

Lean-Focused Operational Due Diligence Provides Insight, Guidance to Potential Investors

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Businesses and other organizations continue to give us new — and sometimes unexpected — examples that illustrate the value-creating power of lean. As the post-recession global mergers-and-acquisitions market climbs, we're seeing one of the newest and most promising uses of lean — guiding corporations and private equity (PE) firms as they evaluate and capitalize on acquisition opportunities.

Lean tools and practices can provide unique benefits during all stages of a firm's investment cycle. Investors gain insight and guidance by using lean for up-front evaluation and pricing, and during the life cycle of the investment. Broadly, lean-focused due diligence can provide potential investors with:

- Assessment of any or all functions/activities within a company's operations.
- Information on the company's operations and cost structure, including identification of gaps and opportunities for performance improvement that will feed value creation — as defined by the investors.
- Evaluation of the company's leadership and organization.
- A go-forward plan — if the firm invests — to reach investment goals within a specified time frame.

The takeaway for a potential buyer could be any combination of these:

- A clearer idea of a prospective company's total potential value over the long term, which could impact thinking on price.
- Detailed descriptions (metrics, observations, personnel challenges, etc.) of the work that would need to be done to achieve desired improvements.
- A roadmap of what steps need to be taken using a lean business system to drive improvements.

The investment team receives insight that reveals operational capability, current cost structure, what the improvement opportunities are; and the steps, time and costs required to attain those opportunities. This is a solid foundation and method that can be quickly implemented upon purchase completion.

How Lean Focused Due Diligence Works

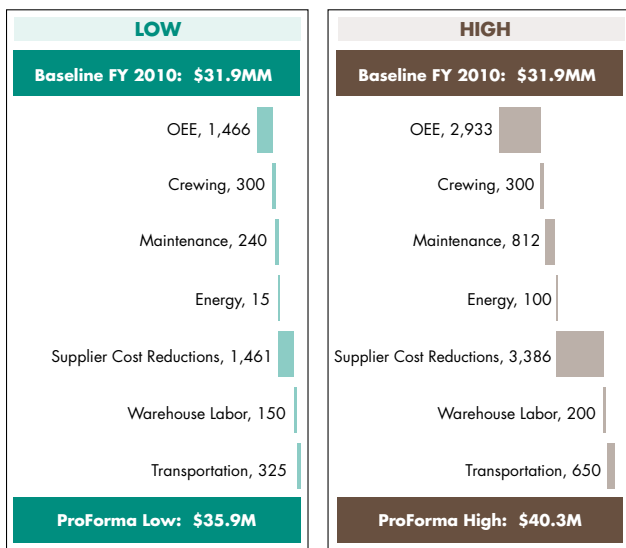
I use a generic case study example — an amalgamation of my experiences with operational due diligence — to illustrate how such a project works.

The example, ABC Company, follows a four-week timetable to assess operations and supply chain capabilities of a company:

- Week 1:** Submit data request to prospective company managers and conduct initial site visits.
- Week 2:** Review operational performance and financial data, analyze findings, provide a preliminary debrief to investment team, and request any follow-up information from prospective company.
- Week 3:** Follow-up site visits; supply chain analysis, review and revise analyses.
- Week 4:** Full due-diligence debriefing, finalize report and submit documentation.

The report and documentation include a report on operational capability, low and high estimates of financial-improvement opportunities, detailed descriptions of improvement possibilities by function/activity, an assessment of the leadership team, an assessment of where the company is on a lean-maturity scale, and benchmarks and recommendations for using lean tools and practices to reach goals.

EBITDA Opportunity Low Estimate & High Estimate



As with all due diligence projects, this time frame and report could vary depending upon individual circumstances, investor goals, size of project, etc., but it always takes place during the traditional due diligence phase, so leaders and managers of the prospective company are informed and participating in the process from the start.

A More Efficient Path Toward Investment Goals

For anyone with lean experience, the high-level benefits of a lean diligence project are likely to be obvious. Lean is a proven improvement methodology that zeros in on value creation as defined by customers. It is a fast and efficient way to determine how far off a prospective company is from reaching its highest potential for value creation, and therefore, its highest potential valuation as an investment.

