The hidden value in operational due diligence

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Private equity firms that focus their efforts on high-profile due diligence areas risk leaving significant money on the table.

Key takeaways

According to estimates, operations now accounts for around half of all value creation.

PE firms typically focus on high-profile due diligence areas—in part because they often lack in-depth knowledge of operations.

In our experience, three areas of operational due diligence hold the greatest potential to improve performance and generate significant amounts of value.

PE firms that make operational due diligence a top priority and use these findings to drive execution will be well positioned to improve a deal’s success.

The private equity (PE) industry is poised on the verge of an avalanche of deals: in 2013, uninvested equity totaled more than $1 trillion, its highest recorded level. As the competition for attractive targets heats up, due diligence will take on added importance to ensure that investments generate the anticipated profits. Traditionally, PE firms have focused the bulk of their resources on high-profile areas such as commercial, financial, legal, and environmental due diligence. However, firms that give short shrift to operations risk leaving significant value on the table.

In our experience, operational due diligence can pinpoint areas where improved performance can generate significant amounts of value. Further, PE firms that conduct thorough assessments of operations can better position themselves to implement and execute strategies to achieve cost savings and efficiencies. Three operational areas represent the highest-value opportunities to make a substantial contribution to a deal’s bottom line.

The case for operational due diligence

Historically, operations was perceived as contributing a relatively small amount to the value of a deal. Instead, PE firms tended to focus on financing and top-line price, which they used to generate handsome profits. In the 1980s, leverage and multiple arbitrage accounted for around four-fifths of total value creation. This trend was fueled by a couple of factors: first, firms could ensure a deal’s success through strategic financing such as leveraged buyouts; if companies could wring a few million in cost savings from operations, it was considered icing on the cake.

Figures from Preqin.
Second, many of the advisers that conducted commercial due diligence lacked the operational knowledge and expertise to identify promising opportunities to generate value.

Over the past three decades, operations has grown steadily in importance. Its share of value creation has increased from just below 20 percent in the 1980s to around 50 percent in the 2010s (exhibit). Several factors contributed to this trend. When credit became more freely available in the 1990s and 2000s, competition among PE firms for attractive targets increased, effectively driving up purchase prices. As a result, PE firms were compelled to find additional sources of profit improvement to offset the higher EBITDA multiples they were paying for businesses. An outgrowth

Exhibit: The growing contribution of operations to value creation

Source: BCG–IESE estimate; Goldman Sachs
of this strategy was that PE firms began to hire former CEOs and COOs as operating partners. Their greater understanding of operations (in contrast to the traditional finance and consulting background of PE professionals) naturally led to a greater focus on the operational levers that could boost profits.

PE firms increasingly recognize that a company’s operational performance provides a valuable window into its current health and future growth prospects. Beyond gauging whether a target company is performing at a high level, operational due diligence can also uncover specific opportunities to increase earnings before interest, taxes, depreciation, and amortization (EBITDA) and cash flow. PE firms that pursue a roll-up strategy in a certain industry, for example, can significantly lower overhead by consolidating functions or creating shared services. Such strategic considerations are particularly crucial in the middle market, where organizations at different levels of maturity can complicate such tasks as postmerger integration and value capture.

**Three high-value areas for operational due diligence**

In the run-up to closing a deal, time and resources are both at a premium, so maximizing the impact of due diligence requires coordination and a strategic approach to identify risk and opportunities to generate value. In our experience, three business areas have the greatest potential to generate operational value for PE firms.

**Manufacturing**

An assessment of a manufacturing company’s facilities, production capacity, and technology can uncover any issues with the potential to hinder business strategy. A company, for example, had developed a proprietary smart meter for utilities that would be a key element in its future growth. A PE firm sought to verify that the acquisition target had the manufacturing capacity to meet future demand. As part of operational due diligence, the PE firm determined the new smart meter prototype was realistic and credible but that the company had staked its ability to deliver on two pieces of manufacturing equipment. An on-site visit determined that the factory was operating at just 15 percent of capacity, and one piece of equipment was not able to function at full speed—a serious impediment to scaling production. At the same time, operational due diligence identified cost-cutting opportunities of $2.6 million that could be achieved over a six- to eight-month time frame.

With this information in hand, the PE firm adjusted its strategy to optimize revenue generation. A key part of this effort was a focus on redesigning the machinery to increase capacity and improve the company’s short-term growth and profitability.
Transport, logistics, and distribution
For companies of all sizes, an increasingly globalized economy has increased the level of complexity in transport, logistics, and distribution. Operational due diligence can help to highlight opportunities to simplify and consolidate logistics and supply chains, which can not only reduce costs but also improve service performance. A PE firm identified a promising target in a company that produced work shoes for employees in a range of industries. With customers across the United States, the company had developed an extensive distribution network that, while effective, was suboptimal, achieving only a 76 percent on-time delivery. Reducing distribution costs and improving delivery would be the key to seal the deal. To optimize efficiency and reduce costs, the PE firm sought to design a new network that met two key criteria: deliver to 97 percent of the United States within three days using ground delivery at the lowest possible cost and achieving a 99.9 percent on time delivery.

A thorough analysis determined that a distribution network with three centers in Tennessee, California, and New Jersey could support an enhanced supply chain model. As a result, the PE firm could reduce distribution costs by $4.3 million annually while improving revenue, delivery times, and client satisfaction.

Procurement
For companies across industries, procurement can yield substantial cost savings. Often, organizations that have grown through M&A end up with geographically dispersed procurement operations. A strategy that consolidates procurement and uses volume to negotiate discounts can deliver substantial benefits. One PE firm targeted a large supplier of equipment and after-market services to the mining, petroleum, and energy industries, for example. As part of operational due diligence, the firm sought to evaluate performance and identify value-creation opportunities. A visit to several sites highlighted a far-flung and poorly coordinated procurement function with seven managers distributed across the United States.

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After an in-depth assessment, the firm determined that if purchasing spending was pooled, the company could generate a 20 percent improvement in EBITDA. This analysis, together with the opportunities we uncovered in manufacturing and value analysis value engineering (VA/VE), enabled the PE firm to move forward with the deal confident in its ability to generate significant value post-acquisition.

**Maximizing the impact of due diligence**

As PE firms seek to find attractive companies for their uninvested capital, a renewed focus on due diligence is critical to achieve profitability targets and anticipated ROI. By following three strategies, PE firms can increase the effectiveness of their due diligence efforts:

1. **Make operational due diligence a top priority:** While financial and commercial due diligence typically receive the most scrutiny, operations should be on the same level as these areas because of its potential impact on value creation.

2. **Verify qualifications:** PE firms should screen their third-party adviser to ensure it has a detailed understanding of operations. If necessary, PE firms should retain a team of advisers with the necessary expertise and breadth to cover all areas of due diligence effectively.

3. **Set priorities for execution:** Beyond informing deal strategy, operational due diligence can deliver significant cost savings through better performance, greater efficiency, and strategic allocation of resources. Therefore, PE firms should bridge the gap between pre- and post-deal operations to ensure continuity.

By elevating operational due diligence beyond an afterthought or check the box exercise, PE firms can bolster their deal strategy and create significant value.

**About the author**

Fernando Assens is the CEO and a cofounder of Argo. In his 16 years with the firm, his primary focus has been operational due diligence and performance improvement for private equity–owned businesses.

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