Mergers & Acquisitions – Off-market Strategic Acquisitions

By John Snead – CFA, MBA

30 years advising corporates in the mid-market on their M&A and Funding transactions across US and Europe.

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Overview

In competitive markets where organic growth is hard to achieve companies often turn to acquisitions to deliver growth and increase shareholder value. Executing a successful acquisition strategy requires careful planning and specialist resources to avoid wasting valuable time pursing transactions that fail to complete.

Before expending valuable time and resources pursuing an acquisition ask yourself what an acquisition will bring to your organisation which can't be developed in-house? This may seem an obvious question but one which is seldom critically addressed by management teams. When it is it usually forms the basis for the target criteria to search against.

Once you have clarity on the expected gains from an acquisition you need to have an honest assessment as to whether companies or targets matching your requirements actually exist. Are they numerous or rare? At the same time, you need to consider how competitive the process might be. Are you the only buyer in town or are there numerous other companies pursuing a similar strategy? Understanding how many suitable targets there are and how competitive the market is will give you guidance with respect to pricing, valuation and potential structures.

Having formed a view on the target landscape, viability and probability of a transaction, you need to assess funding options and potential structures before progressing too far with suitable targets. Will you need to raise external finance in order to complete the transaction? Will the funding at least in part be dependent on the target's profitability? Being prepared and as advanced as you can be with respect to affordability will enable you to position yourself optimally with respect to potential targets and thus increase your chance of success.

Having determined your criteria and available funding you can set about building and processing your target universe or "Deal Funnel". Unless you are extremely lucky or incredibly experienced you are likely to require a much larger funnel than you ever imagined and, working, filtering, progressing and evaluating it is likely to demand

considerable time and resource. You need a strategy for evaluating both Off-Market and On-Market (companies embarking on a formal sale processes) opportunities with a realistic expectation for likely success from each channel.

Common Mistakes – Sell-side advisers will help.

a. In the main the vast majority of M&A advisers focus on sale mandates. They are focused on completing the sale and will typically follow the path of least resistance which usually means approaching the largest and easiest buyers first. They don't need to include additional buyers just to make up the numbers and will do so only if they are required to. While creating competitive tension plays its part, it is a much-overused term.
b. You can spend time talking to advisers explaining what you are interested in and what your criteria is. Unfortunately, this is broadly a waste of time as they are unlikely to record this information or make a note of it for future reference. They are just not that sophisticated – even the larger firms.

Once you have your criteria & target universe identified you need a structured process to engage, evaluate and progress each potential target. Use the criteria to structure interactions and gather information, while identifying red flags early to avoid wasting time and resource. It may sound counterintuitive but after confirming an initial fit, try to identify potential roadblocks or obstacles to a deal. Once you have found something that prevents the transaction move on to the next target. If none found, then press ahead with a deeper evaluation gathering additional information. Detailed analysis of the opportunity should identify any inherent risks providing guidance on appropriate structures and valuation.

It may sound obvious but interacting and negotiating with potential targets is a two-way process. You need to sell your company, why would it be a good buy for the company you have identified? What's in it for them? What are they looking for in terms of a partnership, ongoing involvement, consideration etc? Failure to incorporate their wishes or concerns in a deal construct is unlikely to deliver success.

Once you have an outline agreement Heads of Terms (HoT) or Letter of Intent (LoI) in place you need to establish a detailed project plan covering workstreams,

responsibilities and timescales for the period to completion and ideally also the first 30 days post completion. The due diligence exercise(s) should be targeted at confirming the transaction rationale as well as quantifying identified and unidentified risks from the preliminary analysis. When done properly the findings should be appropriately managed and reflected through the legal documentation entered into at completion.

Corporate Acquisition Criteria

Based on the assumption that inorganic growth is part of the corporate strategy companies need to be clear what synergy gains are to be achieved from an acquisition? How does 2 + 2 = 5? While on the surface it may appear that synergy gains can be achieved through numerous different forms the vast majority are likely to fall into one of the following main categories. They are usually categorised as either Hard or Soft with Hard Synergies being easily quantifiable, achievable and within your control as opposed to Soft Synergies which are less quantifiable, uncertain in their achievability and not always within your control. Below is a list of some typical examples.

