


# Responsible Acquisitions

**YIELD**

# Growth

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STRATEGY



Acquisitions immediately following a downturn generally yield strong returns, yet growing a business in a struggling economy is not only tricky, but could be damaging. Success depends upon an acquisition strategy that balances the need to grow with caution and responsibility.

For companies seeking to grow through acquisition, there's good news: The recession has created a strong buyer's market. Research has shown that acquisitions immediately following a downturn yield strong returns. On the other hand, growth in a sluggish economic era can be tricky, and aggressive pursuits can be dangerous, even disastrous. Companies that emerge stronger will have an acquisition strategy that balances the need to grow with caution and responsibility.

A first step is to evaluate the company's appetite and readiness. Before entering any transaction, first determine if there is the financial wherewithal by performing a thorough financial health check.

Since the recession, most organizations have shifted their focus away from profit and loss statements toward liquidity. Does the company

have enough liquidity to carry off a transaction successfully? If not, consider the company's sources for funding growth before defining the acquisition strategy and the plan for recognizing value post-acquisition.

#### **Sources of Funding**

Funding can come from a variety of sources — internal liquidity, partnership, liquidity from debt or equity.

**Internal Liquidity:** One of the quickest and easiest ways to generate funding is by building internal liquidity. This involves a faster turnover of critical balance sheet items and improving processes like collections, inventory management and supplier settlement. The company could downsize to a smaller-scale version of the business or reshape it by outsourcing non-core functions.

In addition, it could shift from a

fixed-cost structure to a variable one, particularly to help weather weak markets.

When considering options, first understand the customer base and what matters most to them. For example, Dell Corp. was able to cut prices and gain market share by dropping free after-sale customer support. Customers now have the option to pay for the level of support they desire and no more.

**Partnerships:** New opportunities may also exist to gain new alliance partners, to move into adjacent markets, to adopt new pricing models or to enter new channels. Some of these opportunities may be created by the failure of competitors or by a new customer appetite for solutions that show measurable return on investment or reduce the risk.

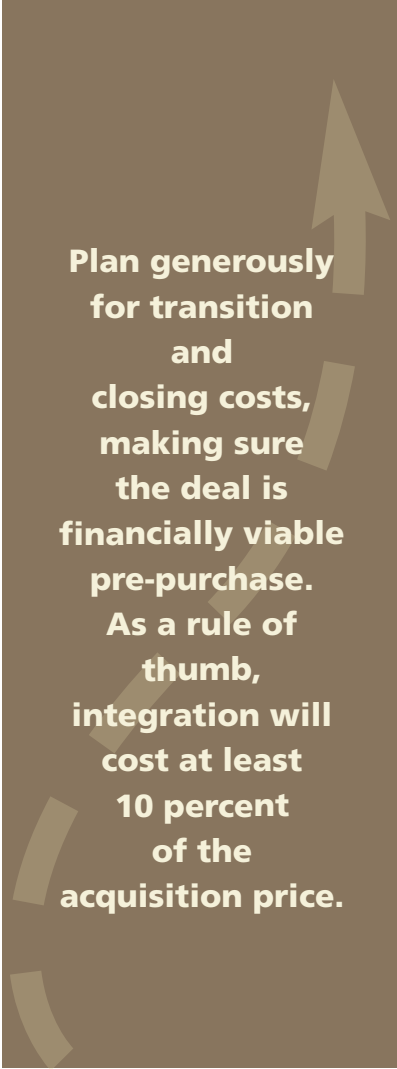
For existing key customers, relationships can be deepened by working together to improve each other's performance. For example, are there aspects of supply chain logistics that could be handled for the customer that reduce overall costs and improve profitability for both entities?

**Liquidity from Debt:** A third option is renegotiating debt. Talk to lenders and update them about the company's assumptions for the next six to 12 months. Be sure they understand any improvement initiatives in place to increase cash flow. This conversation will help determine when the company might be in a position to renegotiate existing credit terms and/or expand borrowing capacity.

Establish relationships with new lending sources before they are needed. Doing so enables the financial executive to best understand the competitive market lenders are facing and what alternatives might be available and when.

Match short-term debt with the need for working capital and longer-term debt with the need for growth capital. Be sure to limit the use of debt for permanent needs — these are better financed with equity.

**Equity:** Nearly 80 percent of private equity investors surveyed by the Bank of New York said they would increase or maintain their current level



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of investing in the future. Private equity offers a potentially rapid infusion of cash for companies that are just beginning their growth trajectory.

There is much competition, and only the best deals are being financed. To stand out, a company must have a true growth story, initial traction in the market and readily available financial information.

Agreeing to private equity financing is likely to bring with it a host of changes, including how the company is governed. So it's vital to understand and be prepared for the changes that would occur if this option is chosen.

#### **Why Consider an Acquisition?**

With funding sources in place, it's time to consider an acquisition. Many companies are timid when it comes to major transactions. But mergers and acquisitions are the lifeblood of growth.

Darrell Rigby, author of *Winning in Turbulence*, writes that acquisitions completed during and immediately

following the recession of 2001–02 generated almost triple the “excess returns” of those made during the preceding boom. Recessions reshape industries faster than strong economic times because long-established business models have been weakened, and competitors have lost customers.

