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Differentiated diligence after COVID-19

How advanced diligence in an uncertain market can lead to outsized investment returns

It is hard to determine how the recovery from COVID-19 will play out or how long and deep the recession will be. We do know that M&A will revive and, if the last recession is a guide, top PE buyers have an opportunity to generate outsized returns. But it will take innovative and intensive due diligence. Here are six essentials for differentiated diligence in a post COVID-19 M&A market.

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Introduction

COVID-19 brought much of the global economy to a halt, drastically reducing revenues, wiping out profits, and setting off a scramble to shore up liquidity. Private equity investment teams have pivoted away from M&A to focus on stabilizing their portfolio companies and preparing them for an impending recession.

But the shutdown is beginning to loosen and PE players will start assessing the landscape again, hoping for the kinds of returns that the smartest investors realized by placing bets early in the recovery from the 2008-09 recession. Like last time, when M&A restarts, the choices are likely to be limited and most assets will be troubled—nobody wants to sell at the bottom if they don't have to.

Complicating the challenge is the unprecedented nature of the COVID-19 recession. Nobody has seen such a sudden seizing up of the economy. Nobody has seen such a rapid rise in unemployment. All the normal metrics buyers use to vet an asset—macroeconomic factors, market growth, competitive landscape, growth drivers, etc.—are suddenly out of date or unreliable. Nobody knows how long and deep the recession will be. Or how customer behavior may permanently change.

This is why using sophisticated data analytics and probing beyond standard metrics of value—differentiated due diligence—is more important than ever. Even when the M&A market was at its cyclical peak, it was clear that the traditional tools used by many due diligence teams were no longer adequate. To identify value—and justify heady multiples—smart buyers knew that they had to get behind the numbers, develop original market insights, and understand the strengths and weaknesses of a target's operating model.

In this paper, we share six essential tactics for successful due diligence in a post COVID-19 world. Using these proven approaches, PE investors may have a better chance of finding true value in the assets that will come to market in the next year or two—and capturing the outsized returns that top-performing funds reaped coming out of the last recession.

Lessons from the past

As PE firms contemplate the restart of the economy and prepare to re-enter the deal market, it helps to draw some lessons from the 2008-09 recession. As the following infographic shows, PE investors can expect a transformation in the M&A landscape that will provide extraordinary opportunities for investors who can see the value among the messy, distressed assets that come to market. In fact, our research from the 2008-09 recession indicates that the performance gap between median and top- quartile funds was twice as large for funds launched during the recession vs. pre-recession funds.

What made the difference? Differentiated diligence. We have seen increasing differentiation in returns between PE funds using typical diligence and what best-in-class PE funds earn. We expect differentiated diligence to put even more distance between top performers and the rest of the pack in this cycle due to the complexity of the post-COVID environment.

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The US, for example, coming out of the global financial crisis saw:

