MERCER

DRIVING HIGHER VALUATIONS FOR PRIVATE EQUITY PORTFOLIOS THROUGH MANAGEMENT OF EMPLOYEE BENEFIT PROGRAMS

MARSH & McLENNAN COMPANIES

Private equity firms (including hedge funds, venture capital and other financial investors) can derive significant value within their portfolio companies by combining the buying power of their portfolio companies when they purchase employee benefit plans. This approach has tremendous upside for improving both cost efficiency and overall quality of program design and delivery, but there are challenges that need to be addressed when implementing these solutions.

Private equity (PE) firms have driven the M&A market in recent years – that is, until the brakes were applied by the credit market crunch that began in 2007. While the PE firms' challenge has become more complicated, their mission remains the same: to build value through stronger, more competitive businesses that deliver higher rates of return to investors. In today's economic climate, PE firms must find ways to accelerate value creation at their portfolio companies.

Value is created through improved management of employee benefit programs using two broad, actionable categories: (1) reducing costs, without necessarily changing program designs, and (2) increasing operational efficiencies, managing government compliance and improving service levels.

Roughly 40% of corporate revenues are currently directed toward wages, benefits, training and other employee-related spending. Many of the cost reductions and operational efficiencies that PE investors seek can be found on the people side of the business. While the leverage and buying power of groups in many cost areas – such as telecommunications and office supplies – are widely recognized, few have taken advantage of similar cost savings that can be realized in employee benefit plans.

One cost-saving opportunity that PE firms should consider is the Mercer Portfolio Benefits Alliance® ("Benefits Alliance") solution, which combines the leverage and buying power of affiliated groups to reduce the cost of benefit programs.

For example, a PE firm with many companies in its portfolio can significantly reduce the total cost of medical, prescription drug, life and disability insurance by coordinating the purchase of these coverages. The firm can realize further savings by driving common design platforms and/or trend management strategies. Instead of each organization negotiating its own purchases, companies act collectively as a larger buying group, realizing meaningful savings in the process.

In the majority of cases, participating portfolio companies maintain their own contracts and plan designs. In an environment of steadily escalating health care costs, the Benefits Alliance is one that can help PE firms to more effectively control medical trend increases.

By our calculations, this "solution" can save 10% or more on annual health and benefits costs while maintaining or improving the quality of coverage. One midmarket PE firm, for example, saved almost $7 million on health spend alone. Large funds generally achieve even greater savings across their portfolio.

Management of medical trend

In addition to Benefits Alliance aggregate savings, value is delivered through trend management.

"Unmanaged medical trends are expected to increase 8% to 10%over the next five years." Mercer's 2007 National Survey of Employer-Sponsored Health Plans

A $100 million unmanaged medical program will grow to $154 million in five years, assuming a 9% trend. By managing trend down 3%, costs would be $134 million after five years, resulting in savings of $55 million over the same period ($20 million in the fifth year alone).

The Mercer Portfolio Benefits Alliance® ... solution can save 10% or more on annual health and benefit costs while maintaining or improving the quality of coverage.

BENEFITS COSTS DECREASE AS GROUP SIZE INCREASES

The Benefits Alliance is a simple concept with many successful precedents. An independent corporation, for example, typically aggregates all its operating divisions and subsidiary companies under a common employee benefit program. Instead of each entity purchasing its own employee benefit plans, the corporation negotiates on behalf of all entities. By unifying its employee base for this purpose, the corporation enjoys greater bargaining power than any of its subsidiaries or divisions could alone, and it has an opportunity to obtain larger volume discounts and pay lower administrative costs.

As the majority shareholder in multiple companies, the PE firm often is in the position to apply buying power, improve efficiencies and create a platform for other cost-saving initiatives. Consider the data in Figure 1, which compares the unit cost of group health insurance for three hypothetical purchasers of substantially different sizes. As shown here, the insurer of 20,000 employees saves slightly more than 20% relative to the cost incurred by its 200-employee counterpart. The lion's share of those savings comes from lower administrative costs.

