Private equity integration and value creation

Get the most out of your investment after the deal is done

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Integration and value creation

Get the most out of your investment after the deal is done

Congratulations! You’ve negotiated a successful deal in the highly competitive private equity environment. Now, it’s time to roll up your sleeves and focus on integration and value creation to earn attractive returns for shareholders. While private equity has continually demonstrated its ability to thrive amid periods of economic instability, with today’s ever-changing economic conditions, it’s more vital than ever to create a solid integration and execution plan to build portfolio value.

While we cannot eliminate risk, we can help private equity owners and their portfolio company management teams develop and execute a comprehensive “first 100 days” plan, including a rigorous assessment of the business’s core strengths, the best opportunities for increasing its value, and areas of synergy with the rest of the firm’s portfolio. Looking through several different lenses — including financial, enterprise risk, information technology, and strategy and operations — we can identify and guide you through the most promising near-term initiatives and help you prepare for longer-term strategic opportunities.

You already know how to make deals work. This executive-level guidebook, which includes practical advice and key takeaways, will help you derive maximum benefit from ownership during the holding period to ensure the best ROI upon exit.

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Ratcheting up value
with performance-based equity incentives

Maximizing the value of a portfolio company from acquisition to exit is heavily dependent on the performance of its management team. Traditionally, private equity firms have rewarded management by giving them equity that vests over time and a share of value in an exit — thus, providing an incentive to remain with the company. Increasingly, performance-based compensation plans, which have become popular for public companies, are taking hold in private equity firms. These plans tie the equity incentive to some form of total shareholder return (TSR). They may replace or be combined with traditional service vesting plans. The greatest benefit of TSR plans is that they more closely align management goals with those of investors.

For example:
Plans can be structured so that management equity incentives are contingent on a target return to investors, who after all, are the ones providing the capital and shouldering the most risk. It is the ability to fine-tune these plans to investor-specific performance goals that make them especially appealing.
For example:
The performance targets could be a minimum ROI, multiple of capital invested, or minimum value at exit. Another attractive feature of TSR plans is the ability to set up payout ratios on a sliding scale that covers a range of results.

As with any compensation plan, TSR performance-based equity incentives have various legal, design, tax, and financial reporting considerations. Nevertheless, when properly structured and administered, these plans can be highly effective at establishing an incentive for value creation and promoting both better returns and a successful exit.
Getting the right balance

by addressing accounting on day one

When it comes to the accounting side of a transaction, the devil is in the details. To avoid disagreements or delays, it’s important to be as specific as possible. We’ve identified three key areas where, in our experience, accounting issues can cause hiccups or misunderstandings between the buyer and seller.

Definition of terms

Every agreement is different, which is why both parties need to pay particular attention to how key terms are defined. A case in point is working capital. Many target organizations maintain their accounting on a cash basis as opposed to U.S. GAAP — the method that will be used for the new entity’s opening balance sheet. The closing agreement should clearly state the method of calculating the target’s working capital on the closing date, whether it is to be calculated based on past practices or in accordance with U.S. GAAP — otherwise, a discrepancy may occur. Even “normal” assets and liabilities such as accounts receivables, inventory, and cash should be defined to avoid misinterpretation.
For example:
A seller may be motivated to leave old or bad inventory or receivables on the books unless the definition clearly states they’re excluded. In terms of cash, generally, there’s a minimum level of cash on hand. But, does that mean cash in the bank? Or the adjusted book value of cash? Are certain cash accounts included/excluded?

Valuation of intangibles

In preparing for the year-end audit, you need to account for all assets and liabilities acquired in the transaction on day one and assess the impact of any potential intangible assets that may arise from the transaction, including goodwill. The valuation process for intangibles can be time-consuming and is also subjective, so starting the process early is key.

While the Private Company Council alternative accounting method allows companies to include some categories of intangibles under goodwill, not all intangibles are covered by the alternative. It’s advisable to have a solid understanding of what intangibles are present at the target company.