Fewer deals…

46% fewer

deals in PE between 2007 and 2009

…that were smaller…

PE deals over $500m were **down 16 p.p.** between 2007 and 2009

…more distressed…

Bankruptcies increased by **+314%** between 2007 and 2009

…and sold at lower multiples…

Median **EBITDA multiples** were down **-34%** between 2008 and 2009

…with reduced debt leverage ratios

PE **leverage** fell by **-54%** between 2008 and 2009

Corporates also pulled back on acquisitions…

25% fewer

strategic M&A deals between 2007 and 2009

…and divested non-core assets to free up capital

150% more

spin-off deals between 2006 and 2008

Based on this experience and the current economic situation, we expect

More troubled assets and 'messier' deal processes

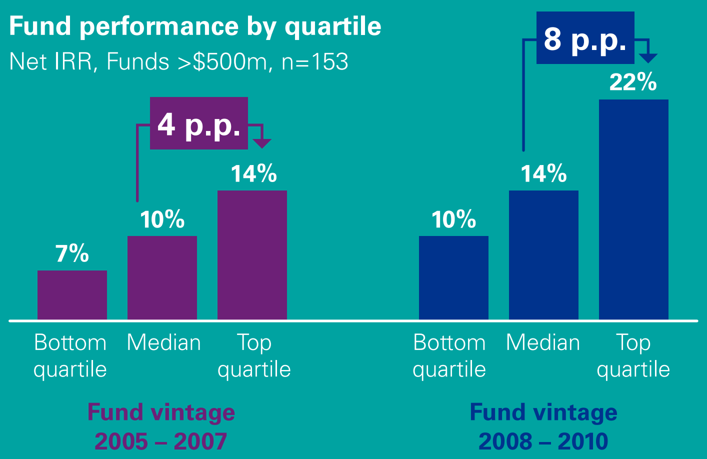
Higher noise in historical performance

Less certainty on future performance

Funds that can navigate the challenges we saw in 2008-09 and the nuances we expect this time will be able to separate from the pack and realize outsized returns

Fund performance by quartile

Net IRR, Funds >$500m, n=153



2x the gap

Between top performing and median funds in uncertain economic times

Reading the signals this time

Lessons from the global financial crisis are certainly instructive, but the coming months and years may take on a shape of their own.

More troubled assets and 'messier' deal processes

As in the last recession, high-performing companies with strong balance sheets may wait for valuations to stabilize before looking to invest. As these sellers sit on the sidelines, we expect the deal mix to shift towards turnaround cases, complex carve outs, take-privates, bankruptcy buyouts, and smaller, messier deals for distressed companies. In the previous recession, bankruptcy filings tripled. Given the severe strains on liquidity due to the COVID-19 lockdown, we would expect even more this time. Together, these trends will likely lead to more complex deal processes involving higher risk assets.

More difficulty separating signals from noise in performance data

The COVID-19 lockdown may create extremely noisy financial and operational data for at least the first half of 2020. CARES Act funding, employee furloughs, temporary pay reductions, short-term supplier discounts, rent deferment and abatement, delayed customer payments, customer churn, postponed or cancelled capital expenditures, and a host of other one-time, non-recurring anomalies could significantly mask underlying performance trends. Some companies will look entirely different as a result of restructurings and other measures taken to survive economic disruption. It may take a step-change in diligence to develop a clear picture of performance before, during and after the lockdown.

Less certainty on future performance

Future earnings will likely be more difficult to predict. The impact of the lockdown will continue to be uneven—across geographies, sectors, and companies. Some industries may be able to bounce back quickly. But, after months of inactivity, some industries may face a slow restart. Manufacturers could struggle to re-engage supply lines and many retailers may experience a delayed return of foot traffic—or new, lower traffic norms. Much of what we know about sector performance may need to be revised and continually updated as the recession unfolds. Deal teams will need to navigate this landscape and build conviction on the forward-looking potential of an asset within competitive processes and tight deal time lines.

Six ways to win with differentiated diligence after COVID-19

For many years, we have worked with deal makers to conduct differentiated diligence. These players long ago recognized that by relying solely on standard diligence practices, they had overlooked significant opportunities for value creation and missed the hidden obstacles to value realization. But by using advanced, data-driven diligence methods, these investors developed insights into markets, strategies and operating models that could not be derived from reported numbers, interviews or published research. This is how they have outperformed the market.

Below, we share six battle-tested elements for differentiated diligence as well as stories from these best-in-class players that illustrate how these approaches pay off. These six methods rely on our proprietary data tools and deeply industry focused deal professionals, and they have been used in the toughest situations over the past several years. We believe their application in today's environment can help provide the critical edge.

