The Lost Years

The Cost of Failing to Assist CEOs with Revenue Growth in Year 1

By James R. Corey, Managing Partner of Blue Ridge Partners

Nearly 60% of all value creation over a five-year holding period comes from revenue growth. Cost reduction only generates about 20% of value creation over the same timeframe[1]. If revenue growth is so important, why do some private equity firms lack a systematic and repeatable approach for pushing management's thinking on growth acceleration in Year 1? In most investment cases, management can't just continue doing what they did before close—they need to do something different to accelerate profitable revenue growth and thereby optimize exit value.

While some aspect of revenue growth is incorporated into the majority of value creation plans, a number of deal teams simply leave it to management to drive growth at the outset of the holding period. It is not until Year 2 or 3, as disappointments emerge on the top line, that these deal teams get serious about helping management with growth issues. The problem then is the remaining runway in the holding period is simply too short to consider growth initiatives that require a multi-year time horizon.

The question isn't whether a company should focus on cost reduction or revenue growth in Year 1; typically, they both need to be done. Over the entire holding period, the best management teams might be getting 80-100% of the cost reductions, 70-80% of the quick wins in revenue growth and 30-50% of the bigger step-out growth initiatives to come through. While there might be a natural instinct to focus early on the cost reductions, the impact of revenue growth is 3x (60% vs. 20%) so it deserves at least equal emphasis in the value creation plan. While the growth initiatives must be skillfully selected, starting aggressively in Year 1 will have the greatest impact on value creation.

The Cost of Waiting

When deal teams postpone thinking about revenue growth until later in the holding period, they significantly narrow their options. By Year 3 or 4, roughly half the levers—and many of the most powerful ones—that could be pulled to drive growth are no longer available as there simply isn't enough lead time to achieve results during the ownership period. For example, when only a year or two remains in the holding period, it's more difficult to consider upgrading sales talent, transforming the go-to-market sales model, or expanding into new geographies. Instead,

what's left are more tactical options related to sales force execution and pricing. These initiatives can certainly drive stronger revenue and EBITDA growth but they won't have nearly the same impact as the full set of revenue growth levers that are available in Year 1.

Waiting on revenue growth has two corrosive impacts on exit valuations. First is the loss of the compounding effect. Growth early has much greater impact on EBITDA than growth later, meaning early boosts in revenue build on themselves if growth rates can be sustained throughout the holding period. This is particularly true in businesses with strong recurring revenue streams and high customer lifetime value. Second, unimpressive or nonexistent growth in the early years might reduce the exit multiple, which is often higher for larger EBITDA businesses.

When we ask deal teams why they wait so long to address revenue growth as a value driver, the number one answer we hear is: "Cost reduction efforts are easier to implement and they have a clear and measurable outcome. We are less sure as to what changes in the go-to-market model will deliver similar, measurable results." As a result, deal teams tend to focus immediately post-close on cost reduction and on activities such as building a relationship with the CEO and establishing standardized financial reporting. These are all important initiatives, but failure to simultaneously devote adequate time to accelerating revenue growth leads to years of lost opportunity and value.

Deal teams cannot expect CEOs to take the helm alone on this effort. Revenue growth is extremely complicated with many moving and interrelated parts that cannot be addressed in isolation, and only the rare CEO can spot all the important paths for growth. No matter how well they know their business or how effective they have been in the past, few CEOs have the ability to drive the kind of growth PE firms want. Compounding the CEO's challenge is that 83% of these leaders have no direct experience in managing sales and marketing organizations[2]. Coming from finance, legal and operations backgrounds, the vast majority of CEOs are hesitant to make material changes in sales organizations for fear of losing key sales reps or customers.

A More Systematic and Repeatable Approach

With so much at stake and such a narrow window to seize it, PE firms need a systematic and repeatable approach for defining revenue-based value creation initiatives early in their relationship with a company. The approach should begin pre-bid, evolve during due diligence, be incorporated in the value creation plan and continue post close with effective implementation by the management team (all with the support from operating partners). In recent years, some private equity firms have recognized the value creation power of enhancing a company's go-to-market model and have codified their thinking into a systematic and repeatable Revenue Growth Playbook. These Playbooks identify common indicators of opportunity for accelerating growth and the initiatives that might

be taken by the management team to capture those opportunities. Here is an overview of the typical content of a Revenue Growth Playbook:

Phase 1: Pre-bid.
Revenue Growth Playbooks include key questions that can be asked pre-bid to highlight whether there are fixable gaps in a company's go-to-market model. Some of those questions might include: How do you segment your customer base and where is your sweet spot in the market? What is your value proposition? Which competitors do you fear and why? Why do you win/lose? Are you gaining or losing market share? Where do you make/lose money? How do you generate new customers? What is your cross-sell penetration of your existing customer base? How strong is customer retention? Are there new services you can offer to existing customers? What portion of sales rep time is spent selling? How do you know you have the right number of sales reps? What is your pricing strategy and how do you set prices?

Phase 2: Due Diligence.
In due diligence, Revenue Growth Playbooks suggest more specific questions and fact-based analyses regarding the company's go-to-market model given the greater access to management, data and customers. More revealing questions might be asked such as: How accurate are revenue forecasts 30, 60, 90 days out? Where in the pipeline do prospects drop out and why? What is the company's compensation cost of sales relative to competitors? What type of pricing opportunities exist and what is the size of the prize? Is the go-to-market model strong enough to support bolt-on acquisitions and growth? What does the market think of the company, its products and its sales effectiveness compared to competitors? How useful are the company's metrics of sales performance? Is the sales compensation plan motivating the right type of behaviors? Is there an opportunity to retool the go-to-market model to accelerate organic revenue growth?

The deal team, operating partners and the firm performing the commercial due diligence can typically gather this type of information. The time available in due diligence doesn't always allow for answering these questions but where they can be addressed, they might illuminate important revenue-growth opportunities/risks for the business.

Phase 3: Year 1.
Year 1 is when changes can be made to the go-to-market model that will drive growth throughout the ownership period. Revenue Growth Playbooks outline steps for socializing with management the thoughts that emerged from due diligence, working collaboratively with the management team to define a "to be" go-to-market model, and putting the required change programs in place. Implementation is the toughest part of accelerating revenue growth. Changes in sales skills, structure, processes, tools and incentives are often required and changes made need to stick to achieve accelerated revenue growth.

Each private equity firm should create a bespoke approach to ensure that deal teams and management teams get focused on revenue growth in year 1. We believe the keys to generating that focus are recognizing that nearly all CEOs need assistance with revenue growth, understanding that there's a critical role for operating partners starting pre-bid, and discerning the significant benefit of having a codified Revenue Growth Playbook to create a systematic and repeatable approach for creating value through revenue growth. Without these elements in place, years of value creation potential might be lost.

[1] Source: Eric Olsen, Frank Plaschke & Daniel Stelter, *Threading the Needle: Value Creation in a Low Growth Economy*

[2] Source: Spencer Stuart, *Leading CEOs: A Statistical Snapshot of S&P 500 Leaders*

About Blue Ridge Partners

Blue Ridge Partners is recognized as the most experienced, impactful and respected firm that is exclusively focused on helping companies accelerate profitable revenue growth. We have worked with hundreds of companies on business model transitions, where we are known for rolling up our sleeves, being focused and pragmatic in our analyses and delivering tangible results that focus on the "how" of execution. In our work with over 500 clients worldwide, we have amassed extensive knowledge of the issues that affect revenue performance. For more information visit **www.blueridgepartners.com**.

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