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MANAGEMENT BRIEFING

Operational Due Diligence Provides Insight and Guidance

How buyout managers can identify opportunities and actions to accelerate improvements in EBITDA and working capital.

Executive Summary

Operational due diligence provides private equity investors with insight and guidance on EBITDA and working capital opportunities.

By conducting what we call operational diligence pre-acquisition, buyout managers can identify the opportunities and actions to accelerate improvements in EBITDA and free up working capital.

Operational diligence focuses on value chain performance opportunities and the company's potential to realize those gains.

Operational diligence includes:

- An assessment of the company's operating activities versus best-in-class practices;
- An evaluation of the company's leadership and organization;
- Analysis of the firm's cost structure against industry or like-industry benchmarks; and,
- Identification of improvement opportunities in EBITDA and working capital, including a go-forward plan with timing and resources required.

Conducting Operational Diligence

An operational diligence review takes between one to four weeks depending on the size of the company, complexity of operations and the depth of the assessment desired. **(See Figure 1)**

Final documentation includes a report on operational capabilities; assessment of the leadership and organization; and detailed descriptions of financial opportunities, including high and low estimates for each. **(See Figure 2)**

FIGURE 1

The standard assessments consist of four phases

Phase 1: Review available financial and performance data collected to date; prepare additional information requirements; and conduct on-site review.

Phase 2: Collect additional financial and performance data; conduct follow-up interviews by telephone; begin analysis of operations and performance versus best practices and benchmarks; and review initial observations and next steps with buyout managers.

Phase 3: Conduct additional on-site reviews as needed; complete analyses versus best practices and benchmarks; develop first-cut report of financial opportunity; and review with buyout managers.

Phase 4: Refine financial estimates and develop projected timing and resourcing required; complete and submit formal report to buyout managers; and conduct review either on-site or by teleconference.

Two Case Studies, Different Outcomes

A couple of case studies will illustrate why operational diligence should be conducted after a letter of intent (LOI) is signed.

In the first case, we performed an assessment for a PE client in the process of acquiring a mid-size, single-site pharmaceutical company.

The firm's operations were well organized and maintained, but our initial review and analysis indicated some strong upside in equipment efficiency and certain supply-chain activities. After additional on-site reviews and researching their competitors' and industry best-in-class performance, we identified specific opportunities to increase EBITDA by nearly a third and free up between $14 million and $20 million in working capital. (See Figure 2)

> We realized about $13 million in working capital and $1.4 million in EBITDA improvements.

We were engaged to work with the management team and, since closing on the acquisition a little over a year ago.

In the second case, we did an assessment for a client looking at a consumer packaged goods company. This company's products were in a fast-growing and highly profitable market niche. The assessment again identified significant opportunities in both EBITDA (See Figure 3) and working capital. However, two significant risks were uncovered.

Working Capital Opportunity

		TURNS		TARGET INVENTORY	
	Usage/COGS	Low Est.	High Est.	Low Est.	High Est.
Raw Materials	$90.60	8	10	$11.30	$ 9.00
WIP	$119.80	10	14	$ 1.60	$ 1.60
Finished Goods				$11.90	$ 8.60
Total Opportunity				$24.80	$19.20
Working Capital Improvement vs. July FY'11				$14.30	$19.99

	Inv $M	Turnover	ABC Brands	Inv $M	Turnover
Branded	$23.70	3.34	Brand A	**$ 1.20**	5.02
Private Label	$14.80	3.83	Brand B	**$ 0.13**	0.84
Inactive	$0.70		Brand C	**$ 4.25**	3.72
Total	$39.20	3.46	Brand D	**$ 3.75**	2.50
Wo			Brand E	**$ 0.28**	3.42
			Brand F	**$ 9.83**	3.17
			Brand G	**$ 4.30**	3.65

Competitor Brands*	# of Turns	# of SKUs
Competitor Brand A	2.4	**>22,000**
Competitor Brand B	3.9	3,600
Competitor Brand C	3.7	>1,300
Competitor Brand D	3.5	3.46
Competitor Brand D	2.5	244
Other Similar Manufacturers	6.7	
Related Category Manufacturers		

*Sampling of Public Companies

Industry	Inv $M	Inv $M FY 2010	Benchmark Turns
Raw Materials	**$13.70**	6.8	9.4
WIP	**$ 1.60**	37.7	34.9
Finished Goods	**$17.30**	6.9	12.5

* Each improvement opportunity is explained in depth using operational and financial metrics.