Six differentiated diligence elements for post-COVID M&A

1	**Real-time market intelligence**	Combine real-time market data sets to develop a nuanced understanding of the target company's "right to win" in a newly defined market landscape
2	**Deep target analytics: moving beyond the trial-balance**	Separate signal from noise by using transaction-level data to build a more granular view of underlying business performance
3	**Dynamic financial scenarios**	Adopt a more flexible set of input assumptions, scenarios, and predictive models to drive a range of 'what if's' in an uncertain recovery environment
4	**Operating model preparedness**	Evaluate whether an asset's infrastructure, capability, and available resources are sufficient to execute on a given investment thesis
5	**Digital readiness**	Assess an asset's technology and infrastructure for its strategic, revenue-enabling capabilities, rather than viewing IT as a back-office cost center
6	**Value-creation roadmap**	Develop a robust implementation plan in diligence that connects the financial ambition defined in the investment thesis with the operational plan required to execute post close

1 Real-time market intelligence

Traditional approach	**Differentiated diligence**
— Industry reports — Historical CAGRs — Expert interviews	— Location/channel-specific data points (e.g. foot traffic, cell phone tracking, POS data) — Real-time indicators & proxies (e.g. online reviews, web traffic patterns)

Suddenly virtually any industry projections made before COVID-19 seem irrelevant. Standard reports can't tell you what will happen in a given market in the next 12 to 18 months. Now, more than ever, commercial due diligence needs to evolve from the typical playbook of industry reports and expert interviews, to real-time data. That will be the only way to understand what is currently going on in the market and how well (or poorly) an asset is positioned. The new reality is yet to be determined, and closely monitoring supply and demand trends can inform a more robust picture of an asset's landscape in real time. As the examples here show, using various kinds of data buyers can develop original insights, such as:

- How well has a restaurant chain pivoted to take-out or delivery vs. its competitors?
- How quickly has a retailer ramped up its e-commerce capabilities—and what are its competitors doing?
- What is the prognosis for recovery in a specific sub sector?

It is possible to mine data from cellphone pings, credit card swipes, social media posts, job changes posted on professional networking sites, building permits, product reviews, search engine analytics and a myriad of sector-specific data sources. Analyzing these data streams can help build a nuanced understanding of a business in real-time and will be particularly useful in this environment of disruptive and rapid changes in markets and industries.

Stories from the field
Pre-COVID case examples that are more relevant post-COVID

Online review volume highlights product offering gap

By web-scraping more than 50,000 online reviews for a niche e-commerce company and its competitors, the deal team found that review volume was highly correlated with revenue at the product level.

The competitor's review volume (and, by proxy, market share) had grown at more than twice the pace of the target, which was traced to a specific set of new SKUs offered by the competitor and not the target.

As a result of these findings, the target went on to offer these specific SKUs in their portfolio to rapidly address a product gap representing 5 percent of revenue.

Stories from the field
Pre-COVID case examples that are more relevant post-COVID

Enhanced intelligence reveals customer loyalty and competitor incursion risk

To enhance the investment thesis of a PE considering a quick-serve restaurant chain, we used real-time intelligence to better understand the company's competitive positioning.

The deal team analyzed more than 10 million cell tower pings, geo-spatial characteristics of 1.5 million consumers, 2,000 stores across 19 QSR chains, and order-level financial data, and learned that the asset had twice the loyalty of competitors.

Similarly, we quantified the competitive incursion risk of the asset's six major peers, noting that a specific competitor incursion resulted in a 5 percent drop in same-store-sales for the next twelve months at a given store. This gave the buyer a better understanding of who the asset's real competitors were, and how exposed the target was to incursion.

2 Deep Target analytics: moving beyond the trial-balance

Traditional approach
— Historical P&Ls
— Trial balance granularity
— Trends / seasonality
— Top 20 customers / suppliers

Differentiated diligence
— Transaction-level data across customer, supplier, freight, marketing, channel, etc.
— Granular view of drivers beyond top-line seasonality (e.g. unit economics, channel mix, new-lost-existing, etc.)

Before COVID-19, the most sophisticated private equity firms knew to dig deep and see what goes on beneath the trial balance. In every P&L category they look through the target into its customers and suppliers in order to assess the strength and stability of each. This can better isolate underlying drivers of P&L trends, build confidence about cash flows, and quantify risk. In this environment, with so many anomalies, one-time events, changes in the business, restructurings, and other noise, this robust understanding of financial strength is critical.