Fair value and other balance sheet accounts

Some accounts will need to be revalued because opening balance sheet rules require different measurement than accounting for continuing entities. Two examples of items that are generally adjusted are deferred revenue and inventory. Companies sometimes overlook the complexities of these calculations, since they tend to be familiar with the concept of deferred revenue or inventory (unlike certain intangibles).
However, they may not realize how these items are valued in the opening balance sheet under U.S. GAAP. Many target companies — on whom buyers rely to assist with valuation calculations — are under the misconception that whatever is on their books at the time of the closing date is what goes onto the opening balance sheet, but this is not the case.

For example:

*Inventory* that’s considered a work in process needs to be revalued to consider the margin markup, estimated costs to complete, and the related costs of disposition.

Clarity around these key accounting issues can avoid surprises, misunderstandings, and most importantly, post-acquisition disputes.
Preventing value erosion

with proper tax planning and implementation

Following the close of an acquisition, a buyer should address (and remedy) any material issues identified during tax due diligence, and determine the optimal short-term and long-term tax positions and strategies. Having an organized, methodical approach will help prevent costly mistakes and time-consuming data-gathering efforts.

Putting first things first

During the first 100 days, the buyer should devote attention to any material tax exposures identified during due diligence. The buyer should also retain a tax preparer to identify any additional information not currently being collected but needed to prepare future returns. The following page outlines nine key considerations buyers and tax prepares should have during due diligence.
NINE KEY BUYER AND TAX PREPARER CONSIDERATIONS

(Note: This list is not intended to be all inclusive)

1. **Allocation**
   Purchase price allocation and the resulting impact on the effective tax rate

2. **Estimated payments**
   Estimated quarterly tax payments, including identification of all filing requirements

3. **State exposures**
   Voluntary disclosure agreements for state exposures identified during due diligence

4. **Filings and elections**
   IRS filings/elections that must be made prior to the filing of the tax return for the year of the acquisition (e.g., Sec. 338(h)(10) election/Form 8023)

5. **New filings and elections**
   New filings/elections for the post-acquisition period

6. **Accounting method changes**
   Automatic and non-automatic tax accounting method changes (a non-automatic accounting change must be filed during the tax year the change is to be implemented)

7. **Interest expense**
   Deductibility of interest expense on acquisition debt

8. **Transaction cost analysis**

9. **Restrictions**
   Restrictions placed on the acquired entity’s tax attributes resulting from the change-in-control (e.g., Section 382 limitations)
Data collection for tax reporting

Tax planning and optimal tax positions depend on the source data, the proper interpretation of the data, and an understanding of future expansion plans. If the data required is not currently gathered or is organized in an inefficient manner, you may have difficulty supporting and defending that tax position if challenged. Simply stated, information that may be readily available at one time, may be very difficult to collect and organize after the fact. Policies and processes should be reviewed from both a historical and future perspective to determine whether any information gaps exist, or will exist due to business expansion. Common data collection issues to be considered include, but are not limited to the following:

- Tracking additional sales and customer detail (e.g., origin, destination, and customer location)
- Tracking employee travel and the use and location of independent contractors
- Monitoring and tracking of property located off-site (e.g., storage, transit, or consignment)
- Identifying different revenue streams (e.g., online sales) and the corresponding sales tax treatment of each stream

Tax planning for a growing business

As noted above, it is not uncommon for the buyer or the acquired company to make significant changes after an acquisition to its geographical footprint, customer base, revenue streams, and operations. The buyer should evaluate how its business plan and strategy will impact the buyer’s or the acquired company’s existing tax reporting requirements and overall tax strategy.

For example, the expansion into a new jurisdiction may result in additional income tax filings and a variety of other filings, such as sales, use, employee withholdings, property, and value-added (VAT) taxes, as well as custom duties. Additionally, as the business expands, it may be necessary to consider changes to the entity structure from both a domestic and foreign perspective to accomplish the desired business, legal, and tax objectives.
Upgrading the finance function
to achieve financial reporting proficiency

Most private equity firms understand that when they begin integrating an acquisition, they’ll need to make some improvements to the seller’s finance and reporting capabilities. In our experience, the degree of upgrading that’s required isn’t always fully appreciated — and may even come as a surprise, especially for smaller, family-owned acquisitions. There are three areas where private equity firms should be focusing their efforts in order to begin building value.

