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1.6.22/509
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ROUNDTABLE

SHIFTING GEARS

As part of a roundtable hosted by *Real Deals*, a group of due diligence providers and GPs explored the growing demand, shifts and evolution in the DD market, as well as ongoing diversification and specialisation of DD services in the PE space.

Photography by **Phil Bourne**

SPEAKERS

Fleur Hicks *onefourzero*
William Emtage *RPS Group*
Tom King *Global Counsel*
Justin Maltz *Mobeus Equity Partners*
Bruce Douglas *Confidas*
Marcel Baettig *Humatica*
Piers De Wilde *StoneTurn*
David Turner *Foresight Group*

Moderated by
Simon Thompson

How are demands put on DD providers changing and evolving in the current market environment?

Tom King: Covid-19 obviously created new demands around risk mitigation and value creation as there were fewer deals happening. We had to find a way of demonstrating value to our typical client base by working in more detail on commercial and operational concerns. This has been great because it's further integrated the investor services piece of our business with the corporate strategy piece.

Whether it's ESG or more general political risk, we're in a higher state of volatility, and that is probably going to persist for longer than any of us hopes. This means people are increasingly thinking, even at deal time, about exit, and what the entire story of that investment is going to be. That's helped us in that we were already thinking three to five, to 10 years out. However, when it comes to something like net zero in the UK, or similar macro trends, these are all milestones that are 10, 15, even 25 years into the future. Demonstrating how an asset is not only understanding and navigating that trend, but capitalising on it commercially, is increasingly important.

Fleur Hicks: The earliest stage diligence is coming in pre-deal, in a bid to overcome, and get a lead on, the short supply of diligence in the space. It has been quite a competitive market, particularly in the commercial space, whereby there have been long wait times to access diligence providers. As such, we're finding that people are bringing us in earlier and earlier because the data scraping element of what we do allows for a comprehensive outside-in view earlier on. For us, the technology we've built in order to gather the data improves efficiencies and cuts down lead and delivery times on all diligence and all stages. We're also finding that we are increasingly getting commissioned by LPs and that's a really interesting twist, because they are either validating some of the hypotheses of the GPs, or coming to GPs with prospective target assets or asset groups – a shift in the dynamics that we've never seen before, certainly in our years of trading.

Being commissioned by banks and pension funds directly to do market mapping and validate target asset diligence may indicate that the pressure on GPs is increasing. Especially when you consider that some banks are setting up their own equities divisions. This is all very interesting given banks' historical data-led approach.

Bruce Douglas: As a DD provider, our focus is always on developing the quality of our recommendations and the clarity of our reporting. A PE or VC-backed business is entropic in the sense that it only becomes faster, more complex and less efficient. We have developed a framework for assessing the scalability of management teams, which essentially is a predictor of an individual's ability to scale and grow with the business. We then use this to provide a clear development focus for an individual and team so that people are playing to their strengths. The challenge is ensuring that this becomes a tool investors can use to get the most out of their teams, and with minimal disruption.

To what extent has the timing and use cases for DD providers in PE evolved?

King: We are coming in increasingly earlier. Even if we're not mandated formally, we'll have a conversation earlier in the process than we used to. That's gone so far back that we're now working with a couple of funds to help them with deal origination. At that point it's no longer about specific assets, it is about what sub-sector or niche might work from a pre-qualification perspective — from a political point of view. We have a couple of arrangements where we sit with the IC thinking about long-term drivers like decarbonisation. Additionally, we are assessing and looking at other areas or sectors that are going to be robust enough or countercyclical enough to grow, even in a recessionary environment.

William Emtage: You've got to start the process early in terms of getting your clients to think about where potential transaction opportunities might arise. This extends due diligence to consider the whole ecosystem of stakeholders that surround a client business. This involves a mapping exercise to identify where ESG risks and opportunities might drive a

Maltz: In terms of DD in a competitive market, we've seen supply-side constraints for the first time in a while where we haven't always been able to get the consultants we wanted to work on deals.

When it comes to diligencing management teams, to what extent are GPs' priorities and values in line with what you are seeing to deliver best results in the market?

