White Paper

Acquiring Profit Opportunities
A Breakthrough M&A Mode

Steven R. Anderson

Chairman, Acorn

Kevin Prokop

Director, Questor Management

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"We have before us a new approach to M&A - never before contemplated. … What if you knew the profit improvement potential of a company in great detail, up front? … EBITDA multiples would become irrelevant.

If you could achieve a 5x increase in profits without adding a dime in revenue, you would laugh all the way to the bank." – Steven Anderson

A Breakthrough M&A Model: Acquiring 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 traditional 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.

We propose a breakthrough approach to mergers and acquisitions. By using sophisticated Fast Track Profit Models™ to identify profit opportunities before an acquisition, the acquirer can 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, we explain how this new Fast Track Profit Model™ approach works, demonstrate its success through a case study, and discuss its potential usage for would be acquirers, whether they be industry insiders or financial outsiders.

Key Benefits of the Fast Track Profit Model™

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 an 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 functions, we interviewed principals at over 18 leading private equity funds. As a result, we identified four steps in 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

To assess the fit, acquirers review high-level financials (balance sheet, income statement, historicals), market comparables, and qualitative reviews. The advantage of this traditional approach is the speed of the process. This analysis usually takes one to two months. Speed is important. 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 the value of the candidate and opportunity identification. Acquirers do not dissect the performance of the business in great detail, as this traditionally requires a high level of effort for a transaction with 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 records, deal structures, and financing arrangements. Distinctions between acquirers fade. From the perspective of the acquiree, whoever 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. 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. In our scan of private equity acquisitions, we saw that many had their management team replaced. Another "easy" step is improving the business systems. In the Sarbanes-Oxley 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. What they will show is the hit to the bottom line from these investments. *Not surprisingly, actual profit improvement occurs only in some cases.*

Harvesting the Opportunity

It is critical that the private equity firm increase the sale multiple. Through our interviews, we learned some of the ways firms achieve this: merging with other entities within the portfolio; market expansion; and image polishing. Good news! Most of the acquisitions we reviewed showed 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 struggled 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.

Characteristics of 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 in 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.

This 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 what 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 used 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.

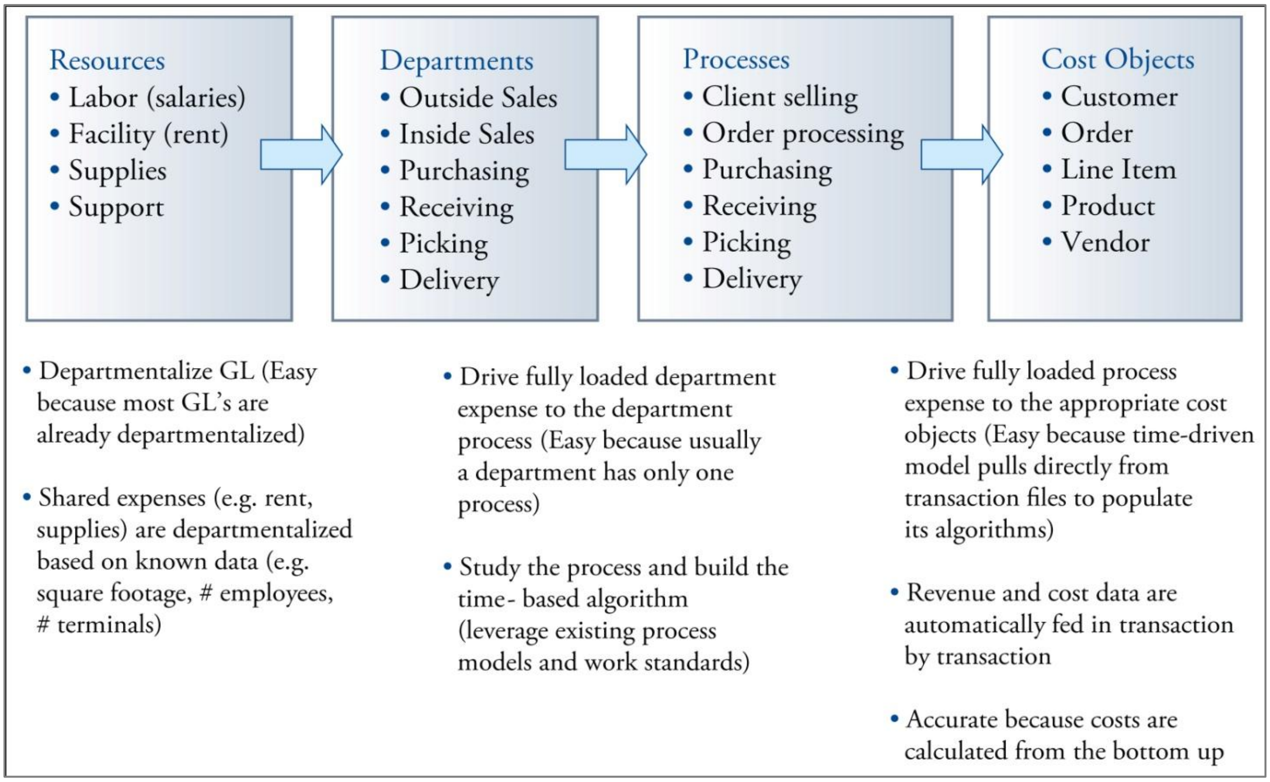
Fast Track Profit Models™: The New Approach

