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Forensic Tools for "Fuzzy" Due Diligence

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According to the Q1 Middle Market Indicator from the National Center for The Middle Market, in 2013 middle market companies are continuing to grow, have more confidence in the global and US economies, and predict to invest extra cash instead of holding it. All of these are likely to be good signs for middle market deal flow in the coming months. As these investments increase, business owners and investors are placing renewed emphasis on identifying, qualifying and optimizing deals. A key step is conducting due diligence on the target company to identify the implications of a potential transaction, particularly the non-obvious ones.

Yet evaluating a potential deal and investigating a target company requires more than a cursory review of the financial statements and pre-packaged reporting. Adding forensic investigative techniques reflected in emerging due diligence trends can greatly increase the likelihood of a successful deal.

Forensics and Fuzzy Due Diligence

It's important to make the data work for you when considering a merger, acquisition or non-controlling investment. By adding a forensic element to due diligence, you greatly increase your ability to evaluate a deal, adding an investigative and analytical slant to top-level observations. Forensic due diligence takes a data-driven approach to evaluating a target company and provides quantitative analysis upon which to base a go/no-go decision.

Conducting a thorough course of due diligence using analytic tools not only helps identify opportunities within a deal, but also guides post-acquisition integration activities.

By "fuzzy," we are talking about non-financial forms of due diligence – those that may be considered less often in the normal course of business. In part, this is because such forms of due diligence can be difficult to refine into actionable decisions given their undefined nature. However, these non-financial analyses can be completed within an accelerated timeframe and can have significant impacts on the outcome of the deal.

So let's discuss some of the analytic trends, both new and existing, that can advance deal success.

There are many forms of due diligence, beyond the financial analysis, that can have a significant impact on the outcome of a deal. Here we discuss three of the emerging forms:

- ***Customer due diligence***
- ***Insurance and risk management due diligence***
- ***HR due diligence***

These types of non-financial due diligence can uncover threats and identify new opportunities to improve transaction economics and help frame post-acquisition processes.

Customer Due Diligence

The results of customer due diligence, which is increasing in prominence across all market segments, can have significant impacts on the terms of a deal and post-close strategies that have implications throughout the business cycle. Within the realm of customer due diligence is the emerging best practice of Predictive Customer Analytics (PCA), a quantitative framework based on a collection of financial and marketing measures used to increase business intelligence and improve valuation.

With tighter resource constraints and greater pressure to do more with less, business success, perhaps even survival, requires forward-looking, data-driven solutions to help the C-suite achieve bottom-line improvements, top-line growth and more effective risk management. Many B2B organizations traditionally rely on historical trends in quarterly sales figures, cookie cutter reporting and analysis tools, and gut instinct rather than comprehensive data collection analysis to guide strategic and operational decisions.

Whether in the context of a transaction, the budgeting process or restructuring, insights gleaned through customer analytics can improve revenue prediction, harden ROI measurement and facilitate better communication between the marketing and finance functions. Due to the inherent collaboration between these functions, forward-looking PCA applications help marketing and business intelligence executives bring analytical rigor to their planning and benchmarking processes in a language that finance executives and CEOs find both credible and substantive.

When done properly, PCA is an essential tool that can help a company measure and predict risks and opportunities across its customer base, ultimately leading to better business outcomes. In the context of mergers, acquisitions and investments, PCA can also impact the deal value by revealing important risks and opportunities embedded in the revenue base, such as the stability and sustainability of that customer base.

Early-adopter executives who have harnessed PCA have been able to realize compelling business value and high returns on investment. The primary benefits of employing PCA are to:

- Decrease risk in the revenue stream
- Discover previously untapped top-line growth opportunities
- Identify bottom-line profit opportunities
- Enhance stakeholder value by systematically reducing enterprise risk

The typical review of an acquisition target's historical data and forecast summary provides only a piece of the picture. In today's economic environment, capital providers and senior executives must drive a new level of rigor that includes a thorough understanding of forward-looking trends based on data analysis and interpretation at more granular levels.

Understand more of how PCA works by reading our case study on page 10.

The PCA Toolkit

Addressing market, customer and strategy issues, PCA takes a multidisciplinary approach to piece together various data sources to drive a bigger picture understanding of the company.

