Pre-deal diligence drives PE profits

An earlier focus on performance improvement pays off.

kpmg.com

Introduction

The prolonged downturn in the private equity (PE) deal market has heightened the industry's focus on the urgency to create value. In 2023, U.S. deal value and volume fell 45 percent and 29 percent year over year, respectively.[1] Many PE firms today realize that they can't just cut costs, repackage, and retrade their assets in the market. Longer holding periods—which may rise from a 12-year high of 4.2 years to an average of 4.4 years by the end of 2024, according to PitchBook[2]—and higher costs of debt should turn deal makers' attention to something they may have overlooked: performance improvement initiatives to grow the business of their portfolio companies for a profitable outcome. Indeed, many PE executives tell KPMG that this is a top priority for portfolio companies.

At the same time, PE firms are sitting on plenty of capital—global PE dry powder stood at a record $2.59 trillion as of December 2023[3]—and watching for signs of a thaw in the deal market. Deal-making activity could pick up rapidly whenever the conditions become ripe again.

PE deal makers, however, know that money is no longer cheap. In a high-interest-rate environment, they will need to lean more into value creation to match the level of returns the ultra-accommodative interest rates of the past used to deliver. Prices of some potential targets may have fallen. Still, the deal market remains competitive, and the high cost of capital has heightened the importance of buyers having a clear roadmap to achieve the ultimate value realization they envision.

Value creation efforts in PE deals will pack more punch the earlier you implement them. Deeper diligence processes, particularly in the pre-deal phase, can help you identify and test key growth and cost considerations that underpin an investment thesis to make a go/no-go decision. In the KPMG 2024 M&A Survey, 52 percent of PE respondents said the current economic landscape has heightened the importance of diligence and risk assessment. And if the transaction is on, then sophisticated value creation plans—with not just the deal partner but also the operating partner behind the strategy—will allow you to implement granular action from the moment you pencil the deal. By starting the clock faster and bringing the value question to the fore early, everyone will be aligned on what to deliver and implementation can begin on Day 1.

[1] Source: "Better days ahead? M&A trends in private equity Q4'23," KPMG LLP, February 2024

[2] Source: Madeline Shi, "What PitchBook analysts predict for PE for 2024," PitchBook, January 8, 2024

[3] Source: Muhammad Hammad Asif and Annie Sabater, "Private equity firms face pressure as dry powder hits record $2.59 trillion," S&P Global Market Intelligence, December 13, 2023

Why focus on value creation in the pre-deal phase

Until recently, it was typical for PE firms to take advantage of low interest rates and load up on debt financing when acquiring targets to amplify their return on investment. They then focused on quickly taking out costs before reselling the asset within a couple of years to realize returns.

With much more expensive capital and extended holding periods, PE firms must approach value creation differently from the outset, emphasizing increasing operational efficiency and driving organic growth. Additionally, investment committees increasingly view the value creation plan as a critical input in the deal model for exit valuation and underwriting/financing. By training a performance improvement lens on the deal at the earliest phase, PE firms can secure a rapid understanding of the target and gain confidence in their key investment thesis. When valuations remain high, as in the current market, PE firms bidding for an asset will want to be thoroughly convinced about the sources of value. Knowing from the beginning exactly where and how performance improvement programs will be deployed will help ensure maximum value creation from the deal. It will also help prevent value leakage from the lack of a rigorous process and accountability—which 60 percent of PE executives in our survey said is key to ensuring value realization.

Pre-deal due diligence of a target can be deployed to rapidly evaluate the “size of the prize” or potential value opportunities. In a series of quick one-week assessments, this process can help PE firms understand and estimate the likely upside for EBITDA[4] improvement. It can also lead to the identification of critical risks associated with the investment, such as market volatility, competitive landscape, and operational challenges. PE firms can then leverage the analysis to negotiate favorable terms for debt financing of the deal—e.g., interest rates, covenants, and repayment schedules.

The evolving role of the operating partner

The operating partner plays a pivotal role in assessing value creation opportunities. Typically, operating partners get involved post-transaction to implement operational efficiencies, cost optimization, and growth initiatives to enhance the profitability of the acquired target. However, with a greater emphasis on value creation earlier in the deal cycle, the role of operating partners is evolving. Working in tandem with the deal team, they are taking a more proactive approach to evaluating value creation during pre-diligence and diligence, helping with ideation, target screening, and the honing of the deal strategy. Such early engagement of the operating partner in the deal cycle allows PE firms to align the investment thesis with diligence and rigorously test opportunities, paving the way for value creation from the outset of the deal cycle.

[4] Earnings before interest, taxes, depreciation, and amortization

Value capture strategies in the pre-deal phase

Early identification of value drivers allows PE firms to prioritize and plan for immediate action during the post-sign phase by crafting an overall roadmap with specific initiatives and detailed timelines (Exhibit 1).

