THE PROACTION℠ GROUP LLC

KEY INSIGHTS FROM PRIVATE EQUITY PROFESSIONALS

The Value Of Pre-Close Operational Diligence In Mitigating Risks and Uncovering Hidden Value

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Executive Summary

Just like a quality of earnings (QofE), the use of operational diligence is growing in relevance and utilization. Identifying undisclosed risks pre-close is not about avoiding deals, rather it allows better clarity for the prospective private equity sponsor to negotiate well pre-close, and approach the deal with a more complete plan to address those issues post close. Identifying risks early in the diligence process is central to addressing those same issues before they achieve critical mass two or three years after closing.

The ProAction Group conducted a survey around the value of operational diligence with well over 100 Private Equity executives, across a wide variety (e.g., size, market concentration) of private equity firms to identify and understand their key concerns when considering pre-close operational due diligence. This executive summary provides a reflection of the risks that are on the minds of Private Equity Investors, and emphasizes the evaluation and balancing of these factors to make informed investment decisions. The summary highlights the concerns of Private Equity Investors, the risks involved in acquisitions, the stages of risk in the acquisition process, the importance of due diligence, and the feedback from Private Equity Investors regarding the operational diligence provided by the ProAction Group. Key risks noted by private equity sponsors during these discussions were in the following areas.

RISK CATEGORY	FOCUS AREAS
Safety/Physical Security	Compromised safety to personnel - imminent danger (someone is going to get hurt), latent danger (someone may get hurt), or the physical security of an asset is at risk (a non-employee is accessing the property/stealing inventory).
Margin Compression (Profit Margin)	How vulnerable is the company to negative margin pressure in future years, especially from volatile material and labor costs, key person attrition, regulation changes, negative pricing pressure or the ability to pass on related price increases.
Business Interruption	Is the company prepared to withstand supply chain scarcity or temporary restrictions, key person attrition, equipment failure or other changes?
Customer Attrition/Loyalty	How vulnerable are the company's relationships and ties with key customers?
Un-budgeted CAPEX Requirements	Is there evidence that the company will face CAPEX costs not accounted for or disclosed in their budgets?
Not Scalable/Fragile Environment	The current process works great but has no ability to flex up or down, any change leads to trouble.
Reduction in Value of an Asset	The risk that an asset on the books is significantly overvalued or is vulnerable to becoming overvalued.
Sensitivity to Macroeconomic Market Issues	Black Swan events will happen. How resilient, nimble and flexible are the company's supply chain, operations and organization to absorb or react to Macro-Economic Events?
Under or Over-estimate of Capacity	If the capacity is underestimated, it could lead to unnecessary investments in new capacity. When capacity is over-estimated it will lead to unsatisfied customers and premium expediting costs.
Rabbit-hole Risk (a misdirected corrective action)	The risk that a leadership team is committing resources and energy to an irrelevant or distracting topic.
Fraud, Irregular Activity, Shrinkage, Supplier Fraud, Kickbacks	Some operations have solid controls in place, others rely on the integrity of their employees.
Inaccurate Cost Accounting	When actual part costs are incorrectly recorded, and the company thinks they are making money in areas when they are actually losing money.

Executive Summary

Key Takeaways

1. **Risk versus Value:** An obvious consideration when contemplating an acquisition is weighing the risks against the potential value of the target company. Thorough due diligence is essential for identifying and evaluating risks, while a comprehensive analysis of market dynamics and industry trends helps assess the potential latent value. Operational diligence is a key contributor to a thorough diligence effort working alongside other diligence efforts (e.g., QofE, Legal, Environmental, Customer/Market analysis).

2. **Private Equity Investor's Concerns:** Private Equity Investors express concerns about the sustainability of earnings, the emotional investment of the business owner, market conditions, leadership capabilities, and economic factors. They strive to mitigate risks and maximize the potential of their investment through comprehensive due diligence.

3. **Risks Involved:** The acquisition risks include financial, market, operational, legal / compliance, human capital, and integration risks. Identifying and assessing these risks is crucial for making informed decisions and negotiating reasonable terms.

4. **Stages of Risk:** Risk levels vary at different stages of the acquisition process. Early-stage risks require focused efforts, intermittent symptoms demand attention, consistent symptoms call for significant actions, and late-stage risks can potentially eliminate equity value.

5. **Importance of Due Diligence:** Operational due diligence has become increasingly important due in large part to increasing valuations and a shrinking margin for error. It involves operational improvements, risk mitigation, a focus on the demand side, procurement optimization, and long-term planning. Investors must adapt to these changes to secure returns on investments.

