

## KEYNOTE INTERVIEW

# The power of operational due diligence



*In a world where private equity firms can no longer rely on leverage and multiple arbitrage, operational due diligence has become more important than ever, say LEK's **Claudio Molinaro**, **Sebastien Beausoleil** and **Tom Marshall***

## **Q** How has operational due diligence evolved over the course of the past decade?

**Claudio Molinaro:** Operational due diligence has always existed alongside financial, legal and commercial due diligence, but its use has intensified greatly over the past 10 years. The scope of operational due diligence has also increased, now including several subcategories, including due diligence focused on carve-outs, build-ups and value creation potential.

Faced with tightening market conditions, supply chain disruption, inflation and now tariffs, private equity firms can no longer rely on multiple arbitrage or

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leverage to deliver returns. Instead, managers need to address core, operational performance improvement.

## **Q** What role can operational due diligence play in helping a buyer understand business performance, in order to lay the groundwork for a value creation plan?

**Sebastien Beausoleil:** In our case, for instance, we start by doing a deep dive into a target's true operational base

line. We then use a mix of benchmarks, external advisers and our own internal advisers to compare core processes and functions against top quartile, which helps identify gaps. Each gap is a candidate for a value creation lever.

Finally, findings should be stress-tested with the deal team and target management team, so that a value creation plan can be drafted before day one.

We aim to bring both growth and margin levers to the table from the outset. Around 50 percent of gross returns across the buyout industry over the past 20 years have come from both growth and margin improvement, so viewing

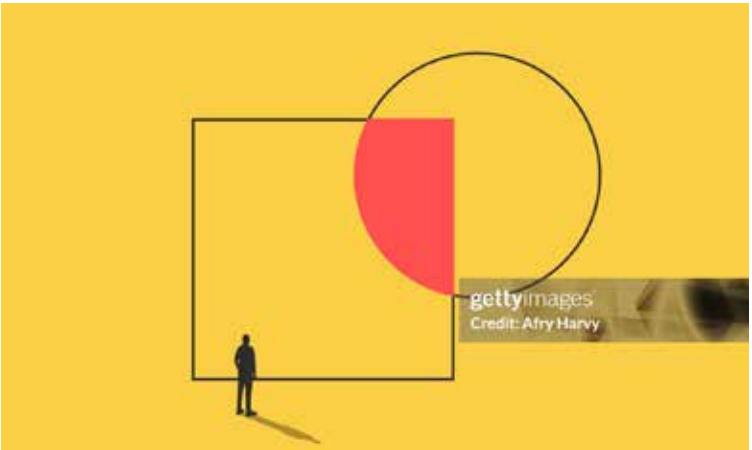
**Q How can due diligence be used to assess integration readiness in an M&A scenario?**

**TM:** Cultural fit, and where a company sits on the spectrum of passive and reflective through to proactive and forward-looking, are important factors to consider. That is not to say a platform and potential acquisition have to start in the same place, but any differences are important to understand.

Systems compatibility matters too, to ensure smooth integration and to limit cost build-up or duplication. Thirdly, we need to think about talent scalability. It is important that a leadership team is well placed to allow a platform to grow, and that it is not going to become stretched as the business scales.

Finally, any potential traps that might exist within the synergy valuation need to be considered. Is the platform both strategically and operationally ready to integrate further targets, or is the business too immature to act as a cornerstone for a buy-and-build strategy?

We need to explore all these factors to determine whether a target will make a good platform for inorganic growth, and to a lesser extent when considering whether subsequent acquisitions are suitable to join the business.



operational due diligence through both lenses is critical.

**Q How can this due diligence help quantify and prioritise value levers?**

**SB:** Again, it is about using a three-pronged model. On EBITDA gain, it is about the cost required to achieve that gain and the time it will take to implement the lever. On top of that, we highlight the prerequisite actions and produce a high-level roadmap.

It is very important that the investment thesis stays top of mind. Identifying those levers that can maximise

margin and top-line expansion is all well and good, but checking which levers will contribute to the business plan and which are upside is still essential.

**Q How can operational due diligence be used to ensure feasibility and impact?**

**SB:** This is a matter of checking capability and capacity. For instance, we assess whether a team, capital budget and systems can deliver on the plan and provide options where gaps are evident.

We recently worked on a mandate, for example, where the target lacked M&A and marketing capabilities. We

made sure we took this into account so that we weren't producing a plan that was written by consultants but undeliverable by management.

