catalyft
Business Improvement & Advisory Services

Turning Organizational Energy Into Results That Matter

The Role & Importance of Financial Due Diligence…from an Operational Perspective

Co-Authors:
Steven Koinis, Managing Director, Private Equity, Catalyft LLC
John Bova, Vice President Private Equity, RGP™

Our position: Having diverse subject matter expertise on hand can benefit Deal Teams — starting at indication of interest (IOI), to diligence, and all the way to post-close value creation.

With leading Private Equity firms incorporating Operating Partners into diligence teams and 100-Day Plan value creation teams, the functional expertise and industry experience gained by having Operators plugged into Deal Teams is becoming a competitive advantage. The historic approach of deploying Operators as interim managers after closing may not be ideal for longer-term portfolio company executive team development or even organizationally advantageous. An alternative approach, deploying pre-close advisement and value creation assistance, may be the stronger lever after the deal settles.

An Operating Partner - providing an executive mindset, industry specialization, and tangible experiences - in Financial Due Diligence (FDD) helps the Deal Team orchestrate strategic visioning, position risk mitigation measures, analyze historical rates of improvement, and design practical growth goals. This perspective is essential to balancing the deal thesis by underwriting Management's ability and past results, thus, increasing higher internal rate of return (IRR) and multiple on invested capital (MOIC) probabilities.

Essentially, FDD seeks to confirm assumptions and model future financial scenarios based on historic performance. Three key components include:

1. Reviewing historical financial statements via quality of earnings reporting
2. Understanding historical performance and trend data to assess projections
3. Analyzing ongoing operations considered in deal underwriting

As Investment Committees and Deal Teams work through the financial modeling side, the Operator seeks to link current operational and organizational capabilities with the financial analysis, extrapolate future upside potential through operational trends, and track down additional relevant data requests to round out the qualitative perspective. In today's competitive deal environment, excessive data requests could negatively impact deal closing probabilities. In most deals, the Operator's experience to quickly build a growth acceleration model via management meetings, data rooms, and management acumen assessments through conversation will make the difference. In some instances, coveted diligence items like clean data sets cascading and flowing into existing reporting is not available given the deal's time constraints. A way to get the answer needed may involve more structured questions based on past experience, asking executives and subject matter experts to *please describe the journey to reporting effectiveness* or *what are the key reports and operating trends you rely on to make sure the financial plan is met?* Experienced Operators can confirm the team has the metrics and reporting foundation in place to drive data-backed decisions and, also, to know where additional analytics, data visualization, and management training are needed to meet investment thesis expectations.

Understanding how the firm's operational indicators translate into financial reporting provides the beginning of what improvements the 100-Day Plan must include from a data management and reporting process vantage point.

From a financial reporting perspective, the income statement becomes the greatest focus of the diligence for the Operator. Future improvements geared toward revenue growth, revenue diversification, margin enhancements, cost containment candidates, and advantageous compensation structuring will flow from that deep dive.

An Acquirer's first time with Management will provide such a limited view into the revenue generation model that working the data will be needed to fill the gaps at diligence.

Revenue diversification, for example, can be viewed from several angles. Cutting the data in ways to create a small data set to provide segmentation of sales from several angles will illuminate gross and net margins. Interesting data slices include:

1. Geography
2. Channel
3. Products and services (legacy + less than 2 years old)
4. Sales organization model and measurement
5. Customer acquisition costs
6. Customer retention rates

The goal is to have data comprising historic trends quickly analyzed to provide directionality of future profit opportunities, profit margin parameters, and an estimation of the level of effort needed to meet the investment thesis.

Sales compensation models provide an interesting, valuable place for a deeper dive, too. Total compensation structure - including base plus commission/bonus or bonus with performance contingencies and accelerators to develop variable compensation - is a reflection on Management's understanding of the business and how revenue is derived.

Additionally, understanding the frequency of compensation model changes over the last five years reveals valuable insight into Management. The Operator is interested in getting a sense of compensation models to ongoing channels versus new channel compensation. Putting the Deal Team's arms around the possible tipping of channel versus direct (and potential) cannibalization of clients provides deep insights into Management's assessment of risk, application of industry knowledge & experience, and prescience toward market dynamics.

