Successful Growth Through Acquisitions

by James J. Scheinkman, Partner, Snell & Wilmer L.L.P.

Many midmarket companies have long recognized the need to grow their businesses by acquisition to supplement internal organic growth. Particularly, in the present challenging low growth economy, acquisition may be the only means to significantly increase market share. It may also be the only viable avenue to acquire certain technology, vertically integrate company products and supply chains, procure attractive talent and brand recognition or expand geographically. For owners of companies looking to sell their business in a few years, an acquisition or two of other companies can add the "sizzle," revenue and profitability growth necessary to effect a future successful liquidity event. In valuing businesses, size does matter, and a business that has successfully managed several acquisitions will often command premiums in the M&A marketplace both on account of increased earnings and the demonstrated talent of its management in successful acquisitions.

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In a significant portion of acquisitions, however, buyers fail to achieve their original financial, strategic and business objectives – in many cases, spectacularly. Business study after business study have concluded that at least half, if not more, of business acquisitions failed to generate the desired results in either shareholder value or financial goals. As U.S. economist and writer, Irwin Stelzer, said, "when it comes to mergers, hope triumphs over experience."

There are numerous reasons why this is the case. All too frequently, the strategic objectives for the acquisition have not been well thought out or articulated, due diligence on the selling company is incomplete, post-closing integration of the business is poorly implemented and there are wide, sometimes insurmountable, cultural differences between acquirer and acquiree. Sometimes, it appears that what drives the desire to acquire is the perception of the need to acquire, akin to the need of individuals to accumulate goods. To borrow from the Greek poet, Hesiod, "acquisition means life to miserable mortals."

While Fortune 500 companies may have more resources to absorb a bad acquisition, smaller midmarket companies do not have such room for error. A bad acquisition by a smaller company can not only have a dramatic adverse effect on earnings, but may also destroy culture, brand recognition and employee morale. Smaller companies also have fewer resources and less experience with acquisitions which may create greater execution risks. For these reasons, proper planning for the acquisition is even more essential for these companies.

The following are some key components for a successful acquisition:

Assemble the Team Early

Having an experienced team of both internal resources and outside advisors is critical. Team members should include the members of management with responsibility for both the integration and the "P&L" of the acquired business, human relations and information technology staff, internal or external finance and tax personnel, seasoned M&A counsel and public relations. The overriding strategic goals for the acquisition should be understood by all team members, and divisions of responsibility in the due diligence process, deal negotiations and post-closing integration should be articulated. Those responsible for integration, particularly HR and IT staff, should be engaged up front and not just before the closing of the transaction. The extent that input from others is needed should be identified early in the process. For example, the time to speak to the buyer's bank or CPAs to determine the need for lender consent to a change in loan covenants on account of the acquisition or the auditor's views of the effect of the transaction on the buyer's financial statements is not after the transaction takes place.

Set Achievable Goals

Particularly, if the acquirer has not previously made an acquisition, it may be better served by first setting its sights on smaller companies to acquire rather than a comparably sized company which will involve greater due diligence and integration challenges. Also, the purchase price for the acquired business should not be so high that the buyer cannot afford greater than anticipated integration costs or be unable to weather the inevitable hiccup in integration or initial post-closing operations of the acquired business.

Conduct Thorough and Multidisciplinary Due Diligence

By the end of the due diligence process, a buyer should know the seller's business better than the seller's management. The primary purpose of due diligence should be to determine whether the original financial, strategic and business objectives for considering the acquisition in the first place are likely to be realized.

Obviously, this starts with extensive financial and accounting due diligence. Accounting procedures at midmarket companies sometimes seem like fingerprints – no two are alike. For example, what are the seller's revenue recognition, inventory and reserve policies and internal controls, and will these need adjusting after the closing? What impact will these have on the seller's represented profitability and the post-closing earnings from the acquired unit? Have all liabilities, such as vacation accruals, been properly reflected on the books?

If the seller is seeking to make adjustments to its earnings to justify a higher value – as will be any self-respecting seller advised by an investment banker – will those adjustments be achieved post-closing? For example, if the seller is reducing its stated costs by the compensation of any owners who will not remain with the business after the closing, will any of the functions performed by that owner need to be replicated by new hires?

Further, the buyer should take its own operations and cost structure into account. For example, if salaries and benefits of the target company are lower than those of the buyer, how realistic is it to expect the buyer to have a "two-tiered" compensation and benefit structure in place after the closing?