1. **Customer Survivorship Assessment (CSA)**
   An expression of age-life characteristics of the customer base, establishing quantitative parameters for existing customers and predicted attrition for future ones.

2. **Customer Lifetime Value (CLV)**
   Representation of the dollar value of a customer relationship to assess the long-term financial impact of customer relationships.

3. **Brand Valuation**
   Assessment of the value of the brand, framed as the intersection of customer survivorship and CLV, wrapped in a portfolio of market assets.

4. **Customer/Product Matrix Mapping**
   Analytical process for identifying customer-product combinations that generate positive profit.

5. **Marketing ROI Metrics**
   Assesses the interrelationships between price, volume, cost and risk to provide a path for performance evaluation and benchmarking.

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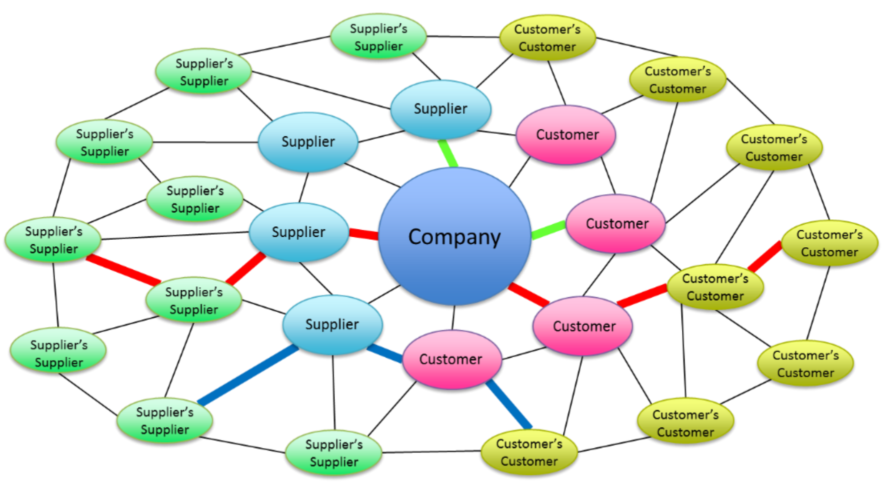
Insurance and Risk Management Due Diligence

Insurance and risk management due diligence encompasses an assessment of the liability, risk and exposure of a target company, as well as the insurance coverage in place to protect against future unforeseen events. This assessment can vary greatly dependent upon the industry segment, as well as the corporate history of the target company.

We're going to limit our discussion here to organizations that are part of a supply chain – but you will see how these and similar issues would likely impact an assessment of any target company.

In today's global market, the supply chain for any product, especially food and beverages, can be many steps long, pulling in component pieces from multiple suppliers and involving multiple customers. Target companies could be located anywhere along the supply chain, and thus facing different risks. The end of the supply chain comes with the company that is seen as selling the final product to the end user. The longer and more complex the supply chain, the greater the risk for exposure can become as the risks associated with sourcing ingredients and components increases. Companies need to know their suppliers and their customers well to limit exposure.



Comprehensive due diligence not only reveals the risk in the deal, what the future may hold for the company and post-acquisition expectations, but can also illuminate unknown and unrealized opportunities. Understanding the supply chain risks that exist for a company, the loss mitigation efforts either in place or absent can provide additional insight into a company's future value. Within the context of opportunities involving a supply chain company, there are two main purposes to conducting due diligence on insurance and risk management: to measure the risk, and to identify regulatory requirements.

Top Global Business Risks for 2013

1. **Business interruption, supply chain risk**
2. **Natural catastrophes (e.g. storm, flood, earthquake)**
3. **Fire, explosion**
4. **Changes in legislation and regulation**
5. **Intensified competition**
6. **Quality deficiencies, serial defects**
7. **Market fluctuations (e.g. exchange or interest rates)**
8. **Market stagnation or decline**
9. **Eurozone breakdown**
10. **Loss of reputation or brand value**

Source: Allianz Global Corporate & Specialty "Risk Barometer" survey

Measuring the exposure

Using investigative and forensic methodologies, an assessment of risk, liability, corporate history and other factors can articulate how prominent the present or future exposure of the target company may be.

