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# Identifying Operational Opportunities to Reduce Risk During Due Diligence

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This is the seventh article in our series on Identifying Opportunities to Improve Operations. We have divided the opportunities to increase the market capitalization of a company into seven value lever buckets. For each area we describe the signs we look for that indicate the company can improve their financial performance, position in the market and their enterprise value. In other words, we are highlighting points you want to know BEFORE you buy the company; things that expose opportunities to increase EBITDA, capacity and asset utilization.

*The Seven Value Levers include*:

1. Throughput. Can we increase the output of a plant, office, service location, or other facility?
2. Variable Costs. Can we reduce the costs directly tied to our volume and revenues?
3. Fixed Costs. Can we reduce the costs that do not change in the short term, based on customer demand?
4. Order to Cash Cycle. Can we shrink the time between investment on our part and collection from our customers?
5. Pricing. Can we collect more revenue for the services we are providing?
6. **Risk. How can we reduce risks related to running our business?**
7. Asset Utilization. Can we increase inventory turns, the use of plant equipment, or the use of facilities?

In our prior articles we reviewed opportunities to improve the market value of a company through improvements in EBITDA, order fulfillment and working capital. Another powerful lever is to manage and mitigate risk. Auto mechanics have tools that enable them to run diagnostics that identify parts in the car that will fail in the near future. Similarly, companies rarely suffer a negative event that could not have been predicted to some degree. This article focuses on the items we look for to indicate or expose a risk that needs to be managed and mitigated.

An additional point, we have not yet been in the situation in which we encouraged a PEG client to walk away from a deal due to a risk. When we identify a risk that a company cannot sustain their current performance level or cannot scale, we quantify the steps and costs required to manage the situation and correct course. We highlight the items a good deal maker wants to know BEFORE they buy the company!

Regarding risk related to operations, we are looking for indications that our client can:

- Scale, growing without reducing customer service levels or margins
- Sustain current results and realize management plans
- Avoid supply chain interruptions
- Avoid building “assets” that the company is then on the hook to sell or convert (otherwise known as excess and obsolete inventory)
- Prevent and identify any irregular activity and / or shrink
- Avoid embarrassing situations

This is a powerful topic. Often, risks are not readily visible above the surface to the naked eye. We need to look for the following indicators that could show a company is susceptible to the risks listed above.

| Indicator | What it can mean |
|---|---|
| **The company relies on tribal knowledge.** | At the basic level, companies that rely on employees to know what to do, where to look, what file to use, what tool to use in an operation, how to complete a change over, how to schedule production, how to quote or many other tasks would suffer great loss with even nominal attrition. We look for the following to show that a company is protected from this risk:<br>• Executives, managers and supervisors all take vacation. In other words, the operation is as productive with the boss there or not there, at least for the short term.<br>• Work instructions are documented and the onboarding process includes more than on the job training<br>• The company uses a robust customer relationship management system that documents all customers, prospects, quotes, agreements and bids.<br>• Storage facilities are bin located, and cycle counts demonstrate that items are where they system shows.<br>If any of these items are missing, it is a sign that the company relies on the knowledge of workers to operate smoothly. |
| **The company takes physical inventory** | Banks today normally require physical inventories be taken only if the company does not demonstrate that their perpetual inventory system is accurate. If the company does still perform full physical inventories on a periodic basis, then further investigation is required. The risk is, if it is common knowledge that the company does not have accurate records, then it is common knowledge that shrink will not be noticed, at least in the short term. |
| **The company develops new products that generate excess and obsolete inventory** | For many companies that develop new products (consumer products companies for example), the company can develop a sizable inventory of products. Part of the danger is that the resulting inventory shows up on the financial statements as an asset. If the company does not track excess and obsolete inventory for new products; or if they do not hold the product manager or marketing manager accountable for aged inventory, then the company may have an asset they cannot covert into cash. What is worse is that they have processes and an organizational design in place that will continue to create obsolete inventory. |
| **The company does not monitor the development of, nor the disposition of, excess and obsolete inventory.** | This is the second time we are raising an issue related to excess and obsolete inventory in this article. It is an important issue because it is the symptom that a company suffers resulting from poor demand planning and supply planning practices. These practices impact the company every day. Every purchase of raw material or outside service, the level of labor we employ, how we utilize our plants, warehouses, suppliers and other resources. These are the daily habits that drive many outcomes for a company. If we see any of the following, more investigation is needed:<br>• There are no reports showing excess and obsolete (E&O) inventory<br>• There is no process to examine existing E&O levels or to develop countermeasures to prevent such balances in the future<br>• Product managers or marketing managers are not held accountable for remaining inventory levels after a new product roll out<br>• Inventory aging is not measured or reported on regularly |
| **The company relies on Legacy IT systems** | Many private equity investors plan to scale new acquisitions into new markets, products, geographies and revenue targets. These changes often require alterations and upgrades to the IT / ERP systems. If the company's IT system is built on legacy systems, was home grown, has been modified or is not utilizing current versions of databases and platforms, then it may be difficult to modify the systems to enable the growth in whatever form it takes. Even if the company can squeak by for the hold period for the current private equity firm, the next buyer will factor the investment required to correct the situation into their offer. Another side risk is that the cost to maintain older systems can go up dramatically. As the "supply" of programming expertise fades for a dated platform, the programmers become scarce and can charge exorbitant rates. |
| **No disaster recovery plans** | Companies should have documented plans to deal with natural disasters, power outages, server crashes and other exceptions. At the very least, the company should have a clear plan to address a computer system failure. A good plan may address redundant systems, automated off site backups, reserve programmers and external resources. If the company does not have a documented plan to address IT disasters, it is common that they will not have documented plans to address supplier failures, supply chain interruptions, extreme weather conditions, strikes, etc. |
| **Shrink is not measured** | Shrink relates to inventory write-offs due to loss, theft, quality defects or damage. Companies that track and measure these numbers are able to dramatically reduce shrink. We have seen companies cut 1-3% of cost of goods sold through effective management of these issues. If the company does not monitor shrink or take corrective action, then weak processes and controls may remain unexposed. |

