Strategic Acquisition Program Series Part III: Addressing the Challenge

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Synopsis: A successful acquisition can create significant shareholder value. However, a positive outcome is not inherent in the acquisition process, and it depends on the development of core competencies necessary to align an organization's capabilities with its desire for proprietary acquisitions. The inevitable risks associated with the acquisition process can be considerably mitigated by the application of external, purpose-built resources.

Read on for our views…

The Challenge

How Do I Best Leverage My Internal Capabilities?

An acquisition strategy is not sensible in many cases. In many situations, acquirers that lack core competencies in (i) sourcing, (ii) executing, and (iii) integrating acquisitions will destroy shareholder value. Conversely, significant shareholder value can be created for those companies that have committed the resources to develop these competencies.

The most successful companies are those that effectively align their resources with their objectives. This is equally true for those companies that are not interested in acquiring and have no internal resources as it is for those active acquirers that have the resources to execute their strategy. However, issues arise when there is a gap between motivation and capabilities:

Table 1: Motivation and Capability Correlation Matrix for Acquisitions

		Strategic Motivation for Acquisitions	
		Low	High
Capability	Low	▪ No proprietary deal flow ▪ Limited to no resources expended on reactive approach to auctioned assets ▪ Not a bad outcome; no gap between aspirations and capabilities	▪ Not seeing as many opportunities as desired (auctioned or proprietary) ▪ Reacting to auctions; “lumpy” activity, urgent timing, higher valuations, and low close rates ▪ Lack of proprietary deal flow ▪ Limited time diffused between travel to conferences, cultivating intermediary relationships, assessing deals, and non-M&A responsibilities stretch internal resources thin, resulting in inconsistent execution ▪ Aspirations exceed capabilities: inferior return on internal resources
	High	▪ Overstaffed with corporate development and M&A personnel ▪ Overinvestment in systems ▪ Many acquisition leads generated and qualified, but low closure rate ▪ Ability to respond quickly to auctions, but may not be contacted for all of them if inactive ▪ Capabilities exceed aspirations: poor return on internal resource investment	▪ Significant proprietary deal flow; multiple successfully integrated acquisitions per year ▪ Significant return on internal resources, steady activity, controlled pace ▪ Significant shareholder value creation (EVA on acquisitions far exceed costs) ▪ Credibility with targets and intermediary community regarding ability to close and perceived as a “go-to” consolidator • Specialized roles and knowledge within the team and purpose-built systems to produce scale and scope benefits ▪ No gap between aspirations and capabilities

For those companies that possess the core competencies, there can be significant Economic Value-Added ("EVA"), even from a small acquisition. For example, the $30 million acquisition of a typical industrial company[1] would create $7.5 million in EVA if bought at 1.5x below the acquirer's EBITDA multiple (i.e., 6.0x EBITDA vs. 7.5x), assuming no synergies. This multiple "arbitrage" on that same company in auction would be much lower because of the higher purchase price. If the acquirer can increase target margins through cost synergies and sales through distribution synergies, the EVA increases significantly (see adjacent table).

Figure 1: EVA Under Synergy Assumptions (1)

Cost Synergies → ; Distribution Synergies ↓

				Revenue Growth
7.5	10.0	12.5	15.0	0.0
8.8	11.3	13.8	16.3	2.5
10.0	12.5	15.0	17.5	5.0
11.3	13.8	16.3	18.8	7.5
15.0	15.0	17.5	20.0	10.0
0.0	1.0	2.0	3.0	%

Margin Improvement

This paper focuses on those situations where there is a gap between a desire to make proprietary acquisitions and the resources available to effectively execute the strategy, particularly the sourcing aspect.