Douglas: One interesting trend that we've seen recently when measuring and diligencing management teams, is a shift in value when it comes to attributes of valued leadership. Businesses with teams that performed exceptionally were usually those that delivered well during Covid and were able to pivot slightly to make use of the resources they had.

Looking at the psychometric test and the understanding of the individuals and profiles of these people, we noticed that they tend to be much more unflappable, stable, structured and organised in how they approach problems, and perhaps a little bit more technically sound. For PE, that is not something that has been so valued in the past, rather, it has been more about charismatic entrepreneurs. As the market is forced to deal with ongoing market disruptions, businesses have had to adapt, which means that there is more focus on people who are extremely practical or who can look at a problem in a new way.

This is quite interesting to see. PE generally loves extroversion in their management teams, but we've seen that the effectiveness of teams is much more about leaders' ability to remain calm, make a plan, and then deliver that effectively. The preference for someone's personality to dominate and influence has slightly dropped away.

Marcel Baettig: I would agree that a real point of importance is for a management team to have the ability to implement and execute a plan. Historically, a lot of the PE world, as Bruce mentioned, put a lot of value on charisma. That has changed in a lot of our deals that we're doing. Now, it's much more about how the organisation can collectively rally together and also how middle managers can further contribute to realising value.

We are doing a lot of that type of work in the post-deal world. I am a bit critical when I see clients go for a quicker fix, for example, when they get a new CEO and expect everything to get better. However, we are seeing that attitudes toward management teams are changing to becoming more sophisticated, with people increasingly recognising that an organisation needs to be totally aligned to deliver optimal value creation.

convergence of commercial interests later down the line – maximising the potential for deal origination.

While ESG-driven transaction opportunities can take a long while to gestate, they can materialise suddenly with compressed decision timeframes. Firms that have embedded ESG data into their decision process will have an advantage in terms of processing the opportunities deftly and efficiently. Again, this calls for early preparatory DD engagement – the value of which we strive to highlight for our clients.

David Turner: The risk profile in the market has changed. Whatever business model we're looking at, the breadth of what we're doing and assessing has increased significantly. Previously we would do certain DD assessments in-house, but now we're increasingly looking to leverage that skillset and capability from specialist DD providers.

In an increasingly rapid deal process, are long and in-depth DD reports still fit for purpose?

Piers De Wilde: We do have a tension in what we do. I recently discussed with a colleague that we needed to summarise a DD report for one of our clients into just three sentences. There is a challenge around demonstrating the comprehensive checks that have taken place versus the amount that the investment committee will need. This is especially the case when the checks can include large volumes of data around research into multiple individuals and geographies. We need to be able to show that we've checked every single box so that in five years' time someone can go back and reference that.

Justin Maltz: I think you've got consultants who are experts in their field who want to write a report that demonstrates that expertise, and that has a lot of technical back-up. We have struggled at times with the weight of DD reporting. In our firm, the investment committee members will read each DD report, but that's increasingly focused now on the executive summaries. Same with management teams — they are busy running a business, so they are not going to be able to take in/action all of that. It's important for DD providers to find a way of condensing and summarising it all in a way that presents clear findings, recommendations and actions.

In terms of the scope and timing of DD projects, there's a difference between the work that is fundamental to the investment decision and the work that may be fundamental to delivering the value play. Elements of the latter may be more sensibly undertaken post completion as part of a 100 day plan. It's work we know we've got to do, but doesn't necessarily change whether we're going to make the investment or not.

Emtage: We've found great traction with management teams by having early-stage conversations to define not only the scope, but the presentational structure of a report from the outset. Clients can implement findings more efficiently if they can easily share DD insights with other (often time-poor) stakeholders. Increasingly, we have clients asking for an executive summary that segues immediately into a timeline of actionable recommendations.

The entire rest of the report, detailed methodology and rationale for those recommendations, is then presented later as a supporting appendix. It comes back to this point about making sure that the data you provide for your clients is useful. Part of that is how you frame the data itself.

Is there any change in terms of demand, and can you get all the DD providers you need when you need them?

Turner: Some of the M&A processes now are quite accelerated. You don't necessarily have all the access you want. I think that where we can, we look to bring things in early, certainly on the people and technology side, as these are the key differentiators of value for a lot of the businesses we look at.

