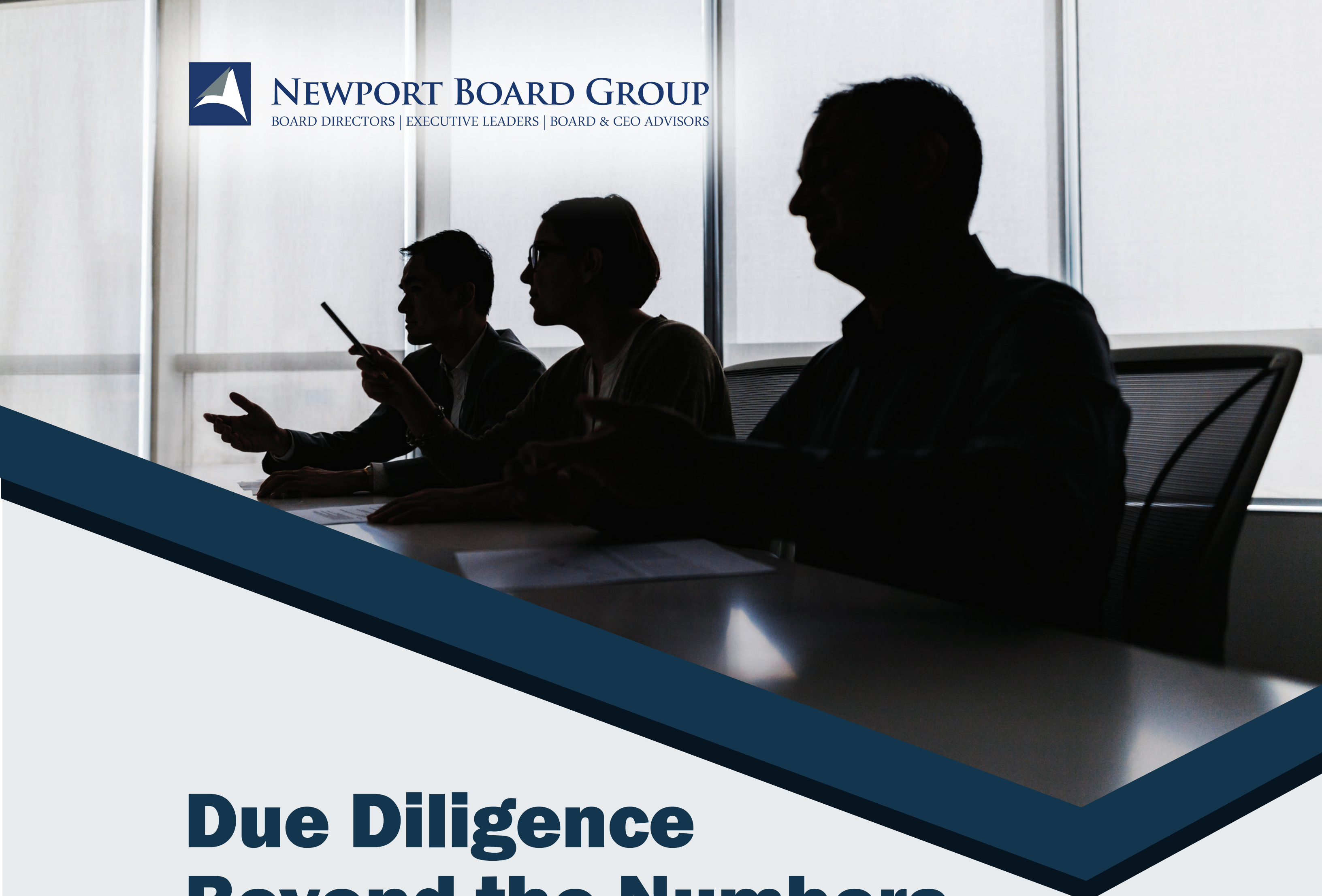


Due Diligence Beyond the Numbers

Lessons From My M&A Experience

At the mid-point of 2017 the state of M&A is mixed. Deals are in short supply, impacting the ambitions of both Corporate and Private Equity (PE) dealmakers.