Profit Models are not new. Consulting firms have been using activity based costing to identify sources of profitability since 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 must 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 Kaplan9, is the cornerstone of a new solution that has enabled organizations to build exactly what the private equity world needed (see Figure 1). Company overhead and expenses can now be driven intelligently to all customers and products based on how much time was spent. This gives management a true understanding of profitability drivers.

Industry template models, complete with standard process time equations that are easily customizable to an acquisition candidate, create a very accurate model. Building an accurate model is now easy. Time driven models naturally have order and line item cost objects. As a result, pulling standard transaction files is straightforward. MIS is not tasked by custom downloads, and getting data is easier.

Figure 1: Building the Fast Track Profit Model™[10]



Each of the steps in Figure 1 can be daunting at first. For example, a general ledger may have over 5,000 accounts. There can be more than 200 departments in a company, and the number of orders can be over 1 million. According to Acorn, a typical Profit Model can take two months to build, and several more months to validate. This track record is impressive compared with traditional consulting projects which can take years to implement. But for this Profit Model to be feasible for private equity, a modification was necessary to fast track building and analysis.

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

1. Gain executive buy-in and ownership up front
2. Get clean data up front (e.g. organizational, financial, and transactional files)
3. Start with a standardized model
4. Focus the analysis where it counts

By following these steps, an Acorn project team is able to dramatically accelerate analysis. A new, viable methodology emerged for building profit models that could generate the information in days instead of months. (See Figure 2)

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 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.” -Steven Anderson

Based on the experience of Acorn, the pioneer of the Fast Track Profit Model™, 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 2: The Fast Track Profit Model™ Approach[12]

	Traditional Model	Fast Track Model
Model structure	•Interview HR & department heads (1 week)	•Leverage payroll file, org charts (1 day)
Import and Drive GL $ to Departments	•Meet with Finance to access, load, and drive each GL line •Gather dept data (sq ft) (2 weeks)	•Calculate total payroll by department •Allocate additional buckets provided •Use Acorn OH markup (1 day)
Drive Dept $ to Activities	•Interview 2-3 employees per •Department to determine the 3 core activities (1 week)	•One process per department (1 hour)
Drive Activity $ to Cost Objects	•Create 3-5 cost objects •Create accurate process time equations (2 weeks)	•Only 1 cost object – products • Simple equations (1/2 day)
Run model	•Import 3-5 cost object files •Exhaustive analysis (2 wks)	•Import cost data •High level analysis (2 days)
	8 Weeks	1 Week

Case Study: The Fast Track Profit Model™ is validated at Fairmont Company

In May 2005, Questor Management approached Acorn 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 a leading investment bank. Fairmont is one of the world’s oldest housewares 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 effects turnaround by leveraging its industry-seasoned team to takes a hands-on operational approach. Questor's track record enabled it to pass the first cut, reducing the number of suitors from twelve to five. The investment bank asked these five to submit their offer price by June 27.

"Given the size and operational complexity of Fairmont, we realized that we would have to move quickly to size up the operational improvement needed. With over 20,000 SKUs, numerous channels, and thousands of customers, this task was daunting." (Dennis Kirby, VP, Questor). Questor had no formal experience in 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, was referred to Acorn. 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. According to Kirby, "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 the investment bank would be unable and unwilling to provide such detail in an auction environment. Kirby stated, "If only our firm out of the group is asking for this detailed information, why would they bother?"

The investment bank was able to provide a P&L that listed major expense buckets, but unfortunately it was too high level to break down to departments. However, shortly after this, the team 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 could be used to calculate departmental performance metrics (e.g. shipping cost per order), but would not provide much insight on the all-important SKU profitability.

Persistence paid off. Questor's repeated requests for the product file struck gold on June 3rd when the investment bank sent a detailed SKU file providing financial performance data (e.g. five years of sales data in 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.

