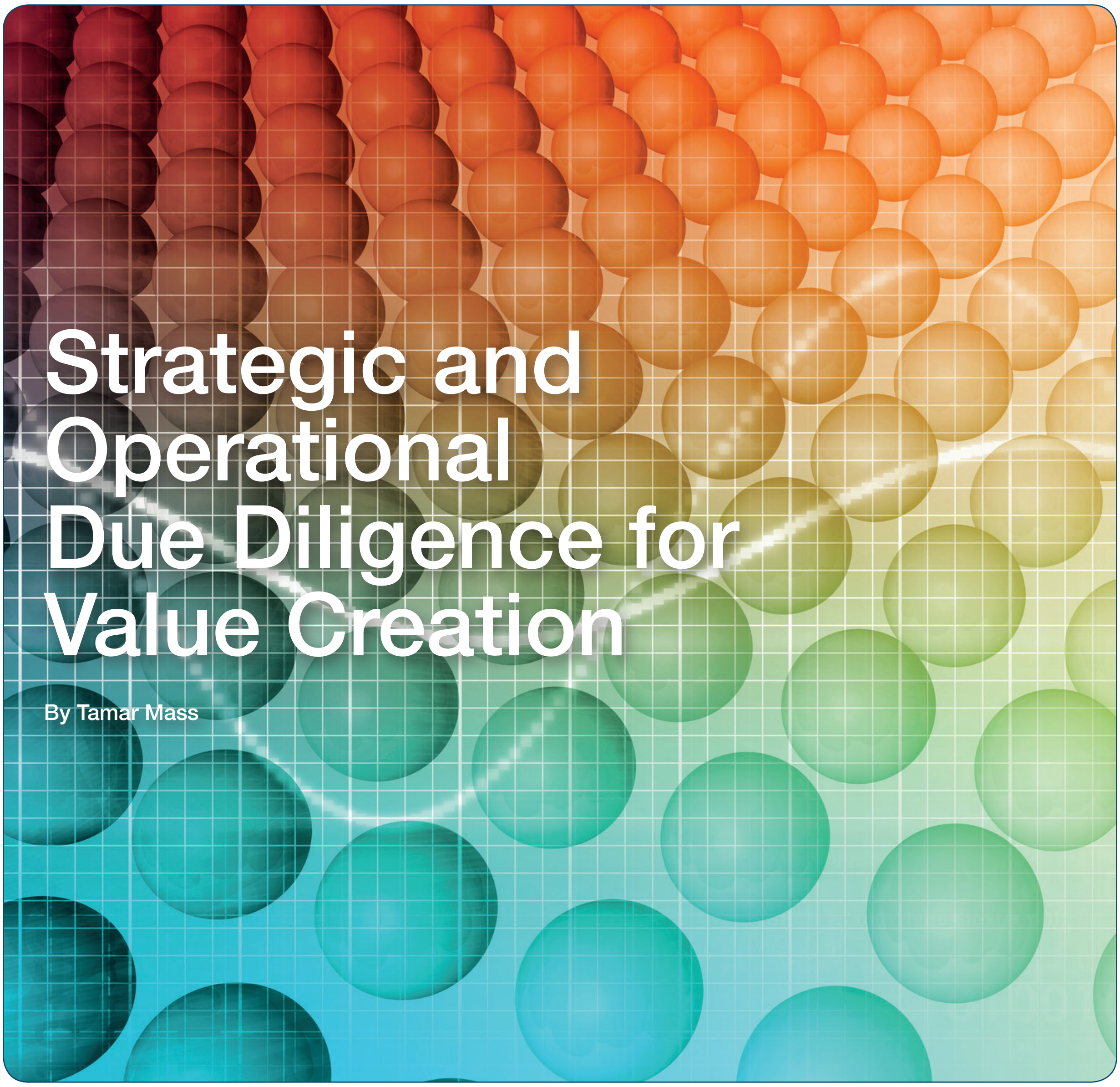
Strategic and Operational Due Diligence for Value Creation

By Tamar Mass



When a company (not a private equity one) considers the acquisition of another company, its main goal is to create business leverage by penetrating new markets; searching for synergies between the buyer and the acquired company activities; consolidating shared services in order to reduce operational costs, and using the company's reputation as a business growth engine etc. These goals are formulated as long-term objectives and as part of the business strategy.

