THIS REPORT IS BASED ON A RECENT PRIVCAP WEBINAR:

EXPERT DISCUSSION

PE Challenge: Creating a Plan of Action from Operational Due Diligence

Value-creation experts from Sun Capital Partners and AlixPartners discuss the latest techniques for operational due diligence ahead of private equity investments. The experts also discuss the advantage that PE firms can gain by having operating partners engage in due diligence as early as possible, the need for speed in ODD, and the limits of using benchmarking to assess company performance.

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FEATURED EXPERTS:

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> - NETO ALEXANDER, ALIXPARTNERS

Privcap: As a starting point, what is a good definition for operational due diligence?

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Neto Alexander, AlixPartners: Due diligence, more broadly, is all about validating a deal thesis. The work you perform during diligence really depends on the aspect of the thesis that's under examination. For example, commercial due diligence tends to be a bit more market-focused - trying to understand competitive dynamics, customer stickiness, etc. Funds are trying to answer the question, "Do we want to be in this sector?" and "Is this the right company for us to invest in, given our own investment strategy?"

You also have financial due diligence. That's a bit more inward-looking and, as the name suggests, focuses on the financials - quality of earnings, audit controls, and so forth. That's around establishing a clear understanding of the historical financial performance. That's going to be the baseline against which you measure feature performance.

Then, you have what I'll broadly call the operational due diligence work. Here, the questions the fund is typically trying to answer is, "What is the go-forward full value-creation potential for that asset?" and "What are the potential risks associated with it, in terms of capturing that value potential?" Is there an opportunity to perhaps improve salesforce effectiveness and efficiencies? Are there opportunities to optimize the general and administrative function? How about the procurement capability? All of these questions are part of what gets examined in the operational due diligence, the output of which is a set of initiatives, of value-creation plans, that the fund can then use as part of the underwriting process, as well as part of their first 100 days or first 12-month planning once the transaction has closed.

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Susan Clark, Sun Capital Partners: As Neto suggested, ODD is all about validating the investment thesis and drilling into available data to validate and/or disqualify those investment thesis criteria.

ODD is also used to evaluate the executive team and understand the level of talent within the company and where there may be gaps and create a go-forward plan post-close. That go-forward plan is all based on assumptions and data that we're able to see pre-close. Post-close, Sun

Capital spends the next couple of months double-clicking and, in some cases, triple-clicking into those three to five areas that we believe are the greatest areas of opportunity.

"We can bring best practices that, as we often say, are common sense but not common practice."

- SUSAN CLARK, SUN CAPITAL PARTNERS

We have a process within Sun Capital called "shared vision." That is when we share our diligence findings with the executive team, get to know the business at a more detailed level, and pull together a vision of what the company will look like in 3-4 years' time. Out of that shared vision we collectively determine what needs to be done now in order for us to achieve those goals. That, in essence, becomes our value creation plan.

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Steve Hilgendorf, AlixPartners: Bringing in the operational assessment earlier in the process can really have advantages. You can identify risks upfront and there's potential to identify additional upside that may not be built in already. There's always going to be sales growth and productivity and grand visions of what the potential is. We're there to help identify risks, but also upside that General Partners may not realize. Part of that may be assessing the management team and what their capabilities are.

Privcap: Private equity firms typically have deal partners and operating partners. Historically, the deal partners do the deal, and after the company gets acquired, the operational people flood in. In today's ODD, do those lines get blurred?

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Clark: As far as who owns ODD at a private equity firm, it really depends on the structure of the organization. There are firms like Vista and Sun Capital where there are in-house operational folks like myself that take ownership in the process in partnership with the deal team. I also will bring in outside firms, especially in areas where I do not have direct expertise. For example, I have not coded in 25 years…so I bring in firms to understand how solid the company is technology-wise. Those firms will uncover code strength, tech debt, and overall highlight areas of opportunity for the development organization. In firms that do not have folks in my role they will often offload much of the operational due diligence function to capable partners like AlixPartners.

Whoever does ODD work is well positioned to execute the value-creation plan post-close. If I hire a specialist that does salesforce evaluation during diligence, it is much easier for me to turn over the work to them post-close given they have already done their homework and can jump in quickly to begin creating value.