After receiving these files, the team fast-tracked the model. Time was critical because they would need to share the findings by June 15th.

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

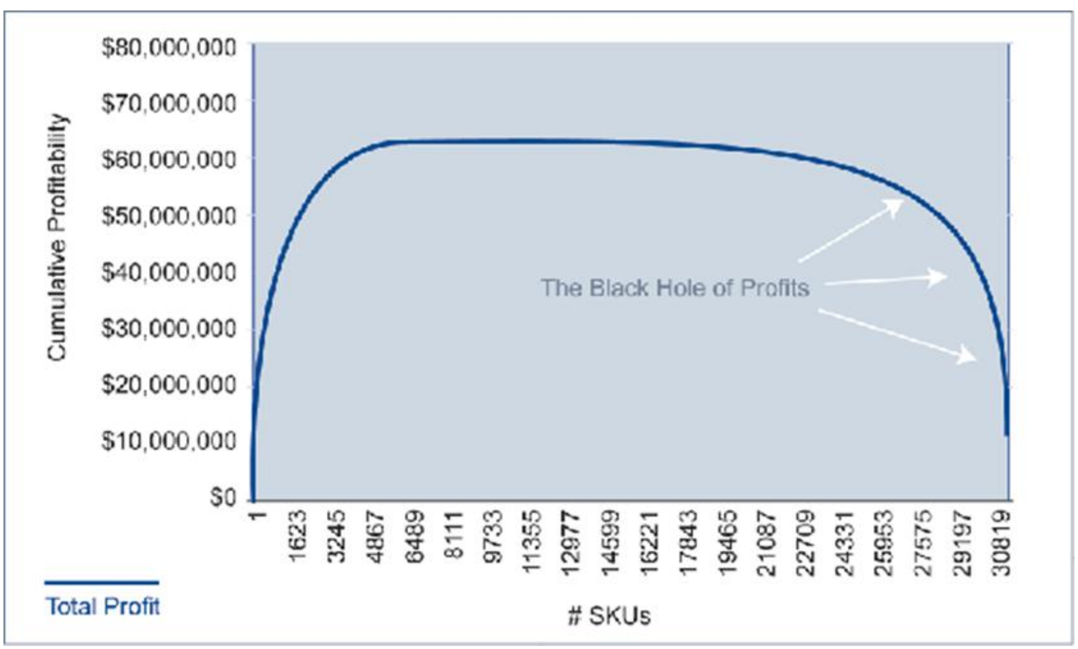
Table 1: Fairmont Departments & Processes

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 the general ledger and SKU files needed to be loaded. Loading this data took place on June 10th and took approximately 3 hours.

Step 3: Review Findings. The model was run on June 10th, and again on June 13th after revisions were made. The team identified over $60 million dollars in profit improvement potential, or 480% of current profits of $13 million. Over 80% of the SKU's were unprofitable. 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 3: Opportunity at Clairmont[14]



Summary

As the private equity industry becomes more congested, the supply of capital has 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. With this surge in competition, financial buyers increasingly seek an advantage over their peers. Fast Track Profit Models™ offer a strong advantage in the due diligence process and should be seriously considered.

As we have explained, sophisticated and accurate models can be built quickly, providing great insights into profit opportunities at all stages of an acquisition's life. Some of those applications follow.

Scope the Opportunity

The power of a Fast Track 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 if the contract for an unprofitable customer could be renegotiated.

Implement the Strategy

We have found that the Fast Track Profit Model™ approach and the findings it generates help garner support for change and implement redirected strategy.

- During the process of identifying the underlying causes that drive profitability differences, the acquirer and company can begin to build buy-in for needed changes. We have found that people who feel that they have contributed to understanding the differences are more likely to feel ownership in the solution.
- 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 Fast Track 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.
- Fast Track Profit Models™ highlight 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 toward its objectives.

Figure 4: Profit-Driven Acquisitions

	Scope the Opportunity	Drive the Investment Strategy	Implement the Strategy	Harvest the Returns
Purpose	Target industries & companies that benefit most from the profit enhancement approach	Leverage team experience to expedite and properly structure acquisition	Expedite company profit improvements by leveraging expertise	Accelerate and expand exit opportunity potential to achieve superior investor returns
Actions	• Screen industries based on market & investment attractiveness • Screen industries based on strategic fit with profit model methodology • Build a profit model to identify profit potential in advance of acquisition	• Perform additional due diligence the profit model and fund managers' expertise • Raise and structure capital to effect transaction • Devise management incentives to drive operational changes • Align key stakeholder interests around profit enhancement	• Install Acorn's proprietary profit management software to identify and capture profit improvement • Actively participate with management team on value capture and improve operations • Institutionalize profit management across organization • Document and report performance enhancement	• Establish company as leader in profitability and operational performance, promoting the company's track record of successful execution • Cultivate relationships with multiple exit channels - industry consolidators, brokers, banks, private equity firms

Harvest the Value

Fast Track Profit Models™ are not static. The relative profitability of different segments, channels, customers and geographies changes as the environment changes and as the company changes. Some types of customers become more profitable, while others become less profitable over time. Harvesting value is a continuum.