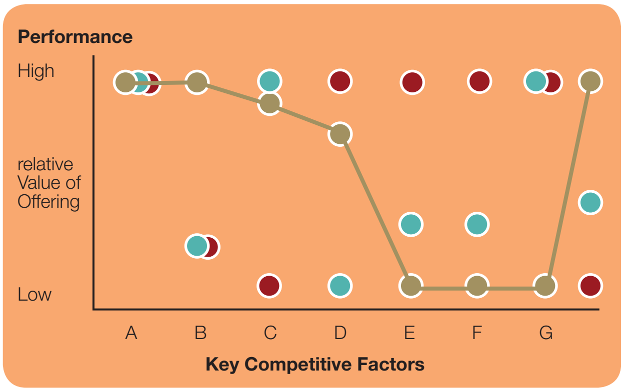
However, for a private equity company, the planning horizon is much shorter, approximately 5 years. The factors to be taken into account during the acquisition process are therefore different. The EBIDTA is often taken as the primary goal and this then raises the significance of an operational due diligence process.

This is illustrated by the example of a private equity company which was considering the acquisition of a market leader for construction-industry chemical products. This company had achieved an annual turnover of 300M USD. The estimated potential savings of 10% (30M USD), identified during the operational due diligence process, became the key factor in the decision to bid for the company.

In this article, we want to find out how this type of pre-acquisition operational analysis can justify such a significant investment and why the savings identified played such a great role.

So what exactly is operational due diligence?

When a company considers buying another company within its own industry, the role of due diligence is mainly to verify the data and information provided by the acquired company. The acquiring company uses its experience and knowhow of the relevant market, plus the verified data, to assess the expected impact of the acquisition on its value curve.



As mentioned above, the benefits of the acquisition are not necessarily planned for the short term.

Private equity companies, in contrast, also use due diligence to assess the growth potential in EBIDTA (achieved not by synergy and mergers but from stand-alone performance optimization), with a view to gaining a significantly higher sales value by the time of their exit (timeframe of 5-8 years). Those private equities specializing in asset management, rather than "turnaround" transactions, place an even greater emphasis on a successful due diligence process.

Although we have seen that the main focus is on deriving value from growth, reality does not always meet these expectations. Therefore, in the short-term (investment period), it is much more predictable to aim for cost benefits through operational improvements than for growth through revenue increase. Business development is often unpredictable and depends not only on a company's behavior or decisions. It is significantly influenced by market trends, consumer preferences and competitors' behavior. Moreover, cost savings through operational improvement are the easiest way to inject cash into the portfolio company. This cash can then be used for growth-related investments.

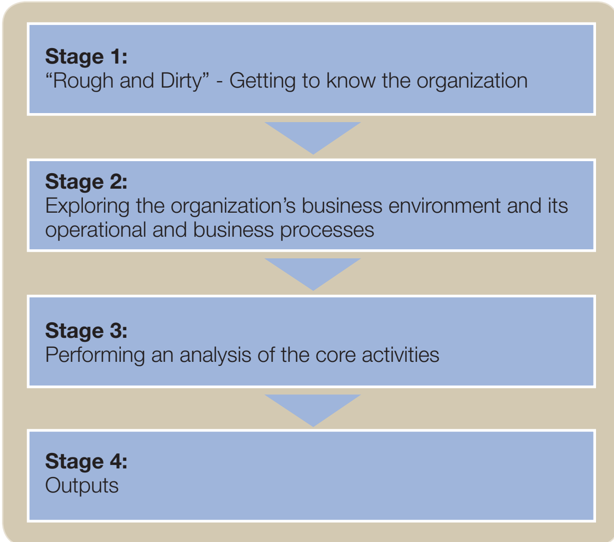
Operational improvements also have an immediate impact on the organization's "bottom line". The implementation of such improvements is controlled by the company, so it is easy to quantify the savings potential with high certainty (regardless of the variability in the market).

So how can we improve the EBIDTA of the acquired company?

Growth in income – the main drawback of this is the lack of certainty. A company's income depends not only on internal factors, but also on external factors such as customers, competitors and market behavior.
Cost reduction – depends primarily on internal factors, meaning that the level of certainty is much higher.

An operational due diligence process that manages to define an applicable plan for significantly increasing the EBIDTA will make a substantial contribution to the private equity's decision to acquire the company.

