Dr. Tom McKaskill

MASTERCLASS FOR ENTREPRENEURS

on

Acquisitions

INSIGHTS ON DEVELOPING A SUCCESSFUL ACQUISITION PROCESS

BREAKTHROUGH PUBLICATIONS

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Key Insights

Most acquisitions fail to achieve the intended benefits because a systematic process of evaluation and post-acquisition was not followed.

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Remember that what can go wrong, probably will.

Dr. Tom McKaskill

Global serial entrepreneur, consultant, educator and author, Dr. McKaskill has established a reputation for providing insights into how entrepreneurs start, develop and harvest their ventures. Acknowledged as the world's leading authority on exit strategies for high growth enterprises, Dr. McKaskill provides both real world experience with a professional educator's talent for explaining complex management problems that confront entrepreneurs. His talent for teaching executives and his pragmatic approach to management education has gained him a reputation as a popular speaker at conferences, workshops and seminars. His approaches to building sustainable, profitable ventures and to selling businesses at a significant premium, has gained him considerable respect within the entrepreneurial community.

Upon completing his doctorate at London Business School, Dr. McKaskill worked as a management consultant, later co-founding Pioneer Computer Systems in Northampton, UK. After being its President for 13 years, it was sold to Ross Systems Inc. During his tenure at Pioneer, the company grew from 3 to 160 people with offices in England, New Zealand and USA, raised venture capital, undertook two acquisitions and acquired over 2,000 customers. Following the sale of Pioneer to Ross Systems, Dr. McKaskill stayed with Ross for three years and then left to form another company, Distinction Software Inc. In 1997 Atlanta based Distinction raised $US 2 million in venture capital and after five years, with a staff of 30, a subsidiary in New Zealand and distributors in five countries, was sold to Peoplesoft Inc. In 1994 Dr. McKaskill started a consulting business in Kansas which was successfully sold in the following year.

After a year as visiting Professor of International Business at Georgia State University, Dr. McKaskill was appointed Professor of Entrepreneurship at the Australian Graduate School of Entrepreneurship (AGSE) in June 2001. Professor McKaskill was the Academic Director of the Master of Entrepreneurship and Innovation program at AGSE for the following 5 years. In 2006 Dr. McKaskill was appointed the Richard Pratt Chair in Entrepreneurship at AGSE. Dr. McKaskill retired from Swinburne University in February 2008.

Dr. McKaskill is the author of eight published paperback books for entrepreneurs covering such topics as new venture growth, raising venture capital, selling a business, acquisitions strategy and angel investing. He conducts workshops and seminars on these topics for entrepreneurs around the world. He has conducted workshops and seminars for educational institutions, associations, private firms and public corporations, including KPMG, St George Bank, AMP, AICD and PWC. Dr. McKaskill is a successful columnist and writer for popular business magazines and entrepreneur portals.

To assist Angel and Venture Capital investors create strategic exits for their investee firms, Dr. McKaskill conducts seminars, workshops and individual strategy sessions for the investor and their investee management teams.

Dr. McKaskill completed six e-books for worldwide distribution. He has also produced over 150 YouTube videos to assist entrepreneurs develop and exit their ventures.

Tom McKaskill is a member of the Brisbane and Melbourne Angel Groups and of the Australian Association of Angel Investors.

Dr. Tom McKaskill

Australia

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info@tommckaskill.com

www.tommckaskill.com

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Preface

If you are a large corporation with a team of staff assigned to merger and acquisition activity, you at least have some capacity and capability to undertake an acquisition and achieve positive results. Although it is surprising just how badly the activity is undertaken. Research shows that about 70% of all large scale mergers and acquisitions fail to achieve positive shareholder returns. So one might ask about the state of knowledge in many large corporations.

The smaller firm is not so fortunate. They have nether the capacity nor capability to take on the daunting task of a large acquisition. Furthermore, it is usually the case that the senior management team has little or no prior experience of undertaking an acquisition. Yet it is quite common to see medium sized firms rush into an acquisition. It is not surprising that the results are often a disaster.

To my surprise, I discovered that the vast library of books and articles on the subject of mergers and acquisitions did little to help the smaller firm. They are mostly written for large scale acquisitions and often in an academic style which could only be understood by fellow academics. I therefore set out to write about the experiences of the smaller entrepreneurial firm and the strategy they should follow to achieve positive results in acquisitions but to do this with their limited capacity.

My own experience of acquisitions comprised two times when my firm purchased other firms and two times when we ourselves were purchased and I stayed some time with the new owners. One successful acquisition and three failures. So I have been in the center of both the negotiations and subsequent operations.

What is very clear from my own experience and reading of the literature is that few people understand the level of change and disruption that an acquisition brings with it. Generally it happens over a short period of time, it is a significant investment and it is highly disruptive in both the buyer and vendor firms. Thus a formal systematic approach to the selection, negotiation, integration and management of the vendor form is required for success.

At the same time, few people appreciate that you can undertake an acquisition and yet limit the level of change and still achieve very significant benefits. You don't have to merge operations. We don't all have to look the same. We can often offer more to the newly acquired firm than they can offer us with a very good outcome. It just needs a new way of thinking.

Clearly cultural change is under-rated. If anything is going to undermine achieving benefits in an acquisition it is going to be the people dimension. This is where you need to put considerable effort both before you commit to the deal and after .

However, a systematic process of acquisition can be highly rewarding. It just needs to be carefully thought through and adequately staffed.

PART A: STRATEGY

In the majority of cases, failure to achieve positive results from an acquisition is mostly a failure to undertake basic strategic thinking. Why are you doing it? How are you doing it? What are you doing to manage the process and ensure success?

Basically, back to the fundamentals. Few companies have a systematic approach to acquisitions and these are the ones who are most successful. Too often the evaluation is rushed, the assumptions are not checked and ego and emotion dictate the outcome. Mostly a recipe for a disaster.

In addition to a strategy, you also need to be honest on what you can take on. What capability and capacity do you have to undertake and acquisition. Very easy to end up in a crisis situation which can take down the business you have put so much effort into.

So take the time to do it properly.

OVERCOMING CONSTRAINTS

An acquisition strategy can be a cornerstone for growth

If you are a high growth enterprise then you will almost certainly be bumping up against some growth constraints. Few people appreciate just how difficult it is to maintain a double digit growth rate and, in fact, only a very small percentage of companies are able to do so. Those that do often use acquisitions to overcome capability and capacity roadblocks.

Imagine that you have a business which has 100 staff and you are growing at 50% per annum. That means that you will have another 125 employees in two years. If you experience a 20% attrition rate, you will be recruiting an additional 50 staff to replace those who have departed. Couple this with additions to office or factory accommodation, telecommunications and IT infrastructure and you can start to see the size of the task. The business today will look very different from the business in two years time. With such a growth rate, major changes are likely to occur in organizational structure, reporting systems, location and product/markets interfaces every few years.

Just the task of recruiting that number of new employees and absorbing them into the ever changing organization is a challenge. When this is taken together with the search for new office accommodation, upgrading infrastructure and acquiring specialized equipment to support the growth, you can see just how mammoth the problem is. Now add the problem of financing such growth and watch the banks scurry away as they recognize that you don't have the asset base to guarantee the debt and you can see why acquisitions suddenly take on an attractive dimension.

Acquiring already trained staff is a priority for any business which has difficulty finding knowledgeable, qualified or experienced staff. When you need to do that in significant numbers, buying a business which has a stable workforce which can be easily moved to supporting your marketplace certainly makes a lot of sense. Acquiring finance to support such an acquisition can also be easier as the acquired firm may have assets or be generating sufficient free cash to support the borrowing. Alternatively, a share swap may be used to acquire the business in a situation where new external capital may be difficult to raise.

If you are fortunate to be generating excess demand then acquiring capacity to service that demand may be a very smart growth strategy. Buying a firm which has under utilized plant or has ready access to additional capacity, can allow the acquirer to take on major growth spurts without the pain of having to build out the capacity themselves. Such a move might also be relatively easy to finance especially if the added capacity can quickly generate additional cash to service the new debt.

Acquisitions are also frequently used to access new technology, acquire specialized expertise, enter new markets or secure key customer or supplier relationships. While acquisitions come with their own challenges, perhaps the key here is to be very clear what contribution the acquired business is making to the overall growth strategy and to ensure that the evaluation and subsequent management of the acquired people and resources keeps the investment objectives firmly in focus.

DIRECTION

Acquisitions by SMEs

In a buoyant economy with relatively low interest rates and near full employment, emerging companies need to look to acquisitions to solve their growth problems. Acquisitions have always been a strategic path for large corporations seeking growth. Now the SME sector faced with difficulties recruiting staff will need to undertake acquisitions to acquire skilled staff, channels to market and/or complimentary technologies or products. However acquisitions are not without their challenges and the smaller firm needs to be very cautious before putting their hard earned fortunes at risk.

Acquisitions are often a key part of the strategic plan for the entrepreneur looking for rapid growth. Some are using acquired assets and capabilities to provide a better base for a strategic sale of their business while others are developing a platform for an IPO. Once listed, many small capital businesses are utilizing the liquidity of the stock exchange to provide exit paths for the owners of businesses being acquired. Others are using a strong cash flow to service debt finance to allow them to acquire businesses. More and more businesses are using combinations of debt and equity to leverage their growth. At the same time, larger corporations are divesting parts of their business to release cash for better investment opportunities, to improve the debt position or to get rid of poor performing business units. These provide a feeding ground for the SME seeking growth assets.

Entrepreneurs that have not been involved in acquisitions before can, however, be sadly misled with the belief that an acquisition could be a quick fix to their growth problems. There are countless businesses that have destroyed acquisition value through poor management of the integration process, a clash of cultures or a misalignment of businesses. Managing the acquisition process is something few do well and thus the beginner should not assume that it will happen all by itself. Often the selling entrepreneur that joins the merged business is very disappointed with the lack of support, empathy and knowledge that was given to the integration activities.

Graeme Browning of Ernst and Young Transaction Advisory Services has a clear understanding of how the best firms manage the acquisition process. “Only 25% of the private firms generate increased returns from an acquisition. Those that do are experienced acquirers, have developed a very strong investment justification process to evaluate potential acquisitions and have a well developed acquisition and integration strategy”.

Small high growth firms are especially at high risk in an acquisition activity, particularly if it is their first. Most emerging firms are short on resources and thus the executive time that is needed to evaluate and manage an acquisition can severely disrupt on-going operations, especially if the process goes awry. Few firms have spare cash and thus don’t have the slack to cover an extended investigation or lengthy integration effort. If key staff decide to walk, the effort required to recruit and train new employees can severely drain senior executive time. Basically, if they get it wrong, their entire business could be in jeopardy.

In the first acquisition I undertook, I ended up suing the prior owners in the US federal court system. The process took over 5 years and used up over a year of my time during the process. A more thorough pre-acquisition investigation would have uncovered the problems and the purchase price would have been renegotiated and the litigation avoided. I recall that, when one of my firms was acquired, the purchaser failed to appreciate the level of support our products required and the business ended up losing every reference site within 18 months, sending the combined business into a loss for several quarters until the customer service systems were redesigned. On the other hand, the last acquisition I made of one of my distributors was near perfect without a single disruption to the combined business. I had learned some hard lessons from my earlier experiences.

Many unlisted firms undertake acquisitions where shares are issued instead of cash and the resultant company is a merger of the two former businesses. In the process, the management teams and shareholders are merged and the business has to come up with a new structure that incorporates all the former players. This is an incredibly difficult outcome to achieve and should not be undertaken unless there has been a long period of time working together before the merger. You can only really appreciate the culture of a business by spending time getting to know it.

According to David Harding and Sam Rovit in their book “Mastering the Merger”, the successful acquirer is one that has the experience, investment evaluation and integration processes to successfully leverage targeted acquisitions.

Using this template as a guideline, the entrepreneur needs to put the preparation time in first and get some good advice. There is some good literature available in the acquisition and merger area and time spent reading would not be wasted. Then the firm should consider employing an executive experienced in acquisitions and/or working with external consultants and professional advisors to develop an acquisition strategy and an investment evaluation process. Finally a realistic plan should be developed for the integration of any acquisition. This is one of those times when you either do it properly or not at all!

STRATEGY

Make it part of your strategy

Too often acquisitions fail to deliver a positive outcome because they are sidelined when more important aspects of the business need attention. An acquisition which is undertaken to drive revenue growth but which is not core to the overall strategy of the business, has a much higher chance of failure than one which is fundamental to achieving the major growth objectives of the business.

If we are to be brutally honest, few acquisitions are going to proceed without some level of disruption to the acquired business as well as to the buyer's operations. Most acquisitions generate high levels of uncertainty about the future. While we anticipate this in the vendor's business, few corporations adequately consider this within their own organisation. Vendor employees will be concerned about their job security, job descriptions, location, benefits, new reporting structures and even minor issues such as their right to a car space, whether they can still take a previously booked holiday and what biscuits they get with morning tea. However, over at the acquired business, they may be wondering whether some of the newly acquired staff may take over their jobs or deny them anticipated promotion. These personal issues impact productivity, on-going external relationships and even people's willingness to stay long enough to see the changes through. Resignation rates at both the vendor business and the acquirer can be expected to dramatically increase in the periods immediately before and after an acquisition.

Such changes are disruptive, placing additional strain on remaining staff and creating knowledge gaps in organizational capability. Managers are then under pressure to change work duties, replace departing staff and manage stress points in those who remain. If this situation wasn't bad enough, now consider who is taking on the acquisition tasks.

Given the size and impact of an acquisition, few senior management will be untouched by the activities involved in evaluating the fit of a potential acquisition, the tasks of due diligence and then the subsequent management of intervention and integration activities. They need to undertake all this while they are also coping with staff needing individual support and managing resource changes and disruptions in their current organizations. Little wonder then that most senior management will focus on shoring up their own activities before they will give full attention to those of the acquired business.