| Indicator | What it can mean |
|---|---|
| **Undocumented supply agreements / Simplistic hedging practices** | For many companies, the cost of purchased goods and services are impacted by commodity prices. If a company does not document formal agreements with suppliers on how to handle changes in commodity pricing, then the company is exposed to potential pricing increases in the future. |
| **Compliance with the Foreign Corrupt Practices Act (FCPA) is not clearly demonstrated.** | For companies doing business across country borders, there are regulations that govern ethical practices. If any of the following good practices are missing, then there needs to be more investigation:<br>• The company has a formal chief compliance officer (that does not imply a full time position, simply that there is a clear compliance "owner" in the company. If the company is public, then this officer should have direct access to the audit committee<br>• The company has a documented FCPA code of conduct, and training in that code is tracked by employee |
| **Sourcing controls** | The cost of purchased goods and services is often 20% to 80% of the total cost structure for manufacturing and distribution companies. The basic controls that should be in place to ensure that no kickbacks, irregular activities or cronyism occurs include:<br>• All checks to suppliers are mailed by accounting, are sent electronically and are NEVER held to be given to a buyer or other employee to be delivered to the supplier.<br>• All sourcing agreements are documented<br>• Suppliers are selected through competitive processes and are chosen based on quantitative criteria and by a cross functional team |
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| **Succession planning / company and management team background checks** | The personnel and management team that comes with an acquisition is a major part of the value. Conducting routine background checks can identify court rulings, bankruptcies, compliance issues, social media behavior and other dangerous items. While this step is often considered a basic part of diligence, it is often neglected. A sound vetting of key management and their ability to sustain and grow the business after the ownership change can avoid major disappointments. |

Examining these risks is not just an exercise in avoiding pain or bad situations. The poor processes and controls that allow risk to germinate and grow also cause poor financial performance. In addressing risks, we have seen the following positive results at clients:

- A major global industrial products manufacturer had poor controls in place regarding international freight. This situation exposed them to risks related to non-compliance with FCPA and to potential litigation that would have caused significant additional expense and undesirable media coverage. In addressing the situation and putting appropriate controls in place, the company actually reduced their annual spend by over $10 million, or 25%.
- A US based consumer products company recognized that it has poor sourcing controls in place. The sourcing manager routinely "delivered" checks to suppliers personally and, it was discovered, took kickbacks. Addressing this situation led to the company to reduce the price for items paid, reduce inventory levels and increase order fulfillment. As it turned out, the original supplier won the business to satisfy ulterior motives.
- A private equity client was evaluating a target company for acquisition. The company relied on a system built on antiquated software and databases. By identifying this issue in diligence, our client was able to negotiate appropriate relief and was able to complete the deal and implement a robust system.

We have all heard that the best deal is often the deal not done. By exposing and vetting risks in the diligence process, we gain the knowledge while it is still actionable! Dig deep!

In our next article we will look at indicators that a company can improve asset utilization and turnover.
If you have any questions or requests, please feel free to contact me at tvm@proactiongroup.com.

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