"Starting the process"



Stage 1: "Rough and Dirty" – Getting to know the organization

The aim of the first phase is to study the organization's main activities and to identify its key contribution to revenue and expenses. This phase helps to define the objectives and scope of the diagnostic process.

Tools and methods used in the 1st stage:

- **Cost structure analysis** – identify operating segments with high costs for the project's focus
- **Internal benchmark (between sites)** – identify "best in class" in different categories and examine the implications of bringing others to this level

Stage 2: Exploring the organization's business environment and its operational and business processes

The second stage focuses mainly on learning the business environment, current market share, growth potential and competitors' behavior.

Tools and methods used in the 2nd stage:

- **Market analysis** – market share, market demand trends, competitors analysis
- **Organizational structure** analysis
- **S&OP**
- **Inventory and procurement** management methods
- **Brand power** – consumers perceptions, TOM awareness
- **Trends** – category trends, price trends
- **Sales** – sales processes, sales policy – SFE*, Customer segmentation, SKU rationalization (volume & profit), returns volume and policies

Stage 3: Performing an analysis of the core activities

The 3rd phase is a thorough analysis of the core activities in the organization, in order to identify potential savings, opportunities for improving efficiency and required investments

Procurement

- Procurement processes (centralized / decentralized)
- Inventory levels
- Contracts with subcontractors and suppliers examination

Manufacturing

- Manufacturing processes
- Value stream mapping

- Bottlenecks identification
- Manpower standardization – organizational structure & manager-employees ratio
- Operational excellence (OPEX)

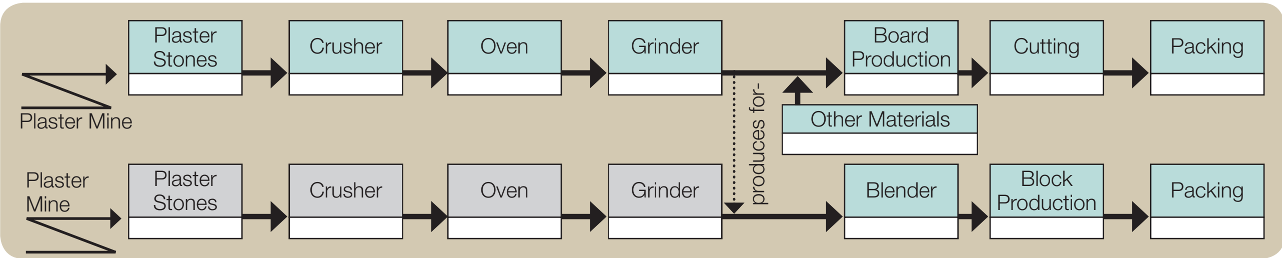
Supply Chain

- Haulage & distribution efficiency (scheduling methodology etc.)
- Driver payment methods
- Trucks maintenance
- Loading and unloading processes

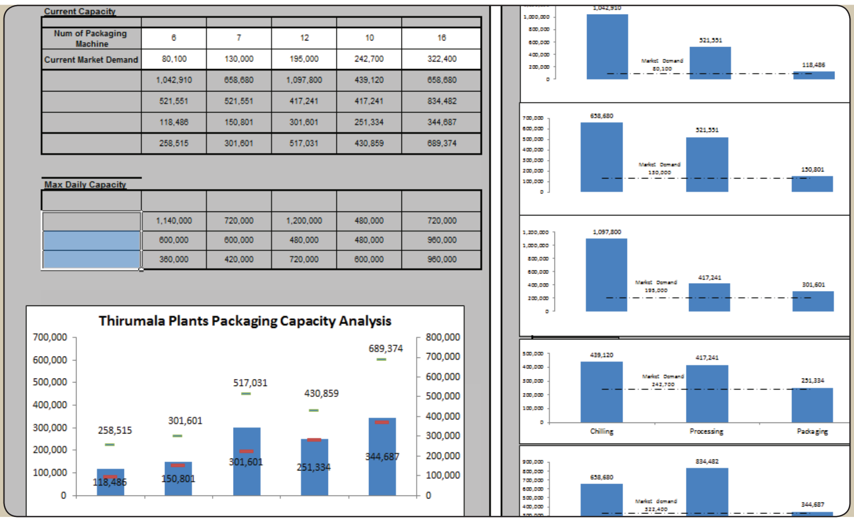
Quality

- Waste
- QA infrastructure and processes
- Quality control procedures
- Lean & 6 sigma