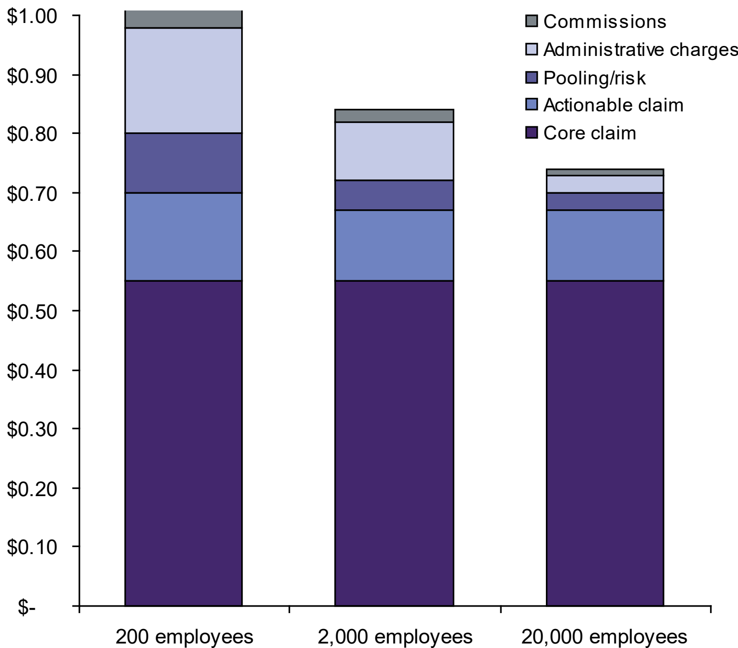

Figure 1:
Comparison of unit costs for group health insurance

Similar savings can be achieved for other benefits as well, as shown in Figure 2. As noted, some of these savings are more easily obtained than others, with medical and benefits administration on the more difficult end of the spectrum. In contrast, cost savings are more easily obtained in areas such as group life, disability and dental insurance. These represent the "low-hanging fruit" of cost savings but also offer the lowest potential savings.

Type of plan	Potential savings from plan cost*	Estimated annual savings per employee	Degree of difficulty
Group life and AD&D	10% to 20%	$6 to $12	Low
Voluntary benefits	10% to 25%	NA	Low
Short-term disability	3% to 5%	$12 to $20	Low to moderate
Long-term disability	10% to 20%	$20 to $40	Low to moderate
Dental	5% to 10%	$40 to $80	Low to moderate
Prescription drugs	6% to 12%	$70 to $140	Moderate
Medical	3% to 10%	$180 to $600	High
Benefits administration	Savings through process improvements and technology fees	Varies	High

*Net employer savings %

Figure 2:
Savings opportunities* by benefit area based on Mercer's experience

Applying the EBITDA multiplier to the cost savings realized from our Benefits Alliance can increase firm value significantly.

While administrative and transaction costs represent the greatest source of savings, portfolio companies also enjoy other benefits by standardizing HR processes and administrative functions, including improved customer service, increased employee self-service (due to more sophisticated technology options) and the outsourcing of noncore administrative functions to third-party vendors. In addition, the Benefits Alliance provides an improved platform to help mitigate the risk of government compliance reviews.

INCREASED BUYING LEVERAGE: TWO PE FIRMS' EXPERIENCES

To help you appreciate the monetary value of the Benefits Alliance, we have included an illustration based on Mercer's PE work.

Consider the experience of two PE firms: one large, the other of midmarket size. The examples below are representative of Mercer's aggregate market experience involving numerous assignments and are not specific to any particular firm.

WHERE AGGREGATE PURCHASING PRODUCES SAVINGS

Savings, typically, are found in two different categories: benefit cost and benefit delivery.

