Think. Forward! (Part One)

By Dan Kowalski, Arun Shukla, Phil Lynch

Use Deliberate Thinking to get back in business after the gut punch of COVID-19 in the Private Equity world.

Unless your portfolio is singularly built on business platforms whose models work even when people self-quarantine (think Netflix and hand sanitizer production), your portfolio company valuations have taken a hit due to the spread of coronavirus 2 (SARS-CoV-2). COVID-19 may have thrown you off course from the value creation roadmap, but a deliberate detour will get you back on the value creation highway. So, now what?

Introduction

For seasoned PE Portfolio Managers, there are time-tested playbooks that have evolved through prior experience and can be drawn on when needed, e.g., an investment thesis challenged for a portfolio company, such as an out of balance SG&A or faltering revenue, a balance sheet issue of bloated working capital, or constrained free cash flow. In these situations, we *automatically know* what to do: conduct the analysis to validate and get to the root cause, eliminate the issue, and get the business back on to the value generation curve. The thriving PE world we know of now, didn't exist in 1918 when the devastating Spanish Flu pandemic occurred. And despite our ability to research that history, chances are beyond improving trivia knowledge, we will not find concrete answers to the questions that didn't exist until few weeks ago.

There are NO playbooks. But we do have tools to use.

We must use the sapient capability that comes from our Homo Sapiens species name. Sapient is an adjective that means having great wisdom and discernment. We have the capability, now we must direct it to discern what to do as the pandemic runs its course. Nobel Laureate and behavioral economist, Daniel Kahneman, calls this ability "System 2" Thinking: deliberating on the situation and developing a path forward.

Deliberate Thinking works for both tactical and strategic issues. Since chances are that your entire portfolio and the companies within are currently facing tactical issues related to COVID-19, this multi-part article will show how Deliberate Thinking can help. Here are three typical portfolio or portfolio company related questions which may arise:

1. Do we do X? (This question forces a "yes" or "no" answer.)
2. Is there anything positive that can come out of this and if so, what can we do?
3. Our current methods for value accretion won't work, what can we do differently?

A quick primer on Deliberate Thinking

Deliberating Thinking starts with developing a thorough understanding of the issue or matter at hand. This means asking questions to garner as much information as possible before jumping to action. The nature of the situation determines the type of questions to ask. Typically, at least two people should engage in a Deliberate Thinking session to hold each other accountable. Getting all the information visibly out in the open helps the thinking process. For a PE portfolio company, this dialogue should be between the leadership team and operating partner(s).

"Yes" or "no"? Could there be a "maybe"?

We make "yes" or "no" decisions on a regular basis, e.g., engage with the target upon receiving the CIM (or not). These binary decisions typically require discreet answers since we cannot reject the CIM and remain interested in the target (or at least, shouldn't). But what if we perform due diligence on the CIM and *also* met with the management? Many seemingly binary choices do have a hybrid option that provides the best attributes of the two discreet options. When faced with a "yes" or "no" decision, first discuss whether a hybrid option exists.

There really are only two choices, now what?

With a hybrid solution, we often get to optimize our outcome by cherry picking the upside of the options. When we complete due diligence on the CIM as well as meet with the management team, we can discern between the façade of hockey stick charts and get the facts behind the numbers including the strength of the management. We can better formulate an investment thesis. When we only have binary options, we face a classic dilemma requiring a choice between equally undesirable alternatives.

Imagine you have several portfolio companies in the elective healthcare space that are experiencing significant appointment cancellations due to COVID-19 and must now decide if they should temporarily shut down their clinics. Saying "yes" means delivering bad news to a lot of people including patients and facing the fallout from this decision. Saying "no" could seriously impact the overall business and community if the clinic becomes a node of spread. Not an easy choice.

How do we prepare for discussion and minimize conflict?

First, we must clearly communicate that this binary decision will be difficult and require accepting the downside. Second, we must make information about both options visible for all decision makers by identifying and evaluating what upsides we gain and what downside risks exist for each option. Let's pick a very real post-COVID-19 scenario of the "demand declines due to the inability of the customers to afford such elective procedures". We can use this scenario to explore the potential upside and downside options.

If we decide to temporarily shut down the clinics, then we:

- Will control expenses. *
- Will allow for a severance / disruption package for the employees.

