Differentiated diligence after COVID-19: Asia Pacific

How advanced diligence in an uncertain market can lead to outsized investment returns

It is hard to determine how the recovery from COVID-19 will play out or how long and deep the recession will be. We do know that M&A will revive, and - if the last recession is a guide - top Private Equity buyers have an opportunity to generate outsized returns. But it will take innovative and intensive due diligence. Here are six essentials for differentiated diligence in a post COVID-19 M&A market.

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Introduction

COVID-19 brought much of the global economy to a halt, drastically reducing revenues, wiping out profits, and setting off a scramble to shore up liquidity. Private equity investment teams have pivoted away from M&A to focus on stabilizing their portfolio companies and preparing them for an impending recession.

But the shutdown is beginning to loosen and PE players will start assessing the landscape again, hoping for the kinds of returns that the smartest investors realized by placing bets early in the recovery from the 2008-09 recession.

As before, when M&A restarts, the choices are likely to be limited and most assets will be troubled - nobody wants to sell at the bottom if they don't have to.

This is why using sophisticated data analytics and probing beyond standard metrics of value - differentiated due diligence - is more important than ever. Even when the M&A market was at its cyclical peak, it was clear that the traditional tools used by many due diligence teams were no longer adequate. To identify value - and justify heady multiples - smart buyers knew that they had to get behind the numbers, develop original market insights, and understand the strengths and weaknesses of a target's operating model.

In this paper, we share six essential tactics for successful due diligence and value creation in a post COVID-19 world. Using these approaches, PE investors may have a better chance of finding true value in the assets that will come to market in the next year or two - and capturing the outsized returns that top-performing funds reaped coming out of the last recession.

Andrew Thompson
Head of Private Equity
KPMG Asia Pacific

Coming out of the global financial crisis, Asia Pacific saw:

Fewer deals…

15% fewer

deals in PE between 2007 and 2009

…that were smaller…

PE deals over $100m were **down 3%** between 2007 and 2010

…more distressed…

Bankruptcies increased by +60% between 2007 and 2009

…and sold at lower multiples…

Median **EBITDA multiples** were down **-50%** between 2007 and 2009

…with reduced debt leverage ratios

PE Leveraged Buyouts fell by **-45%** between 2007 and 2009

Corporates also pulled back on acquisitions…

13% fewer

Strategic M&A deals between 2007 and 2009

…and divested non-core assets to free up capital

17% more

Spin-off deals between 2007 and 2010

Based on this experience and the current economic situation, we expect:

More troubled assets and 'messier' deal processes

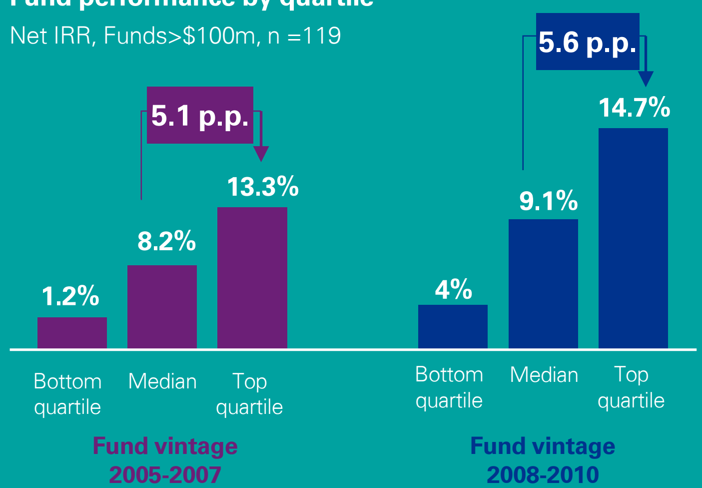
More difficulty separating signals from noise in performance data

Less certainty in future performance

Funds that can navigate the challenges we saw in 2008-09 and the nuances we expect this time have the potential to separate from the pack and realize outsized returns

Fund performance by quartile

Net IRR, Funds>$100m, n =119



1.1x the gap

Between top performing and median funds in uncertain economic times

Source: KPMG research based on market analysis (data as of June 2020).