If we can have a good view on that early, that allows us to really make an informed view against an opportunity. We certainly are doing things in-house, but that is usually because of supply, or simply the ability to make that assessment quickly. The scope of DD in the small-cap market is only increasing.

What challenges has the public's increasing awareness of PE, and a growing societal focus on healthy workplace culture, created for deal teams?

Fleur Hicks

Turner: On the cultural aspect point that was raised, five years ago we just thought these kinds of issues [in a business] were fixable and something we could change. It may be that society is changing, but we now see it as more of a risk. In small companies, culture is so important, and if we see a fundamental issue in the culture of the business we probably won't invest.

Douglas: Culture issues are increasingly something we come up against. I'm interested in investors' perspective on this, because we do get varying levels of interest in this area. It's important to understand what you're letting yourself in for, but I think that things can be changed and an organisation can be helped. Removing parties that are having a negative impact is absolutely the right thing to do, but in a deal process, often investors' time is ticking to get things done. However, the impact will be left on management after that. Cultural issues or problems shouldn't be a barrier to an investment, but really understanding what they may be, and having some insight in how to manage them, can help an investor unlock value and be a way of avoiding issues down the line.

Hicks: Increasingly, we are being asked about management reputation too, and so whilst a lot of the data scraping that we do will be reputational around the brand, we are now often taking an outside-in view of

De Wilde: We are seeing that poor or entirely inappropriate workplace culture is often seen by our clients as a massive red flag in deal situations. We have recently seen matters where we've been specifically asked to look at sexual harassment allegations or cultural issues. Following a thorough investigation into the individuals in question and their networks, it is key to remove a problem as quickly as possible, but it's quite often very difficult to put into practice. Many cases boil down to literally one word against another, which is almost impossible to deal with from outside the business. Attitudes have evolved to some extent, and as a provider, we've not necessarily changed our line of questioning, but people have been more inclined to volunteer information on the staff side than perhaps they were a few years ago. If something negative concerns them and is on their minds, they are quicker to volunteer it.

Baettig: I had to deal with a fund that found out a key figure in a management team was in court twice for an offence totally unrelated to the job. It was not a problem in terms of the person's work or contribution, but it rightfully brought up a concern as the fund was interested in a stable management team. The fund needed some sort of pragmatic advice, looking at the overall strength of the organisation and levers to strengthen and build a framework of support in case there was an additional problem down the road.

Tom King

management and staff happiness as derived through social media, forums and LinkedIn. Through regression modelling, we can actually weigh that as a lever against commercial performance historically, and therefore model what impact management dynamics, sentiment and reputation might have in the future.

Maltz: The size of the businesses we are backing means they are typically driven by owner/managers and founder entrepreneurs. The culture is often, predominantly, a reflection of that individual. One of the key challenges for us is making a business more scalable, building the management team and reducing the reliance on the founder. Sometimes there are really important elements of the founder's DNA that have made that business successful and we are reluctant to let those bits go. Culture is a nuanced thing - there may be some prehistoric attitudes or elements of the culture that are simply unacceptable and need to be addressed immediately, but you have to be careful not to throw the baby out with the bathwater. The other factor, in terms of culture and reputation, is our own brand as a business, both with LPs but also with management teams. When we go out and talk to a new management team, they will Google us, they will look at our website, they'll reference us. If they find questions about our integrity, our behaviour, our values, then we are going to really struggle to win hearts and minds. Mobeus has a long history in this industry and has built a very strong reputation with management teams – protecting this reputation is very important to us.

Bruce Douglas

Piers De Wilde

How is the expanding scope of ESG creeping into your area of DD?

King: We offer services labelled ESG, but a lot of this is what we've been doing all along – it is a subset of political and regulatory risk in many ways. We've always looked at labour relations and recruitment issues, governance risks, modern slavery and supply chain resilience. The challenge now is integrating ESG within the broader regulatory frameworks that are emerging. The risk for investors and assets is that they see all this as a 'one and done' rather than a constant journey, and you can't do that solely through compliance with current rules. We now have a lot of clients who have internal ESG structures, but it's how they can be standardised and communicated for the most benefit – and that means to LPs, who are hot on this, to potential acquirers of portfolio companies, and ultimately, to clients, consumers and the public.

