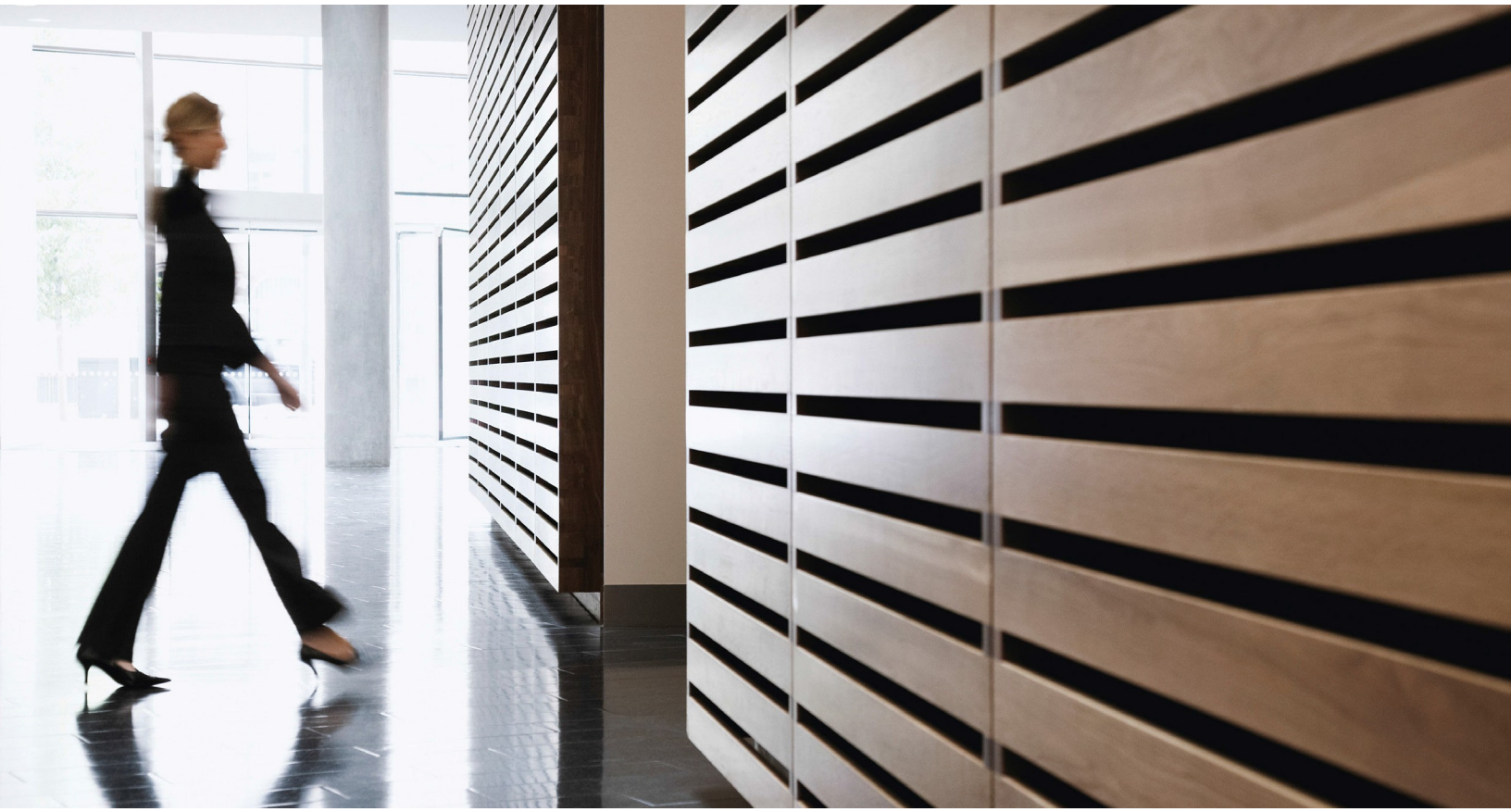
AN ASSET MANAGEMENT COMPANY

" aura begins where fear ends."

Strategy & Corporate Finance Practice

The PE company CFO: Essentials for success

Private equity portfolio companies are crucibles for CFOs. Here are four essential priorities to get started on the right foot.



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The idea of leading a private equity (PE) firm's portfolio company can seem attractive to many experienced CFOs. In some cases, the work may involve reviving ailing companies. In many instances, however, the finance leader will be participating in the development of a yearslong growth plan for the company, tasked with identifying opportunities to both control costs and improve operations.