Typically, the most challenging aspects of developing core competencies in acquisitions are in sourcing acquisitions and integrating them. Applying external, purpose-built resources to the sourcing effort can generate a greater and more consistent flow of proprietary acquisitions, while freeing up internal resources for planning and execution of the integration. Significant time, resources, and skill are required to execute a comprehensive sourcing strategy and the needs will likely change over time. A comprehensive sourcing strategy entails:

- Researching and identifying targets that advance the company's strategic objectives;
- Approaching targets in a professional manner and maintaining a reliable, consistent target follow-up program;
- Developing and executing a qualification protocol, including a preliminary financial assessment, that balances confirming the most relevant information that a target can easily provide with ensuring that due diligence resources are not wasted on poorly qualified targets;
- Maintaining momentum with and sequencing multiple targets while negotiating or conducting due diligence with another target; and
- Managing document and information flow with multiple targets, including follow-up on information requests and execution of agreements.

[1] Illustrative EVA analysis ($ millions) assumptions are:
- $5 million target EBITDA
- Acquirer trading multiple of 7.5x EBITDA and proprietary target valuation of 6.0x EBITDA
- 15% EBITDA Margin and 20% Contribution Margin (on incremental revenues from distribution synergies)

How Valitas Adds Value

Valitas has developed a Strategic Acquisition Program ("SAP") that surfaces (i) more passive sellers, (ii) acquisitions that make strategic sense, and (iii) acquisitions at reasonable valuations. The expected result is the accelerated cultivation of a proprietary acquisition pipeline and maintenance of that pipeline.

Our significant expertise and resources are applied to a process that is complementary to your existing acquisition strategies and effectively manages the early stages of target interaction to allow you to focus your internal resources where they add the greatest value.

A. Effective Process and Depth of Resources

i. Committed, Purpose-Built Resources

- Valitas has a full team on each SAP with each member specializing in different aspects of the program.
- We have done many of these and have continually enhanced the process, making improvements based on careful, continuous, and empirical evaluation.
- Significant investment in custom systems for target databases and contact management.
- These projects are resource-intensive, and we limit the number of these projects we will execute concurrently to ensure a high level of service and responsiveness.

ii. Professional, Systematic Coverage, Monitoring, and Follow-Up

- Oftentimes, the response is neither "yes", nor is it "no". The response is often "not now".
- Valitas maintains contact as called for by the circumstances.
- If the target wants us to follow up in the summer three years from now, we have the systems in place to ensure that happens.

iii. Effective Management of Conflicts

- When Valitas commits to pursue a defined target list on a client's behalf, any targets within that defined universe are exclusive to our client during the course of our engagement.
- We do not take on more than one client in a given target segment.

B. Expertise in Managing Vendor Dynamics

i. Vendor Approach Expertise

- Valitas carefully assesses the shareholder structure of the target.
- Publicly listed targets require varying approaches depending on their listing jurisdiction and shareholder composition.
- Private company strategy depends on the number of shareholders and the nature of their interaction.
- How active the shareholders are in the operations of the target impacts strategy.

ii. Positioning a Proposal with the Vendor

- We understand how to best present our client's value proposition with the vendors.
- As seasoned divestiture advisors, we understand vendor psychology and how to anticipate and assuage their concerns.

- We know how to position a strategic buyer versus a private equity buyer and vice-versa.

iii. Creating a Buffer and Building Vendor Trust

- We conduct ourselves with the utmost professionalism, respect, and integrity.
- We maintain vendor confidentiality and will not share anything with our client without the vendor's express consent. We offer to execute an NDA if desired by the target.
- This establishes trust and respect with the vendor and allows us to open a meaningful dialogue quickly.
- This open dialogue and exchange of information allows us to effectively qualify the target.

iv. Management of Vendor Ensures Smoother Execution

- The trust we build with the vendor helps us to intervene if the vendor behaves outside of M&A market norms.

C. Complementary to Existing Efforts

i. Thorough Understanding and Appreciation of Your Objectives

- Through our extensive M&A and strategic advisory experience, we understand the importance of strategic fit in the context of your overall strategic objectives.
- We invest significant time and energy to understand your objectives and acquisition criteria.
- This ensures that our clients do not waste management time on targets that do not fit.