Needless to say, the acquirer should make a careful assessment of business operations. While the seller may understandably want to limit disclosure of the transaction until at or just before closing, the buyer should consider requesting meetings with key customers and suppliers, particularly if the target company has a highly concentrated customer base or is reliant on sole source vendors. For technology and manufacturing companies, buyer's operations personnel should carefully review product information and manufacturing processes.

Legal due diligence is also important. Some issues to consider are, confirming proper organization of the seller, existence of liens on assets, accurate records of share ownership and identification of any issues involving minority shareholders, potential tax, employment or other contingent liabilities, strength of the target's intellectual property and existence of any potential IP infringement, Foreign Corrupt Practices Act or other regulatory compliance concerns, need for third party consents, material contract review and other items. This type of due diligence is not "one size fits all," and the Company and its counsel should discuss division of responsibility, identification of key issues as it relates to both the buyer's and seller's businesses and resource availability and cost allocation.

"Soft" due diligence should not be overlooked. This may involve taking the seller's owners and spouses to several dinners or social events to assess true motivations for the sale or spending time with the target company's management to develop an understanding of their strengths and weaknesses, as well as learning more about the target company's culture. It involves identifying the key employees of the acquired business and ensuring that they are properly motivated to remain on board and contribute to the combined businesses' success. It also involves a discussion process of validating that the synergies between the companies are real and not just imagined.

Establish the Process

Once a target has been identified and basic deal parameters have been established, milestones and timing should be discussed by both the buyer and seller teams to ensure the absence of misunderstandings. From a buyer's standpoint, it is critical that its proposal to acquire the target not become the "stalking horse" for a rival bidder. Therefore, it is customary to enter into a preliminary letter of intent to set forth the parties' nonbinding initial understandings of basic deal terms and a binding "exclusivity" or "no shop" provision in which the seller commits not to solicit or consider offers from other suitors while the parties are negotiating definitive agreements. The letter of intent will often also set forth timeframes for completion of due diligence, negotiations among the parties and closing.

The parties and their counsel should discuss timing for provision of documents in response to due diligence requests and seek to avoid responses being delayed until the 11th hour. If there will be numerous documents to be produced with multiple individuals needing to review the documents, the parties should consider establishing a "virtual data room" in which documents can be reviewed remotely. Items needed from third parties, such as equipment appraisals, environmental reports, title reports, or audited financial statements, should be identified, and deadlines communicated to the vendors providing these items. The parties should discuss and establish a timeline for drafting and negotiating definitive agreements and stick to the timeframes established. It is usually not in the interest of the buyer or the seller to have a closing delayed due to protracted negotiations or delayed due diligence, while nerves become frayed, rumors of a deal circulate and competitors seek to gain advantage by soliciting the target's anxious employees and customers.

Negotiate and Close the Deal

Prior to the time of preparation of the definitive purchase agreements, the parties and their counsel should have settled on a basic deal structure – e.g., effecting the transaction by asset sale, sale of the target company's stock, or merger. Typically, to limit "successor liability" for the seller's liabilities, a buyer would prefer to structure the deal as an asset sale but this is not always possible due to tax, regulatory, third party approvals, or other reasons. In addition, the parties will negotiate the typical risk allocation features in the purchase agreements – seller representations, warranties and indemnifications, purchase price escrows and holdbacks to secure the seller's indemnification responsibilities, and the like. However, these negotiations should not be done in a vacuum without consideration of what the parties' relationships will be after the closing. In a 2013 study by Shareholder Representative Services, two-thirds of the sampled transactions resulted in post-closing issues relating to indemnification claims, purchase price adjustments and/or achievement of earn-outs. To the extent that the buyer will be relying on the employment or services of the former owners of the acquired company post-closing, the buyer and its counsel should consider the impact of possible post-closing disputes on that working relationship and seek to negotiate provisions which reasonably protect the buyer, but are less likely to harm ongoing relationships.

Conclusion

Acquisitions can be a very valuable strategy for midmarket companies to achieve their goals, but can also create considerable risks. Through proper strategic planning, due diligence and integration, midmarket companies greatly increase the odds of a successful acquisition.

James J. Scheinkman

James J. Scheinkman is a partner in the Orange County office of Snell & Wilmer L.L.P. and leads the firm's Business & Finance Group in California. His practice regularly involves counseling companies involved in M&A transactions and representing companies and shareholders in shareholder disputes. He can be reached at jscheinkman@swlaw.com or 714.427.7037.