Calling all Operators and Private Equity firms:

Operational Due Diligence is critical to the success of your platform or add-on acquisition.

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"Operational due diligence doesn't make sense for us!" - Private Equity (PE) investment team

Why not? Responses ranged from "not enough access to management, customers, distribution channels, etc." to "not enough time" to "the deal team should cover that too".

Our contrarian position: getting a seasoned operational perspective on your potential acquisition, answering where trapped value resides, what new capabilities are possible, and the level of effort needed to drive earnings (EBITDA) after the acquisition can add substantial value to your negotiations and, ultimately, to your return.

Are you sitting down? According to most academic and consulting surveys over the past 10 years: **66 to 90%** of mergers & acquisitions (M&A) plans have failed to live up to investor and management expectations *(please see HBR, March 2011).* With all these relationships ending in grumblings of missed opportunities, hurt feelings, and perhaps, a few exasperated tears, M&A is not for the faint of heart or sensitive of stomach.

Whether firms are looking to leverage acquired company assets for synergies (such as customer acquisition, cost reductions, product development, production capacity, and distribution channels) or grow new capabilities by acquiring novel business models (such as higher margin products & services, innovative technologies, and new go-to-market capabilities), the anticipated returns have not materialized with the speed and magnitude expected by most investors.

Several operational due diligence (ODD) questions repeatedly surfacing during our PE conversations…

Does the lack of emphasis on pre-closing ODD or poor execution of the investment thesis contribute to high M&A failure rates?

Past experience tells us it is a combination of these two factors; however, a rough road starts without pre-closing ODD. This is the crucial time in the deal process. ODD assesses operational & organizational risks, forms tangible implementation options for necessary changes, and quantifies the value creation trajectory (based on current vs. future business capabilities).

What are some operational & organizational risks to watch out for during ODD?

Highest risk usually revolves around cultural alignment and management team chemistry. The team dynamic changes every time a person is added or subtracted from the team. Now, start talking about hundreds of new team members and the permutation dynamics start to get very interesting. The new management team will be in flux. Whether directed by investors or self-selected, **over 50%** of management will move on one year after firms are combined (*please refer to ResearchGate, November 2014*).

A major operational risk is the Supply Chain — potentially harboring some unwelcomed features if it does not get the attention it needs. Nefarious, expensive surprises like unplanned stock-outs, disappointed customers, dejected vendors, and ballooning expediting costs. ODD is the right time to identify pockets of existing strengths, surface issues (current and future disruptions, excessive costs, inefficient cash usage, etc.) and evaluate opportunities for improvement. Supply Chain wins wars and wins new customers. This aspect of the business has numerous weighty implications (customer satisfaction, safety concerns, environmental impacts, cost of goods sold, employee frustration levels, vendor relationships) and warrants a deeper assessment prior to closing.

Without a thorough look at the target's internal operations, assessing the Supply Chain, cultural fit, logistics practices, product development cycles or systems-related capabilities, the acquirer cannot truly understand EBITDA upside potential and investment risks.

So, what do you look for in a pre-closing ODD exercise?

Post letter of intent (LOI) but prior to closing, we help the deal team answer the following questions:

1. Is the investment thesis for the acquisition executable from an operational & organizational perspective?
2. Does the current management team have the depth of experience needed to meet expectations?
3. Can current management and employee talent be aligned with the investment thesis?
4. What are tangible implementation options to bring about new business capabilities or total business transformation?
5. What are the operational and organizational risks to overcome on the way?
6. What are the ranges of financial upside potential based on past implementations?

In practical terms, what is the ODD process and what are the benefits?

We follow a disciplined process - whether collaborating with a corporation, PE firm, or family office acquirer. Our first step is meeting with the deal team to map out their customized ODD plan. Full access to management, customers, distribution and supply chain representatives is not always possible or even advisable at pre-closing; therefore, we work with the deal team to ensure there's an understanding of all sensitivities, outline necessary analytical studies and surveys, provide our rationale behind the prescribed assessments, and map out how the results tie in with the deal team's objectives. With deal team representatives, we next meet with target company management to incorporate their business perspective, understand overt concerns, and analyze any operational performance data already on hand.

Involving the potential partner in the entire process is critical. Yet, we know management will undoubtedly be guarded during the sale process. Some practical steps include data collection through the data room, a structured question & answer session to frame the process, and alignment around a kickoff meeting with target company management.

Discovery involves engaging stakeholders in a detailed review of the current business and identification of barriers to achieving the investment thesis objectives. This process includes:

1. Executive interviews for leadership alignment, perspective and vision
2. Focus interviews related to operational excellence - preferably by subject matter experts of the acquirer or external resources
3. Organizational effectiveness assessments or Change Readiness diagnostics

Data analysis includes key operational performance metrics related to revenue trends, gross margins, customer service levels, quality control parameters, productivity calculations, cost components, and historical EBITDA movements. These metrics must be mapped to operational systems & processes in order to develop a preliminary business case incorporating near-term integration requirements and improvement options (benefits ranges, resources needed, implementation plan) to accelerate EBITDA growth.

Depending on the level of support the deal team requires, the ODD process takes 5 to 15 business days to complete – an investment that can reap major benefits in your final deal structure, acquisition terms & conditions, stakeholder expectations, and even in financing. It also lays out the basis for the 100-day plan post acquisition since ODD outlines major areas of opportunity required for investment thesis execution. In scenarios where targets are experiencing their first round of institutional funding, we have found the process helps to align new management and reduce turnover – thus, materially contributing to the ultimate success of the acquisition.

The bottom line: operational due diligence (ODD) is a crucial step to understanding risks, establishing a healthy partnership mentality, and quantifying the level of organizational & operational effort needed to improve EBITDA, thus, boosting an acquisition's success rate several fold!

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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.

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