Zachary Scott
TRUSTED ADVISORS

Zachary Scott—an investment banking and financial advisory firm—has published this newsletter since 1997 to bring you a thoughtful analysis of issues affecting middle-market businesses.

PERSPECTIVES ON THE CAPITAL MARKETS WINTER 2018

IN$IGHT

Where Private Business Acquisitions Go Wrong

Part 1: Clear Strategic Rationale

by Kapil Sharma

For publicly traded companies, it has long been established that buyers often overvalue the synergies to be had from acquisitions. It is known as the "winner's curse" – the majority of shareholder value created in an acquisition is likely to go to the seller and not the buyer. Similar research on privately-held firms, the large majority of which are family-owned, is relatively scarce.

Academics have put forward many theories to explain why few M&A transactions produce the desired, or expected, benefits for acquiring firms. Buyers usually face an acute lack of information – they have little data on the target company, limited access to executives or other stakeholders, and they often have insufficient evaluation experience. Even seasoned buyers and their investment bankers mostly focus on financial due diligence at the expense of strategy, people, corporate culture, and company structure due diligence. Furthermore, post-merger integration planning rarely gets the needed priority or visibility until after the deal has closed.

In this new series, we will focus on three other factors that drive acquisition success: clear strategic rationale, thoughtful post-merger integration, and the effective management of cultural and leadership mismatch.

Do these concerns apply to privately held business M&A as well? Yes, although we think some reasons might be different. Combing through our years of experience, we have come up with some practical advice to enhance acquisition success.

We published a series of IN$IGHT articles on "Improving Acquisition Success" in 2016.

In those articles, we focused on financial assessment of the target and explained how many failed acquisitions are due to misjudgments on sustainability, capabilities and price.

In this new series, we will focus on three other factors that drive acquisition success: clear strategic rationale, thoughtful post-merger integration, and the effective management of cultural and leadership mismatch.

FOUR THEMES

PART I - CLEAR STRATEGIC RATIONALE

Successful acquirers have well-developed value creation ideas that drive their interest in an acquisition. Less successful acquisitions are often accompanied by ambiguous rationales, such as supporting growth, providing access to new skills, or adding sophistication to the business.

In our experience, private business acquisitions that create value almost always fit into one of these five well-defined categories: running the target more efficiently and profitably, gaining customers, eliminating competition, cheaply acquiring transformative skills or technologies, or improving scale in specific business areas.

1. Running the Target More Efficiently and Profitably

Many private businesses can benefit from a more professional management to improve their stand-alone performance. Many operate based on rules of thumb and instinct. Often performance can be improved by measuring activity in a granular way, establishing repeatable processes, and upgrading the talent pool in certain functional areas.

All of this requires active management because the assumption is that the existing team doesn't already do this and change will need to be embedded within the culture.

2. Gaining Customers

A common impetus for M&A is to gain access to new customers and cross-sell to existing customers.

Smaller private businesses often struggle with sales – it is hard to get access to and then nurture prospects with a stretched-thin sales force, covering limited locations. An acquirer with a larger, more-sophisticated sales force can often quickly overcome these limitations and thus accelerate the target's revenue growth. Years ago, our client, Nile Spice Foods, was acquired by Quaker Oats. On the day the acquisition closed, Quaker's sales force presented the new product line to all of their North American grocery customers. Sales boomed almost instantaneously.

Success with this strategy requires the tar-

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get's products to be closely related to those of the acquirer. In our experience, unrelated diversification rarely works.

3. Eliminating Competition

Mature industries, often in capital-intensive sectors, tend to develop excess capacity over time. The strategic rationale for M&A in these situations is "eat or be eaten."

After consummating the deal, the acquirer quickly closes less competitive facilities, reduces the size of the workforce, and rationalizes operations. Furthermore, exchanging fixed costs for variable costs can bring significant gains. Execution speed determines whether this strategy succeeds or fails.

An example of this occurred in the Alaskan Seafood industry when Glacier Fish bought Alaska Ocean. Both companies operated at-sea catcher processors. Both were profitable but operated far below capacity. Following the merger, one vessel was quickly "parked" and all combined fishing operations were loaded on a single vessel. This was an example of where "1 + 1 = 4".

In some cases, weak competitors – usually with low pricing – harm everyone in the industry. However, consolidation by one party can help all remaining competitors too, the classic "free rider problem".

4. Cheaply Acquiring Transformative Skills or Technologies

This approach works best in industries with ever-shortening product life cycles. In these situations, acquisitions can be a cheaper substitute for in-house research and development.

Acquirers might get access to technology more quickly than building it themselves. In industries where "patent thickets" are common, acquirers can save on royalty payments and potentially keep key technologies out of the hands of the competition.

To succeed with this strategy, acquirers need solid evaluation processes to truly understand what they are buying. Acquirers also need world-class integration talent. Second-rate technology and poor integration cannot lead to first-rate performance.