Create a robust internal control framework

Many acquisitions have a relatively limited internal control structure, in any. Certainly very few can meet the rigorous reporting requirements of their buyer, nor have they gone through an external audit with a major, or even a regional, accounting firm. The level of information that management needs to gather, and the reports they have to compile, can be bewildering — and the buyer may not realize the extent to which the acquired company is unprepared.

To get a handle on the state of an acquisition’s internal controls and determine what kind of structure is appropriate, a thorough assessment is in order.
The timeline for completing an assessment may depend on the time of the next reporting period and how quickly the seller needs to be ready for an external audit. It could also depend on the private equity firm’s specific needs in adequately addressing the reporting requirements.

The optimal approach for improving financial reporting will also depend on the owner’s overall integration strategy.

Improve the efficiency and timeliness of financial reporting

The highly metrics-driven focus of private equity firms, as well as their specific reporting methodologies, can create a challenging environment for management of the acquired organization. Smaller companies, in particular, often don’t have the ability to track financials at a truly granular level or to compile accurate reporting on such items as net revenue, cash flow, and selling, general and administrative expenses on a weekly or even a daily basis. Arriving at this level of proficiency takes both time and resources, so the earlier the process starts, the faster the finance function can begin adding value.

The optimal approach for improving financial reporting will also depend on the owner’s overall integration strategy.
For example:

*Does the new company have multiple business units that need to be organized within a single controls and reporting framework? Or, are there opportunities to leverage systems and frameworks from other portfolio companies?*

**Upskill or upgrade the finance talent pool**

An acquired company often has a relatively unsophisticated finance team that is more focused on bookkeeping than on pulling together monthly reconciliation reports. Yet, many buyers are surprised by how unprepared their acquisition’s finance staff actually is when faced with a new set of demands and responsibilities. There are several ways a private equity firm can get an acquisition’s finance staff firing on all cylinders.

If the current team is fairly knowledgeable, then staff can be trained on the finer points of the reporting requirements, such as:

- Improving the efficiency and timeliness of the financial close
- Monthly reconciliations and financial statement preparation
- 13-week cash flow forecasting and cost analysis
- Preparation of accurate budgets
- Purchase agreement compliance

Alternatively, they may need to replace staff or bring in reinforcements, either from within their organization — if they maintain a finance “SWAT team” — or by enlisting third-party experts. A strong finance team will not only guide efforts to streamline financial reporting; it will also be better positioned to extract value-adding insights from the data gathered.

Achieving a robust level of financial reporting proficiency for a new acquisition is often harder than it looks — but, it is critical during the first few months after the transaction closes. An accurate picture of the new company’s financial performance will help the buyer implement an optimal path to integration and value creation.
Assessing the IT environment
and developing a strategy to add value

During the busy due diligence phase of a transaction, the majority of activity tends to concentrate on the financials, with less emphasis on evaluating the information technology (IT) environment. However, for many organizations, IT has transitioned from a simple support role to a competitive advantage, which makes evaluating the acquired company’s IT environment an important piece of the diligence process.

**PRIMARY QUESTIONS**
*When assessing a target’s IT system*

1. **Value**
   - How can IT deliver more value to the organization?

2. **Threats**
   - Are there any operational and financial risks that might threaten effective delivery of IT services?

Answering the first question requires a thorough review of the existing environment by a team of experts. By using industry benchmarks and best practices, the team can quickly identify operational and financial risks that may exist in the target’s IT environment. The answer to the second question will depend on the overall business strategy for the new company.
For example:
If you plan to integrate the acquired company with all or part of your existing platform, the approach to IT will be quite different from a situation in which you intend to manage it as a standalone business.