Outperforming the market with differentiated diligence after COVID-19

Relying solely on standard diligence practices overlooks significant opportunities for value creation and misses the hidden obstacles to value realization.

By using advanced, data-driven diligence methods, investors are outperforming the market by developing insights into markets, strategies and operating models that could not be derived from reported numbers, interviews or published research. Here, we share six tested elements for differentiated diligence as well as stories from these leading investors which illustrate how these approaches pay off to help provide the critical edge in today's environment.

Six ways to win with differentiated diligence after COVID-19

Real-time market intelligence

Combine real-time market data sets to develop a nuanced understanding of the target company's "right to win" in a newly defined market landscape

Deep target analytics: moving beyond the trial-balance

Separate signal from noise by using transaction-level data to build a more granular view of underlying business performance

Dynamic financial scenarios

Adopt a more flexible set of input assumptions, scenarios, and predictive models to drive a range of 'what if's' in an uncertain recovery environment

Operating model preparedness

Evaluate whether an asset's infrastructure, capability, and available resources are sufficient to execute on a given investment thesis

Digital readiness

Assess an asset's technology and infrastructure for its strategic, revenue-enabling capabilities, rather than viewing IT as a back-office cost center

Value-creation roadmap

Develop a robust implementation plan in diligence that connects the financial ambition defined in the investment thesis with the operational plan required to execute post close

Real-time market intelligence

Analyzing various data streams can help build a nuanced understanding of a business in real-time and will be particularly useful in this environment of disruptive and rapid changes in markets and industries.

Traditional approach

— Industry reports
— Historical CAGRs
— Expert interviews

Differentiated diligence

— Location/channel-specific data points (e.g. foot traffic, competitor pricing)
— Real-time indicators and proxies (e.g. online reviews, web traffic patterns, social media sentiment)

Stories from the field in Asia Pacific

Foot traffic and geospatial analytics for Japanese retailer's new store planning to increase potential revenue by 12%-15%

To enhance a PE-owned retail client's revenue, the KPMG Team were engaged in an assessment of optimal locations for new store openings. Using fresh foot traffic data for a key target location for the client – a dense and highly competitive retail area in Tokyo – the Team was able to recommend specific areas for potential new stores. Garnered from authorized consumer GPS locations, the Team accessed and analyzed nearly 10 million target consumer records, with over 240 million data points containing movements by age, gender, day and time for a one-year period, and determined both major and minor streets that tended to attract foot traffic of the target consumer base.

This foot traffic data was then combined with geospatial analytics that uncovered factors highly associated with store performance, as well as operating costs. As a result, four potential new store locations were identified at a street level, enabling potential incremental revenue increases of between 12%-15%.

Deep Target analytics: moving beyond the trial-balance

By isolating transaction-level trends, savvy buyers can better understand unit economics and the underlying drivers of current performance—and develop a more informed view of future cash flows.

Traditional approach

— Historical P&Ls
— Trial balance granularity
— Trends / seasonality
— Top 20 customers / suppliers

Differentiated diligence

— Transaction-level data across customer, supplier, freight, marketing, channel, etc.
— Granular view of drivers beyond top-line seasonality (e.g. unit economics, channel mix, new-lost-existing, etc.)

Stories from the field in Asia Pacific

Competitor geospatial and saturation analysis to help Chinese retailer understand EBITDA impact of competitors' store density across Asia

A Chinese retailer wanted to identify areas of high concentration of competitors to inform their entry and expansion strategy. KPMG's analysis utilized the company's EBITDA, geographic coordinates of stores and their competitors' stores across Asia, to identify optimal locations and potential network overlap through this trade area analysis. This allowed the retailer to assess the proximity of competitors on profitability, and assess the competitiveness of a region (province, city, district level) for market entry or exit through observing the competitors' store density. The outcome was increased profitability of stores where competitors were more densely populated.

Dynamic financial scenarios

The greater the investment in scenario planning and the more possible outcomes modeled, the greater the buyer's confidence can be that diligence has not overlooked any potential sources of value or value leaks. Scenario planning is equally valuable for the deal theses it validates and those it eliminates. Predictive modeling further enhances the need to incorporate a range of potential scenarios.