1. **Hard Synergies**
    a. **Margin enhancement –** Increased purchasing power, supply chain rationalisation, leveraging professional services resource etc.
    b. **Overhead rationalisation –** By combining two organisations' overheads can be reduced through headcount and facilities rationalisation as well greater leverage of other overheads such as marketing, regulation, finance etc.
2. **Soft Synergies**
    a. **Gaining customers** – Acquiring a company whose customers are applicable to your Company's products and services can drive significant value through increased sales. Care needs to be taken when evaluating the target's customer base to make sure all or most of the Target's customers' profiles are appropriate and the relationships are capable of generating additional sales.
    b. **Extending product or service offering** - This is essentially the reverse of a) in that you are looking to acquire a company whose

products and services are applicable to your customers. You need to confirm there is sufficient capacity to meet the anticipated increase in revenues and also that your customers would be happy to purchase those products and services from your company as sometimes brand and credibility can sometimes be an issue. This also covers increased sales where products and services fit together in combination and as a result lead to increased revenues – “One-stop-shop”.

c. **Domain expertise** – This is really an extension of a) and b) but covers the situation where you need credibility for your products and services to be accepted within a target market. Establishing your company as a “Go To” market participant will usually lead to increased market share.
d. **Increased scale or geographical expansion –** While this will often deliver hard synergies referred to above it also covers market share gain and increased sales. The increase in sales is likely to be derived from the ability to provide greater credibility, and reliability as well as reduced supplier risk.
e. **Rationalising scarce resource** – Where companies have scarce resource such as R&D, combining two organisations which are applying similar resources to the design and production of comparable products and solutions, provides the opportunity for realignment and increased output from the same resource.

Establishing clarity on expected synergies is paramount to creating a robust, acquisition criteria necessary for identifying suitable targets. The criteria will often be segmented into primary or “must have” features and secondary or “nice to have” features. The criteria need to be detailed enough to correctly identify appropriate candidates without being too prescriptive so that suitable candidates are not mistakenly rejected. The composition of the expected synergies will determine how rigidly the criteria should be applied remembering that during the initial evaluation phase it is difficult to accurately assess an individual target’s fit with the criteria. In the vast majority of cases no single candidate will be a perfect match, so it is important to establish what compromises are acceptable in determining suitable candidates to progress.

When evaluating a large number of potential targets, it is useful to apply a scoring system in order to rank companies objectively based on their respective fit with the criteria. Typical criteria for scoring and ranking might include the following:

1. Product or service offering – the degree of overlap in terms of capabilities and offering.
2. IP – differentiation, domain knowledge etc.
3. Customer fit – in terms of size, industry, geography, relationships etc.
4. Revenues – in terms of
    a. size
    b. composition etc.
5. Partnerships – in terms of technology, channel, etc.
6. Profitability – Gross and/or operating margins
7. Management – Strength, retention etc.
8. Geography – Extension or rationalisation
9. Regulatory – licenses and certifications

Common Mistakes

While many of the suggestions above may seem obvious, companies often struggle in execution and often make the following mistakes:

- **Strategy criteria mismatch** – The criteria does not focus on identifying target attributes which will deliver the desired synergy gains**.**
- **Criteria overly detailed** – Where criteria are unnecessarily detailed it can result in a focus on due diligence type activities before the high-level investment case has been made. Remember initially it is about sifting through numerous targets to identify candidates worthy of further research and evaluation.
- **Criteria overly rigid** – Lack of flexibility with the criteria especially where information is incomplete will reduce the pool of “suitable” targets, missing targets which appear borderline or a poor fit, however following more detailed investigation turn out to be good candidates.

Funnel Creation & Processing

Creating the optimal funnel requires a variety of techniques to efficiently identify promising targets, in combination with preliminary filtering activities to weed out non-starters. It is seldom possible to obtain a complete list of likely targets from one single source but rather it is more common and necessary to identify and review multiple sources to uncover potential targets. Typical sources for target identification are trade body associations, trade shows, partner listings, industry reports, articles & journals, online databases and internet searches.

Gathering target profile information is usually time consuming and resource hungry so an efficient process incorporating effective sifting is essential.