Hicks: Do we provide ESG scores? It is a question we are often asked. As we know, ESG is much more than a score so we always recommend working in partnership with an ESG-focused firm. I've observed that working in partnerships is something that we're

William Emtage

seeing more, which I hope will continue. The discussion around the table today has highlighted that ethical and ESG considerations penetrate all of our diligence and value creation streams. What we're finding is that boutique specialist firms working in partnership could, in a sense, compete with some of the larger firms who are offering this under one umbrella. Whether a growing preference to engage more boutique specialists in aggregate, as opposed to the larger catch-all firms, continues will be interesting to review in 12 months time when we're sitting around the table again.

One issue that I've been pondering is whether we need to add another E to ESG – Environmental, Ethical, Social and Governance. It is implied, but does it need carving out in light of recent socio-political trends? It is certainly something that we have picked up on.

De Wilde: I think the challenge now is integrating ESG DD within the broader regulatory frameworks that are emerging. The techniques and regulations are there, but now it's about producing something which is fit for purpose and can be used when clients talk to external stakeholders. We have a lot of clients who have internal ESG structures, but it's how they can be standardised and communicated that is more challenging.

What advice would you give to firms in the context of DD and ESG trends?

Hicks: The environment is changing within and outside of PE. Directors and associates within the industry who are rising through the ranks are much more comfortable requesting and making decisions based on data. They are making 'go/no-go' decisions based on morals and ethics. They are seeking a change in the way all diligence is run and this, for me, represents huge potential in the way assets are managed through the hold period. Thus, my advice would be: don't forget to review the internal culture and policies within funds and firms. If we purport to invest in supportive, inclusive cultures, then make sure you are not working your own staff into a mental health crisis. As a single mum who runs a transatlantic consulting firm, I know all too well that time constraints play a real part in pressure and stress. I do not, and indeed cannot, work 18 hour days, so I do not expect my staff to. Thus, realistic deadlines are quoted, factoring in weekends. Practise what you preach and the whole industry will be a better, more productive - and more ethical - place.

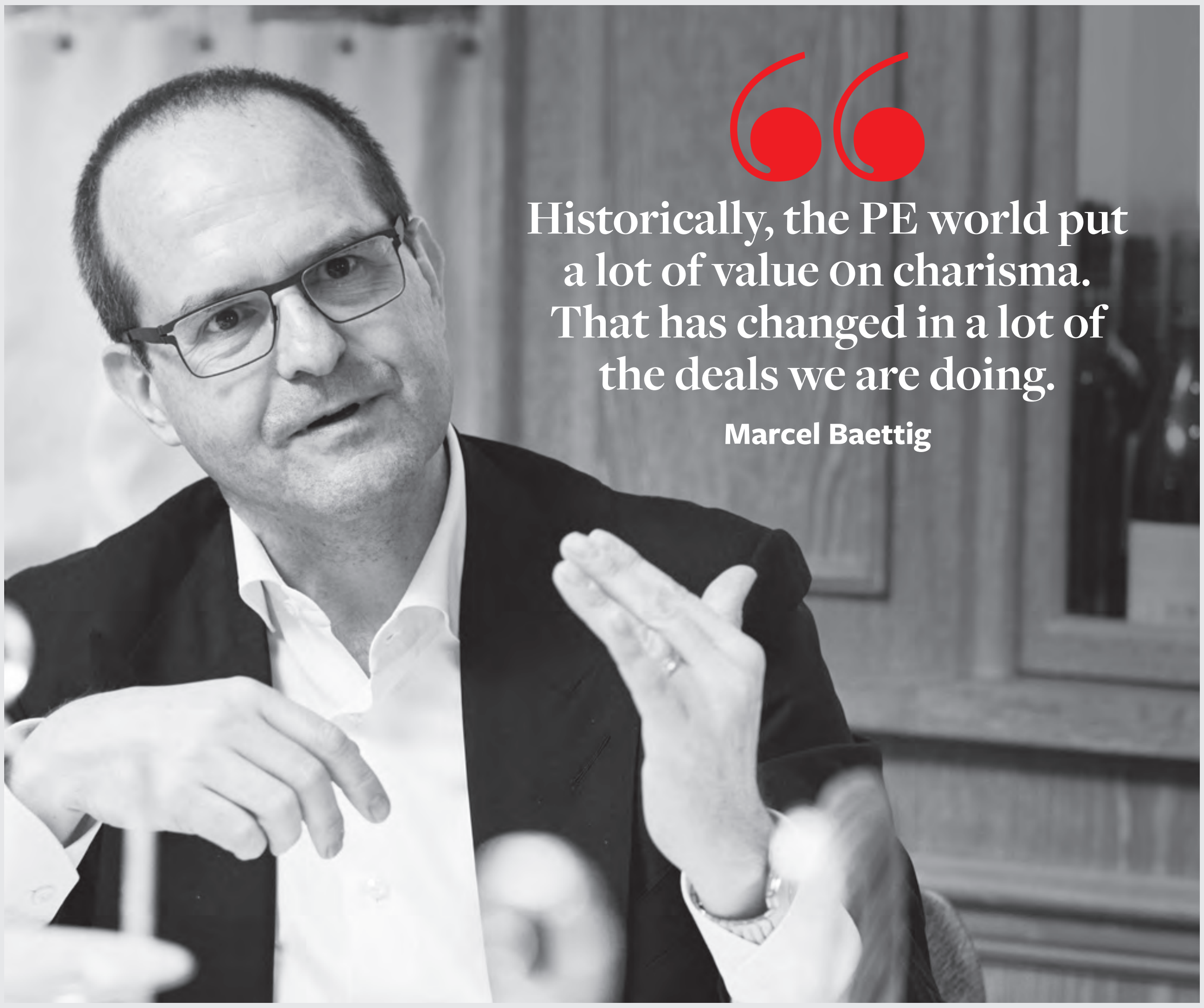
How can DD providers make their ESG insights more material and implementable?