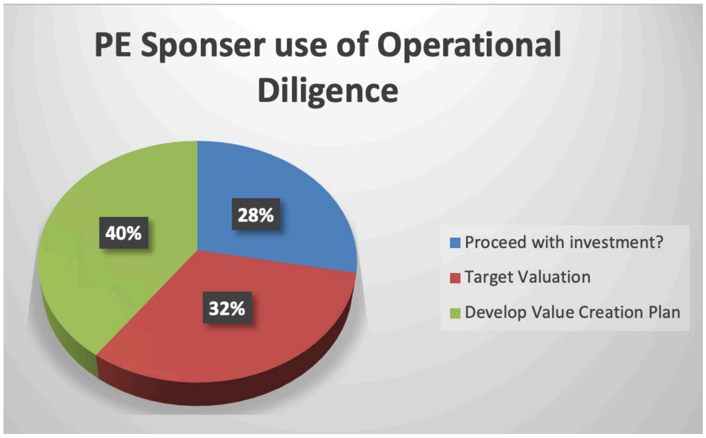
6. **Private Equity Investor's Feedback:** Private Equity Investors highly value the operational diligence information provided prior to closing a transaction. It helps validate investment opportunities, assess costs, guide post-closing activities, facilitate negotiations, influence decision-making, and drive continuous improvement.

By considering the risks and potential value in an acquisition through the lens of operational due diligence, investors can make informed decisions as they finalize the deal and plan their onboarding of the company.

Risk versus Value in an Acquisition

When considering the purchase of a company, it is crucial to weigh the risks against the potential latent value it may offer. Buying a company involves substantial investments of time, capital, and resources, and understanding the balance between risks and potential rewards is essential for making an informed decision. Nearly 40% of respondents stated they utilize operational diligence to guide improvements in support of their value creation plan after the investment. Further, 28% of respondents indicated operational diligence informed their decision on whether to proceed with the transaction, while 32% noted that operational diligence helps guide the decision on how much to offer the seller.

One of the primary risks associated with buying a company is the possibility of inheriting existing liabilities. This includes legal issues, financial debts, and operational challenges that may impact the company's profitability and long-term viability. Conducting thorough due diligence is vital to identify and evaluate these risks before finalizing the purchase.



Feedback from our Private Equity Investors

"Our company highly values the operational diligence information provided by the ProAction Group, as it is a crucial tool in our investment decision-making process and post-closing operational improvements. We utilize this information in several ways to ensure that our investments are sound, risks are mitigated, and opportunities for improvement are identified and achieved within the desired timeframe."

"First and foremost, we use operational diligence information to validate whether an investment opportunity is worth pursuing. By thoroughly evaluating risks, opportunities, and potential improvements highlighted by the ProAction Group, we can make informed decisions regarding the feasibility and viability of the investment. This validation process helps us assess whether the acquisition aligns with our strategic goals and financial expectations."

Additionally, market dynamics and industry trends play a significant role in assessing the potential latent value of a company. A comprehensive analysis of the target company's competitive position, customer base, intellectual property, and growth prospects can help determine its future profitability and market relevance.

Acquiring a company also provides the opportunity to leverage synergies and gain access to new markets, technologies, and talent pools. This latent value can result in increased revenue streams, cost savings, and improved operational efficiencies. However, realizing these benefits requires effective integration strategies and strong leadership to align the acquired company's goals with the acquiring company's vision.

In conclusion, buying a company involves inherent risks but can also unlock significant latent value. A careful evaluation of the risks and a thorough assessment of the potential rewards is crucial for making a well-informed decision. Success lies in strategic planning, effective execution, and continuous monitoring to maximize the latent value while mitigating the associated risks.

Our Private Equity Investor's Concerns

When purchasing a new company, our Private Equity Investors have various concerns that keep them up at night. One major worry is the sustainability of the target company's earnings. They want to ensure that the revenue streams they are acquiring are durable. They also focus on the psychological aspect, wondering if the business owner will remain emotionally invested after the transaction. Retaining key people is crucial, as they want to keep talented employees on board to drive future success.

Another fear is the uncertainty of the future. Private Equity Investors question the validity of projected revenues and if they are buying a business with sustainable growth. They analyze market conditions, customer loyalty, and potential disruptions. Additionally, they assess the leadership team's capabilities, motivations, and drive to navigate challenges and seize opportunities.

Private Equity Investors are also concerned about economic factors, such as interest rates, inflation, and the overall economic outlook. They want to understand the impact of these factors on the company's future performance.

Overall, Private Equity Investors worry about paying a premium for a deal and having little margin for error. They seek multiple paths to create value and carefully scrutinize all aspects, including the supply chain, market multiples, inventory management, and long-term financial stability. By addressing these concerns through comprehensive due diligence, Private Equity Investors aim to mitigate risks and maximize the potential of their investment.