Basically, marginal acquisitions can be expected to get marginal support in a time of crisis. Unless success in the acquisition is critical to senior management achieving their own departmental objectives, you can expect problems at the acquired firm to take a long second place to problems closer to home. Anticipating such a reaction can, however, greatly assist an acquisition strategy. It is clear that senior management resources need to be set aside during the acquisition process. This can either be achieved through internal succession planning to ensure that current operations are well catered for or by acquiring new resources which can be dedicated to managing acquisition activities. Probably some combination of these two extremes works best in most instances.

What is very clear is that the success of an acquisition must be the principle objective of at least some senior executives and that, the more central to the core objectives the success of the acquisition is, the more likely it is to receive the attention it needs.

FAILURES

Failure rates are high

How many firms would be willing take on a major project which had an expected 70% failure rate. This is the rate of failure of major acquisitions according to numerous research studies over the last 20 years. However, you need to be careful how you interpret the data. Most of these research studies are based on the movement in the share price of publicly listed acquirers in a short period before and after the acquisition. The assumption has been that a drop in the share price soon after the acquisition indicates a failure to enhance shareholder value as a result of the acquisition.

Other studies have shown a significant loss of acquired senior management within nine months of the acquisition, frequent losses on the subsequent sale of an acquisition and significant delays in achieving integration objectives.

You do need to be cautious with these results however. Share price movements over a short period after an acquisition are not necessarily indicative of long term results. Losses of acquired executives and delays may be anticipated by the acquirer and be factored into the evaluation. Even so, it is not unreasonable to expect a high rate of failure as many large scale acquisitions take on a level of risk which well above that which most corporations experience in their normal investment projects and few have the experience to handle such change situations.

Few companies really appreciate the size of the task they take on with a large acquisition. In many cases it will be the largest investment a business makes, certainly on a grander scale than, say, the investment in a new factory or the entry into a new marketplace. At the same time, this is a project which is undertaken over a relatively short period of time, often just a few months of evaluation and negotiation and yet it can significantly change the size and structure of the acquirer. Such a project can also be highly disruptive to both the acquirer and the business being purchased and all this is going to happen in a condensed timescale. No wonder few companies get through it unscathed.

The of course there are corporations who have a long record of acquisitions success. What do they do differently? Generally they fall into two camps, those who are undertaking consolidations of similar business and allowing them to remain as stand alone business and those who are buying small firms with high strategic value. Avoiding large scale integration seems to be one way of ensuring a better outcome. Alternatively taking on a smaller firm where the upside is significant and the organizational impact is low seems to be the other successful strategy.

While there are numerous things which can go wrong in an acquisition, the most frequent causes would appear to be based on cultural differences and the failure to integrate organizational units or to manage the people aspects of the acquisition. Too little effort seems to have been put into anticipating employee concerns both within the acquirer and the acquired businesses. Losses and delays due to high levels of uncertainly resulting in resistance, disruption and loss of productivity appear to be common outcomes. Managing change would seem to be a talent which few corporations are good at and many ignore until it is too late. Perhaps a lesson in this for all of us!

THE WRONG APPROACH

Allowing emotion and ego to dictate

There are far too many large scale acquisitions which are dictated by senior management ego than objective analyses of the underlying profitability generated by the investment. If you think that this is limited to large companies, then think again. SME entrepreneurs who want to grow aggressively are often so consumed by the vision of being bigger that they often fail to see the obstacles in the deal. Too often the larger salary and benefits which they anticipate from being bigger colours their view or they want to be seen at the head of a larger business and see an acquisition as a quick path. Few anticipate the problems ahead in actually bedding down the acquisition and making it pay off.

Large corporate acquisition and mergers are often done by professional management on the justification of being bigger to compete better, gain access to funding markets previously out of reach or to fend off anticipated competition or market changes. But one wonders whether it is the personal benefits that accrue with size that are the underlying motivations. The fact that such a large portion of acquisitions fail to achieve positive shareholder value must inevitably lead to such a conclusion. But smaller owner managed firms are most often managed by the most significant shareholder – why would they take such risks?

We cannot assume that all owner mangers are knowledgeable about the risks inherent in an acquisition nor that emotion and ego do not play a role in 'seizing the moment'. Many acquisitions occur due to unexpected opportunities to acquire or to owners seeing an acquisition as a way out of a difficult situation. In the heat of the moment the obvious benefits provide the stimulant to bring the deal to a head. What is generally missing is a thorough evaluation of the target and/or a well thought out fit with the underlying core strategy of the business.

Opportunistic buying is probably the most risky. Suddenly a business comes on the market and time is of the essence. Often the prospective buyer was not even considering the target firm as a suitable acquisition but, now, time is of the essence if the business is to be acquired. In this scenario there are often professional advisors and business brokers eager to show just why such an acquisition would be a good fit, with often spurious benefits. At the same time, the potential buyer is enamored with the thought of all the benefits which would accrue personally and to his business if his business was bigger and had the capabilities and capacity generated through the acquisition.

In this idealistic world, the prospective buyer has neglected the costs, delays and disruptions associated with an acquisition. He or she has also forgotten that the current business is taking up all their available time and resources and undertaking an acquisition will stretch them to the limit. Even an efficient and well managed acquisition can be a challenge, imagine if the acquired business has put onto the market because it faces problems. Instead of generating incremental benefits for the buyer, it is more likely to negatively impact the acquired business.

The bottom line is that successful acquisitions fit neatly into the core strategy of the buyers business. More often than not, the acquired business has been targeted for consideration and the buyer has a clear understanding of how to extra key benefits from it. Few opportunistic acquisitions work out positively. If you want to be successful growing through acquisitions then ‘leave your ego at the door!.

CAPABILITY

What capability do you have to execute and acquisition strategy?

Not everyone can or should undertake an acquisition. Even if you do decide to plunge into this activity, you still may not have what it takes to acquire certain types of businesses. Understanding what you are capable of is a critical part of an overall acquisitions strategy. Too often acquirers have failed to achieve a return on their acquisition investment because they took on an acquisition task which was way beyond their knowledge, skill and experience level. In most cases, they were not even aware of the problems they might encounter. The critical lesson here is to only take on what you can confidently manage.

Acquisitions can be very complex projects. The entire cycle of target selection, evaluation, negotiation and post-acquisition integration requires many different skills and a wide range of professional expertise. Not only will there be contributions required from several different functional areas within the acquirer but external advisors will need to be integrated into the acquisition evaluation, negotiation and contract stages. The tasks range from competitive market analysis, legislative compliance requirements to complex change management processes. It is highly unlikely that any one person will have the knowledge and experience to cover all tasks and so some level of project management is also required to ensure everything is undertaken at the right time.

The greatest danger for any business is to take on a complex activity without proper preparation. The landmines are in what you don't know, not what you do. Thus preparation starts with an understanding of the acquisition process and mapping your capabilities onto the various types of acquisition activities so that you build up a list of what additional training is required, what further specialist resources need to be brought in and, especially, what acquisition projects you are capable of managing. Acquisitions vary enormously in terms of degree of complexity, level of analysis required, degree of post deal intervention and integration and the level of difficulty of managing the operation once it has been adapted to your use. Once you have worked out what you are capable of undertaking, even with external assistance, you can then limit your acquisition projects to ventures which have a highly probable chance of delivering positive returns.

Start with finding out what prior experience your own management team has with being the acquirer or the acquired. Find legal and financial service providers who can provide you with some training on the process. Often you can get them to do this as part of your own due diligence in selecting your advisors. Bring in a project manager with operational experience of integrating acquisitions if you don't have that experience in-house. Buy some relevant textbooks on acquisitions and have your senior management team gain some basic understanding of the process. Ask your external advisors to provide you with some relevant articles and case studies to read to give you a feeling for what goes wrong and what the best practices are.

Acquisitions are often the largest single investment companies make and they undertake them over very short period of time. They can be highly disruptive to the existing business as well as to the acquired firm. You owe it to yourself and to your investors and employees to only take on an acquisition activity which matches your capability of managing it to a successful conclusion.

CAPACITY

Do you have the capacity to undertake an acquisition?

Few first time acquirers have any idea of just how much time and effort will go into an acquisition. Usually they acquire a firm similar to their own, with similar or complementary products or services and often in their local geography. Most often they have been sensitive to not taking on a business which is too different or at a great distance knowing that the risks are likely to be too high. What they usually have not predicted is just how much senior executive time the process will absorb, how disruptive to their business the activity will be or what level of funding it is going to take to see it through to a successful conclusion.

The lead up to an acquisition is something of a courting process. Everyone wants to know as much about the other as possible before they make a commitment. There will be many dates that don't work out and some that linger well past their use by date. Even the most likely partners will go though some rocky times as they miscommunicate intentions or get sidetracked with red herrings. There will be many more meetings than expected, the service providers will use up more time than budgeted and the negotiations will be more complex than hoped. To limit the risk of the wrong decision, several members of the senior management team will be asked to investigate various aspects of the target business or the projected post-acquisition organization. All this activity is done under pressure to close the deal and can lead to a lack of attention to normal business with resulting loss of customer goodwill and revenue loss or delay.

Even once the deal is done, the pressure does not let up. There will be numerous issues to deal with in terms of change of ownership, integration or intervention activities and problems of redundancy, new organization structures, new internal and external relationships to establish and various infrastructure changes. All this is done during a period of rapid change and the loss of some staff, both in the acquired firm as well as the acquirer. In this period of disruption, funds also have to be found to keep the existing business going as well as finance the acquisition.

What this tells us is that acquisition are highly complex, disruptive and resource hungry. They require considerable high level management attention as well as some level of dedicated project management and change management resource. The bottom line – if you are not well prepared and resourced to take on an acquisition, it may be the worst mistake your business will make.

However, not all acquisitions look the same. Many types of acquisitions can be undertaken with less disruption to the acquired business as well as the target firm. An acquisition strategy should be able to factor in what level of management intervention is needed throughout the various stages of the process. External specialist can be used throughout and short term contracts can be used to provide some of the resources required. Management needs to be sensitive to their involvement and put in place succession plans for when they are away working on the acquisition project. Simply put – only take on what you can successfully manage.

ONE SIZE FITS ALL

Do you need to change an acquisition

One of the fundamental mistakes made by acquirers is to make changes to acquired firms which really do not add anything to the benefits received. Too often the buyer imposes a 'one size fits all' approach to an acquired firm on the assumption that the only way to do business is the one used by the buyer. Not only does this fail to appreciate that there may be processes which are superior in the acquired firm but it risks disrupting business capabilities which were working well in the first place. Not everything has to be the same to create value!

There is a class of acquisitions where the benefits accrue to the buyer where the acquired firm can be left unchanged. When you consider the nature of strategic value, you often find that assets or capabilities can be passed from the seller to the buyer. So, for example, if we buy a business to take advantage of a brand, copyright, regulated rights, patents or a unique process, we may be able to transfer the use of such assets or capabilities without disturbing the acquired firm. In fact, we may well wish the acquired firm to remain as it is if it has the capability to improve the value of transferred items or to generate new ones which the buyer can subsequently take advantage of.

One of the assumptions which business executives often make is that M&A is about merging business activities. Not only are these types of acquisitions highly complex and fraught with risks but they represent only a small part of overall acquisition activity. If you want to reduce the risks associated with acquisitions, you should be looking at ways in which value can be extracted with little or no change to the acquired business. If you focus your attention on how value can be created by transferred strategic assets from the seller to the buyer, or from the buyer to the seller, you gain the benefits of value creation often without the costs and risks associated with merging business units.

Roll up strategies will often deliberately set out to find target businesses which need little or no change. By focusing on businesses which are well managed, have robust revenue and profit capabilities and require little external input, the consolidator gains the benefits of scale without the problems of putting many firms together. A more advanced strategy would provide centrally held IP in the form of brands, improved performance setting and reporting systems and central specialist advisory services to improve overall profitability. Often these additional benefits to the acquired firm can be absorbed slowly over time resulting in a smooth transition to additional value capture.

The focus in an acquisition strategy should be to zero in on the specific capability or capacity which the parent needs. If that can be acquired without disrupting on-going operations of the acquired firm, the benefits can be exploited with much less risk to both companies. Making changes which have little incremental effect on value generation makes little sense if they introduce risks of staff loss, business disruption and the delay of value exploitation.

BEST PRACTICE

Frequent successful acquirers

If you were guided by the statistics which show that the majority of acquisitions fail to achieve the anticipated benefits for the acquirer, you would probably not go down that path as an expansion strategy. Even so, some frequent acquirers are consistently successful so there must be some accumulated wisdom out there which can help the prospective acquirer avoid the most common mistakes.

The major problem is that acquisitions are highly complex activities which occur over a short period and can often severely disrupt both the acquired firm as well as the buyer. Many corporations take on an acquisition without first building up knowledge of the process and then wonder why it all goes badly wrong. Too often acquisitions have been driven by a desire to be bigger rather than smarter. If you look at successful acquirers they not only go about the process in a highly systematic and objective manner but they are very careful about which risks they take on.

The research into successful acquisition strategies reinforces the view that it is better to walk before you run. Risks can be limited by starting out with small acquisitions where the impact of failure is contained. One could argue also that taking on acquisitions which are left as stand-alone entities, even if some aspects of the business are enhanced, avoids the pitfalls awaiting those who jump into merger activities. There are, in fact, many forms of acquisitions which leverage IP or capability of the acquiring firm into the newly acquired subsidiary without merging operations. These limit the impact of the acquisition on the acquirer while making marginal changes to the purchased entity.

Smart acquirers tend to buy well run companies and avoid fire sale or firms in trouble. Firms which are under performing often need considerable remedial work to bring them up to a sustainable level. This not only eats up quality management time of the acquirer but extends the time over which the acquisition can be made self supporting. A smarter acquisition strategy is to target firms which can quickly take advantage of the economies of scale, cost saving synergies or intervention activities of the acquirer. A business which is already well managed and has sustainable profits does not require urgent intervention and so the acquirer can take more time to make those changes which are beneficial to the acquired entity.