As PE firms contemplate deals now, they should dive into transaction-level detail across all areas of the business. In the diligence process, analysis at this level of depth can answer questions about:

— Supplier payments – What was invoiced and what was paid? In which department and how frequently? Which pricing terms changed?

— Freight and logistics – What was shipped—from where, to whom, by whom, when?

— Marketing touches – What interaction, from which campaign, elicited the best responses, and at what cost?

— Inventory management – Which products are turning, in which locations, to support what product or customer?

— Customer health and expansion – Who is at risk and who is growing? Why? What is the impact of contract revisions?

— Pricing power – What pricing levers, by SKU, customer segment, or geography, can lead to incremental revenue?

— Pipeline strength – What prospects look most likely to convert? What is the historical conversion trend and how will it change post COVID-19?

— Channel mix – Where are sales expanding or contracting? What drives these shifts?

By isolating transaction-level trends, savvy buyers can better understand unit economics and the underlying drivers of current performance—and develop a more informed view of future cash flows. This can give investors greater conviction on their thesis in this uncertain economic environment.

Stories from the field
Pre-COVID case examples that are more relevant post-COVID

A granular network optimization model reduced consolidated platform costs by 15 percent

A private jet company aggressively pursuing scale via both acquisition and organic growth needed to better understand profitability per trip and the potential gaps in its expanding network.

Aggregating transaction-level detail across the expanded fleet and developing a 'per-trip' allocation methodology highlighted opportunities to optimize flight fulfillment and planning, reduce operating costs, and in-source maintenance operations between the two companies.

For the new consolidated platform, these findings drove a cost reduction opportunity of 15 percent of the combined cost base of the company.

3 Dynamic financial scenarios

Traditional approach

— Base / upside / downside
— High-level growth and cost assumptions
— Flexibility built into deal models, but limited dynamic modeling of the various inputs that drive the deal model

Differentiated diligence

— A range of 'what if' scenario capabilities, tailored to each aspect of the value chain (e.g. network optimization, ramp scenarios, etc.)
— Predictive modeling for COVID recovery and expansion

Deal models traditionally include a base, upside and downside case for a particular company. While that framework likely will not change, sophisticated investors will need to significantly enhance the robustness of assumptions, granularity of inputs and sensitivity capabilities.

In many industries, the downside story has already been written. COVID has created an unprecedented loss in demand, and buyers are now looking to size a range of upside recovery scenarios. In this uncertain environment, feeding the model with inputs that better capture uncertainty and a range of likely outcomes can make or break investment decisions. Advanced inputs such as real-time market intelligence and transaction-level data can inform these scenarios. The analytics need to be built with this extreme flexibility to account for a range of scenarios:

— What if the target loses a key customer?

— What if the cost of underlying commodities change?

— Can the company boost share in a segment by re-allocating marketing spend? How much would be needed?

— Which element of working capital is most flexible?

— What does our cash flow forecast look like? What if the company changes channel or product mix?

— What are the opportunities to grow revenue in a down market in this industry? What would enable that?

Each input will need a toggle, a likely distribution across a range of scenarios, and a story to support a dynamic investment thesis. The greater the investment in scenario planning and the more possible outcomes modeled, the greater the buyer's confidence can be that diligence has not overlooked any potential sources of value or value leaks. Scenario planning is equally valuable for the deal theses it validates and those it eliminates. Predictive modeling further enhances the need to incorporate a range of potential scenarios.

Stories from the field
Pre-COVID case examples that are more relevant post-COVID

Machine learning-based predictive modeling convinces buyer to pass

A child care business that was being sold incorporated a significant amount of pro forma adjustments to account for the expected ramp of greenfield locations. To calculate the pro forma adjustment, the target had applied the historical ramp curve and the average revenue for mature locations.

