MAKING THE RIGHT MOVE

Implementing an acquisitions growth and value creation strategy.

By Thomas M. Edens

Implementing an acquisition strategy can be an effective means to accelerate the growth and value of one's business. Creating value is typically a sustaining goal of closely held company shareholders. This article will identify the steps necessary to create an effective acquisition strategy for the small- to medium-sized receivable company.

Consolidations have been a prevalent activity in the accounts receivable management industry for at least the past five years. At any one time, the top five to 10 largest acquirers can be identified by the frequency of their transaction-closing announcements. What has not been prevalent is acquisition activity conducted by medium and smaller agencies.

Defining acquisition goals and strategy

One of the first steps in pursuing an acquisition is to define the strategic goals that should be satisfied by the target company. There are a number of benefits—other than a fast track to growth—which can be derived from a successful acquisition. An acquisition can usually fulfill one or more of the following goals of the acquirer:

- **Customer Base:** Sometimes it is more effective to acquire a company with an attractive client base than it is to endure the long process of building the customer base from organic means. There are a number of credit sectors that are difficult to penetrate, such as credit cards (especially primary placements), telecommunications and student loans, to name a few. Acquisitions can leapfrog you into these industry sectors overnight, thereby reducing your time to enter a market or improve market share.
- **Geographic Footprint:** Often, large national clients want their service providers to operate on a broader regional or national scope. A single client could provide you with the reasons to consider an acquisition whereby the target has licensing in most of the required states. Acquiring a company in a different part of the country may prove to be a way to better serve these clients, although long-distance rates have reduced the cost-driven need for offices in different time zones.

- **Scale:** Acquiring another company could be a way to enjoy the benefits that accrue with scale of operations. Benefits of scale often include access to larger clients that only transact with larger companies, cost savings of various expenditure components (i.e., long-distance, mailing services, etc.) and affordability of higher priced management talent. A small company usually has a difficult time justifying the cost of hiring such executives as CFOs, CIOs or national sales executives. This scale will often translate into enhanced market power. An acquisition may also allow you to enjoy synergies of reducing combined costs after consolidation, such as redundant administrative and overhead costs, while gaining leverage with your vendors. Being a low-cost provider is a proven way to remain competitive in a decreasing commission rate environment.
- **Other:** Other advantages of accelerating earnings growth fueled by an acquisition could be enjoying an overall higher value for your company when you decide to sell. This occurs by utilizing valuation multiple expansion. This truism is derived from the market-driven principle that—all other things remaining equal—the larger the enterprise, the larger the earnings multiple that the market places on the business. This is provided that the acquisition was executed well and contributes to the expected earnings in the future. Acquisitions can also accelerate the desired dilution of concentration of your largest client. Reducing client concentration by adding new clients can often be a very slow process. Acquisitions can accelerate the reduction of this concentration risk. Another reason to acquire a small- to mid-sized company, would be to gain the technology of the target, whether it is converting to a new system or acquiring additional licenses or seats on your existing system. Still another reason to acquire a company would be to gain access to an environment where labor is readily available and/or less costly than in your home territory. It is best if your acquisition goals are written and clearly defined. You will constantly refer to these goals in your acquisition search and due diligence.

Defining acquisition criteria and resources

It is important to define the specific attributes that the ideal acquisition target should have before you start analyzing or identifying prospects. It is often best to determine as specifically as possible the attributes you desire in a candidate, but be prepared to be flexible. Very few (if any) acquisition prospects will have all of the specific attributes that you have targeted. The most common acquisition attributes that you will need to address are as follows:

- **Size of Target and Resources Available to Employ:** You should know in advance the enterprise value range that you are targeting and will be able to fund. Otherwise, you could be wasting a lot of your time and money examining companies that you do not have the ability to close. Prior to embarking on your acquisition plan, it would be prudent to obtain a commitment range from your banker that focuses on the financial resources that you will able to employ on an acquisition. Most acquisitions of smaller companies are structured so the seller carries a note ranging from something as small as 10 percent to substantial amounts ranging over 50 percent. You could possibly engineer a stock-for-stock transaction, although this is not common in smaller transactions. The caveat is not to give up more in intrinsic value than you are receiving.
- **Geography:** Where should the target be located ? This attribute can be as broad as a five-state region of the country or as specific as the top two or three cities that would be acceptable.
- **Industry Sectors:** Your criteria may include only agencies that focus on a particular sector of the credit market. If your goal is to acquire a company that only provides auto deficiency recoveries, for example, it would be beneficial to communicate this to other members of your acquisition team so prospects with healthcare, credit cards, retail or commercial business are eliminated from your search.
- **Management:** You should determine whether you are looking for a company in which the selling shareholder leaves after a transition period or whether it is imperative that the primary executive remain after a sale to continue running the business. Part of your acquisition strategy may be to “acquire” marketing talent or specialized operating talent with skills such as “early out” receivable management expertise for hospitals. The primary role of a company’s leader is to allocate capital. It is often prudent to allocate capital to acquire knowledge and competence through the acquisition process. The primary caveat is to be very sensitive to retaining the talent that built the business and was responsible for sustaining its growth.

Assembling acquisition team

Most business owners do not have the complete skill-sets (much less the time) that are required to execute and close a successful acquisition. The more common professional members of the acquisition team would be comprised of the following:

- **Attorney:** The attorney is crucial to protecting your interest in any legal contracts that you execute. This professional is also an important member of the due diligence team.
- **CPA:** The certified public accountant can assist an acquirer in several key

ways. First, he can play a lead role in the financial due diligence efforts. And more than likely, you will seek advice that yields the most tax efficient structure for the acquisition. The CPA can also assist you in preparing a loan application package for the bank. Forecasts are often important to determine what you believe your company, on a consolidated basis, will look like after closing (from a balance sheet perspective) and in the near term from both an income and balance sheet perspective.

- **Banker:** As mentioned earlier, your banker should advise you of his institution's guidelines regarding the maximum lending levels that could be afforded to you. Your banker will also have to "approve" the acquisition in order to advocate to the loan committee that the project should be funded.
- **M & A Advisor:** Utilizing a merger and acquisition advisor can be beneficial in several important ways. First, the advisor can help identify the target companies. After a cursory screening, the advisor can provide the valuation guidance for maximizing your benefits from an acquisition. Or more importantly, an advisor can assist you in not paying too much for the company. By utilizing a M & A advisor specializing in the receivable sector, you can receive specific market guidance, which could prove invaluable. The advisor could also quarterback the acquisition process from start to finish as you continue to run your business (your other full time job).
- **Systems Professionals:** The collection industry is very dependent upon the use of technology to drive the maximum returns from the accounts placed for recovery. The efficiency in which you integrate the systems will minimize the lost revenue in the first few critical months after closing an acquisition. The importance of this member of your team cannot be over emphasized.

In choosing your professionals, hire the best team that you can afford. When making a substantial investment (perhaps the greatest financial commitment you will make in your lifetime), you do not want to subsidize "on the job training" for inexperienced attorneys or CPAs wanting to learn the transaction business.

Start search and identify candidates

After you have identified your team, solidified your goals and the attributes of your acquisition target, you are ready to begin identifying prospects that meet your criteria. There are a number of ways of identifying prospects. First, you can inquire with the M & A firms that specialize in the receivable market regarding their current sell-side engagements. Second, you should naturally network with your colleagues in the industry and inquire whether they are aware of companies that may be available for acquisition.

If your geographic criterion is your own local area, then CPAs and attorneys are good network possibilities for leads. You can also embark on a specific campaign of contacting the companies (by phone or mail) in your desired geographic area. Managing this process can be very time-consuming. Alternately, you can hire a firm to perform an acquisition search. In addition, the Internet is becoming a more sophisticated and substantial marketplace for business sale activity, and business sale exchange Web sites should be searched for appropriate candidates.