Frequent acquirers build corporate intelligence over time through a series of small acquisitions until they have a set of refined processes for targeting, evaluating, negotiating and managing acquired firms. They buy throughout the economic cycle and pace themselves in terms of how much activity they can absorb as they expand. They stick to their evaluation criteria and investment hurdles and don't take on something which they cannot easily manage.

The fundamental lesson for the new acquirer should be to take it slowly, start small and access the best experience that can be afforded. Acquisitions are one of those activities where getting it wrong can put your entire business at risk.

LET THEM GO

Watch out for the entrepreneur

Almost without exception, entrepreneurs make really bad employees, so if you are in the acquisition business, be warned. Not that this should come as a surprise to another entrepreneur. After all, the very nature of the entrepreneur is that they carve out their own future. Working for someone else is really not on the agenda.

I recall my very first Chairman, a person with considerable large corporate M&A experience, saying that they always got rid of the entrepreneur as soon as possible. When I asked him why, he commented that they really didn't fit in to a corporate structure (unless they were at the top). They resented having to be accountable, didn't like committee decision making and absolutely didn't like to have to wait to get permission to do something.

However, it is not just the decision style of the entrepreneur which fails to fit into a corporate culture, you need to put your self into the shoes of the entrepreneur once the deal is done. They usually have worked for many years to build value in the business and almost certainly want to take a break. Remember that they are now cashed up so the 'fire in the belly' is now gone. They don't need the job. They now have sufficient wealth to do whatever they want to do and the last thing on their mind is taking orders. They may well have another venture they wish to pursue, another business on the side they want to put their efforts into or they may simply want to take time to give back to their community in some way through a not for profit involvement. Many would rather try their hand at angel investing and get caught up in the excitement of building another business with others.

This scenario is not always the outcome but it has a high probability of happening. Whatever you do, you need to take into account that you do need to move loyalties to the new owner, you may need to introduce new reporting lines and new performance disciplines. In the end, you are almost always better off moving the entrepreneur into a different role inside the organization away from their baby or simply see them out the door and let them get on with their new life.

You also should recognize that a similar case can be made for most of the senior executives. Most will have enjoyed working at the top level in a small company and not find it conducive to work inside a large corporation. Also remember that many of them will cash up at the same time as the entrepreneur and their future agenda may be very different from yours.

You simply have to be realistic and recognize that you will either want most of the senior team to leave or they will leave of their own accord. What this means for your acquisition strategy is that you need to build this potential loss into your evaluation and be sure that you can achieve the acquisition benefits without them.

ADVISORS

Beware of commissioned advisors

The problem of buying advice is you don't know if you have received value for money until after you have used the advice and, even then, it may take some years before the results can be ascertained for you to make a judgment. When the advisor is remunerated by a commission on the transaction rather than the quality of the outcome, there is an inherent conflict of interest. This situation is especially problematic in an acquisition situation where the advisors are paid on the value of the transaction rather than the acquisition objectives achieved.

I have seen numerous situations where entrepreneurs were encouraged to enter into acquisitions where the advisors were pushing the deal but the acquirer really did not have the capability or capacity to enter into the transaction. Perhaps we shouldn't really expect any other relationship, after all, the advisors are there to sell their services and they don't get paid unless a deal occurs. If we are willing to enter into such arrangements, we are naive to expect any other result. That is not to say that all advisors act this way, but how do you tell the good from the bad.

What we have in this relationship between advisor and client is a conflict of interest in the way in which outcomes are used to reward the parties. If I as an advisor get paid regardless of the quality of the outcome, I may not put as much effort into ensuring the right transaction is undertaken, especially if I end up putting lot of effort into rejecting the wrong ones. The better advisors want to be part of the journey for a long period of time and earn fees over multiple transactions so they have an interest in ensuring you come back to them because of the quality of the prior outcomes but not all advisors have a long term view of a relationship.

What this means is that you have to be very careful with whom you engage. You need to treat your advisor like any other critical supplier and do your homework. Undertake due diligence on them in the same way that you would investigate a potential acquisition. You can learn a lot by seeing how they work and what processes they use to identify possible acquisition candidates for you. If they suggest spending time working with you on the strategy and acquisition criteria and they bring their experience into that discussion, that should help with the assessment. Talk to their other clients and ask about the outcomes of prior acquisitions several years after the deals were done.

What you want in an advisor is a partner who will go the distance with you. Rather than force them into a take or leave it commission arrangement, discuss a fee for service arrangement where they help you with strategy and process before entering into a transaction. See if they will take part of their remuneration in deferred commission based on acquisition outcomes being reached. Their rewards need to be aligned with your own objectives otherwise it is a partnership which has a high potential to steer you in the wrong direction.

SOURCES OF FINANCE

Loans or equity finance

It is a very rare SME which has a war chest for acquisitions. Most of us have to go begging for the money to fund an acquisition. While banks are somewhat sympathetic to financing growth through acquisitions they are still risk adverse and still want to see their risks mitigated by asset coverage. On the other hand, equity is a possibility but it does dilute the existing shareholders. Given that the future is never guaranteed, finding a solution to the finance problem takes some work.

The problem with the choice between equity and debt financing is that it represents two risk extremes. On the one hand, the bank needs assurance the debt can be serviced with interest payments and they want to know they will get their money back from capital repayments. On the other hand, when equity is used to finance an acquisition, the business has no contractual obligation to pay dividends and investors take the risk they might lose all their investment.

While many people complain that the banks are inflexible and unreasonable in their lending policies, we need to take into account their risks. A bank which is trading on a 2% differential between the costs of borrowing and lending has to do 50 times more lending to make up for a bad loan. You would have to be a brave bank manager to extend a loan without adequate cover on both the interest payments and the capital repayments. So bank finance has limited application in the acquisitions space.

When you get to the other extreme and raise equity you face another set of hurdles. If you are seeking venture capital or angel finance, you have about 1 in 10,000 chance of raising the funds. Even so, you will need to have an exit strategy for the investors which normally means a plan to sell the business. Not quite what you wanted when you are busy growing through acquisition but how else does an investor in a private company get their investment back. An initial public offering is a possibility but very few ever make it. Even if you can raise the money from private investors, you still have to convince your existing shareholders they will be better off with a smaller share of the business. Since most private investors prefer preference shares, they also have to agree to second place.

Looks a bit like somewhere between a rock and a hard place. However, debt and equity can work in some situations. A business which, after the acquisition, is a cash cow should be able to find a willing lender. A high growth potential business which has a strong exit possibility will have few problems raising equity. However, most businesses are going to struggle to find external debt or equity to fund an acquisition.

What this means is that the acquirer needs to build a war chest as a buffer for their acquisition strategy or find acquisitions which can fully or partly pay for themselves.

SELF FINANCE

Can the acquired firm finance itself?

Given that acquisitions are challenging, it is great when you can get a break. The one which we all seek, but rarely uncover, is when the acquisition can actually fund itself. While unusual, there are situations where this can work very well.

Most high growth firms face growth constraints which can often be best overcome through an acquisition. But at the same time, they are usually cash poor as they use whatever spare cash they have to finance their growth. Thus, while an acquisition may look attractive, they are unable to finance the investment. Finding an acquisition which can fund itself is thus a real win.

Perhaps the easiest strategy is to asset strip. There are many situations where businesses have idle assets which can be stripped out and sold passing funds back to the business. An acquirer who focuses on the core of the business might find a number of assets which can be sold off to generate cash. A similar exercise can be used to sell off non-core parts of the business with those functions being outsourced.

There are also situations where the business is being acquired for one specific asset or capability and the buyer has no need for the rest. Once the key asset or capability is secured, the rest of the business can be sold with the proceeds being used to pay off the vendors. Sometimes this can be done with little impact on the vendor business. For example, the acquirer might be interested in gaining ownership control over specific IP but might then license this back to the business as part of subsequent sale.

Anther technique which can be used is to sell and lease back assets of the business. Thus where the vendor has considerable land, building and plant, these may be able to be converted to a lease agreement so that the acquirer can release the value of the assets and yet continue with long term use of those same assets.

Some businesses have significant cash flow which can be used to finance debt, especially where the vendors have not used this resource themselves to finance debt. This can be attractive to a lending institution where the acquirer is able to provide additional guarantees on the debt.

Cash generation may also be used in situations where gross margins can be substantially improved following the acquisition. This may occur where the acquirer can reduce input costs or enable prices to be increased. The additional margins may be sufficient to service increased debt which can be used to finance the acquisition.

In order to set up these types of deals, the acquirer will have to find a lending institution which will underwrite the deal until such time as it can be refinanced. For this to happen, the acquirer will have to be very certain of the post acquisition changes which can be undertaken to refinance the acquisition. But it is certainly possible if you find the right target firm.

PART B: EVALUATION

The evaluation of a potential acquisition is non-trivial. It is a very complex situation involving evaluating the inherent problems, risk and liabilities of the vendor firm, reviewing the issues involved in making the change of ownership and then evaluating the potential benefits. Each of these areas is fraught with missing information, assumptions and hidden agendas.

The only way through is to have a well documented systematic process for evaluating the potential acquisition. Too often this is undertaken in an informal mode without proper consideration of the complexities of taking on an acquisition.

EVALUATION

Poor evaluation of benefits

Some acquisitions are not worth doing and others should have been done. It is amazing how poorly potential buyers identify and analyze potential benefits that accrue from an acquisition. More often than not, the focus is on the obvious without consideration for secondary benefits or they fail to see that the obvious benefits are undermined by serious failings in other parts of the business. Too often the analysis is undertaken at a surface level thus missing underlying problems or obscure opportunities. It is no wonder that so many acquisitions fail to deliver a positive return on the investment or fail to achieve the anticipated acquisition objectives.

Probably the most serious shortcoming of most acquisition evaluations is to look at historical performance without considering what the business might be capable of under new management, especially with the loss of the former owner. By focusing on the historical performance, the intended buyer misses two major insights, what the business would do without the former owner and, secondly, what the business might be capable of if the buyer concentrated on its potential rather than its history.

Few acquired businesses can duplicate what they did in the past. They either grow with renewed management, more resources and the application of new knowledge or they falter where the new owners don't have the knowledge, resources or experience to take the business forward. In evaluating the future of a business, it is what will happen to it in the future which is important, not what it has done in the past. While the past might give some indication, many things will change during the transition from one owner to the next, thus basic assumptions about the nature and capability of the business need to be challenged.

What is needed is a systematic process for analyzing the current and future performance of the business. This must be done at both a financial level and an operational level. We should be interested in both how the firm got to where it is, but also whether it has the underlying capability and capacity to continue in its present form. This means reevaluating the product/market interface as well as its ability to prosper in any anticipated changes. At the same time, it makes little sense undertaking an acquisition unless the new owner can extract more from it than the prior owners. In any conventional valuation process, the buyer will be paying for what has been achieved. Given the risks in any acquisition, the new owner should be looking to where their contribution to the firm can provide a vehicle to gain a contribution well beyond that imbedded in the purchase price. The analysis of the future profitability of the acquired firm should be undertaken within a framework of new owners and new opportunities. If all that can be done is to continue as before, then, given the risks of change, disruption and employee loss that is almost always associated with acquisitions, one must ask why do it?

Basically, successful acquisitions are all about generating a premium on the investment. The major evaluation consideration should be on how a new owner can do more with the business than the prior owner. Only by undertaking a thorough evaluation and looking for opportunities to exploit the acquired resources will the buyer avoid a loss and only undertake those acquisitions which have significant upside.

OFFER

What can you offer?

Why is that we always think of acquisitions in terms of integration. If you examine the available literature, it is heavily biased towards large scale mergers and integration issues. The fast growth company that has little acquisition experience and doesn't have 15 staff in their M&A department will find little useful guidance from such literature. Too often this one-size-fits-all model of acquisitions misleads the growth minded entrepreneur to believe that acquisitions are not for them, but there are in fact simpler forms of acquisitions which are ideally tailored to the high growth SME. One of these I call 'what can I offer'.

Put yourself into the shoes of the high growth entrepreneurial firm. The characteristics of such a business will almost certainly involve strong competitive advantages, normally based around some form of intellectual property. Often they have global markets, access to external private equity and more opportunities than they can cope with. With such prized assets, they can look at a potential acquisition as a way of leveraging their IP, market reach, excess demand and infrastructure. Instead of merging with a target firm, their objective might simply be to make the acquisition more productive and profitable by putting assets and capabilities into it.

Developing an acquisition strategy with a 'what can I offer' approach presents a very different planning scenario compared to the norm. By taking inventory of your own business and identifying those assets and capabilities which can be readily transferred to an acquisition can lead also to a low risk growth strategy. You might have a range of IP which can be leveraged by another firm. This might include patents, copyright, brand, trademarks and deep expertise. You might have sophisticated performance setting and evaluation systems and good management disciplines which could be implemented to improve overall productivity and focus of an acquired firm. If you have excess demand, you could divert this demand to improve the profitability of the acquired firm. Basically, what you could do is take something which has little incremental cost to transfer and find a target firm where it can substantially improve its growth and profitability prospects.

Most high growth firms are stretched to the limit. They really need to limit their risk exposure on an acquisition because they don't have the management resource to sort out problems. But if they can take on an acquisition where their involvement is limited, they can grow through such a strategy. The ability to quickly enhance the growth and profitability of an acquisition also allows them to target better performing businesses, those that already have good management, internal systems and are free of problems. They can afford to pay a premium for such firms as their upside through their own involvement can readily produce a healthy return on their investment.

The level of desired intervention into the new acquisition can be built into the acquisition criteria. Thus firms with limited capacity can seek out firms that are able to leverage inputs from the new owner with little assistance from the buyer. This enables growth through acquisitions but doesn't come with the normal baggage associated with traditional merger based acquisitions. Simply ask the question 'What can I offer?'

