# Acquiring Profit Opportunities: Rethinking M&A

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## The New M&A Model: Acquire Profit Opportunities

### Acquisition Game

By now, the statistics are well known. Most LBO fund returns net of fees are lower than S&P 500.[1] Average returns for funds as of 2004 were less than 8%.[2] Private equity returns have fallen with the increase in capital chasing deals. With over $450 billion sitting in private equity[3] , and with 4-5x that amount in purchasing power[4] , investors have a good reason to be nervous. The additional private equity approach is growing increasingly risky as competition intensifies over very few deals.[5] Buyers of all types are struggling with how to reduce the risks and increase the returns of their acquisition programs.

An emerging way private equity funds are improving returns is by employing sophisticated **Profit Models** to identify profit opportunities in advance of an acquisition, so the acquirer can now know the profit improvement opportunities in great detail, up front. Acquirers can customize industry profit model templates to simulate actual operations of a prospective acquisition, and then feed actual transaction data from the prospect through this model to provide valuable and reasonably accurate insight into business profitability and performance across the enterprise. Specific opportunities and risks are now more rigorously identified. The model can also quantify synergies.

In this paper, the authors explain how this new Fast Track Profit Model approach works, demonstrate its success through a case studies, and discuss its potential usage for would be acquirers, whether they be industry insiders or financial outsiders.

1. By offering a framework for understanding a target company's cost structure and profitability, the Profit Model approach brings additional focus and rigor to the due diligence process.

2. The Profit Model approach can be sequenced and staged to provide meaningful and real insights no matter how much time a buyer has for diligence.

3. The output leads to series of questions that can provide the next level of insight for potential buyers. Stark differences in profitability by different SKUs within the same product family, as example, inevitably lead to questions around the cost to produce and what is driving the differences in the cost of production.

4. These insights, in turn, can become the basis for developing a series of value creation steps around

cost reduction, profit improvement and growth post-acquisition.

## Traditional Value Creation

To better understand how private equity functioned, we conducted interviews with principals at over 15 private equity funds. We amassed the data to spot commonalities in the methodology and were able to document in four steps the traditional acquisition process: Scoping the Opportunity; Driving the Investment Strategy; Executing Change; and Harvesting the Opportunity.

Scoping the Opportunity: To find a “good deal,” six things matter:

1) good management team

2) favorable industry dynamics

3) easy cost cutting

4) image makeover

5) low acquisition multiple

6) opportunities for up-sell or cross-sell of the new entity.

In order to assess the fit, acquirers review high-level financials (balance sheet, income statement and cash flow statement), market comparables, and qualitative reviews. The advantage of this traditional approach is the speed of the process. This analysis usually takes 1 – 2 months. This speed is important because a financial buyer may only have a short window of time to negotiate a letter of intent (LOI). The disadvantage is its *imprecise measurement of value of the candidate and opportunity identification. Acquirers do not dissect the performance of the business in great detail, considering the high level of effort involved for a transaction that intrinsically had a low probability of success*.[6]

Investment Strategy: Finding private, negotiated deals is increasingly difficult in today’s congested market. With debt and equity as commodities, the reality is that most M&A is competitive, and will stay that way for the next 10 years. Therefore, acquirers rely heavily on the value that they bring to the table to sell the deal. Acquisition teams assemble pitch books to boast prominent industry veterans, industry partnerships / alliances, prior deal track record, deal structure, and financing arrangements. Distinctions between acquirers fade. From the perspective of the acquiree, whomever pays the highest multiple of EBITDA or cash flow will win. *The original plan - buy at a low multiple, lever up, and sell at a high multiple - is no longer a sure thing.*

Executing Change: “Now that we paid a full price for the company, improving the business is tantamount.[7]” For many firms, bringing in new, seasoned leaders is an easy first step course. This is why so many former CEOs and Leaders (e.g. Louis Gerstner, Jack Welch, Robert Rubin, Bill Clinton) are on the payroll of these firms. As we scan private equity acquisitions, many had their management team replaced. Another “easy” step is improving the business systems. In the Sarbanes-Oaxley era, firms like Accenture and IBM are often brought in to install a new, multi-million dollar ERP system to improve financial reporting and capture synergies. Whether they achieve these goals is debatable, but they will be able to show definitively is the hit to the bottom line from these investments. *Not surprisingly, actual profit improvement is mixed.*