Previous recalls, investigations and business interruptions can often be red flags to investors and merger partners. However, looking at the severity of the incident and how the company responded could reveal that the incident may not be as fatal to a potential deal as originally thought.

A look back at how a company has handled itself during a crisis may highlight the strength of the company in handling events which through unforeseen may be inevitable given the company's position on its industry.

Furthermore, understanding a company's attitude and response to a current crisis may provide investment opportunity. Correctly evaluating the likely outcome of a financial damages loss brought against the company or by the company against another is important in understanding the current value of the company.

Many companies handle a crisis well, though often mid-tier and smaller companies, who are well run, can come under tremendous cash flow pressure as they react and respond to an unforeseen supply chain event. While many mitigate the risk through insurance programs, the losses can quickly be much greater than the insured losses leaving them with a good business model and valuable product, but limited cash resources.

When investigating a target company for acquisition, merger or investment opportunities, there are a number of items that should be considered:

1. Position in the Supply Chain
   Where is the target company positioned within the supply chain? Are they an ingredient supplier, vendor, customer, distributor or reseller? Position within the supply chain has a significant impact on the potential exposure risk of the company associated with a recall incident. For instance, if the company supplies raw ingredients in a 5-step supply chain when a contamination event and recall occurs, the company's liability and loss can be compounded depending upon when the contamination is discovered and how many steps in the supply chain are involved.

2. Potential for Third Party Damage
   Is there is a potential for third party damage? It is important to understand that if the company is positioned early in the supply chain and a contamination event or recall occurs, the company has a higher exposure for potential damage to their customers and their customer's customers.

3. Insurance Portfolio
   How much insurance coverage is currently in place? Is the coverage adequate relative to the potential exposure and liability? Here, the investor or merger partner must determine if there is adequate coverage if a loss were to occur.

4. Existing Insurance Claims
   Are there existing, pending insurance claims outstanding under the company's coverage policy and how are these claims being addressed? Are existing and past claims being handled expeditiously to preserve relationships and speed the recovery of business processes?

5. USDA/FDA Investigations and Notifications
   Are there USDA or FDA investigations or recall notifications in place or recently conducted for the target company or across their industry? The analysis here is to examine the historic frequency and impacts, as well as the potential that the company will be faced with a regulatory investigation or a recall notification in the future.

6. Attitude of Leadership
   What is the company leadership's attitude toward the recall risk? Are they conservative, cautious and prepared in the event an incident occurs? Or are company leaders just crossing their fingers and burying their heads in the sand, hoping that nothing bad happens?

7. Customers and Vendors
   Who are the company's customers and vendors? And how secure and strong are those relationships? Some of this can be answered using predictive customer analytics, but it is important to take a 360-degree look at the company and examine vendors, suppliers and customers.

   What kind of leverage does the company have within its supply chain – can it pass the burden of an error or fault away from itself onto others in the supply chain or must is deal with that burden itself in order to remain on the customers' supplier list? A company's exposure is often affected by the strength of its relationships within the supply chain – both upstream and downstream. The goodwill established could greatly influence how smooth or difficult incident management can be.

8. Crisis Management Recovery Plan
   Does the company have a crisis management recovery plan in place? How prepared is leadership to respond in a crisis – from a recall event to business interruption to catastrophe response?

9. Brand Rehabilitation
   In the event of a recall, a product or company brand is often damaged or impacted in some way. What will be the short- and long-term impacts of a potential recall? And are plans in place for how to mitigate and repair any damage to the brand?

Identifying regulatory requirements

Another important consideration is to examine current and pending regulatory requirements the company is subject to. For example, in 2011 the US Food and Drug Administration (FDA) launched sweeping changes to the regulations associated with companies in the food industry. Two proposed rules are currently in the commentary phase, and will ultimately be finalized. Companies will have to become more robust in their manufacturing processes, record keeping and recovery planning. This will include having the resources to:

- Perform a hazard analysis
- Address preventative controls
- Monitor the effectiveness of controls
- Establish corrective actions
- Verify controls and corrective actions
- Maintain accurate records
- Have a written and communicated plan

This has required many companies to make significant investments in infrastructure and technology in order to remain compliant under the new regulations. It has also meant companies are looking closely at their resources and their ability to remain compliant under new regulations. This opens a potential for future deal considerations and increased deal flow in the middle market as supply chain companies look for liquidity strategies to cover these investment costs.