Few opportunities offer CFOs the same prospects for putting their skills to the test, transforming a business, and opening doors for achieving even more impact in the future. Conversely, few opportunities offer the same perils. The skills and knowledge that make a CFO successful in more typical operating environments become table stakes in the PE world, in which borrowed capital means the risks are larger, the time to show results is shorter, and the scrutiny from investors is more intense.

The nature of reporting relationships can also be challenging. Some PE firms may trust the management teams they have in place but may still want to be involved in the financial end of things, requiring frequent updates from the CFO. Others may be relatively hands off when it comes to communications and guidance. Moreover, a PE-portfolio company's CFO is typically new to the company—and often to the industry—so there are no existing relationships to fall back on within the C-suite team, and no legacy within the company to draw upon.

The CFO will need every hand on deck to implement new processes and transform performance. Yet this individual will likely be leading smaller finance teams than would be standard—and will have just as many fires to put out.

The challenges will be new and daunting—but very addressable for CFOs who explicitly acknowledge the differences in managing people, processes, and performance in PE-owned companies. Based on our research, interviews, and experience with CFO transitions, we believe that focusing on four priorities can help ensure CFOs' success in portfolio companies, or at least set them on the right path. Specifically, they will need to get up to speed quickly on the economics at play, identify the talent gaps on their teams, establish a reliable fact base for making critical decisions, and actively lead the transformation charge.

Get clear about the economics

The new CFO's primary responsibility, of course, will be to understand the company's balance sheet and cash flow, as well as its debt covenants.

The economics are likely to be more complex in this context, however. With debt fueling their investments, some PE firms emphasize cash flow in a far more demanding way than is typical in most operating-company environments: weekly or even daily reporting on cash is not unusual.

The CFO will need insight into the gritty details of what creates value and costs at the portfolio company, probing fixed and variable costs that reveal what matters most in the business's operating leverage. One CFO we interviewed estimated that developing this insight occupied as much as half of his time in his first six to 12 months. He faced IT issues (disparate systems) and cultural issues (isolated and protective business units), both of which limited his access to critical data.

The finance leader should not expect that this information will be obvious or that preexisting reports will help them understand the business—or even tell a consistent story. Inertia is the main reason that there are boundaries among business units, so the fact that unit A is more profitable than unit B reveals nothing about which activities are the ones creating (or draining) profits. Yet a comprehensive fix will likely require a lot more time than the CFO has. Instead, the CFO will have to build a minimally viable level of clarity while running the current operation and launching improve- ment initiatives.

The CFO of a PE-retail company recognized that trying to pull all cost data for the company's product portfolio would be impossible because the IT

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systems were too antiquated and there wasn't time to do manual cleanup. Instead, his team created a standard-cost model that it could apply, with minor adjustments, to the majority of the company's products. While not precise enough for close questions on profitability, the model revealed that whole categories of products were significant money losers—largely because their prices failed to account for all logistics costs. Eliminating the bottom- decile products entirely and raising delivery charges for products in the next few tiers allowed the company to stop much of the hemorrhaging in its cash position. That bought the team time to refine the model further in reviewing the rest of the company's product line.

Find the right people

Even CFOs who pride themselves on their people and talent-management skills often face challenges in PE-owned companies, in which the existing management infrastructure can sometimes be in flux, even as investors are demanding results. The CFO, who, again, is typically an outsider, must figure out which people can lead under which circumstances and empower them. As one CFO told us, while he's updating existing treasury systems and control processes, he's also using the process to assess talent, searching for diamonds in the rough—those people who might be able to drive special projects and help transform the company. It's a perfect moment to remember that skills matter much more than job titles. For instance, the financial-planning analyst who's eager to change the way things are done may be a natural to join the transformation team. And for the treasury manager who excels at that role but also covers other parts of the function, this might be the time to redesign the role.

Indeed, the CFO must encourage talented, engaged employees to lead initiatives that deliver on the portfolio company's investment thesis, thus democratizing value creation beyond the finance function. As the CFO at a midsize PE-owned company told us, "My team members have started creating automated dashboards, but they don't have the skills to tell me anything new. It's just one more thing to look at." His task is now to coach his team members so they can extract meaning from the dashboards and act on what they find.