We try to include at least three or four quick wins, which can land within the first 100 days and then fund the programme from there. In some cases, we will also stress test against external factors. For example, we recently produced a value creation plan that included factory consolidation and model redesign. Those are initiatives that require union approval and employee representation. We took that time and risk into account in the roadmap and also provided a plan B.

**Q Why is carve-out operational due diligence so important, and how can it help ensure a buyer knows exactly what it is that they are buying?**

**CM:** Carve-out due diligence is one of the oldest forms of operational due diligence precisely because the buyer really needs to understand what we call the 'as is' view – the way in which the carved-out entity is currently operating. Traditionally, however, that due diligence focused exclusively on historical costs and what the impact of those costs would be at separation. It considered which functions would need to be recreated and which services were no longer required, thereby giving a view of what past profitability would have been if the business had been standalone.

That approach still leaves a lot of questions unanswered. Buyers need to understand more than the past. They need to look at those capabilities that are critical for the company to grow and succeed going forward. This can be tricky because the carved-out entity will typically not have its own information.

In a recent case, a B2B professional services company with several hundred million euros in turnover did not have its own productivity data, for example.

It can therefore be difficult for buyers to know what they are buying.

When we look at carve-outs, therefore, we not only look at historical costs in detail, we also help the buyer identify what they need in terms of information assumptions in order to set the company up for future growth. It is not just about cost and risk – it is about how ready the business is for the buyer to take it to where they want it to be.

**Q To what extent can carve-out due diligence ensure that the execution process itself runs smoothly?**

**CM:** A core requirement of carve-out due diligence is day-one readiness. Before the seller can transfer the asset to a buyer, there are a number of operations that need to take place, and it depends on the sophistication of the seller as to how much effort they put into preparing the transaction. Sometimes, that preparation is good and the transaction can be executed seamlessly. Very rarely, the target is already functioning in a devolved manner. Most commonly, however, there are significant entanglements with the parent company.

It is often the case that support functions such as IT, HR, finance and treasury management are entangled. Sometimes, core operational functions such as manufacturing plants are also shared. That means you need to set up transitional service agreements (TSAs) to ensure the target can keep operating while the carve out happens, which can take months and sometimes over a year.

It is critical to explore these factors during due diligence, not only because TSAs have a cost but also because at some point they will end. The company needs to be ready to run on a standalone basis.

**Q What role can carve-out operational due diligence play in helping drive growth post-deal?**

**CM:** Traditionally, carve-out operational due diligence has been

performed by financial due diligence providers because the focus has primarily been on historical costs. Now the focus is more forward looking, which means understanding whether the commercial model is aligned with the investment thesis and looking at how the organisational structure can facilitate future growth.

That could mean looking at whether the IT system is fit for the future, for example. Strategy houses like us have become involved because this is no longer just a cost adjustment exercise, it is about how the separation plan serves the growth story.

**Q How can build-up operational due diligence be used to size and validate synergy potential?**

**Tom Marshall:** Build-up operational due diligence is important when an investor is looking to assess whether a company is suitable as a scalable

platform for future inorganic growth. For instance, we evaluate the robustness of the target's management capabilities, systems and integration readiness, together with the potential synergies that will inform the build-up strategy.

We think about three key areas, in particular. First is the speed of integration. Private equity firms have short investment horizons relative to strategics, so we need to ensure that any bolt-on investments can be quickly integrated into the platform to allow value to be created. We also ensure the integration plan is linked to the value creation plan and eventual exit, and we make sure there is a clear plan to merge the acquired companies into the platform seamlessly.

In terms of sizing and validating synergies, it pays to go beyond the identification of cost savings, making sure to link synergies with the strategic rationale. That might mean increasing market access, cross-selling between different client bases, or increasing technical capabilities. We evaluate whether synergies are critical to that investment thesis or whether they are optional upside, making sure that time and resources are placed in the right areas.

First, we work with functional leadership teams to assess potential areas of synergy, exploring both the revenue and cost implications of different levers, before using tried and tested methodologies to assess the size of those synergies, using benchmarks from previous work. That results in a robust initial sizing that can be captured through a synergy reporting template.

Working with the valuation team, we can then track a consolidated view of the synergies, constantly refining as additional information from the management and private equity teams is received. After all, a strong flow of accurate information is essential to building an accurate assessment of future inorganic growth potential. ■

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**TOM MARSHALL**