It also gives potential investors something that purely data-based assessments can't — a true reflection

of how much work will need to go into changing behaviors to achieve goals — and this, of course, is the most difficult part of any improvement cycle. With this key insight, investors can make more informed decisions. And if they do invest, the go-forward map provides the newly combined leadership/management team a platform to immediately reveal a well-defined improvement strategy, the crucial "first step" of many toward changing a culture.

Starting out with a very clear and concise plan — *Here's what we want to do in the next 60 to 90 days* — lays the tone of pace and aggressiveness that will be taken for operational improvement. This is crucial because it allows people to see that you — as the new owner — have confidence that they can achieve these improvements.

From this point, going-forward responsibility is handed off to the leadership team with or without further TBM assistance from consultants. If work goes as planned, the lean implementation will work as any other for as long as investors — and perhaps future company owners — support the effort.

Driving Value Creation Through Operational Excellence

TBM Consulting Group is a global consulting firm that drives rapid execution of business strategies to achieve significant growth in sales and earnings through operational excellence. We work with clients to improve business performance by leveraging their investments and creatively engaging their human resources.

Our clients achieve significant responsiveness and reliability for customers to achieve leadership positions in their categories. TBM clients leverage operational excellence to grow their bottom line, optimize total working capital, increase speed to market, and create significant value for associates and shareholders.

Our consultants have ten to twenty years of operating management experience before joining the company. They work hand-in-hand with clients to transfer knowledge and provide a framework for a comprehensive performance improvement system to remove obstacles and achieve full potential.

A key element of our LeanSigma approach leverages our Lean Six Sigma heritage evolved from Japanese lean management principles and the Toyota Production System (TPS).



Working Capital Opportunity

Inventories increased by \$5MM in FY 2010. Inventory turnover is slightly above 3.5. Inventories at the end of July are slightly under \$40MM.

ABC Company's turns are in line and or slightly better than their larger competitors and selected manufacturers in the same industry but lag in the category where they play — consumer packaged goods.

Lower turns are explained in part by regulatory inspection and testing requirements.

ABC Company can capitalize on its lower SKU count and POS visibility with major accounts to improve inventory turns without negatively affecting service levels.

A target between 4.8 and 5.7 annual turns is the higher and lower end of the range, improving working capital between \$14.3M to \$20.0M.

	Usage/COGS	TURNS		TARGET INVENTORY	
		Low Est.	High Est.	Low Est.	High Est.
Raw Materials	\$90.60	8	10	\$11.30	\$9.00
WIP	\$119.80	10	14	\$1.60	\$1.60
Finished Goods				\$11.90	\$8.60
				\$24.80	\$19.20
<i>Working Capital Improvement vs. July FY'11</i>				\$14.30	\$19.99

	Inv \$M	Turnover	ABC Brands	Inv \$M	Turnover
Branded	\$23.70	3.34	Brand A	\$1.20	5.02
Private Label	\$14.80	3.83	Brand B	\$0.13	0.84
Inactive	\$0.70		Brand C	\$4.25	3.72
Total	\$39.20	3.46	Brand D	\$3.75	2.50
			Brand E	\$0.28	3.42
			Brand F	\$9.83	3.17
			Brand G	\$4.30	3.65

Competitor Brands*	# of Turns	# of SKUs
Competitor Brand A	2.4	>22,000
Competitor Brand B	3.9	3,600
Competitor Brand C	3.7	>1,300
Competitor Brand D	3.5	244
Other Similar Manufacturers	2.5	
Related Category Manufacturers	6.7	

*Sampling of Public Companies

	Inv \$M	Turns FY 2010	Industry Benchmark Turns
Raw Materials*	\$13.70	6.8	9.4
WIP**	\$1.60	37.7	34.9
Finished Goods**	17.30	6.9	12.5

Each improvement opportunity is explained in-depth using operational and financial metrics.

Summary:

- Major raw material highly commoditized
- Focus on taking positions when market conditions are favorable
- Asian supply purchased through US distributors
- Limited supplier cost reduction programs
- Sourcing team experienced in executing commodity purchasing

TBM's Due Diligence Operational Assessment evaluates 65 core capabilities and over 180 best practices. Each core capability is rated between 1 and 5 based on the level of implementation and performance achieved.

Best practices are scored on the following and consolidated into a 1-to-5 rating:

- Level of implementation
- Tools employed
- Process ownership
- Performance
- Level of importance to the enterprise

In the case of an organization such as ABC, which has not formally initiated a Lean Value Chain program, scores between 2 to 3 would be normally expected.