ii. Focus Internal M&A Resources Where They Add the Greatest Value

- We often identify targets that are not on our clients' radar screens, but not always.
- Our expertise is in converting names on a list into actionable opportunities.
- We enhance "coverage" of a given target list by cultivating it into qualified targets that are motivated to sell at reasonable valuations.
- Only once the target is qualified and the vendor provides consent to disclose information does our client spend time on or meet the target.
- Additionally, Valitas' management of information gathering, preliminary financial modeling, preparation of letters of intent and support with due diligence, negotiations, and documentation frees significant management time for our clients to focus on business due diligence, negotiation, and target transition/integration planning.

iii. Regular, Customized Reporting

- Valitas provides concise, informative, and regular progress reporting.
- Typically, we schedule a weekly call where we walk through a customized "dashboard" report showing:

  a) Conversion metrics;

  b) Pipeline status;

  c) Progress to date;

  d) Activities and follow-ups for the coming week; and

  e) A clear list of items and/or time required from our client's team.

iv. Process Control and Risk Mitigation

- In a proactive process, regardless of how many actionable targets are in the pipeline, our client controls the process. The process is not controlled by the vendor, their agent, or other bidders as in an auction process.
- Only those targets that the client approves are approached. Hence, there is no interference in any existing target dialogue.
- The worst outcome is spending a lot of time and money assessing and negotiating with a target, then failing to close. Our approach yields less risk of "losing" as is often seen in auctions.
- Having greater process control minimizes risk by allowing more complete due diligence and assessment as well as better access and sufficient time to conduct the review.
- Our vendor management skills reduce closing risk.

v. Our Client Controls the Pace and Determines Sequencing of Targets

- There is discretion over the pace and timing of approaches.
- For proprietary deals, there is more timing flexibility within the process, which allows greater time for due diligence and some ability to speed up or slow down.
- This ability to adjust pace on individual targets within a pipeline of acquisitions allows our client to optimize the sequencing of the targets.
- This is particularly useful when internal resources cannot accommodate parallel processing of targets.

D. Significant Resources Available When You Want Them at No Fixed Expense

i. Avoid Risks Associated with Building Significant Internal Acquisition Sourcing Resources

- Hiring the right people, then training and retaining them is time-consuming and risky.
- Typically, specialists are hired as permanent employees with a salary and bonus. It is difficult and slow to adjust staffing levels up or down.

ii. No Risk of Incurring Expenses with No Identifiable Benefit

- There can be a long, unproductive ramp-up period as the team is built and trained and systems are developed.
- The majority of these expenses are fixed and are not tied to results.

iii. Flexibility to Adjust Resources and Expenditure to Desired Activity Levels

- Easy to increase and decrease activity levels based on your strategic needs.
- Avoid having internal capacity management issues drive acquisition sourcing decisions.

E. M&A Advisory Expertise

i. We Can Assist with Financing Strategy and Execution of the Financing Plan

- We can anticipate financing issues and help ensure that financing does not become an impediment to closing acquisitions.
- Our financial modeling tools are useful in assessing financing needs and in supporting credit applications and/or investor presentations.

- We have helped clients change their investment banking relationships when they received inferior service from their incumbent bankers.
- In some cases, capital providers have indicated that our involvement provides them with comfort that the acquisition process is being professionally managed.

ii. Sophisticated Assessment Tools

- We employ the assessment techniques used by the most sophisticated investment banks and private equity funds.
- Some techniques include: EPS Accretion/Dilution analysis, Unlevered IRR, Discounted Cash Flow (DCF) analysis, credit capacity, dynamic analysis of projected credit ratios and interaction with covenants, Economic Value Added (EVA) analysis, and synergy and integration risk analyses.

F. Compelling Value

i. Significant ROI on SAP Fees

- Per the example above in *Figure 1*, the EVA from more favorable acquisition valuations far outweighs the fees charged on an SAP.
- In the earlier EVA example, the EVA is approximately 11 times Valitas' fee, assuming no synergies.
- If the acquirer can increase target margins by 2% and sales by 5%, the EVA doubles to $15 million (approximately 20 times Valitas' fee).
- Net of fees, each incremental acquisition with these characteristics would create $6.8 million in EVA ($14.3 million with synergies).
- Any increase in acquisition volume (number of acquisitions) multiplies this effect.

ii. Transparent Fee Structure Where Our Clients Maintain Complete Control Over When Fees Are Incurred

- Milestones and success fee formulas are agreed in advance under a master engagement letter.
- The engagement letter only applies to targets that the client explicitly approves.
- All fees are only triggered at client decision points, such as submission of an LOI, sharing a draft definitive agreement and of course, closing.
- No surprises.