Tools and methods used in the 3rd stage are observations, interviews, benchmark analysis and risks analysis



- Capacity model



Current Capacity

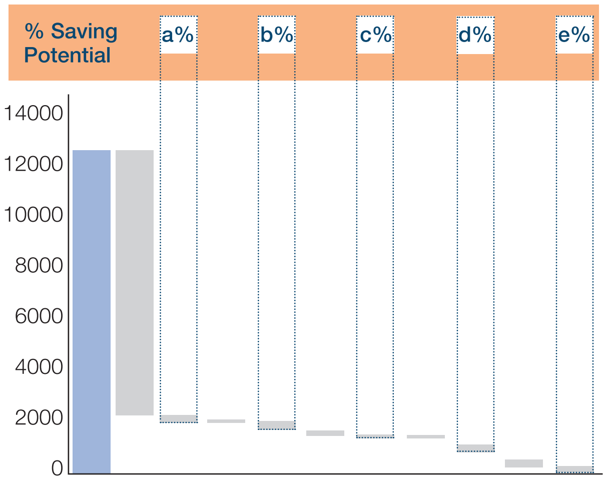
Num of Packaging Machine	6	7	12	10	16
Current Market Demand	80,100	130,000	195,000	242,700	322,400
	1,042,910	658,680	1,097,800	439,120	658,680
	521,551	521,551	417,241	417,241	834,482
	118,486	150,801	301,601	251,334	344,687
	258,515	301,601	517,031	430,859	689,374

Max Daily Capacity

	1,140,000	720,000	1,200,000	480,000	720,000
	600,000	600,000	480,000	480,000	960,000
	360,000	420,000	720,000	600,000	960,000

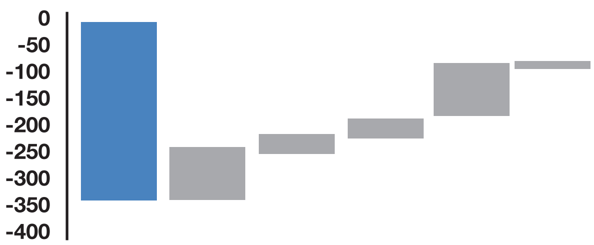
Stage 4: Outputs – examples of tools for final analysis

1. Saving potential evaluation



Potential Cost Saving		Certainty Level (NIS)		
Topic	**Potential saving**	**Low**	**Medium**	**High**
Procurement	xM	yM		yyM
Quality	xM	yM	yyM	
Manufacturing	xM	yM		yyM
Supply Chain	xM		yM	yyM
Sum	YM	YM	YM	YM

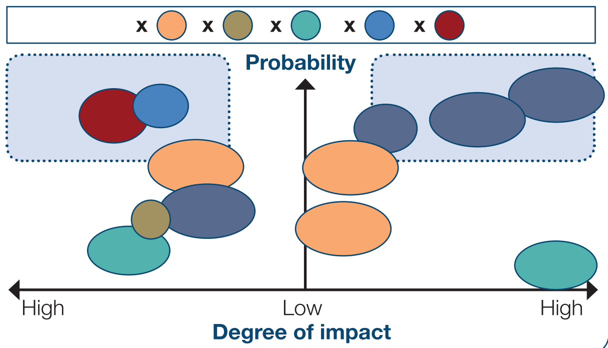
2. Required investments (CAPEX)



3. Potential growth & strategy

Potential revenue and profit		Certainty Level (NIS)		
Topic	**Potential revenue and profit**	**Low**	**Medium**	**High**
Product A	xM, yM	yM		yyM
Product B	xM, yM	yM	yyM	

4. Risk analysis



Traditionally, strategic acquisition requires a financial and business due diligence regarding market share, trends and different forecasts. This claims to predict a company's status over the short and long term. However, the main drawback in the traditional financial/business due diligence is the high level of uncertainty in its findings and inferences.

Private equities seeking to acquire a company must be exposed to reliable, high-confidence information regarding the organization's capabilities, quality and operational abilities and drawbacks. This applies both to the current state of the company and its ability to support future capacities set according to the company's business strategic plan for growth. In addition, potential buyers must take into consideration required investments, business and operational opportunities etc.

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