A Private Equity Perspective on Budget Planning

Fall is budget-planning season for many private equity firms and their portfolio companies. Fall also is an ideal time for prospective sellers to get their team together to think proactively about the future.

“Most management teams are smart, passionate, and extremely well-versed in their industry and their company,” said Prospect Partners’ Vice President Brett Holcomb. “Yet, when we meet for the first time, we discover that many have never done an actual budget. Everything is in their head.”

For owners considering selling a business to a private equity firm, migrating all that extensive internal knowledge – the I-can-tell-you-in-my-sleep whether my revenue is likely to go up or down next year, what (and how much) my top customers will buy, and how my key costs are trending – to a formal written budget is important for many reasons.

“A budget is a conversation-starter,” Holcomb explained. “It lets us look strategically at the company and helps us, as a prospective investment partner, see where we need to invest for the management team to achieve its goals.”

There are many other ways a budget can help a business. Consider these seven additional benefits:

1. Organizes the company around its key activities

A budget is a unique document because it serves both as a stake in the sand – a clear statement of how the company thinks it will perform in all areas of the business – as well as a guide that can be updated as the year goes on. Regardless, the budget centralizes everyone’s focus around the primary drivers of the business.

2. Foreshadows challenges and achievements

While owners typically can gauge things like near-term spikes and declines in sales, they often can’t pinpoint different overarching factors that might affect the coming year, or years. Like, for example, the impact of a new federal or state law on important cost drivers, such as the effect of the recent minimum wage increase on labor costs. Or, on the positive side: how better purchasing decisions might result in a lower cost of sales.

“Understanding big-picture cause-and-effects helps leadership better manage those factors and, as a result, more accurately prepare for the coming year,” said Prospect Partners’ Vice President Brad O’Dell.

What should a budget include?

At minimum, the management team should be prepared to share with prospective investors the following financial projections for the company for the coming year:

- Monthly income statement
- Monthly balance sheet
- Monthly cash flow statement
- Monthly capital expenditure schedule
- “Bridge” explanations from current to coming year. For example, say this year’s revenue/EBITDA are $20 million and $3 million, respectively, and the team projects a jump to $30 million and $4.5 million in the coming year. The “bridge” explains how the team accounts for that increase (e.g., through new customers, higher pricing, and so forth).
- Assessment of relevant customer and supplier trends. For example, has the company won a new big customer? Are suppliers consolidating?
- Anticipated organizational changes

“If the team provided all of this information, I would feel very comfortable they are thinking proactively about their business in a clear, systematic way,” said Prospect Partners’ Holcomb.

3. Prioritizes big spends and resource allocations

A budget helps management assess all spending needs – whether for assets, people, or other investments in the business.

"It helps answer: 'what is my plan for the coming year, and do I have what I need to execute it and hit the ground running?'" said Maneesh Chawla, a Principal of Prospect Partners. "This is especially important for smaller companies, which often need to prioritize carefully. A budget keeps management focused on the key investment goals and where the company is investing its money and people."

Toward that end, a well-drawn budget will reveal the amount of resources available for large capital and growth initiatives, such as new machinery or IT systems, a website or marketing program, a geographic expansion, hires, and other key investments. It also makes it much easier to evaluate factors related to the ability to fully support them, including: Does the company have enough available debt capacity? Might it need more equity? How does it liquidity look?

4. Helps think through compensation structure

A budget also helps ensure that the overall compensation and incentive structure supports the business.

Senior and middle management are often paid in the form of a base salary and a potential bonus. But what should raises and bonuses be based on? Talking about "how we

define success" can help management determine performance-based budget thresholds.

For example, compensation criteria for functional-level employees might be tied to how they perform their specific responsibilities (e.g., did the billing and collections manager shorten the time to get bills out to customers and speed collections as a result?), while bonus programs for senior level managers may be based on how the company does overall.

Said O'Dell: "For senior executives, a typical solution is to tie a portion of their bonus targets to whether the company achieved its annual target for EBITDA because each individual's criteria can be clearly established and aligned with the company's performance."

4 Common Misconceptions About Budgets

To be sure, sellers don't always think prospective investors have their best interests in mind when it comes to budgets. Here are four common misperceptions we regularly hear:

1. You will be hyper-focused on month-to-month trends. Not so, says Prospect Partners' Chawla. "We take a holistic view and look for long-term performance and value creation. We understand there are many uncontrollable factors, including seasonality, revenue and expense timing, and sales cycles, that contribute to better or worse-than-expected near-term performance. That said, a budget serves as a great reference tool that helps management anticipate and plan for known factors and the inevitable variability. It also can help everyone respond and adjust appropriately."

