ORGANISATIONAL DUE DILIGENCE

Soft factors: the third wave

GPs know that it is important to bring operational capabilities to their deals if they want to make stellar returns. But in overlooking the importance of soft factors they are missing out on a crucial and lucrative lever, says Andros Payne, founder of Humatica

Private equity is becoming increasingly competitive. More players enter the market each year, making it harder for GPs to differentiate themselves. And a combination of higher entry prices and a tougher macro environment are making good returns harder to come by.

The solution of GPs has been to focus on boosting performance through operational improvements. Operating partners are engaged in the pre-deal phase to help craft a value creation plan with the deal team, while more extensive market, financial and legal due diligence is completed to help mitigate risks.

But operational capabilities alone are no longer enough.

"Everybody knows that financial expertise is no longer adequate, you need to have operational competence. But operational capabilities have now been implemented, particularly in the larger funds," says Mirja Lehmler-Brown, senior investment manager at Aberdeen Asset Management.

"Because there is so much capital in the market and the prices are full, funds need to add new layers to what they do to grow value."

The next wave – or "value creation 3.0", as Lehmler-Brown sees it – is a focus on the soft factors.

Recently, both GPs and LPs approached Humatica seeking answers on how to uncover more about the critical soft factors in a target company before they acquire a business or invest in a management team.

"It is important to understand what stage the organisation is at," says Ulrich Eckhardt, heading the value creation team at Swiss private equity firm Capvis. "It is also important to understand where changes are needed, and to know that early on."

"When private equity acquires a firm, it is not seeking to maintain the status quo; they are looking to drive sales growth and increase profitability," says Andros Payne, of Humatica. "Realising operational improvements involves changes in management processes and the way people interact within the organisation to make the change happen."

Conducting a thorough "organisational due diligence" pre-deal, to evaluate soft factor behaviours, can help GPs get beyond the management presentation and understand how capable a portfolio company's management and organisation are of executing on a demanding value creation plan.

As Payne points out, almost anything uncovered during organisational due diligence is highly unlikely to stop a deal going through; after all, ineffective managers can be replaced and poor leadership processes changed. But knowing this ahead of time puts the GP at a significant advantage.

"Knowing what you're up for in terms of having to make organisational changes in

order to implement operational improvements and drive the business case – that's where investors have real interest," Payne says. "It is about realising full potential earlier and faster."

"Understanding the way an organisation works gives GPs a better view of whether the organisation will be able to support the CEO and the value creation plan to drive growth," says Lehmler-Brown. "If the people below are not organised in a good way which releases their energy, so that they can work and take decisions together, then despite a really good leader and a good plan, you're not going to get the full potential out of an organisation."

While it is clear that GPs recognise the importance of soft factors for the ultimate success of a portfolio company, on the whole they do not have a structured assessment approach.

Humatica's research, consisting of expert interviews and a survey with over 75 European private equity professionals, found that just 30 percent of respondents conduct organisational due diligence as part of their normal due diligence process, and only 16 percent have a structured approach toward assessing organisational factors. Even more tellingly, 97 percent of respondents said that the initial business plan was either sometimes or often delayed because of organisational problems. A clear gap to close.

"Sponsors that address organisational issues early are better able to exploit the opportunities and avoid the risks," Payne says. "If you can capitalise on a new business model because your organisation is capable of acting on it, that will increase multiples and valuation."

Eckhardt agrees that the benefits of having the right organisation in place go beyond a swifter exit and accompanying healthy internal rate of return.

"If it takes too long to get organised, you might miss a window in the market," Eckhardt says. "So it is not just IRR, it is also money multiple that is at stake."

The main hurdle GPs feel they must overcome in order to implement a structured approach to organisational due diligence is access, particularly in auction processes where interactions are limited to well-rehearsed management presentations.

However, GPs often have much more access than it might appear – they just need to know where to look for it.

"One of the big myths is that you can't evaluate the organisation below the senior management if you're in an auction," Payne says. "There's actually more information than you might think, but it is not yet co-ordinated and fully utilised."

As Eckhardt also points out, before the deal is signed GPs are in a delicate position.

"There is a relationship being developed during the deal phase, and it may be difficult to ask critical questions on the organisation," he says. However, this is a role that an adviser can play.

"The GP wants to befriend the management since the management has a say in who will acquire the company. That puts significant constraints on how direct the questioning might be," Payne says. "An adviser may have more freedom to collect that information."

An outstanding organisational due diligence includes interviews with mid-level managers deeper in the target organisation to understand the way the most critical processes for realising the business plan are managed. But even when this is not possible, GPs can better utilise the available touchpoints during market, financial and legal due diligence to find out more about how an organisation works.

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>
> **Andros Payne**

"There are a lot of interactions within a normal due diligence that can be used to gather information about an organisation," Payne says. "If you ask the right questions, you get the right answers. Even simple questions asked to multiple parties can be telling about communication in the target company."

Although it is still early days, and many funds are just now grappling with the best way to integrate soft factors into their due diligence processes, one thing is clear: GPs know this issue is important and that it is here to stay.

"It is more than understanding. Actions are being taken," Payne says. "GPs have realised that to achieve operational excellence they first need to achieve organisational excellence. The third wave is coming." ■

To download your copy of Humatica's Organisational Due Diligence study please visit www.humatica.com (available from 20 October).