OLIVER WYMAN

VALUE DUE DILIGENCE

REFOCUSING TRADITIONAL DUE DILIGENCE ONTO WHAT REALLY MATTERS FOR PRIVATE EQUITY

MARSH & McLENNAN COMPANIES

VALUE DUE DILIGENCE

The private equity industry has survived the 2008 "credit crunch," and stronger players will ultimately prosper in what are sure to be more turbulent and challenging times ahead. However, the rules of the game have changed: Now investing decisions are increasingly dependent on operating performance gains rather than financial leverage and multiple arbitrage.

By Tobias Eichner
and Bernd Oehring

As a consequence, most private equity investors rely on the judgment of ad-hoc teams of industry executives brought in to critique management and develop new operating plans. Most traditional commercial and operational due diligence projects merely focus on confirming the market outlook, current business trajectory and checking a few risk factors. Hence, in Oliver Wyman's experience, investors often fail to identify and complete diligence on critical drivers of potential return and risk exposure. Moreover, investment theses and business plans sometimes miss opportunities to create value and improve business plan execution.

To meet the needs of its private equity clients investing in industrial assets, Oliver Wyman has developed a "Value Due Diligence" capability.
It leverages the firm's extensive experience serving private equity clients, deep industry sector expertise and a proprietary suite of proven performance levers. And it cuts back complexity while putting a relentless focus on the key levers for post-acquisition value creation and risk management – thus helping our clients to hone their competitive edge in the quest for investment returns.

PRIVATE EQUITY IS BACK TO OLD STRENGTH

Private equity found it hard going after the "credit crunch," with some commentators questioning the record of mega funds, the growth of secondary activity, the broader ability to add value for investors and even the industry's long-term viability. However, despite many doubters, fund raising continued steadily. As dry powder in terms of funds to invest is now close to peak levels (at just under USD 1 trillion), private equity is clearly here to stay. It continues to offer above-average returns, including in particular vintage years during periods of recession.

EXHIBIT 1: EXTENSION OF TRADITIONAL DUE DILIGENCE OFFERINGS TO FOCUS ON VALUE CREATION

	Traditional due diligence focus (industrial assets)	**Value Due Diligence focus** (in addition to reduced traditional elements)
Commercial Due Diligence	– Company overview – Market environment – Customer priorities – Competitive landscape – Business design analysis – Business plan review (top line) – Commercial risks	– Performance levers related to top-line and gross-margin growth – Review of business plan risks (bottom line) – Performance levers related to cost structure and free cash flow – Consolidation of levers and risks into: - A tailored "Oliver Wyman Case" (P&L), including scenarios for valuation, financing and management target setting - Indicative post-acquisition value creation roadmap (e.g. high level 100-day plan)
Operational Due Diligence	– Manufacturing – Purchasing/supply chain – Other core and overhead functions – Ongoing improvement initiatives – Operational risks	
Value Due Diligence concept	Reduce commoditized standard analyses by 30 – 50% to a relevant minimum	Identify key value drivers and add items that really matter to a financial sponsor's decision making

NEW RULES OF THE GAME – A QUEST FOR OPERATING PERFORMANCE GAINS

The recent financial crises and the failure of targets to meet expectations have left their mark, however: tighter credit markets have meant more equity financing, while low nominal interest rates have meant that carry hurdles now require significant real returns before sponsors start generating profit shares. At the same time, competition for investment targets is increasing, as is the need for more operational value creation to replace financial gains. And both the sensitivity to the risks of assuming multiple expansion and investor discrimination in new fund-raising rounds are rising. In a nutshell, multiple factors are forcing private equity firms to adopt much more rigorous investment decisions, and to stress test those choices at greater levels than ever before.

