Making a Successful Acquisition

Making a business acquisition is a quick way to grow your company. But this type of transaction also carries several risks. In order to succeed, careful preparation is required. Here are the critical steps to follow—before, during and after an acquisition.

PARTNER IN GROWTH

HEC MONTRÉAL

BUSINESS GROWTH AND VALUE CREATION

Are you the person in charge of taking your business to the next level?

Then this program is for you!

- Learn from experienced leaders with a proven track record for growth
- Tap into strategic development opportunities
- Find out how to meet (and exceed!) your growth and value creation objectives

REGISTER TODAY!

hec.ca/ed

Part 1

Before the acquisition: Take your time

To survive in a competitive environment, it's imperative to keep growing your business. Growth can come organically, from an increase in sales and operations, or it can come through acquisition, which may allow a company to scale up more quickly and efficiently and reach a size and positioning that lets it generate greater profits.

Larger companies enjoy several advantages, including being more attractive to customers and suppliers: They know they can count on a partner that is able to meet their needs and expectations. Employees, too, feel that their career prospects are better with a larger company.

Lastly, acquisitions are a quick way to gain access to new technologies, products and markets, plus new employees and customers, while limiting the risk that comes with having to innovate or expand into the unknown.

1 CAREFULLY PREPARE THE PROCESS

An acquisition can often make strategic sense, but the process is complex. To succeed, you need to target potential acquisitions that will enrich both the company and its shareholders. Avoiding paying too much for acquisitions, and integrating them quickly and efficiently into the existing business, is key to deriving the maximum benefit.

So the first step involves asking yourself the right questions. It is critical to have a clear vision of why a particular acquisition is the best way to grow your company.

- Do I want to address a weakness by buying a company that is better positioned in a market that I covet?
- Do I want to expand my range of products or services, or vertically integrate production?
- Do I want to achieve economies of scale?
- Do I want to become larger in order to better compete and offer lower prices?
- Do I want to gain access to human resources and talent?

The number-one aim of any acquisition should be to strengthen the company's strategic position. You must establish as clearly as possible what your goal is in making an acquisition. Letting yourself be persuaded that an acquisition you hadn't seriously considered is a desirable one can be very dangerous.

Once you've established your goal, you can start looking for companies for sale that will help you reach the objectives you set out at the beginning.

2 SET UP A WORKING GROUP WITH YOUR ADVISORS

The acquisition process is long and requires a great deal of work and attention. Often, it is necessary to set up an in-house team to manage such a major undertaking. Companies that make multiple acquisitions generally appoint a director to be in charge of acquisitions and set up a team devoted to selecting and acquiring other businesses.

Obviously, not all companies are large enough to have a whole team dedicated solely to mergers and acquisitions. But at the very least, putting one of the company's executives in charge of M&A is very wise.

Eventually, the acquisition process will also involve your accountants, financial institutions and lawyers. It's helpful to have your lawyers involved right at the outset, as they can act as counsellors during the acquisition. It is up to you to decide what level of engagement you expect from them.

It makes sense to consult with your team at the very beginning of the acquisition plan so that they can support you from start to finish.

Some accounting firms offer specialized merger and acquisition services. But even if yours does not, it is still important for your accountants to be involved in evaluating and performing due diligence on the targeted acquisition.

Your lawyers, meanwhile, should take part in preparing the documents necessary for making the acquisition. They can also participate in the due diligence, particularly in terms of the state of the target company, the existence of permits, licences or patents, for instance, and the existence of current or possible litigation. In the case of a large acquisition, they will assess whether it raises competition or antitrust issues.

In certain industries, business transfers are subject to government approval. Your lawyer should be able to guide you in choosing which clauses to include in your offer documents and in the acquisition agreement.

3 WORK WITH A FINANCIAL INSTITUTION FROM THE START

All acquisitions entail costs, and often, therefore, financing needs. It is strategically important to bring your financial institution on board in the negotiating process right at the outset. This way, it will be familiar with the file and will be able to answer your needs and participate in the necessary financing.

