

MFA Perspective

*Time to Shine: Three Crucial Questions
About Strategic Acquisitions*



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TIME TO SHINE: THREE CRUCIAL QUESTIONS ABOUT STRATEGIC ACQUISITIONS

Much has been made of the anemic mergers and acquisitions market over the past two years as economic turmoil and tightening of available credit slowed transactions to a snail's pace. Profitable deals were few and far between, and with IPOs also trending downward, the lack of exit opportunities provided little motivation for investments in mid-sized firms.

These conditions opened a window of opportunity for smart, synergistic mergers that can mark a leap to a new stage of performance. While the landscape is changing rapidly, the lack of participation in smaller transactions from traditional investment firms has temporarily put small to mid-sized businesses in a rare position of strength as strategic acquirers.

Executives should therefore pause to consider whether a well-structured deal might make sense for their business. As they evaluate areas for improvement and growth, strategic acquisitions should be part of the conversation even for those that would not under normal circumstances consider such a move.

THREE TOUGH QUESTIONS FOR BUSINESS LEADERS TO CONSIDER

There are solid signs that the window will not be open for much longer – private equity investors have resurfaced and will be increasingly active in the months to come. Companies in a position to grow via strategic acquisition should be assessing their options now, and it is important to have a full understanding of the potential target before entering into any deals. Even in an environment that benefits such deals, maximizing the value of the transaction means conducting due diligence that suits an evolving and often intense regulatory regime.

Companies that find themselves in a strong market position should be thinking through three key questions:

1. Are you a buyer?

Under these economic conditions, companies that may not normally consider themselves strategic acquirers have good reason to reassess their position. Small to mid-size organizations have a rare opportunity to establish a new

stronghold in their industries and gain significant ground on the competition.

There are a host of issues that can be addressed via merger, and each of them will be familiar to mid-sized businesses. Business leaders should weigh the benefits provided by an acquisition, for example:

- a competitor's talent pool that is well recognized, trained, and ready to make an immediate contribution
- a drop-in sales channel or product line that expands revenue streams
- an operational structure that is better suited to drive aggressive growth

Organic growth may have been the original plan, but adapting to the landscape is part of what allows a business to thrive. Those that have reasonable liquidity, resources or access to credit can structure an attractive deal that fits well with their strategic vision.

2. Can you stay true to your strategic motivation for acquiring?

"Don't fall in love with the deal" is commonly cited wisdom, but it is often easier said than done. It is critical for acquirers to identify how a target company will improve their position, and even more critical to stay focused on those drivers as the deal comes together. As the due diligence process unfolds, leaders should prioritize investigation of areas that are strategically important and be prepared to walk away if they are not in fact as well-aligned as anticipated.

Indeed, exploring a strategic deal means proving that the motivating reason for a merger will be effective when integrated with the acquirer's operations. The due diligence process may reveal impressive strengths in unexpected areas, yet show shortcomings around the original strategic intentions – in other words, great company, wrong fit – and that should be reason enough to kill the deal. The earlier the deal team can probe the right areas, the more time and resources can be saved in vetting the merger.

3. How can you most effectively manage risk?

Even if the target company aligns perfectly with the acquirer's strategic profile, a great deal of focus must be given to managing risk through due diligence and deal structure. Tools

such as seller paper and earnouts, for example, are more in favor in a tight credit, risk-averse environment.

Seller paper is essentially a loan from seller to buyer that gets paid back over time, and often can carry a more reasonable cost of funds than, for instance, mezzanine debt. Earnouts are provisions that require acquired companies to achieve specific benchmarks of performance, i.e. a revenue/income targets or a product milestone. With liquidity harder to come by, smaller acquisitions can benefit from earnouts that call for additional payouts that correlate with performance until the full terms of the sale are fulfilled.