There is pressure on PE management fees especially from limited partners demanding co-investment rights. A shortage of deals requires that acquirers execute due diligence so they can close faster than ever before. Acquisition professionals facing these challenges are tending to shortcut diligence practices and overly rely on financial analysis i.e. “the numbers” at the expense of a more holistic approach to evaluating the target company.

Newport partners have considerable experience evaluating, executing and integrating corporate and PE transactions.

As an executive at serial acquirers Textron and ITT, New England-based Newport partner Keith Boudreau played a key role in significant transactions on both Sell and Buy sides. He ran businesses that had been acquired and were allowed to operate with relative autonomy within a corporate structure—broadly similar to the PE model.

Keith Comments

“I have always considered myself to be a “numbers guy.” My background is in commercial

finance and I'm a Six Sigma Black Belt. I've learned to embrace the power of data, statistics and the inferences that can be drawn from them.

At Textron and ITT our approach was to run the companies we acquired as stand-alone divisions. While they leveraged some shared services such as accounting systems and HR administration, the acquired units were responsible for key functions such as talent, marketing, sales, customer service, new product development, pricing, etc.—much as any independent company would.

As Division President with P+L responsibility for the acquired companies, I had a strong personal stake in the performance of the business under its new owner. There was no "exit plan" for these new businesses within 5-7 years as PE would insist on. Yet the short-term imperative was largely similar to private equity's: earn a high return on investment by rapidly improving operations, revenue and profits.

My personal leadership approach was informed by training in Six Sigma and immersion in some fundamental concepts of modern business management. A foundational truth from W. Edwards Deming is that "every system is perfectly designed to get the results it gets." In simple terms, if our results weren't meeting expectations, we'd take a hard look at the "system" that was producing them to identify causes and solutions.

Now that I'm an advisor on evaluating deals, executing them, and occasionally fixing good deals gone bad, I rely on the principles I learned from my own M&A experience to provide value.

Meet Keith

Keith Boudreau has had a distinguished career in the corporate and private equity M&A arena.

He has extensive experience across the M&A buy and sell-side transaction cycles. Keith has played a key role in evaluating, performing due diligence on, pricing, deciding on and executing M&A deals for companies renowned for their expertise in this area including ITT, Conseco and Textron.

Applying this experience to the current market environment for corporate and PE acquirers leads to these observations:

- Too often, due diligence is superficial and overly reliant on financial analysis.
- Too many investors ignore the old saying that "Anyone can captain a ship when the seas are calm." They fail to question retained management's capability to execute an aggressive growth plan—especially when this is a new experience for the team.
- Inadequate attention is paid to deeply understanding company culture.

Inadequate Due Diligence

In one Sell-Side experience I led the process of spinning off a $1 billion commercial leasing company where I was President and COO. One potential buyer conducted its due diligence by sending in a team of 26 functional area experts to assess everything about us. Most of them spent their time interviewing and collecting data from my executive team and others further down in the organization. They dug deeply into performance management, understanding the roles of everyone on the org chart down to the level of receptionist. In doing so they identified sources of potential value creation. They went into personnel records and interviewed managers about employees and their career paths, trying to identify the real "difference makers" in the company. They identified who was really impacting our revenue—and the people whose retention was essential. They sought to understand how our national sales relationship structure worked and how deeply into the customer's and our own organization these relationships extended.

When the due diligence team left, there was little about each moving part of our business they didn't know and understand. Their exhaustive approach enabled them to make a fully informed bid that was almost double the investment bankers' expectations. Post-acquisition, the acquired company became the core of the buyer's national commercial leasing

Meet Keith continued

While at ITT, Keith led the due diligence and purchase of a division of Carrier Corp from United Technologies, and relocated to Syracuse NY to lead the enterprise. That business subsequently received internal recognition as Division of the Year from ITT management. Under Keith's guidance it tripled in size over 4 years. While at Textron, he replicated this success in acquiring and taking leadership responsibility for a division of Electrolux AB located in Columbus, OH.

At Conseco, he led the 2-year turnaround and subsequent sale of a large commercial leasing business to Wells Fargo for a $163 Million premium, double the amount anticipated by the parent. As a partner with Newport Board Group, Keith leverages his extensive Buy and Sell-side M&A experience to advise clients on due diligence and post-transaction integration of acquired companies.