Analyzing candidates and making an offer

After you have identified the candidates that fit within your pre-set parameters of acquisition candidates, the analyzing of candidates can be a tedious task. Oftentimes, at the pre-offer stage you are gaining a cursory understanding of the target business through discussions with the owner, reviewing financial statements, learning about the client mix and management depth and attempting to understand the prospects for the future.

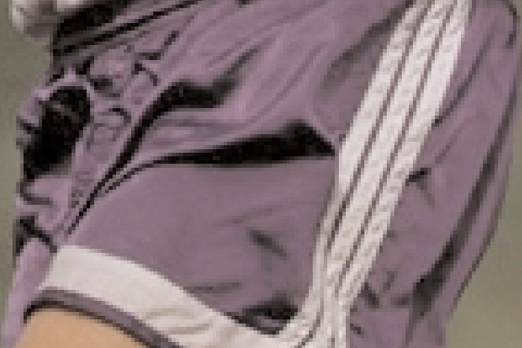
Ideally, in determining an offer amount and form of structure, your valuation analysis has considered the valuation drivers that are inherent in this industry. The most common valuation drivers are:

- Sustainability of revenues and cashflow.
- Management with specific tangible profit and loss experience in this industry.
- Track record of profits and positive growth (top line and bottom line) trends.
- Concentration of clients.
- Market niches and ability to grow in those niches.
- Location of offices.
- Scalability of operations.
- Culture adaptable to change.
- Scalable collection software.
- Capital expenditure requirements in the near term.

After determining the value range for the target, you are ready to make an offer. Most often the offer will be based on a valuation derived from applying a multiple to an earnings stream such as EBITDA (earnings before interest, taxes, depreciation and amortizations). However, be mindful of future capital expenditures.

The offer can take the form of a two-to-seven-page letter of intent, or the offer can be communicated in a one page term sheet that outlines the broad terms of an offer. Usually, after several rounds of negotiations, the parties arrive at an acceptable price or they terminate discussions. In any event, the letter of intent is usually a nonbinding agreement (except for the confidentiality and "no-shop" provisions) and signals to the acquirer to begin the formal due diligence process.

The most important consideration at the time of the offer is the structure of the offer. Consider whether the transaction should be an asset sale or stock sale. There are usually



vastly different tax consequences between the two structures to both the seller at the time of sale and the acquirer in the years following the transaction. Also consider what percent of the purchase price will be in the form of cash, seller notes, earn-outs or other contingent considerations, non-compete agreements and employment or consulting agreements. To maximize an acquirer's tax efficiency, you will require specialized tax knowledge, consideration of risk management factors and successful negotiations with the seller.

Be prepared to walk away from any deal if negotiations consistently turn in the wrong direction or you grow uncomfortable dealing with the sellers (especially if the selling shareholders will remain as key executives after a sale). The long-term cost of doing a bad deal far outweighs the time, energy and cost expended in exploring a transaction. The price you pay for an acquisition is not necessarily the most important factor in a transaction. As Warren Buffet would suggest, it is better to acquire a good business at a fair price, than a fair business at a good price.

Due diligence

The due diligence process is probably the most important component of the transaction process. Due diligence refers to the investigation conducted by parties to a business transaction and a procedure of continual risk assessment. The goal of due diligence is to confirm and/or challenge the assumptions you have made about the target up to this point. The greatest burden is on the buyer or the party who is trading cash for a business, which is largely an intangible asset in the form of goodwill. The letter of intent will effectively charge each party to begin their investigations and will typically specify that each party bear the cost of their own due diligence efforts. Due diligence is expensive both in terms of cost to the acquirer and of the time demands made on executives during the transaction process.

There are a number of ways a buyer attempts to protect himself from unforeseen negative attributes of the company he is buying. The core of this risk management effort centers on a thorough due diligence effort. Other risk management techniques include escrowing a certain percentage of the purchase price for a time-certain period after closing. This allows for previously undiscovered contingent liability items to surface or can provide a mechanism for any post-closing working capital reconciliation.

The operative mindset in any due diligence process should be full disclosure by both parties. The more open the parties are throughout the process, the sooner the due diligence can be completed and the determination made to conclude the transaction or part ways.

