

## Private Equity

### When Economies of Scale Fail

Over the past few years, competition within the private equity industry has heightened dramatically, driving up buyout prices, reducing potential returns, and making the management of any portfolio that much more of a challenge for senior leaders. Recently, many firms have recognized the opportunity that exists to improve EBITDA growth by reducing overhead expenses, essentially creating purchasing “consortiums” amongst their portfolio companies. Unfortunately, many of these same firms have underestimated the time, expertise, and most importantly the discipline required to realize this newly created value.

While the concept of economies of scale is generally acknowledged as an effective means of reducing administrative expenses (ie. pooling corporate-wide overhead procurement under portfolio-wide vendor Master Agreements), leaner cost structures may not only fail to materialize as a result of these blanket contracts, but the PE may potentially be exposing itself to loss of reputation and even litigation if their program(s) fail.

Consider these not uncommon situations:

- Impact of the 80/20 rule – while a blanket vendor agreement may successfully translate into savings for 80% of the PE firm’s diversified companies, it is likely to increase costs for the remaining 20% due to peculiarities in specific usage patterns, and may result in higher overall expenses.
- Lawsuits - since earn-out and other performance-related portfolio company management compensation



is tied to financial results, unexpected increases in administrative expenses may expose the PE to costly litigation; the implications being that the PE could easily lose far more than they stood to gain through the portfolio company purchasing program.

More common are the below scenarios that arise when a private equity firm underestimates their vendors’ desire to maximize their own margins over time:

- Lack of validation of actual savings/cost reductions – the PE is rarely prepared to perform savings validation, and therefore relinquishes control over meeting their cost saving objectives.
- Confirmation of vendor and portfolio company compliance – even with vendor agreements in place that promise specific rates and service levels, the PE is ill-prepared to confirm that these rates and service levels are actually being delivered.

Regardless of the specific cause, the misguided implementation of a portfolio company purchasing program typically fails to produce the intended competitive administrative cost structures, and hence, profit and related financial objectives. This often exposes the private equity firm to a loss of their reputation for delivering on investor expectations.