Feedback from our Private Equity Investors

"Cost considerations are also a significant factor in our decision-making process, and operational diligence information plays a crucial role. The ProAction Group helps us identify any deferred investments that may be required, such as fixing damaged equipment or addressing operational inefficiencies. This information allows us to accurately assess the costs associated with the investment and evaluate whether the seller can absorb these costs or should be factored into our calculations. By understanding the true financial implications of the investment, we can make well-informed decisions and avoid any potential deal-breaking surprises."

"Furthermore, the operational diligence findings act as a guide for our post-closing activities and improvement plans. The ProAction Group's assessment identifies areas where operational enhancements can be made, enabling us to create a comprehensive plan for post-close implementation. Whether it involves streamlining processes, optimizing productivity, or expanding customer acquisition strategies, we rely on diligence information to prioritize and allocate resources effectively. This strategic approach ensures that our investments yield returns and drive operational excellence and long-term value creation."

The Risks Involved

When buyers consider purchasing a company, they seek to uncover and assess various risks associated with the transaction. Based on the feedback obtained from our survey, the main risks investors want to explore can be summarized as follows:

1. **Financial Risks:** Buyers want to evaluate the target company's financial health, including its revenue, profitability, cash flow, and debt levels. They analyze financial statements, tax records, and conduct due diligence to identify potential financial risks, such as undisclosed liabilities, pending litigation, or inaccurate financial reporting.

2. **Market Risks:** Buyers assess the target company's competitive position, market share, and industry trends. They analyze the market demand for the company's products or services, potential threats from competitors, and any regulatory or legal issues that could impact its operations. Understanding market risks helps buyers gauge the company's future growth prospects and sustainability.

3. **Operational Risks:** Buyers investigate the target company's operational capabilities, including its supply chain, production processes, and critical operational contracts. They examine potential risks related to operational efficiency, dependence on essential suppliers or customers, technology obsolescence, or any pending legal or compliance issues that could disrupt operations.

4. **Legal and Compliance Risks:** Buyers want to ensure the target company complies with applicable laws, regulations, and industry standards. They scrutinize legal agreements, contracts, permits, licenses, and intellectual property rights to identify any legal or compliance risks, such as pending litigation, regulatory violations, or breaches of agreements.

5. **Human Capital Risks:** Buyers evaluate the target company's workforce, including key employees, talent retention, and labor relations. They assess potential risks related to employee turnover, talent acquisition, labor disputes, or undisclosed employee-related liabilities, such as pending lawsuits or regulatory penalties.

6. **Integration Risks:** Buyers assess the challenges and risks of integrating the acquired company into their operations. They consider factors such as cultural differences, IT system integration, customer retention, and potential disruptions during the integration process.

By thoroughly examining these risks, buyers can make informed decisions and negotiate reasonable terms and conditions to mitigate or account for any identified risks before finalizing the purchase of a company.

Feedback from our Private Equity Investors

"The ProAction Group's operational diligence findings also play a pivotal role in our negotiation process. Based on their assessment, we can engage in meaningful discussions with the target company's management. The solid facts and defendable points of view provided by the ProAction Group enable us to have substantive conversations about the current state of the business, potential improvements, and the timeline for implementation. This collaborative approach helps establish a shared understanding of the investment's value and facilitates smoother negotiations."

The Stages of Risk

Based upon the information learned during our survey, risks tend to present themselves in various stages. As these risks become apparent and pose varying challenges, it is vital to understand these four risk stages.

Stage I: Early-stage risk - This stage involves risks that are only easily detectable with focused efforts. Identifying and managing these risks requires attention from management and may involve moderate capital expenditures (capex) or additional ongoing costs. However, any ongoing costs at this stage are generally manageable.

Stage II: Intermittent symptoms - During this stage, signs of potential risks may appear sporadically. These symptoms include increased scrap, absenteeism, decreased productivity, missed shipments, growing backlogs, customer complaints, and longer lead times. However, these symptoms may temporarily disappear as efforts are made to address them. It is still manageable to tackle issues at this stage. The teams involved are usually flexible and open to adopting new approaches. Major capex or significant losses in earnings before interest, taxes, depreciation, and amortization (EBITDA) are often avoidable, and customer attrition is minimal.

Stage III: Consistent symptoms - At this stage, the symptoms mentioned in Stage II persist and gradually worsen after intermittent occurrences. The leadership team may become accustomed to the situation and overlook the severity of the risks. Addressing issues at this stage may result in several outcomes, including a more extended hold period, requiring an additional two years to replace the leadership team, which carries additional risk and undesirable consequences. There may also be a loss of one or more significant customers, and undetected losses due to a lack of accurate understanding of profit generation. Taking aggressive action to reverse the negative momentum of the prior culture, practices, and norms becomes necessary.

