MENTOR
CAPITAL PARTNERS LLC

Achieving Entrepreneurial Wealth

Should Acquisitions Be A Part Of My Company's Growth Strategy?

John A. Colwell, Managing Director
Mentor Capital Partners
john@mentorcappartners.com
(410)296-2200
www.mentorcappartners.com

© Mentor Capital Partners LLC

The market value of a business is substantially dependent on its rate of revenue and earnings growth, profit margins, diversification, and size. In particular, companies that rank among the first quartile of performers in their industry sell for a substantial premium, while below average performers can be difficult to sell at any price. Owners seeking to maximize the value of their businesses should consider how to outperform their peers, and to reach key valuation inflection points, levels for these performance measures that produce substantial jumps in what buyers are willing to pay for companies like theirs. For the many companies that cannot achieve these goals by means of internal growth alone, the right strategic acquisition at the right price can provide a critical element to building shareholder value and liquidity.

Consider the following five factors when deciding if acquisitions should be part of your company's growth strategy.

Are Market Conditions Right?
Times have been good for corporate acquirers. Companies have been able to purchase businesses at the most reasonable prices in years because the recession has depressed target companies' earnings and purchase price multiples have declined. In a recent survey by Mergers & Acquisitions and Merrill DataSite®, 66% of respondents reported that they had considered an acquisition or divestiture within the past six months, and 64% said they are more likely to do so in the next half year. This interest in acquisitions isn't limited to large, publicly-held companies: 58% of companies responding to the survey have revenues under $100MM.

Buy or Build?
Some corporate objectives can be achieved either by organic growth or by acquisition. For instance, a company can increase revenue by hiring additional sales personnel, or by buying a company that has a superior sales force. Similarly, a company that needs to expand production capacity to meet demand can accomplish this by purchasing additional equipment or by acquiring a competitor.

When evaluating whether to Buy or Build, consider your company's core competencies and the competitive characteristics of your industry.

If the company above needs one or two additional sales staff, and they have a record of hiring productive people, the organic approach would probably result in a more cohesive organization because each salesman would be hand-picked. It might also be faster, because an acquisition can take up to a year to complete. However, if the company's goal is a major expansion of the sales organization, the right acquisition could achieve this in a single transaction. In addition, it would provide an expanded customer base and perhaps also entry into new vertical or geographic markets.

For the company that needs to increase production, the organic solution might be better if equipment is readily available and inexpensive. However, if internal expansion requires a large new production facility, or if the equipment needed is expensive and has a long delivery time, an acquisition could be less expensive, and faster. Highly fragmented industries tend to experience relatively high M&A activity as growth-oriented companies

© Mentor Captital Partners, LLC.

compete for industry leadership and to achieve critical mass, broadening their product/service offering, and serving larger customers in multiple markets.

Expansion in low-growth industries also often favors acquisitions. In these industries, purchasing a competitor can achieve increased market share while also removing excess capacity, whereas internal expansion tends to result in greater overcapacity, more intense price competition, and lower margins.

What Are Your Acquisition Objectives?

The first transaction many corporate acquirers pursue is an unexpected opportunity that they can't ignore. For other companies, an acquisition search is part of their overall strategic plan. Whatever the origin of their acquisition-mindedness, strategic buyers tend to seek to achieve one or more of the following objectives:

- Increase share of markets currently served
- Expand into complimentary product or service markets
- Broaden geographic coverage
- Diversify away from a declining business
- Eliminate a particularly nettlesome competitor
- Acquire a specific technology or capability that would be risky / costly / time-consuming to develop internally

Are You Able To Execute Your Strategy?

Successful acquirers are:

- Focused: Establish specific, well thought-out acquisition criteria
- Pro-active: Identify and initiate discussions with multiple acquisition candidates that appear to fit the company's criteria
- Committed: Expect to evaluate a number of potential acquisitions in order to find the right one
- Patient: Understand that it often takes six to twelve months to close a deal
- Decisive: Recognize and respond quickly to opportunities
- Thorough: Organized and objective in conducting due diligence
- Attuned: Closely follow month-to-month results of the target company, and be aware of any meaningful changes in the way they operate or market themselves
- Creative: In negotiating and structuring transactions
- Prepared: For the critical post-close challenges of integrating the acquired company's personnel, facilities, systems
- Disciplined: Avoid buying the wrong company or paying too much for the right one

How Will The Transaction Be Financed?

Sellers are naturally suspicious of buyers that may not be able to obtain the funding needed to close the deal. And this has become amplified because the number of banks willing to finance acquisitions has declined. Others have reduced the proportion of the purchase price they will fund, and they take longer to commit to a deal. Nonetheless, good deals can be financed. In most small transactions, and to a less extent those with a value up to $30MM, the seller takes a note for a portion of the purchase price. Some deals provide for an earn-out, which

© Mentor Captital Partners, LLC.

specifies additional payments to the seller based on future performance.

Companies considering a significant-sized transaction, or a series of acquisitions, should consider the benefits of using subordinated debt to supplement the funding they can get from their bank.

Finally, be creative. In the case of two recent transactions we negotiated, the sellers agreed to accept partial payment in the form of our client's common stock, priced to reflect the expected value of the combined business post-close.

© Mentor Captital Partners, LLC.