Keith is a Six Sigma Black Belt, has an MBA from Washington University in St. Louis, and is a certified Executive Coach and Sales Trainer.

business and substantially enhanced their market share, operational capabilities and profitability. Over the next ten years, the business eventually became a significant contributor to the parent's results.

To be sure most PE and many Strategic buyers are not able to deploy this level of internal resources for due diligence. PE often lacks a strategic buyer's depth of knowledge of the target industry. Yet even within the limits of the PE model I believe that acquirers can dig deeper to validate the people, processes and culture that give a company its edge…. or may prove problematic in the future.

In contrast to this exhaustive approach to M&A due diligence, consider the following example of a superficial process. Several years ago, I was engaged to assist a PE firm with problems they were experiencing with a non-bank, commercial leasing company about six months after acquiring it. The business was 5 years old and was launched by former community bank leasing managers. The PE firm was trying to find the profitable growth that the founders hadn't been able to.

The PE firm's roots were in banking; the partners were confident they knew commercial leasing well enough to make an informed investment. They focused on the financial aspects of the company and how they could bring in additional capital to fund growth. They also believed their banking experience would be valuable for improving operations.

What the PE firm had missed in its due diligence was that, while bank commercial leasing is similar to non-bank commercial leasing in many respects, there are major differences in how they source and manage deals. All of this company's deal flow came from independent leasing brokers. Banks on the other hand don't generally rely on brokers, so the PE partners had no experience with them.

The non-bank leasing company I sold (mentioned previously) had an extensive track record with lease brokers, obtaining 20% of originations from them. Our assessment of portfolio performance by origination source revealed that "broker business" historically had a much higher default/loss rate than all other origination sources. In fact, broker lease performance was so bad that we had stopped accepting applications from 90% of them. On the PE engagement, I quickly recognized that the broker-dependent leasing company acquired by the PE firm had a business model designed to almost guarantee failure. A more complete due diligence led by an industry expert could have prevented this PE transaction from occurring.

Penny Wise, People Foolish

This expression refers to the tendency to overemphasize the financial side of due diligence. As acquirers have shifted their focus in recent years to smaller deals, they must evaluate management teams that often have less management experience or skill than was once the case. In smaller firms, the capabilities of owners/founders and their management teams tend to be mostly centered on the technical aspects of the business and its industry. They are generally less capable on functions like marketing or talent development.

One of the cornerstone philosophies of PE is: “Back the Jockey, Not the Horse.” Some acquirers, corporate as well as PE, tend to see the skills of the individual(s) currently leading the business as the equivalent of the company’s capabilities.

While there is no argument that effective management is essential, I take issue with the tendency of some acquirers to overweight this element of the purchase decision. Here’s why:

It relies heavily on the ability of the buyer to assess management in place, based on limited pre-acquisition exposure to them.