Conclusion

Acquiring a company that makes strategic sense at a reasonable value can create significant shareholder value. The combination of controlling the pace of the process, having unfettered access to due diligence, and having the flexibility to structure the consideration paid to the vendor, can significantly mitigate the inherent risks in acquiring that company. For the most active consolidators, having the additional benefit of having many such opportunities available in parallel brings further benefits. Using our prior example in *Figure 1*, if a typical acquisition adds $7.5 million in EVA pre-synergies, the ability to acquire more targets more often, creates more shareholder value. Targets identified based primarily on strategic fit provide the added benefit of synergy potential, which further multiplies the effect. There are other tangible benefits that manifest from the negotiating leverage our clients enjoy in those cases where qualified targets are abundant.

Valitas has developed a process that works and has the purpose-built resources to execute it effectively. We accelerate our clients' acquisition plans by generating additional acquisition targets that our clients would not otherwise find. We do this in a way that is not only complementary to our clients' internal capabilities, but also leverages these internal resources to their highest, best use. Our fee structure is transparent and our client controls when fees are triggered. Clients generate economic value many times greater than the fees we earn. A Valitas SAP is a complex service. We have developed a comprehensive Frequently Asked Questions ("FAQ") document for those who would like additional information. We have finite capacity to execute these projects and we only work with one client in any given industry at a point in time. Please do not hesitate to contact us if you would like to explore how we might work together.

If you have questions, click here **for our FAQ Sheet.**

About Valitas

Valitas Capital Partners is a relationship-focused merger & acquisition (M&A), corporate finance, and strategic advisory firm. We collaborate with ambitious owners of high-performing businesses with a potential value of at least $100 million, to discover, unleash, and realize their full business value potential.

Owners and their leadership teams rely on Valitas when they:

- Want to triple the value of their business in five years or less, but realize they lack the expertise and experience to achieve this alone.
- Want to sell their company now, assured they will look back after the transaction knowing they got the best possible outcome.
- Seek the peace of mind of taking some chips off the table now, to secure their family's financial future without giving up control or the future increased value in their business.
- Are anguished they had to say no to growth opportunities they worked so hard to create because their bank cannot keep up with the needs of their fast-growing business.
- Are frustrated at the lack of traction they are getting with their acquisition efforts, whether it is not seeing enough quality acquisition opportunities, or by wasting time and money coming up empty-handed in auctions.
- Are dispirited by the significant investments in expensive specialists, technology, systems, and financial modeling capabilities required to execute their audacious strategic goals.
- Are intrigued by the idea of selling their business to their management team over time but want to recognize the full value now, while getting their cash payments as quickly as possible.

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About the Author

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Paris Aden is the founding Partner of Valitas Capital Partners. Since 1994, he has been involved with more than 100 M&A transactions with an aggregate value exceeding $80 billion. He has advised clients at Morgan Stanley, Credit Suisse First Boston and RBC Capital Markets and has acted as a private equity investor at Clairvest Group where he served on portfolio company boards. Paris was also a co-founder of Alluence Capital Advisors, a mid-market M&A advisory boutique that focuses on cross-border transactions.

Paris is recognized as an expert in business strategy, M&A and corporate finance. Previous roles and speaking engagements include:

- Lecturer at the Stephen J.R. Smith School of Business at Queen's University in their Master of Finance (MFIN) program
- M&A subject matter expert for Moody's Analytics' Advanced Capital Markets Program for capital markets professionals
- Three-time expert panel moderator for the Toronto Business Transitions Forum
- TEC Canada "2018 Speaker of the Year" recipient
- Guest speaker for various industry and business leadership organizations

Paris formed Valitas to meet the unanswered needs of ambitious business owners seeking to:

- At least triple their business value in five years or less; or
- Are seeking an elite advisory boutique as their trusted advisor for their complex, mission-critical transactions.