NEED

What do you need?

Undertaking an acquisition strategy is not for the feint hearted. The marketplace is littered with numerous failures in both large and small businesses. Even so, there are those acquirers who are consistently successful. One of the characteristics of their success, which has been identified through several research studies, is that their acquisitions form a key component of their overall corporate strategy. Basically, to get the proper level of attention, an acquisition should contribute to the underlying core strategy of the business. In that context, one of the key acquisition strategy questions should be 'What do I need to make my core strategy successful?

Too often acquisitions are opportunistically undertaken or they are peripheral to the main strategy of the business. While this probably works in good times, just wait until the pressure is on and senior management have to choose where to put their effort. Those parts of the business which are fundamental to the core strategy get the resources and attention and the rest falls by the wayside. The same approach is usually taken with investment evaluation – if it is part of the core strategy it gets serious evaluation as the risks of getting it wrong are too serious to not do the job properly.

Start your acquisition strategy with the core business strategy. You should be setting out to identify those capabilities and capacity issues which inhibit the ability of the business to achieve its growth and profitability goals. As each limitation is identified, it goes on an acquisition criteria list. This gradually builds up a set of profiles for acquisition targeting. The acquisition activity then sets out to find firms which can overcome core strategy limitations. The evaluation of any target firm is then undertaken against the identified problem or limitation. Since the impact of such a limitation is understood, the acquirer can also place a value on of resolving the limitation or problem. This provides a strong investment case for the acquisition. Because of its application to core strategy, the responsibility for the acquisition at an operational level will also be reasonably clear. Thus active involvement of line management in the evaluation can be expected and responsibility for integrating the new assets or capabilities is also usually apparent.

While this strategy should be adopted by any acquirer, high growth firms have a much greater need to take this approach than most businesses. Generally high growth firms run out of resources quickly. If you grow by recruiting skilled staff, you soon run into recruitment and training problems. If you need to rapidly build out manufacturing capacity, you soon discover that acquiring and fitting out new plant is a very slow and bureaucratic process. Buying capability and capacity is a fast track for such companies. It also often solves the funding issues as well. Where debt finance is hard to get for growth investment, it is relatively easy to source to buy an existing profitable business.

Businesses which have strong growth and profitability can afford to pay a premium to acquire good firms where they can readily capitalize on the newly acquired capacity or capability. If your strategy is to grow, then the last thing you should be taking on is peripheral activities or those which are going to suck out your best talent and waste your money. Your most successful acquisitions will be those where you stick to those acquisitions which solve core problems and by targeting firms which can make a contribution quickly.

ASSET STRIPPING

Can you finance by stripping out assets?

Whether you buy a company to run yourself or to consolidate into a group, you should be looking at what assets the acquired firm has which are redundant to the acquisition objectives. The disposal of such assets can assist to fund the acquisition. By doing some clean up of the business, you might also create a leaner, more easily managed operation.

Mature firms often take on activities over time which, while needed at the time, are often badly managed as they don't fit with the core activities of the business or, some years later, can be outsourced to other firms which can do the job better. An examination of a target business should focus on the fundamental purpose for the acquisition. The normal objective is to acquire a specific capability or capacity. The next level of analysis should be to identify which business assets and capabilities are needed to support that objective either to ensure its transfer across to the buyer or to support it as an on-going business. Once this analysis is complete, other assets or capabilities which the target firm has can be consider redundant to the main objective and should be considered for disposal.

The sale of such assets or capabilities can often provide a much needed contribution to the funds required to finance the acquisition. Using the proceeds of target firm asset sales can also reduce the drain on internal funds or reduce the need to source external finance. Very few acquirers have the funds to make a significant acquisition without resorting to external loans or new equity injections. By leveraging surplus assets of the target firm, the acquirer can reduce the impact of such external finance.

Even if surplus assets or capabilities are not sold off, the business might be easier to operate if parts were closed down. Often older businesses continue with activities even when they are making a loss or not contributing a fair return on investment or effort. An objective and, often, unemotional review of the business will identify such activities for closure.

Another possibility which should be considered is that some activities might be better transferred to another business entity within the group of even placed with an outsourced firm who can manage it better. Sometimes equipment and plant should be sold off and replaced with more advanced equipment which has higher productivity, newer capabilities or is less expensive to operate.

Another consideration for the buyer is that the acquired firm may be able to undertake some of the parent's activities at higher levels of productivity or with better results. Under consideration should be the sale of assets or capabilities of the buyer where activities can be transferred to the acquired firm. This process can also lead to higher consolidated profit and also help generate funds for the acquisition.

The important consideration here is that the sale of assets or the closure of activities in both the buyer and seller businesses should be part of an overall acquisition evaluation process. The focus should be on what best contributes to making an efficient and effective outcome. A by-product is that it may well provide funds for the acquisition and/or make the subsequent businesses more profitable and easier to manage.

TURNAROUNDS

Build capacity via turnarounds

Perhaps the most effective form of acquisition is the turnaround. It is the untapped potential of an acquired business which often results in the highest return on the original investment. Our acquisition literature tends to focus on mega mergers with their inherent problems of culture clashes, systems integration and hard to reach synergies. The buy and fix scenario is a dream compared to merger nightmares.

Start your acquisition strategy with the questions ‘What do I do really well? Or ‘What do I have to offer which can make a substantial difference? Work out what capabilities or capacities you have which can be applied to an acquisition. At the same time, you need to have a clear view of what you need to be in place in the acquired business for your contribution to make a difference.

This is the game which is played very successfully by private equity firms. They are not simply hunting around for cheap deals. What they are looking for are places where they can make a substantial difference by bringing something new to the table. This might be new management, financial acumen, industry connections, funding or strategic buyers. They don’t want to simply improve the business marginally, they want to jump start it to a new level. Finding a match between what you have to offer and what a business needs to take it quickly to a new level is the key to success in the private equity sector.

There is no reason why a potential buyer can’t apply those same principles to an acquisition. Personally, I have always thought that it is difficult to achieve a healthy return on an acquisition investment by buying a firm to be bigger and thus gain economies of scale, or to take out overlapping costs. But if you can clearly bring a capability or capacity to the new business which dramatically changes its potential, then you have the basis of a very strong acquisition case.

With such an approach in mind, you need not limit yourself to cheap deals or optimistic purchases. Instead, focus on buying businesses which are well managed where you are not going to inherit a load of problems. Target those where you can make a substantial difference. Basically, you are setting out to change the future of the acquired business where you exploit the new capabilities or capacities which you bring to the table. These need not be overly dramatic. Often new energy, updated skills, personal networks and a different view of how the business can be better positioned can be sufficient.

Too many acquisition fail to achieve positive results because they are made without proper appreciation of the post-acquisition work which needs to be done. By concentrating on how new value is created, by careful selection of the target business and by ensuring you have a game plan to implement those critical changes, you can substantially improve your chances of success.

BENCHMARKING

Use benchmarking to check the upside

When we buy a business we not only want to know what we are getting but we want to know what we can do with it, that is, what potential it has. The greater certainty we have about being able to execute on improving the business, the more willing we will be to take on the acquisition. Sometimes it is simply a matter of acquiring a competency or capacity which will enhance our existing business but for lots acquirers, it is simply bringing a business up the curve on industry best practice.

What you really want in an acquisition is a high probability of achieving excess gains. That is, being able to generate a level of profitability over the level which the business had achieved prior to the acquisition. The newly achieved excess can generate additional cash to pay down acquisition loans or increase the value of the business well beyond the purchase price. While there is no silver bullet to such gains, there is the tried and true method of using benchmarking to select a target business which has almost certain upside.

Benchmarking is a technique used to compare like businesses within an industry over a wide range of performance metrics. This is particularly powerful where many businesses are very similar in their product/market interface and structure. The benchmarking data will indicate the range of performance of a large number of similar businesses. The ideal acquisition is where an acquirer has a knowledge of best practice within an industry and is able to implement the changes needed to bring a business up to best practice level.

Don't imagine that you have to do all the heavy lifting by yourself. Within any industry there will be a source of advice and consultancy on industry best practice. Providing there is enough margin in the acquired business to justify the additional investment, recruiting some proven executives and contracting in industry expertise should enable you to generate those additional profits. Clearly there is an advantage if you have a background in the industry and have worked for one of the high performers. Knowing where to direct your energies and investments to get momentum in your productivity improvements will save you time and generate additional cash faster.

However, watch out for those firms which are so far behind that they have lost the capacity to come out of the trenches. You want to look for businesses which are well managed but lack the knowledge of best practice rather than one which has run out of steam. Your investments need to go into incremental improvements rather than a drastic overhaul. You want to find a business which has good foundations and will benefit from renewal rather than one where there are fundamental flaws. Look for business which are poor performers across a range of metrics where you already know how to make the adjustments but which has the resilience to allow you to spend the time doing it. Watch out for the business where your money simply delays the ultimate sinking.

Benchmarking is an essential tool for screening target acquisitions and, if used well, will pay off in enhanced post-acquisition profitability.

FINANCIAL ACQUISITIONS

Evaluating financial acquisitions

While there is an overwhelming focus on cost savings and synergies through integration in the merger and acquisition literature, there are considerable challenges in securing those benefits. Such a focus, however, overlooks much of the mainstream acquisition activity which is often simply about buying a business to run yourself, or buying a business as a corporate acquisition because it offers considerable upside through intervention activities within the business. This is where the concept of a financial acquisition rather than a strategic acquisition plays out.

A strategic acquisition is generally held to deliver value to the acquirer well beyond the profit projections which the acquisition as a stand alone entity can deliver. But for the moment, let us just consider the stand alone business and where value can be derived from that. What we need to do is to evaluate the future stream of net earnings that stem from the resources contained within the acquired entity. If no additional profits accrue to the parent company or owner outside of the entity itself, then there are no strategic benefits arising from the acquisition. That is not to say it can't be very profitable, but this would be regarded as a financial acquisition.

A very stable and resilient business may provide a target rate of return even if not discounted. There are also acquisitions which left to pursue their current plans will return a very good return on investment (ROI), especially if the price at acquisition undervalues the future earnings or overstates future risk. For instance, some firms are sold at a discount in order to secure other benefits such as future employment for loyal staff or retaining family brands. On the other hand, the buyer may be seeking a business where there are opportunities for expansion or intervention which offer good prospects of higher net earnings or capital gains.

The future prospects of a business may be enhanced simply by bringing new energy, skill, knowledge, contacts or orders to the business. Higher levels of intervention my include replacing existing management, implementing new systems and processes, reorganizing the business, closing down or stripping out under-performing activities, refocusing the business on its core capabilities and so on. A corporate acquirer may bring to the business new IP in the form of brands, copyrights, patents and trademarks which improve the productivity or attractiveness of the business. Similarly, a corporation my channel excess demand to a newly acquired entity.

Acquisitions which are not integrated can most often present very attractive ROI while avoiding the inherent risks of full or partial mergers. When you are considering an acquisition remember to separate out what the business is currently capable of achieving with what it could achieve with planned intervention. If you can provide the means of leveraging higher levels of productivity, greater resilience or increased growth, stand alone acquisitions can be of relatively low risk but still return high ROI. The key here is to be able to assess your own contribution and to seek out businesses where those interventions have the highest impact.

INTELLECTUAL PROPERTY

Sending IP to the acquired firm

Acquisitions are not always about gaining access to a capability which can be used directly within the buying company. Sometimes it is about providing a capability to the acquired firm to lift their growth and profitability. This is certainly the case when intellectual property is provided to the acquired firm to enhance its market performance.

By providing an acquired firm with the right to use restricted, licensed or protected knowledge contained in patents, copyrights, brands, trademarks and licensed rights, the acquirer is providing market leverage to its subsidiary, often at little cost to itself. Such intervention can often enable the acquired firm to leverage new market power. The subsidiary can take on many of the IP benefits which accrue to the acquirer. In the case of brand or trademarks, it may immediately provide a new market advantage, not only generating revenue but often making it cheaper per transaction to acquire new business.

IP in the form of patents and licensed rights can provide significant market competitive barriers to competition. A new subsidiary taking on the advantages of such IP will have an immediate lift in market competitiveness.

In developing an acquisition strategy, the acquiring company should review the market leverage it could apply by providing acquired firms with its IP. If the IP has strong market leverage but the constraint is people or distribution channels, a strategy to acquire firms which have people and distribution channels that could leverage the additional IP would make a lot of sense. The strategy should be to target firms which have the capacity and capabilities to fully leverage the inserted IP. A business which is thus acquired at market valuation based on some EBIT multiple could become much more profitable through such intervention without placing any significant burden on the acquirer. In such situations, the acquirer might be prepared to pay a premium over conventional valuation to get the right target firm. This would make sense if the business being acquired had good management systems and people and had the capability and capacity to quickly exploit the inserted IP.

A corporation with strong IP but limited expansion capital should consider some creative strategies for expansion. If the IP can consistently improve the profitability of partner firms then the IP can be used to leverage various longer term acquisition strategies. A sell down strategy could be used to entice business owners to sell part of their equity in return for higher valuation exits in the future. Joint ventures can be used where contribution can be part in IP and part in finance. Distributors in new geographies can be signed up with future buy out options.

Expansion through acquisitions is a very common strategy for building capacity but too often it fails to deliver the anticipated benefits. Too often the strategy is one of merger rather than intervention, where the former process has higher inherent risks. By leveraging IP and keeping the acquired firm as a stand-alone entity, an acquirer expand but could take some of the risk out of the acquisition process.

FINANCIAL VALUE ACQUISITION

What does a financial acquisition offer?

Too often the discussion in the M&A area is about getting bigger through mergers rather than getting bigger through acquiring stand-alone entities. The advantage of the latter is that they are much easier to evaluate, certainly easier to transition to new ownership and don't have the problems of culture clashes which mergers seem to throw up.