Traditional approach

— Base / upside / downside

— High-level growth and cost assumptions

— Flexibility built into deal models, but limited dynamic modeling of the various inputs that drive the deal model

Differentiated diligence

— A range of 'what if' scenario capabilities, tailored to each aspect of the value chain (e.g. network optimization, ramp scenarios, etc.)

— Predictive modeling for COVID-19 recovery and expansion

Stories from the field in Asia Pacific

Predictive modelling using big data to understand brand perception and market potential of a coffee chain in China within two weeks

A potential investor in a China public coffee shop chain with 4,000+ stores wanted to estimate the revenue potential in the next five years and whether it can reach 8 billion in sales. We conducted a growth potential analysis for the coffee shop chain by sizing the market and commenting on the feasibility of management's plan.

Our predictive model used competitor density and geospatial attributes to identify potential new store locations. Marketing sizing was conducted using external data, such as app downloads and consumer average spending per store, to determine spending patterns across cities in China. To understand brand perception and customers' feedback, we conducted text based analytics on 5,000+ customers online reviews using out proprietary analytics tool. As a result, the investor obtained a comprehensive understanding of the market potential and brand perception and later realized gains within the first two weeks of their investment.

Operating model preparedness

In the coming years, we can expect deal flow to be made up of distressed assets and carve-outs by corporations that need to refocus on their core. To make these deals work, PE players will have to consider "cost to achieve" and "time to realize" more carefully and more realistically. This will drive the need for a deeper understanding of operating model strengths and weaknesses as a critical part of diligence.

Traditional approach

— Peer benchmarks

— Pre and post-management presentation dinners

— Desk-based analysis

— Post-diligence assessment of the operating model by operating partners or advisors"

Differentiated diligence

— Nuanced understanding of operational processes, scalability, and implementation risks

— Operational interviews, stress-tests, and granular modeling

— Operational experience (internal operating partners and/or external advisors) engaged in diligence

Stories from the field in Asia Pacific

US$83 million in working capital savings for a global automotive supplier in China

An initial desktop analysis of the global automotive company's China, UK and US operations uncovered a significant opportunity for cash improvements across each country's Order to Cash cycle. To fully understand the root cause for operational inefficiencies, KPMG professionals conducted a series of onsite process walk throughs from order to invoice, one-on-one interviews with the Company's management team and ongoing stakeholder engagement to form a robust solution. A review of the Company's Chinese Purchase to Pay process uncovered an additional US$34 million of opportunities to enhance cash flow in China. Our implementation plan will enable the manufacturer to serve customers faster and more effectively, minimize errors/delays and ensure performance data supports effective decision making. It will also improve consistency of payment practices whilst delivering significant cash improvements across the business.

Digital readiness

COVID-19 has accelerated the adoption of all things digital. Companies of all kinds have to accommodate remote workforces and must rely on digital connections with customers, employees and suppliers.

Traditionally, technology diligence has looked at data centers, core application lists, and perhaps system architecture. This exercise highlighted savings or investments and capital requirements. But due diligence today must also take into account how well technology platforms and systems support the company's strategy and enable revenue.

Although IT due diligence has evolved in the past several years, the accelerating digitization of business now indicates the need for a step change in technology diligence. The back-office diagnosis will still be important, but savvy investors will want to understand a business's broader digital strategy - not as a cost center, but as a revenue driver and a differentiator.

Traditional approach

— Standard back office diligence (e.g. core ERP assessment, deferred capex analysis, infrastructure review)
— Risk-focused exercise

Differentiated diligence

— Strategic technology diligence to uncover risks and opportunities to drive revenue, business productivity or customer acquisition through digital channels

Value-creation roadmap

Enlisting operational specialists from the beginning is key to cut down on what is lost in translation between pre-transaction diligence and post-close integration. Specialists will ask the difficult questions and can help identify execution nuances, be explicit about all the costs and obstacles that a deal team might miss.