Further, the FDA now has enhanced authority, including the ability to enforce Administrative Detention Authority, meaning that in Class I and Class II recalls the FDA can detain food articles for up to 30 days. This authority has already been exercised multiple times, and could have significant impacts on risk and exposure for companies within the supply chain.

Knowing new regulations are in place and additional changes are coming may open new opportunities for deal flow in the coming months, while understanding the risk, liability and exposure of a target company prior to deal closure can impact the deal terms and prepare all parties for post-close integration.

Human Resources Due Diligence

A relatively new area of due diligence, human resources analysis is a widely underserved market segment that provides invaluable knowledge to and about companies. HR due diligence, also referred to as Big HR Data and Workforce Analytics, focuses on creating insight into an organization (strategically and operationally) by connecting people performance to business performance, identifying where the risks and opportunities lie.

Within the context of M&A – specifically post-merger integration activities, there are key nuggets of information that live within many of the operational systems which can give a whole new perspective on organizational health and most importantly, the business outcomes which are created by the organization's employees.

Recently Imposed FDA Regulations

The FDA Food Safety Modernization Act (FSMA) was a long overdue overhaul of food safety regulation launched in September 2011 providing a proactive approach to food safety control. It focuses on detecting and halting the distribution of contaminated food.

In the case of a suspected contamination event, the new regulation requires increased inspection of company records, suspension of the company's registration with the FDA and development of a corrective action plans.

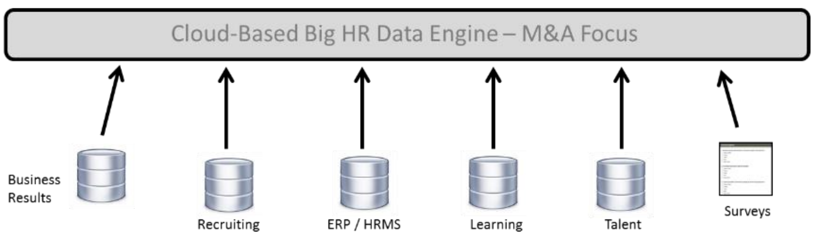
Further FDA Regulations Anticipated

- **Standard for Products Safety**
- **Sanitary Transportation of Food**
- **Enhanced Tracking and Tracing of Food and Recording**
- **Decontamination and Disposal Standard**

Wouldn't you like to know who the key value creators within an organization are? Who are the ones who create, on the one side the most positive outcomes for the organization, and on the other side, who creates the most turmoil in terms of quality issues and customer satisfaction?

While many of us have used benchmarks to help drive change and improvements in our businesses, these aggregated benchmarks are often flawed and dumbed down. With "Big HR Data" you can clearly see who the outliers are, both positive and negative, and understand the specific characteristics so that you can either replicate it or remove it.

HR due diligence compiles Big HR data from a number of sources for a comprehensive analysis.



The reality is that every company collects a plethora of data about the business, operations, outcomes and employees. The difficult part is that, often times that data lives in disparate systems and is rarely consulted in an integrated way. Taking a forensic approach, it's possible to make sense of all of the data to tell the story and gauge the sustainability of a company so HR and business executives can make better business and people decisions.

Why is HR Due Diligence Important and Valuable?

A common thread in many M&A deals is not only the health of the company financials, the size of market share and the sales forecast, but also the quality of the people, and most especially the quality of the management team. We all know that members of the management team can typically be masters of positioning and even more so when faced with the opportunity of an exit, yet they don't always have the full picture, especially in larger organizations with many layers of management. If they did, running a business would be easy.

At the end of the day, it takes the sales reps to close the opportunities, not necessarily the VP of sales, and it takes line managers and supervisors to keep production flowing, not necessarily the VP of Operations. So, if your target company has tremendously high turnover across the top sales reps, then that's an issue. If they have certain plants, shifts, managers or teams who are throttling production, then that's also an issue. If the company has a tenured management team with no succession plan, then that could have a major impact on stability a few years down the road.