In targeting potential acquisitions, companies too often overlook acquiring businesses that can be left to operate substantially on their own. Too much attention is given over to overlapping activities, merging operations and cost savings. Take time out to look at which business could be acquired and contribute to overall profitability but be left under local management. One of the advantages of such an acquisition is that the evaluation is limited to what the acquired business can do in its own right without having to work out what combined operations will deliver.

I have always thought of a stand-alone acquisition as a financial deal rather than a strategic one. While I am sure there are sometimes elements of threat mitigation, a stand-alone business basically generates future profits without the complication of trying to assess synergies. Thus the evaluation is often much simpler and probably less influenced by non-objective or emotional or personal agendas.

Start with the existing operation. Instead of focusing the evaluation on what has been achieved in the past, concentrate on what can be achieved in the future. The value of the investment is entirely in what it can produce as net earnings in the future not what the current management has achieved in the past. After adjusting for the probable loss of the business founder and some senior executives, you need to work out what you would need to do to put the business on an effective and efficient basis. The next phase of the evaluation is to factor in what you can do to the business to make it more profitable, more resilient and more growth oriented. This is where your own capabilities need to be tapped. What do you have in the way of spare resources, processes, intellectual property or business acumen which can be inserted into the new acquisition? What effect will this intervention have on the overall growth rate and future profitability of the business?

When you have competed this analysis, after accounting for the costs of the intervention activities, you will be able to value the business using a net present value calculation applying your hurdle risk rate. This is the maximum value of the business at the time of acquisition. If you are able to acquire the business for anything less then this value, you are likely to achieve a rate of return above your investment hurdle.

The key to a successful financial acquisition is to evaluate what you will do to the business after you take control of it. If you don't have the capacity or capability to undertake the evaluation, negotiation and subsequent intervention, then perhaps you should walk away from this type of acquisition. However, if you can see your way to a clearly defined strategy of business improvement post-acquisition where you have the available resources and knowledge to undertake the task, then this type of acquisition can be much less problematic and much more reliable in terms of subsequent returns than the oft sought merger.

STRATEGIC ACQUISITIONS

What does a strategic acquisition offer?

In the acquisitions game, my preference has always been to focus on strategic value. I am not talking about making a few people redundant because of overlapping operations or squeezing some costs out through economies of scale, but genuine new incremental revenue which is gained by leveraging off an asset or capability acquired in the purchase. Too often acquisitions are justified on simply getting bigger by combining business units rather than gaining significant growth by acquiring some asset or capability which provides a positive impact on competitive advantage.

Growth is fundamentally fueled by competitive advantage, especially in products or services which provide solutions to compelling needs. However, most firms are constrained in their capacity or capabilities to take advantage of market gaps. Either they have an outstanding solution but lack the capacity to take advantage of it or have the capacity but lack the capability to exploit what they have. The acquisition strategy of the former should be on acquiring capacity such as people, facilities, distribution channels or cash. The acquisition strategies of the latter should be focused on buying in products, processes and intellectual property assets which can be supported by the capacity resource.

The aim of a strategic acquisition should be to enable the acquirer to do something on a much larger scale which results in a kick up in growth beyond the mere summation of the existing revenue growth of the combined entities. By definition, a strategic acquisition should change the acquiring business, not simply add more of the same

In developing an acquisition strategy, a company which wants to increase its growth rate should address those constraints which are holding it back. The business should target potential acquisitions where it has the capability and capability to successfully undertake an acquisition which removes those constraints. While additive acquisitions are useful, they fail to provide the thrust that a good strategic acquisition can. They can add to revenue and often deliver some scale benefits, especially in services functions, but they don't have the effect of significantly changing growth potential.

What is often forgotten is that strategic assets and capabilities can often be acquired from relatively small firms. If you are looking for innovation, this is often where they are to be found. If you need capability, then acquire them incrementally. Small is easier to absorb and less risky if it goes wrong. Often a strategic acquisition is simply about getting something you can readily leverage to create size organically rather than buying size.

I prefer to look at acquisitions which will return a 5 fold or better return on the investment. The major advantage is that, given that some things will go wrong, I should still end up getting a 2 to 3 times return. If I aim to get 15% or 20% return on my investment and something goes wrong, the chances are that I will end up with a negative return. The advantage of strategic acquisitions is that they have considerable upside in them if they are done right and often limited downside.

BENEFITS

Overestimating benefits

If you concentrated on everything that could go wrong with an acquisition, you probably would avoid that path to growth and stick to developing organically. However, this would exclude you from achieving significant step increase in capability and capacity as well as possibly resolving some underlying weaknesses in the business through acquisitions. What you do, however, need to avoid is overestimating the benefits which can come from an acquisition.

Forecasting your own revenue and profit for one year in advance is difficult enough, imagine the problems of estimating what the benefits are likely to be from an acquisition. Even with this caveat, far too many acquisitions have come unstuck because buyers have been overly optimistic on the size, duration and timing of the benefits accruing from an acquisition. Not only have they failed to take into account the operational problems of taking over another business but they have failed to properly recognize the delays, costs and disruption which occurs though managing the change process itself. Few such activities ever go according to plan and many go completely off the rails.

Estimating benefits from an acquisition is highly problematic. You have to make so many assumptions just to put one set of numbers together let alone develop a number of possible outcome scenarios. This is then highly colored by the desire to get the deal done and justify the investment. Too often, executives undertaking the evaluation are undermined by their own desire to get the deal done that they take an overly optimistic view of the outcome from the acquisition. If they anticipate cost saving through overlapping operations or economies of scale, they fail to take into account the costs of making the changes. New sales opportunities are estimated without also taking into account that existing customers may resent the loss of a competitor or the additional pressure to take up new products or services. Target revenue numbers may be used to justify the investment but the disruption due to the loss of key employees may not have been factored in.

What you really need to do in an acquisition evaluation is to have part of the evaluation team act as devils' advocates. Their role should be to question the validity of assumptions, put forward possible delays, costs and disruptions and question the intervention and integration strategies. While this may sound negative and unsupportive, what you want out of the evaluation is a highly pragmatic plan with a high probability of success and a good chance of achieving a reasonable return on the acquisition investment. Even slowing down the enthusiasm to allow for better consideration of possible problems has its merits when so much is at risk. Having an external advisor who has deep experience in M&A activities review the evaluation and the post-acquisition changes will often bring a more objective and experienced assessment of the costs and benefits of going ahead.

In the end, however, you will still need to make the decision to proceed even where some factors cannot be reasonably estimated.

DEMAND

Excess demand

Sometimes it is not what you can do for us, it is what we can do for you! One of the paths that you can take with an acquisitions strategy is to focus on what you have in abundance which you can supply to a new acquisition to make them more profitable, especially if this is something which you can't use yourself or which has no marginal cost to you. Thus a company which has excess demand and does not have the capacity to service that demand might look to buy a firm which can readily take on new demand and contribute additional profits to the new owner.

Rapidly growing markets often throw up situations where demand outstrips supply. The usual market reaction is to increase prices until these are again in balance. However, a supplier might take a different approach and seek out an acquisition which can be readily converted to a new source of supply. The target acquisition would need to have the capability and capacity to convert its facility so that it could produce the product or service in demand as well as have the capability and capacity to satisfy that demand.

What you should avoid is simply buying a lookalike business which is already supplying into the market. While you may pick up some economies of scale, these are somewhat unreliable. Instead, you should be focusing on areas within your own business which are placing constraints on your ability to increase your supply. Select target firms which can provide capacity in those areas where you are constrained but are in a situation or market where the intervention can lift their profitability. The objective of undertaking the acquisition is to take advantage of a market shift where you can direct the excess demand to the new subsidiary and use that opportunity to increase their profitability.

Your own constraints can exist anywhere along your supply chain, so your acquisition targeting needs to focus on that part of your supply chain which can have the greatest impact on your ability to lift revenue and profit. For example, you may be constrained in manufacturing capacity in which case even an overseas factory might be in your sights. If, on the other hand, you have excess manufacturing capacity but have limited distribution capability, you might look to buy a firm with extensive distribution capacity.

One aspect of this situation which you need to be sensitive to is that your own staff may already be stretched satisfying a buoyant market. If that is the case, you need to look for potential acquisitions which can operate without a lot of intervention. You need to find a firm with good management and internal governance systems but which also has a team of senior management who desire to stay with the firm post-sale or where there is a good succession plan to replace departing senior management.

Excess demand in an area where you have competitive advantage can give you an opportunity for growth. However, make sure you only take on something which you have both the capability and capacity to manage.

EXCESS CAPACITY

Leverage excess capacity

Can I turn a problem into an opportunity? Part of the creative craft of the entrepreneur is to do just that. So the problem of excess capacity, in fact, offers a growth opportunity to the business which can use this situation to leverage benefits from an acquisition which has the opposite problem – too much demand.

Most entrepreneurs would love to have the problem of too much demand but it can be problematic for the business which cannot resolve the problem. Customers who have to wait too long for product or service delivery don't usually congratulate the supplier for being successful. In practice, they are more likely to complain and then tell all their friends how bad the service is. This can be damaging to the company brand and result in long term reputation problems. However, the business with excess capacity which can solve the excess demand problem is in an ideal position to use this as an acquisition opportunity and y doing so step up their revenue levels.

Since most companies suffer from too little demand, a company which has excess demand can be an ideal acquisition, especially if the price paid is based on the actual revenue levels rather than potential. If the business can be readily integrated into the acquirer's supply chain, the acquirer can quickly optimize the excess capacity and bring in new revenue.

When we think of capacity we should not just think of plant and equipment. Capacity can be any form of productive asset including warehouse space, distribution capacity, idle staff, unused patents, office space, retail shelf space and so on. We should be on the alert for spare capacity throughout the business and seek out acquisitions which can effectively utilize what we are already paying for but which we are not leveraging into revenue.

Strategic acquisitions have this as their foundation. We seek out an acquisition which we can exploit because we already have the capability and capacity in place to exploit them. The acquired product added to our product portfolio. The acquired customer base can absorb our existing product range. We can reduce the head office headcount in the acquired business because the work can be absorbed by our existing staff and so on. Instead of having to build new infrastructure to take advantage of the acquired products and services, we use our existing resources thus dramatically reducing the additional scalability costs.

Success in an acquisition strategy comes from finding an attribute of the acquisition you can exploit beyond simply growing the acquired business. What you are looking for is something which the combined entities can exploit to gain significant synergies. In this case, we are using what we have in abundance to deliberately target potential acquisitions where we can use the excess capacity to advantage. So acquiring a business which already had similar excess capacity would rule it out as a potential acquisition unless there was some other attribute within the target which we could leverage. But finding a business which can use the excess capacity makes great commercial sense.

SUCCESSION PLANNING

Acquirer succession planning

We have all been told that succession planning is critical in an acquisition if we are to retain key staff, but how many acquirers remember to undertake the same task in their own operation during the acquisition process. Vendor staff are not the only ones who are concerned about their future during an acquisition. It is highly likely that the acquirer will lose staff as well.

In the highly charged environment of an acquisition, we are only too sensitive that we need to retain the people who understand the business, have the connections to the customers and supplier and know how to manage the day to day operations. We set out to identify these people early in the discussions and ensure that the acquisition and due diligence process locks them down so they are not lost to the business. We can expect these people to be concerned about their future and we go out of our way to assure them of their continued importance to the business.

Back at the ranch, however, there are often unrecognized stresses. Senior executives are taken out of the day to day operations to assist with the evaluation, negotiation and due diligence process. Once the deal is done, more time and effort is needed to bed in the new operation and complete whatever intervention and integration activities are required to gain the acquisition objectives. While this is happening, others have to take up the tasks which the executives are not able to. So in addition to doing their own tasks, some people are required to put in extra time to ensure everything continues to operate smoothly. That is of course assuming that this problem of delegation has been addressed and those assigned the additional tasks are prepared to take them on rather than leaving to go somewhere else where life is a little easier.

This is not the only place where stress will occur in the acquirer. Acquisitions often create organizational changes. Where operations are integrated, the vendor staff need to be accommodated. Few acquirers can afford the wholesale loss of acquired staff with a ‘we are the new owners and we get all the good jobs’ approach. Thus some of the acquired staff will step into senior positions resulting in current staff missing out on promotion. There will be new bosses, new positions, new job descriptions and so on. Life will be unsettled for some period of time and not everyone is going to be happy with the result. In fact, some will leave rather than face the risk of losing out while others will prefer to go to another company where their future is more stable and certain.

What this means for the acquirer is that effort needs to be put into retaining their key staff and undertaking succession planning within their own business. A focus only on the acquired business will risk undermine the acquisition objectives if this results in serious disruption in their own business. Part of the acquisition process needs to ensure that the current business is secure.

DUE DILIGENCE

Due diligence – what are you looking for?

According to a substantial body of research, only about 30% of acquisitions achieve their investment objectives. While there are numerous reasons why this happens, much of the blame must fall back onto inadequate evaluation of the target firm and the investment justification. Basically, inadequate due diligence was undertaken.

The due diligence undertaken by the professional service providers is essential but somewhat conventional. They are going to examine the existing business to ensure the acquirer is fully informed of its operations, ownership, liabilities and obligations. These inspections are aimed at uncovering future risks, delays and costs inherent in the current business. The potential buyer has the opportunity of factoring these findings into the price, revising their projected investment outcomes or walking away from the deal. This type of due diligence process is critical but only covers part of the evaluation.

The due diligence on the vendor operations can be utilized by any acquirer, but it is the combination of the vendor business and the acquired business which is critical to achieving investment objectives. Two other areas need to be carefully examined; change of ownership issues and post-acquisition operations.