Some financial institutions have teams that specialize in business transfers and are able to provide advice throughout the purchase process. They will attend certain meetings, take care of structuring the financial transaction, coordinate the various stakeholders and support the legal and financial advisors in the preparation of documents. They can also refer you to experts who can evaluate the target company and assist in tax planning.

4 TARGET THE RIGHT COMPANY

Identifying a worthwhile target is a crucial step. Every now and then, you might stumble upon a very interesting purchase opportunity by chance. But in most instances, it's best to be proactive and target a company or type of company that fits into a carefully developed strategy.

Stay within your sector

To find the right target company, it's important to remember that an acquisition made within a sector that you already know well is more likely to succeed. Acquisitions often develop naturally: Entrepreneurs gain knowledge and unique abilities that they can use to run other companies within their field of expertise and generate greater profit than their competitors can.

So the best targets are ones that are in the field you operate in. And the top performers in the sector are also often the companies that are best able to make successful acquisitions.

The best way to identify a great acquisition target is to look around your immediate environment. Most of the time, companies will end up acquiring a competitor, a supplier, a customer, or a company that belongs to the family.

Choose a company you know well

Acquiring a company that you are very familiar with gives a greater chance of success, because it is always difficult to know the true state of any company that's up for sale. Rare is the acquisition that doesn't come with a few surprises down the road. Even though everything has been thoroughly vetted, inevitably there are some wrinkles to be ironed out.

Acquiring a company that is well-known to the buyer—because they are part of the owner's family or the firm's management team, for example—makes the process much easier. Many of the risks associated with a business acquisition are removed when the buyer or the seller comes from within.

5 ACTIVELY SEARCH

It's not easy to find businesses for sale. Frequently, companies don't advertise the fact that they would be interested in selling. So, you need to be proactive and rely on networking and specialists to find the right deal. For this reason, once again it's advisable to stay within your field rather than venturing off into a new market or a new business sector.

Within your own field, as an entrepreneur you can use your network to put out the word that you are interested in finding a company to buy. You will soon know which businesses might be up for sale, and from there you can pick and choose. Another option is to use an intermediary and benefit from their insider knowledge of businesses for sale. Investment banks, commercial banks, firms that specialize in mergers and acquisitions, and auditing firms can be a good source of information about companies up for sale. Unless a market intermediary has a negotiated sales agreement with their client, there is generally no exclusivity arrangement in the sale of companies.

Something to keep in mind: Even though a company may not be for sale, it might be interested in being sold. In many cases, the owner is enticed to sell because a buyer approached them first and showed how a sale would benefit both them and their company. Therefore, if you are interested in a company, don't be afraid to reach out to the owner—tactfully—to start discussions.

On the other hand, just because a company is up for sale doesn't mean the process will be any easier. Negotiations can break down, for instance, if the two parties disagree on the price. It is essential to set certain criteria and limits and be willing to walk away from the deal if certain conditions that are important to you are not met.

To be contacted whenever a company that corresponds to your search profile is put up for sale, you can inform intermediaries of your desire to purchase. Obviously, it is essential to clearly state your criteria in order to receive useful target proposals. You also need to make sure your intermediaries are capable of making initial selections based on your criteria in order to avoid wasting time.

6 ESTABLISH THE RIGHT PRICE

The success of any acquisition depends first and foremost on getting the right price for the business you are acquiring. This usually involves paying the company what it is worth. And although the rare pearl will never be sold for a bargain, the risk of paying too much must also be taken into account.

Sometimes, you may have to compete with other potential buyers. Actually, it can be a good sign that there are other suitors, and the fact that a business is being targeted is not a reason to lose interest in acquiring it. But the true danger lies in getting carried away and paying too much, for fear of missing out on a good opportunity.

If there is a formal bidding process, then it's even more important to establish a maximum price that you are comfortable with and then stick to it. Acquiring the perfect company at a price that's too high boils down to a poor acquisition, because it will be very difficult to make any money off the transaction and derive any benefit from it.

Part 2

During the acquisition: Do in-depth analysis

Before completing the purchase, it is essential to take the time to correctly evaluate the target company. The results of this evaluation will enable you to determine if the selling price is fair or not, so this step is of the utmost importance. Of course, a valuation is not an end in itself, but rather a tool for negotiating a final price.

