

Buying a Business: Avoiding the “7 Deadly Sins”

Business owners and executives sometimes look to acquire another company as a means of growing their business. While corporate acquisitions can help in achieving growth objectives, it is important to avoid those things that can significantly erode shareholder value, and possibly be disastrous.

While there are numerous reasons that acquisitions fail to yield the results anticipated, this article addresses some of the most common reasons for failure. These “7 deadly sins” are summarized in Exhibit 1:

Exhibit 1

The 7 Deadly Sins of Corporate Acquisitions

Lack Of Strategic Fit
Inadequate Analysis
Too Much Emphasis On EBITDA
Ignoring The Balance Sheet
Overpaying For Synergies
Focusing Only On Price
Poor Integration

Lack of Strategic Fit

Many business owners and executives take a reactive, as opposed to a proactive, approach to acquisitions. That is, they wait for opportunities to present themselves rather than actively seeking out prospective targets that meet established criteria. The risk in a reactive approach is that acquisition opportunities might be pursued because a target company becomes available for sale, but it might not represent a strategic fit for the buyer.

Corporate acquisitions must fit into a company’s long-term strategic plan. Based on its strategic plan, buyers should be able to compile a list of acquisition criteria, in terms of target company size, product and service offerings, markets served and other pertinent criteria. Having well-developed criteria beforehand will help the buyer to avoid

expending time and effort on acquisition opportunities that are clearly not a fit. The buyer's strategic plan should also address other key elements, such as when it would be better to build vs. buy, or when a joint venture might be considered.

Taking a proactive approach can assist the buyer in creating new opportunities and may allow the buyer to avoid a long drawn-out auction process. This is not to suggest that a proactive approach will result in a buyer paying less than fair value for an acquisition target, but rather it can allow the buyer and seller to work together in an expedited and confidential manner that facilitates structuring a deal that meets the needs of all parties involved.

Inadequate Analysis

Many buyers do not expend sufficient effort to conduct a thorough analysis of the target company. There are many reasons for this, including constraints due to time, cost or other resources. In some cases, buyers look to rely on the seller's representations and warranties to compensate for shortfalls in due diligence. However, such a strategy seldom works out as planned. Inevitably, buyers that do not conduct sufficient analysis on the target company find themselves faced with hidden liabilities, unanticipated integration issues and other problems that consume far more time and expense than would have been incurred to conduct thorough due diligence in the first place.

Buyers should recognize that corporate acquisitions will require a considerable investment in both management time and the cost to engage the external resources needed to fully assess the opportunity (e.g. intermediaries, legal counsel, tax advisors). In this regard, business owners and executives should ensure that the external advisors who are retained are intent on providing sound and objective advice, and that they are not eager to get the deal done simply to generate fees.

Too Much Emphasis on EBITDA

Buyers tend to emphasize the target company's most recent EBITDA (earnings before interest, taxes, depreciation and amortization) when assessing the cash flow prospects of the target company. While multiples of EBITDA are frequently referred to as the basis for business valuation and pricing, an over-emphasis on EBITDA can be dangerous.

EBITDA is a lousy measure of shareholder value. This is because EBITDA ignores important components of value, including:

- the capital expenditures that a company will require in order to maintain and grow its operations;
- the incremental working capital that a company will need to support revenue growth; and
- income taxes.

A preferable approach is to adopt a discounted cash flow valuation methodology, based on forecasted discretionary cash flow, which explicitly accounts for all of the factors outlined above. Buyers should also take into account synergy expectations (discussed below), integration costs and debt servicing costs when assessing cash flow expectations.

Ignoring the Balance Sheet

Buyers usually focus on the past and prospective operating results of an acquisition target as indicated on its income statement. The balance sheet of the target company often is not given the consideration that it deserves. The balance sheet reveals the underlying assets that the target company will need in order to generate sales and profitability. In particular, the buyer should focus on the target company's working capital and fixed asset requirements.

The buyer should ensure that it understands the working capital requirements of the target company, in order to avoid a situation where the buyer must make a capital injection shortly after the transaction date, in order to settle liabilities such as accounts payable or even to make payroll. In this regard, the buyer should be particularly cognizant of any seasonality within the target company's operations so that it understands how working capital requirements will change over the course of the year.

The target company's fixed asset requirements are also important for the buyer to consider. In this regard, the buyer should ensure that it understands the level of capital expenditures that will be needed in order to maintain and grow the target company's operations. The cash flow statements can be insightful in this regard, as they will illustrate historical spending patterns. Buyers should be alert for situations where the seller has reduced capital investment levels in the years leading up to the sale, thereby leaving the buyer with outdated equipment that will have to be upgraded in the near term.

