

# The Journal

## Due Diligence in the Post Melt Down Era

By David Smalstig

FTI Consulting, Inc.

Over the past two years during the economic recession, we have been reminded of a few things about properly performing due diligence to gauge investment risk, and more importantly, provide a framework for post deal execution of strategies should the key underlying business drivers not materialize as planned. The days of just providing a Quality of Earnings Analysis and Working Capital Analysis are gone, just as the conversion from the old validation of accounts fell to the wayside in favor of truly understanding the earnings stream of a company. Connecting the financial diligence with operating knowledge, management competence and strategic orientation should be the end result of an effective diligence process. Some of the key attributes that need to be evaluated during a diligence process include the following:

1. Cost to reduce fixed overhead
2. Cash flow forecasting; the true net working capital measure
3. Contingency planning
4. Forecast and loan covenants
5. Management support in reorganizing the business
6. Company's ability to not only expand production, but cost effectively reduce volumes
7. Know when it is time to reorganize in a cost effective manner
8. Know the competition, and its ability to scale cost in a competitive manner
9. Standard costing methodology and impact on future margins

Often the focus has been related to understanding a company's ability to expand and the excessive capacity; however, this approach lacked the focus to fully ►

understand the true cost to reduce capacity and fixed overhead. These costs can be significant and often result in consumption of available cash and resources, together with execution of not well thought out strategies. Just understanding fixed and variable costs together with the breakeven volume are not enough, one needs to know the cost to reduce the fixed overhead nature of a firm in order to maintain acceptable profitability.

In addition, the concept of a 13-week cash flow model historically was viewed as something a distressed business was focused on maintaining. We now see most businesses managing cash much better, but the discipline to truly develop and maintain a cash flow model still is lacking. Management needs to understand working capital and how this converts to cash flows, and maintain a rolling 13 week cash flow model to predict cash requirements well in advance to any crisis situation. This then feeds the requirement to have some form of contingency plans in place should the forecast not materialize as predicted.

The forecast and the corresponding diligence needs to clearly identify the process management has undertaken to set the course for the next 2 years, together with the key underlying assumptions relating to volumes, pricing, material and labor economics, overhead cost structure of the business, and cost savings initiatives together with any related costs to achieve. This aspect of due diligence should be fully vetted, and if there is not a well thought out 2-year forecast, invest the time and efforts upfront to assist management in developing a forecasting model that clearly has the key assumptions and detailed underlying support, this will serve as the foundation to work from in the formation of potential contingency plans.

Even after understanding management's ability to develop potential contingency plans, it is often that management requires support in reorganizing the business. Management teams that cannot effectively develop and implement such plans in a timely manner may lose control of the company and the process, resulting in loss of confidence from the equity sponsor and the lender. This typically results in a Chief Restructuring Officer ("CRO") being inserted into the company and the beginning of a change management cycle. Planning ahead in the diligence and short term period post close to address these matters will empower management to not only foresee the warning signs, but to have a detailed action plan in place to implement. This plan can be refined should the need arise but development of a plan in a crisis mode seldom leaves management in a controlling position with the confidence of the investors. During periods of positive growth and profitability these same tasks are retooled into performance improvement initiatives.

Many companies were significantly impacted over the past two years by their inability to reduce volumes in a cost effective manner. By addressing some of the attributes identified above during the diligence process, and just as importantly, immediately after the deal closes to capitalize upon your knowledge, will position the company to maintain control during unpredictable and uncertain times. A full understanding of the fixed overhead structure; the cost to reduce overhead; cash flow models in place that are part of the standard management tool kit; well thought out forecasts and contingency plans; and having the proper internal and external skill set to develop and implement these items is of paramount importance to avoid expensive reorganizations. ►

Even after all the proper diligence and planning, there are times when it is necessary to reorganize the business to address a permanent change in the business environment or business model. This can be approached in a cost effective manner if management has the tools in place as discussed above, and the ability to adequately refine and implement contingency plans in a non crisis mode.

Obviously the implementation of corrective action early on in the process helps preserve cash; limits additional equity infusions; maintains the company's value with key stakeholders (i.e., clients, suppliers and employees); and keeps the management team in charge during a difficult situation. We often learn of distressed situations through the lending group once the company either misses its payments or breaches its covenants, only to find out that none of the above basic business tools existed within the company. The process of developing, implementing and addressing such situations at that point come at a significantly higher cost in terms of financial and human capital. It is best to identify these items throughout the due diligence process, and put a plan in place post closing to address the missing elements.

Another often overlooked item is the evaluation of competition, not only in terms of what they offer, pricing and their value proposition; but have they in fact developed contingency plans to scale their business to remain cost competitive and profitable during a downturn. Competition sets the tone during the down cycle in terms of what customers and suppliers are willing to accept during reorganization. If your competition is better organized to address the downturn, this most likely will result in a more expensive endeavor on your behalf to quickly reorganize to stay competitive.

A driver in the determination of the measurement of profitability is a company's standard cost of production. It should be evaluated to fully understand whether a company is consistent in the development of its standard costs, and whether it is absorbing all of its overhead (including the excessive capacity), resulting in a higher inventory cost and potential future repressed margins as volumes return. This element of the diligence really focuses on the overhead absorption aspect of the standard costing (versus materials and labor), to understand the impact on profitability. Once again, making sure the investor truly understands the overhead structure of the company and the ability to quickly change the overhead together with the cost to implement.

All of these diligence matters should be addressed both in a healthy and repressed environment, as they truly are indicators of how the business is managed and the quality and depth of management. Addressing these throughout the diligence process and immediately post closing will not only save the company significant time and resources under any reorganization process, but will create the foundation for a performance improvement plan which can be implemented regardless of the external pressures the company faces. ■

### About the Author



**David Smalstig**

Senior Managing Director, Midwest Transaction Advisory Services Practice Leader

David Smalstig is a Senior Managing Director and is FTI's Midwest Transaction Advisory Services ("TAS") Practice Leader, serves on FTI's Global TAS Executive Steering Committee, and is a member of FTI's Performance Improvement Group. He is responsible for the strategic direction of the Midwest TAS group, and serves as the primary relationship and project manager to various private equity and strategic clients.

This article is one in a series of contributions by ACG Chicago's Sponsors and was taken from ACG Chicago's publication, *The Journal*, April 2010 issue. We appreciate FTI's support.

*FTI has an unmatched combination of breadth and depth of expertise across a worldwide network of 3,500 employees in 26 countries on six continents. FTI's vast network and collaborative culture enable our teams to overcome even the most complex threats to enterprise value. We see broadly, think deeply and act decisively to drive results and achieve the best possible outcome for every engagement. Within our ranks we have forensic accountants; former chief executives and political leaders; Nobel laureates; former SEC professionals; top-ranking economists; certified turnaround professionals; interim management professionals; corporate investigation specialists; banking and securities professionals; certified public accountants; chartered financial analysts; and corporate, financial and crisis communications specialists. [www.fticonsulting.com](http://www.fticonsulting.com)*