1 DO AN EVALUATION

Although it's extremely important, the evaluation cannot establish the value of the target com-pany in absolute terms. But it should take into account the market and context in which the company operates. A valuation is based on the expected profits that a company is likely to generate and/or on a comparison to the price paid for similar companies.

The valuation of a company performed in the context of an acquisition is comparable to that of a stock market investment: The buyer wants to pay a price that will allow them to achieve a favourable return.

There are several different valuation methods, but all of them are based on two simple notions: the ability of the company to generate profits and the expected return on the capital invested.

The company's ability to generate profits is often expressed as its ability to manage free cash flows, i.e. the surplus cash that it will generate in the future.

Discounted cash flow method

Discounted cash flow (DCF) is the most common and advanced valuation method. It involves estimating the expected cash flows a company will generate during its useful life, and then calculating the present value using an appropriate discount rate.

This exercise therefore consists of anticipating cash flows, i.e. creating a financial forecast to project a company's results and financial position in the future.

The financial forecasting model should establish the free cash flows that a company's operations are likely to generate in the future. The concept of free cash flows is simple: Essentially, it is the money that the owner will be able to pocket each year, after ensuring the survival and growth, if any, of the company. The owner can choose to reinvest these profits in order to grow the company, either through investments or acquisitions. Any such decision should be evaluated using the same metric: What will the value of free cash flows be?

Here is a simple financial forecasting model to show how to determine free cash flows:

In the cash flow model, historical results should serve as the basis for financial forecasts. But they don't tell the whole story. Adjustments must be made to more recent results to "normalize" them, that is, remove anything that pertains to the company's current ownership that may not accurately reflect its actual state, as well as any non-recurring items.

For instance, any non-essential expenses incurred by the company may not be necessary in the future. Similarly, superfluous or redundant assets retained by the company's owner could be sold off once the acquisition is finalized. Conversely, revenues may need to be re-evaluated. If a large, one-time-only sale was made to a customer, it is best not to factor it in when evaluating future cash flows.

In short, a "spring cleaning" of historical results is necessary to provide as accurate a picture as possible of what the company will look like after it's acquired. Once the historical results are restated, they can be used to establish financial forecasts that will provide a clear valuation.

The forecasts are based on the knowledge of the target company that the buyer has developed, and on what the buyer plans to do with the new acquisition. And they should take into account any changes the new owner wants to make. The buyer may want to test different scenarios (pessimistic, realistic, optimistic) to determine if the assumptions are reasonable. The new owner may also want to include some wiggle room in case things do not go as well as planned. Of course, the forecasts will become more refined as the buyer becomes more familiar with the target company. And due diligence, which involves a detailed examination of the company's results, plays a large part in this deepening understanding.

Estimate potential return

An investment decision should be viewed like any other business decision: The selling price must be greater than the costs incurred to realize a profit. The greater the risk to make a profit, the greater the potential margin should be. In company valuations, this margin is represented by the discount rate used to calculate the present value of free cash flows. This helps to offset two specific risks: The higher the rate, the more the valuation of expected long-term and higher-risk cash flows will be reduced.

A higher rate of return is required for a small, emerging company than for a large one that has reached maturity and whose future cash flows are easier to estimate.

Other factors can also justify requiring a higher rate of return. For instance, a company faces greater risk if it operates in a highly competitive market, compared to a rival company that enjoys an undeniable competitive advantage (thanks, for instance, to a patent, a privileged market position, favourable business locations or because it owns a popular brand). The company that lacks this positioning may have to lower its prices to keep its market share. This has to be taken into account when establishing a selling-price valuation for an acquisition.

The required rate of return (RRR) when acquiring a private company falls somewhere between two extremes: the average return that large publicly traded corporations achieve (about 7%), and the expected return of small start-ups (40% or more).

But determining a required rate of return is not an exact science. What's most important is to be aware of the rate required and be able to clearly establish the impact of a variation in this rate on the company's value. Keep in mind that the discounted cash flow method allows you to develop a model that will provide a basis for negotiating an acquisition price. The goal is not to obtain an exact valuation of a company, but rather to have as clear a vision as possible in order to determine the right price to pay.

