PE has begun to reimagine the diligence process

An overview of recent changes

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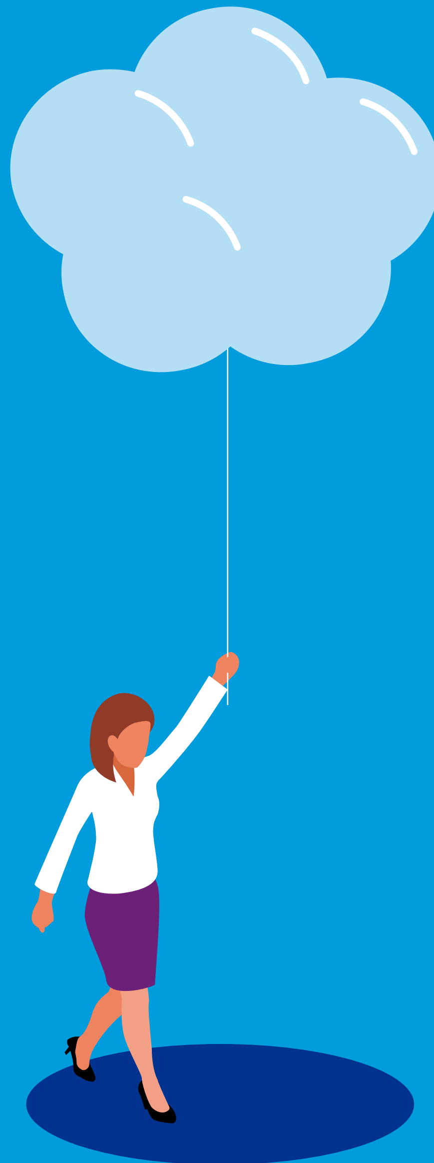
Competitive pressures are encouraging leading PE funds to reassess their M&A processes. KPMG professionals consider the reasons behind this and give an overview of the main market trends.



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PE houses shift focus to operational improvement

The PE landscape has changed dramatically over the past decade. In 2016, European PE deal values reached their second highest point since 2007, a total of €342bn ($389bn) across 2,746 deals. European PE EBITDA multiples ended the year at their highest median levels (8.4x) since Q3 2007, a trend also reflected in increased revenue multiples[1].

The need to maintain competitive advantage and to minimize risk in an increasingly crowded and high-priced market is forcing PE houses to re-think how they drive value. The result: their focus is shifting from leverage and multiple arbitrage to operational improvement. Where operational value accounted for just 18 percent of value in 1980, it soared to two-thirds of value by 2010[2].

The question KPMG professionals are frequently being asked is: how are pioneering PE houses moving from concentrating on financial engineering to delivering value through operational improvements?

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[1] Pitchbook Global PE Deal Mutliples Report: III

[2] INSEAD Report *'The value of in-house operations teams in private equity firms'*, Financial Times, May 2015

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Diligence of prospects

Recent discussions with our main PE clients reveal that analysis of the past is no longer enough. They want comfort on a positive future for the business – to identify the longer-term potential and operational upsides of assets. They have in mind a target exit value and use the diligence process as a platform to assess and prepare for value creation.

From the origination stage, many forward-looking houses are assessing potential upsides and working out how to deliver them. Investment theses at these leading houses have taken a giant leap forward, while in-house operations teams are growing and spending more and more time on upfront diligence.

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Disruptive technology

This gaze into the future can now take advantage of big data combined with deep functional and sector expertise to predict winning and losing assets. With the spotlight on value, it identifies bankable revenue, cost and cash uplifts, together with potential shifts in business models that could significantly shift the exit multiples.

Areas in which technology is changing the nature of diligence include:

— Rapid assessments of value upside: these can be carried out in 2-3 days post-IM stage rather than in weeks or even months

— Specific financial and operational benchmarking is now being used earlier and more frequently in the diligence process

— A deep mine of the most detailed available management information, including transactional level data, can review customer and product profitability and pricing

KPMG professionals have seen a number of processes using big data techniques that give incumbent management teams a unique view of their own data. The effect of big data promises to be extraordinary as buyers demand more and more access to company information to cut in multiple ways, and sellers are obliged to use this in advance to be ready and to drive their own story.

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Assessing management

It is not only a target's numbers that are being analyzed: now its people are too. Many leading houses are carrying out due diligence on the management teams using a variety of tools and technologies.

There is a growing realization that the incumbents may not always be the best team to take the business forward and that the fiery talent –the 'doers'- may sit deeper in the organization. Increasingly PE firms set out to find and develop the best possible management team, sometimes by bringing in outsiders to the sector or by elevating talent from within to drive change and value on a deal.

Emergence of the 1000-day plan

Post-completion, implementation of activities is also undergoing a radical transformation. The 100-day plan is on its way out, being replaced by the 1000-day or value creation plan. This plan focuses on long-term cementing of value from investment to exit, and is enacted from day one.

Why the change? Received wisdom has been that 60 percent of upsides are delivered in year one when a 100-day plan is in place.

However, KPMG analysis of a sample of recent deals suggests this number to be just over 23 percent when weighted by total upside value[1]. Only when a 1000-day period is reviewed can somewhere much closer to 100 percent of value be delivered.

Rapid cost reduction has its place for quick wins, but no longer forms a core part of the investment thesis. Longer term, sustainable improvements are now the order of the day – customer, product and channel growth, cash flow enhancement and sustainable transformations to cost base form the backbone of the 1000-day plan.

Leading houses no longer want reams of management information on costs. They are looking for shorter, succinct management information focusing on priority value levers, often incorporating the non-financial KPIs and benchmarks used during the diligence phase.

[1] Sample of KPMG in the UK reports in 2015-16

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Adapting to the new environment

The number of easily-available assets from which to drive value has diminished and multiples have increased. Leading houses which adopt a seamless view of value from origination, through investment and implementation, to exit, can be expected to continue to drive good returns.

The key to achieving this is to focus on operational improvement. This involves conducting diligence over the future; using technology; assessing management; looking beyond the traditional 100-day plan to a three-year view. PE houses that do this will be successful in their industry.

Diligence of prospects

PE houses typically ran the management case with a few 'hopeful' upsides. Now, the best operators look for a transformational thesis with five to six properly diligenced levers. This is one of the keys to success.

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