HR Due Diligence Within the Deal

Within the context of M&A, there are two sides to using HR Due Diligence:

1. **Pre-Deal Assessment**
   Understand the health, culture and characteristics of the organization. Identify key value creators and assess the cost and rate of turn over. Are we leaving large opportunities on the table?

2. **Post-Close Implementation**
   Using facts, plan for success in implementation and integration after the deal by identifying where the gaps are and determining how to close them.

These are not only issues which might drive material movements on the valuation and term sheet, but on the flip-side, they may be tremendous opportunities for new management to focus on after the deal closes.

But the question is, how does one perform this business workforce analysis when many organizations themselves don't know many of these answers? Let's quickly look at that.

Cloud-Based Big HR Data Services – Rapidly Deployed, Flexible & Value-Driven

A company's finances are typically available in a timely fashion, to a certain degree of standardization and quality – and it's typically a company's most important information source. And while the finances are not always easy to understand and clean, they should be in pretty good shape. Operationally however, many organizations struggle with how to understand and leverage all that other information because it's expensive and complex and dare we say it, always involves a big, internal IT project.

Ironically, it's much easier, quicker and more affordable to get full-suite business analytics, specifically workforce analytics (or Big HR Data) if you deal with an external service provider – as opposed to an internal IT shop. With the advent of cloud-based services and business models, and an app-store mentality of "if I can dream it, I can download it and have it, now", cloud-based workforce analytics, and the answers to all of those questions (posed at right), can be switched on within days, not years, at pennies on the dollar compared to a traditional BI install or project.

Workforce investment is tied to 60-70%+ of operating expenses (OPEX) while the efficacy of that investment is currently a black hole in many organizations, and that simply isn't good enough – operationally, strategically, and arguably, not from an M&A perspective either. The need to identify the risks and opportunities associated with the people-side of the business gives rise to a highly complex, value-driven solution which can be affordably implemented within days – cloud-based Big HR Data Services. This is critical because every business output has a people component that must be considered.

Learn more about putting Big HR Data into action in our case study on page 11. It's your workforce data, you should be able to use it.

Using Big HR Data Strategically

HR Due Diligence can answer a number of question:

- **Who are the key value creators? Is there turnover risk? Are there successors ready and in place?**
- **Is there unusually high turnover in the management team? Key operations? Key value creators? Top performers?**
- **Are there behavioural assessment flags for the Executive Team (undesirable or problematic traits and behaviours)?**
- **How much cultural alignment and compatibility exists between the two companies (command and control, self-evolving teams)?**
- **Are the core competencies of the business models compatible (customer, product or delivery-centric)?**
- **What is the cost and impact of planned turnover and retirement in the next 2-3 years?**
- **Are the highest paid the best performers/top producers?**
- **How does engagement translate into sales, productivity and outcomes? Are the top performers the most engaged?**

What It Really Means for You

The ultimate goal when contemplating a deal is to get your hands around the big picture of the target company and the transaction as quickly and accurately as possible. Fuzzy due diligence can

- Balance risk and opportunity
- Provide quick turnaround in a cost effective manner
- Understand strategic implementations
- Return a high value on the investment

The Key Takeaways

Customer Due Diligence	Insurance and Risk Management Due Diligence	Human Resources Due Diligence
Assess the sustainability of the customer base, and thus the company.	Evaluate the level of exposure faced by a company in light of: • Its position in the supply chain • Risk associated with its products • Regulatory shifts • Ability to handle crisis management	Identify key value creators in the company and determine the sustainability and stability of these people, teams, managers and executives.

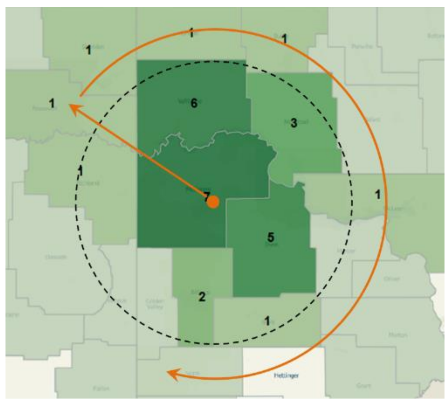
Forms of fuzzy due diligence are quickly becoming core steps in the strategic planning and executive decision making processes, including in anticipation of, during and following M&A and investment deals.