As with any piece of the deal, earnouts must be crafted to benefit both parties and ultimately support a fully integrated post-merger environment. As noted in a 2010 Deal Magazine article, this calls for significant attention to detail, “close negotiation, careful structuring, and perhaps even a measure of clairvoyance because good earnout provisions are designed to anticipate the occurrence of a broad range of potential future events.”¹

STRONG FOUNDATION FOR ACQUISITIONS

There is still time to consider these issues and take action, but the full extent of the opportunity will not be there for the taking much longer. Having sat on the sidelines for much of the past two years, private equity investors are hungry and back in the game. As economic conditions improve, the competition for the best deals will grow tougher.

In fact, the level of activity in the first quarter rose dramatically over the previous year, buoying confidence throughout the deal market. The volume of all mergers and acquisitions totaled \$573.3 billion worldwide during Q1, representing a 21% increase over the same period in 2009.²

This rising tide has lifted the outlook for the future with it. A semi-annual survey conducted by Thomson Reuters shows that 85% of dealmakers expect M&A activity to pick up in the next six months – up significantly from just 56% a year ago.³

The vast majority of respondents, 88%, said the current environment is a buyer's market. It is not surprising then, that 95% say strategic investments should also accelerate in 2010.⁴ The manufacturing and distribution sector will lead the way, they predict, with nearly half of all the activity in the third and fourth quarters of 2010.

Several green shoots point to increased private equity activity as well:

- In the second half of 2009 a total of 31 major deals were announced, compared to only 12 during the first six months of the same year.⁵
- More than \$500 billion of deals were announced in the first two months of 2010, showing a growth of more than 20% over the same period a year before, according to the Nightly Business Report.⁶
- Recent government actions, including the passage of the healthcare reform bill, have removed a degree of uncertainty for investors.⁷

With the economy strengthening, private equity executives recently surveyed by BDO are hopeful that they will be able to deploy more capital in 2010 than they did in 2009. Though their funds were hit hard last year, the capital market executives feel the worst is behind them. After taking significant steps to mitigate losses, they now report that they are on solid footing and are committed to their primary investment strategies.⁸

EVERY DEAL IS DIFFERENT

The evidence is there: this is a unique period in economic history. Small to mid-sized companies with strong balance sheets and solid financial backing can capitalize by pursuing the right fit for their business, especially as prospects for organic growth will in many cases require a more dramatic improvement in the overall economy.

The business landscape is always daunting, but the past several years have seen a full and diverse complement of challenges. Each obstacle, however, provides the opportunity for leaders to

¹ Paucity of credit enables earnouts to take their star turn, Adam R. Moses, The Deal Magazine, April 8, 2010. <http://www.thedeal.com/newsweekly/community/paucity-of-credit-enables-earnouts-to-take-their-star-turn.php>

² Mergers and Acquisitions, <http://www.biztimes.com/money/2010/5/11/>

³ Dealmakers more positive of M&A growth: survey, <http://www.reuters.com/article/idUSTRE6452DW20100506>

⁴ M&A Forum will provide insight into changed M&A marketplace, <http://www.biztimes.com/money/2010/5/11/>

⁵ Tara Loader Wilkinson, Wealth management M&A soars, <http://www.wealth-bulletin.com/wealth-business/private-banking/content/4058614461/>

⁶ Suzanne Pratt, NBR for March 8, 2010, http://www.pbs.org/nbr/site/onair/transcripts/nbr_transcripts_100308/

⁷ Dinah Wisenberg Brin, Government Scrutiny On Health-Care Deals Seen Increasing, <http://www.nasdaq.com/aspx/stock-market-news-story.aspx?storyid=201003261500dowjonesdjonline000578&title=government-scrutiny-on-health-care-deals-seen-ncreasing>

⁸ BDO Perspective, December 2009.

advance. In this market, even small to mid-sized strategic acquirers can seize the moment, particularly with a well-structured deal.

With that in mind, management teams should know that every acquisition is unique and must be approached with a clear vision. Cultural implications, methodologies, management style, business process, and other factors will all come into play, and having the right team in place to assess the merger and structure of the deal will be paramount to success. To fully capitalize on the circumstances of the market, leaders should examine their company's direction, gauge the acceleration that could be provided by an acquisition, and maintain the discipline necessary to close not just any deal – but the right deal.

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