Operational Due Diligence Of Testing Services Provider: Rapidly Validating Margin Improvement Opportunities And Assessing Capacity/CapEx Risk

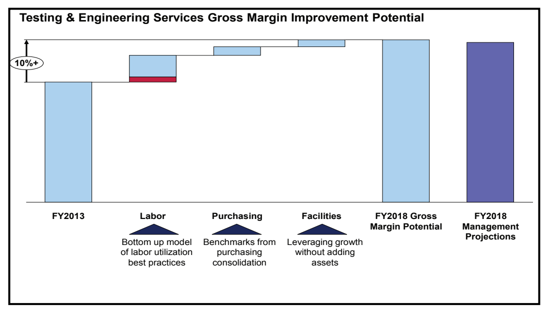
The Challenge: Our client, a large PE firm, had a proprietary opportunity to acquire the largest independent product testing services company, with a short window to finalize its bid to avoid an auction. The target had grown rapidly via acquisitions and its network now spanned 20+ facilities, each operating independently. Only recently had the target consolidated G&A (Finance, HR, and IT) and Sales (Salesforce, Estimation, and Marketing) functions to leverage backoffice synergies. Management believed that the target already had available capacity and a suitable fixed cost structure to support expected revenue growth over next 5 years and would experience 10+% points margin expansion in this period. Given that management's beliefs and estimates were top-down in nature, our PE client asked us to conduct a rigorous 2-week operational due diligence to validate margin improvement opportunities and assess capacity/CapEx risk.

Rapid 20+-Branch Service Operations Assessment: In the available 2-week window to conduct this assessment, Gotham undertook a multi-pronged effort, including: (1) site visits to 7 facilities (representing 55% of the target's revenue) to observe operations first-hand; (2) a full-day operations review with management to understand the target's operations approaches/processes (including estimation/pricing, scheduling, staffing, and CapEx allocation) and related vision/plans moving forward; and (3) in-depth analysis of available cost and operational data to understand/profile performance at the individual facility level.

To build a robust fact base, Gotham had to start by recasting target's labor cost structure, as the financials only tracked labor by billable and non-billable hours with no direct/indirect function details readily available. Gotham developed an operational view of labor costs – labor cost by function and labor utilization – by mapping 800+ employees into direct and indirect functions (e.g., technician, engineer, report writer, maintenance, supervisor) based on payroll headcount data, facility-level organization charts, job description, and timesheets. Gotham also analyzed job-level data to understand the profitability by facility, test type, and job type to better understand variability in pricing/estimation and cost management.

10+% Margin Improvement Opportunities Through Labor/Purchasing Savings And Fixed Cost Leveraging

Leveraging our fact base on target's costs and margins at facility level, Gotham built a bottom-up model to establish margin opportunities, including:



- **Labor Utilization:** Our labor utilization and margin analysis showed large disparities among facilities, partly driven by lack of common approach for estimation and scheduling. During site visits, Gotham saw clear differences in labor and equipment utilization, and we developed best practice benchmarks by type of facility and function. Gotham then modeled labor additions required to absorb projected growth assuming facilities achieve these benchmarks, establishing that a 7% margin improvement opportunity exists from the facilities improving labor utilization and achieving best practice benchmarks.
- **Purchasing Spend:** The target had no purchasing function, with over $50MM in equipment/supply/services spend done at the facilities on ad-hoc basis. Because the ERP system provided no identifying spend by commodity, Gotham had to piece together spend by vendor from accounts payable records and classify vendors by commodity in order to estimate this spend. We established that by consolidating vendors and leveraging scale across facility, the target could capture 5-8% reduction in purchasing spend.
- **Fixed Cost Leverage:** We assessed facility cost structure vs. historical revenue for facilities ranging from less than $5MM in revenue to over $20MM in revenue. We segmented facility costs into fixed (e.g., site manager) vs. semi-fixed costs (e.g., electricity), and developed fixed cost benchmarks as they relate to revenue levels. We then built a model to estimate margin expansion achievable with the projected volume growth as the fixed cost gets absorbed over a bigger revenue base.

Target's Capacity Understated Due To Poor Scheduling, With Potential To Support 3x Projected Volume Growth

Our conversations with facility personnel/management indicated varying scheduling philosophies across facilities to accommodate last-minute customer changes and cancellations. While the best-performing facility avoided idle time by overbooking and being creative in managing customer conflicts/changes, most facilities booked machines to customer jobs sequentially and had gaps when customers ran into issues in their own product development timeline. Since equipment utilization data was not collected, Gotham analyzed shift data and capacity utilization at current and hypothetical shift schedules, finding enough capacity to support 3x the projected volume growth. During this analysis, Gotham also identified 2 small facilities that were potential targets for consolidation and established that planned $5-7MM in CapEx might be avoidable given the additional capacity that would be available via enhanced scheduling.

Significant Long-Term Gains From Further Centralization, Managing Labs Centrally As Fulfillment Centers

In addition to the purchasing consolidation opportunity already noted, Gotham identified 2 other key opportunities to leverage network scale: (1) centralized scheduling to cross-leverage labor and equipment across facilities, eliminating misaligned incentives keeping facilities from sharing work; and (2) unified operations model with standard KPIs based on operational best practices. As the final step of the centralization strategy, the target would manage all support functions centrally and treat its facilities as fulfillment centers, with profit incentives based on company-wide performance.

The Outcome: Gotham's operational due diligence findings provided clarity on target's CapEx risk and margin improvement opportunities, confirming our PE client's investment thesis and justifying the valuation target needed to avoid an auction.

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