Once the deal is done, most acquired companies go through a series of changes to put them into a state where they can be exploited by the buyer. This process often requires both intervention in the current operations as well as integration of all or parts of the vendor business with that of the acquirer. This period will often see internal systems change, jobs realigned, new management appointed, operations relocated and so on. The due diligence task needs to review these intended changes and assess whether they can be undertaken within reasonable cost and time. Often such an examination will find that there are undue stresses, delays, disruptions and costs involved. What appeared to be an easy transition when negotiations commenced with the vendors can turn out to be a endless task undermining operations in both companies. Few integration processes go smoothly and many are abandoned.

Even if the business passes the test of inherent due diligence and transition, there still remains the question of how the investment objectives will be achieved. In developing the investment case, many assumptions will have been made about the state of the product/market situation and the operations of the combined entity. These assumptions need to be thoroughly examined to ensure they are realistic. Sales projections need to be validated, supply lines confirmed and costs verified.

Common problems which are often overlooked are the loss of key employees and the loss of customers. Acquirers need to anticipate problems which will occur during the change of ownership and after operations are settled in. While many of these issues can be effectively managed, some early research into the marketplace and current employee expectations can show underlying problems which are not easily addressed. Sometimes when these are factored into the investment model, the acquisition fails to show it can achieve the desired result. In such situations, the acquirer is better off walking away from the deal.

PROBLEMS

Risks, delays and costs

It is after the deal is done that the real work of acquisition begins. Basically, anyone can negotiate a deal but very few can extract a high return on the investment after the event. There are simply hundreds of things that can go wrong, and often do go wrong, once the dust settles. The smart acquirers start mitigating the risks well before the agreement is signed.

The due diligence undertaken by the buyer should not be limited to inherent risks in the selling business. While it is critical to ensure that there are no skeletons in the closet, it is just as important to examine what will happen to the business once ownership passes and the buyer needs to achieve whatever acquisition objectives they justified the deal on.

The classic due diligence; that is, the one we all imagine will happen to us when we sell a business, concentrates on the risks, costs and delays the buyer will incur to bring the business up to an efficient and effective level. It is also designed to uncover weaknesses and problems in legal structure, outstanding real and contingent liabilities and obligations, missing information and errors of misstatement and representation. Such a review will also examine historical and forecast levels of revenue and expenses to uncover business performance, resilience and anticipated profitability. Unexpected problems or considerable risks uncovered at this point might result in a renegotiation of the price or a termination of the acquisition activity.

What is often neglected in this examination process are those aspects of the acquisition which occur after the ink is dry. A change of ownership often involves many activities on the part of the buying and acquired firms. Some level of intervention in the affairs of the selling firm are inevitable. At the same time, some level of integration might occur between parts of the seller and buyer organizations. These changes are often time consuming, disruptive and problematic. Differing cultures hamper progress and result in the loss of good employees. An essential part of pre-acquisition due diligence on the part of the buyer is to construct a detailed plan of ownership change which minimizes disruption and staff loss.

Lastly, due diligence needs to consider how the investment objectives are to be achieved once ownership has changed. Basically, how is the growth and profit potential in the acquisition to be realized? Too often acquisitions are made without detailed consideration of how the opportunity is to be exploited and by whom. This may mean additional funding, new structures, changed responsibilities, recruiting new managers and so on. Anticipated delays, problems and costs of achieving investment objectives need to be considered well before the deal is completed. If you can't see your way through to a healthy positive return on the investment, perhaps this is the wrong deal or the wrong time to do it.

From a wealth of research we know that 70% of acquisitions fail to achieve a positive shareholder return. Since many acquisitions fail to undertake a thorough due diligence across these three stages of investment realization, it is easy to see how such an outcome occurs.

PART C: TRANSITION

It is the time after the deal is settled and signed which is the most critical in gaining acquisition benefits. This is when the human factor kicks in. Few people appreciate just how stressful and disruptive this time can be for both the acquirer and the vendor. Not only are you coping with increased work loads sorting out changes in both businesses, you have new roles to settle in, people leaving and customers and suppliers to look after who are concerned about what is happening.

Having a really good process to work to and a good project manager who can get things done is fundamental to surviving this process. At the same time, most mergers are overcooked. Few people really appreciate the level of change which really needs to be undertaken to achieve acquisition benefits. In fact, this is one of those times where 'less is more'. The phrase 'don't fix what isn't broke' should be widely applied here.

POST-ACQUISITION

Managing after the acquisition

We have been told many times that acquisitions often fail to achieve their investment objectives, but few people have ever pointed out how difficult it is to manage a new subsidiary at a distance if you have never done it before. If you have become accustomed to meeting with your managers on a frequent basis and getting first hand reports of activities, imagine how you will feel if that is no longer possible. What if your new business unit is in a time zone several hours different to yours and a visit consumes a day's travel each way. What we often forget in undertaking an acquisition is that we might need a completely different approach to managing when time and distance intervene.

When I was the president of a UK software business, we acquired a software supplier in San Diego. My intention was to establish a personal presence there for 3 months, settle the business in to a new direction, promote one of the local managers to take over and go back to the UK. What I had failed to recognize was that the prior two owners worked on site and had their fingers on every aspect of the business on an hourly if not daily basis. When I started to request performance information from my UK location, I found that the underlying data collection and reporting systems were not up to the task. I also discovered that the new manager was not used to weekly and monthly performance reporting and really had little idea of what was required to run the business or what we needed to monitor at a distance. I ended up sending my CFO to San Diego to install a budgeting system and a weekly and monthly reporting management pack. It was only once these systems had settled in that I had confidence that I could monitor the business from a distance and intervene only when it was necessary.

What is very clear to me from this experience is that you cannot micro manage another company from a distance and that the costs of active management monitoring on site is prohibitive from an executive time and cost viewpoint. What is required is that you have a well thought out performance setting and reporting system ready to go as soon as the dust settles on the purchase agreement. You might also think very hard about who is to manage the new subsidiary. While there are benefits in using someone from the existing operation, you need to think about how quickly you can settle the firm into a proper operations monitoring and performance system if they have not worked under that discipline before.

More than anything else, you have to put yourself into situation where you can anticipate problems before they become crisis. A good management reporting system underpins that objective. You might also consider setting up a local Board of Advisors or Directors to provide advice and guidance to local management and to give yourself a higher degree of comfort of local governance. In the end, you will have to rely on local management but this should be supported by good reporting systems.

CULTURE SHOCK

Culture shock on mergers

Every textbook and article on acquisitions will tell you just how important cultural fit is but few help you understand just what that means and even less provide a pragmatic way of working out whether you are going to have a problem. It seems that this material is written for academics, behavioral consultants or executives who already have significant experience with such projects. Rather unfortunate for the aspiring entrepreneur who is trying to make sense of it all.

I have my own cultural fit scars from several acquisitions and divestments I was involved in. In the case of the businesses I acquired, I was keen to retain the acquired employees but it is very difficult to provide guarantees when you don't know what the future will entail. At the same time, I could see that the staff were coping with a massive change in their work environment. In one case we were acquiring a business from two retiring partners who had founded the business over twenty years earlier. In another case we were merging with a business where the structure of the business would have to be changed to avoid duplicate roles. Little wonder the acquired employees were uncertain and stressed out.

In the business I sold, one went to a recently listed US business where we really knew little about the management. We found out very quickly, however, when our new CEO turned up and told us we were all incompetent and going about our business in entirely the wrong manner. In the second case, we sold out to a global corporation who seemed to lose us for a few months after the acquisition as they went through several restructures.

From these experiences and from extensive reading of the literature, I can see that acquisitions quickly go off the rails when the acquirer fails to consider the impact on the individual, whether they are employed in the vendor or in the buyer. The basic issue is one of stability. While business life is not without its risks, people become accustomed to their circumstances and find a balance between work and private endeavors which they cope with. When this balance is upset through the possible and actual acquisition activities, they react by focusing on their own world and often react by resigning, neglecting their duties or aggressively working against the takeover. Even assurances of continued employment and no change is sometimes not sufficient to settle their fears.

Providing individual counseling, frequent communication, retaining staff and leaving the acquired business to continue as an independent entity can go a long way to stabilizing the transition to new ownership. However, many acquisitions result in redundancies, mergers of departments and changes in direction. Major changes are anticipated to impact individuals more and thus much greater attention needs to be given to individual transitions. When such change also involves a dramatic shift in the manner in which the business operates, especially in the manner in which people interact, make decisions, are rewarded or interact with customers and suppliers, significant numbers of acquired personnel can be expected to resign, be less productive or be disruptive. It is,therefore, of little surprise that such acquisitions often end in failure. Smart buyers work hard to manage the changes involved or simply avoid taking on acquisitions where they can foresee such outcomes.

WORST CASE

Make sure you plan for risk mitigation

If you are going to spend time in the acquisition game you are probably an optimist. If you dwell too much on what can go wrong, you will most likely talk yourself out of this activity. That being said, a little bit of risk mitigation can go a long way to protecting you against things that can and do go wrong.

My first acquisition was of a 54 employee software firm in San Diego. They were our major software supplier and we decided we needed to take control over their R&D activity to ensure we had the underlying technology to allow us to produce the layered application software products we developed. The business was owned by two aging founders who decided that this was as good an opportunity as they would see to take the money and run. We negotiated a price of $2 million but were only able to raise venture capital for $1.5 million. We had to meet the balance out of profits. The purchase agreement was signed after a national auditing firm signed off on the accounts.

It would have been an ideal acquisition if only the auditors hadn't discovered some irregularities in the accounts several months later. Our investment looked more like $1 million after the adjustments. Within a few months we ended up in litigation in the US Federal Court against the prior owners and the auditors. This activity polarized the staff, distracted us from operating the business, sucked up lots of time and cash and almost sent the San Diego business into bankruptcy. The action lasted five years and we eventually lost on a technicality (just to make matters worse).

We had simply left ourselves with too little room for mistakes. We had stretched ourselves to the limit on our lines of credit. Our expectation was that one of the senior managers would take over and allow us to get back to the UK to run the operation there. Due to the internal turmoil and the work on the litigation, I ended up moving to the USA for two years. While we had done the right thing in getting a professional due diligence undertaken, the lesson is that they don't always find everything.

Not all acquisitions have this outcome. I undertook another acquisition several years after that had not a single hiccup in the process. However, you simply can't depend on such luck. You do need to have a worst case game plan. We make lots of assumptions about a target business during the evaluation. Try relaxing some of those assumptions and test how you would handle a change in circumstances. What if you lost some key employees, important customers or critical suppliers? How would you fund the acquisition if the newly acquired business got into trouble and was not generating excess cash? Which of your current management team would you be able to spare to step in to manage the operation if there was a crisis?

When you take on an acquisition, you need to have spare capacity to deal with unforeseen problems. It is worth spending some time before you make the commitment to ensure you can deal with things that could go wrong.

INTERVENTION VS. INTEGRATION

Post acquisition changes

If you have read much of the literature in the merger and acquisition space you will have noticed that it is very much 'one size fits all'. There is an overwhelming attention to mega-mergers and to putting together giant global corporations with a focus on culture and systems integration. What about the hundreds of thousands of smaller acquisitions which are purchased by new owner mangers or those which have little or no integration?

If you take a broader view of acquisitions, what you see is a wide range of types ranging from pure investment, turn-arounds, roll-ups, consolidations and, finally fully integrated operations. The degree to which the acquisition is changed and integrated varies greatly depending on what the objectives of the acquisition are. In some cases the desire is to leave the acquired business as a separate entity. In others, the intention is only to remove some head office functions but leave the operational side of the business as it was. Instead of a focus on integration, we need to look to both intervention and integration as paths to improvement.

Intervention occurs when the operations of the acquired business are proactively changed by the buyer to improve the firm's performance. This could involve any number of activities including new management, new systems and processes, new funding or new investment as well as the use of the buyer's economies of scale in procurement or the use of the buyer's trademarks, patents, brands and so on. The aim of intervention is to fix any deficiencies in the business as well as to put it into a better trading position. Many acquirers seek out target businesses where they can make such changes knowing that they have a high probability of achieving a premium return on their investment.

Integration occurs where all or parts of the acquired business are merged with those of the acquirer. Often this is done to eliminate duplicate activities or otherwise redundant operations. However, the level of integration can vary widely. A consolidation play might just take over Head Office functions. A company with excess manufacturing capacity might only move manufacturing activity but leave the rest of the business operating as a separate entity. Where the acquirer has an excellent distribution channel, it might close down the sales activity of the acquired firm and take on that task itself. At the extreme, the whole operation might be merged including relocating all the employees to a common facility.

Many acquirers make the mistake of thinking that everything has to work the same way and look the same. Instead of focusing on where changes need to be made to make improvements, they plan to integrate everything. In doing so, they often destroy the value they acquired. People leave both companies due to uncertainty, operations are disrupted and the changes take longer than anticipated. The basic rules of acquisitions should be to take on only what you can manage, don't fix anything which isn't broken and concentrate on where the big gains are.

DISRUPTION

What about disruption in the acquirer

Those who know a little about mergers and acquisition activity will warn you of the key employee losses and business disruption in the newly acquired firm as it progresses through the selling cycle. However, few think to remind you that similar losses can occur in the acquirer. Loss of key personnel and business disruption in your own business is something to watch out for if you are pursuing an acquisition activity.

Acquisitions are not your everyday transaction. They are very large in comparison to most revenue expenses and generally much larger even compared to large capital projects. Unlike building a new factory or shifting premises, they happen relatively quickly, consume large amounts of senior executive time and can result in significant changes to the acquired business. Where the acquisition involves significant intervention in the operations of the newly acquired business, the loss of senior management time to the newly acquired firm can go on for some time. If some parts of the businesses are merged, there will be significant disruption to both the selling and buying businesses during the integration period.