To test this assumption, the buyer's team developed a machine learning model to assess the impact of site-specific variables and the psychographic and competitive profile of each new trade area. When this model was applied, the locations were found to be under-indexed on important variables such as the proximity to elementary schools and parents with college degrees in the trade area. Based on this analysis, the buyer discounted the pro forma adjustments proposed by the seller and passed on the deal with confidence.

4 Operating model preparedness

Traditional approach
- Peer benchmarks
- Pre- and post- management presentation dinners
- Desk-based analysis
- Post-diligence assessment of the operating model by operating partners or advisors"

Differentiated diligence
- Nuanced understanding of operational processes, scalability, and implementation risks
- Operational interviews, stress-tests, and granular modeling
- Operational experience (internal operating partners and/or external advisors) engaged in diligence

Diligence has historically focused on the quantification of upside potential, but usually with a limited focus on how an asset's operating model enables—or prevents—value creation. In order to drive post-deal performance improvement, a business should have a strong management team, the appetite for change, the proper enabling technology, and more broadly, a sufficient and scalable operating model. We expect that this will be especially true in the post-COVID environment. If this capacity does not exist, this risk needs to be red-flagged and required investment quantified. With businesses reducing costs to manage through COVID, ensuring the business has an appropriate operating model to support future growth will be even more critical.

Data analytics can help uncover value opportunities, but management still needs to execute. The best insight in the world won't help if the management team lacks the capabilities to turn the insights into strategy and business plans. This may require a significant business transformation, the requirements of which (including leadership talent) need to be fed into the deal model as additional investment. Operating model preparedness evaluation can highlight gaps in management experience, functional capabilities, and supporting infrastructure.

The unsettled economic situation highlights a need for greater operating model flexibility across all sectors. As the economy rebounds, can the asset's operating model scale back up, and if there are stops and starts along the way, is the business nimble enough to react?

In the coming years, we can expect deal flow to be made up of distressed assets and carve-outs by corporations that need to refocus on their core. To make these deals work, PE players will have to consider "cost to achieve" and "time to realize" more carefully and more realistically. This will drive the need for a deeper understanding of operating model strengths and weaknesses as a critical part of diligence.

Stories from the field
Pre-COVID case examples that are more relevant post-COVID

Operating model diligence suggests an outsized investment requirement

A robust review of a growth-by-acquisition veterinary hospital aggregator suggested significant risks to its decentralized approach to integration.

Its business plan required doubling annual acquisition volume to scale to 300 hospital units. However, it had historically not integrated or centralized any back-office or support functions, which led to post-acquisition EBITDA erosion averaging 240 basis points. Significant operating model improvement would be required to achieve its growth ambition and maintain its margin position.

As a result of this investigation, the deal team incorporated $2 million per year of costs-to-achieve across nine operating model initiatives and an extended three-year transformation timeline to better protect against downside.

5 Digital readiness

Traditional approach	**Differentiated diligence**
— Standard back office diligence (e.g. core ERP assessment, deferred capex analysis, infrastructure review) — Risk-focused exercise	— Strategic technology diligence to uncover risks and opportunities to drive revenue, business productivity or customer acquisition through digital channels

One thing we do know from COVID-19 is that it is accelerating the adoption of all things digital. With stores shuttered, retailers are racing to build up e-commerce capabilities. Companies of all kinds have to accommodate remote workforces and must rely on digital connections with customers, employees and suppliers.

Traditionally, technology diligence has looked at data centers, core application lists, and perhaps system architecture. This exercise highlighted savings or investments and capital requirements. But due diligence today must also take into account how well technology platforms and systems support the company's strategy and enable revenue.

— How well does a retailer's website support an omni-channel shopping experience?

— Is this industrial company using data analytics as well as its competitors to identify the best sales leads?

— How is the company using technology to engage with the workforce?

— Does the business have the appropriate cyber security controls in place to mitigate risk?