As a consequence, early in-depth insights into potential investments' baseline performance and into the key levers for delivering upside are now critical to successful competition for assets and post-investment management strategies. Unfortunately, traditional due diligence approaches and reports are dealing with management plans and downsides, but provide limited insights on specific operational improvement opportunities. Is there any investment professional who hasn't received a 200-page report filled with endless unfocused tables of data and an executive summary that just plays back the key issues raised by the sponsor's executive advisers, and wondered if the due diligence process yields anything meaningful at all?

THE VALUE DUE DILIGENCE CAPABILITY

Oliver Wyman developed a "Value Due Diligence" capability that goes beyond commoditized due diligence analyses of markets, competition, business design and operations. It focuses on specific key performance levers and associated risks for a potential investment. In other words, Value Due Diligence refocuses the evaluation effort on what really matters when making an investment decision. By paying careful attention to the most important value drivers, much greater depth of understanding is achieved without sacrificing project resources or schedules.

> "Value Due Diligence refocuses the evaluation effort on what really matters when making an investment decision."

Value Due Diligence combines three ingredients: first, deep industry insights from sector experts with extensive experience in the target asset's competitive ecosystem; second, exceptional functional expertise in manufacturing, supply chain management, sourcing and other disciplines; and third, systematic scrutiny of a business's top line, cost structure, investment profile and cash generation characteristics. This powerful combination enables Oliver Wyman to identify the pivotal performance levers and associated risks and then deliver a tailored management case assessment – alongside a draft for a post-acquisition value creation roadmap.

As a result, Oliver Wyman's Value Due Diligence has proven to be far more than a mere combination of conventional commercial and operational due diligence reports. The extension of scope, the combination of industry and functional expertise and the focus on the value creation drivers that really matter for each investment pave the way for better decision making, immediate action and faster results.

“The approach enables sponsors to rapidly identify and prioritize critical operational value levers and thus reveals the full economic potential of an asset.”

OLIVER WYMAN APPROACH – THE PERFORMANCE LEVER SUITE

Value Due Diligence was developed to methodically examine the entire suite of performance levers and to identify the most important levers in each case. Levers typically reviewed include top-line and margin growth; cost reduction and efficiency increase; cash flow fortification; and performance-enabling factors. In several industrial sectors, Value Due Diligence uses Oliver Wyman’s proprietary internal benchmarking database as well as interviews with market and business experts – including Oliver Wyman’s own industry specialists – to test business plans, performance improvement levers and associated risks. The Value Due Diligence approach thus enables sponsors to rapidly identify and prioritize critical strategic and operational value levers, assess their potential contribution and define top-level implementation plans. It reveals the full economic potential of an asset.

EXHIBIT 2: PERFORMANCE LEVER SUITE FOR VALUE DUE DILIGENCE

1 **Top line and margin growth**	1.1 Market potentials in existing business areas	1.5 Sales force effectiveness
	1.2 Identification of new business segments	1.6 Growth in after-market
	1.3 Add-on acquisitions	1.7 Margin increase through product portfolio mix
	1.4 Increase of customer share of wallet	1.8 Improvement of pricing positioning
2 **Cost reduction and efficiency increase**	2.1 Optimization of manufacturing footprint	2.5 Value Sourcing (procurement)
	2.2 LEAP (operations improvement)	2.6 Overhead efficiency
	2.3 Management of capacity utilization	2.7 Outsourcing
	2.4 Optimization of supply chain and logistics	2.8 Reduction of product costs
3 **Cash flow fortification** (excluding financing levers)	3.1 Management of working capital	
	3.2 Review of capital expenditure	
	3.3 Divestment of assets	
4 **Enabling factors**	4.1 Incentive systems	4.4 Transparency (e.g. reporting and KPIs)
	4.2 Organization and core processes	4.5 Integrated financial planning
	4.3 Program management (PMO) tools	4.6 IT systems and tools