Benefit cost savings:

- Lower administration fees (self-insured plans)
- Lower premium rates (fully insured plans)
- Market-best discounts (self-insured plans)
- Reduced brokerage and/or consulting fees
- More centralized and streamlined management mechanism
- User initiatives (for example, workforce wellness programs)
- Trend and claims target guarantees (self-insured plans)

Benefit delivery savings:

- Standardized HR processes and administrative functions
- Cataloging of all existing programs and compliance monitoring
- Rationalized HR functions across portfolio
- Outsourced noncore administrative functions to third parties
- Increased employee self-service through technology
- Improved customer service and claims handling
- Improved vendor performance through guarantees

The large PE firm illustrated in Figure 3 applied the Benefits Alliance to the purchase of group life insurance across its companies representing more than 52,000 employees. Multiple insurers were invited to bid on the package. As shown, bids were substantially different, both for the individual companies and across companies.

Portfolio company	Annual life premium	Bidder 1	Bidder 2	Bidder 3	Bidder 4
A	$0.5M	-26%	-10%	-18%	-13%
B	$2.9M	-25%	-18%	-19%	-20%
C	$0.7M	+8%	-5%	-19%	-14%
…	…	…	…	…	…
M	$4.0M	-18%	-16%	-18%	-23%
Total	$23.4M	-21%	-17%	-17%	-19%
Annual savings		$4.9M	$4.0M	$4.1M	$4.4M

Figure 3:
Life insurance costs and savings for a large PE firm

One insurer (Bidder 1) offered significant discounts over current premiums for most of the portfolio companies involved but actually raised premiums for 30% of the other portfolio companies. Overall, however, its offer was 21% less than the current total of annual premiums, representing annual savings in excess of $4.9 million.

In the end, however, Bidder 4 was awarded the business, for two reasons:

1. Under its bid, each portfolio company would obtain a lower premium cost. There would be no losers (unlike with the offer by Bidder 1, which would require some companies to pay more).
2. Negotiations with Bidder 4 resulted in an improved offer, one that roughly matched that of Bidder 1.

Ultimately, each portfolio company obtained reduced premiums and the PE firm experienced an annual savings of 20% – while retaining a top-rated insurer. That savings could be anticipated for every year that the firm held these investments. And as new investments were added, they would immediately benefit from participation in the Benefits Alliance. Again, benefit levels were unchanged – each of these companies maintained its own contract and plan design.

Are cost savings available to smaller and midmarket funds? Experience indicates that they are, and the absolute size of those savings can be even greater when they move from lower-cost plans such as group life to higher-cost plans such as medical insurance.

For example, a midmarket PE firm recently engaged Mercer to analyze its portfolio companies and find medical insurance programs that could be linked together under a common administrator. Purchasing medical insurance is complicated, as it involves a significant number of variables (for example, employee impact, discounts, physician networks, care management and administration capabilities), all of which need to be accounted for on a regional basis. Nevertheless, application of the Benefits Alliance to this midmarket fund yielded an 8.1% overall savings ($6.8 million), with three of the four participating companies realizing savings of 6% or more (see Figure 4).

Portfolio company	Number of employees	Medical insurance costs	Savings	% savings
A	3,800	$16.6M	$1.0M	6.0
B	1,600	$12.0M	$1.2M	10.0
C	5,000	$44.8M	$4.3M	9.6
D	1,300	$10.6M	$0.3M	2.8
Total	11,700	$84.0M	$6.8M	8.1

Figure 4:
Medical costs and savings for a midmarket PE firm

IMPLEMENTING THE BENEFITS ALLIANCE

There's nothing mysterious about the cost-saving power of the Benefits Alliance. The challenge lies in the feasibility assessment, the engagement approach and its implementation. Here are a few issues to consider:

- Some portfolio companies operate autonomously and therefore may be unfamiliar with the benefits gained from aggregate purchasing.
- A single solution is not always satisfactory when portfolio companies differ greatly in employee demographics, industry, extent of unionization, geographic location and plan renewal dates.
- The PE firm may not have a staff person positioned to coordinate and champion the Benefits Alliance. Likewise, portfolio company resources may be a concern.

Both solutions described above achieved meaningful annual cost savings correlated with different coverage areas: roughly $4.9 million for the large firm and $6.8 million for its midmarket equivalent. In each case, the savings justified the effort. And because those savings will recur every year, the Benefits Alliance provides continuing value to the firm. But there is a much greater payoff: firm value.