Traditional approach

— Value levers quantified and modeled
— C-suite level plans
— Limited 100-day plans

Differentiated diligence

— Roadmap developed during diligence; transformation benefits, costs and time horizon fed into the deal model
— Operating partner and specialist involvement in diligence
— Road-mapping through diligence to highlight execution considerations (e.g. one-time costs, TSAs, etc.)

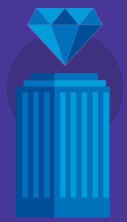
Stories from the field in Asia Pacific

Identified up to AU$65m in Working Capital opportunities, within one week

A food manufacturer was acquired by Private Equity in 2019. Post-acquisition, Management embarked on various operational improvement and value creation initiatives, and sought KPMG's expertise in the field of cash and working capital management. We were engaged to identify opportunities to unlock across the Order to Cash, Purchase to Pay and Forecast to Deliver working capital cycles.

KPMG's Value Creation team undertook a one-week rapid scan and identified and quantified improvement initiatives in the range of AU$40m to AU$65m. The team leveraged KPMG's purpose built working capital analytical tool, and conducted onsite interviews and process reviews. We were subsequently engaged to assist with planning the implementation of the improvement initiatives, working shoulder-to-shoulder with the client over a five week period.

How sellers win with differentiated diligence



In a downturn, buyers will assume that any asset that comes to market is troubled in some sense. Valuations and deal volume are both expected to be depressed for some time and buyers are likely to be more aggressive in dissecting an asset's performance.

Sellers will want to do everything they can to position an asset for a successful sale - and demonstrate why, unlike other businesses on the market, theirs is truly a "diamond in the rough."

Using the approaches described in this paper, sellers have effectively prepared their assets for sale and achieved the full value potential in an efficient process. By showing their understanding of market dynamics, drivers of performance, upside scenarios, operating capabilities, etc. - all supported by both internal company and external market data - sellers can go on the offensive. When they demonstrate a nuanced understanding of the landscape, upside scenarios, and a roadmap to increasing value, sellers can pre-empt buy-side probes and build confidence in the deal process.

Stories from the field in Asia Pacific

Enhancing sell-side EBITDA and cash flow using deep-dive analytics for Southeast Asian retailer

A Southeast Asian retailer's proposed equity fund raising was put on hold due to the current climate. Our team had already identified the need to build the value story as part of our sell-side proposal.

With the proposed sale on hold, KPMG professionals performed a value creation exercise – adopting a data and analytics led approach to identifying opportunities for EBITDA and cash flow enhancement to deliver a higher valuation for the future sale. KPMG's team of retail and functional experts deployed analysis including store profitability, promotion effectiveness, SKU level contribution and customer sentiment analysis to identify areas of value whilst advising the retailer on positioning themselves in a post-COVID retail environment.

A different approach to Private Equity...

Uncovering exceptional value for clients

Delivering value-based market outcomes

Providing industry leading cost-to-value

Bringing experience that matters

Generating insights at deal speed

...that increases returns at each step

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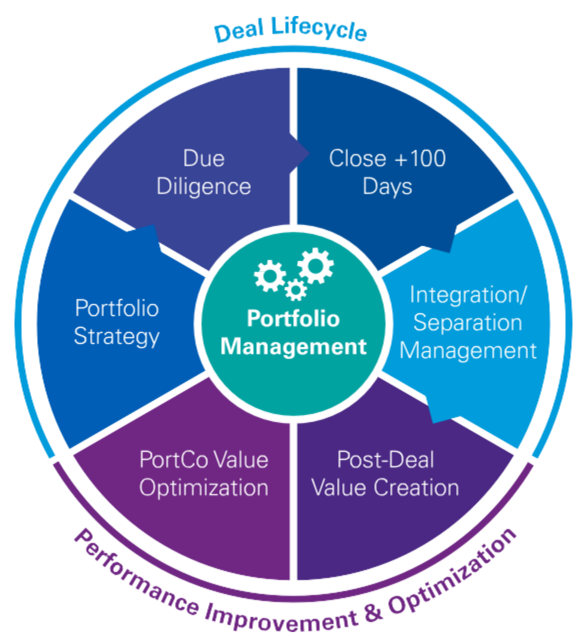

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