

## A Thorogood Special Briefing

# Chapter 1 Reality, Strategy, Opportunism and Theory

- Most acquisitions underperform
- Safer and risky acquisitions
- Kissing frogs is essential
- Commercial due diligence is vital
- Opportunism is a must
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# Chapter 1

## Reality, Strategy, Opportunism and Theory

Your acquisition strategy must be firmly rooted in reality, opportunism is needed to complete deals, but theory is a waste of time.

### **Most acquisitions underperform**

The stark reality is that well over 50% of acquisitions underperform compared with pre-deal expectations, as judged by the acquirer with the benefit of hindsight. This is based on research carried out over the past 25 years from a variety of studies around the world. Press articles underline this evidence by reporting profit warnings which reflect underperformance from many acquisitions

### **Safer and risky acquisitions**

Tangible evidence, rather than theory, offers an insight into safer acquisitions and risky bets, but there is rarely ever guaranteed success.

### **Market leadership or increased market share**

Over many years there is clear evidence that the market leader is likely to be the most profitable in the sector. So acquisitions which enable a company to achieve market leadership in the existing segments and territories already served should be regarded as safer, provided there are no anti-monopoly problems and the pursuit of diminishing returns will be avoided.

Similarly, increased market share is a valid goal, particularly for a company to become one of the three largest players in the sector. This means that prospective customers are likely to be motivated to find out what you offer because of your visibility in the sector. Similarly, if the market leader is allowed to dominate the market, the number two and three players have legitimate concerns. So there

is sense in, say, the number two and three coming together to create a more serious competitor.

### **Acquire a niche business**

Niche businesses, which are relevant to your strategy and are market leaders in their segment, often prove to be robust acquisitions. The reasons are that their market share will continue to provide the momentum needed post-acquisition, and the smallness of a niche market means that other companies are unlikely to enter the segment.

An example is an international support services company that entered the hospital trust car park management segment by acquiring the market leader in the UK, and this helped them to expand geographically as well.

### **Broaden the product or service range**

The rationale for this approach is to achieve more of a one-stop offering to customers and clients, and benefit from cross-selling opportunities for other services. An example could be that a marketing services group acquires a public opinion survey company. Many companies have found, however, that it is much more difficult than expected to realize cross-selling benefits.

### **To enter an important distribution channel**

In recent years, supermarkets have carved a significant market share in selling wines and flowers. Likewise, some supermarkets have built up sizeable chains of small outlets serving local communities and inner city neighbourhoods. The route has been several acquisitions of local store chains, because it would take far too long to obtain planning permission and build new outlets or to acquire leasehold premises piecemeal.

### **To secure a key supplier**

Some companies are highly dependent on one supplier to provide a continuing source of supply. Whilst it can be argued that a second source should have been developed years ago, the reality now is that if a competitor acquired this vital source of supply it could cause serious problems. On the other hand, when a key supplier is acquired, other customers will seek alternative sources. Consequently, there needs to be a strong case to protect a key supply by acquisition.

If an important supplier approaches your company to acquire a minor equity stake, perhaps coupled with a loan, my advice is not to invest in these circumstances and instead to find or develop another source of supply urgently.

### **To provide cost rationalization opportunities**

Cost rationalization as a benefit of acquisition seems attractive. For many acquirers, however, unlocking synergy has proved to be as difficult as spotting the Loch Ness monster on a dark and foggy night. Successful delivery of post-acquisition synergy needs to be based on identified savings pre-deal! It is not enough to guesstimate that head office costs will yield a 20% reduction across the board. Specific individuals need to be identified and other savings rigorously evaluated.

### **Overseas acquisitions**

The highest risk category of acquisitions is probably overseas acquisitions. Anyone considering an acquisition of a company in a new market sector in a country where there is no existing subsidiary, should first of all learn to walk on water at the local swimming pool; in other words – forget it!

The lowest risk category is to acquire a bolt-on acquisition for an existing subsidiary overseas. Intermediate risk categories to extend geographical cover are to acquire a business in an adjacent market segment in a country with an existing subsidiary, but to acquire a similar business overseas in a country without an existing operation is a higher risk.

## **Kissing frogs is essential**

Some years ago a listed company told me that 12 unquoted companies had been acquired within two years and in every case the vendors made the initial approach. No other acquisitions had been identified. This stemmed from a new chief executive determined to consolidate a fragmented sector. Within a further three years the group was put into administration. The financial director told me that the board was flattered by these unsolicited approaches. The reality was the private vendors recognized a lucrative band wagon for them and jumped aboard. The company overpaid significantly, did inadequate due diligence and made a mess of integrating the businesses acquired.

In stark contrast, the most successful acquirers I have been privileged to advise probably considered at least ten targets, in a differing amount of detail, for every acquisition completed. In other words, they know that kissing frogs is a must!

## Commercial due diligence is vital

The single most frequent cause of an underperforming acquisition is that the acquirer took the commercial well-being of a target company on trust. The vendors sales pitch was enough to hook a deal. Ten years ago many acquirers ignored commercial due diligence, and some still do today. Private equity houses, however, are committed to commercial due diligence as a matter of routine.