FIGURE 3

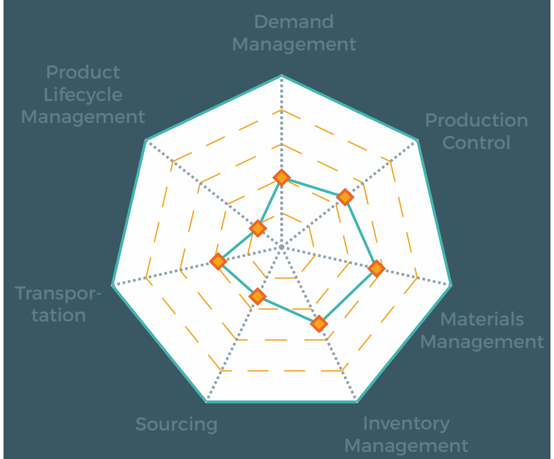
EBITDA Opportunity Low Estimate & High Estimate

LOW	HIGH
Baseline FY 2010: $31.9MM	Baseline FY 2010: $31.9MM
OEE, 1,466	OEE, 2,933
Crewing, 300	Crewing, 300
Maintenance, 240	Maintenance, 812
Energy, 15	Energy, 100
Supplier Cost Reductions, 1,461	Supplier Cost Reductions, 3,386
Warehouse Labor, 150	Warehouse Labor, 200
Transportation, 325	Transportation, 650
ProForma Low: $35.9M	**ProForma High: $40.3M**

*High and low EBITA Assessment for a consumer packaged goods company.

First, while the industry was lightly regulated, that was likely to change during the next five years—something we learned in our discussions with trade groups and regulatory officials. As a result, the company would require sizable capital outlays to comply with anticipated facilities requirements.

We also called out recruiting and retention and the caliber of operations management in general. The location of production operations was ideal for raw materials supply, but the community was remote and offered few amenities. Turnover in line supervision was very high. For these and other issues, our client eventually terminated the buyout.



Conclusions

Is Zuckerman correct? Has the impact of financial engineering and leveraging on PE investor returns become muted? In the current environment, it may, at best, be on hiatus. However, building value through organic growth and value chain efficiency is not a new strategy for the PE industry. Perhaps it is more prominent today than pre-2007.

We believe that a robust assessment of financial opportunities helps buyout managers set expectations and make more informed decisions on acquisitions.

We advise clients to set the tone early by setting 90-day, six-month and 12-month performance goals and delivery plans.

THE BOTTOM LINE

Using operational diligence, PE firms and senior leadership can identify specific targets and the specific steps needed to deliver the desired results.

About TBM's Acquisition + Integration Practice

OUR WORK WITH PRIVATE EQUITY FIRMS + PORTFOLIO COMPANIES

TBM is a global operations and supply chain consulting firm for manufacturers and distributors. Our mantra—Speed Wins Every Time. At TBM, we push the pedal down in your operations to make you more agile and to help you accelerate business performance 3-5x faster than your peers.

Our services include Operational Excellence, Supply Chain Management, Management System Implementation + Operational Leadership and Acquisitions and Integration. We support private equity firms and their portfolio clients by evaluating the potential and risk of a merger deal from both an analytical and operating perspective, we quickly uncover additional synergies and savings opportunities that can lower your internal deal multiple and reduce risk. Then we help create and implement a plan to obtain those gains by optimizing processes post-merger, enabling the business to more rapidly realize its expected performance.

SPEED WINS EVERY TIME

TBM specializes in operations and supply chain consulting for manufacturers and distributors. We push the pedal down in your operations to make you more agile and help you accelerate business performance 3–5x faster than your peers.

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