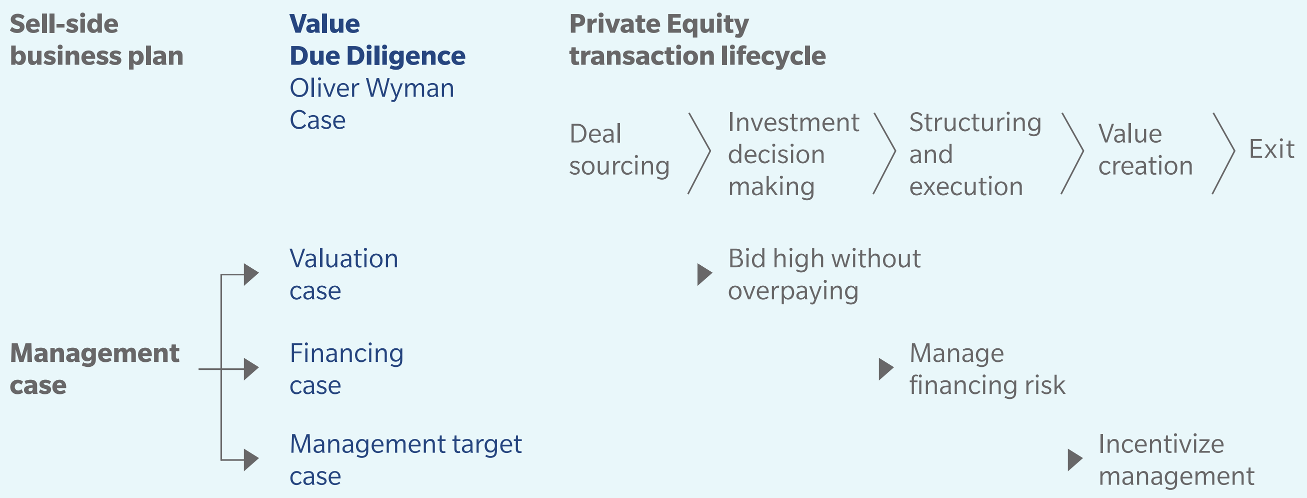
Note: Individual levers are sustained through defined concepts, analyses and KPIs as well as proven case examples for fast response

THE VALUE DUE DILIGENCE REPORT

Despite its analytical depth and rigor, an Oliver Wyman Value Due Diligence report will typically be more concise than a conventional due diligence report, since it pinpoints only the key investment theses for the specific asset under consideration. Moreover, instead of leaving private equity clients with a variety of individual analyses, it consolidates results into an "Oliver Wyman Case" that provides a robust set of top-line and EBITDA projections as well as aggregated sensitivities under multiple business case scenarios.

Such a well-synthesized and practical set of conclusions, rather than the commonplace ambiguous scenario ranges, facilitates the creation of robust valuation, financing and management target cases.

EXHIBIT 3: BUSINESS PLAN ASSESSMENT ALONG VALUE CREATION ROADMAP



These are complemented by associated value creation and risk management roadmaps – from indicative red flag analyses highlighting potential deal breakers to 100-day programs outlining post-investment plans and targets – which help private equity firms to proactively manage individual asset investment risks and returns in both the short and the long term.

PRECONDITIONS FOR PROJECT SUCCESS

While Oliver Wyman's Value Due Diligence approach is broadly applicable, it has a proven track record of delivery in:

(1) industrial products and/or services, and
(2) cases where performance improvement is a major part of the investment thesis.

Additionally, Value Due Diligence requires a sufficient timeframe (a minimum of four weeks is recommended), good access to management and to financial due diligence results.

For more information on Oliver Wyman's corporate finance capabilities and Value Due Diligence product, please contact one of our specialist partners listed on the overleaf.

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CORPORATE FINANCE AT OLIVER WYMAN

Oliver Wyman's Corporate Finance practice offers strategic and transaction expertise to complement the in-depth market and industry knowledge of our expert industry groups. Our practice undertakes more than 250 projects annually for financial sponsors, creditors and corporates. Our capabilities include support for investment, divestment, M&A, project finance, restructuring/workouts, privatization/PPP, concessioning and litigation.

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