And we must accept that we:

- *Might* lose business.
- *Might* never be able to reopen.

If we decide to keep the clinics open, then we:

- Will offer an across the board pay cut for all employees (and must look for cost cutting in many other areas).
- Will generate goodwill in the community.

And we must accept that we:

- *Might* not have demand to keep clinics open.
- *Might* have a divided physician and front-line workforce if some don't accept the pay cut.
- *Might* have an upset lender or LP questioning our investment.

Note:* This example provides a simplified set of factors to illustrate the concepts. Real life situations will have many more factors to consider including legal and regulatory. We should include as much cross-functional input as possible when identifying the upside and downside of options.

How do we address the uncertainty of "might"?

Every decision we make within a PE portfolio environment requires predicting how well an option will meet our fund's goals and what impact it might have. Otherwise, all decisions regarding new platform investments, new add-on acquisitions, and carveouts would turn out perfectly with no failures. Our prediction accuracy depends on how much we can know for certain about an option's performance. When making a platform investment, we have access to a plethora of data on the market, fragmentation, prevailing valuations, strategic players, and M&A activity to enable a reasonably accurate prediction of the platform fit within the overall fund strategy. But how much data do we have on things that have sprung in the COVID-19 environment such as "might have a higher customer churn rate on business software subscriptions" or "might not have enough demand to keep the clinics open?"

We must make some educated guesses about the probability and impact so that we can focus a discussion. Let's pick our example of a healthcare portfolio company in the elective space. Using a matrix for each option like the following will help:

Temporarily close the clinics

If…	Probability	Then…	Impact
Patients think we treated our people unfairly	Medium+	They take their business elsewhere.	Medium+
We want to reopen	Medium+	We may not be able to get people to come work for us.	Medium+

Keep the clinics open

If…	Probability	Then…	Impact
Demand continues to decline	Medium+	We still must close and will have a smaller package to offer.	Medium+
Not everyone agrees to the pay cut idea	Medium	There will be animosity within the workforce.	Medium+

While this is just an example, most binary decisions have risks that are at least a medium-level probability (50-50 chance of occurring) and at least a medium-level impact (disruptive or worse). This reinforces the challenge of choosing between equally undesirable alternatives.

What if there is a difference of opinion on information?

In cartoons, when a character faces a binary decision, opposing sides are characterized by an angel whispering "no" in one ear and a devil whispering "yes" in the other. In the PE world, opposing sides are supported by actual people who may have lined up for one option or the other. The operating partner and the CEO may be at odds even though they have a perfectly aligned performance system. Deciding whether to temporarily close a clinic could elicit strong emotions both for and against the option.

Creating matrices like the one above provides us with the opportunity to think through what we can do to lower the probability or impact. For example, how can we create messaging that shows how we decided to illustrate the challenges? What might we do to engage the workforce to understand the challenge and what is needed? Do they have other ideas for lowering costs? There are no off-the-shelf mechanical models that exist for such situations. The models need to evolve through Deliberate Thinking.

How do we make the choice?

In the clinic closing example, no correct answer or magic formula exists. We would make the choice based on the information we have and the circumstances we face. At times, temporarily closing the clinic makes sense, at other's we would keep it open, or even further still, we may come up with an entirely different, hybrid option. In any case, we would make the choice knowing that we looked at the options from all angles, accepted the downside that come with the selection, and mitigated the risk as much as possible.

To recap, when we face binary decisions, we must keep the following in mind:

1. Identify if a hybrid option exists. e.g. for the clinic decision, it might be possible for all clinics to reduce their hours and take some downtime to match demand.
2. If no hybrid exists, then accept that deciding will be tough (and usually emotionally charged).
3. Identify the upside and downside risks for each option and make them visible. Remember to include multiple viewpoints.
4. The risks will typically require prediction. Use a matrix to assess the probability and impact.
5. Use the matrices to discuss how to mitigate risks.
6. Select the option that provides the most acceptable risk and deploy any mitigating actions. Remember that no option will be 100% correct.

What's next?

As this pandemic unfolds, many people have used the adage, "when life gives you lemons, make lemonade." Great advice, but only if you have sugar, water, and ice available. In Part Two we will look at identifying if there are lemons, if they are ripe, and what ingredients, actions, and other resources we need to turn them into lemonade.