Privcap: Do private equity firms that bring in operating partners earlier in the process gain a competitive advantage?

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Hilgendorf: Yes, they really do. The timeframes are getting compressed. There are a ton of transactions going on, and everyone is trying to do things faster. It's really easy to overlook something. Getting people that can dive deep quickly and uncover risks involved is really important.

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Alexander: Steve is absolutely right. The pace of deal-making has increased, multiples have increased, and competition for these assets is pretty high. So, funds get great value from having experienced folks supporting them—whether that be in-house folks or partners—early on. They get to first quickly identify where perhaps there's value that others may not see. And they certainly do so in a way that results in an actionable plan. Conversely, they may get to understand where perhaps there's too much risk, or the risk or the pricing perhaps does not warrant the value that they think is there.

So, there's tremendous benefit, with respect to not just doing the operational due diligence, but engaging the operating partners and advisors early in the process so that you have the benefit of that perspective going into the final deal-making decision.

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Clark: Sun Capital often looks to invest in founder-led companies. Founders want to make sure they're handing over their baby to a firm they can trust. As such, there is true value in forging a relationship early on between the operating partner and the founder. Aligning on a high-level future state of the company and discussing value creation ideas during diligence may ultimately help a founder make a decision on which firm to choose.

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Alexander: That's a great point, Susan. The due-diligence process is also that period where you're getting to understand the culture of the asset that's being bought. You can understand how they make decisions, how quickly they move, what makes the organization tick.

That's really important because, much like the shared vision at Sun Capital, it's very hard to execute on these things without an aligned management team. It's important early on in the process to use that due diligence to understand the tactical things as well as the value-creation plan. They need to understand technical issues, but also some of the softer things including assessing if this is the right kind of culture and asking how they will work with these folks going forward to capture the value that gets identified during diligence.

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Clark: Founders will make a call because they get excited about a partner that can help them grow the company in multiple ways, through resources that we as operating partners can bring. We can also bring well-vetted resources such as AlixPartners, as well as knowledge of best practices that can ultimately drive growth within a company. We can bring best practices and, as we often say, are common sense but not common practice, that can ultimately drive growth within a company.

Privcap: I'd love to hear some stories about things that get uncovered, whether on the positive or the negative side, by doing operations-focused due diligence as early as possible.

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Hilgendorf: I'm always looking on the delivery side of things. You're always going to have a grand, rosy picture of tremendous growth potential that the target is presenting, and I'm always trying to look at whether they can really deliver that. So, from a capacity standpoint, is it real? Just because they have the equipment doesn't mean it's been maintained and it's actually capable. So, really trying to deep dive into whether this is real. This is important to know because there's going to be a huge CapEx check written after the fact to deliver the growth you're looking for.

On the people side, they usually have some productivity assumptions built in. Sometimes it's easy to scrutinize whether that is real or not. I also find there can be huge productivity upside that the target doesn't realize because they think they're operating as best they can. From an outside perspective, there could be tremendous potential to perform even better than they are assuming. That's an important input as well. Of course, assessing the talent, like Susan alluded to already, is always a key thing because, most times, the management team is either going to help this thing get to the next level or they're not.

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"You always should be thoughtful about the priorities, so you get the quickest payback."

STEVE HILGENDORF, ALIXPARTNERS

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Clark: There are two categories I put all diligence findings in. One is fixable, the other is not-fixable. I work in tech, so we look at, is the product built well? Is there a ton of tech debt that would get in the way of roadmap progress? If we are looking at M&A and add-ons, will we have to deal with the tech debt versus some of the growth accelerants? I enjoy finding a company that has amazing products that customers love, and that no one knows about, because that would indicate they don't have an effective marketing team. Perhaps they haven't expanded and don't have an effective salesforce. That's where we can really lean in and it's all about growth in those two categories.

