Merger & Acquisition Focus

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Scale or scope?
The critical choice for business buyers

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Ask the Advisor

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Everingham & Kerr, Inc.

Merger & Acquisition Advisors focused on the Lower Middle Market

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Scale or scope?

THE CRITICAL CHOICE FOR BUSINESS BUYERS

Most business acquisitions fall into one of two broad categories: scale or scope. While an M&A transaction can realize both of these goals, successful buyers typically decide which type of deal will best serve their long-term strategic objectives *before* they begin the acquisition process.

Choosing between scale and scope enables you to tune out the "noise" and focus on specific acquisition needs. You may end up, for example, passing on a company that's appealing in many other ways but doesn't work strategically. Or you may buy a company that on the surface shares little in common with your own, but offers specific long-term opportunities.

The case for scale

In a scale acquisition, the buyer seeks an enlarged presence in a particular market or sector and hopes to achieve greater overall economies of scale. For such acquisitions, buyers typically target a competitor or a company in a related sector or a new geographic market. Ideally, both companies should share similar costs.

While there are many potential economies of scale, some common ones include:

Reducing expenses. The purchase of a rival company may enable the consolidation of operations, thus reducing the new entity's overall overhead and administrative costs. The combined organization is also likely to enjoy greater purchasing power as it negotiates prices with suppliers, which can lower variable costs, such as direct materials and labor, as well as fixed overhead expenses, such as rent and insurance premiums. Mergers of all types of companies, from oil pipelines (for example, Kinder Morgan and El Paso Corp.) to airlines (such

as Southwest and AirTran), have been realized to get more "bang for the buck."

Building a capital base. An acquisition can push your company to the next stage in its growth cycle. For example, a midsize manufacturer that buys a similar-size competitor could now generate enough revenue to invest in new equipment and technology upgrades that vastly expand its production output and improve quality. And lenders typically perceive larger borrowers as less risky, so a scale merger can improve your access to lower-cost financing.

Expanding research and development (R&D). A scale merger may enable you to cast a wider net and acquire new business intelligence. For example, in the pharmaceuticals industry, success depends on developing the next big drug. A company may buy a rival to consolidate R&D departments and apply R&D expenditures to a greater number of potential sales opportunities.

Support for scope

Scope deals aren't as concerned with streamlining operations and cutting costs as scale deals. Typically, these transactions are made by companies that are already well established in their current market but want to move in a new direction. Mondelēz International has purchased several companies — including Kraft Foods and Cadbury — using this strategy.

Scope buyers often use their acquisition as a springboard into new and unfamiliar territory. The long-term goals of such a strategy are to:

- Expand the company's breadth and geographic range,
- Open up new markets,
- Sell products to new customers, and
- Diversify the company.

This last objective is important because it makes the acquiring company less susceptible to market fluctuations and product cycle downturns.

On the other hand

It's important to note that both scale and scope deals carry potential risks. Buyers in a scale deal risk devoting too much time and energy to cost-reduction initiatives when their primary focus should be on integrating the acquisition. Fixating on (often minor) cost synergies can sabotage future growth — not to mention employee morale.

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Scope deals have the potential to be unrealistic if they aren't backed up by solid due diligence and at least some core compatibilities between the two companies. If you acquire a company in an unfamiliar sector with a markedly different corporate culture, you should expect serious integration challenges.

Seller on board

Given the complexity of these needs, buyers and sellers need to be on the same page when it comes to the core strategic rationale of an acquisition. Knowing which type of deal you want and making sure that your seller supports your goals can help you make the right choice. ■

The seller's role

The concepts of "scale" and "scope" primarily are tools for business buyers. But when a seller knows which strategy a buyer is pursuing, it can better position itself for a successful sale.

If the deal is one of scale, sellers should draw up a list of potential cost synergies and other opportunities to reduce expenses. It's important to quantify such cost savings and carefully consider whether any might compromise quality.

If a buyer wants to expand its scope, it will look for acquisition candidates that offer entry into a new, unfamiliar market. In this situation, the seller will want to emphasize its market share and sector knowledge. For example, the seller might provide regular briefings to the buyer on industry performance and growth prospects. The seller also needs to take an active role in integration — working to retain key staff and transfer customers — so that the combined entity is up and running as quickly as possible.

Déjà vu deal: What to do when a buyer comes knocking *again*

After his M&A transaction collapsed, Fred, the owner of a midsize agricultural equipment company, was understandably wary of soliciting bids from new prospective buyers. So he took his business off the market, intending to try again in a few years. Six months later Fred received an unsolicited bid from a familiar name — his failed buyer. Fred's first instinct was to send the returning buyer packing. Instead, he called his M&A advisor.