Firm value is generally a product of EBITDA and the market multiplier, which at this writing is in the neighborhood of 6X. Since every dollar of cost savings increases EBITDA by an equal amount, the Benefits Alliance increases firm value by six times the size of its EBITDA contribution, for the following results:

Large firm example: $4.9 million x 6 =
$29.4 million increased value

Midmarket firm example: $6.8 million x 6 =
$40.8 million increased value

Despite these and other challenges, the monetary potential and improved benefits delivery of the Benefits Alliance are usually well worth the effort. In our experience, the three-step implementation process outlined below has been most successful. For this process to be effective, however, each step must embody rigorous planning and execution.

Each portfolio company obtained reduced premiums, and the PE firm experienced an annual savings of 20%

A THREE-STEP PROCESS

Step 1: Collect data on the employee benefit programs of portfolio companies; data should include employee/employer costs, geographic location and benefit plan design. Analyze this data to identify the spectrum of cost-saving opportunities and their implications.

Step 2: Review the findings of Step 1 in light of the PE firm's governance model. Some PE firms operate with significant control over portfolio companies; they direct their companies to join an aggregate purchasing plan for benefits. Others follow a looser governance approach, allowing each company to choose its own benefit plan arrangements. The implications of this latter approach are more limited efficiencies and cost savings, a smaller platform, and a greater potential for the program to unravel.

Based on the governance model and the analysis developed in Step 1, select the strategy that makes the most sense. In our experience, the best strategy typically is one of the following:

- Preferred vendor programs. Preferred vendor programs are selected and offered to portfolio companies on the basis of pricing and services. Each portfolio company has its own contract. This approach offers the least leverage.
- Coordinated plan management. This strategy combines two key components:
  - Consolidation of current programs. Participating companies appoint a single consultant to work on their behalf with vendors and insurers. Success depends on the extent to which portfolio companies can be blended together in common programs. For example, say that five of nine portfolio companies can all use the same medical vendor; consequently, they demand that the vendor treat them as one large customer, not as five small ones.
  - Aggregate purchasing. Portfolio companies do their buying through a common set of health and benefit vendors and insurers, using a request for proposal process. Each company can design its own plan.
- Corporate benefits management. This is a one-size-fits-all approach. The PE firm designs programs and directs its portfolio companies to use them. Complexity is reduced as the portfolio companies adopt common administrative standards and benefit platforms. Savings are greatest under this scenario.
- Global Benefits Management. This approach is utilized when the portfolio is multinational. Cost savings can be maximized with respect to risk benefits by leveraging global buying power. The premiums you pay and the terms and conditions applicable for your risk benefits around the world are the best available.

Each of the different strategies falls somewhere along the governance continuum described in Figure 5. As shown, the preferred vendor program is most suited to the loosest form of governance; the coordinated plan management is most appropriate when management exercises moderate control; and the corporate benefits management strategy conforms with tight control exercised by the PE firm. In all cases, the appointment of a single consultant to work on behalf of the portfolio companies with vendors and insurers provides the most leverage.

The monetary potential and improved benefits delivery of the Benefits Alliance usually make it well worth the effort.

Figure 5:
Strategies and the continuum of PE firm governance

Step 3: Define program objectives and work with portfolio companies on structure and governance.

In many cases, the best way to handle this step is to establish an oversight committee with representatives from participating portfolio companies. With the PE parent's blessing, they can act together to determine which approach makes the most sense for each company and for the portfolio as a whole.

Geographic location often plays a part in this important step. Portfolio companies tend to be geographically scattered and must be served by local markets for health plans. Differences in what these local markets have to offer must be accommodated within the Benefits Alliance.

Mercer has found that the best approach to dealing with local market differences is to connect portfolio companies with "local service teams" whose members are familiar with local benefit markets and the needs of the portfolio companies. Because they understand local markets for medical and other services, as well as the state regulatory environment, these local teams are in the best position to select appropriate services. They know that if a company's employees are concentrated in St. Louis, a vendor's health insurance program must include certain hospital providers in the St. Louis metropolitan area. They also know which vendors will not allow customers to carve out pharmaceutical coverage in other locations. These location-specific issues make local market knowledge essential for proper employee coverage and program success.