With most M&A transactions, the focus is usually on preparing and executing the deal. However, once a transaction is complete, it is still quite a challenge to merge the two entities.

5. Improving Scale In Specific Business Areas

Acquisitions often aim to grow scale. However, generic economies of scale rarely justify the acquisition price.

Success requires gaining scale in specific parts of the business that will truly help the acquirer or the target become more competitive. For instance, economies of scale around purchasing might be key if industry profits are driven by materials cost or if suppliers yield a lot of power.

This strategy only works if either the acquirer or the target is not already operating at scale. Each industry also has its own optimum scale, and growing any larger can actually be a disadvantage because of the so called "diseconomies of scale".

AVOID THE SIREN'S SONG

Sometimes imagination exceeds operational ability, leaving the acquirer saddened by failure to reach lofty goals. We caution acquirers justifying a transaction based on 1) being cheap, 2) achieving scale benefits in a "rollup", or 3) valuing a target based on lofty and unproven future results.

Finding something "cheap" is the opposite side of looking for a low-flying pigeon. The truth is that they rarely exist in the wild. There is usually some reason for being cheap and the buyer is usually disadvantaged in determining what that is.

Rollups rely on talent, processes, and scale that none of the rollup parties have beforehand. Combining a number of low value businesses to create a much more valuable business is a tough road. It is not that some rollups haven't been successful, but far more have not.

Excel is a magical tool. Combined with an imagination of "what could be", the user can prepare a future that is attractive. This is where only venture capitalists can make money. Their experience is different than that of most traditional business investors and operating company managers.

ON TO INTEGRATION

With most M&A transactions, the focus is usually on preparing and executing the deal. However, once a transaction is complete, it is still quite a challenge to merge the two entities. In the following articles in this series, we will share our thoughts on post-merger integration and how to manage cultural and leadership differences. **zs**

Effectively Using a Quality of Earnings Study

What is a QOE, when is it necessary, and how it should be deployed?

by Michael Dannenberg

Over the last decade, the use of formal quality of earnings studies ("QOE") has become a standard part of the buy side due diligence process, allowing acquirers to outsource a significant portion of the financial due diligence to a third party, thereby providing significant manpower in a short period of time and a stamp of approval from an established firm.

In response to this trend, the middle market has seen a corresponding increase in seller commissioned studies, with many advisors encouraging business owners to incorporate them as part of the pre-marketing process. While we generally believe that an appropriately scoped QOE is helpful to the seller (The Case for a Seller Conducted Quality of Earnings Study, Spring 2013), there is confusion in the market about what a QOE is, when it is necessary, and how it can be effectively deployed in a sales process.

WHAT IS A QUALITY OF EARNINGS STUDY?

A QOE is quite simply a due diligence report performed by a third party, generally an accounting firm, analyzing the historical profitability of the business with the intent of assessing the normalized and sustainable future profitability of the business. Rather than an audit, which authenticates the accuracy of recorded transactions, a QOE is a restatement of the company's performance, adjusting for trends, one-time events, and extraordinary revenues or expenses. Perhaps the biggest misconception is that these studies are standardized, when in fact, there is a wide variation in the scope, quality and cost to have these performed.

As a firm, our view has always been that rigorous analytical preparation is the cornerstone for creating a competitive market and for minimizing the risks that the chosen deal will fall apart during diligence.

Commissioning a QOE is not a "box-checking" activity. In fact, a sell-side quality of earnings report should not be thought of as a replacement for sound financial preparation, but rather as a tool to be carefully considered as part of a holistic approach to preparing a business for market.

RIGOROUS PREPARATION IS A REQUIREMENT FOR A COMPETITIVE PROCESS

As a firm, our view has always been that rig-

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orous analytical preparation is the cornerstone for creating a competitive market and for minimizing the risks that the chosen deal will fall apart during diligence. During a competitive process, the goal is to allow multiple potential buyers to learn as much about a company in a short period of time, so that they can submit competing bids based on complete knowledge about the economic opportunity and the specific risks inherent in the business. Preparation is critical because, although these bids (which may come in the form of an indication of interest, a term sheet, or a letter of intent) are designed to clearly detail the economics of a proposed transaction, terms at this stage are never binding. This leaves room for a buyer to walk away based on discoveries during diligence. Furthermore, upon agreeing to pursue a specific proposal, exclusivity is almost always granted to the buyer, causing negotiating leverage to swing away from the seller in favor of the buyer.

At this point in the process, a seller must have complete confidence that the information that has been and will be shared with the buyer is complete, accurate, readily accessible, and will not be contradicted when the buyer eventually commissions its own QOE. Final diligence should be an effort to confirm, not discover. The discovery of new information at this time can impact the economics of the deal negatively and give the buyer an excuse to reexamine its position.