As the advisor told Fred, turning away a former prospective buyer without first considering the new offer can be foolhardy. Such buyers are likely to have learned from their mistakes and be much more focused and committed to making the deal work the second time around.

What went wrong?

When your company is considering a second offer from a past suitor, you'll need to revisit and analyze the original transaction to determine exactly what went wrong. Try to differentiate between the influence of outside factors and the buyer's mistakes and missteps.

An example of how outside factors can kill a deal is AT&T's failed 2011 acquisition of T-Mobile, which got tripped up by an antitrust suit. Along with regulatory problems, financing is a common culprit. The sluggish credit market of recent years has made it difficult for many serious, qualified buyers to obtain adequate financing to close the deal on time. But if issues such as these no longer exist, there's no reason you shouldn't entertain a new offer.

Fixing real problems

But what if the original deal crumbled due to buyer mistakes or incompatibilities between

the two companies? You and the buyer should address them before moving forward.

If, for example, the deal failed for financial reasons, review the numbers. Was the buyer overleveraged and unable to raise the necessary cash? Ensure that the buyer has cleaned up its balance sheet and can now secure adequate financing to meet your asking price.

Or mechanics might have sabotaged your deal. Did the buyer perform inadequate due diligence and then raise an overlooked financial or legal issue late in the game? Or did the buyer poorly communicate its progress with you, move too slowly or use inaccurate valuation methods? If any of these are true, the buyer should provide you with a detailed description of how the process will operate more efficiently this time.

Culture incompatibility is another major deal-killer. If your original transaction stumbled because the two companies had dissimilar management structures or compensation levels, you need to ask what's different about the buyer's or your organization now that would prevent the same issue from rearing its ugly head again.

Smoother sailing

If you can resolve past errors and obstacles, consider some of the positive aspects of a second-chance deal. Original negotiations have likely already laid much of the necessary groundwork and introduced you to the personalities and their negotiation styles. You can skip the meet-and-greets and get down to business relatively quickly.

And although both parties need to perform new rounds of financial and legal due diligence, you and your buyer will have a better idea of what to focus on and the types of information to request. What's more, when you're familiar with each other's business models, leadership structures and product lines, you can begin planning for a smooth integration as soon as deal negotiations begin.

Second hearing

You have no obligation to meet with a *déjà vu* buyer if you're dead set against any further negotiations. If you don't trust the company's owner or executives, that's an excellent reason *not* to do a deal with them. But in many cases, the factors that initially attracted you to a buyer will still be in place — and you may find that many of the obstacles to closing a transaction have since been removed. ■

Taking the private path away from the public spotlight

Although not as familiar or common as going public, going private is an increasingly attractive option for some companies. For example, if you feel that your public company is undervalued or unfairly punished by the public markets, or that your leadership doesn't have enough control and flexibility, you may want to consider this type of transaction.

Just be prepared for a long and complicated process. Going private is potentially one of the biggest and most consequential decisions a company can make.

Before proceeding, you need to understand the risks and be confident that the potential benefits outweigh them.

Count the reasons

Not every company goes private for the same reason or set of reasons. But there are several common problems that these transactions can mitigate or eliminate:

The cost of compliance. Since the Sarbanes-Oxley Act was passed in 2002 and additional SEC requirements were introduced, public company accounting costs have shot up — and are still rising. For some companies, such costs can be the difference between a profitable and a disappointing quarter or year.

Exposure to outside forces. Activist shareholders can demand changes in your corporate governance and compensation. Investors can punish your company's share value for no other reason than sector weakness or negative general economic data. Consider Ancestry.com. It went private in 2012 in part because it felt it deserved more than $20 per share for its $500 million in revenue and 40% EBITDA margins.

Public risk. These days, public company CEOs and financial officers potentially face high fines and other consequences if their 10-K and 10-Q forms are found to be deliberately misleading, exposing the company to scrutiny and costly defenses of its business practices. Not surprisingly, directors' and officers' insurance premiums have increased in part to offset this risk.

Just another M&A

There are several ways that a company can go private. But the two most common transactions are, in essence, M&As.

With a going-private *merger*, the buyer combines the acquired company with a newly created entity. That entity pays all of the selling company's shareholders merger consideration, leaving only one stockholder — a subsidiary of the buyer. The entity then files with the SEC to go private.