Accountancy firms have an established track record in providing financial and tax due diligence, and many now offer commercial due diligence as well to maximize their fee income from a deal. Too often it is done by people who are resprayed auditors, as I call them, who lack commercial insight. Fortunately, specialist firms now provide commercial due diligence.

Some of the issues where commercial due diligence is appropriate includes an investigation of:

- customer satisfaction, compared against competitors
- the awareness and reaction of non-customers to the target company
- the distribution channels used, compared with rapidly growing, mature or declining channels
- the standing of the company as a potential employer
- the anticipated impact of technology on the sector and the target company

The key to commercial due diligence is to identify and focus on those issues which are most important for the future success of the particular target company.

## Opportunism is a must

It may seem to be a contradiction that my message is all about a measured and rigorous approach to every acquisition, and yet I regard opportunism to be a must. There is no contradiction whatsoever. Relevant acquisition targets decide when they wish to sell and you may be made aware of a sale by the corporate

finance adviser acting for the vendors. Provided that acquisition criteria have been formulated, preferably in the form of a written Acquisition Profile (described in Chapter 3) it will be easy to judge the relevance and importance, or not, of the target company for you. The timing of the vendors may conflict with your budgetary season, or whatever, so be it! Nonetheless, you need to pursue the opportunity.

I know of one chief executive who reacts differently. He is always on the look out for a bargain deal and commits resources to pursue every deal which crosses his desk. As a result, there is a massive waste of management time because there is no focus and he rarely ever completes a deal.

Receivership opportunities are another potential time waster. Within two days of the announcement of receivership, the receiver may announce that about sixty expressions of interest have been made. Only a handful of prospective acquirers will be invited to meet the receiver, and they will be expected to respond as a matter of urgency. So, first of all, decide that the opportunity really is relevant before making any contact.

If the business is acquired from receivership, management must be injected from the outset. It is absolutely naïve to think that installing a good finance director will restore success. A stand-alone business requires a full-time chief executive and a finance director, and there is no substitute for a chief executive with successful turn-around experience.

A controlled auction of a business may prove to be a major time wasting exercise. The first step is to understand the typical controlled auction process:

- The sale of a business, usually a division or subsidiary of a group rather than a private company, will be announced in the press by a news article and not by an advert.
- In addition, the corporate finance advisers may contact selected bidders at home and overseas to make sure that people are aware of the opportunity.
- Prospective purchasers will be required to make a written offer, typically within four to six weeks, and without any contact with the management team. The offer needs to be made purely on the lengthy information memorandum prepared by an accountancy firm on behalf of the vendors.

- Up to 25 offers may be received, and these will be reduced to five or six – and may include an MBO from the management team or private equity players acting as principals.
- The short-listed bidders will be given access to an on-line ‘data room’, and invited to carry out the bulk of their due diligence and to meet the management team. Often the vendor will release the draft Share Purchase and Sale Agreement to be used.
- Typically only about two or three weeks will be allowed to submit a final offer, which may be higher or lower than the initial offer.
- Usually two bidders are selected, with one of them ‘kept warm’ in reserve, and the aim is to rapidly complete any outstanding due diligence and to have final negotiations prior to legally completing the purchase.

The fundamental difference compared with the usual sale process is the timing of due diligence.

In a controlled auction, a substantial amount of due diligence needs to be done prior to the second round of offers. This requires not only in-house management resources, but costly work which needs doing by third parties and you may not be selected to go forward as one of the two preferred bidders.

In contrast to the usual sales process, Heads of Agreement are signed and a period of exclusivity given to the prospective purchaser to carry out due diligence and complete the deal.

Consequently, the risk of abortive management time and due diligence fees is much greater in a controlled auction. So there is a clear cut message – do not enter a controlled auction unless the target really is relevant for you and you believe that you are well placed to be successful.

## **Mergers should never happen – well, hardly ever**

Probably only one in ten merger attempts result in a completed deal. Why? The two companies simply fail to agree on the split of the equity. Merger attempts often start out in an amicable way, because the people involved have ‘known’ each other for years, and end in recriminations and annoyance that so much management time and advisory fees have been wasted.

Two issues need to be agreed at the outset:

- the split of equity, which may require one party to inject cash or extract it, to achieve the desired split; and
- the top management structure agreed by job definition and choice of individuals. It is nonsense to even think of joint managing directors, joint marketing directors or whatever. There will be too many directors and some will need to leave.

Only when the equity split and management team have been agreed, should advisory fees be incurred. An awful situation is where each party appoints corporate finance advisers to value both businesses or to recommend the equity split and any cash adjustment needed. Worse still, I know of cases where each party rejected the proposal and agreed to have a third advisory firm, and yet more fees, to decide what is fair. Even this may well result in deadlock.

## **Stock market listed acquisition targets**

Failed attempts to acquire a listed company are expensive and the ensuing press coverage may be adverse. If the bid is to be hostile, higher bids may be triggered. When a bid approach is made on an expectation of an agreed offer, the likelihood of success is greater but other bidders may still come forward.

My advice is not to attempt a hostile bid unless there is a compelling commercial rationale and a rigorously evaluated likelihood of success.

Whether friendly or hostile, however, an investment bank should be appointed to advise well before any approach is made. Stock exchange regulations require a 'standard' timetable to be followed and careful handling of the transaction to ensure that the correct procedures are followed, so these situations are outside of the scope of this Special Briefing.