Looking Beyond the Numbers

Margaret Reynolds, of Reynolds Consulting, LLC, discusses some of the key variables that will determine whether or not an investment outperforms.

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The market is coming back and deals are being made. The question for many investors is "Which deal will yield the targeted return?" Surprisingly, it may not be the one you think.

Most deal analysis requires extensive diligence. For many professional investors, the majority of the effort is concentrated on the financials. The essence of the work is to validate the accuracy of the financials and identify any potential problem spots. Once financials are thoroughly scrubbed and accepted, the valuation can begin, right? Whoa, not so simple.

McKinsey produced a report that evaluated 60 deals from 11 leading private equity firms and discovered that the primary source of value creation came from companies that outperformed the industry. How can investors be sure they are selecting companies that accomplish that feat? It takes more than looking at the numbers.

There are essentially two key variables: due diligence needs to become more comprehensive and investors need to become more active investment partners. In today's markets, most industries are in a state of flux. The recent recession has changed the way most of us will do business. The majority of industries, from healthcare to publishing/printing to heavy industry, are forever changed by new measures of value along with new game-changing technology.

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Granular validation of strategy is critical to accurate valuation

Astute investors, who are vested in evaluating the potential of a business through its strategic plan and determining if the assumptions behind the forecasts, will reap bigger rewards. The history of a company is only a part of the picture and now, more than ever, not a great predictor of the future. In fact, according to a McKinsey article, Why Some Private Equity Firms Do Better Than Others, "In 83% of the best deals, the first step for investors was to secure privileged knowledge." In addition, "the most effective deal partners simply devote more hours to the initial stages of the deal."

Most of us know the numbers behind "deal success" or clearing investment hurdle rates. Not as good as we would like but enough to keep us investing. But did you also know that most companies' strategic plans fail (approximately 70%) due to poor execution? And that only one in four investments made in growth initiatives generates a return on investment? And even for successful plans, the average yields 66% of projected value due to lack of sufficient resourcing and lack of effective leadership?

Successful deals require a good understanding of the validity of the plans in place for the future. The secret to analyzing those plans is to 1) assure there is a reasonable growth plan in place by evaluating the assumptions in light of market trends and facts 2) getting as granular as possible in the current business searching for relevant facts to reinforce the "reasonableness" of assumptions and 3) ensure there is a detailed and well communicated and resourced execution plan in place that aligns the companies' actions.

The first requirement can be accomplished by strategic experts and common sense. Have the plans---business plan, strategic plan and/or marketing plan--reviewed by an objective professional and they can quickly tell you whether it was an exercise or serves as a valid compass for the future.

Secondly, don't assume current business trends extend into the future. In January-February 2011 Harvard Business Review, the article, Reinvent your Business Before It's Too Late, claims that "things often look rosiest just before a company heads into decline." Evaluating financials just don't tell the full story; the numbers need to be connected to market trends and business processes. Perform a granular dissection of current business to evaluate the validity of future business projections by looking at a variety of variables. Some of the key things to look for include industry growth rates, market share, a company's value proposition and customer concentration.

Investors should also keep tabs on the ranges of current and potential products along with their target markets. As part of this, it's important to consider how much revenue is from new products or markets and whether the target markets are considered growth markets.

Moreover, don't understand the importance of a purposeful and positive culture? We know that often the best deals are made with experienced professionals with proven track records. One way to find out if the people are the real deal is to look below the surface. If the company values are on the wall, do the employees know what they are, embrace them and believe they are central to the way the organization operates? Of all the variables that matter, people are the ones that drive passion, productivity and performance. They are a priority. Some clues come in the form of employee surveys, customer satisfaction ratings, turnover rates and training investments.

Buyers should also pay attention to how the organization is structured and resourced to execute the plan. As mentioned earlier, under allocating resources and lack of effective leadership are the chief causes of under performing potential. It is often said that "strategy is how you spend your money", which is just another way of saying it is not what we say, but what we do that counts. Cross reference organization structure and resource allocation with plans to ensure that the initiatives intended to drive the future are enabled to accomplish the goals.

The third check point is to follow the old tactic of "walking around". To know whether employees understand their role in generating value, how their roles are evolving, and what is expected of them, nothing works as well as asking them. Spend time with others required to make the deal work—employees, vendors, customers, and other stakeholders to assure that your perceptions are reality. This is the "privileged information" critical to a good valuation.

Congratulations! After much hard work, commitment of time and thorough due diligence, a great deal has been made, an investment in a company that has a tremendous future (and return) in sight. Now what?

Active ownership generates better returns

As an investor, staying informed is imperative, yet, particularly if the investor doesn't have a controlling share, they are subject to getting information on an ad hoc basis. Multiply that challenge by the number of companies in the portfolio, and the chances are that a great deal of time is spent trying to chase information and stay on top of investments. How can that process be simplified?

The easy answer is to make it a condition of investment. Determine what is needed and spell it out in the agreement. Combine that with following the process above, in which their strategic or growth planning capability is scrutinized, and communication and reporting issues become more limited in the future. For investors sitting with an existing portfolio, the answer isn't so easy.

One of the complaints I have often heard after the deal, is that "the company is not performing up to expectations" and "we can't get them to give us a strategic plan" or "they don't know how to do a strategic plan." In other words, things aren't going well and the investor doesn't know if it's fixable or the current executive team is capable o fixing it. What then?

Recognize the last thing any company wants to do is report less than stellar news to their investors. Be sure there is an open channel of communication where all news is good news so that at least it is heard early and there is a chance to help right the ship for everyone's benefit.

The assumption that the current executive team doesn't know how to communicate a plan is probably right on. Statistics say that many who write a plan either do so from a purely financial perspective without a link to specific actions (which is more wishful thinking than planning), or they develop short term (one year) initiatives intended to fix issues without regard to the underlying challenges causes the problems. It brings to mind the arcade game Whac A Mole; a never ending cycle of one-off problem-solving. Most of us would never align just one tire on a car for fear of losing tread on the other three wheels. Trying to write a plan that addresses symptoms or one part of the business, without looking at the impact on the entire business model can create more problems than it solves.

What if the company doesn't know how to write a proper plan for the future or revise their business model to stimulate the next wave of growth? Consider becoming an active partner, regardless of the investment portion. While ultimate control over the companies' follow through may not exist, by offering support in the form of professional resources that can work directly with the company, the results are better for all involved. Consider it an investment in the future of the company, as well as your portfolio.

As an investment partner, if the resources needed are not your area of expertise, help identify them. In fact, you may want to provide them. By providing these tools to the entire portfolio, the role of active partner is established, risk is reduced, and you begin to influence a common approach and a common language among your portfolio companies in which to discuss the business and it's performance. These consistent tools are readily available on the internet to not only provide support, but also education, executive coaching, and "do-it-yourself" planning workbooks.

Successful investing, like everything else, is becoming increasingly complex. The issue isn't how good a company is, it is how good will the company become. Develop the discipline of comprehensive due diligence and become an active investor, achieving higher investment returns. Why settle for average when the portfolio return can be consistently increased by looking at the strategic future of the company before and after the investment is made?

Margaret Reynolds is a managing principal of Reynolds Consulting, LLC