In a going-private *tender offer*, the buyer purchases shares from the seller's stockholders with the intention of acquiring at least 90% of each class of the seller's stock, a "controlling" stake. The buyer then completes a short-form merger in which all remaining shares are bought without a shareholder vote or negotiation. Again, at the end of the day the buyer is the sole shareholder and is able to take the seller private.

Since SOX was passed and additional SEC requirements were introduced, public company accounting costs have shot up — and are still rising.

Brace yourself

If your company wants to go private, it could face a lengthy and possibly contentious deal process. Buyers often are private-equity firms or consortiums of private-equity firms, and they may have different expectations than your company is accustomed to with public shareholders. Expect many due diligence requests, especially if the buyer is a consortium. (Each member will have its own agenda and questions.)

You also might encounter resistance from your shareholders. Consider the drawn-out bid by Dell Computer's founder to take Dell private via a leveraged buyout. Activist shareholder Carl Icahn contested the bid — arguing that Michael Dell was undervaluing the company — and proposed a part-public/part-private alternative. Shareholders eventually agreed on a $24.9 billion buyout to take the company private. Most deals aren't this contentious, but there's a chance shareholders will mount a similarly passionate resistance to your plans.

Potential remedy

Going private certainly isn't for every company, and other possible remedies exist for problems such as high compliance costs and corporate governance risk. But if the timing's right and your shareholders are supportive, going private could be a great way to improve your company's outlook. ■

Ask the Advisor

Q. How do I choose between two appealing prospective buyers?

A. For most business owners trying to sell, this is a dream quandary. But believe it or not, choosing between two buyers with equally enticing offers can be challenging.

Find the real differences

Many sellers make this decision with their gut. If the two potential buyers really do offer a similar price and deal terms, have similar plans for your company and have both secured financing to make the purchase, it could come down to personal relationships. Which owner or executive team do you and your managers like and trust more?

The chance that you've received two truly identical offers, however, is small. When you scrutinize them, you're sure to spot some important differences.

For example, one prospective buyer may be a midsize company that already operates in your industry. It plans to buy your company to eliminate competition and acquire products that will complement its own. The other prospective buyer may be a large diversified company that's hoping to use your business as a gateway to a new market sector.

There are pros and cons involved in either offer. The key is to understand your own goals. Do you want your business to capture a larger share of your current market? If so, merging with a competitor may be the more appealing option. But if you want your company to be part of a larger enterprise, with greater access to capital and new markets, the multi-industry buyer may be the better choice.

Study cultures

Comparing the two prospective buyers' corporate actions, reputations and cultures may also make your decision easier. Has one been on a serial acquisition binge, while the other has been slow and deliberate in its purchases? Is one considered to be the established leader in its industry while the other is an up-and-comer?

Getting a sense of each buyer's culture is critical. For example, one may have a hierarchical culture that's likely to alienate many of your employees. The other may have high turnover because it's poorly managed and doesn't value its people. For the sake of staff members and customers who will stay with the company after the sale, choose a buyer with a culture and values similar to your own.

Make the call

There's a limit to the amount of information you can gather about a potential buyer before finally committing to a sale. But if you work with an experienced M&A professional and thoroughly research your options, your decision will probably be the right one. ■

Everingham & Kerr, Inc.

Merger & Acquisition Advisors focused on the Lower Middle Market

Passing the Business Torch ... One Successful Transaction at a Time

Our Firm:

Everingham & Kerr (E&K) is a regional merger and acquisition advisory firm focused on implementing exit and growth strategies for lower middle market companies. Our client base includes private and publicly owned companies, investor groups, family businesses and entrepreneurs. Since 1988, the firm has successfully completed nearly 200 transactions spanning virtually every industry sector.

Our Maxim:

Combining Experience, Teamwork and Persistence to Produce Superior Results.

Our Services:

Sales:

E&K provides representation to sellers of lower middle market companies including sales of entrepreneur and family owned companies as well as divestitures of business units of private and publicly owned companies.

Acquisitions:

E&K assists companies, entrepreneurs and corporate executives develop and execute customized acquisition strategies designed to result in successful transactions.

Transaction Consulting:

In some instances the parties to a transaction locate each other through informal industry or personal channels. These transactions include sales to unrelated third party acquirers, as well as management, family and partner buyouts. E&K is often engaged to structure these transactions and navigate the many issues requiring attention from the initial stages to the consummation of the transaction.

Business Valuations:

E&K provides a full range of valuation services to business owners for personal and corporate affairs. Supporting our belief that all owners should know the “real” value of their business, E&K offers the “Owner’s Planning Valuation”. This is an informal valuation that can be prepared in a cost-effective manner and updated periodically to assist owners with company and personal planning issues.

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