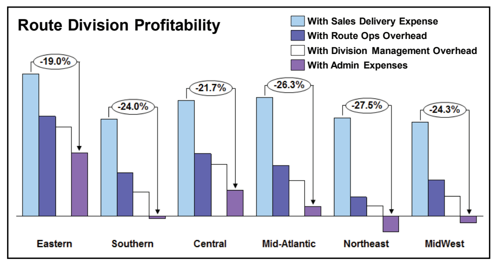
Operational Due Diligence Of National Coffee Roaster & Distributor: Establishing Quick Read On Cost Savings To Support Early Stage Go/No-Go Decision

The Challenge: One of Gotham's long-time PE clients was pursuing a hotly contested auction of a family-owned, national coffee roaster and distributor. The target had a portfolio of 3,000+ coffee- and tea-based products, and 24,000+ customers nationwide, including large national accounts and a DSD network serving 100,000+ customer locations. Although one of the largest players in the industry, the business was operating at razor-thin margins. To achieve targeted returns, our client would need a 3-4% point EBITDA margin improvement. As such, our client asked us to rapidly establish the existence of any significant cost reduction opportunities to support an early stage go/no-go decision on the auction. To this end, Gotham undertook a 2-phased effort: Phase I (2 weeks) would leverage data room information and Gotham's extensive coffee roasting and route-based distribution experience to deliver a cost reduction opportunity assessment sufficiently robust to enable a go/no-go decision; and Phase II, if required, would involve a more detailed assessment of the target's operations to validate and refine the value of the cost savings opportunities.

2-Week Phase I Cost Savings Opportunity Identification: Faced with limited access to the target's management, plants, and operations data during this early stage of the auction process, Gotham leveraged our analytical expertise in deciphering cost/operational performance from available financial data and other information as well as our extensive experience in the industry.

- **Establish Clear Picture of the Cost Structure:** Financial data in the data room provided little insight into the operations cost structure due to: the aggregated nature of the data; intra-company transactions; and shared costs among divisions. Gotham quickly overcame these limitations by dissecting available personnel and operating expense data and leveraging additional data room information (e.g., headcount tables, compensation data, real estate lease agreements, vehicle records) to build a cost fact base at the functional department level. We then aligned costs with the target's operational structure (16 sales divisions, 4 manufacturing plants, and 3 distribution systems). We then compared this operations cost fact base with our proprietary benchmarks from similar companies and were thus able to identify potential cost savings opportunities.
- **Assess DSD Network:** The target's complex DSD network comprised 130+ routes, ~80 sales and service centers, ~450 vehicles, ~300 employees, and ~90 executives spread throughout 4 layers of overhead in ~30 regions and 6 divisions. To establish true route-level profitability, Gotham first leveraged financial data to create an initial picture of route profitability based on route sales and material costs. We then layered in delivery expenses by allocating vehicle, sales and service center, and equipment costs to each route. Finally, we added overhead cost structure by dissecting overhead costs to establish Route Ops, Division Management, and Admin Expense cost buckets, which we then allocated to each route. We also aggregated and analyzed DSD revenue and volume data by division to understand pricing differences by region.



Significant Cost Reduction Opportunities In DSD Network But Longer Term Viability Of DSD Business Questionable

Using our route profitability analysis, Gotham established that the DSD network was not as profitable as our client had initially believed and that 3 out of 6 network divisions were actually unprofitable. Each of the 3 unprofitable divisions were facing 3 key challenges: (1) lower pricing; (2) insufficient volume to achieve benefits of scale; and (3) suboptimal product mix. Moreover, the target was facing an overall strategic and profitability issue moving forward – namely volume declines due to the growing trend in the market of shifting from DSD to foodservice distributors. In response to this trend, the target had partnered with a leading foodservice distributor to avoid losing market share, which in turn was reducing DSD network volume and route density, further eroding the target's DSD network profitability. While Gotham identified an opportunity to reduce DSD costs by up to 25% (streamlining the overhead structure and pruning unprofitable routes/optimizing the route network), the target's longer-term options for its DSD network – either scaling back the size of the network or operating a low-margin DSD business – were not attractive.

Oversized Overhead Structure But Capturing Cost Reduction Would Be A Cultural Challenge

Although Gotham had no access to the target's sales force, we were able to leverage available data to assess the effectiveness of the target's 7 separate sales divisions that comprised a total of 113 employees. We established that the target's largest sales division accounted for 38% of the total sales force expense while bringing in only 25% of revenue. Furthermore, over 50% of this division's sales came from 10 accounts, indicating an opportunity to streamline the division. As regards management overhead, our assessment indicated an oversized organization with high salaries and bonuses; rich benefits; and many perks. Furthermore, due to recent headcount growth, G&A personnel expenses had increased at 18% CAGR over the last 5 years, significantly outpacing the target's 3% CAGR revenue growth over the same period. Overall, Gotham estimated that shifting to a leaner overhead structure would add 1.3-2% points of EBITDA. However, capturing these savings would be a major cultural challenge as savings would require substantial headcount reductions and significant changes in management practices.

Limited Opportunities In Operations Cost Reductions Due To Well-Capitalized, Automated Operations

When compared to Gotham's roasting operations benchmarks, direct labor costs were in line with expectations, but indirect labor costs were high. Near the end of Phase I, Gotham had the opportunity to do a quick plant tour of 1 of the roasting facilities, revealing fairly modern equipment and automated roasting operations that controlled yield loss and changeover very well, thus limiting throughput and material waste opportunities. While the plant tour did indicate some minor opportunities to reduce freight, warehousing, and logistics costs, overall, operations costs were in line with Gotham's proprietary benchmarks.

The Outcome: Gotham found that there were cost reduction opportunities that could achieve our client's financial targets. However, capturing those savings posed significant cultural and business strategy challenges. Given the high valuation of the target and the significant hurdles standing in the way, the client decided not to pursue this opportunity further.

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