Harvesting the Opportunity: It is critical that the private equity firm increase the sale multiple. Through our interviews, we learned of some of the ways that firms are able to achieve this: merging with other entities within the portfolio; market expansion; and imagine polishing. The results belie the success. *Good news! Most of the acquisitions we reviewed demonstrated an expansion in the sale multiple.*

## What Has Changed?

Developments in business intelligence and information systems over the past few years have created a more favorable environment for private equity. In the past, buyers would struggle to piece together a holistic view of the health of a company. But with events like Y2K and SARBOX legislation, visibility is easier to come by. The new environment:

1) **Enterprise-wide, profit model** templates exist for a variety of industries. Templates can be easily customized to simulate actual processes performed by a business, from sales to assembly to delivery. These models give insight into revenue, cost, capacity and profitability at virtually any level of granularity

2) **Transaction data** is readily available. Most companies now run their business with ERP systems, and have staff experienced with downloading data from the customer, order header, order detail, and product files

3) **Reporting systems** have improved to dissect and aggregate this data in a meaningful way. Now, the acquirer can more quickly pinpoint what is plaguing the acquiree's business and why

The resulting environment has enabled accurate and detailed profitability models to be built in days instead of months. These models highlight which specific customers, sales representatives, contracts, products, services and vendors are undermining profitability, and which changes can be made to enhance profits. According to the Boston Consulting Group, "the acquirer needs to take an all-encompassing view of the value that might be created or lost in a prospective transaction.[8]" This new approach, if utilized properly to capture value, could now make achieving an EBITDA multiple gain irrelevant. Profit enhancements will become a stronger driver of value than changes in multiples.

It turns out that upgrading the systems were not so bad after all, provided we can leverage them beyond traditional financial reporting

## **Profit Models:** The New Approach

Profit Models are not new. Consulting firms have been using activity based costing to identify sources of profitability throughout the 1990's. However, rarely are these models enterprise wide or granular enough to be truly useful, and most of these models take months to build. In the private equity world, would be acquirers have to move quickly. Often they have less than a month to make their offer. They are demanding customers – they need accurate and usable company wide information quickly.

Time driven activity-based costing, introduced by Mr. Steven Anderson and Dr. Robert Kaplan[9] , is the cornerstone of a new solution that has enabled organizations to build exactly what the private equity world needed (see **Figure 2**). Company overhead and expenses can now be driven intelligently to all customers and products based on how much time was spent enabling management to have a true understanding of the drivers of their profitability. Industry template models, complete with standard process time equations that were easily customizable to an acquisition candidate, resulted in an extremely accurate model. So building an accurate model is now made easy. And the fact that time driven models naturally have order and line item cost objects, pulling standard transaction files is straightforward. MIS is not tasked by custom downloads. So, getting the data is even easier.

Each of the steps above can be very daunting upon first inspection. For example, a general ledger may have over 5,000 accounts. The number of departments can easily exceed 200 company-wide. And the number of orders can be in excess of 1 million. According to Acorn System, a typical profit model implementation can take 2 months to build, and several more months to validate. This track record is impressive in comparison to traditional consulting projects which would take years to implement. But in order for this to be feasible for private equity, a modification was necessary to fast track both the building and analysis of the profit model.

**Figure 2:** Building the Profit Model[10]

There are number of key success factors that can simplify the process:

• Gain executive buy-in and ownership up front

• Get clean data up front (e.g. organizational, financial, and transactional files)

• Start with standardized model

• Focus the analysis one where it counts

By following these steps, an Acorn project team is able to dramatically accelerate the analysis. A new, viable methodology emerged for building Profit Models that could generate the information in days instead of months. (see **Figure 3**).

What does this mean? In less than one week, your team can have detailed profitability of every customer, order, product, service, sales representative and vendor. Where are the losses being generated, and exactly why? “If you have a 5x increase in profits without adding a dime in revenue, you would be laughing all the way to the bank.”

And based on the experience of Acorn Systems, the pioneer of the Profit Model approach, this vision is not far off. Their clients generally discover opportunity equal to 300% of their current profit level. The actual impact on the bottom line for Acorn clients ranges from 50 to 100% increase.[11]

**Figure 3** The Fast Track Profit Model Approach[12]

**Total**

**8+ Weeks**

**1 Week**

**Case Study #1:** The Profit Model Approach is Validated at Fairmont Company

In May 2005, Questor Management approached Acorn Systems about a company they were bidding on in the housewares arena. The company for sale, which we call Fairmont, had agreed to be auctioned off by Goldman Sachs. Fairmont is one of the world's oldest house wares manufacturers, with several well-known brands. As global competition increased in the 1980s, margins began tumbling and they agreed to be acquired by an American conglomerate in the late 1980's. But when its own core business began tanking, the conglomerate decided to shed its non-strategic, under-performing Fairmont division.

