Preparing for race day

How can you extract maximum benefit from the commercial due diligence process? Rafi Musher of Stax Inc. provides some handy tips.

You've been buying businesses for 20 years—and doing quite well, thank you.

Why refine your diligence process now? Running your private equity firm successfully is about putting significant money to work for the best combined ROI and ROEF—Return on Effort, which includes keeping deal teams focused on good deals instead of spending lots of money and months of effort chasing the wrong deals. You and your deal team need to get the job done well, and you need to last.

The general goal of an auction is to extract maximum price— achieved by ensuring that excited, competitive, less-informed buyers bid up prices. Following are thoughts and advice based on our experience completing more than 1,500 projects with investors and corporate management teams in companies of all sizes. Hopefully, some of these insights and examples will help you proactively manage a process intentionally designed to keep you inefficient.

Sellers provide limited and positive information in order to put the best face on the asset, thus maximizing buyer interest. Or in layman's terms, some people try to put lipstick on a pig. Private equity firms call on diligence providers with focused needs, ranging from "test one element of our investment thesis" to broader mandates, such as "read the offering memo, sleep on it, and based on your experience in the sector, advise us on areas for review." When reading an OM, look both for assertions that should be tested and the items conveniently omitted.

What aren't they telling you?

A large PE firm asked us to look at FTD.com going private. Their intention was to buy the asset without major changes. FTD.com, formerly an industry consortium, was essentially a marketing company connecting consumers with retailers. The book did not mention cost of sales leads and conversion rates of those leads into sales over time, which our research showed other competitors were willing to discuss. Counter to the original diligence request from our PE client looking for a market size, growth, and share study, we suggested a Deal Triage™ instead—taking a targeted look, analyzing management performance on sales conversions. Findings on the triage led the deal team to leave the auction early in the process, saving themselves considerable time and resources.

Dig a little

Data from the seller may reveal something about the company that management does not realize. Diving into the prospects of a mid-market service firm, we asked management for their sales team's prospect lists, to interview noncustomers and potential customers. A brief analysis of the prospect list revealed an implied strategy targeting small manufacturers in the Midwest— unlikely their best target market. Though somewhat embarrassed, the management team and investment firm were gratified to learn that the sales force could refocus on greener pastures. Question what the company is doing on a daily basis, read between the lines, and you'll learn more than expected.

"Be the ball, Danny."

We've seen some investors get excited about the financing but look above the product. Shocking but true, every once in a while we find ourselves explaining to investors how the widgets of their target company work, and how these widgets are installed. Before designing any diligence plan, do the homework to understand what the widget does (read white

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papers, technical specs), how it gets sold, and to whom it gets sold. We find that immersing ourselves in this way gives us more respect for the product and the people in the business. We find this critical in engaging customers, suppliers, and competitors in deep conversations, so they tell us what they wouldn't tell others. Whether you want to talk to head traders at hedge funds for 30 minutes about trading platforms, farmers in India about genetically modified seeds, or plant managers in Taiwan about capital equipment, they'll tell you more if your head is in the game.

Always look on the bright side of life

We all like optimistic management teams but it's tough to beat macro economic cycles and structural changes within an industry. A major healthcare provider couldn't determine why growth was slowing in several areas. Back-testing patient volume growth against economic cycles and changes in employer and insurance policies, our analysis estimated continued, slowing market growth for several years. Management could cut spending and work on market share growth, but it would be an uphill battle, and unlikely to be a good place for a private equity investor.

What about Wal-Mart?

"Can you get inside Wal-Mart, Target, and the other mass merchants?" we hear private equity firms ask us. Mass merchants are rational, their people walk and talk like other business people, and the companies generally behave in line with a defined strategy. Even if one can't "talk" to the corporate buyer, it can be done indirectly. Get into the mind of the mass merchant. Who are their customers, what do they want and buy? What is going on with competitive products, category shelf space, and private label within the stores? What is the mass merchant looking for, brand leader or price leader, exclusivity or a traffic driver? Most of these things can be measured and analyzed to project share and changes over time.

In 2003, when reviewing a deal in a crowded auction for a consumer convenience item sold at mass merchants, supermarkets, and convenience stores, several private equity firms in the auction had the same question: "How much can I raise the price?" of this convenience item. Conducting a large-scale survey, our analysis showed consumers were price-flexible, and one could put together a demand curve for optimum profitability. However, each channel, we found from direct interviews and past behavior, had a different perspective on the product's benefit for their chain—money-maker or traffic driver. Taking the channel into account, the price raising was possible, but had a different governor (speed inhibitor) in each channel. Diving into the characteristics of margin split in each channel, we saw opportunity to raise retail prices selectively and increase gross profits significantly—though to different levels in each channel.

> *Before designing any diligence plan, do the homework to understand what the widget does*

Big may not be beautiful

Just because mass merchants have mass distribution, does not mean that selling through them is the right strategy. The China Price is nothing new. Neither is the India Price, the Canada Price or global competition. Customers are just pricing faster these days, and questions from investors have turned from "if," to "when and from where?"

Investigate the competition

Think good old-fashioned "secret agent man" research, identifying inside and outside contacts, eliciting information. Don't just look for people who were in the business years ago. Find fresh contacts who are active participants in the field. How many missions have turned to debacles because of faulty reconnaissance?

Talk to customers

Nine of ten diligence cases rely heavily on primary research, in-depth customer interviews, to understand drivers, intent, and predictions for future purchasing. Are they seeing foreign product; are they getting sales calls for it; or are they thinking of self-supplying? Some of your target's customers may be moving their operations abroad, and seeking local supply. One can always find customers and potential customers. If finding potential customers for target co is impossible, you might want to add that to your model for growth or barriers to entry—depending on situation.