Overpaying for Synergies

Buyers frequently focus on the expected synergies that will be generated in terms of cost savings, incremental revenues and other strategic benefits stemming from combining their existing operations with those of the target company. The costs of realizing those benefits, and the risk that they may not materialize to the extent anticipated, often are not afforded adequate consideration.

The costs of realizing cost-saving synergies can include such things as severance payments, relocation expenses and restructuring costs. With respect to synergies in the form of incremental revenues, the buyer should be aware of the incremental costs necessary to generate those revenues. This may include headcount additions, new equipment and higher levels of working capital (e.g. inventories and accounts receivable). In many cases, the expenditures must be incurred up front, with the hope (and risk) of the synergies materializing as planned.

Buyers should assign a "probability factor" to the synergies that are anticipated to accrue from an acquisition. The probability factor should reflect the risk that the synergies may not be realized as anticipated. Therefore, the probability factor may differ based on the nature of the synergies (e.g. cost savings may be more readily attainable than incremental revenues). To the extent that synergies are not paid for, they represent a buffer against other unanticipated costs that may be incurred following an acquisition.

Focusing Only on Price

It is natural for the buyer to focus on paying the lowest price for an acquisition, while the seller is concerned with maximizing the price received. The buyer (and the seller) should recognize that the terms of the deal are just as important as the price that is paid.

The terms of the deal revolve around three basic elements, being (1) whether the assets or the shares of the target company are acquired; (2) the forms and terms of payment; and (3) the provisions of a management contract.

Buyers usually prefer to buy the assets of the target company in order to avoid hidden liabilities and for tax advantages (in terms of additional write-offs), whereas sellers usually prefer to sell shares for their own tax benefit. The buyer may benefit from a purchase of shares where the seller is prepared to compromise on the purchase price and is amenable to holdbacks or other mechanisms that reduce the risk of the buyer assuming hidden liabilities. The purchase of shares can also simplify a transaction where it helps the buyer to avoid having to transfer and renegotiate contracts held by the target company.

The forms and terms of payment dictate when, how, and under what conditions the purchase price is (or is not) paid. Apart from cash on closing, the buyer can use holdbacks, promissory notes, share exchanges, earn-outs or other payment structures to satisfy the purchase price. To the extent possible, the buyer should focus on devising a “value-based pricing strategy”, whereby the purchase price is paid as value is realized from the acquisition. This can help in bridging the price expectations gap between the buyer and the seller, while mitigating the risk to the buyer.

A management contract usually is entered into where the seller’s continuing involvement in the operations of the business is necessary in order to help transition the acquired company. Buyers should be aware that, in many cases, management contracts do not generate the anticipated results over the longer term, particularly where the seller receives a substantial amount of cash at closing, and leaves them with little incentive beyond that point. In any event, many sellers find it difficult to make the transition from being their own boss to an employee of the buyer. Therefore, the buyer is well advised to work on ensuring a quick transition.

Where it is important that the seller remain involved in the company for a prolonged period of time (say 3 or more years), the buyer might consider acquiring less than 100% of the target company (say 60%), and allowing the seller to retain a minority interest, with a call option on the remaining shares that takes effect at some future date. This can help in aligning the interests of the buyer and the seller in terms of long-term shareholder value maximization. However, it can create other issues in terms of the buyer’s accountability to the minority shareholder and their rights. A well constructed shareholders agreement is critical in this regard.

Poor Integration

Poor integration frequently is cited as one of the most common reasons that acquisitions fail. In many cases, buyers do not adequately plan for issues that arise subsequent to the transaction date, particularly those stemming from different cultures, management styles and other employee-related matters. In some cases, the buyer is so intent on ensuring that the customers and employees of the acquired company are content that they neglect to consider the impact of the transaction on their existing operations. The results can be catastrophic.

Buyers should assess the level of “transition risk” at an early stage of the acquisition process. Transition risk is the risk of losing key employees and key customers of the target company following the transaction. Where the buyer perceives that transition risk is high, it should re-evaluate the business case for the transaction, no matter how attractive the price or terms may appear to be.

Where the buyer does proceed with the transaction, it should ensure that a sound integration plan is in place beforehand, complete with milestones, assigned responsibilities and a good communication plan. Further, those employees who are in charge of the integration should be given the authority to modify the plan as needed, in order to deal with issues and opportunities that undoubtedly will arise.

Next Steps

Corporate acquisitions can be an effective means of creating shareholder value, so long as they are conducted in a disciplined manner and the major downfalls are recognized and avoided. Readers that are interested in learning more about how shareholder value can be created at each stage of the acquisition process should refer to Veracap’s most recent publication, *The Acquisition Value Cycle*[™] (Carswell, 2009). Please visit our website (www.cvpl-veracap.com) for more details on this and other resources.

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70 University Avenue, Suite 320 PO Box 11, Toronto, ON M5J 2M4 tel: 416-597-1198 fax: 416-597-9779