Stage IV: Late stage - At this stage, the risks have fully manifested and become obvious, both in person and through a review of financial statements. Risks that reach this level present a significant threat to the organization, and can potentially eliminate the sponsor's equity value. While the company may survive, it will likely undergo a change in ownership.

In summary, the stages of risk in acquiring a company progress from early-stage risks that require focused detection efforts, to intermittent symptoms that can be addressed with relative ease, to consistent symptoms that demand more significant actions and carry the risk of extended hold periods, loss of major customers, and undetected financial losses. The final stage is the late stage, where the risks are highly visible and can lead to a loss of equity value for the acquiring company.

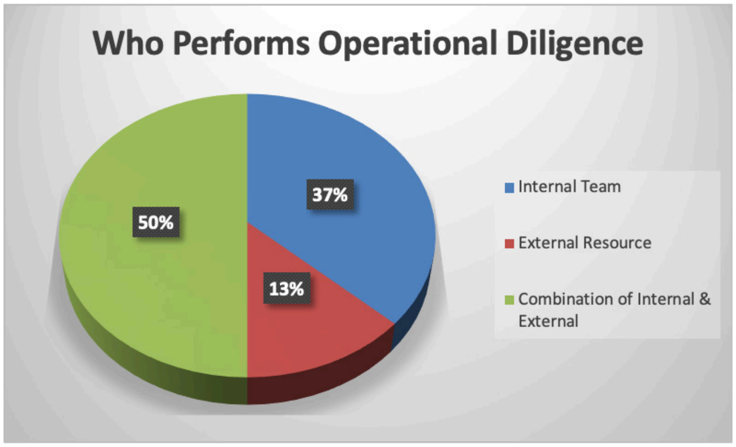
Feedback from our Private Equity Investors

"Additionally, the operational diligence information directly influences our go/no-go decision-making. While we have our own opinions and perspectives, the ProAction Group's assessment serves as a critical factor in determining the viability of the investment. By objectively analyzing the operational performance and potential of the target company, the diligence findings provide an additional layer of evaluation, enhancing our confidence in making informed investment decisions."

The Importance of Conducting Due Diligence

The importance of due diligence when buying a company has significantly changed in recent years due to various factors. Tight money, supply chain issues, limited opportunities, and increased risk have made it crucial to conduct thorough due diligence to ensure long-term success.

Over the past two years, the private equity industry has witnessed a great deal of variability with deal flow. Good deals are difficult to find, and shortened exclusivity periods can lead to a fast-paced environment where shortcuts are more common resulting in overlooked details affecting value. However, these shortcuts can have severe consequences, especially when dealing with businesses not running optimally. The increased risk and higher prices in the market demand a greater focus on operational and demand-side aspects to secure returns on investments.



Moreover, as interest rates rise and margins of error tighten, due diligence becomes even more critical. The next two years will separate successful investors from those who struggle. The procurement playbook becomes essential in identifying opportunities and potential challenges in the next business ventures.

Visibility and early insights into the sufficiency of processes and systems are crucial in making informed investment decisions. The ability to generate benefits and understand the intricacies of a transaction has become paramount for success. This shift in importance is a significant change that has occurred over the past two decades.

Feedback from our Private Equity Investors

> "Continuous improvement is a core principle of our company, and the operational diligence information from the ProAction Group supports this philosophy. We leverage their findings to identify the gap between the current state and the desired future state of the target company. This enables us to develop actionable strategies and plans to bridge that gap, leveraging the insights from the diligence process to drive performance improvements and maximize value creation."

In summary, due to the changing business landscape, the importance of due diligence when acquiring a company has evolved. Operational improvements, risk mitigation, a focus on the demand side, procurement optimization, and long-term planning have become essential components of a successful due diligence process. Investors must drive operational improvements and leverage their expertise to identify potential growth opportunities and navigate roadblocks effectively. By adapting to these changes and prioritizing due diligence, investors can position themselves for success in an increasingly challenging market.

The increased competition for deals adds pressure and reduces the margin for error. The progressive investors responded that they are conducting the Operational diligence to identify undisclosed risk and hidden value. They leverage those findings to inform the deal team on several fronts, including: final negotiations, unstable areas that need attention immediately post close, risks and opportunities that can be addressed through a relevant value creation plan, and opportunities to get ahead of plan. Our prediction: Operational diligences will become as ubiquitous as the QofE! Portfolio theory allows for deals to falter in years two or three of the hold, but you don't want to be the deal team that didn't see it coming!