Sweating the P&L: Success in a PE Portfolio

by Joe Hunt

When I conduct c-suite searches for private equity portfolio companies, my first qualifying hurdle is demonstrated experience and accomplishment "sweating the P&L".

Many executives at multi-national companies state they own or are responsible for P&L on their resume, but digging down to what that actually means in each case requires some excavation to uncover.

In most organizations with shared services and/or centralized functional verticals across brands or business units, only the CEO can truly own P&L.

While many would argue with that last statement, I pose the question whether a VP Supply Chain, VP Marketing, VP Sales, or a business unit General Manager is fully managing a P&L? By my literal definition, the answer is NO. Some may think it's semantics, but to own P&L an executive has to control every variable of the business, including commercialization AND cost.

A business General Manager or Country Manager is often little more than a glorified sales or commercial manager. Not controlling the product development, product supply, other cost variables, or a globalized brand strategy of products they're charged with selling, are knock out factor for owning a full P&L. A chief marketing officer is charged with making important strategic business decisions based on many variables including cost and market demand, but doesn't control either the cost or the actual delivery of commercial execution in markets.

I'm not suggesting most executives are misrepresenting themselves when they make P&L accountability statements. But, there is a big difference between managing a budget and truly owning the delivery of a P&L. In most cases, at best, executives are accountable for delivering components against the P&L.

Giving credit where credit is due, other than the government, there aren't too many organizations or even departments running pure cost center models. Even the necessary evil departments, like accounts payable can deliver significant cash-flow, order to cash and other cost savings that contribute to overall P&L.

When I interview candidates and dig into how they realized stated accomplishments, it's relatively easy to understand their actual role in the results delivered. It would help standardize our common business language to install a "budget variance" contribution KPI for every position in the enterprise that rolls up through every department and is visibly matrixed to the entire organization.

Employee "A's" contribution combined with employee "B" and manager "C", should all balance to the department and company KPI against the P&L. Despite all the technological capabilities available today, I won't hold my breath.

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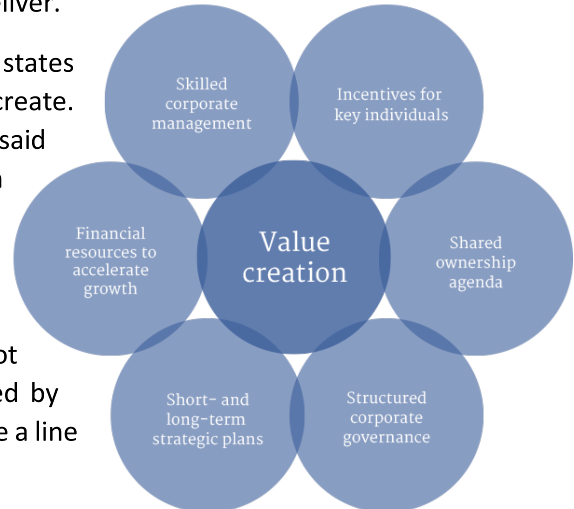
While most managers responsibility is to enable others to deliver vs. personally deliver, today many managers have to at least wear a hat and half as player coach. It's equally as true in business as it is in personal relationships that 1+1 should equal more than the sum of its parts. That delta is an example of actual value creation, which is every business person and I'd argue also each individual citizens' responsibility to deliver.



The law of compensation should be more than a theory, which in part states everyone is compensated in direct proportion to the value they create. Common sense is rarely common practice and obviously a lot easier said than done in application. While challenging to quantitatively assign extrinsic value to a high percentage of important jobs like teachers, police officers or stay at home parents, it's not difficult to do so in a for profit business environment.

I'm not discounting intrinsic values in what people do, but that's not the subject of this article. Unfortunately, the intrinsic value realized by accomplishing goals and creating value for stakeholders does not have a line item on a balance sheet or P&L statement.

The fact of the matter is most managers would benefit greatly from significantly heightening their mastery in overall financial and business acumen along with their technical competencies and people management skills. This is especially true for those wanting to succeed in the fast-growing middle market and private equity world.

As a middle market PE investor and board member, I expect every executive I help recruit into my clients to fully understand the standard set of growth variables ranging from *Cash Flow and Churn* to customer acquisition efficiency metrics like *CMRR (Committed Monthly Recurring Revenue) and CAC (Customer Acquisition Cost and Payback Period) in order to* make informed and intelligent decisions that measure progress against the *value creation plan (VCP).*

Having an MBA or fundamental understanding of the financial definitions is purely academic. Financial and business acumen is about applying each important variable to every business decision you make and analyzing each against the action you take.

Basic financial acumen is table stakes for every executive *working against the VCP and should be an imperative for* every employee to learn and be accountable for "sweating the P&L". While key business metrics will vary by business type, a minimum fundamental understanding requires utilizing the following universal KPI's:

Bookings - The value of a contract between the company and the customer. It reflects a contractual obligation on the part of the customer to pay the company.

Revenue or Sales - All the money a company takes in from doing what it does — whether making goods or providing services.

Net Revenue or Sales – Equates to sum of gross revenue minus directly related selling expenses. At a minimum, this should reflect the wholesale cost of products sold, including freight, and any sales commissions paid.

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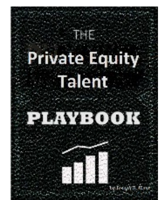

Net Income - aka the bottom line - is simply profit, and the whole income statement flows toward this number. You start with net sales or net revenue, subtract your expenses, factor in any gains or losses from other activities and set aside money for taxes, if necessary. Whatever is left is net income. If more money went out than came in, the company has a net loss.