The sudden departure of senior management for hours and days on end during the negotiation and due diligence period places a burden on their subordinates increasing their workload and working hours. When this is likely to go on for some time following the completion of the deal, some will resent the additional burden and become negative or even resign placing even further pressure on those left behind. The loss of senior management and the additional work for those under them can also result in a lack of attention to the existing business resulting in revenue disruption and a loss of customer and supplier goodwill.

If the acquisition involves some level of integration due to overlapping or duplicate functions, employees of the acquirer may start to wonder about their own jobs. The acquirer is caught between providing assurances to old employees while still wanting to retain the good ones being acquired. While all this is being resolved there is going to be some level of stress and uncertainty within the acquirer's own staff. Some will find this difficult to deal with and will decide to leave for a more secure position instead of waiting to see what happens. Such departures further increase the levels of stress and uncertainty but also increase the workload for those remaining.

If in fact some of the existing employees are made redundant during the merger process, surviving employees will be quickly assessing their own positions and watch carefully the process used to select and deal with departing staff. Any lack of consideration, fairness or equity in these processes will quickly alienate staff who will react negatively towards acquired staff and may decide to resign to seek other employment.

Any disruption within the acquiring business will translate directly to lowering productivity, disruption of customer and supplier relations and thus impact cash flow and profits. The bottom line - any acquisition strategy needs to deal with possible disruption at both the selling and buying business if it is to be successful.

INTELLECTUAL PROPERTY LOSS

Watch the IP walk out

An acquirer might like to consider what could be done do about protecting the intellectual property of any business purchased if, on average, forty percent of acquired senior executives leave within nine months and seventy percent are gone within four years. If you think that is a bit scary, consider that those statistics relate to large corporate mergers, my suspicion is that the rate of departures in small acquired firms is much higher.

Most large acquisitions involve senior executives who already work in large companies and probably receive little compensation from the acquisition event. Compare that to small acquisitions where senior management are likely to have an equity share and probably prefer to work in a senior role in a small firm. They are cashed up, looking for the next opportunity and like what they do. Your chances of losing senior management and key employees in a smaller acquisition can be expected to be much higher than the large M&A average.

Smart acquirers know this already. They also acknowledge that entrepreneurs and SME senior executives generally make poor subordinates and rarely fit into large corporate structures. They therefore anticipate significant losses of key staff and look to mitigating this outcome through proactive succession planning, short term retention bonuses and documentation of corporate knowledge.

Planning for such an eventuality comes well before the deal is done. Key employees are identified, those senior managers who need to be retained are targeted and the level of corporate documentation of internal processes is noted. From this review comes a decision on how the acquisition activity should be approached. Where the losses are expected to be high and knowledge is poorly documented, the target price falls steeply or the opportunity is bypassed. Where key employees and managers can be approached prior to the acquisition, with current owners agreement, strategies might be put in place to stem the tide of those intending to leave. However, lack of documentation is a problem and thus this becomes an urgent post-acquisition activity.

A broader view of IP would encompass customer and supplier relationships.

These can suffer disruption and possible loss with the departure of key personnel. If the loyalty of the relationship is primarily with the person rather than the company then there is a serious risk if that key individual leaves. The acquirer needs to step in quickly after the purchase to establish a broader net of relationships with the business, especially with the new owner's representatives, so that more time can be given to firming up good relationships with the on-going business.

Where the entrepreneur desires to stay on with the buyer, arrangements need to be put in place to move loyalties to the new owner. This might mean a change of responsibilities to a new area of the business, the formation of a wider senior management team or a board of directors and the implementation of deeper performance setting and review systems across key areas of the acquired business.

Retaining key employees and corporate knowledge has to be a key strategy of any acquisition activity.

PROJECT MANAGEMENT

Do you have a project manager?

You would not contemplate building a new factory or moving your Head Office without assigning primary project management activity to a senior member of management. Thus you would be surprised how often a major acquisition is undertaken without a similar role being created to manage the pre and post activities of an acquisition. For many businesses, an acquisition is the largest and most disruptive project they will probably undertake and yet many fail to adequately devote resources to managing the activity. It is no wonder that the majority fail to deliver in a positive outcome.

In the lead up to the acquisition agreement, the acquirer will undertake a detailed review of the target business including numerous interviews by senior management of their counterparts in the target firm. This activity would be complemented by a financial and legal due diligence inspection by external service providers and a funding discussion with bankers and investors. Existing shareholders and key managers and employees of the buying firm will need to be briefed and a post acquisition plan assembled. While all this is going on and senior management are being pulled away from their every day responsibilities, the current business has to continue.

However, the pre acquisition activity is likely to be the easy part. Just consider how much work is to be done once the ink is dry. The chances are that some of the acquired senior management will leave prior to or on the date of sale. There may well be key employees who are concerned about their new roles and need to be directly dealt with. At the same time, customers and suppliers of the acquired business will be concerned about on-going support and some effort will need to be spent to assure them of continuing operations. The loss of management in the acquired business also results in some loss of corporate knowledge and disruptions and delays are likely to result.

If the acquired business is to continue in full or part as a stand-alone business, the new owner will need to move quickly to establish effective management over the activity. This may mean implementing new reporting systems, setting up an advisory or director board and, perhaps, installing new senior management. All this will need to be done quickly while providing assurances to acquired staff of business continuity.

If some level of merger activity is to take place, there will need to be consideration of new roles and responsibilities, the possibility of some redundancies and perhaps even relocating to new premises to handle a larger number of staff or functions. Systems and processes will need to be integrated, cultural differences dealt with and existing business levels protected.

Can all this be done by existing management while continuing to cover their primary responsibilities? Almost certainly not. Few managers have an intimate knowledge of M&A processes and few have the capacity to take off extended periods of time away from their primary roles. The only way to tackle this type of activity is to bring into the firm someone with M&A expertise, perhaps also someone with change management expertise. While much of the decision making cannot be outsourced or delegated, the day to day management of the acquisition activity can be. Whether this is a full time role or a part time one, there is a strong case for putting someone in charge of the entire process.

OUTSOURCING

Outsourcing capabilities

There are very few senior executives who have participated directly in an acquisition and even fewer who have undertaken several. Given the risks involved, it is a brave business owner who takes on an acquisition for the first time. The research shows that even experienced acquirers are not immune from messing up an acquisition, therefore, what hope does the beginner have? This is one of those activities where it is better to be safe than sorry and admit that you need help from more experienced and, perhaps, wiser heads.

When you look across the acquisition process you need a wide range of expertise. It is highly unlikely that any business owner will have the knowledge and experience to undertake a competent job in all. Thus is makes sense to look for expertise in a number of different areas. We need to be able to develop a targeting strategy, undertake due diligence, negotiate the deal, manage intervention or integration activities and then manage the acquisition once the dust settles. Even the smartest acquirers know that there are legal and accounting aspects of the deal which are better handled by specialist service providers. Given the risks, you should seriously consider building additional capacity and competence across several of these areas by taking on external consultants for limited projects within the overall activity.

While large corporations have the economies of scale to take on full time experts in areas of strategy development, due diligence, negotiation, change management, project management and so on, the smaller firm simply doesn't have the workload across these specialist areas to justify full time staff. This should, however, not stop them from taking on specialist for a project based assignment. Better to pay for an expert and make sure the job is done competently than do it yourself and end up with a problem which will cost you dearly in executive time and money.

You might start with a firm of accountants or lawyers who have extensive experience in mergers and acquisitions in your industry. Develop the overall acquisition plan with them and set out the range of external advisors that you will need to get the task done properly. Then using their networks, interview and engage the specialists you will need. Ensure that you also take on someone, internally or externally, who can project manage the entire process as this person will need to coordinate all the different advisors and internal staff working on the project.

Acquisitions tend to be very disruptive. We tend to forget that they tend to occur over relatively short periods of time, are somewhat unpredictable as to when the serious activity occurs and absorb large amounts of senior executive time. If much of the day to day work can be outsourced, this will leave management to concentrate on the strategic decisions. The normal operations of the acquirer can then be continued without putting too great a strain on internal resources. Using external advisors as and when needed may also be much more cost effective in the long run.

To limit your risk as a new acquirer, you need to tap into the accumulated experience and wisdom of service providers and specialist advisors. While this may seem to be expensive at the time, the probability of avoiding an acquisition disaster will be substantially reduced.

OPERATIONS

Merging operations

If you read the merger and acquisition literature then you will soon discover that it is mostly about mega mergers; corporations of 20,000 employees merging with others of 15,000 employees. What is also clear is that this mostly ends up in some form of disaster where the original benefits are either not achieved or only achieved after considerable time and, usually, at a return on investment well below the target. Then there are those mergers which are a complete failure and end up demerging in order to protect whatever value is left. This is a minefield and not for the feint at heart.

While the potential problems are numerous, acquirers tend to make the same major mistakes. They fail to take into account the level of systems and processes that need to be re-engineered and fail to recognize the massive problems involved in merging cultures. While systems and processes can be fixed with enough time and money, there are cultural issues which simply cannot be overcome just by throwing resources at the problem.

We tend to forget that businesses develop over time in a somewhat random manner. Systems are cobbled together to overcome short term problems and end up becoming part of the fabric of the firm. Over time, new systems are layered on top of those and one off systems are developed to link all these disparate bits together. Buried in this mountain are also systems to manage activities which are unique to the way in which the business works. While two businesses may look the same from the outside, there may be countless differences at the transaction and decision making level. So when it comes to merging operations, not only do systems not look the same, they don't work the same and often the underlying data is defined in an incompatible manner. What looked like a simple merger operation now takes on the size of a mountain. Of course, many corporations exacerbate the problem by merging too many systems, aiming for a one-size-fits-all when in fact they could have just as well left it alone.

The major problem of merged operations is, however, cultural mismatches. Just because you are in the same business does not mean that you think alike, operate the same way or have the same set of corporate values. While some people are able and willing to change to a different way of operating, some are simply resistant. This gets even more problematic when underlying ethical values are different. Even some differences in culture can take a long time to change, often with a loss of some employees. When those differences are significant, there is little chance that making everyone the same is going to be quick, inexpensive or without the loss of a large number of staff.

We too often forget the basic rule of business – if it is not broken, don't fix it. Far too often mergers have failed through over-integration. Basically, if you don't have extensive experience of putting together two different business units, then you should think long and hard about your acquisition strategy. If you do need to bring units together, then perhaps a different business structure which keeps units operating with loose connections may achieve 90% of the benefits but avoid 90% of the headaches.

ONE HEAD OFFICE

Merging Head Office functions

While large scale integration activities tend to result in merger failures, the same cannot be said for limited integration activities, especially of non-core or service activities. A common theme which you see in many successful consolidation and roll-up strategies is to leave the operations activities in the acquired business to be managed by local management while service functions such as personnel, public relations, investor relations and other head office service functions are consolidated. This leads to some economies of scale while still retaining the integrity of the major operations.

Too often acquisition activities are approached with an objective of 'one size fits all' and 'lets all be one big family' without appreciating the costs and risks of pushing and pulling everything together for often dubious benefits. Few companies have experience at large scale integration and even fewer have managed to do it successfully. Not only does one have to cope with physical integration of premises, information systems, products and operations but one also has to sort out how to accommodate two sets of employees with different cultures. Then, of course, one has to wonder if the merger benefits were in any way realistic from the outset or whether they were someone's fantasy of what they would like to happen rather than what is the most probable outcome.

Those acquirers who set out to build scale by buying stand-alone operations, usually in the same industry, who recognize the benefits of keeping the operations well contained and focused, tend to achieve better acquisition results. However, they do tend to centralize common service functions where economies of scale and specialization has corporate benefits. Often smaller companies cannot justify the services of specialists and usually outsource those function. A larger entity can bring these in house and provide a better outcome by having the personnel focus wholly on the activities of the corporation. Some benefits can also accrue to all group companies through centralized procurement or group preferred purchasing agreements.

Even though decentralized group structures may give up some scale benefits by leaving operations loosely coupled, they often have the benefit of lower risk and greater resilience. Smaller business units tend to be more responsive to market changes and can purchase more specialized systems and equipment to suit their limited market. Another advantage of loose coupling of business units is that it allows the group to buy and sell business units more easily. Uncoupling an integrated activity is highly problematic and confronts both buyer and seller with higher risks.

While cultural differences are most often the cause of merger failures, it is interesting to note that most central service functions often have more in common with each other across companies than they do with other parts of their own business unit. Thus most PR activities tend to recruit similar people and work in similar ways. The same could be said about legal services, shareholder relations, treasury and other head office services. Thus combining these functions is often far less problematic from a personnel viewpoint than combining operating units.

Hesitation to merge should be the fundamental rule in acquisitions. Unless there is a compelling case to integrate activities, they should be left alone. That is not to say they should not be improved with better management, systems and processes, but pushing business units together should be resisted unless there are significant and readily achievable benefits.

ETHICAL VALUES

How important are ethical values?

One of the well know problems of merging activities of a newly acquired firm into those of the buyer is cultural mismatch. It is not just that there might be different ways of conducting operations but that the unwritten rules on which decisions are made may be based on a different set of underlying values. A clash occurs when parties take very different positions on either the manner in which some business issue should be dealt with or on the desired outcome. A much deeper problem is that of differing ethical values. While these underpin organizational cultural values, they stem from individual beliefs rather than more widely held corporate norms and are harder to determine.

Our ethical values come primarily from our upbringing as modified by our personal life journey. Most often they express ideological and religious beliefs or beliefs about how societies should work. Our personal ethical values tend to be aligned with those of our friends and, often, work colleagues. We tend to find employment where we are comfortable with the ethical values of those around us. Ethical values can be sufficiently strongly held that we won't compromise them even if offered generous incentives to do so.

In a merger, culture can be changed to a limited extent, however, only to the level that the new situation is aligned with the underlying ethical values of the individuals involved. Therefore, ascertaining the ethical values of the target firm in a potential acquisition can become critical in achieving post-merger success. Unfortunately, we do not have an easy way of ascertaining ethical positions. One technique that I use which can assist to avoid major clashes is based on situation scenarios or hypotheticals.

