Private equity funds – when to pull out

Deloitte Ireland and Carlton Strategy Advisors speak to *ACQ Magazine* about PE and the importance of due diligence.

Ronan Nolan

Deloitte is a leading global professional services firm, providing corporate finance, consulting, tax and audit services to a wide range of clients. With a globally connected network of member firms in 140 locations, Deloitte brings world class capabilities and deep local expertise to help clients succeed wherever they operate. ACQ caught up with one of the firm's partners.

What determines what makes a PE portfolio ready to be flipped / exited?

In general a PE Fund will have clear objectives when making its initial or any subsequent investment in each asset. Key aspects will include such factors as desired rate of return, sector focus and risk profile, but there will also be a requirement for a clear exit strategy. PE Funds are not normally interested in holding particular assets for indefinite periods, so they will demand a business plan which demonstrates a reasonable prospect of development of the business in a way which makes it an attractive prospect for a trade sale or IPO, for example.

There will then be an ongoing review of progress against this plan, and a decision to exit may be taken, subject to general market conditions at the time, if the objectives have been achieved. This is a very dynamic process, and timelines cannot be predicted with any certainty. In summary, PE Funds will make hard headed decisions based on their assessment at a point in time of whether there is a greater economic benefit to them through exiting or holding each element of their portfolio.

What should be taken into account before making the decision to exit?

Desired rates of return will have been established at the point of investment. These will be arrived at by reference to the PE Fund's own cost of capital, the perceived risk of the sector, and of the business itself. If an investment has matured and no longer projects a satisfactory future rate of return, that could be a trigger for consideration of exit. Consideration will also be given to: the overall profile of the PE Fund's portfolio and to alternative investments available; the expected level of interest from purchasers in the business and their financial health (i.e. ability and appetite to fund the transaction); the readiness of the business for disposal (eg is it operating on a standalone basis and are robust historical financials available for this business).

Do you think companies are skimping on their due diligence when merging or acquiring because they do not have the finances to carry out adequate investigations? Why / why not?

No. Our experience is that serious investors recognise the value of a rigorous due diligence process as part of their assessment of investment decisions. Undoubtedly cost is a factor, and the market among DD providers is competitive, but a balance must be struck between cost and the required level of assurance, given the risk involved in every investment decision. DD providers need to ensure that their scope is agreed, and is adequate to provide their client with an appropriate level of assurance.

A lack of due diligence could lead to major risks in the target business being underestimated or overlooked, potentially with dire consequences for the investor. It can be extremely dangerous for investors to rely on the target company's information and their own investigative work, unless they are themselves well resourced and sophisticated.

What are the pros and cons of sell-side 'vendor' due diligence?

A vendor Due Diligence is an independent review of the business commissioned by the shareholders (vendor) seeking to dispose of their interest. The major advantage is that the vendor retains control of the process, it presents information in a very efficient manner, provides equal access to a potentially wide range interested parties and thereby provides better comparability of indicative bids and reduces the information risk discount in bids.

It is vital that it can clearly be relied on as genuinely independent, and the involvement of a reputable firm on a non-contingent fee basis is essential. Potential investors may seek to gain additional assurance through commissioning additional due diligence, but the presentation of a comprehensive Vendor DD should enable the target company to control such demands for additional access, and minimise disruption to their own business.

Unfortunately, the significant advantages of vendor due diligence are not readily achievable on all transactions. Those transactions most suited to a vendor due diligence process are those that: Include enough potential purchasers to generate an auction process and the vendor's business is complex or operates from multiple operating units and geographies.

DETAILS

Deloitte.

Ronan Nolan, Partner, Deloitte
Deloitte & Touche House, Earlsfort Terrace, Dublin 2, Ireland
T: + 353 (0) 1 4172250
F: + 353 (0) 1 417 2300
E: rnolan@deloitte.ie
W: www.deloitte.com/ie

Reproduced form the February issue of ACQ Magazine. www.acqmagazine.com

Most SMEs may baulk at the idea of the extra services and extra costs involved in selling their business. However, vendor due diligence provides a tool for the vendor to retain control of the selling process and to reduce the possibility of value erosion. Vendor due diligence may not be cheap but the advantages (both financial on non-financial) outweigh the costs – and the costs can generally be passed onto the buyers.

Carlton Strategy Advisors (CSA) Ltd is a commercial due diligence and business strategy consulting firm based in London, with national and international reach. Their emphasis is on small and lower-mid markets, involving transaction values between £2m and £100m. ACQ Magazine spoke to David McClelland, the Director of CSA.

What are the different challenges faced when carrying out FDD and CDD due diligence?

Due diligence, in its two main forms of financial (FDD) and commercial (CDD), will examine a business's trading history compared to a management plan or forecast. There are, however, key differences between the two transaction services processes in terms of their respective areas of focus and investigative depth of analysis. CDD will likely examine a business's trading horizon over a forward time span relevant to the business. This could be typically three, five or 10 years or longer. It will be directly concerned with a business's anticipated selling volumes, prices and margins, if not the rational and logic behind a particular management strategy or business direction. By way of some contrast, the FDD will most probably take a more intensive look at the key financial numbers, drilling down further to the bottom line than would normally be asked of the CDD. FDD will examine levels of cash flow and working capital resting within the business but often over a somewhat shorter forward business time frame. Where there should be cooperation between the one and the other is in the situation, for example, where the CDD spots a key variance in a company's market forecast and/or customer pipeline against a business management plan and is able to pass this information to the FDD team for sensitivity checking.

When should a PE portfolio be exited?

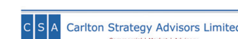
Due diligence seeks to understand the various levels of reasoning that lie behind the joint actions of a company management team and its existing equity backers acting to take a business along a key strategic direction or route to market. It provides an independent assessment and opinion about the risks/benefits found in a company when trading is aligned to key customers/suppliers and competitively positioned against alternative market providers. It seeks to identify synergy within the business – utility in raw materials, applied technology and customer markets, for example. Assessing when a PE portfolio business is ready to be exited is therefore a process of judging when its strategy and plan have become sufficiently robust and with the right primed mix of resource, capability and capacity to take advantage of a defined level of market opportunity. It is the evidence presented as a result of the due diligence that the management team is in control of the company's own destiny: the business model works and has the capacity to be further expanded within a sustainable market niche or otherwise protected industry segment.

Does the 'vendor' aspect of due diligence change the process?

The process of due diligence should be the same if applied to either the 'buy-side' or 'sell side' of the transaction equation, providing an independent opinion of a business's financial and commercial strengths/weaknesses and opportunities. Unfortunately, it can be a truism that sell-side due diligence or 'vendor DD' is temptingly treated by the selling party to be a further aid to the marketing and sale of the business to a new owner/equity investor. However, VDD that identifies a 'skeleton in a cupboard' does give the incumbent company management team the necessary time to redress particular problems and thus maintain business valuations during exit negotiations. It may also serve to speed transaction completion. The pragmatic, new-to-business, equity investor or trade owner for the larger part will still want to know the 'warts and all' aspect of a potential portfolio investment in addition to its identified 'beauty spots'. This can be balanced in the investment case and with any overhanging difficulty weighed up for its turnaround 'upside'. What the new investor or owner does not want is to experience the prospect of some previously hidden surprise emerging in any post-deal situation. This is the importance and advantage of good, timely, due diligence.

David McClelland

DETAILS



Carlton Strategy Advisors Limited
Carlton Mews
Arterberry Road
London SW20 8AG
E: david.mcclelland@carlton-advisors.co.uk
T: +44 (0) 208 947 5108
W: www.carlton-advisors.co.uk