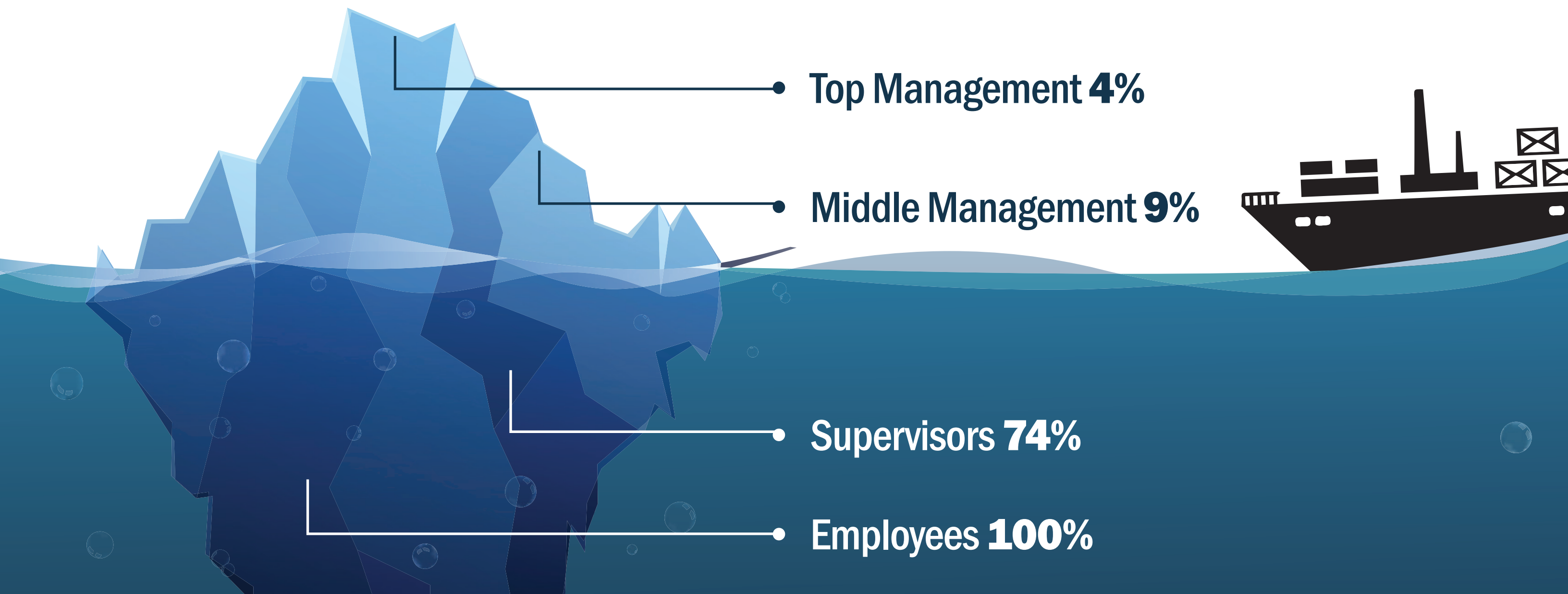
It also fails to recognize that current management will be engaged in 4 Alarm Crisis Management during and after the transition to new ownership. An acquirer must ask a hard question: has management done anything like this before?

Overconfidence in management is often the result of a subjective impression rather than an objective and disciplined assessment of their capabilities and the presence of an integration support system. Many buyers believe that everything that does not directly contribute to revenue growth is “just cost.”—and that future success can be driven almost entirely by the top team and its strategy… but can it?

Iceberg of Ignorance

Executive leadership has been proven to be an unreliable resource for developing comprehensive knowledge about the state of the company and its prospects. Researchers have identified this disconnect and visually described it as the “Iceberg of Ignorance”.

PERCENT OF PROBLEMS KNOWN



As a Six Sigma Black Belt, I learned by leading projects in various Textron divisions (Finance, Aerospace, Golf Products) that the leaders of a business can readily articulate the direction and results they want for the business. But it takes people who actually perform the work to understand issues, get at root causes and develop effective solutions. The Buyer Bias of evaluating a company based primarily on an assessment of its leadership team can be fatal. Large companies that do a lot of M&A typically institutionalize best practices in HR management and the customer experience. These best practices include robust communication systems such as employee opinion surveys and 360 degree reviews that are rarely done in smaller companies. They establish continuous feedback loops from customers and their own people. These practices inform a Wide Lens due diligence process that helps to explain why their acquisitions have a very high success rate.

The Rush to Change

A core philosophy of the PE playbook is the implementation of a "100 Day Plan" that reflects a "rush to change" immediately after the closing. Some corporate M&A personnel take a similar approach. This mindset is especially problematic because:

1

It assumes the buyer has captured wide and deep knowledge about the company, its industry strategy and internal operations during the due diligence process. This assumption is optimistic at best. In my experience integrating acquired businesses, we always encountered post-acquisition surprises, some positive and some negative, that impacted our management decision-making and strategies going forward. A "Ready-Fire-Aim" action bias leads to many problems that a more considered approach would avoid.

The financial-centric approach to due diligence leaves wide knowledge gaps that make immediately charging ahead with substantial operational changes akin to running into a burning building blindfolded. Every business has "Go-To People" (aka: A Players) at all levels that make the business run much more effectively than it would if left to the efforts and talents of the B and C Players. Most businesses have A Customers as well… the top 20% of customers that generate 80% of company results. These critical customers and employees aren't always identifiable by looking at sales reports and Org charts, but become obvious once you've been running the business for a few months. Early in the integration phase, they may be especially sensitive to actions by a new owner that fail to take their value to the business into account.

