KEYNOTE INTERVIEW

Integrated diligence as a value-creation lynchpin

The PE approach to diligence is now less about what you get with an asset and more about what you can do with it, say EY's Neil McFerran and Jason Spencer

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Q How has the role of, and approach to, due diligence evolved in recent years?

Neil McFerran: Financial diligence is a foundational element of the private equity lifecycle, and as the operating environment for PE becomes increasingly complex, it's critical to get it right. At the same time, it's become an intensely competitive space where a differentiated experience is key. Employing an integrated approach – that takes a holistic view of a target's strategy, operations, financial, tax and other circumstances is essential to identifying and understanding the extant opportunities for value creation. The growth and importance of technology diligence, for example, continues to escalate.

The industry and sector nuance that you need to bring to due diligence has also become infinitely more important. The first question I get asked is if we have direct experience of the asset, or if we have worked with a competitor or in the sector before. The closer you can get to the sector and the asset, the better.

Historically, operational due diligence had a narrow remit – it was focused on the quality of assets as opposed to being value-focused. Today, we've moved towards a more expansive and cohesive approach that considers, for example, how you can best integrate components of digital, commercial, technology, HR and operational value creation together to come up with a plan that maximises the potential for the asset.

Jason Spencer: Due diligence originally started life in audit and today it continues to be seen by a lot of advisers as an audit checklist. In the past, private equity firms received that checklist in a report and then had to identify the risks and opportunities themselves. Now private equity firms demand more from

their advisers, so at EY we transitioned to an insight-led approach a while back to advise funds on how best to exploit the value opportunities and mitigate the risks.

Q Why is it so important that diligence be integrated and aligned with the investment case?

NM: The capital structure of the deal is mission critical, and therefore the basis of the investment thesis around growth, operational value creation and cash needed to deliver transformation is a major focus of our clients. In an environment where a lot of private equity firms are still pushing capital structures hard, and where multiples can get quite aggressive, integrated diligence gives the investment committee the comfort to take more aggressive decisions on debt levels and on the overall performance of the deal.

JS: Historically, financial diligence, tax, legal, operations, technology and cybersecurity diligence all had separate volumes within a diligence report, with very little integration between them. This resulted in not all deal opportunities and interdependencies surfacing. For example, if a technology opportunity had a significant operating model impact it may not have been fully captured and understood in the other volumes of the report. As a result, we have moved to a fully integrated diligence product that successfully manages all the interdependencies, providing a unified diligence service.

Q How should diligence incorporate a value-creation lens?

NM: Value creation includes a holistic review of cash, operations, commercial and digital, so the diligence product needs to coherently bring all those components of the thesis together with the phasing for delivery. There may be low-hanging fruit, such as purchasing for example, but then the timetable for using digital as an enabler to improve business productivity can take two years to deliver and might also have a bigger cost component. You need to be cognisant of that time and cost. If you are considering these elements in isolation, you are likely missing the point.

JS: While the deal market is currently in the process of shifting from due diligence to value creation, our core diligence products continue to benefit our clients from having value creation at their heart. Our standard diligence offering today looks for both top- and bottom-line value opportunities. For example, a key component of our top-line analysis is the revenue opportunity driven by the potential to transform customer interactions using technology and operating models. In my personal view, if you are not digitally interacting with your customers then you are behind the curve, and if you cannot see how to get on that journey it has the potential to scuttle a deal.

> *"Technology diligence is now a key component to any diligence engagement"*
>
> **JASON SPENCER**

Q What steps should managers take to get from diligence to a defined end state, before negotiating the share purchase agreement?

NM: There needs to be buy-in around what is a realistic position for the company to be in when you are approaching the exit horizon. The PE deal and operating teams and the management team need to agree on something achievable and reasonable, and there needs to be explicit buy-in of that end goal and the path to deliver on that. Getting everyone aligned in terms of onboarding, expectations, as well as information flows and needs, is critical from the outset.

JS: This is where private equity firms in my view have become much more progressive. Rather than just taking an initial two-year view during the transaction, funds now tend to engage us with a broader deal horizon to diligence. This ensures funds can articulate those early stages of their end state journey in the transitional service agreements and sale and purchase agreement to safeguard the provisions they need to support the required transformation.

Q How will the role of technology diligence change over the next five years?

JS: It has certainly moved up the priority list for private equity managers. Most funds now recognise that technology needs to be fully understood both to mitigate deal risk but also as a key enabler of any kind of value creation. For that reason, technology diligence is now a key component to any diligence engagement, and it is not uncommon for us to perform standalone technology diligence to support private equity.

We now look at technology as a key enabler for business growth, so our technology diligence is typically focused on understanding how to support the business to establish new products, launch new business services, enter new markets and interact efficiently with customers. We still

Q How should diligence be focused to take account of current market challenges, such as inflation, rising interest rates and supply chain issues?

NM: In March 2020, we had a call to action and all our diligence became much more focused on the macroeconomic conditions and market challenges. We were looking more closely into business resilience as a whole and considering transformational questions around what it means to grow your business in a low-growth environment while facing variations to the cost base. Another focus was how to create a cost base that you can move up or down as the market moves.

We find that diligence is now focusing on three components: inflation, supply chain issues and commodity prices. Inflation has moved up the agenda, such that our most recent deals have included a focus on the impact of wage inflation on the fixed cost structure, and then a consideration of how we can pass those input cost inflationary pressures on to the customer base.

With the long-term ramping up of energy costs, we are doing discrete pieces of work looking specifically at those issues on a country-by-country basis. Interest rates are also a big concern when it comes to the cost of debt.

Private equity managers are involving us much more in origination than they did in the past, so even before the first investment committee discussion we are being asked to kick the tyres. That allows us to bring to bear other aspects of our offering, to give that client a broad view of the opportunity.

We have seen a period of significant growth in private equity that led to some of the largest valuations ever seen in the technology and software space last year. Those assets are now likely to sit in fund portfolios for longer than their owners would ideally like, because buyers and sellers are now not necessarily aligned on valuations. So, we also see private equity firms looking at diligence from the other side, as they consider how to make those assets look attractive in order to bring them back to market.

provide the more traditional hygiene technology diligence, but we are much more interested in helping our clients to understand the role technology can play in transformation and in driving value-creation opportunities.

Q What can you identify during diligence around the cash position, and how that might fund the process or provide additional resilience in constrained debt markets?

NM: The subject of the cash position is mission critical. In a scenario where transformation, particularly with a large digital component, can be costly to implement, getting a clear view of how a business manages its payments, receivables and inventory position is critical with the aim of 'releasing cash' quickly.

For example, post-deal, in the first 100 days, often the focus is on the liquidity position and the strength and resilience of the finance function. It is not so much about the process, but there is a piece of work to be done around liquidating the inventory. The other piece is whether you can use a liquidity process to unlock value so that you don't have to fund investment with additional capital. That is a question we are asking all the time. Then, in terms of modelling, we look to see if there is potential for cash release, which from a valuation perspective can offset one-off costs to achieve purchase price adjustments.

Outside of cash, we have been doing quite a lot of work on capital allocation – understanding, costing and planning capital allocation and then dealing with that as part of the diligence programme. That means looking at the management plans for capital allocation. There is now a much greater degree of focus on that because the days of a capital expenditure wish list are at an end thanks to the cost of capital increasing. There is also an enhanced focus on payback on investment in today's environment. ■

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