# Asynchronous Risk: How to Stack the Deck through Operational Diligence and Excellence

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Tony Robbins wrote a new book, "Money, Master the Game" in November, 2014; his first in over 20 years. He interviewed the 50 wealthiest people in the world to find out their secret to investing. Two of the principles hit home:

1. Don't lose money. (While it seems contrite, the idea that we don't invest when there is meaningful downside risk is substantial.)
2. Asynchronous Risk. (Seek investment opportunities with limited downside and an unbalanced upside.)

Asynchronous Risk occurs when you have an upside disproportionate to the cost and exposure to loss in a transaction.

Let's start with a metaphor. A farmer is selling farmland. He is seeking top dollar for this tillable land through an auction. Can you justify the purchase price it will take to win? What if you could know that the land contains drillable oil? Would you want to know this before the auction is complete? What could be better than competing to buy an oilfield when everyone else thinks it is farmland?

In September, during the PEI Operating Partners Forum in NY, we focused on ways to maximize the value of our portfolio companies through growth and margin expansion. The firms asked to speak at this event lead the PE industry in driving operational excellence in their portfolios (and the related improvements in EBITDA and market cap). They grow their companies and keep more of the value they create. Elite. Year after year. Best in Class.

However; the majority of the operating partners discussing their approach are not invited into the pre-close diligence process. The majority of these operating partners don't get involved in the company until after the closing.

What does this mean? In our farmland metaphor, this means we have a group of investors competing to buy a limited supply of farmland, and only a few (of the elite) are testing to see if the land is actually an oil field disguised as farmland.

In most transactions, there is operational information that can be learned before the auction is complete – information that can help you find the oil fields. What can we know before we buy a company or compete in the auction process?

- **True capacity.** Many companies, especially if they have not gone through many PE cycles loosely understand their capacity. Or they may understand their capacity, but only from the perspective of how they currently run the plant or distribution network. They do not understand what their capacity could be if they were to make appropriate adjustments. Combined with growth, tapping latent capacity leads to dramatic EBITDA growth. We frequently find companies that have at least 10% latent capacity - and that can lead to a 40% increase in EBTIDA. No new equipment. No new people. It can be just a matter of awareness and a commitment to change. An example, one client increased capacity by 20% through the use of an alternative production scheduling tool.
- **Cost reduction opportunities.** We often find that companies can increase EBITDA between 10% and 20% through basic blocking and tackling operational improvements (sometimes from 30% to 50%). These relate to lean manufacturing, sales and operations planning, inventory control and management, global sourcing and sales force effectiveness. We helped one client, for example, eliminate overtime and reduce the need for temps by conducting a changeover improvement event. This change led, with a few other improvements, to a 15% increase in EBITDA in less than 3 months.
- **Market position game changers.** Cost reduction can put the company in a better competitive position in their market. However, operational excellence tends to also produce reductions in lead times, quality exceptions and late deliveries. We often find opportunities to cut lead times in half while reducing the cost structure. If a company competes on speed, quality and price, then this type of improvement leads to growth and pricing strength. One seafood client reduced their lead time from 36 hours to less than 8 with existing equipment and staff. Process, flow and training improvements with less than $10,000 in capex led to this improvement. It's not about how hard you try, it's about knowing which changes will produce the results customers notice.

For many privately owned companies, “life style” and insulated thinking create opportunities. Some owners grow accustomed to the results of their company if they support their lifestyle. They don’t want to risk what they have in order to pursue something greater. Understandable; but also a good driver of latent value! In addition, many entrepreneurial companies have a small group of long term employees. They have a set way of thinking. They have beliefs. And they probably have blinders on to other ways of doing business. These factors lead to value that is hidden to the management team. And the longer these factors exist, the longer those old bones buried in the farm field can transform into oil.

Of course, there are also times when someone is selling an oilfield that is really farmland. That is good to know too. The “unexploded grenades” that we can identify before completing an auction or buying a company include:

- Will the plant, warehouse or equipment need additional capex? What will be needed to sustain current operations and growth in the future? Has the capex budget been underfunded? Is there a gap between funded capacity and the company’s growth plan?
- Is the management team capable to lead to the next level? We don’t need the people to build the bus, but they had better be able to drive it. What holes do we see? In the executive suite and on the plant floor (if we find management holes on the plant floor we learn something about the executive team as well…).
- How much work will it take to institutionalize the tribal knowledge? Is the risk related to tribal knowledge (that can leave!) significant? How much will it cost to mitigate and implement effective processes, tools and controls?