— Are the software products and platforms used by the target the most competitive—and are they likely to remain so?

Although IT due diligence has evolved in the past several years, the accelerating digitization of business now indicates the need for a step change in technology diligence. The back-office diagnosis will still be important, but savvy investors will want to understand a business's broader digital strategy—not as a cost center, but as a revenue-driver and a differentiator.

6 Value-creation roadmap

Traditional approach
- Value levers quantified and modeled
- C-suite level plans
- Limited 100-day plans

Differentiated diligence
- Roadmap developed during diligence; transformation benefits, costs and time horizon fed into the deal model
- Operating partner and specialist involvement in diligence
- Road-mapping through diligence to highlight execution considerations (e.g. one-time costs, TSAs, etc.)

In this environment, we can expect many distressed assets to come to market with 'transformational' investment theses. To make these deals work, linking diligence to execution will be more important than ever. This must begin during the early phases of diligence.

Enlisting operational specialists from the beginning is key. These subject matter professionals can cut down on what is lost in translation between pre-transaction diligence and post-close integration. We have seen acquisitions stall in their first several years because value creation takes longer than expected and requires more effort and expense than anticipated during diligence. Often, value erosion occurs when the roadmap is not well-defined, unspecific, and fails to include robust post-close metrics.

The specialists will ask the difficult questions and can help identify execution nuances that a deal team might miss. For example:

- What people, process and technology is required to execute against the investment thesis?
- Are the transition-support agreements sufficient?
- What are the disentanglement requirements, timelines, and associated risks?
- Are stand-alone costs modeled at the right level of depth?

Asking and answering these questions will protect against downside surprises and give investors a more accurate sense of what they are signing up for. Being explicit about all the costs and obstacles, as well as the upside, will help the team execute effectively.

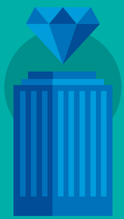
Stories from the field
Pre-COVID case examples that are more relevant post-COVID

'Walking the plant floor' in diligence to drive Day 1 execution

A PE firm looking at a global beauty products manufacturer hypothesized significant upside value in improving profitability at its plants. The deal team assembled a group of subject-matter specialists to visit each of their six sites on three continents.

The specialists identified opportunities to reconfigure manufacturing lines and improve layouts. They also assessed equipment quality. From there, the deal team worked with management and PE owner to develop a transformation roadmap for plant-level improvements across all locations. Detailed planning in diligence enabled immediate post-close execution with alignment across all stakeholders.

How sellers win with differentiated diligence



In a downturn, buyers will assume that any asset that comes to market is troubled in some sense. Valuations and deal volume are both expected to be depressed for some time and buyers are likely to be more aggressive in dissecting an asset's performance.

Sellers will want to do everything they can to position a asset for a successful sale—and demonstrate why, unlike other businesses on the market, theirs is truly a "diamond in the rough."

Using the approaches described in this paper, sellers have effectively prepared their assets for sale and achieved the full value potential in an efficient process. By showing their understanding of market dynamics, drivers of performance, upside scenarios, operating capabilities, etc.—all supported by both internal company and external market data—sellers can go on the offensive. When they demonstrate a nuanced understanding of the landscape, upside scenarios, and a roadmap to increasing value, sellers can pre-empt buy-side probes and build confidence in the deal process.

Stories from the field
Pre-COVID case examples that are more relevant post-COVID

Robust sell-side assessment boosts sales price by $1 billion

A seller wanted to assess targeted performance improvement opportunities to prepare a software platform for sale. To understand the possibilities, the team looked at transaction-level data to derive details about the customer base, vendor spend, and marketing efforts.

The deal team worked with management to define the value-creation roadmap and document progress to-date across each initiative.

The corresponding upside case of over $40 million was incorporated into the buyer's bid and pushed the multiple up to 25x EBITDA—a $1 billion gain.

