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OPERATIONAL DUE DILIGENCE

An end to the easy gains

Maximising operational value is essential in this era of high multiples and recession planning, says Gary Hoover of TBM Consulting Group

***Hoover:** PE investors are anticipating a slowdown*

Every private equity deal today has some measure of operational value factored into the investment thesis. For manufacturing companies – especially those that have already gone through one or more buy-outs – the easy gains have been realised. That leaves more complex and challenging opportunities. These deals require ownership with deeper expertise to quickly grow both revenue and EBITDA.

Because time is always of the essence, operational due diligence often starts before the letter of intent is signed. A thorough assessment only requires enough time for site visits and data analysis to develop a clear estimate of a deal's operational risks and opportunities. For example, we recently assessed the leadership capabilities, plant conditions, current performance and improvement potential of a company with six plants on four continents. We identified $9 million-$14 million in achievable savings within six months of the deal close and an additional $1.1 million in working capital reductions, which we detailed in a recommended go-forward plan.

Comprehensive post-LOI operational due diligence will include an execution plan that goes beyond reducing costs and provides a detailed evaluation of leadership effectiveness, the target's M&A capabilities and pipeline, and organisational readiness to support growth plans.

The prospective acquisition's true potential is revealed by overlaying the due diligence and the executive team's plans with what support the PE firm can offer to help the target move toward its goals – and beyond – as quickly as possible.

CHANGES IN INVESTMENT STRATEGIES

Record levels of dry power, high deal multiples, and the fact that we're now in the ninth year of economic expansion – reminding everyone that a market correction is likely to occur sooner rather than later – are complicating private equity deals in the industrial space.

Whatever the triggers might be, private equity investors are anticipating a slowdown within the three- to five-year holding period of any new investments. That possibility is shifting deal teams' focus to recession-resistant sectors, according to one senior operating partner at a large US private equity firm with whom we work. When evaluating potential deals, they ask if the targets still look attainable – especially at such high valuations – after factoring in the possibility of a down period that it takes a year or more to recover from. In many cases, they don't.

Today's high multiples and economic uncertainty decrease the margin of error and make operational improvement and effectiveness even more critical during the holding period and divestment. In the event of a slowdown and declining demand, well-structured and effectively managed portfolio companies will respond quickly, ratcheting down fixed costs to protect earnings.

DAILY OPERATIONAL DISCIPLINE

There are three main opportunities for growing EBITDA that we quantify and prioritise during the operational due diligence process: One-time cost savings, performance gains that deliver long-term margin improvements, and daily management effectiveness (see table on p. 52). The third, and often neglected, opportunity for driving significant financial improvements is how well the target company is managed on a day-to-day basis. We refer to this as its "management system".

A company's management system – whether it's recognised by business »

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THE THREE EBITDA DRIVERS REVEALED DURING AN OPERATIONAL ASSESSMENT

	OPPORTUNITIES	CHALLENGES
One-time cost savings	One-time cost savings in a manufacturing business include plant consolidation, supplier rationalisation and shrinking inventory levels, which will lower operating expenses, material costs and working capital requirements, respectively. Aggregating spending across portfolio companies to achieve volume-based price concessions is another example.	These opportunities exist in all businesses and can deliver substantial one-time benefits. While the potential operational and financial impact can be significant, they require effective planning and project management to fully capture. The challenge is identifying what impact each initiative will have within 12 to 18 months.
Performance gains that deliver long-term margin improvements	Examples of performance gains that can yield long-term financial benefits when sustained include reducing scrap rates, improving quality, increasing productivity, speeding up changeover times and improving overall equipment effectiveness. Operational excellence and continuous improvement efforts tend to focus on these areas.	If unplanned downtime is high, it can be a warning sign that machine maintenance has been deferred to save costs in the short term. Increasing equipment utilisation by improving maintenance practices and reducing setup times can free up capacity. These capacity gains can be used to grow sales and avoid or delay unnecessary capital investments.
Daily management effectiveness (management system)	Daily management miscues and process failures are often overlooked during the due diligence process, but they can add up over the course of a single shift or week. Accounting for the extra effort required by employees to respond, fix and ship quality products on time, these performance leaks can reduce daily productivity by 5-15 percent.	Symptoms that a company's management system could be improved include short but frequent line stoppages and lengthy equipment changeovers. Others are habitual rework, excessive operator movement and the intermittent disruption of material flow because of poor lineside material-stocking practices.

» leaders or not – is how value is created and how orders get shipped out the door every day. An effective management system is an integrated set of management processes that align the company strategy and annual objectives with daily activities, performance monitoring and corrective actions. A disciplined management system reduces daily firefighting and provides a foundation for managers and employees to make process improvements and sustain forward progress.

