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COMMENT

Going for gold - The new face of organisational due diligence

Andros Payne, Managing Partner and Founder of Humatica discusses the shift from traditional due diligence to today's forward-looking, value creation-focused DD.

Making good investment choices is getting harder. With more institutional money in the market and the industrialisation of private equity, the number of attractive opportunities are shrinking, while the criteria for investment are increasing. As a natural consequence, more focus is being put on due diligence. Investors are trying to ensure that risks are properly priced, but with ever less time to do so, and without jeopardising the relationship with management. Traditional due diligence is necessary, but no longer sufficient and fund managers are innovating to master the new DD challenge.

Diligence has typically been a backward-looking, risk-off exercise, focusing on historical financials, legal and environmental risks. However, with more ambitious value creation plans, due diligence has evolved to be more forward-looking and include commercial, IT and leadership DD - a broader set of complex topics to cover in a shorter period of time.

Dennis Hall, Global Head of Portfolio Management at Baird, explains the challenge: "We have lots of diligence tools, but how do we agree on and then execute the path to value? A big part is not covered by traditional DD. Understanding the team and organisation's capability to execute are fundamental."

In particular, investors struggle with assessing the ability of the target company's organisation to implement the value growth plan. They are frustratingly stuck with rudimentary tools that limit their ability to understand the organisation's true ways of working and the quality of management below the C-Suite. The limits of traditional assessment have been reached.

Psychometric testing provides valuable inputs on manager strengths and weaknesses. And full-blown management assessment gives more breadth and depth at the individual and team level. However, deal teams complain that results lack value creation plan context, and don't address other drivers of organisational readiness. In addition, individual assessments are intrusive and subjective tools that run a risk of alienating management and jeopardizing the deal.

Creating value

So how should investors get under the hood to understand the inherent ability of a company to execute a value creation plan? The answer is to look beyond the senior leadership and at the quality of management processes which drive day-to-day decision-making and implementation. Baird Capital has been on the leading edge of implementing human capital and organisational effectiveness reviews as part of their investment process. According to Hall: "The benefit is clarity on the organisational development journey with management up front. This helps us get buy-in and alignment with the team on necessary improvement steps."

Working closely with mid-market fund clients over many years, Humatica refined a structured approach to assess diverse organisational readiness factors pre deal. In a short period of exclusivity, deal teams get fact-based transparency on how the target company really works, and likely organisational bottlenecks in the context of the value creation plan.

Valuable insights come from triangulating multiple data sources including the data room, desk research, structured management interviews, and inputs from the deal-team and advisors who interact with the management during DD. By codifying best-practice management processes in a maturity model, a few targeted questions reveal the gaps which would otherwise go undetected until the implementation stumbles. What a management team may proudly describe as a best-practice management process that "got them there", may not be adequate to "get them there".

A documented maturity model enables rapid, fact-based assessment of management process quality in all functional areas critical for value growth, including sales, product development and marketing.

Other benefits of this approach are that it is non-threatening for target company managers. They find the structured interviews pleasant and valuable. Good questions trigger a healthy re-think of existing management processes in the context of the next value growth step. The assessment of management process maturity also provides a more objective and relevant leadership assessment since as-is processes are defined by the leaders and are, therefore, an unfiltered indication of their competence.

Identifying bottlenecks

Identified organisational and management bottlenecks can then be factored into the investment case. This is not only valuable for the deal team, but management also benefits by sharing the organisational DD results post deal. It helps them to rethink needed organisational and leadership changes up-front, and execute the value creation plan on time. It's a lot better for all stakeholders to identify potential issues in the beginning, rather than have sledgehammer changes 1-2 years down the road when implementation stumbles.

Organisational due diligence is evolving with PE market requirements. As entry multiples reach new highs, investors are digging deeper into target organisations. And for this, they need new tools. Like modern-day gold prospectors, more sophisticated methods are being employed by pioneer mid-market funds to go beyond traditional leadership assessment with broader organisational due diligence. Their quest to understand the inner workings of the target company up front and initiate required organisational changes early, is delivering golden nugget exit multiples.

As Hall notes: "Baird's consistent performance is partly driven by focusing on applying integrated human capital and organisational DD processes."