Get ready to win

Dealmaking just got a whole lot more complex for PE players. With so much noise in performance data, getting a fix on value is far more challenging. And the distressed nature of the assets that will come to market adds to the challenge of discovering true value. On top of this, PE firms have been sitting on dry powder, waiting for this moment—so competition for the best assets will remain intense.

This is why a differentiated diligence process is essential. PE players will need to probe more deeply, use data analytics to develop original insights, and understand the asset as well—or better—than the seller. And they will need to do all this at deal speed to win.

We believe that the six approaches to differentiated diligence that we describe in this paper—used in a coordinated, integrated way that doesn't compromise deal timelines—can give PE players the edge in what promises to be a very challenging M&A environment. This will enable players to widen the performance gap vs. the pack.

How KPMG can help

Through all M&A cycles, KPMG helps private equity investors enhance value and returns. Our wide-ranging M&A services start with deal strategy (market intelligence, target identification, and portfolio analysis) and continue through evaluation, negotiation, due diligence, post-close integration and value-creation and exit.

KPMG member firms serve clients with fully integrated, multi-disciplinary teams that operate as a single, cohesive deal advisor. This enables smooth orchestration of deal activities across multiple functions. Our teams use advanced data analytics to generate unique insights into companies and markets. Our investments in advanced analytics, deal-specific proprietary technology, and unique data sets help us deliver these insights at deal speed.

In addition to market-leading tools and capabilities, our PE practice brings a deep bench of PE dedicated deal practitioners. They bring deep industry and functional knowledge and enable KPMG professionals to support clients through all phases of the deal cycle, including the performance-improvement measures that help realize value. Our integrated value delivery model provides a structured method for post-merger value capture.

A different approach to Private Equity…

Uncovering exceptional value for our clients
As a trusted advisor, we invest considerable effort to understand our clients' priorities.

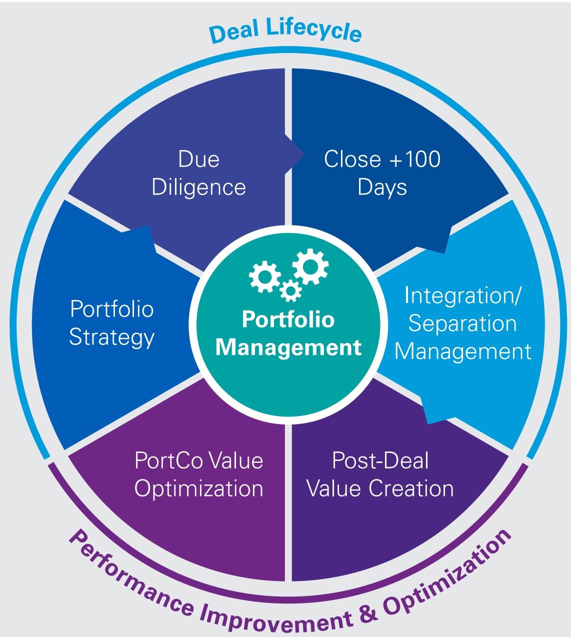
Bringing experience that matters
Our hand-selected, experienced team brings the right mix of PE, industry and functional capabilities to serve as thought collaborators.

Generating insights at deal speed
We have heavily invested in developing proprietary tools and methodologies that provide detailed diagnostic insights, enabling us to quickly drive results.

Delivering value-based market outcomes
Our clients routinely experience sustainable market-leading returns when utilizing our cutting edge capabilities to support their deal cycle and performance improvement agendas.

Providing industry leading cost-to-value
Our relentless focus on value is a core competency. Our teams have led hundreds of improvement projects that consistently deliver value at 10-15x our fees, increasing our clients' return on investment.

…that increases returns at each step



This breadth of capabilities, talent and tools can be particularly helpful as PE investors seek value amid radical uncertainty. When conventional methods and tools will not be sufficient to find reliable signals in the noise, when industries and markets are undergoing unprecedented disruption and transformation, KPMG's differentiated diligence can give PE investors confidence.

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