AN IMPLEMENTATION EXAMPLE

To get a better sense of the issues involved in implementing a Benefits Alliance, consider the illustrative case of a PE firm. The experience underscores many of the challenges and results that PE firms face when they implement this cost-saving solution.

The PE firm's portfolio includes 11 companies that collectively employ 25,000 people in three geographic regions. It understood the potential of aggregate purchasing and employed a dedicated "procurement manager" to champion portfoliowide purchasing of technology and other services. Eager to better manage costs and realize efficiencies, the firm engaged Mercer to create an "employee benefit purchasing group" to identify and leverage opportunities in the medical care area.

Adhering to a loose governance approach, the PE management did not mandate participation in the purchasing group. Seven of the 11 portfolio companies joined the program. After the data-gathering and evaluation phase (Step 1 on page 5), several of these companies were judged to be unsuited to the Benefits Alliance and were readdressed at a later phase. This does not come entirely as a surprise: Not every company will fit into this type of initiative.

Complexity was another challenge for the purchasing group. The participating portfolio companies differed widely in both the number of people they employed and the types of benefits they offered. Over the course of several months, however, the purchasing group was able to identify and negotiate favorable terms with best-in-class medical providers serving the geographic locations of the participating companies.

This initiative reduced first-year costs by more than $7.5 million, exceeding initial expectations. Since the PE firm anticipates a 6X multiple on the sale of its portfolio companies, those savings translate into $45 million of overall fund value.

This particular purchasing group example involves just a few portfolio companies on a voluntary basis and focused on a single HR-related cost-saving opportunity: medical insurance. Nevertheless, it demonstrated to management what could be accomplished when affiliated enterprises work together.

The Benefits Alliance is a proven method for finding and capturing cost-saving opportunities.

THE BOTTOM LINE

The cost reductions and delivery benefits achieved with the Benefits Alliance should be reward enough for the time and effort that goes into implementation. But value is created in other forms:

- Dissemination of best practices across the entire PE portfolio. For example, when one portfolio company developed an employee wellness program that reduced the number of employee sick days, its practice was quickly adopted by its sister portfolio companies.
- Improved customer service. Vendors lavish their best service on their largest customers to avoid defection. For example, a health insurance provider set up a dedicated service team whose sole responsibility was to handle calls from a single PE firm's employees. When those employees called with questions or problems, they were immediately connected with service representatives who thoroughly understood the policies and benefits of those employees. This resulted in greater employee satisfaction and less work for the HR managers of the portfolio companies. That's the power of aggregate purchasing at work.
- Employee benefits consultancies versus local or regional brokers. Purchasing groups generally employ a national/multinational consultancy firm, as opposed to a local or regional broker. This allows for an extended team with specialized resources and expertise – as well as global reach and resources.

While a substantial sum may be spent on employee benefits, such programs contain many cost-saving opportunities. As demonstrated here, the Benefits Alliance is a proven method for finding and capturing those opportunities. It is, in fact, an important strategy in the PE firm's arsenal, poised to provide competitive employee benefits and plan architectures at favorable costs.

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- Bring clarity to the business context
- Provide analytical support, solutions and proprietary tools for all people-related matters
- Offer guidance in managing and deploying the workforce
- Prepare and help organize HR to be successful in deal work and to help ensure that business goals are met

ABOUT MERCER H&B BUSINESS

Mercer helps employers of all sizes meet their health and benefit program objectives while controlling costs. We are also committed to a vision of a more rational health care market – in which providers are rewarded for providing higher-quality, cost-effective care; where employees know what health care services cost and understand the role they themselves must play in managing their own health; and where the buying power of our clients is harnessed to ensure fair pricing and greater accountability from health plans along with transparency of costs. We help clients design, manage and administer their health care programs; comply with local regulations; and secure health and welfare coverage to promote the health, security and well-being of their employees.

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