There are numerous components of a business that a typical acquirer will want to examine. Most often the due diligence will be separated into areas such as clients/markets, financial, legal, management and operational. The due diligence team can be composed exclusively of employees of the acquirer, or the acquirer can outsource much of the investigation to outside professionals. There is often a correlation between the size of the transaction and the use of outside professionals to conduct the due diligence. The main reason, of course, is cost. The smaller the transaction, the less the transaction can bear the costs of expensive outside service professionals. However, whether you perform most of the due diligence yourself or outsource the majority of the process, insist on a thorough examination.

Due diligence is the best time to quantify the expected synergies from the transaction. Be sure the due diligence goes beyond just the financial and legal aspects of the transaction. Operational performance, cultural differences and technological competence are often under-examined in due diligence.

Due diligence efforts should consistently refer back to your acquisition goals to determine whether you are accomplishing those goals. If you outsource the due diligence process, it is usually best if the due diligence report is addressed from a business execution perspective, rather than a banker's or legal perspective.

Closing

Toward the end of the acquirer's due diligence process, he will signal his attorney to produce the draft of the definitive agreement. This documents the understandings as intended by the parties and protects the acquirer's rights. Your transaction attorney should be experienced and skilled at preparing and negotiating these documents. There will be numerous representations and warranties in the definitive purchase documents that will allow recovery from the seller, through offsets or otherwise, if there were misrepresentations, pre-closing liabilities or matters that were not previously disclosed to the buyer.

Common mistakes in acquisition execution

There are a number of common mistakes that acquirers make in executing acquisitions. The most common mistakes that can lead to transaction failure are as follows:

- Paying too much for the company.
- Not paying enough attention to the speed and effectiveness of integration.
- Ignoring the potential impact of culture clashes by bringing the two companies together.
- Underestimating the amount of capital expenditures required by the target company.
- Misjudging the strength of management and waiting too long to make the necessary changes.
- Expecting significant synergies that do not materialize.
- Over-reliance on the purchase contract

(or under-reliance on due diligence) for transaction risk protection.

- Not understanding the impact of the number of family members and related parties that are employed at the target company.
- Insufficient due diligence or not fully exploring discrepancies discovered in the process.

By some estimates, over 50 percent of acquisitions fail to deliver the value anticipated. Thorough due diligence and utilization of competent acquisition team members can mitigate much of the risk associated with the above strategic errors.

Value creation through acquisitions

The immediate focus before and after closing a transaction should generally be on value preservation, value realization and value creation from the transaction. The key is integration. The effectiveness in which the acquisition is integrated is probably the largest determinant of the success it will have in creating value for the acquirer. Integration can range from determining that the target will be a stand-alone autonomous subsidiary or that it will be fully integrated with swift duplicative cost elimination effected immediately after closing. Strength of executive management will often be a substantial factor in determining the degree of integration.

Performance measurement systems should be in place to monitor performance of an acquired target as well as the parent company. At a minimum, there should be measurements indicating not only absolute numbers or percentages, but also time frames and milestone events. It is often beneficial to assign an executive who will be the advocate and claim "ownership" of each milestone to be achieved for accountability purposes.

Reward is often found in minimizing duplicate staffing while expanding opportunities in hiring a more sophisticated (and hopefully more productive) marketing staff. You should also address client and employee retention issues early in the process and often throughout the transaction closing and integration cycle.

Also, protect the bottom line. Focus on activities that will have the most impact on preserving the sustainability of the target's earnings.

Hopefully, the acquisition strengthens your economic engine. The more powerful the engine, the more the ability to overcome obstacles and setbacks—further providing the foundation to accelerate growth. This should translate into value.

Summary

Few occurrences will impact your business more than an acquisition or merger. The organizational, financial, cultural and legal changes will be major. However, an acquisition can be a very effective means of increasing shareholder value. The primary determinant of an acquisition's success is creating, delivering and measuring shareholder gains resulting from the transaction. **CM**

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