Unexploded grenades may not destroy an investment, but it will lead to many hard days and a lot of expended calories. How much work will it take for the PE firm to guide the company and realize the investment thesis? What is the cost to a PE firm when they have a company that resists change, misses targets, trips covenants and requires extensive hand holding? How much distraction?

**Real World Example:**

One PE Client participated in an auction to buy a $6 million EBITDA industrial company. They put an additional $50,000 at risk to add an operational diligence component to their LOI regimen. Our operational experts reviewed, data, toured the plant, and interviewed management. We identified $2 million in additional EBITDA opportunities available at the current sales levels. This information emboldened our client to increase their bid and they ultimately won the auction. We then prepared a plan to buttress the management team, put the right processes in place and realize the value within 24 months. 18 months later, the company topped $9 million in EBITDA without meaningful topline growth (yes, we were wrong in the diligence, the company added $3 million to EBITDA, not $2 million). This increase came through proven and modest improvements in their Sales and Operations Planning processes, through lean manufacturing and through global sourcing. While the prior management team did a great job building a stable and profitable company, they did not fully realize the potential value - the latent value.

So, here are the numbers. They put $50,000 at risk to add operational diligence to their LOI process. They won the deal and increased the market cap of the company by over $30 million dollars in less than 2 years. In addition, operational improvement (or continuous improvement processes) are not ascetic in nature. They do not cause pain to the organization (like an ERP implementation might). During this process the company realized $1,000,000 in EBITDA improvements in the first year of ownership, increased plant capacity by 20% and virtually eliminated late deliveries.

An IRR of over 2,100%. An investment multiple of over 600 on that marginal investment. The PE firm realized a $30 million return in less than 3 years.

There was oil in that farmland.

**A Hairy Deal**

We completed a diligence for a client looking to take a distributor out of bankruptcy. We looked at all facets of their operations; sourcing, inventory control and management, the DC network, freight, storage and picking. We toured the primary facilities and identified the following controllable opportunities. We say “controllable” because all of these changes could be completed without customer involvement or knowledge. No top line change was needed.

We identified the following:

- Current warehouse management and staffing issues limited the number of orders that could be filled on a daily basis, driving up overtime and staffing, and reducing on time delivery.
- Inventory planning and sourcing inefficiencies further drove down order fulfillment and customer service levels.
- With improvements in warehouse management, the company could close 2 facilities and eliminate over 140,000 square feet in a 3rd.
- The current sourcing and freight strategies were developed much earlier in the company history and did not take advantage of current leverage and available resources.

In total, we identified $3 million in EBITDA improvements, $4 million in working capital reductions, and opportunities to increase customer service levels from 80% to over 95%. Once again, the elegance of operational excellence is that cost savings do NOT come at the cost of customer service. Rather, we implement changes that improve the customer experience. In many cases, the side effect is cost reduction.

So did these opportunities prove out? Yes, within 9 months, the company added $4.5 million to EBITDA, consolidate 2 facilities (eliminating 250,000 square ft. of warehouse space), improved customer service levels from 80% to over 95%.

The IRR for this deal surpassed our first example. For less than $100k in deal costs and about $400k in implantation costs, the PE firm increased the market value of the enterprise by more than $40 million.

**The Other End of the Spectrum**

In another diligence, we dug into every best practice and estimated the financial impact for a target acquisition. The management team for this liquid fill, human care product manufacturer had either implemented or had specific plans to implement virtually every operational lever that would drive EBITDA and market cap improvements. We documented management's approach and explained their approach, prudence, judgment and discipline to the PE firm. They acquired the company and we went away.

The PE firm spent $50,000 on operational diligence and learned that they were acquiring a company with the "A" team in the executive suite. This would be a company that would be low maintenance. It would not require painful conversations trying to get the management team to take action. The management team would realize their targets and the PE firm's investment thesis.

**Conclusion**

Here is a bold prediction. In 5 years Pre-Close Operational Diligence will be as common as Quality of Earnings audits are today. At some level (but not always in practice), we all know that financial engineering is no longer sufficient to routinely beat the S&P as a PE firm. It is not enough to attract new investments in the next fund. We have to embrace operational excellence and build real value in our portfolio companies. Pre-Close operational diligence can help you win the right deals. Win them and mine them.

For now, you can be the one bidder who knows there is oil under the farmland.

If you have any questions or requests, please feel free to contact me at tvm@proactiongroup.com.