Finally, go local

When researching foreign threats and opportunities, we either staff locally or with people familiar with both language and local custom. In some Asian countries, you can get more information from a fax than a phone call—it's a matter of formality. When we look at China pricing, we may draw on local procurement expertise rather than market analysis expertise, and we'll take a different tack for industrial research and consumer research.

Choosing your team

Some people think your diligence team should be a fixed case team from start to finish, with renaissance players all the way through. How many motorcycles are built from start to finish by one person or even the same four people? None I'd want to take on the turnpike—let alone around the racetrack. Specialize, and get people doing what they do best for a high ROI on each person—and a more powerful end product.

Translating the theory to the operation

Even though primary research is critical to due diligence, you don't need MBAs from Harvard or Stanford trying to interview CFOs, doctors, or plant engineers. You need great interviewers naturally good at reaching people and getting them talking—people trained to ask questions, listen, probe, and spend several days in a row asking the same questions. Similarly, when you want to forecast the number of mid-priced transmissions needing repair every year over the next ten years, or estimate the total warranty liability for a freezer door company, based on historical defect data, you bring in the hard-core modelers— people who feel comfortable describing a regression, macro, or pivot table as "cool."

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Keeping it all on track

Diagram A speaks volumes. Early in a project, the ability to influence change is high, and the costs to change project direction are relatively low. Over the course of a project, the ability to influence change and outcomes diminish, and costs of any change increase substantially. Setting the plan is important, and the project manager's role is critical, managing both content and progress, regularly providing feedback to clients and changing what needs to be changed, real time. The earlier you get back on plan, the less costly and better quality the product.

Making money with your diligence

Some people use the diligence as a rubber stamp. We've had senior lenders ask us for diligence on top of the equity sponsor. When the deal is done, how can you turn the diligence cost into helping management chart a more profitable course? Bring in the management early, and ask them what they'd like to know from a market analysis. What would they ask customers, noncustomers and competitors? Find out what keeps them up at night. Companies below $3 billion in size rarely have research and consulting staff, save one person at best. Many a management team appreciates a collaborative investor, and when the deal gets priced, a good relationship with management may help break a tie in your favor, winning you the nod.

Built to last?

Bringing solid research and analytic components to bear, layer them just like brick—the market overall, customers, suppliers, competitive positioning, and you can build a solid forecast of expected performance. The fanciest analysis and "strategic view" on a foundation with soft support and assumptions is sure to topple, just like castles made of sand fall into the sea, eventually.

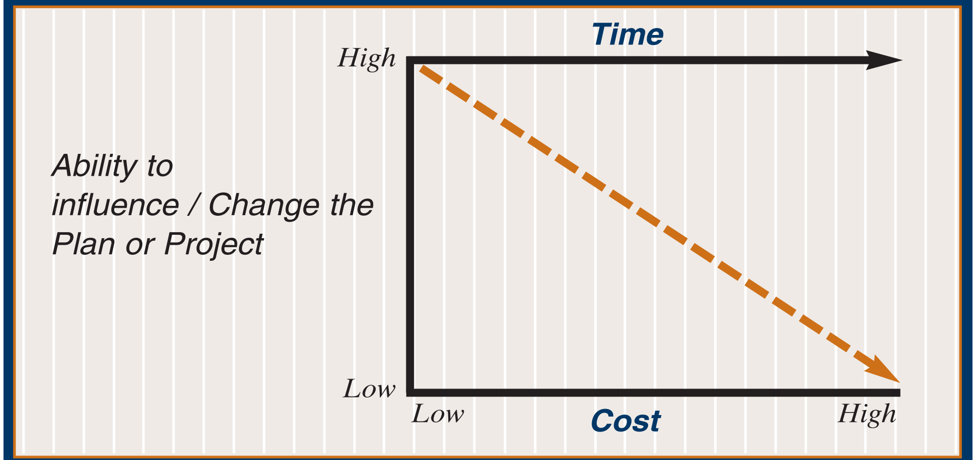
Winning on race day

Do you think that Formula One driver Michael Schumacher races alone, or waits until the week before race season to test his car—or Ferrari waits until the last minute to put their race cars to test? A thoughtful, coordinated and rehearsed team of experts plan well in advance, in order to put winners in front on the track. Maybe you don't race a Ferrari as a private equity firm. But the speed of deal closing is increasing, the capital available to field competitive teams has increased, and it might make sense to plan ahead for the races. ■

Diagram A

Before you begin...

"Someone Has to Lock Himself in a Room and Write a Plan"



Rafi Musher

CEO

As founder and CEO of Stax, Rafi currently heads up our investor-related work. His experience with institutional investment firms spans 10 years, working with more than 30 LBO firms. He specializes in reviewing investment opportunities with clients, identifying what to look for or hypotheses for testing, and building research methodologies that deliver the best answers under parameters and pressures of the investment cycle.

In his work for corporate clients and the portfolio companies of investment funds, Rafi focuses on-identifying and prioritizing growth opportunities (markets, products, channels); eliminating stagnant performance; and increasing marketing effectiveness. His industry exposure and interests are wide-ranging from consumer services to business services, industrial products to marketing services and media in between.

Previously with the MAC Group/Gemini Consulting, Rafi's focus was on market and competitor analyses in chemicals, agriculture, industrial products, and consumer packaged goods. Founder and manager of two successful magazines while still in college, he has published on due diligence, the changing world of research and analysis, improving ROI in efforts to close deals, and general issues within the M&A world. His articles have been featured in The Deal, The M&A Journal, and Private Equity International, and he has been featured on CNNFN, Business Unusual. He has a BS from Boston University in Communications and Advertising.

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