- **Constant sifting** - Early rejection of unsuitable targets, such those owned by a parent unwilling to sell, is paramount in-order to channel resources on best-fit candidates.
- **Initial profiles** - Similarly, focusing on collating relevant data with interpretative skills and logical analysis will help to focus valuable resources. Often a company's partners will provide insight to their likely customer's profiles, for example leveraging benchmark KPI data can assist in estimating financial information.
- **Direct contact** - Desk based research will only achieve so much and ultimately interaction with the target's management or shareholders will be necessary to gain a thorough understanding of the business and its operations. As with earlier steps there is a trade-off in gathering data and focusing on suitable targets. Focus on the primary attributes and reject early by identifying deal breakers as soon as possible, maintaining time efficiency.
- **Free information** - Where you have direct contact never miss the opportunity to gather useful information before rejecting – Who are the target's main competitors etc? While they may not be a fit they may well know someone who is.
- **Deeper dive** - Gathering information often requires skill, especially for off-market opportunities. Reaching out cold and gathering meaningful data requires etiquette, respect and mutual information sharing so be prepared to provide similar details about your own organisation. If you outline what you

are looking for and why rather than running through a detailed list of questions, it will make it easy for the target to respond informatively without feeling they are being interrogated. Also engaging in free-flowing conversation covering shared experiences will often garner more information and insight than a straightforward Q&A session.

- **NDA** - It may help to sign a non-disclosure agreement (NDA) in-order to obtain meaningful information, although putting one in place will slow things down a little, so try to be selective. Remember initially you are only trying to establish the following which if they check out support putting an NDA in place.
    - General profile
    - Stakeholders interest in a transaction
    - Likely agreement on value
- **Detailed analysis** – Face to face meetings will always provide greater information and insight and are a necessary part of the project. Even though video conferencing has become ubiquitous post covid, physical meetings still have their place, especially in building relationships and providing greater detail, demonstrating a degree of commitment. Even though you may have hundreds of targets in your funnel, in-order to make meaningful progress it is helpful if each candidate thinks they are unique and not one of a long list of possible targets. If the process turns competitive it will often help if you have managed to build a rapport with the vendors. While you need to be structured and comprehensive in your detailed analysis, in-order to establish synergistic fit remember this is not a due diligence exercise at this stage, so stick to profile building rather than confirmatory activities. Look for buy-in and confirmation of any assumptions you have. Also understand what the other party's aspirations and objectives are and the potential for alignment. Can you see a mutual solution?

Common Mistakes

- **Funnel size –** After expending valuable resources over an extended period on a small number of initially promising targets companies often realise their funnel is sub-scale either from over rigid criteria or insufficient target identification.

- **Poor sifting** – A lack of interpretive analysis or inaccurate and inefficient rejection techniques hampers quality candidate identification producing sub-optimal results.
- **Insufficient resource allocation** – It requires time and commitment to build and properly process a significant number of possible targets, and companies often underestimate the time and detail required.
- **Poor data collection** – Unstructured data-gathering and unsympathetic target engagement is unlikely to deliver the desired results in identifying and progressing "best fit" candidates.

Negotiation & Outline Agreement

Having identified a "strong-fit" candidate a detailed review and information gathering exercise needs to be carried-out in-order to make a well-considered proposal. Again, focus on understanding the profile of the business and its potential for delivering the desired synergies and resist the temptation to embark on a due diligence exercise. Notwithstanding this make sure you are clear on the major risks inherent in the target business and consider how these risks can be nullified through sensible structuring such as contingent payments or Earnouts or due diligence. Also, if only a portion of the business is of interest explore the possibility of purchasing part of the company.

It is important to fully understand what the vendors are looking for in a transaction and failure to appreciate this is rarely a successful approach. Further, transactions require a willing buyer and a willing seller so negotiating with someone who is not really interested in selling often results in wasting time or overpaying. Structuring a transaction which meets the vendors requirements, such as a particular figure, but on terms acceptable to the acquiror, for example based on performance over time, often delivers a win-win outcome. Also never forget it is a two-way process so take care in outlining why your company is an ideal buyer. What is different about your company, which makes you a preferred buyer? You may want to consider:

- If you have a deep understanding of the vendor's business so reducing transaction risk.
- Is there compelling logic to the business combination giving an attractive future for remaining employees and shareholders?

- Can you easily demonstrate ample funds to complete the transaction?
- Do you have the resources to complete the transaction efficiently?
- Do you have a referenceable track record of successfully completing acquisitions?

The timing of an offer is often as important as the offer itself. Be careful not to play to someone's vanity but rather try to elicit their interest in receiving an offer. Are they in a position to accept an offer? Will they need to carry-out their own research or marketing exercise in-order to gain knowledge to be in a position to accept an offer? Tactics will often come into play so be careful not to make a proposal which is not time dependent and only acts as a marker or a lever for the other party.