CONFIDENCE IN SUSTAINING A DUE DILIGENCE PROCESS

In our engagements, we spend a significant amount of time analyzing financial, operational, and customer data so that it can be presented to a buyer in an easily digestible format with a clear reconciliation to the source documentation. Before taking a company to market, we seek to have answers to all of the questions that buyers will need to formulate their investment theses including sustainability of earnings, nature of customer and supplier relationships, segment, product, and geographic profitability, anticipated future capital expenditures, working capital requirements, and adjustments for pro-forma or non-recurring items.

Although we do not prepare an official QOE report, our due diligence process is extensive and designed to develop confidence internally that the company is prepared to provide the materials and explain each area of inquiry that will eventually be probed.

A QOE is an additional tool that can be used to shorten the analysis time for buyers and reduce the potential for discovery derailing a deal that both parties expect to complete.

With certain clients who have robust financial capabilities, regular audits or reviews, monthly management reporting, sophisticated IT and financial systems, and strong financial management teams capable of providing data and responding to requests, the need for outside help might not be as critical. However, more often than not, closely-held businesses, especially those with an entrepreneurial culture, do not have this infrastructure, thereby placing enormous strain on the organization and risk to the deal. Over the years, we have seen several types of situations where the expertise of a third-party accounting firm has (or would have added) substantial benefit. Some of these characteristics include:

- Limited internal financial horsepower
- Limited reporting capabilities
- Lack of sufficient financial controls
- Financials that are not GAAP compliant (especially with regards to accruals)
- Multiple subsidiaries that are not consolidated
- Complex issues with foreign currency translations.

WHAT SHOULD BE DONE?

A QOE should be thought of as a tool to solve specific problems in presenting and validating key pieces of financial information. Prior to taking any business to market, a good advisor should be able to methodically walk through a very detailed list of questions that will need to be answered and describe the supporting data that will be required both for marketing the business and surviving due diligence. Specific areas of weakness should be identified and, to the extent that internal capabilities are insufficient to provide accurate and timely responses, carefully scoped third party assistance should be utilized.

Maximizing value through a competitive process requires an extremely invasive diligence process at a speed that few closely-held businesses are prepared to handle on their own. The probability of success almost always favors those businesses that have the infrastructure and are organized to respond quickly to each area of inquiry. A carefully scoped QOE to address specific weaknesses can fill holes and drive value.

A seller-commissioned QOE is an additional tool that can be used to shorten the analysis time for buyers and reduce the potential for discovery derailing a deal that both parties expect to complete. The most effective use of a QOE is to develop scope that fills the holes of the entirety of the financial preparation. **zs**

To Roll or Not to Roll

Understand the economics and risk on reinvestment in the newly-capitalized company.

by Jay Schembs

Our clients are generally entrepreneurs or families who have built successful businesses over many years or decades. When they finally reach the difficult decision to sell, most do not contemplate retaining a piece of the business after a transaction. This is not because they have a negative view of the business, but instead have poured so much of their lives into their businesses that to retain any involvement – financially, operationally, or emotionally – conflicts with their decision to sell.

For many prospective buyers – strategic parties in particular – a 100% sale presents no problems. Most private equity ("PE") buyers, however, strongly prefer that selling shareholders retain a piece of ownership in what is colloquially known as an "equity rollover." What an equity rollover means to the seller in terms of economics, risk, and eventual liquidity for this retained investment are important to understand before seriously considering.

WHAT IS A ROLLOVER AND WHY IS IT IMPORTANT TO PE FIRMS?

Equity rollovers are a reinvestment by sellers into the newly-capitalized company. In other words, they sell less than 100% of their interest with the balance becoming equity in the new capital structure. Equity rollovers generally result in post-transaction ownership by the seller in the range of 10 to 40%. In a 30% rollover, for example, the private equity firm would own 70% of the newly-capitalized equity in the business, with the seller "rolling" a proportionate amount of value to equate to 30% of the new equity. One primary benefit to sellers is that rollovers are generally done on a tax-deferred basis.

For a variety of reasons, most private equity firms strongly prefer equity rollovers. The primary reason is the asymmetric information advantage a seller has over a buyer. In other words, "this owner has operated in his/her industry for 30 years, why sell now?" Sellers who accept an equity rollover signal confidence to private equity buyers that continuity will

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be assured and the interests of the seller and buyer will be aligned. Additionally, a seller's "skin in the game" provides investors with some comfort that those who built the business are incentivized to help if fortunes change since they retain an economic interest in the business. Lastly, in some cases, the rollover is advantageous because less capital is required by the buyer.