Geography and diversification of revenue flow is important to understand - especially if a business has significant overseas sales. Overseas business divisions can have challenging payment terms, partner agreements, alternate risk mitigation approaches, and culturally-dependent relationship development dynamics to consider. These implications generally arise through the broader consideration of the international marketing costs and new channel development.

Below the top line, focus needs to be on products & services delivery complexity. The process of conversion must be understood by the Acquirer – along with the variability of costs and possible replacement options for inputs. Changes in the business model and the products & services portfolio will happen over time - but *what costs can be passed on to the customer? What premiums are new customers willing to pay for new products & services?* This comes back to the professionalism of the sales team. Trend data on top line needs to be considered through the construct of top client concentration and their historic margin levels. Ultimately, the question to be answered: *is the sales team composed of hunters driving new logo and new opportunities with enhanced margins or are we focused on farmers with steady-state sales?* The challenges of driving margins with a sales model of farmers who cannot pass on input cost changes can signal an issue worth prioritizing in the 100-Day Plan (and subsequent growth initiatives). On the balance sheet side, two principal asset line items should be the Operator's focus:

- **Accounts Receivable:** This provides insight into liquidity risk, velocity of cash flows based on credit policies in place, and the ability to free up cash for future investment.

- **Inventory:** Key raw measures of inventory, inventory turn, and inventory conversion to cash through the cash conversion cycle (CCC).

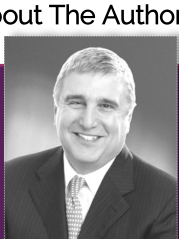
Private Equity owners will measure leaders on how well they sweat assets and improve cash conversion. The Chief Financial Officer (CFO) will most certainly come into focus for this skill crucial set.

A last area of concern on a Deal Team analysis: review of the documentation, governance, and measurement of return on investment (ROI) from capital expenditures and investments. This final area includes financial analysis as well as the trail of management skill, decision-support data analytics, and the approaches (or heuristics) applied to business decisions. Surfaced at the diligence phase, this perspective provides a sense of Management's ability to take on larger capital investment responsibilities. Through this analysis, Management's emphasis on new products & services through research & development (R&D) investments and the trajectory of information technology (IT) adoption can be assessed by the weight of investment in these areas versus peer groups. An Executive who efficiently applies technology to empower the team at-large, translates voluminous data sets into useful information, and provides a sound business case for future investment is a **bankable** Executive.

The Operator can provide the bridge from operating trends to financial information, ultimately, laying out investment upside potential based on tangible operational and organizational capabilities. Working alongside the Deal Team, transformation steps to investment growth is aligned with risk management and matched up to management team underwriting.

At the end of the day, the Operator's imperative is to hand the Deal Team an experience-based assessment of upside potential - *built up from operational reality* - and the necessary steps to deliver transformational results.

About The Authors:



catalyft
Business Improvement & Advisory Services

Steve Koinis

Steven Koinis leads the Private Equity Practice for Catalyft LLC, a practitioner-led, boutique operating partner firm focused on strategy implementation and operational improvements in middle market businesses acquired by Private Equity, investment firms and Family Offices. Steven has held several senior executive positions with the sovereign wealth fund Abu Dhabi Investment Company, Huron Consulting Group, and as C-level executive and Board member of private firms in the US, Europe and Middle East. Steven earned his MBA from Harvard Business School and has two Bachelor of Science degrees in Mechanical and Materials and Metallurgical Engineering from University of Michigan, Ann Arbor and speaks conversational Greek, German and Arabic.

RGP

John Bova

John Bova leads the Private Equity Practice at the global consulting firm RGP. John has played many roles in the private capital space over 30 years Including senior executive to fast growing middle market companies, Independent Sponsor, PE and Family Office Advisor and Consulting Practice Leader. John earned his MBA from Pace University—Lubin School of Business and has a Bachelor of Arts in Economics and International Relations from Fairfield University.