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Alexander: In many cases, you will have a management team that puts forward a somewhat optimistic view as to what they think the performance improvement potential might be. A big part of operational due-diligence work is to validate that. So, if the management team says, "We think we can get margin improvement of a certain quantum," you've got to do the work to double-click and understand, if we're going to do this reprioritization of portfolio, are we sitting on a lot of technical debt? Are we sitting on a lot of bugs and promised features? Would these require so much investment that you'd be prevented from putting your R&D dollars behind the products needed to drive growth in the future?

So, a lot of what we tend to uncover is based on, as Susan described, things that certainly could accelerate if there's opportunity to unlock better value. We also uncover risks or potential "watch outs" in terms of what the management team might think the operations should look like in alignment with the strategy that's been put forward.

Privcap: Talk about how to translate ODD findings into a plan of action.

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Clark: Ultimately, it's pattern recognition. As an operator within private equity looking at tech, there are baseline metrics that I've seen repeatedly get realized in companies that we've invested in. So, by implementing, for example, salesforce effectiveness best practices, I know we can get cross-sell, upsell from X to Y. Certainly, there's conservatism built into that plan. We don't want to overstate it. We do that by checkins to make sure that, in fact, the goals can be met. The ideal goal would be for the deal team to collaborate with the operating partner - or the outside provider they've hired - to validate and get additional credence and credibility behind those numbers.

At Sun Capital I meet with the investment committee alongside my deal partner. We all agree to the base case we are presenting, but I'm also signing up for what's required post-close to get them there. That's where collaboration should be a part of the process from start to finish.

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Alexander: The pattern recognition Susan discussed becomes even more critical with the pace these deals are moving at. In many cases, you're operating with imperfect information. Many times, you're going to have to make a decision on what you think a value-creation opportunity might look like without the perfect set of data. During pre-close planning and after the deal closes, you'll probably have opportunities to refine that, maybe narrow the range down, to take that iterative process.

The findings that come out of operational due diligence go into the deal models. You may find that maybe there's going to be a need for CapEx

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investment, or perhaps you find that there's a $100 million EBITDA improvement opportunity. Those findings—whether it's the raw numbers or some adjusted view of those numbers from a conservative perspective—ultimately go into the deal model and influence how much folks are willing to pay and how they think about the value-creation story going forward.

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Hilgendorf: You want it to be as seamless as possible. Despite not having all the best information and often a very compressed timeframe, we're trying to put together the most realistic value-creation plan we possibly can, and one we'd be prepared to step into and start implementing immediately. Usually, imprecision yields a bit more conservatism. But either way, you ought to be able to have a plan to immediately put into action.

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Clark: Because everything is done at such an accelerated pace, we as operating partners need to take post-close the investment thesis and run with it. During that process, it's not only validating, but getting the executive buy-in to what needs to be done so that ultimately they have full ownership. You shouldn't have the PE firm or the outside provider pushing them on things they're not bought into.

Privcap: How do you deal with a management team if there's a bit of pushback on pacing or urgency?

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Hilgendorf: That's often the case. We're always willing to go faster than they are, in general. So, that's a natural tension. We work very closely with the PE firm to get the management team oriented in the right direction and calibrated to the right pace. There may be a need to change out if ultimately we can't get there. But this is all about getting buy-in. There's change management here. So, all the normal skillsets apply here to get everybody aligned on a goal and motivated down that path.

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Alexander: All the more reason why it's important early on in the process to get an understanding of the culture and understanding how they make decisions. Because changing a management team is difficult. Doing anything to change a management team is disruptive. It takes time. Searches can go on for months, and you'd love to avoid that if you can.

In many cases, I've seen private equity firms do a great job of partnering with management, or bringing additional resources and showing how things could be done differently. They might pair up members of the management team with other portfolio company executives or external support to help them understand why the "art of the possible" is possible. A big part of this is change management. It's a bit of winning hearts and minds, but also driving forward and making sure you can capture the value that you set out to in your deal model.

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Clark: Executive teams often are already overloaded with running the business. That is why I usually add someone to the chief of staff role—chief transformational officer, director of strategic programs—you can label it however you want but, in essence, this is an individual that owns the value-creation plan. Sometimes it's someone within the company that can be elevated to that role. In other cases, we may need to bring in someone from the outside. But ultimately it's someone that the CEO and executive team can look to orchestrate and really own value-creation plan execution.

