inherent risk of picking the wrong options for an organization. Compounding things, of course, is that recessions leave little margin for error and second chances. Together, these factors do not diminish strategic sourcing's potential, though they do put the onus on managers to make the right decisions.

Having studied the intersection of providers and customers through evolutions, booms and downturns, advisors in our practice urge managers to consider a few timely concepts when framing decisions. First, "avoid slash and burn" when it comes to cost-saving ideas. It is all too possible to bid a service for so little that the resulting output is flawed, or becomes a liability.

Next, seek out experienced and objective parties who can help examine your organization and evaluate strategic sourcing options. The biggest advantage here is putting fresh eyes on the target. We know from experience that even the best-run and most innovative companies must work hard to maintain a current vision of their own status and challenges, a vision that might include the general state of their industry to an extent, but usually ends there. From proposal vetting to helping craft and review agreements, third-party input helps keep myriad provider ideas and strategic themes in context and offers an extra layer of due diligence and risk management.

It is easy for private equity leaders to overlook strategic sourcing initially, particularly if it conjures up images of offshore manufacturing or call centers, but these contexts belie both the current state of strategic sourcing models and the immediate advantages they can offer. Investment managers have a unique opportunity to benefit from providers' ideas and responsiveness, and could arguably benefit from "intangibles," such as providers' contacts or presence across industries, more so than in boom times.

The fundamentally good news for buyout firms is that almost any business-critical capability can be delivered from almost anywhere, dramatically freeing them to apply the greatest mass of resources toward objectives. It all starts with a plan. In today's wide world of strategic sourcing, just like investing, it pays even more to do your homework and ask the right questions.

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