If the rate of return used to evaluate the company is too low, the company may be overvalued. And that means the price may be too high. On the other hand, if the rate is too high, the price will be low, and therefore not easy to swallow for the seller.

The comparables method

The comparable transactions method is another widely used means to evaluate a company in the context of an acquisition. It involves determining a valuation by analyzing the price that other comparable companies have sold for recently using identical comparison criteria. As much as possible, the sample should include companies in the same field of business, of the same size, with similar results and located in a similar geographical area, etc.

Then, ratios are applied to determine a valuation. In cases where a more formal, DCF-based evaluation is not used, the most widely used method for evaluating a target company is the Enterprise value (EV)/Earnings before interest, tax, depreciation and amortization (EBITDA) multiple.

The basic information used is the EBITDA, in other words the cash flows produced by business operations, minus financial expenses, tax, depreciation and amortization. This amount must also be adjusted, or "normalized," as previously indicated in order to arrive at a figure that correctly represents the anticipated future performance of the company.

For instance, if a company has an adjusted EBITDA of $200,000 and the multiple of the enterprise value over EBITDA is 5 times, the company will have a value of $1 million. The same exercise can be carried out by analyzing the evolution of the EV/EBITDA multiple over a period of years. It should be noted that relying solely on this valuation method may not provide a complete picture, since there may be other factors that influence the price, such as the presence of surplus assets and/or outstanding debt within the company. That's why we recommend you consult with your professional accountants for greater insight.

2 MEASURE THE IMPACT OF SYNERGIES

One of the key factors in a successful acquisition is achieving synergies, or at the very least improving the operations of the acquired company in order to boost profitability. There are many different types of synergies.

Revenue synergies

If, for instance, the acquired company has an attractive range of products but has trouble bringing them to market due to a limited distribution network, the acquirer could use its own distribution network to increase the sales volume of those products. This would be an example of revenue synergies. Value is created through an increase in revenues and the achievement of profit once the acquired company has been integrated with the buyer's company.

Cost synergies

The acquirer may also be able to reduce the acquired company's operating costs. This would be an example of cost synergies. Value is created through an increase in the acquired company's profits. Ideally, these synergies should benefit the buyer, without having to be accounted for in the purchase price. Synergies can be created by having companies operating in the same sector. The profitability of the acquired company can also be increased by streamlining its management to reduce costs and improve productivity. These reductions are examples of cost synergies.

If no synergies are foreseeable, you should think twice about pursuing an acquisition. True, some financial buyers will acquire this type of company in order to restructure it or improve operations in the hope of ultimately deriving a profit. But in such cases, major changes must often be made to put a struggling company back on its feet. This is the main reason why it's best to target complementary businesses.

Part 3

During the acquisition: Negotiate and finance

Pursuing an acquisition can prove to be a gigantic task. The key to success is to carry out the operation leaving as little as possible to chance. But it's important to remember that an acquisition plan can meet with failure several times before ultimately coming to fruition. You need to be determined, organized and systematic. And you need to be able to start all over again when the targeted acquisition doesn't work out. That being said, when the target company is interested in selling, here are the steps to follow.

1 MAKE AN OFFER

At the very first meeting with the leaders of the target company, as a potential acquirer you must convince them that you are serious about the process, and then quickly determine if they are prepared to consider selling. If so, it's important to know why they would like to sell their company. Once you know their reasons for selling, you'll be in a better position to lead the negotiations.

The acquirer must also know how to gauge the chances of reaching a deal that will be satisfactory to both parties. Once again, there is the risk of trying to convince the owner to sell by offering too high a price.

Other buyers may also be interested in acquiring the target company, and this is not necessarily a bad thing. But not all buyers are equal. Some may be able to pay a higher price and derive greater profits from an acquisition if they are able to run it more efficiently or exploit certain synergies. It's important to keep these factors in mind during negotiations.

A first offer must leave room for negotiation, specifically on price. Unless you are taking part in a formal call for offers, the first price proposed is never the final one. You must display some flexibility and be prepared to compromise, without however going beyond the limits you set at the beginning.