Fairmont was just the type of company Questor was looking for. Questor Management seeks "companies with performance opportunities, ranging from corporate divestitures, to under-performing and troubled companies." Questor leverages its industry-seasoned team to takes a hands-on operational approach to effect the turnaround. Questor's track record had enabled it to pass the first cut, reducing the number of suitors from 12 to 5. Goldman had asked these five to submit their offer price by June 27.

"Given the size and operational complexity of Fairmont, we realized that would have to move quickly to size up the operational improvements…. But with over 20,000 SKUs, numerous channels, and thousand of customers, this task was extremely daunting." Furthermore, Questor had no formal experience within the housewares arena. Since it was founded in 1995, its previous investments were centered around automotive and logistics companies.[13] The Questor team would need to dig deep to understand this space and the specific opportunities with Fairmont.

Dennis Kirby, a VP at Questor, had been referred to Acorn Systems, Inc. Questor had heard of Acorn's success in building models quickly and inquired if this was possible for Fairmont. Acorn said that it was possible, provided certain conditions were met:

1) A general ledger could be provided / constructed

2) Departmental / organizational information (e.g. headcount, salaries) could be shared

3) Product SKU and/or customer information could be provided

4) Business information (e.g. channels, policies…) could be provided

The Questor team was particularly concerned about the explosion in SKUs and product lines at Fairmont. "It seemed that the business was growing out of control…lines were added to preserve revenue growth."

The information was requested in late May, and there was a credible fear that Goldman would be unable and unwilling to provide such detail in an auction environment. "If only our firm out of the group is asking for this detailed information, why would they bother?"

Goldman Sachs was able to provide a P&L that listed major expense buckets, but was too high level to break down to departments. But those concerns were fortunately short lived, as the team promptly received a detailed employee roster that listed their salary, department, and position. Acorn could now estimate within a reasonable degree of accuracy the fully loaded costs of each department! This information would be useful to calculate departmental performance metrics (e.g. shipping cost per order), but would not provide much insight on the all-important SKU profitability.

But again persistence paid off. Questor's repeated requests for the product file struck gold on June 3rd when Goldman sent a detailed SKU file providing financial performance data (e.g. 5 years of sales data in both dollars and units, price, cost, category information, inventory level). "This file surpassed expectations because it enabled us to cost both warehousing costs and the sales and marketing related activities as well. Upon receiving these files, the team fast-tracked the model. Time was of the essence because they would need to share the findings by June 15th.

**Step 1: Build Model Structure.** By June 8th, all of the critical files and data had been assembled. On June 9th and within a matter of 6 hours, the team had built the entire model structure for Fairmont. The model would have approximately 30 core departments (see **Table 2**), with time-based algorithms to drive their processes to all SKUs.

**Table 2:**Fairmont Departments & Processes

| Core Department | Core Process | Fully Loaded Cost |
|---|---|---|
| Product Mfg | **Product Mfg** | $ 64,525,119 |
| Selling | **Selling** | $ 49,810,376 |
| Marketing/Advtg | **Marketing/Advtg** | $ 15,602,778 |
| Product Development | **Product Development** | $ 13,467,378 |
| Infrastructure Supt | Drive to depts. by SF | $ 9,317,472 |
| Business Technology | Drive to depts. by # Term | $ 9,095,990 |
| Customer Service | **Customer Service** | $ 6,253,866 |
| Accounting/Finance | Drive to depts. by HC | $ 5,760,851 |
| Executive | Drive to depts. by HC | $ 4,471,422 |
| Dist Picking | **Dist Picking** | $ 3,743,724 |

**Step 2: Load Data.** Since the team was only analyzing SKU profitability, only two files needed to be loaded. A general ledger file and the SKU file. Loading this data took place on June 10th and took approximately 3 hours.

Step 3: Review Findings. Running the model took place on June 10th, and again on June 13th after revisions were made. The findings were even more profound than Rawson. Over $60 million dollars, or 480% of current profits of $13 million was identified. Over 80% of the SKU's were unprofitable. But there were a number of heavy losers. By consolidating inventory, re-pricing, and/or changing service levels, at least $15 million in profit improvements could be captured.