Predictably, M&A activity is on the rise. Robert W. Baird & Co. reported an impressive 93-percent increase in United States middle-market M&A transactions in March, the largest monthly deal count since June 2000. And the second quarter of this year was the strongest M&A quarter since the beginning of the credit crisis, with 175 deals done, amounting to approximately \$26.7 billion in capital deployed.

Though opportunities are ripe and liquidity is loosening, it's important not to rush into an acquisition, particularly for first-time acquirers.

Be sure the strategy in identifying an acquisition target is clearly understood. Ensure that the team in place has the experience to assess a transaction, complete the investment process, forecast its performance and tolerate sensitivities around the results. External advisers with the right experience are often necessary. In all, make certain that the projected benefits, synergies and savings from the transaction can in fact be realized.

#### **Define Goals and Success Factors**

The M&A strategy should stem from an analysis of the company's current competitive position and its future objectives. That means understanding what the business is doing, where its leaders want to go and what they value most.

Just what is the company trying to gain through an individual transaction? Is it increasing market share, entering contiguous markets, increasing economies of scale to be the low-cost provider in its market, eliminating a competitor, expanding a product line or achieving vertical integration? Whatever the rationale, be sure it is well understood and translated into specific, measurable goals and success factors.

Through the process, focus on goals relentlessly. The acquisition should be a way to bridge the gap between the company's current state and the future state desired. Align decisions to this future vision throughout the process. These factors become the items to test for in screening for prospective targets and performing due diligence.

### **Due Diligence**

Due diligence is more than an audit or a financial exercise of checking historic results. When done properly, due diligence should test the strategic fit of the acquisition to the original goals as well as map out what it will take through the integration process to make this a reality.

There are a number of important factors to consider in screening acquisition targets, including integration feasibility and developing revenue and cost models for the combined organization. When searching for candidates, avoid becoming too enamored of any particular one; search for alternatives, understanding the pros and cons of each.

Becoming too personally attached to any one opportunity can cloud judgment, and a negotiator must be prepared to walk away if necessary.

Another useful technique is to write a mock press release announcing the acquisition. It's an exercise that forces the focus on the relevant factors related to the acquisition and encourages thinking about the negotiation process before it actually begins.

Also, plan generously for transition and closing costs, making sure the deal is financially viable, pre-purchase. As a rule of thumb, integration will cost at least 10 percent of the acquisition price.

If the company cannot absorb a wide swath of sensitivities around forecasted performance, it won't succeed. Pre-close planning should include performance tracking measures that will help monitor the transaction's success post-close.

### **Integration**

More M&A deals fail due to poor integration than any other factor. In

fact, experts estimate that almost as many as 50 percent of post-merger integration attempts are poorly executed. To ensure a successful integration, begin planning as soon as a target is identified.

**Planning for Integration:** Major transitions require strong leadership, so it is critical to create a transition steering committee and a functional team. These groups should engage leaders from both sides and understand their role in realizing value assumptions.

They should set their expectations high and work from a well-defined project plan, revisiting it as conditions on the ground change. The integration team must include line managers closest to the action, who can see problems brewing.

For example, in General Electric Co.'s integration team concept, major players from both the buyer and target work together to ensure that the integration will work at all levels.

This year, Tyco International Ltd.'s ADT division acquired Broadview Security Inc. The divisional chief executive, a former GE executive, formed an integration team with members from both companies, representing all functional areas. Former senior members of Broadview also became members of the CEO's senior management team. Although it took some time, the best practices of each group — including cultural — were used for the new entity. This appears to be a continued strategy for a successful integration.

Another key aspect of integration planning is to ensure the integration accounting team has a detailed understanding of how the purchase price accounting will be applied. This allows the books to close and reopen on deal day with all the necessary adjustments posted, instead of trying to determine how to apply the accounting procedures many months later.

**Executing the Integration:** Organizational and cultural issues are the most significant factors as to why deals succeed or fail. Yet they are often the most overlooked.

Contrary to what most people think

about integrations, it is generally best to integrate operations and culture first and wait on information technology systems.

Businesses that have survived due diligence begin with using the existing IT systems first and spend the initial integration thriving in the marketplace rather than drowning in a new IT system. A system implementation can always be done at a later date.

Remember that no matter how thorough the due diligence, what's actually purchased is generally not known until the post-merger integration process has begun.

Seeing a business from the outside is often very different than seeing it from the inside. As integration begins, revalidate the plans developed since the deal was first considered. Continue to evaluate what drives value, what is working and what is not.

Do not be timid when it comes to modifying plans if that's the right move. Be sure to communicate, communicate and communicate even more. Members of both teams must understand — as quickly as possible — the direction to be taken and how they play (or not) so as to maximize value to both sides. Throughout integration, remember speed is crucial at this stage — delay drives failure and may cost key people.

Mergers and acquisitions will always be a critical step on the path toward growth. To ensure success, know well the organization's identity, resources and goals. Plan carefully and thoroughly. Before any action is taken, evaluate every alternative.

Be aggressive in pursuing and negotiating, but remain conservative in forecasting and integrating. With an intelligent, measured approach to acquisition, the risks can be overcome, the company's growth trajectory can be accelerated and it can land on top of the pile — even in this volatile buyer's market.

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