MECHANICS OF A TYPICAL ROLLOVER

Owners contemplating an equity rollover often find themselves facing a new world in terms of capital sources and leverage. Most of our clients have simple and relatively unleveraged capital structures, generally consisting of a single class of stock (perhaps split among a very limited number of shareholders, but often just the founder) and a modest amount of bank debt. Private equity capital structures typically consist of multiple tranches of debt (or one large piece of "unitranche" debt) and can include differing levels of preference in the equity structure. The increased complexity and leverage are not business characteristics many owners are experienced or comfortable with.

Consider the hypothetical transaction involving an equity rollover illustrated in the graphic below. Two brothers jointly own a distribution business where they are considering a transaction with a private equity firm. The headline enterprise value is $60 million, the outstanding debt is $5 million, and a $5 million equity rollover has been requested. After paying off the debt and reinvesting the $5 million, the brothers pocket $50 million. The new capital structure in the middle column is 50% equity and 50% debt (a mixture of senior and mezzanine debt), with the PE firm owning 83.3% and the brothers owning 16.7% of the recapitalized equity.

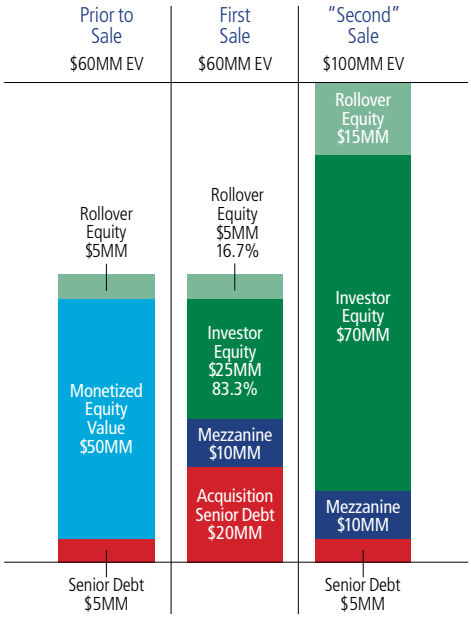
Leverage is implicitly touted as a benefit to sellers considering a rollover as PE firms explain the "second bite at the apple." The argument is that when the business grows, debt is paid down, and the business is eventually sold to a strategic buyer for a higher price. In this example, the second transaction will yield $100 million for the business. All equity owners earn a return on their investment; in this case, the brothers parlay their $5 million rollover into nearly $15 million.

THE GOOD, THE BAD, AND THE UGLY

Equity rollovers offer substantial upside, substantial downside, and pose lots of questions. Because the rollover structure is likely something an owner has never encountered, questions should be asked until the answers satisfy concerns that the transaction outlined is acceptable. Unfortunately, many owners don't know where to begin the questioning.

PE investors generally operate with a more leveraged capital structure than family-owned firms. While added leverage boosts equity returns, risk increases as well. For the PE firm considering this business as one in a portfolio, the risk/return ratio might be more suitable

Proposed Economics for a Rollover



than for the sellers with this being their only investment. PE firms love to promote success stories, particularly the instances where an owner made more on the second bite than in the initial sale. A seller doesn't typically hear about the disasters, the probability of which increases with greater leverage. A seller considering a rollover should ask for a pro-forma capital structure, as well as the detailed financial projections the PE firm has created to support such a capital structure, and evaluate its risk within the context of familiarity with the business and its cycles.

Further, owners rolling equity need to fully appreciate that while they are partnering with the PE group "buying" their company, the seller's influence over important decisions may be minimal. Compatibility with regard to strategy, expectations, and performance under stress are important to assess before becoming partners. People matter. Some firms assign junior members to a new portfolio company to monitor the business – usually by burying management with requests for information and data they have never previously used in the business. Others rely on a board of directors, sometimes populated with experienced business leaders. It is important to become comfortable with the style as well as the decision-making rules of the governance agreement.

Some PE firms expect a hidden form of return that often doesn't show up until the deal is being documented. Fees for management and putting the deal together, or preferred returns all contribute to a skewing of the returns among the parties. PE firms will argue these expenses are non-recurring and therefore shouldn't affect value in a future sale, but they are real cash expenses that alter the return profile of the two parties. Asking for a complete schedule of proposed fees earlier in the process will reduce unpleasant surprises further down the road.

Equity rollovers present real opportunities to owners that want to take some chips off the table while still preserving an ability to share future upside in the company they have created. For those considering a rollover, be sure to at a minimum ask about the following:

1. Taxes – confirm that the transaction enables a tax-deferred rollover;

2. Corporate governance – what say does the seller have in ongoing strategic, operating, and financial decisions?

3. References – how has the PE group behaved in partnership with previous sellers?

4. Debt – make sure there is no personal guarantee of the debt in what will most likely be a more leveraged business.

Those seeking a clean break, both financially and emotionally, might find themselves disappointed if the primary market for their business is with financial investors. Getting some advice in advance of engaging discussions with investors as to what should be expected and how to maximize the result is wise. **zs**

ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, go to **ZacharyScott.com.**

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