2. You care only about the income statement. Private equity firms care about *everything* related to the business. That includes revenue and expense information in the income statement as well as the assets and liabilities data in the balance sheet, *and* how money flows through the business, which the cash-flow statement shows.

3. You will use my budget to micro-manage my business. "Our management teams run their companies. We provide support, but are not day-to-day operators. So, really, the budget helps the team manage (or micro-manage) their own company," said Prospect Partners' O'Dell.

4. You prefer I set an overly aggressive budget to push my team./You prefer I set a budget I know I can beat. The real answer lies somewhere in the middle. "Companies budget differently and often those differences reflect the personality of management," Chawla said. "Some tend to be too optimistic and use stretch budgets to motivate their teams. Others use budgets to set the cost structure and are more conservative on the revenue side to manage spending. The ideal budget strikes a balance."

5. Illuminates trends

A budget also helps prospective investors gain a better understanding of the company. "Looking closely at the business often reveals some trends, especially when factoring in leadership's outlook and other information the team knows that could affect the business and its industry – for example, rising health insurance costs or price increases from certain suppliers or changing labor rates," said Chawla.

6. Tracks progress toward strategic goals

The budget serves as a gauge on progress toward achieving larger strategic objectives. It also can provide an early warning signal, helping management stay ahead of problems or take quick action if the company hits a rough patch.

7. Demonstrates progress to lenders and other financial partners

For lenders, budgets signal credibility and help them track the company's progress. Further, loan covenants – which require a borrower to fulfill certain conditions or forbid undertaking certain actions – are based on budgets.

Starting the budgeting process

Assembling the senior team for a budget development meeting is a good first step for prospective sellers. Depending on the company, that team might include the CEO, CFO, COO, and the directors of sales, marketing and human resources. Together discuss the strategic framework – the firm's key priorities and activities that serve as the primary components of the budget.

From there, "individual team members can take ownership of the numbers for their respective area," O'Dell suggested. "We have found it best if one person – perhaps the CEO or CFO, if the company has one – assumes ultimate authority for how the numbers get rolled up into the final budget, since that person can impose a consistency to the thought process and presentation."

Added O'Dell: "Remember: A budget is fluid. But getting it on paper helps keep the team on the same page and aware of the main priorities. It also is a key positive signal to prospective investors."

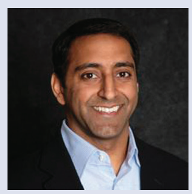
The views expressed in this article are solely those of Prospect Partners and do not necessarily represent the views of other private equity firms.

About Prospect Partners

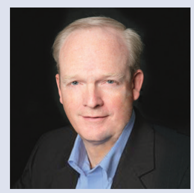
Prospect Partners is a leading private equity firm that invests opportunistically nationwide in smaller lower-middle-market companies. We focus exclusively on management-led leveraged recapitalizations and acquisitions of niche market leaders with revenues typically under $75 million. Since 1998, Prospect Partners has completed more than 135 transactions to build nearly 50 platform companies in widely diverse niche manufacturing, distribution, and specialty service markets. Prospect Partners manages $470 million of committed capital across three private equity funds.

Reach Out To Our Team

Prospect Partners is actively investing in new portfolio companies and in follow-on acquisitions for existing platforms. If you know about an interesting company you think will interest us, please call us today at 312.782.7400, or contact a team member:

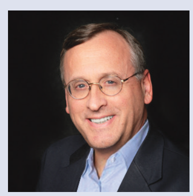


Maneesh Chawla
Principal

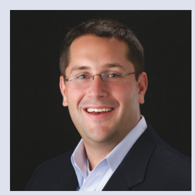


Lou Kenter
Founding Principal

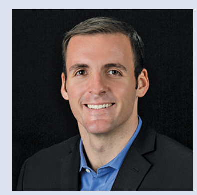
Erik Maurer
Principal



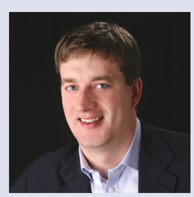
Rick Tuttle
Founding Principal



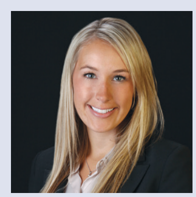
Brett Holcomb
Vice President



Mike McInerney
Vice President



Brad O'Dell
Vice President



Molly Clark
Associate Director of Business Development

Prospect Partners
Private Equity Expertise. Small Company Focus.

200 West Madison St., Suite 2710 • Chicago, IL 60606
312.782.7400 ph. • 312.782.7410 fx.
www.prospect-partners.com