In the first instance, you’ll probably want to look at solutions like shared services centers, while in the case of a standalone business, making upgrades to the existing IT or even a diverse platform may be more appropriate. The extent of this investment will also depend on the time horizon for an exit. It all comes back to the importance of aligning the IT strategy with the overall business strategy.

An established IT strategy

IT is an enormous line item for many companies, and there’s often a significant opportunity to achieve operational efficiencies. Once the IT strategy has been established, you can begin to make tactical decisions about necessary improvements. Look for ways to eliminate redundancies in IT functions and replace manual processes, such as data entry, with automated ones. You may also find it beneficial to use external resources for noncore IT functions. Replacing home-grown solutions with cloud-hosted, third-party software is another option — but, there’s no one-size-fits-all solution, and the appropriate platform often depends on the industry.

At times, the best way to achieve efficiencies is by leveraging any existing IT resources — including people, systems, tools, and technologies — from other portfolio companies. Instead of thinking of each acquisition in a vacuum, re-evaluate your overall portfolio and identify opportunities to redeploy assets in a way that increases value across the entire group.

For example:
You may be able to achieve economies by standardizing certain processes or resources such as role descriptions or policy manuals.

You can also identify shared resources for certain functions — particularly those that are not well developed in many acquired companies, such as a
project management office. Another way private equity firms can gain leverage is by pooling purchasing across their portfolio of companies. The combined buying power of multiple entities can improve your price-negotiation position and help you win volume discounts for hardware, software, and even third-party resources.

**Keeping cybersecurity on the radar**

With increases in cybersecurity threats, diligence activities should also take into consideration a high-level review of cybersecurity, regulatory, and compliance needs. Following the deal close, especially in industries that have stringent regulatory and compliance oversight, it’s critical to dive deeper into the acquired company’s cybersecurity:

- **DISPENSE WITH UNNECESSARY PERSONAL DATA:**
  Inventory all personally identifiable information such as credit card numbers or social security numbers and protected health information of customers, and expunge all unnecessary data.

- **PROTECT HIGH-PRIORITY INTELLECTUAL PROPERTY AND OTHER DATA:**
  Determine what information is most valuable or requires greater protection. Identify security risks in the new company’s systems, and establish whether the company has ever suffered a breach.

- **MAKE SURE YOU’RE COVERED:**
  Review the seller’s cybersecurity insurance. Policies may need to be updated or modified — for example, the terms of the policy might change with the change in ownership.

- **STAY AHEAD OF THE CURVE:**
  Monitor the threat landscape and evaluate any weaknesses or gaps in the company’s cybersecurity posture on an ongoing basis. Tap into professionals who stay abreast of the latest software and best practices — they can advise you on the optimal cybersecurity technology for your acquisition.

**ADDING VALUE THROUGH IT:**

*Key considerations*

- What IT functions are candidates for shared services across other portfolio companies?
- What manual processes can be made more efficient through appropriate use of technology?
- Can cloud-based software-as-a-service be used to manage any portions of IT currently hosted in-house?
- Should any IT functions be outsourced to a third party?
- Does the organization have the right metrics in place to measure IT performance?
Creating value out of the gate

*and strategically positioning yourself to compete*

Value creation is the point of every deal. Here are three ways private equity firms can make sure they begin creating value starting day one.

**Build on the business case**

Most private equity firms develop a solid business case for their acquisitions, including an in-depth industry analysis. Yet, all too often the business case is relegated to a filing cabinet once the deal closes.

It’s important that firms understand the acquisition in the context of the industry in order to determine where they’re best positioned to compete. This will drive value-creation decisions ranging from where to locate plants or other facilities, to which businesses to close or sell, to whether the company is even selling the right products.
For example:

One private equity owned company operated for the first two years post-acquisition in a mature geographic location while much of the market growth was in regions over 1,000 miles away.

This led to stagnant growth and the company’s having to scramble to build a new facility, which took an additional year.