Now, certainly, all management has functional ownership, and the CEO has ultimate ownership. In some cases, if there are execs that still are dragging their feet or not understanding the pace at which private equity works, you need to have that hard conversation with them. If this isn't the role for them then let's figure out a way to transition them out. Also, connecting them to other companies that have gone through that allows them to provide some helpful hints on how to get through that transformational process.

Alexander: Susan described it as the chief of staff role. But if you think about how this process works, you're going to go through this diligence period, you're going to have the outlines of value creation, you're going to perhaps validate a lot of that pre-close and the early stages post-close, but you're going to end up with a plan that says, "Here are the six or seven big initiatives that will drive value creation."

There does need to be program governance, whether that's a chief of staff role or a transformation office or a PM. To Susan's point, everybody's got a day job. Everybody's got work to do. So, it's important to make that investment so that you can get those value-creation ideas and initiatives prioritized and on the CEO's agenda, in addition to all the other things that were already on that agenda before the deal closed.

Hilgendorf: Prioritization is key—you're always going to have more stuff you want to do than you can do at any one time. You always should be thoughtful about the priorities, so you get the quickest payback.

Privcap: Susan, you spent most of your career in tech and software deals. Are there any steps you always take as part of your operational due diligence?

Clark: There are two providers that I pull into every deal: one is a tech diligence provider that looks at cybersecurity, the strength of the tech organization, and at how well the product has been developed. The second provider looks at how effective the code is, and where there may be problematic areas.

They work very collaboratively together to give me a full view on overall product quality, overall tech, cybersecurity, data quality, and governance down to the code level. That's the make-or-break evaluation which, if it comes back negative, or there's too much tech debt, or the whole organization is not coding as effectively as possible, one shouldn't take lightly.

We evaluate the executive team to see how ready they are for this sort of transformational opportunity. We look at go-to-market and salesforce effectiveness, because that often is an area of opportunity. Often, the deal team does customer calls to see how the company is serving their customers. How are they ensuring that customer success is paramount to the process? What does that customer journey look like?

Privcap: Does anyone use KPI benchmarks in the pre-deal stage to compare the company against the performance of similar companies?

Hilgendorf: I think that's a slippery slope. Everybody asks for benchmarks because they love to see where they stand against others. But you have to be very thoughtful in how you apply them because they're never perfect. There are always differences, even within the same industry. Everyone could have a reason for something to be different and maybe that's their advantage, like they're doing more, trying to be more responsive to the market and they have more customer service.

We use it to identify areas that are out of line and potential opportunities or risks. But then we always do the deep dive underneath that to try and understand what's driving that—whether it's justified or if it's truly an opportunity to make an adjustment, to trim things out.

Just to give a super-simple, manufacturing example: You can look at exact same products—two companies making the same thing and one could be a little more automated. You could start benchmarking their headcount and direct/indirect could be totally different, but it doesn't tell you whether one is more efficient or cost-effective. You've got to get underneath that.

Alexander: Benchmarks are a helpful starting point, but, as Steve described, you need to triangulate. Benchmarks might lead you to a top-down perspective or assessment that says, "We think X to

Y is achievable." But then, you need that bottom-up validation. It's very difficult to have a value-creation plan that's simply based on the notion that certain expenses as a percent of revenue are a couple points higher, without understanding why that might be the case. Without understanding what might need to happen to fix that, it's very difficult to put a lot of credence in that kind of finding.

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Clark: One thing to add: there's no greater way of really upsetting your executive team than to say, "The benchmark says we're supposed to do this," because ultimately you need to get to know their business.

Privcap: Do you maintain an ODD playbook so that a strategy that worked on one investment can be applied to the next?

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Clark: I prefer the term "toolkit" versus "playbook." Playbook insinuates that it's something you do every time at the same way. But toolkit means that I have a set of tools I can use that are often "rinse and repeat." Pricing is something I look at for every company, because ultimately, what I've found in tech is every company has opportunity to improve their pricing. I've got a particular provider that is my go-to, so I've got that rinse-and-repeat model with that provider. We all want to move fast and there's only one of me.

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