TRIUMPH ADVISORY GROUP
STRATEGY | OPERATIONS | TRANSACTIONS

Private Equity Practice

Playbook for Conducting an Operational Due Diligence

Overview and Guidelines

Operational due diligence (ODD) stands as a critical component for private equity firms in their investment decision-making process. It involves a comprehensive assessment of the target company's operational capabilities, systems, and management practices. This diligence is pivotal as it helps private equity firms identify and mitigate potential risks, ensuring a thorough understanding of the target's operational landscape. By scrutinizing aspects such as supply chain efficiency, technology infrastructure, regulatory compliance, and human resource management, private equity firms can make informed investment decisions, safeguarding their capital and maximizing returns. Operational due diligence not only provides insights into the current state of a company but also aids in developing strategies for operational improvements post-acquisition, contributing to the overall success of the investment. In an ever-evolving business landscape, where operational intricacies can significantly impact financial performance, operational due diligence emerges as an indispensable tool for private equity firms seeking sustainable and profitable investments.

Operational Due Diligence Overview and Guidelines

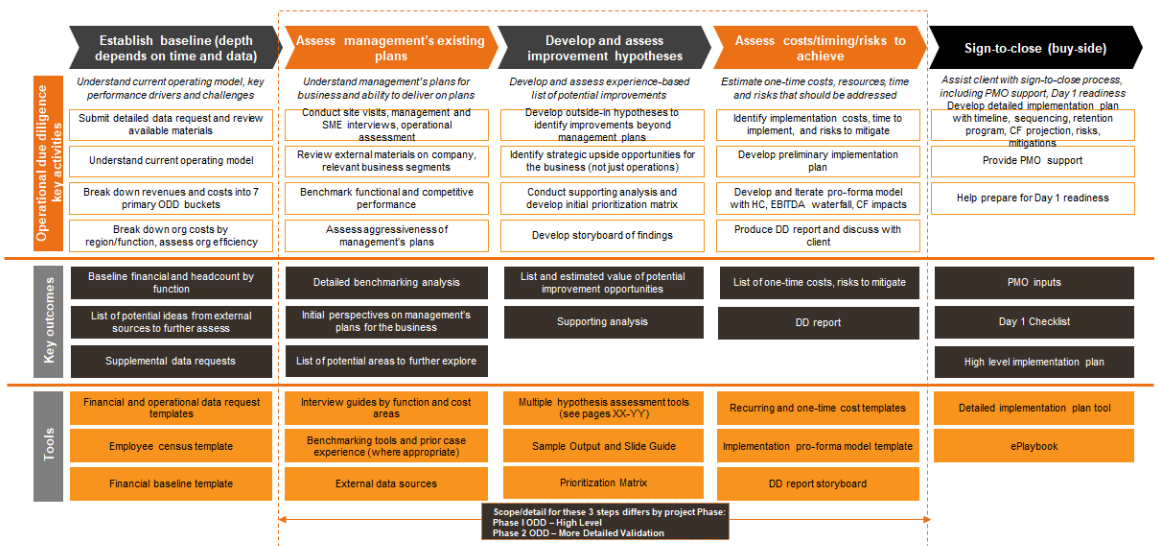
1. Establishing a Baseline

In establishing the baseline the key is to understand up front what data is available in the data room, and what data can be made available within the designated time period to help inform the overall Operational Due Diligence; data available is often a problem on short ODD engagements – so it is best to work hard with what we have rather than hold out hope for what we might be able to get. Still, it never hurts to ask!

First, inventory all available data against a standard set of data request templates that are suitable for the target industry and functional roles relevant to the Target's business

Second, once the inventory is completed, note which data is apparently missing, then create and submit a prioritized data request using a simple Critical, Need to Know, Nice to Know prioritization scale; missing information should be requested as early in the process as possible

Operational due diligence (ODD) methodology



as it often takes considerable time for the Target to organize and provide the additional requested data.

Understanding the current operating model requires a deep understanding of the business, the organization, financial performance and key trends. It is critical to fully understand the current state of the Target so that we can then determine the foundation against which to identify and quantify potential improvements we'll be investigating over the course of the ODD.