If you are going to make an offer, make it is as professional as possible. Ideally an offer be it "HoTs" or "LoI", should be comprehensive, and professionally structured and on formal letterheaded paper. Ideally it should contain the following elements:

1. **Parties to the transaction** – The letter should be addressed to the shareholders and identify the target company and the buying entity.
2. **Etiquette** – Politeness costs nothing and being respectful and appreciative usually helps.
3. **Transaction type** – Is it envisaged that the transaction will be done as a share purchase or an asset purchase?
4. **Basis -** It is helpful to include the key information received on which the offer is based on such as trailing and forecast revenues and profits etc.
5. **Consideration & composition** – Detailed description of the basis for the valuation, enterprise or equity, together with the timing of payments including any related terms such as performance considerations.
6. **Completion mechanism** – Often share or stock purchases will be made for a business based on a debt free cash free basis with normalised level of working capital. As a result, it is sensible to outline if the transaction will include a locked box or completion accounts mechanism.
7. **Due diligence** – General overview of approach to due diligence.
8. **Exclusivity** – All offer letters should include an exclusivity clause to protect the buyer in the event they incur costs in relation to due diligence activities and legal contract drafting and negotiation.

9. **Costs** – A clear outline of responsibility for costs and in particular recovery of costs in the event exclusivity is breached.
10. **Binding terms** – Identification of which elements of the offer letter are binding which usually means exclusivity, costs, confidentiality, and governing law.
11. **Principal conditions**- An outline of the main conditions on which the offer is made.
12. **Confidentiality** – Confidentiality clause referring to prior information exchanged as well as the terms of the offer letter.
13. **Governing law** – Legal jurisdiction for the offer letter.
14. **Acceptance** – Identification of who needs to accept the offer.

In addition to the points above it is important to make sure any offer does not give rise to further clarification questions or gives an invitation to negotiate but rather is in a final acceptable form.

Common Mistakes

- **Poor or naïve structuring** – Often gaps in valuation or obstacles in risk mitigation or funding can often be dealt with through transaction structuring.
- **Misreading the situation** - Failure to appreciate that the vendor is not seriously open to a sale or there is misalignment across the shareholder base.
- **Failure to listen –** Not appreciating what is important to the vendor will often result in a proposal which is attractive to the buyer but not the vendor.
- **Incomplete or poor execution of LOI/HOTs** – Where the LOI/HOTs are not complete or not in an acceptable form will lead to further discussion, negotiations or even “shopping of the deal”.

Due Diligence & Completion

Buying off-market where the vendor is unfamiliar with M&A and does not have an experienced adviser requires significant project management and planning. Identifying and documenting the discrete work streams in detail and prioritising and adequately resourcing on both sides should not be underestimated. Deciding which activities can be performed in parallel and in which sequence will have a significant impact on timelines and can provide timely progression checks should things not pan out.

If you plan to use external advisers for FDD, CDD, LDD and contract negotiation etc. you need to be mindful the potential costs can get out of hand without proper controls in place. It is preferable if the vendor shares information and answers to due diligence questionnaires via a “fit for purpose” virtual data room or VDR. Further, there is little point getting your external adviser actively engaged before the data is substantially populated. Also, agreeing with the vendor a realistic project timetable and necessary workstreams at the start will minimise unnecessary friction during what is already a stressful process.

When selecting advisers to assist you on your transaction make sure you opt for advisers who are very experienced for the type of transaction you are contemplating. see adviser selection article https://resources.danescor.com/adviser-guide/

Common Mistakes

- **Poor adviser selection** – selecting advisers who do not have a demonstrable and credible track record of similar transaction in terms of industry and size is likely to cause issues.
- **Lack of project planning** - Failure to adequately plan, resource and project manage the transaction to completion with the increased risk of failure and transaction costs.
- **Red flags** – Failure to focus on the big risks first and prioritise the tasks to minimise costs should the transaction not complete.
- **Poor data room selection** – Selecting an inappropriate solution to support the due diligence process is likely to cause unnecessary risks and issues**.**
- **Lack of empathy & understanding** – There will undoubtedly be difficult legal points to be negotiated, remaining calm, respectful and creative will usually result in acceptable solutions or workarounds being found.

At Danescor, we are re-defining the M&A market bringing advisors and businesses together on a trusted and integrated transaction process. Interested in learning more? Contact **info@danescor.com**

For more information and to arrange a demo:

John Snead
T: 07979 704302
E: john.snead@danescor.com

John Snead, CFA, MBA has spent more than 30 years advising corporates in the mid-market on their M&A and Funding transactions. His experience has been gained from transactions across US and Europe during his tenure at organisations such as Arthur Andersen/Deloitte, Capstone Partners and KPMG.

danescor.com

info@danescor.com

0203 787 4811

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