Exhibit 1. Value capture roadmap for the pre-deal phase

Pre-deal phase

Client value

Size-of-the-prize assessment

Rapid value identification and positioning of business (outside in or with limited company data)

- Provides a view of the potential EBITDA upside view over and above synergy potential
- Focused on the big-rock value drivers, upside opportunities, and risks

Refining the size-of-the-prize assessment with management discussions

Increasing the accuracy of the assessment

- Assessments utilized by buyers to adjust EBITDA numbers in their investment thesis and deal model
- Alignment on support required for execution to drive identified value

Operational due diligence

Completion of the value creation diagnostic (savings and growth initiatives), in conjunction with your other customary due diligence activities (financial, tax diligence, etc)

Est. timing

3-5 days

1-2 weeks

3-4 weeks

This roadmap has two steps and should cover the following key activities:

01 Initial size-of-the-prize assessment

- **Rapid analysis of the target's data:** With key data inputs, quickly assess the following areas of potential value creation that can be achieved by seizing growth and cost opportunities:
  - **Financial profile and trends:** Develop a baseline of the trial balance and general ledger data to understand the target's financial trends, cost structure, and overall margin profile.
  - **Revenue analysis:** Analyze the sales database to understand key revenue drivers, customers, and products. Sample analysis may include customer and product profitability, product/service portfolio mix, price/volume impact, pricing analytics, etc.
  - **Cost structure:** Understand cost structure by exploring direct costs, overhead, and headcount. Sample analysis includes cost of goods sold (COGS)/overhead cost benchmarking, unit cost trends, cost pass-through, etc.
  - **Organizational analysis:** Evaluate the census to understand overall headcount, reporting structure, and organizational hygiene. Sample analysis includes spans and layers, headcount right-sizing, pay parity, the outsource/offshore mix, etc.
- **Benchmark analysis:** Compare the target's financial and operational KPIs[5] against the industry. Key areas for benchmarking may include EBITDA margins, COGS, operating expenses, headcount, working capital metrics, and growth metrics. Identify performance gaps where the target company lags behind peers and assess the potential for improvement.

02 Refining the size-of-the-prize assessment

- **Hypothesis development:** This involves identification and quantification of cost and revenue initiatives and alignment of quick-win opportunities and timing.
- **Discussion with management:** Present findings to the target's management to test hypotheses and refine estimates. The ensuing interaction is also an opportunity to evaluate management's capabilities to execute improvement efforts.

How pre-deal diligence can inform a go/no-go decision

Tasked with evaluating a PE client's potential acquisition in the media sector, the KPMG team's pre-deal diligence uncovered a pressing need for a major cost reduction program at the target company within days. The identified program, accompanied by a thorough roadmap of our recommended initiatives, necessitated a fundamental shift in the target's operating model and a rethink in our client's strategic direction. The need for a significant overhaul of the operating model, coupled with the associated high costs, called into question the deal's viability. Recognizing the magnitude of change required, the client reassessed the investment thesis and ultimately decided to walk away from the acquisition.

Our rapid "size-of-the-prize" pre-diligence efforts not only highlighted potential risks but also empowered the client to come to a data-driven decision. This case exemplifies the importance of targeted pre-deal diligence to make informed decisions that align with our client's overarching business objectives—thereby helping them to avoid potential pitfalls of a flawed acquisition.

[5] Key performance indicators

By getting into the deal cycle very early and following such a roadmap, the PE firm can have much higher confidence that it has the crucial elements of a successful transaction:

Short- to medium-term benefits

- **Data-based quick reality check:** Earlier diligence will help provide structure to your initial thoughts about the deal and a targeted view of the biggest sources of value to move forward with greater confidence.
- **Mitigation of investment risks:** A proactive approach to value creation can help to mitigate risks associated with the investment. Addressing identified risks early in the transaction can minimize the risk of unexpected issues arising post-acquisition.

The clock for capturing value starts the minute you ink the deal. These findings can directly inform and serve as the foundation for your value creation plan that can be activated on Day 1:

Long-term benefits

- **Higher potential investment returns:** By identifying key areas for value creation, you can develop a more comprehensive investment thesis, enabling the team to maximize the transaction's value and increase potential returns.
- **Improved exit process:** Value creation initiatives can enhance the target company's overall performance and position in the market, making it more attractive to potential acquirers during the exit process.

The PE deal maker's world is struggling with a frustrating combination of higher cost of capital and longer holding periods. In this challenging environment, approach value creation differently from the outset by emphasizing increasing operational efficiency and driving organic growth. For that, we believe deal teams and operating partners must collaborate to drive value discussions earlier and faster. Value-based evaluations must start in the pre-due diligence phase to maximize value creation opportunities.

Transformative acquisitions through pre-deal diligence

A client was considering an acquisition in the environmental solutions sector worth more than $500 million. Prior to the deal, they called in the KPMG pre-diligence team to help uncover value creation opportunities that could be used as a critical input in the underwriting model. We identified opportunities worth over $30 million, which not only shaped the investment thesis but also became a cornerstone of the client's acquisition strategy.