Gross Profit - While top-line bookings growth is super important, investors want to understand how profitable that revenue stream is. Gross profit provides that measure. What's included in gross profit may vary by company, but in general, all costs associated with the manufacturing, delivery, and support of a product/service should be included.

Gross Profit Margin = (revenue – cost of goods sold)/revenue. The gross profit margin should be large enough to cover fixed (operating) expenses and leave you with a profit at the end of the day.

ARR (Annual Recurring Revenue) - A measure of revenue components that are recurring in nature. It should exclude one-time (non-recurring) fees and professional service fees. This comes down to the never-ending tussle between product and one-off value-added consultancy charges and if consultancy really counts. No, not in this metric it doesn't.

EBITDA - Earnings Before Interest, Taxes, Depreciation and Amortization - is essentially net income with interest, taxes, depreciation and amortization added back to it. EBITDA is used to analyze and compare profitability between companies because it eliminates the effects of financing and accounting decisions.

Cash Flow - Although net income is important (no one wants to own a business that isn't making money), private equity managers are fixated on cash flow. They value businesses on EBITDA (earnings before interest, taxes, depreciation, and amortization). That's the number we're looking to boost and the one we'll analyze most closely. Increased EBITDA is what's going to allow the investors to eventually sell the business for more than was paid.

"A cash flow statement combines info from the P&L statement and balance sheet."

Liquidity - A controller or chief financial officer was probably managing your company's liquidity needs, balancing any seasonality in your business with credit availability. Liquidity is going to become more of an issue, because the private equity fund probably used some leverage to buy your company. Private equity managers will want weekly, monthly, and quarterly cash flow models (perhaps even daily in a crisis) to make sure your company stays within the liquidity covenants negotiated with its lenders. It's impossible to predict liquidity needs perfectly, but modeling helps avoid crises.

Expense Control - Any new buyer will dig into current expenses, asking questions about your policies, why certain expenses have spiked, and how they are controlled.

Product-by-Product Analysis - Cost accounting can be tricky in complex companies, and smaller firms can often lose track of where they are really making profits and generating cash. Expect a product-by-product analysis, with the goal of finding the true margins on each product. In service businesses, expect a focus on how contracts are bid and a particular emphasis on avoiding contracts that increase revenue but aren't all that profitable.

Customer-by-Customer Analysis – Similar to Product-by-Product, except the focus in analyzing each customers impact on the business. Risks, resource requirements, margin and longevity impact both day to day business decisions and can profoundly impact valuation variables that determine the ultimate EBITDA multiples paid by investors.

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Customer Acquisition Cost (CAC) is the amount of money you need to spend on salespeople, marketing, advertising, exhibitions and related expenses, on average, to acquire a new customer. It is so easy to underestimate CAC, especially if you only look at the paid marketing/advertising component. But if you had to employ a salesperson for a year to close a sale, and they took 10 flights and 20 nights in a hotel, that is all part of your CAC.

Churn Rate (sometimes called **attrition rate**) - In its broadest sense, churn rate is a measure of the number of individuals or items moving out of a collective group over a specific period. It is one of two primary factors that determine the steady-state level of customers a business has or will support.

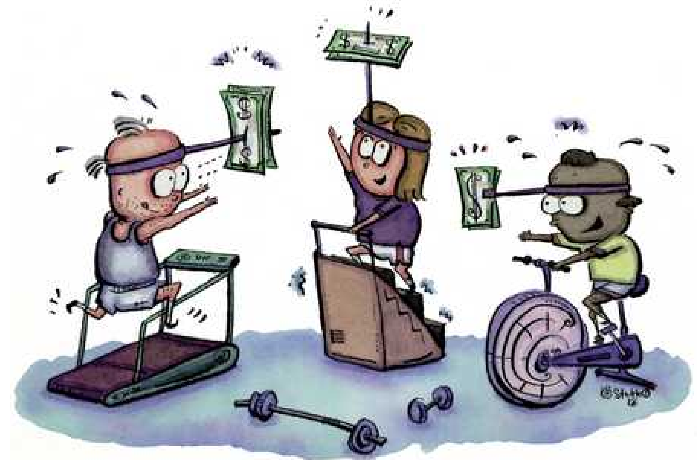
The term churn rate is used in many contexts from revenue decline, inventory turnover to employee attrition, but is most widely applied in business with respect to a contractual customer base. Churn rate is an important input into customer lifetime value modeling and can be part of a simulator used to measure return on marketing investment using marketing mix modeling.

Net Burn Rate - The total amount of money a company loses each month. This tells you how long you can operate before running out of cash and therefore dictates a funding horizon. This is especially important for fast growing companies and turn-arounds. If you run out of money to make payroll and pay suppliers, there may be no recovery even if you have orders on the books.

There are many other financial terms and variables a savvy business executive will apply to be successful, but this list is a thorough example of what you'll need to master and deliver within your environment if you're going for the brass ring of the c-suite and/or private equity wealth creation machine.

Learn or Burn

Whether you're there now, have c-suite aspirations or just want to be an effective executive, it's imperative and non-negotiable for you and your managers to deeply develop and learn to heighten the application of financial and business acumen exponentially. Without mastery in this realm, you'll soon qualify for the federal government's primary workforce-retraining program and be sweating your own families P&L.



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