UNDERSTANDING THE TOTAL COST OF OWNERSHIP

How finding hidden value can give private equity investors a competitive edge

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You've built hotels on Boardwalk and Park Place. Now you find yourself with little left to buy with your stack of golden-yellow $500 bills.

Just like the MONOPOLY board game, today's private equity investors often face a similar situation. While many hold plenty of capital, they frequently find too few companies up for sale in which to invest. This imbalance creates a seller's market, ensuring investors pay top dollar for whatever properties they purchase.

To come out ahead, you need to crunch the numbers with an eye on areas to create value — the value your competition missed.

Sounds simple, right?

OK, maybe not. But there's one area in which many companies can add value that private equity investors often miss — workforce management. Like company managers, many investors currently calculate total workforce costs by simply adding wages plus benefits.

This approach fails to consider the big picture.

Instead, private equity investors must consider the total cost of ownership (TCO). TCO offers a more realistic picture of what employers actually spend on their employees and the management of their workforce. In addition to benefits and salaries, TCO includes costs associated with recruitment, compliance efforts, time and attendance, and the systems required to manage, process and support all of this activity. When you look at a company with just 200 employees this total cost can easily exceed $10 million a year. If a firm can reduce that by just 5 percent, it would add $500,000 to the bottom line. Factor in a standard multiple of earnings of 7 at the time of sale, and it equates to $3.5 million.

A recent PwC study[1] reported only 5 percent of its clients had full-scale workforce analytics capabilities in place. Another 20 percent of respondents said they conduct such analysis on an ad hoc basis. That means if you don't take the initiative to calculate TCO, it's likely no one else has either.

This oversight is often the result of company leadership underestimating the savings they could gain by reviewing TCO. At the same time, some senior leaders may be overconfident in their ability to find savings through current business processes.

The ADP Research Institute, in conjunction with Harris Poll, surveyed more than 1,000 midsized company executives and managers last year to gain greater insight into this issue. The study found that while midsized business leaders consider TCO important, cost was not a major motivator for how they process payroll.

That's a lost opportunity for midsized companies. However, it presents a big opportunity for private equity investors who do their homework.

How big? A 2014 study by NelsonHall[2] revealed that North American firms implementing a workforce management strategy are able to reduce TCO by 26 percent. That's a huge potential savings in what is the biggest expense for most businesses.

On the flip side, understanding the TCO of a potential investment may also save private equity investors from making costly mistakes. For example, is the company you are analyzing Affordable Care Act (ACA) compliant? Meeting ACA requirements can come with additional insurance and administrative costs, while failing to meet specific compliance deadlines can bring about substantial government fines and legal fees. A thorough TCO analysis considers all of these factors so investors don't end up with surprises after they sign on the dotted line.

With so few people calculating TCO, there remains a lack of knowledge on the best way to do this. At ADP, we counsel our clients to consider the following five functional pillars — payroll, employee benefits and administration, human resources administration, time and labor management, and talent management.

The same ADP Research Institute survey noted earlier found only 27 percent of midsized business leaders currently consider all five of these factors as part of their TCO.

TCO offers a more realistic picture of what employers actually spend on their employees and the management of their workforce. In addition to benefits and salaries, TCO includes costs associated with recruitment, compliance efforts, time and attendance, and the systems required to manage, process and support all of this activity.

As a result, it's not surprising that we see a number of inefficiencies within and throughout these pillars in our own analysis of many businesses. One key issue is that many companies still manage core human resources tasks on multiple platforms. With the increased importance of human capital and the complexity involved with linking payroll with HR administrative tasks, companies should make it a priority to integrate their HR functions on a common platform.

PwC's recent study estimates that outsourcing these tasks to a single vendor can increase cost efficiencies by 32 percent. This is just one example of hidden value private equity investors can find by analyzing TCO.

Attracting, developing and retaining top talent comes with a cost. Some of these costs are monetary while others take the form of operational inefficiencies and, ultimately, the loss of personnel. Yet, optimizing talent management requires timely, accurate information. Investors must have the right measurement tools and the institutional knowledge to make the proper corrections.

Finding new ways to create pockets of hidden value is key for private equity investors looking to squeeze more value out of their existing portfolios. Identifying new value creation levers is also increasingly critical in gaining a competitive edge as investors bid on a shrinking number of properties on the market.

For more information, visit adp.com
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1 *PWC, Trends in Human Capital 2012: A Global Perspective, 2012*
2 *NelsonHall, Targeting Payroll Outsourcing, May 29, 2014*

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