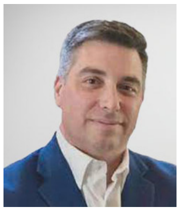
We also crafted a post-close turnaround program, identifying location-specific opportunities, and led the implementation of the value creation initiatives covering operations, transportation, procurement, and revenue management. These strategic initiatives forecasted an EBITDA improvement of 290 percent in just three years. This case clearly showed that the value creation assessment in the pre-diligence phase can shape the investment thesis and help set the stage for a successful turnaround program.

How KPMG can help

KPMG understands the unique requirements of PE and helps our clients overcome deal obstacles by taking a truly integrated approach to deliver value. Our dedicated PE team serves as your trusted specialists through the entire deal lifecycle and provides an integrated set of solutions from the pre-deal diligence phase to post-close holding period to potential sale/exit:

- **Industry and functional knowledge:** Our deep industry experience spans multiple sectors, allowing us to provide you with industry-specific insights and actionable strategies. In addition, our functional specialty across the enterprise enables us to offer a thorough and holistic approach to value creation, considering the unique challenges and opportunities of your industry. Leveraging this knowledge, we identify growth drivers and operational efficiencies, developing a tailored value creation plan that is firmly rooted in the specific industry dynamics.
- **Data-driven insights:** In the pre-deal diligence phase, our data analytics capabilities empower us to sift through vast datasets and uncover hidden opportunities and risks, enabling data-driven decision-making. We leverage our proprietary intelligence platform, which combines extensive data sources, market-leading technology, and data analytics experience, to deliver rapid analysis and insights. On a landscape where speed and precision are paramount, our deal-speed insights help you stay ahead in a competitive environment and quickly understand value creation opportunities.
- **Purpose-built accelerators:** We have pre-built tools based on our previous experiences that support our PE professionals to undertake cogent and relevant analysis rapidly.
- **Wide-ranging ability to execute deals:** We are a one-stop shop that brings together strategy, consulting, and tax professionals to support your entire deal process.

Authors



Adam Pollak

National Practice Leader, Performance Improvement, KPMG Strategy U.S.

Adam is a senior leadership executive who helps companies deliver increased profitability through business and operational transformation. He has close to 30 years of experience in developing and managing high-impact programs for companies across a wide range of industries spanning operational diligence, merger/integration, carve-out/divestiture, enterprise-wide transformation, and turnaround situations. He has extensive experience in leading complex programs focused on top-line growth and sustainable cost realignment involving such topics as product G&A cost optimization, development/R&D optimization, third-party spend reduction, general labor productivity, technology strategy, and digital transformation.

Richard Chen

Principal, Advisory

Richard is a Strategy principal and leads KPMG Strategy's U.S. PE team. He has over 20 years of industry and consulting experience with multinational clients in energy and industrials. Richard is a collaborative, pragmatic and results-oriented strategy and operations professional with large-scale transformation, sales and marketing, technology, and change management experience. His client projects focus on sales and pricing capabilities, cost reduction, and driving improvements to deliver sustainable operating and financial benefits.

We would like to thank our contributors:

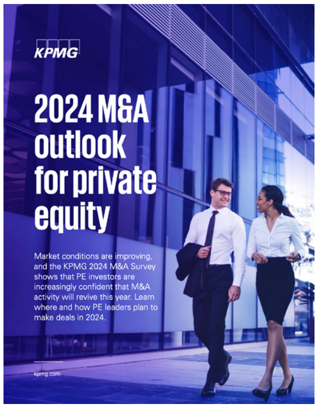
Venkatadri Sreenivasen, Adeel Hasan, Michael Gelfand, Jeff Potter, Charles Lee, and Whitney La Bounty

For more information, contact us:

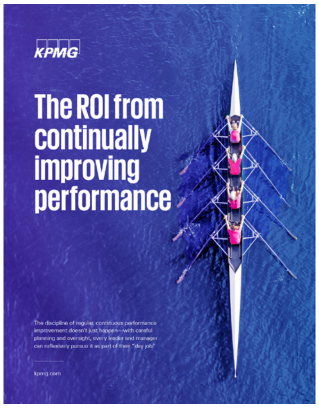
Adam Pollak
Principal
Deal Advisory & Strategy
586-337-6992
apollak@kpmg.com

Richard Chen
Principal
Deal Advisory & Strategy
415-706-0042
richardchen@kpmg.com

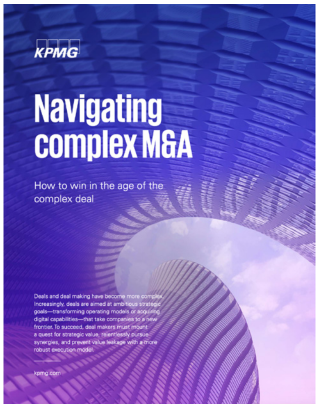
Related thought leadership:



2024 M&A outlook for private equity



The ROI from continually improving performance



Navigating complex M&A

Some or all of the services described herein may not be permissible for KPMG audit clients and their affiliates or related entities.

Please visit us: | kpmg.com | Subscribe