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Private Equity
Making more returns

Differentiated Due Diligence

As leverage multiples increase
and credit becomes more available,
Private Equity has been an active
driver of capital markets.

Differentiated due diligence

Bain and Company's 2014 *Global Private Equity Report* identified five skills that General Partners (GPs) will need when it comes to developing distinctive ways to create value in today's complex private equity environment:

1. GPs will need to build a proprietary deal network with strong industry sector skill in order to capitalise on deal sourcing and acquisition.
2. **The leaders will over-invest in differentiated due diligence to surface a potential acquisition target's relevant opportunities and downside risks.**
3. Operating as owner-activists, top GPs develop and pressure-test their investment thesis and operating blueprint that will guide their management teams throughout the time the fund owns an asset.
4. They start thinking about their exit path from day one, continuously tracking options and identifying potential buyers from the start and preparing the business accordingly.
5. They nurture a deep pool of local talent that possesses the regional and global perspectives needed to build the firm's capabilities[1].

As a provider of due diligence, the second point is worth considering further – what is differentiated due diligence?

There is, of course, no such thing as the perfect due diligence. But that doesn't mean that traditional approaches can't be improved. In an effort to get closer to the 'holy grail', how should one design due diligence into the future – to better cover risks and opportunities, and uncover the unknown?

Differentiated due diligence has long been talked about in private equity circles as one way to gain an advantage over competing buyers – either by seeing some potential the others don't, allowing a more aggressive bid, or unearthing an issue that allows you to walk away and avoid the bad deals that impact overall returns.

So how do you predict the future, find the winners and weed out the bad deals? How do you make due diligence robust enough to rely on?

Commercial and financial due diligence is a critical part of a private equity investor's overall deal decision making process, but it inevitability involves making assumptions about the future which are inherently uncertain.

[1] 'Global Private Equity Report', Bain & Company, 2014

Take a look at macro

Again, according to the Bain report:

"PE firms have undervalued the need for macro analytical capabilities in due diligence and portfolio management, because until recently they were of minor importance."

So is macroeconomic analysis the answer, or part of the equation, when it comes to differentiated due diligence?

The answer is yes – but only to a degree.

Due diligence is about the sum of the parts, evaluating all aspects of financial, tax, HR and commercial issues to better understand the underlying drivers of the business for sale and inform overall decision making.

With the benefit of hindsight, it's easy to suggest that those who recently bought into businesses providing services leveraged to resource expansion missed the macro signals of the recent slowing of the Chinese economy.

On the upside, the recent rush of deals in the healthcare sector has been buoyed by an understanding of the macro drivers of demographics and an ageing population, however the real key to driving value on acquisition is recognising Macro forces early.

But macro isn't in itself the answer – there are many other tools, not to mention the experience of private equity professionals that are important in assessing value – but it does help to have a macro following wind as the acquisition journey begins.

Backed by detailed Deloitte Access Economics analysis, Deloitte's *Positioning for prosperity: Catching the next wave* report identified 25 pockets of growth in the Australian economy which will benefit from that following wind of macro drivers.

The methodology used applies the basic principle of plotting the intersection of global economic growth with areas where Australia has a competitive advantage.

The research in itself is a useful, broad brush guide to future growth areas, but when it comes to private equity due diligence, macro research must be specifically tailored to each acquisition to truly ensure relevance to the opportunity available.

This however is easier said than done.

One powerful asset that exists and is often overlooked is data. Data provides a potential way of viewing traditional analysis through a different lens.

Data also provides a way of making Macro Economic due diligence more specific.

Macro and predictive analysis

At Deloitte, we are driving more specific macro analysis in the review of acquisition target forecasts through the use of detailed data as one of the key inputs in predictive analytics.

Predictive analytics involves five key steps:

1. Downloading granular financial and operational data from a client or acquisition target.
2. Validating the data to ensure a consistent and usable format.
3. Combining the client's or target's data with multiple third party and Deloitte proprietary data sources of demographic, economic and other statistical data.
4. Using powerful computing capability and building complex algorithms to establish associations between historical client or target data and macro external indicators.
5. Applying the historical results to forecast demographic and economic indicators to predict the future trajectory of a client or target's results.

This methodology can be applied to forecast volumes or revenue and provide an independent view to management's forecast. In a series of recent test cases involving industries including distribution and construction services, our forecasts using predictive analytics were within 10 per cent of actual results over a 12 month period and were also more accurate than management's budgets ultimately proved to be.

So is predictive analytics a key part of the answer to differentiated due diligence?

Private equity acquirers would obviously value the ability to 'validate' target forecasts. A recent *Deloitte survey*[2] in the USA found that more than 50% of respondents in corporate and private equity M&A were using some form of data analytics to analyse deals. While the definition of data analytics means different things to different people, it is clear that data, and an understanding of its relevance and value, needs to be considered in M&A due diligence.

The application for private equity is also interesting in validating management forecasts prior to exit, or in considering the longer term trajectory of a business during ownership, helping understand when to invest further in capex or even perhaps in thinking through the time horizon in which to exit.

But there are limitations. This type of data analysis lends itself to high volume transaction businesses such as retail, distribution, education, healthcare and financial services rather than 'lumpy' revenue models driven by the winning of large contracts or tenders.

Likewise in an acquisition scenario it's not always easy to get access to such granular data (although sensitive data does not need to be handed over to an acquirer, and can be analysed in a 'clean room' environment).

Macro and predictive analysis – a case for both

As with macroeconomic analysis, predictive analytics is only part of the solution – the key to differentiated due diligence is using all available information to critically evaluate the available opportunity.

But in today's data-led world, the combination of macroeconomic insights and predictive analysis could provide that much needed edge in the drive for differentiated due diligence and a successful deal.

[2] 'Deloitte's 2014 M&A trends report' Deloitte LLP, 2014

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