Emtage: The ability to move from insight to implementation is a key differentiator between firms. Mobilisation requires an ability to prioritise tasks around a business case that has consensus support and

Justin Maltz

stakeholder buy-in. From the advisory standpoint, this is about ranking ESG insights on a cost-benefit basis in a manner that reflects value-at-risk and opportunity-costs over defined time horizons. Without that linkage to business fundamentals, there is no business case, thereby frustrating attempts to win support from key stakeholders.

Implementation is also about presenting ESG data in a way that is functionally and operationally useful. This cannot be achieved in a vacuum. Operational utility requires deep engagement with practitioners throughout the strata of a client business to understand the key bottlenecks and constraints they deal with. Data can then be presented in a tailored way that ensures relative ease of use, which translates to better uptake. Finally, implementation is about introducing firms to financial mechanisms that can help incentivise behavioural change, especially in relation to key external stakeholders that are otherwise difficult to influence. Note, for example, how Tesco partnered with Santander to develop a supply-chain finance solution that incentivises better cooperation from suppliers on emissions reduction and reporting. By conditioning favourable access to capital to compliance, Tesco is more able to implement far reaching sustainability reforms. Walmart recently announced that it is doing something similar with HSBC.



Marcel Baettig

David Turner

What are the key emerging challenges and trends for DD providers in the current market?

Baettig: Despite macroeconomic and geopolitical events, our post deal business is developing well. Interestingly, there is more activity with companies who are further advanced in the holding period. In our view, this indicates interest by management teams and funds to better prepare their companies for rainier days. Pre deal, we see a more cautionary stance regarding dealmaking with GPs, augmented by sellers who may not be willing to compromise on valuations. Also, LPs who run a multi-asset portfolio will likely have seen their stock and bond side shrink, which may lead them to focus more on protecting liquidity.

De Wilde: An enormous emergent challenge is foreign investment regimes, for example, in the US, with CFIUS (The Committee on Foreign Investment in the United States). The UK has introduced its own version, but it's not clear if this will mirror the US approach. CFIUS is very far reaching, monitoring much more than just purchases from Chinese businesses, and can significantly impact deals. The reach of the UK version and its effect is hard to say at present, but we're certainly doing more to try and educate our clients, especially as we've found that many dealmakers aren't fully aware of the implications.