Message to Manufacturers: Develop a Private Equity Mindset

Ask private equity companies what they look for in a manufacturing investment and the answer might surprise you. They do not focus on optimal inventory levels, improved asset productivity or efficient supply chains. Instead, they want to know how well the company is generating cash flow. It is time for manufacturers to think like private equity investors. Their very survival may depend on it.

At one time or another, manufacturers have embraced any number of popular performance improvement initiatives—from LEAN, OEE and TQM to Six Sigma and the 5 Ss. Sadly, despite the time and effort put into these programs, manufacturers continue to struggle. A recent A.T. Kearney study of North American automotive parts manufacturers finds that average cash flow return on invested capital was 9 percent in 2004, nearly flat from 8.9 percent in 2003.

Given this relatively poor performance, manufacturers may want to think twice before pouring more money and resources into improving their long-term manufacturing capabilities. Rather, it is time to think like private equity investors and ask yourself, "What would I do if it were my money?" PE firms are not looking for long-term performance improvements. They want to generate cash flow, with many expecting cash returns of 40 percent or more per year from a durable goods manufacturer.

By adopting a private equity mindset, manufacturers will be less vulnerable to acquisition by private equity investors that target failing manufacturers to turn them around—often doing so with fresh management teams. And they will be better able to compete because many of their competitors have already adopted such a mindset.

In fact, unless manufacturers develop a private equity mindset, and soon, they may end up shuttering factories rather than building them.

What Is a Private Equity Mindset?

A private equity mindset is fundamentally different from a traditional corporate mindset in three key areas:

Free cash flow models. When corporate manufacturers examine

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financial performance they tend to focus on non-cash measures, such as absorption goals. In contrast, private equity investors and the manufacturers in their portfolios zero in on free cash flow—the cash available to shareholders after all expenses have been met. Also, their cash flow models explicitly include an exit strategy. By focusing on cash, private equity investors can more explicitly maximize enterprise value.

Metrics. In corporate manufacturing, plant managers commonly measure unit costs, quality, service and productivity. They also review revenues, resources, raw material costs and contribution figures, albeit less frequently. While these metrics are necessary, the information they reveal is usually not enough to gauge the organization's overall value. Private owners do just the opposite, focusing first and primarily on investment returns.

Incentives. For many manufacturers, performance incentives are not aligned with issues that matter to the company and its owners. Manufacturers tend to stay with the status quo (or aim for marginal improvements over next year's budget), and strive to maintain managers' high salaries, current labor levels and political power. Private equity firms do exactly the reverse, but they also tightly align managers' incentives with the firm's goals. This way, managers are more likely to make decisions in the company's best interest rather than making decisions that cause the least amount of disruption.

Shifting to a Private Equity Mindset

Developing a private equity mindset begins with sending a clear message of change. A good first step is to rationalize salary-based compensation and restructure total compensation packages to give managers equity stakes in the plant, division or company. This lets everyone know that the status quo is no longer rewarded.

Similarly, as assets are divested or liquidated, managers who meet milestones should be rewarded with cash dividends. Finally, give plant managers responsibility for meeting debt payments on any new equipment purchases. Doing so encourages managers to carefully assess capital requests, knowing they will suffer the consequences if they make an unnecessary purchase.

Other ways to develop a private equity mindset include:

Rewarding cost avoidance and asset sales. Corporate manufacturers that think like private owners ruthlessly squeeze out inefficiencies from existing assets before disbursing cash for additional assets. Similar to private owners, they have a cash focus—always willing to liquidate excess capital. And they reward plant managers who free up working capital by avoiding new purchases and liquidating assets.

Discussing an exit plan. Managers tend to hope for the best and assume that the corporation will operate indefinitely under existing ownership structures regardless of performance. Private equity owners never make such an assumption. They develop exit plans and target "terminal" valuations well before investors take ownership. And they define their long-term strategy by a discounted cash flow model. This model, with its explicit terminal value, clearly communicates expectations and highlights whether or not operations are achieving their investment goals.

Continuing operational improvements. Traditional operational performance improvements serve as a plant's foundation for continuous process improvements. Innovative manufacturers that think like private equity investors go a step further and seek IT efficiencies as well. For example, an A.T. Kearney team recently worked with a manufacturer to eliminate legacy IT costs and avoid new costs by assuring data consistency across systems. The team also extracted new value from the supply chain by leveraging RFID-enabled cargo containers.

Take Control Today

Private equity investors will continue to challenge publicly owned U.S. manufacturers. Unless manufacturers fundamentally change the status quo and achieve higher returns, their very survival is in question. Although some of the strategies discussed here might seem drastic, keep in mind that if outside investors seize control of your manufacturing assets, they are likely to install new managers who have no problem implementing these and other measures. Why wait for private investors to replace your managers? Create the right incentives with the right work force now.

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