There are typically 7 key ODD areas we investigate to identify improvement opportunities. Each of these areas can be quite extensive, and each have whole suites of supporting frameworks, methodologies, tools and, in many cases, performance benchmarks that, when taken together, can help to quickly assess and quantify potential upside opportunities:

- Revenue drivers (volume, price, mix)
- Production operations (for manufacturing companies)
- Supply chain / logistics costs
- Sales, General and Administrative (SG&A) – also often referred to as Overhead costs, includes all staff functions, including IT, and related spend
- Procurement / Sourcing – for both goods and services purchased from 3rd party vendors
- Capital outlays – for both one-time capital and ongoing major maintenance
- Working Capital – Accts receivable, all forms of inventory, and Accts payable

The important thing here is to establish a clear breakdown of Target's financial performance into each of these areas in order to help set the individual foundations for improvement, and to give us a clear baseline against which to estimate potential improvements.

If time and data availability allow, improving organization efficiency can often drive substantial cost reduction, decrease the time to make and implement decisions by driving down decision-making to those closest to the work, and improve overall accountability for results within the Target.

At the simplest level, org efficiency can be improved by reducing layers in the organization (the number of levels between the CEO and the lowest level person in a given organization) and increasing spans of control (the number of people who report into the next higher person in an organization).

2. Assessing Management's Existing Plans

Once you have a basic understanding of the Target based on information and reports, it is then very helpful to get additional input directly from management and select Target company sites – however access to management and locations is often partially or heavily restricted by the investment bank handling the sale of the company; where it is possible and time permits, the team should gather additional information from several sources:

- Management interviews
- Subject Matter Expert interviews
- Site visits

Given input from the above, it should be possible to assemble at least a qualitative operations assessment.

There are typically a wide range of external materials that can help accelerate the path to understanding the Target's current situation and potential improvement opportunities; these include:

- Industry analyst reports
- Cap IQ financial performance comparisons
- Business journal reports
- Where Target companies are involved in the production, sale or purchase of key commodities (e.g. oil, wheat, paper, etc.) there are a wide range of industry trade journals and industry sources of commodity spot and trend prices that can prove helpful in quantifying potential improvement opportunities.

The key is to perform detailed benchmarking analysis by comparing third party benchmarks (by function) to current cost structure, which will help develop initial point of view.

Utilizing the available information from CIM, Management Presentation and data room, and select external and EY (Ch. 2 only) sources, perform detailed benchmarking analysis that will allow the team to draw initial point of view of functional cost and FTEs against industry benchmark and competitors.

Once the team has established a baseline, understands management's plans for the business, and understands how the Target's performance compares to competitors, it is time to transition into assessing the aggressiveness of management's plans and then developing further improvement hypotheses beyond what management is currently envisioning for the business

At a minimum, this assessment should consist of addressing whether management's plans achieve:

- Financial performance goals already demonstrated by competitors – to be fully competitive, Target's performance should be within the first quartile of performance on each measured attribute, with EBITDA and Gross Margin as a % of Revenues as two of the most important competitive metrics
- Parity or better on key functional benchmarks, including spans and layers "norms" by functional area
- Competitive levels of capacity utilization across the production platform; where they don't, there is likely potential for rationalization
- Number 1 or 2 market share in each of their major market spaces
- Parity or better on key purchase commodity categories

Management's plans for the business should also effectively address most or all of the areas highlighted in industry analyst reports, whether opportunities or threats; obvious gaps should be highlighted and then serve as focal points for developing improvement hypotheses.

3. Developing and Assessing Improvement Hypotheses

The key to this activity is to get beyond the way the Target's business may be defined today to highlight additional potential strategic opportunities that should be considered to achieve the full improvement potential of the Target.

Again, the timeframe of an ODD means this will have to be an 80/20 exercise. There may not be time to fully flesh out the impacts/values of these potential opportunities, but clients often find such suggestions thought-provoking, especially where they may not have already perceived an additional opportunity or risk.