2

Perhaps most importantly, behavioral research has established that most employees at any acquired company aren't ready or capable of accepting change at the time of the acquisition. Management and the acquiring firm are excited and ready to go, but that enthusiasm never fully filters down the org chart. The reality is that many of the people in any company have a deep fear of change, and have already developed a myriad of worst case scenarios for their jobs, work relationships and livelihoods for when the new owners take over.

While the mindset in the boardroom is ready and enthusiastic for change, most of the workforce has already been traumatized by the uncertainty of the months-long sale process and is petrified by the idea of sweeping changes yet to come. This is a recipe for a major disconnect. The 100 Day Plan, as described below from a study by Grant Thornton, can be expected to be seen as a negative validation of the rank-and-file employees' worst fears:

"During the first 100 days, PE firms usually make changes to: financial operations and reporting systems, working capital lines, IT systems, supply chain and purchasing agreements. They are also looking carefully at cost-cutting measures, channel expansion, potential add-on acquisitions and expanding into new markets. During the first 100 days, it seems no stone is left unturned as PE firms seek to drive returns."

Coupling the almost universal "fear of change" mindset of the people doing the day-to-day work in the company with management's rush to implement 100 Day Plans can do serious damage to company performance. This is supported by a recent AON/Hewett study that found that employee disengagement increased by 23% after a change in ownership, and it took 3 years for engagement to return to pre-change levels. During the immediate post-acquisition period, when many employees become disengaged because they feel that their worst fears are being confirmed, management is relying on them to produce product, ship orders, deal with customers, etc.

THE M&A PLAYBOOK
Is it Time for a Refresh?

Here are several recommended strategies that offer the promise of better performance from acquired businesses:

Be Diligent About Due Diligence.

One of my early mentors when I started in commercial lending constantly repeated that "A loan well-made is half-collected." Today that's called "Know Your Customer." That's especially difficult when the acquirer's business model leaves little choice but to rely heavily on existing management. Finding ways to capture the core knowledge residing in lower levels of the company will pay off in many ways, resulting in a more effective transition that improves the odds of success. Experienced advisors can help deepen the knowledge base, and show how to help affected employees understand and accept the company's future and their place in it.

Back The Horse AND The Jockey

Take a close look at the management systems in place. People come and go, but a solid management system will produce capable successors ready to assume responsibility. Meet with people at all levels of the "Iceberg" to learn how individual and collective contributions are measured and recognized. Find out who the key players are at every level, value and learn to leverage their knowledge to keep the wheels turning during and after the transition.

"First, Do No Harm"

I believe that the worst time to make sweeping changes in an acquired company can be immediately after the deal closes. A more effective approach would be to convert the "100 Day Plan" to a "200 Day Plan," with the first 100 days spent discovering what was missed during due diligence, and reassuring the workforce that the sky is, in fact, NOT falling. An experienced operating executive from Newport Board Group engaged during the initial 100 days could accelerate the learning process and support the development and execution of a truly effective plan.

Practice Organizational Leadership, not just Financial Management.

Napoleon once said "Leaders are dealers in hope." Setting a vision for the future of the business that the management and staff can be positive about should be THE priority for the new owners. After closing one acquisition, my first Town Hall meeting with the entire group of tense, skeptical and scared employees didn't alleviate all their fears. But it did demonstrate that their new employer held the business and people in high regard, and we were committed to building on its past success. There was no 100 Day Plan, change was introduced gradually and communicated in terms of how it would benefit both the business AND the people who worked there. Results were that in the first full year as a new division, the business earned recognition as the top performer in our operating group. By the end of our third year we had tripled in size and increased operating earnings by 500%, with no loss of key employees or customers.

M&A—whether by PE and other financial investors or by strategic acquirers—is a proven and powerful technique for business growth and wealth creation. But as with any successful system, processes and approaches can become habits that live on past their ability to deliver value. I hope that the above perspectives are useful to all acquirers and to the businesses and people they have such a powerful impact on.

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