The company may never capture 100% of the profit improvement opportunities. By clearly identifying the "next generation" of profit improvement opportunities, the sponsor has a roadmap for future gains, whether they are used by current or future owners.

Conclusion

The Fast Track Profit Model™ approach to M&A has broad applicability and far-reaching implications. For management, it becomes a way of managing the company based on precise and surgical findings. It is also 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, Fast Track Profit Models™ are a powerful analytical tool for due diligence. They are 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 Fast Track Profit Models™ to gain a deeper perspective of the opportunity. We are confident that Fast Track Profit Models™ will become standard within the private equity industry. The information is too insightful to ignore. We contend that it is just a matter of time before all professional firms are using this technique. Questor and Blue Sage Capital 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.

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About the Authors

Steven R. Anderson is Chairman and Founder of Acorn, a profit improvement company that leverages its proprietary software and consulting services to help boost the operating profits of their clients. In 1996, Mr. Anderson founded Acorn to assist turnarounds and buy-outs through its unique approach to Activity-Based Costing that he pioneered (now called Time-Driven ABC. He co-authored the book Time-Driven ABC with Dr. Robert Kaplan, Harvard Business School Professor and noted author. The book was published in spring 2007. This approach has added over $15 billion to the market capitalization of Acorn's clients. Mr. Anderson is an alumnus of Harvard Business School (Baker Scholar), Princeton University, and McKinsey & Company. He also holds an engineering degree from Princeton University (with honors), and an accounting post-baccalaureate from University of Houston (with honors). He can be reached for advice at (610) 687-8400, x1002, 713 963-9000 x2103, 484 437 0953 (mobile), or via email at sanderson@acornsys.com

Kevin Prokop is Director of Questor Capital, a private equity firm specializing in investing in turnaround situations. Mr. Prokop joined Questor in 1998. Previously, he was an Associate and Engagement Manager at McKinsey & Company. Prior to that, he was an Associate at Kleinwort Benson, Ltd. and First Chicago-NBD Capital Markets, where he worked on buyouts and middle market mergers and acquisitions. Kevin received his Bachelor's degree with honors from Georgetown University and his MBA with highest honors from the University of Chicago. He can be reached for advice at (248) 213 2205, or via email at kprokop@questorfund.com. For additional information on Questor, visit www.questorfund.com.

About Acorn

Acorn provides companies with profitability and cost management solutions to drive better business decisions. Combining proprietary technology with proven methodology, Acorn reveals enterprise-wide profit opportunities. Our unique approach enables clients to make continuous, fact-based decisions to improve their bottom line. For more information visit www.acornsys.com, email sales@acorn.com, or call 1.800.982.2676.

[1,2,3] Venture Economics

[4] John Curran, "Sell Me Your Company", Corporate Board, September 2005 edition. Mr. Curran reports debt-equity ratio of 4 or 5 to 1.

[5] According to John Curran of the Corporate Board, over the past 10 years, over $445 Billion of capital has flowed into private equity funds. However, the ratio of uninvested capital / equity invested was over 15

[6] To date, authors have surveyed 18 private equity firms. On average 16% of IOIs resulted in a closed acquisition. Firms surveyed include: JP Morgan Partners; Clayton, Dabilier & Rice; Patterson; Bain; Carlyle and Churchill Capital

[7] Kevin Prokop, Questor Management

[8] Steven R. Anderson & Robert S. Kaplan, Time Driven Activity-Based Costing, Harvard Business Review, November 2004.

[9] Kees Cools, Kermit King, Chris Neenan, Mike Tsusaka. Boston Consulting Group. Growing Through Acquisitions. May 2004

[10, 11] Source: Acorn Systems, Inc.

[12] At the time of the writing of this article, Acorn had over 100 clients. Average profit increase of 2 to 8% of revenue equivalent to bottom line. Primary industry focus: food, financial, retail, CPG, steel, industrial, distribution, chemicals. Profit model templates for these industries are regularly used.

[13] As of May 2005, Questor portfolio companies included: AZ Automotive, American Specialty Cars, AP, Ryder, Teksid, Geologistics, and Polar.

[14] Source: Acorn Systems, Inc.