You must also be prepared to walk away from negotiations if it seems that an agreement on the price and terms will not be possible.

2 SECURE YOUR FINANCING

Before making an offer, the acquirer must know exactly how the plan will be financed. Ideally, you would have enough cash in reserve to pay for the acquisition in its entirety. However, that situation is rare. If reserve cash is not sufficient to cover the deal, which is generally the case, the acquirer will need a financing plan.

If the acquirer wants to call on the firm's shareholders or its other suppliers of capital, then they will need to come to an agreement with them on the type of acquisition to be financed as well as on the terms of financing.

An acquisition must also be closely planned with your banker, who is a front-line partner in this type of operation. The entire financing structure of the company that is making the acquisition comes into play. The possibility of financing any acquisition will depend on the type of company being targeted and the type of financing available. Various financing solutions are available to acquirers, such as a balance of sale from the seller (a.k.a. vendor financing or vendor take-back), or external financing which may come from a bank, a private investor or a venture capital fund. Your advisors can help you reach the right financing decision.

3 FINANCING THE ACQUISITION

Several options are available to the buyer when building a financial plan for an acquisition.

In addition to external financing, the acquirer often makes a personal investment. After the takeover, the acquirer may also draw on working capital.

Where financing needs to be sought to close the deal, there are several types to consider:

- Secured financing, based on the personal assets of the borrower and those of the company, offered by financial institutions
- Financing based on a company's future cash flows when it has no assets or assets of insufficient value
- Financing subordinated debt to senior borrowers based on the company's cash flows, offered by private investors
- Financing by the seller, who agrees, for example, to make a loan to the buyer
- Financing from personal funds or from venture capital firms in return for an equity stake in the company

When you meet with your financial advisor to apply for financing, these are the documents you will require:

- The recent historical financial statements of the company for sale
- The company's interim financial statements along with a list of customer accounts, accounts payable and inventories
- The acquirer's personal balance sheet
- The signed offer to purchase
- The business plan containing your projected financial statements
- The project transaction memo
- The evaluation of the target company and its principal assets, if available

4 PERFORM DUE DILIGENCE

The success of any acquisition depends in large part on carefully checking all pertinent information related to the target company. The acquirer must obtain as much information as possible, including financial statements from recent years. Due diligence is an ongoing process that continues throughout the negotiations. It gives the buyer in-depth knowledge of the target.

The offer to purchase must be conditional to this due diligence, which, to be reliable, must be organized, systematic and, at the same time, as complete and efficient as possible.

Due diligence can sometimes be carried out before an offer is presented. In such cases, the target company gives potential buyers access to the information necessary to get an idea of the value of the company.

Frequently, though, the target company will refuse, on the grounds that if such information were divulged to its competitors, customers or suppliers, it would find itself in a compromising situation. One way for serious buyers to get around this problem is to sign a confidentiality agreement.

But if this too is impossible, the offer can be made conditional on the results of the due diligence, which will be conducted in the period between the acceptance of the offer and the completion of the sale. A price-adjustment clause, for situations where the acquirer uncovers details that were not known at the conclusion of the acquisition, can also be inserted. This, however, often gives rise to difficult and prolonged discussions.

Whether due diligence is performed before or after the offer is made, it must be very carefully planned. It is essential to create an exhaustive list of elements to be verified, have access to the target company's documents and its facilities, and be able to ask questions of its auditors or other professionals who may be able to validate the information or provide additional details. Some kinds of research are fairly delicate: Visiting a factory in full view of one and all when the sale process is supposed to be confidential is not always a good idea. A good deal of tact is required.

The checklist will likely be long and must be adapted to the circumstances of the target company. And it must include the key information that the acquirer will be relying on to make the acquisition. For instance, if a company's main selling point is a patent, you must ensure that it does indeed hold that patent. It is possible to obtain guarantees as to the state of the company during this process. The due diligence must also allow the buyer to be sure that the target company possesses all permits and authorizations required to conduct its business, that it faces no threat of litigation and that no legal matters are currently before the courts. Your lawyer and your accountant can set out a list of things to verify.