The signs of a poor management system are often invisible to anyone without operational expertise. For example, many manufacturers post safety, quality, productivity, cost and other metrics on bulletin boards beside production lines and work cells. These can make everything appear like it's under control and moving in the right direction. Probe a little deeper, however, and the shortcomings appear: performance measures are not linked to plant or company performance, quality issues are being reported but they aren't being analysed or resolved, and improvement projects have been identified but they haven't been prioritised or assigned.

For another recent due diligence project, we evaluated the target company's operational effectiveness, prioritised potential cost improvements and considered the growth potential of the current leadership team. The company was a solid performer but had plenty of areas where its financial performance could be improved. These included a variety of management system-related shortcomings: excessive direct labour, set-up times that could be reduced 50-60 percent and high levels of machine downtime.

In the final report we estimated that they could improve operating profit from 12 percent to upwards of 19 percent without any top-line growth. After the deal closed we helped implement a daily management

> ***Today's high multiples and economic uncertainty decrease the margin of error and make operational improvement and effectiveness even more critical during the holding period and divestment***

system, reduce set-up times and completely revamp the company's maintenance practices. The company achieved the targeted improvements and the increase in EBITDA identified during the due diligence process.

ACCELERATING VALUE CREATION

So far I've primarily focused on cost-savings opportunities. A comprehensive operational assessment also offers valuable insights into the potential acquisition's management team, growth potential and the M&A pipeline and integration capabilities.

Starting with the COO, VP-level operations leaders, site leaders and the continuous improvement team leaders, we look at each individual's experience and track record. Our objective is to determine if they will be able to fill the role if revenue grows as projected. Do they have the ability to accommodate and lead change? If there's one constant in private equity, it's that there will be change. You must have leaders and managers in place who will be excited by and embrace that change.

There are several ways that the operational assessment contributes to estimates of a company's growth potential. On the order fulfillment side, as noted above, manufacturing lines are often running well below maximum utilisation levels. With uptime improvements and setup time reductions, we find that the true production capacity is typically 30 percent to 50 percent higher than what current leaders believe.

That value can be captured in a number of ways. First, manufacturers can grow sales and margins by taking advantage of the newfound capacity without any increase in fixed costs. Second, they can avoid or delay investments in new equipment, thereby preserving working capital.

On the operational side, when it comes to the mergers and acquisition pipeline, we look at the in-house team's capabilities and strategy. Does the near-term acquisition plan offer clear synergies and measurable financial benefits? We then look at how experienced and capable the operations team is of capturing those benefits in a relatively short timeframe. We also estimate what must be done to improve productivity, free-up capacity, and create flexibility and responsiveness for the organisation to successfully absorb change and grow without adding costs.

> ***The signs of a poor management system are often invisible to anyone without operational expertise***

During operational due diligence for another client, we identified significant opportunities in all of these areas. Like a lot of companies that aren't in the midst of a market crisis, they were doing many things well. The plant was organised and the equipment was well maintained. Order-fill rates were best-in-class (greater than 99 percent).

What the company lacked was a clear vision regarding its cost to serve and flexibility. A lukewarm embrace of operational excellence had left some major opportunities. Specifically, based on the due diligence analysis, we estimated that total capacity could be doubled with minimal capital investments. In fact, the current footprint could support a 4x capacity increase. Better inventory management would free up millions of dollars in working capital.

Based on the due diligence recommendations, after the acquisition was finalised, the private equity firm made a number of key leadership changes. On the operations side, the new management team's objectives were to improve labour productivity by 25-35 percent, double raw material inventory turns, improve finished goods turns, and revamp the quality system to eliminate the need for 100 percent inspection of incoming material. They achieved all of these goals. During the first 18 months the company also completed two complementary acquisitions, one for $40 million and the other for $150 million.

The company's valuation quickly doubled and then took off when several large corporations made competing buyout offers. Over three years the company's valuation increased over 500 percent and the private equity firm ultimately realised a 5x gain on its initial investment.

SPEED AND EFFECTIVENESS

PE firms that consistently achieve superior risk-adjusted returns must create value through operational improvements. As I noted above, today's acquisition opportunities at the current multiples require active ownership with deep expertise to grow revenue and EBITDA. This demand is even more urgent today because of the potential for an economic slowdown.

In this environment, generating the necessary value and acceptable investor returns is a function of speed. It comes down to how rapidly your firm can assess potential targets, finalise the deal, launch your 100-day plan and continue to push meaningful performance gains throughout the three-year holding period. ■

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__TBM__ is a global operations and supply chain consulting firm for manufacturers and distributors. Services include operational excellence, supply chain management, management system implementation, operational leadership, and acquisitions and integration for private equity firms and their portfolio companies.