Look for synergies across the portfolio

While private equity firms own multiple companies, when it comes to creating an integration strategy for a single acquisition, they’re so focused on making fixes that they can overlook opportunities to leverage capabilities or achieve economies of scale across their entire portfolio. Taking a step back from this myopic perspective can lead to some surprising discoveries. It’s possible that functional experts (either third parties or those residents in other portfolio companies) may have already solved some of the same issues the new company is currently facing, or they may have discovered opportunities for synergies.

In a recent instance, a private equity firm owned several similar manufacturers, all of which were buying comparable components from more than 40 suppliers. The firm undertook a purchasing consolidation effort and was able to reduce the number of suppliers to six, resulting in cost savings and greater supply chain efficiency.

Don’t wait

Every private equity firm uses value as a lens for making a purchase, yet many are content to focus on “business as usual” for the first 100 days or longer rather than implementing changes right away. That could be a mistake:

If you wait, you may find that the window for value creation has already slammed shut. Achieving a robust level of financial reporting proficiency for a new acquisition is often harder than it looks — but, it is critical during the first few months after the transaction closes.

An accurate picture of the new company’s financial performance will help the buyer implement an optimal path to integration and value creation.
WHAT TO CONSIDER WHEN DESIGNING YOUR PLAN

Ask yourself:

- **Consolidation opportunities**
  Are there consolidation opportunities in terms of plants or other facilities?

- **Core capabilities**
  What core capabilities and resources will be essential for strong financial returns?

- **Divestitures**
  What can we divest that's not adding value?

- **Opportunities**
  Are there opportunities to enhance material costs or gain economies of scale by joining purchasing with other portfolio companies?

- **Best practices**
  What lessons learned or best practices can we deploy across the portfolio?

- **Cross-selling**
  Are there any cross-selling opportunities?
Driving operational improvement

and optimizing for the future

Operational improvements are a key lever for achieving value creation after a deal closes. There are three critical ways to both protect and grow value through operations.

Lead differently

The due diligence process can be highly distracting to the target company. It’s easy to stop focusing on day-to-day operations, resulting in customer complaints, apprehensive employees, and lost revenue. During times of turmoil, an organization’s poor performers tend to stay, and the high performers leave to pursue other opportunities. Don’t let that happen. Identify and retain high-performing employees. When leaders understand and address their team’s natural concerns about the acquisition, they can prevent value erosion in the early days following an acquisition. Assign an integration team to prepare leadership for managing the organization through the transition and to ensure that core revenue-generating processes such as sales, order fulfillment, and billing are working seamlessly.

Optimize for the future

Plans for the critical first 100 days are best divided into weekly and monthly time frames. Early on in the process, focus on quick wins that take minimal effort. These can be used to build momentum for the transition. Activities likely to yield the greatest benefit, but that may take slightly longer, are a good focus for the first 100 days. One important caveat: Many companies tend
to jump to people or technology issues and ignore the process in the belief that it will take care of itself. In reality, the process should be driving the other two.

Establish which processes will optimize results and then determine what people and technology are needed to support those processes.

**Measure for success**

Translate the business case components used to justify the acquisition into tactical success measures. This will ensure that the team is focused on the critical activities that drive value. Key performance indicators (KPIs) such as increased sales or reduction in inventory can be used to both measure and communicate the success of the integration effort. However, often these metrics are lagging indicators that signal what has already been achieved. You also need to select a handful of leading indicators — KPIs such as proposals issued or sales calls completed — that measure the behaviors that are directly linked to success.

**Developing a plan**

Set specific goals for each of the first three months post-close. Goals should include completing activities that will achieve opportunities for improvement identified during due diligence. Without a measurable plan that includes specific goals, it is far less likely that desired benefits and return on investment will be achieved.

**FIRST-100-DAY PLAN**

- **Optimization**
  - 30 Days
  - Shift roles and responsibilities between departments to optimize capacity and efficiency

- **Elimination**
  - 60 Days
  - Develop and implement process changes to eliminate redundancies in work processes

- **Production**
  - 90 Days
  - Spec, order, and implement production automation technology
For more information, please contact:

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