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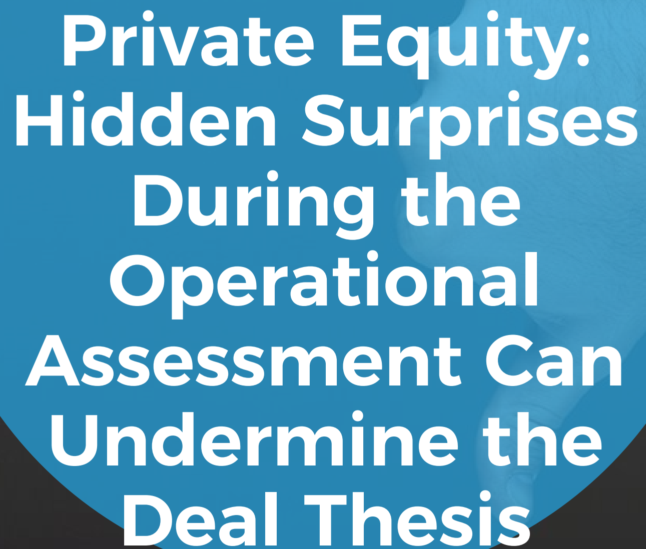

Private Equity: Hidden Surprises During the Operational Assessment Can Undermine the Deal Thesis

An operational assessment provides a pragmatic, unbiased view of the earnings impact from projected cost savings. It can be used to assess how realistic those projections are and estimate the impact of any future spending.

Knowing When to Walk Away From a Deal

Is this a good deal, or not? Will earnings grow sufficiently and fast enough to realize the targeted investment hurdles? Those are the over-riding questions of any due diligence process.

As a deal unfolds and builds momentum, we help private equity firms pause and answer these questions from an operational perspective. We don't gauge how realistic the sales forecasts are, or the market potential, although we do factor those

projections into our assessment. Just like on the sales side, operational projections can be inflated for a variety of reasons beyond the natural tendency of a targeted acquisition to want to make a good impression. Here are some of the issues we've found in our operational assessments that can undermine a deal thesis and help you know when to walk away from a deal.

Beware of the Costs of Future Growth

Sales tend to steadily tick upward, but the infrastructure investment required to support business growth happens in large outlays. During our assessment of a rapidly growing manufacturer and distributor, we noted that the number of SKUs and inventory levels had sharply increased. The company's paper-based approach to order fulfillment had reached its limit. They would soon need to implement more sophisticated picking and slotting practices and invest in a warehouse management system (WMS). Implementing such systems can easily cost $1-2 million. The impending capital requirements and other factors of this deal increased the risk and pushed the purchase price multiple outside of the PE firm's comfort zone and they ultimately walked away.

Watch Out for a Revolving Door at the Top

Employee turnover isn't necessarily a bad thing. Even though turnover is usually seen in a negative light, and it certainly increases costs, higher than average turnover might reflect local labor competition, the nature of the work or a highly seasonal business.

Leadership turnover is another story. Top performers will always come and go, of course, but frequent management changes can severely undercut performance. At one company that we assessed, people were coming and going at all levels. The company had grown through acquisitions and a major merger, and there had been a restructuring, but ongoing management turnover was compounding the ineffectiveness of a weak operational management system. Before a new private equity owner could begin to implement improvements and grow the business they would have to establish a stable baseline. In this case, the anticipated delay and changes in projected cost savings significantly changed the underlying financial assumptions and killed the deal.

Not All Cost Savings are Created Equal

Plotting improvement opportunities on a classic 2x2 chart with “high-to-low returns” on one axis and “easy-to-hard to implement” on the other axis can help operations leaders set priorities. The projected cost savings – and subsequent contributions to earnings – factored into an acquisition justification should be evaluated on a similar matrix.

For example, we were hired to perform an operational assessment on a multi-billion manufacturer of consumer goods with a patchwork of factories across the United States. When we dug into the company’s projected $50 million in annual cost savings, we found that at least half of that aggregated total would require significant capital investments to realize. Adding those hidden investments reduced the projected earnings and made the deal much less attractive.

These are just a few examples of the deal breakers that operational due diligence has uncovered and caused our PE firm clients to walk away from or delay a potential acquisition. Seek a pragmatic, unbiased view of the earnings impact from projected cost savings, assess how realistic those projections are, and estimate the impact of any future spending. Then you'll know if or when to walk away from a deal.