CASE STUDY: PCA in Action

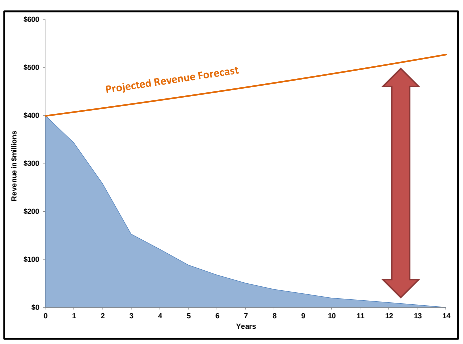
Let's take a look at how this works in the real world with a brief case study of how one company's use of PCA helped them uncover customer attrition trends at a transaction target that saved the acquirer millions of dollars.

In the due diligence process for an $80 million corporate acquisition, the acquirer applied a survivorship assessment to evaluate the sustainability of the customer base.

Unknown to the buyer, the target had churned through customer relationships within its traditional service radius that were unlikely to return, and the continued ability to replace them with new customers had rapidly diminished. To achieve even nominal growth, the target began expanding its service area beyond a radius that was economically feasible, which was confirmed through a time-series, geographical plot of its customers as shown in the illustration.



In order to estimate the magnitude of this decline, we analyzed monthly sales records for 6,000 customer accounts over a period of seven years. Through the analysis, we modeled attrition patterns of the target company's customer relationships to develop a baseline from which to project the expected remaining life of its current customers and to forecast expected attrition in the coming years.



This analysis, which took only days to complete, yielded the revenue forecast far below the acquisition target's modest revenue growth projection of approximately 2-3% growth per year. Of course, new customers were going to help fill the gap, but given the target's resources and geographical constraints, it became obvious there was a significant revenue gap that would not be filled.

Armed with these findings, the acquirer chose to proceed by successfully negotiating a $30 million reduction in price. Importantly, the buyer entered the deal with a much better sense of customer issues and how best to manage the integration process.

CASE STUDY: Workforce Analytics in Action

Blue chip Company A is assessing an acquisition of Company B. The deal is based on Company B's strategic growth projection to add $10M per annum in additional profit and 100 new customers in 3 years.

Assessing the stability of the workforce using comprehensive HR analytics, we can plot a heat map of employee turnover at Company B by performance and tenure.

The heat map, plus additional core HR and business data can uncover some questions and weaknesses within the organization, such as:

1. Why are more than 200 poor performers sticking around? Why isn't management dealing with this?
2. Turnover is very high (22%) for Top Performers within the first year, costing the company nearly $1M in recruiting and onboarding costs annually.
3. Turnover is ALSO very high in the First Year regardless of performance levels – this is very expensive, disruptive and stunts growth. Are things misaligned?
4. The Pacific Sales Region constantly exceeded quota by 23% and has been #1 for last 4 years. However, 42 of the 367 employees eligible for retirement in 2015 are top performers for the Region. Is there a succession plan?

An assessment of the heat map will reveal a great deal about the company and management strategy, as well as raising a number of questions that will likely need to be addressed in a post-acquisition plan, primarily:

1. Is the target business plan achievable?
    a. How can we make the business plan given significant Top Sales Producer retirement planned 2015, our inability to retain new recruits, and an inability to deal with poor performers?
    b. Should we walk away? Negotiate on price? Do deeper due diligence? Change and re-cost the implementation strategy/ROI model?
2. How can we drive more effective post-merger implementation strategies?
    a. Where should we focus first? Where are the know traps?
    b. How can we retain top performers/critical positions and shed poor performers?
    c. How should we measure success and determine Human Capital ROI?

ABOUT THE AUTHORS

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Matthew Morris is Managing Director of RGL Advisors in Dallas. He is a veteran investment banker with 15 years of experience advising corporate clients and shareholders in transactions and has advised on more than two-dozen transactions with an aggregate value in excess of $2 billion. Concurrent with his role at RGL Advisors, Matt is a Partner at the international forensic accounting and corporate finance firm of RGL Forensics. There he focuses on the valuation of equity and debt securities and intangible assets for transactions, financial reporting, tax reporting and disputes, and commercial litigation. mrm@rgladvisors.com

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