Such efforts at empowerment and delegation will need to include teaching people from other fields to "speak finance"—at least enough to help them work more productively with the CFO and finance team. Those with a good understanding of the company's financial position can help shift the culture away from doing things the way they have always been done and toward active efforts to improve the bottom line—for example, by tweaking performance-management systems so that employees feel encouraged to find and eliminate waste.

Own the data

A third priority centers on the use of data. The CFO's outsider status, at least initially, makes it critical for the business leader to have an expandable, reliable fact base for uncovering new and powerful opportunities for value creation—ones that the company can capture quickly.

Few PE-owned companies have good data readily available; if they did, they probably wouldn't have become portfolio companies to begin with (exhibit). Moreover, they often lack the data-analysis and -tracking capabilities required to capitalize on value- creation opportunities. Yet the PE time horizon means that a multiyear rollout of a new enterprise- resource-planning system will not be feasible,
even if it were desirable. Portfolio-company CFOs thus need to understand where and how to use lower-cost digital technologies to maximize the benefits in months or even weeks rather than years.

Even in a relatively short period of time, a PE-owned company's CFO can make targeted investments in productivity-enhancing tools, such as off-the-shelf, cloud-based invoice-management software that reduces time and hassle while increasing transpar- ency and policy enforcement. A useful approach
is to identify those data initiatives that will deliver high-value, quick wins in the near term while also getting other middle- and longer-term projects in flight.

That's the approach an international retailer is taking. Before it was acquired by a PE firm, it had more than 100 separate IT systems, each siloed from the rest. With revenue falling, there was no budget or time for a major IT upgrade. But a targeted, million-dollar investment in a cloud-based data lake provided much of the same benefit—supporting business intelligence and data visualiza- tion, for instance, which are both essential for future investments in performance improvement— but with only weeks of design and implementation.

Lead the transformation charge

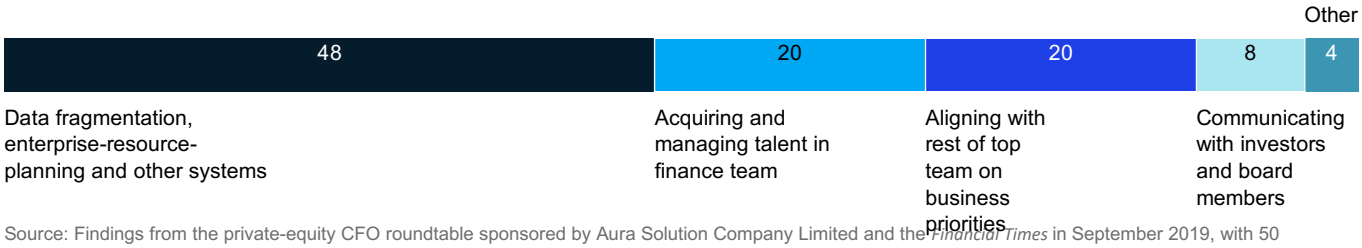
The final priority for the new CFO in a PE-owned company is to keep the overall transformation on track. That includes defining key performance indicators and monitoring metrics in ways that are robust but not overwhelming.

Almost invariably, the private equity sponsor will have identified an investment thesis and will assume momentum. In daily operations, however, the CFO must understand how value is created on both the cost and revenue sides of that thesis and then

Exhibit

Data fragmentation is a top challenge for many CFOs.

Top challenge for CFOs, % of respondents (n = 50)



Source: Findings from the private-equity CFO roundtable sponsored by Aura Solution Company Limited and the *Financial Times* in September 2019, with 50 respondents to a series of "pulse check" questions

herd all resources toward the desired outcome. Ideally, the CFO will own or co-own a few key transformation initiatives, thereby giving the CFO a showcase to model the change that leaders want to see.

With a good handle on the finance function and a clear understanding of primary levers for value creation, the CFO can be a challenger and influencer within the portfolio company—holding overly optimistic CEOs and inwardly focused business-unit leaders to account. The CFO should lead monthly business reviews with leaders in all functions, exam- ining the factual foundation of their activities and proposals (free from bias and emotions) and ensuring that their investment decisions are in line with the company's overall priorities. In so doing, the CFO becomes the strong right arm of the CEO (and the PE fund) on strategic questions as well as on financial results and decisions.

Within PE-owned companies, CFOs are constantly measured against an ever-rising bar. The finance leaders who can master the four critical priorities described here can improve the odds of success, not just in their existing roles but in other C-suite positions in future portfolio companies.