It is important that each of the significant improvement hypotheses we raise be supported by at least one piece of supporting analysis that clearly calls out the opportunity being tested, the underlying assumptions, the quantification of the opportunity, and summarized risks/mitigations that need to be considered.

Only the highest level of the supporting analyses should be included in the body of the final report; more detailed analyses should be pushed to a well-structured Appendix for easy reference. In any case, all underlying assumptions and sources of data should be documented on the page which summarizes the supporting analysis.

Given the tight time frames for the typical ODD assignment, the priority should be on speed vs. comprehensiveness. ODD's call for an 80/20 approach – don't overthink it, do rely heavily on SME input and experience to identify and quantify a short list of 3-5 potential improvements in each of the 7 areas listed above. Once ideas are identified, they should quickly be assessed for "Impact" vs. "Do-ability"

Once hypotheses have been developed, quantified and prioritized, we have all the information we need to begin telling the story. Typically, by this time in an ODD, we've used up most of the allotted time getting to this point so the work will benefit from working to a storyboard from this point out

4. Assessing Cost, Timing and Risks to Achieve Benefits

Most improvement ideas will have one-time and/or ongoing implementation costs in order to achieve targeted benefits.

Time to implement can be hard to accurately judge without significant interaction with other parties that may not be privy to the DD, so SME-based estimates must be used – accordingly, time estimates should be conservative so that we properly set client expectations.

Risks to implement can be especially difficult to identify without benefit of direct access to management. There is typically time once we get to the Sign-to-Close phase to refine estimates, but the team should nonetheless do its best to identify clear, logical risks associated with each hypotheses (usually 1-3 risks per hypothesis) and at the same time develop potential mitigations to address those risks – especially those that could be potential deal-breakers that the client has not previously mentioned to us.

Each of these elements – one-time and recurring implementation costs, time to fully implement, risks and potential mitigations – should be captured for each hypothesis and associated with the potential benefits so that we can then build out an integrated pro-forma of potential impacts, the next step in the process.

5. Sign-to-Close (buy-side)

A detailed implementation plan is required as a foundation to setting up a Program Management Office (PMO), either wholly within the client (Ch. 1) or supported by EY, to drive execution of the plan and realization of the targeted benefits

Implementation plans may take many shapes and forms, but generally consist of all major action steps to deliver the benefits.

The implementation plan is a critical document that underpins everything that follows – it is critical to have a robust plan that provides a solid foundation for the actual implementation effort to follow.

The actual form the implementation plan takes in any given situation should be worked out in conjunction with the Client and the PMO, and leverage the established tools and approaches the Client / PMO intends to use to manage and govern the implementation itself.

Day 1 readiness involves determining priorities for Day 1, planning by function and review / assessment for Day 1. Day 1 priorities – Determine what will happen on Day 1 for each stakeholder group

- How customers and vendors will conduct business with combined company
- Employees understand their new responsibilities and rules
- Compliance with local regulations
- Public and media are appropriately informed

Day 1 planning – Develop robust Day 1 checklist by workstream and highlight Day 1 activities in overall work plan, both critical and suggested.

Day 1 readiness review – Conduct Day 1 readiness review with Executive Steering Committee at least two weeks prior to close to gain alignment on what will and will not transpire on Day 1. Make course adjustments as required.

Conclusion

In the realm of operational due diligence for an acquisition, a critical aspect involves a comprehensive assessment of the existing management plans within the target company. Understanding the strategies, initiatives, and vision articulated by the current leadership is paramount in gauging the potential success and compatibility of an acquisition. This assessment involves scrutinizing the clarity, feasibility, and alignment of management's plans with the overall business objectives. It also allows the private equity firm to evaluate the management team's capabilities and track record in executing similar strategies in the past.

By delving into management's existing plans, a private equity firm gains valuable insights into the target company's strategic direction, potential synergies, and the challenges that may be encountered during the integration process. This scrutiny ensures that the acquisition aligns with the investor's objectives and sets the stage for a seamless transition under effective leadership, ultimately contributing to the long-term success of the investment.

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