**Figure 4.** Opportunity at Clairmont[14]

As the private equity industry becomes more congested, supply of capital has far exceeded demand. Today, new entrants in this arena are coming from traditional corporations, high net worth individuals, hedge funds, early stage venture capital companies, and investment banks. When the stock market is shaky, alternative investments grow in popularity. And with this surge in competition, financial buyers increasingly seek an advantage over the peers. Profit Models are such an advantage and need to be seriously considered. As the authors have explained, sophisticated and accurate models can be built expeditiously, providing great insights into profit opportunities at all stages of an acquisition's life.

**Scope the Opportunity**

The power of a profit model is clearly valuable in the due diligence process. Armed with this information, the private equity firm will know which customers, sales representatives, facilities, products, and vendors matter. For example, Questor may want to know if a particular product could be re-priced? Or for an unprofitable customer, could the contract be renegotiated.

**Implement the Strategy**

We have also found that the Profit Models approach and the findings it generates are helpful in garnering the support for change and helping to implement the redirected strategy.

First, in the process of discerning the underlying causes driving profitability differences, the acquirer and company can begin to build buy-in for the changes that are needed. We have found that people who feel that they have contributed to understanding the differences are more likely to feel ownership in the solution.

**Figure 5.** Profit-Driven Acquisitions

Second, as any change management consultant will say, a key aspect of building commitment to change is being able to clearly communicate the direction a company is heading and the "why" behind that changed direction. While every change management program has skeptics and cynics, the hard and indisputable facts that Profit Models provide can be an integral part of creating the shared understanding around the need for change and communicating the "why" behind the changed strategy.

Finally, Profit Models highlight the one or two key areas that will truly "move the needle" in a company's profit improvement plan. These one or two areas can then be monitored and measured regularly to track a company's progress and ensure that the company is moving smartly towards its objectives.

## Harvest Value

Profit Models are not static. The relative profitability of different segments, channels, customers and geographies changes as the environment changes and as the company itself changes. Some types of customers become more profitable, while others become less profitable over time.

As a result, the company will never capture 100% of all of the opportunity. But by clearly identifying the “next generation” of profit improvement opportunities, the sponsor can properly position the opportunities for the next owner and capture much of the value on exit.

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In short, the Profit Models approach to M&A has broad applicability and far-reaching implications. For management, it becomes a way of managing the company and management philosophy that is precise and surgical in its findings/[analysis] but also one that is easy to understand and communicate to the organization. As such, it can be used to build support for change and, in the process of building support for change, can help ensure execution against the value creation plan.

For financial sponsors, Profit Models are a powerful analytical tool for due diligence but also an important tool for defining a comprehensive value creation plan, for communicating with management, for ensuring world-class execution and for maximizing value on exit. In short, the Fast Track Profit Model can be the ultimate competitive advantage in a white-hot, competitive and crowded private equity market.

What emerges is a new approach to an acquisition that is grounded on current methodology, but leverages profit models to gain a deeper perspective of the opportunity. As with many breakthrough industry ideas (e.g. horizontal drilling for oil & gas), the authors are confident that profit models will become a standard within the private equity industry. The information is too insightful to ignore. The authors contend that it is just a matter of time when all professional firms are employing this technique. And perhaps down the road that even these firms will have to find a new competitive weapon. But one thing is for sure in the writing of this white paper, real change is now occurring when firms like Questor and Kinderhook are already pioneering this approach. Firms like these will always be able to pay more for a given acquisition, and justify it. Can other firms even survive in the long run without it?

In today’s competitive market, some sponsors may ask how they can afford to invest the time and effort in developing this approach. Others that we have worked with and have experienced the power of the Fast Track Profit Model approach are asking how they can afford not to.

## About the Authors

**Steven Anderson** is Chairman and Founder of Acorn Systems, a consulting and software company with offices in Houston, Austin and Philadelphia that specializes in profit management and other decision automation software tools that help boost the operating profits of their clients. In 1996, Mr. Anderson founded Acorn and pioneered the new time-driven approach to activity-based costing. He used the principles highlighted in this article to more than double the net operating profit of a large percentage of Acorn’s clients. He has written several white papers and articles on this and related subject, and is currently writing a book on The Miracle of Time Driven ABC with Dr. Robert Kaplan, Harvard Business School Professor and noted author. Mr. Anderson is an alumnus of Harvard Business School (Baker Scholar) and McKinsey & Company. He also holds an engineering degree from Princeton University, and an accounting post-baccalaureate from University of Houston. He can be reached for advice at (610) 687-8400, x1002, or via email at **sanderson@acornsys.com**. For additional information on Acorn Systems, visit www.acornsys.com.

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