

Making An Aquisition The Smart Way

According to Bank of America Business Capital's 2008 CFO Outlook, among those companies expecting merger and acquisition activity, 86 percent report that they will be making the acquisition, while only 7 percent plan to be acquired by another firm. In other words, many buyers will be chasing few sellers.

That means if you are a would-be buyer, you need to develop a well thought-out process that generates proprietary deal flow, minimizes your risk and maximizes your return on investment (ROI). The right approach will also enable management to continue focusing on its existing business; increase your probability of acquiring the right company at

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the right price, terms and conditions; compress the time frame to complete a transaction; and ensure successful post-merger integration.

How To Get Started: Should you wait for investment bankers or business brokers to call you with deals? That might result in missed opportunities, competitive bidding situations such as auctions, or a stream of companies that do not fit your criteria.

The acquisition process includes a number of steps and requires considerable preparation and careful execution. It also calls for experience and specialized skills in accounting, due diligence, finance, law, strategy and valuation. So let's start at the beginning.

Step 1: Acquisition strategy and criteria. Your first step is to clearly define your acquisition strategy and set of criteria. Some common strategies are to:

- Overcome barriers to organic growth.
- Bolster a company's competitive advantage by acquiring key resources like strong management, skilled labor, complementary or proprietary products or services, production capacity or new technology.
- Expand geographically or manage business risk through market or customer diversification.

Once the strategy has been vetted, set specific criteria for the business you want to buy. Type of business (or industry), size of business (in terms of sales or cash flows), location, size of transaction and equity investment and other qualitative factors are commonly used criteria. If your strategy is off-target or your criteria are too loose, you'll waste time and

other resources or, worse, fail at attaining your goal.

Step 2: Valuation methods and assumptions. It is also important to use valuation methods and assumptions that fit your requirements as well as those of a reasonable seller (for example, market-based). Most financial advisors use the discounted cash flow (DCF) method to estimate the value of companies with positive, predictable cash flows. Purchase price multiples should be used carefully as a rule of thumb to check a DCF valuation or to provide a quick estimate.

As part of the valuation process, you must make assumptions about variables like future sales growth, capital expenditures, cash flows, financing and return on equity. Using generally accepted, reasonable valuation methods and assumptions greatly increases your probability of completing acquisitions of companies that satisfy your strategy and criteria.

Step 3: Acquisition funding. Before reaching out to acquisition targets, as a buyer you should identify sources of debt and equity and determine how much capital you can invest. Some buyers need to look no further than their own balance sheet, since excess cash and existing revolving lines of credit are common funding sources. Other sources include private placements, sale-leasebacks, bridge or term loans, and mezzanine or subordinated debt.

Another alternative is to raise equity from a professional investor such as a private equity group (PEG). PEGs are not only a source of capital, but also provide board-level advice, management and deal-making expertise, and industry experience and contacts. Clearly, the source and amount of capital will influence the size of transaction you can consider as well as the valuation and structure of any proposed transaction.

Step 4: Preparing for a broad search. When you target a large group of companies such as an industry rather than one or a few specific targets, you need to prepare a few more items:

- Have a list of prospective targets based on your acquisition criteria, such as type of business (or industry), size of business (in terms of employees or sales) and location
- Write a brief description of your business and acquisition criteria. Prospective sellers want to know who is courting them and why. This can be presented

to prospective sellers verbally, but many will ask for something in writing.

- Prepare a Confidentiality or Non-Disclosure Agreement. Confidentiality is critical to sellers, especially privately held middle-market businesses. A few prospective sellers will want buyers to sign their own, but many will not be prepared to sell their company and, therefore, will not be ready with an agreement.

- Complete a standard information request. Again, since many prospective sellers will not be marketing their companies for sale, you need to be ready to request pertinent information. An initial screen of about five items is a good place to start.

Step 5: Finding the right fit. Once you have completed the necessary preparations, contacted several prospective sellers and identified an interested party who may be a good fit, the heavy lifting begins. You will need to analyze detailed target company information to understand the target company and determine whether or not it fits your strategy, culture and ROI parameters. Valuation models and transaction structure alternatives need to be developed. If you decide to pursue a transaction, a letter of intent

or term sheet needs to be presented, negotiated and finalized. Funding needs to be arranged. Due diligence needs to be conducted, the transaction needs to be closed and post-merger integration needs to be completed.

The right approach will increase your likelihood of finding the right acquisition. It requires considerable preparation, careful execution, experience and specialized skills. While this process may seem time consuming and a bit intimidating, you can get help. The right team of professional advisors includes your investment banker, attorney, CPA and other experts who will show you the way. ■

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