Part 4

After the acquisition: Quickly assume leadership

Even after the deal goes through, the work is far from done. Now it's time to make the transition, carefully integrate employees, suppliers and customers, take charge and start to pursue your plans.

The goal is to accomplish all of the above without disrupting the company you just acquired. To succeed, you need to have a transition plan and avoid making unnecessary changes that may destabilize the new company.

1 ESTABLISH THE INTEGRATION PROCESS

There's more to an acquisition than just taking possession of another company. There has to be a genuine integration, and the process must be led by the leader of the firm. An integration plan, which includes a timetable and precise objectives, should be prepared and then carefully implemented.

The leaders and executives who are put in charge of the integration must have clear and measurable objectives. Progress reports are essential—they will allow the company to closely follow the integration process and make changes if necessary. To increase the chances of success, the leaders in charge of the integration could be rewarded as specific goals are reached.

If synergies were forecast in the acquisition plan, they should be achieved without delay. Since the selling price was likely influenced by these savings, not putting them to use may render the price paid too high, and turning a profit from the transaction more difficult.

If the buyer already has a company, the mere fact of having acquired a firm operating in the same sector is often a harbinger of success.

2 LIMIT THE PERIOD OF UNCERTAINTY

The goal is to keep what gave the company its vitality (and thus its value) in the first place: its employees, it customers and its suppliers. The acquisition must be perceived as good news—an opportunity to improve business relations or the work climate. This is why it's essential to minimize the period of uncertainty that inevitably follows an acquisition by quickly proceeding with the changes necessary to integrate the new company.

3 MAKE HUMAN RESOURCES THE TOP PRIORITY

The success of the transition begins with integrating the employees and leaders who will be part of the new company. A change of ownership is usually a source of concern for employees. It's critical to reassure them as soon as possible about their future to get them onside. Without this, they may leave the company, not knowing what to expect from their new employer, or even be recruited by competitors who want to take advantage of this period of uncertainty.

You must quickly identify the leaders and executives who will form the management team. To maintain motivation and ease concerns among them, they must be told without delay who will be forming the new leadership. The same goes for personnel. If changes must take place, it's advisable to make them as quickly as possible.

All these measures, if properly planned, explained and executed, will reassure the troops, quickly set the tone and motivate new employees to contribute to the success of the integration and the acquisition.

To recap, here are the six keys to a successful acquisition:

1. Pay the right price
Any acquisition, regardless of how strategic it might be, can become catastrophic if the purchase price is too high. Therefore, it's in the acquirer's interest to make sure the asking price is not greater than the value of the company, and that it fits within the buyer's budget.

2. Choose a target in your field of business
For an acquisition to be successful, the acquirer must be able to make a difference. That means having a sufficient understanding of the target company's business field to be able to assume the leadership and know exactly what must be done to grow the company.

3. Do your due diligence
An objective analysis of the target acquisition is absolutely essential, and this can only be accomplished through an in-depth due diligence process. First, make a list of the main features you must review and of the critical information you need to get a realistic picture of the company. Initially, you can focus on the fundamental characteristics that led you to choose the target (for instance, make sure you will indeed control a particular patent if that was your reason for attempting to acquire the company). You can always tackle secondary issues later on.

4. Maintain motivation
An acquisition process is long and comes with many challenges. You constantly have to restart the machine, and keep everyone involved motivated and focused—and that includes yourself—to reach your goal.

5. Have the right team
Acquiring a company is a question of teamwork, and you need to be surrounded by the right people. Your accountant, your lawyer and your banker will all play important roles in this transaction. And a financial institution is not just a source of financing. It can contribute in a multitude of ways to the success of the acquisition by accompanying the acquirer throughout the process, being present at meetings with the various parties, by coordinating and by supporting the other players in the deal.

6. Don't wait to integrate
Once the acquisition is concluded, you must quickly take control while making sure not to disrupt operations. If your plan involves letting go of certain personnel, do so promptly. Then, reassure suppliers, customers and employees so that they don't start looking elsewhere. The value of the company you have just bought depends in large part on its list of customers and the skills of its employees. You do not want to lose either one.