There are many situations in business where there can be multiple legal outcomes. The choice of preferred outcome is often based on our ethical values. There are many more situations where the legal position is somewhat unclear where possible outcomes are more polarized. Sometimes what is the 'right' thing to do will very much depend on the way we see the world. Take, for example, the classic problem of redundancies. Should I lay off the oldest workers, those with the shortest service or those who are least productive, qualified or team oriented, or should I lay-off the most expensive. This choice can bring out very strongly held beliefs in people. Should I terminate my best sales manager because he made inappropriate sexual remarks to a junior employee or should I move the junior to another department rather than risk losing my best sales generator?

Develop a set of scenarios which really make people think hard about the decision and the alternative outcomes which will bring out their underlying ethical positions. Use this internally to discover your own ethical values. The next stage is to request that these be given to executives in the target company as part of your due diligence. If you get a very different situation to your own, you will know that those two business units will never work together.

CULTURAL FIT

Cultural Fit – What does this mean?

Defining what culture is and how it impacts acquisition success has kept a lot of academics and consultants busy for decades. Even so, we don't seem to be any closer to finding a silver bullet for solving cultural mismatches in merger activities. Perhaps it is just too difficult a nut to crack. However, being aware of the problem and the difficulties of resolving cultural mismatches is perhaps the best risk mitigation strategy we can take when reviewing acquisition targets.

Without getting over theoretical, culture is often defined 'the way we do things around here'. Put into a business context, it describes such things as behavior, shared values, norms, personal interaction, reward and promotion systems and interfaces between business units and external parties. Organizational culture is often said to be collective wisdom or memory. Shared experiences built up over working lives condition the way we approach old and new problems. Thus two organizations in the same market may have very different approaches to how they do business internally and externally because of their individual history of what has worked and not worked for them. Out of this individual internal collective experience comes both written and unwritten rules about how employees are expected to deal with everyday issues which confront them.

While it is possible to use theoretical psychological and organizational behavioral measures to derive some insights into an origination's culture, what we really want as an acquirer is a quick indicator of the size of the problem of bringing two different businesses together. Perhaps it is sufficient to have a set of attributes of culture to tell us that problems will occur. Let me therefore suggest that you start with what you can easily observe. Organizations vary in size, age, product market interfaces, diversity, strategy, location, reward systems, level of decentralization, degree of formalization of dress code, recognition of formal qualifications and so on. Each of these attributes and many others which are readily obtained from public documents, indicates something about the way the organization is likely to operate. If your business has dramatically different characteristics along some of these dimensions, you can expect to meet some cultural challenges.

What we will encounter in an acquisition is a working environment in the target firm which is seen by those who participate in it as acceptable, even if it not ideal. When we come along and wish to impose a different mode of operating, we are suggesting that the prior environment was wrong. For example, we prefer to promote highly qualified people with diverse working experiences who are innovative in approach. They have a history of promoting long serving loyal employees who have worked their way up through the business straight from school. Imagine how confronting that must be. Their whole approach to being a good employee is suddenly undermined. What was right before is now frowned upon. Future promotion is now in doubt. Change is going to be stressful. Many will feel that they wont fit in and that they might be better off seeking employment elsewhere. Those who feel trapped by personal circumstances will resent the change, be disruptive and perhaps work to undermine progress.

The fact is that cultural change is hard and positive outcomes of cultural change processes are difficult to achieve. Perhaps a smarter strategy is simply to walk away from the deal or work out how you can leave the target firm operating in its traditional manner.

WORST CASE SCENARIOS

Develop worst case scenarios

Acquisitions tend to stretch most acquirers to the limit. Perhaps they tend to take on more than they should or maybe they are simply unprepared for the process, but what is obvious is that most buyers fail to achieve their investment objectives. Few anticipate the level of executive commitment required, the extent of disruption to their own business or the size of the project they are taking on. The timing of the deal is often outside their control and thus can come when the firm is already working at capacity. What they often fail to do is to work out what could go wrong before they decide to launch their acquisition bid.

Perhaps the most valuable tool in the armory of the acquirer is the worst case scenario. Murphy's Law is great technique for working out whether you have the capacity and capability to take on an acquisition activity. If you project that you can get through the activity when things go wrong, the chances are that you will come out the other end in reasonable shape.

When I was the President of a UK based software firm of 34 staff, I undertook an acquisition of one of my software suppliers in San Diego which had 57 employees. We agreed the deal, raised venture capital to finance 75% of it and used surplus cash and anticipated earnings to cover the balance. A US based national firm of accountants undertook the due diligence and gave the firm a clean bill of health. Three months after we took control, the same accounting firm undertook an audit and discovered serious irregularities with revenue recognition and inventory counting. As a result of these findings we took the accountants and prior owners to the federal court in the US. Over the next five years the business was severely disrupted, lost money most years, terminated about one third of the employees and drained the UK of cash. Both businesses were almost brought to their knees by the litigation activity.

The mistake we made was to rely on the profitability of the acquired firm to partly fund the acquisition and to assume that the change of ownership would require little attention from the UK executive team. Even though we undertook a proper due diligence, we were let down by our advisors. Basically, we had failed to build in enough capacity to deal with possible problems.

If you start the evaluation process by looking at what might go wrong and how you could mitigate the costs, delays and risks, you have a much better appreciation for what resources you need to have on call in order to get through the process. The worst situation to be in is to suddenly be confronted with an unanticipated problem for which you have no strategy. You need to plan for the loss of key employees, disruption of both businesses, a heavy drain on executive time, more time to bring the business under new management and a longer time to achieve investment outcomes. If you can still make a positive case for the acquisition under a worst case scenario, you are probably looking at a very good investment.

CUSTOMERS

Talk to Customers

They say what you don't know can bite you. This should be the rule when it comes to evaluating a potential acquisition. It is the unsaid and undocumented which will come back and cause delays, disruptions and costs after the deal goes through which will undermine the objectives you have for the investment. Sometimes, a little more time investigating what is not documented might cause you to cancel the deal, renegotiate the price or put in some contingency plans for post-acquisition activities. One minefield of information which should be tapped is the existing customers of the target firm.

The existing customers will have information on the quality of the products and services, problems dealing with sales and post-sales support staff, experiences with agreements, product and service shipping and delivery issues and the ease of dealing with the firm over warranties, product upgrades, maintenance and customer product queries. Tapping into this wealth of information will tell you a lot about the target firm's culture, the quality of their products and their relationships with existing and prospective customers. In any competitive environment, growth, profitability and resilience is highly dependent on recurring business from existing customers and the willingness of customers to refer the firm's products and services to prospective customers. Such feedback will give you the evidence to allow you to judge the quality of the revenue and profit forecasts you are getting from the vendor and will assist you to judge whether your own projections are feasible.

Another aspect of customer interviews which is highly valuable is to compare what the customer was promised with what was eventually delivered. Outstanding work or commitments which are not documented or have not been disclosed to the prospective buyer can dramatically change the value of the investment. This would especially be the case where there were large numbers of customers unhappy with the service being performed and had an expectation of future remedial work which the customer was not anticipating paying for. You might also uncover customers who are sufficiently unhappy that they are actively considering litigation for unfulfilled commitments. This feedback can be reconciled with the written agreements to see if customers are being promised outcomes which the firm is unable to deliver or whether unwritten agreements are in conflict with formal contracts.

On the other hand, you might also be pleasantly surprised with what you find. The vendor may have undersold the degree of satisfaction of their customers or be unaware of the potential to sell additional products and services back into the customer base. A customer base which is highly satisfied can be tapped for additional revenue but can also be stimulated to provide referrals to prospective customers. Feedback might also indicate where uncharged for or bundled services might be able to be priced as separate supplies.

Whether the feedback is positive or negative, it is critical to undertake some level of independent verification of the claims of the vendors. With this data, the vendors can then be asked to address concerns and to clarify issues so that the potential buyer can arrive at a much deeper understanding of what they are taking on.

TRANSITIONS

Personal transitions

When confronted with the imminent sale of their business, employees will focus on their personal issues and this process will continue until long after the acquisition has settled into new ownership. It is the expectation of change in their situation that first unsettles them but soon their fears become real as things are changing around them as the deal is finalized and the new owner starts to create a new future for the business. Some won't stay the distance and will leave, others will resent the changes and be disruptive, while some embrace the changes and look forward to new opportunities. What is very clear is that this is a personal journey for each employee and simply can't be tackled with a herd approach.

When employees are confronted with possible changes, anxiety kicks in and they start to imagine the worst. Will I still have a job? What about my planned vacation? Will I be able to take time off for my studies? What if I don't like my new supervisor or my job changes and I can't cope with the new responsibilities? Uncertainties fuel rumors and, of course, rumors support the worst possible outcomes. As an acquirer you need to quell these uncertainties as quickly as possible with both personal interviews to answer questions and group information to show what is happening and to set expectations.

Once the personal situations have been resolved, individuals will then grapple with the changes. Even at this point there are unsettling situations. Some people are likely to be made redundant and so there is a loss of friends and work colleagues. Workloads are likely to increase through the change process as some people leave and systems and processes are changed. Not only does the current work need to be undertaken, sometimes with fewer people, but change brings with it additional work. During this period, organizational changes are occurring, new management and ownership are getting to know employees and, often, new directions are being set.

As the dust settles on the changes, those that have been retained begin to become used to the new environment. Things aren't quite as bad as they thought. New relationships develop and new friends are made. Life goes on and people start to gain personal security under the new owner. They start to look forward and plan for a future in the newly acquired business.

What is very obvious throughout this period is that each individual must go through a personal transition to let go of the old and embrace the new. Each person will undertake this journey in their own time as they face their own anxieties and fears. Some will quickly move forward, some will resist and proceed slowly while others wont complete the journey and leave or be terminated. Understanding this process is critical for an acquisitions strategy. Communication of changes, quick resolution of issues and a well thought out process for identifying and resolving personal concerns has to be at the heart of any pre and post acquisitions project plan. Failure to recognize the importance of individual transitions will seriously undermine the achievement of acquisition objectives.

EXPECTATIONS

Managing expectations

We all know exactly what to expect from an acquisition, or do we? Actually, we will probably have as many views as to the impact of a new acquisition on our business as we have employees. Some will be optimistic, some pessimistic and others simply focused on what is likely to happen to themselves. You can be certain that, without extensive communication, most will have the wrong end of the stick and the outcome will be different from what they expected.

Inside the acquirer, this is going to create problems. Some will be disappointed, others will be dismayed, some will leave due to uncertainties and a few will be really pleased with the result. In the middle of all this, work will be disrupted, some will be stressed out and others will be maneuvering to take advantage of the changes. Only with comprehensive briefings, updates and some personnel counseling will the acquirer get through this period without some loss of staff and disruption to ordinary business.

Now let us turn out attention to the vendor firm. If you think you have problems in the acquirer, it will be nothing like the level of stress and disruption in the vendor. They have an uncertain future. Some will lose their jobs, responsibilities and reporting lines are likely to change, remuneration packages and health benefits and vacation benefits may be up for review. Some people will leave due to the level of uncertainty around their future. Current business levels will suffer as people focus on their own problems, take on the additional work of the due diligence process and spend time in discussions with their co-workers.

What we have is basically an expectation problem. Wherever there is an information gap, rumors and gossip will fill in the blanks, usually with inaccurate or highly biased information. The result will fuel the fire of uncertainties and create even greater levels of stress and disruption.

Smart acquirers and smart vendors know this is going to happen and work to put out the fires before they gain traction. It all comes down to communication and process. Staff in both companies, acquirer and vendor, will be concerned about their jobs and their futures and only by putting the time and effort into satisfying questions will the acquisition process be able to deal with this issue.

Perhaps the single biggest contribution to this problem is to set out very comprehensively the reasons why the acquisition is being undertaken and the manner in which the acquisition objectives will be achieved. The next step is to show the impact on each organization and the manner in which the post-acquisition business will be conducted. Since few acquisitions actually are fully merged into the buyer, many of the fears of loss of jobs or changes in responsibilities will go away. Management needs to ensure that all impacted staff are briefed and have the opportunity to voice their concerns and have their questions answered, promptly. Lastly, there needs to be frequent communications about progress. The biggest danger will come from doing too little too late.

POST ACQUISITION MANAGEMENT

Setting up reporting systems

After months of negotiations and due diligence, the deal is finally done. You are now the proud owner of a business 2,000 km away. If you have not done this before, you are about to find out what it is like to live on a plane. Managing a subsidiary at that distance is no trivial task. You are about to find out why time zones make life difficult and why face to face meetings really are important.

The vast majority of entrepreneurs work physically closely to their staff. They see them on an hourly or daily basis. They have regular interaction with them over activities and issues and deal with most situations through face to face interactions. When things need the personal touch, they visit the office/factory/site where decisions are needed and resolve the problem in close consultation with the employee/contractor/supplier or customer.

Now lets put 2,000 km between you and the problem. You now have to rely on others to tell you what is happening. You can't physically examine the situation unless you get on a plane and spend a day or so travelling. Even so, you can't be doing that every other day or week without something breaking. Then there is the problem of trust. If you don't visit on a regular basis, can you really be sure you know what is going on?

Basically it gets down to reporting systems. You need to have sufficient data to be able to judge whether things are going according to plan and whether problems are being identified and rectified. While you can have endless phone calls, you really need information on a regular basis to show you the state of play but also to indicate trends which may cause you to initiate action.

Many business owners are satisfied with conventional monthly financial reports for the business they operate on a daily basis but they are inadequate to monitor the future of a distant business. Financial reports show you what happened and may indicate a trend but they are often weeks behind actual events and due to aggregation of data, often hide problems at a more detailed level. What you really need are activity reports and trend data. It is important to have current information on what is happening in the business on a daily, weekly and monthly cycle. Activities such as leads, orders, shipments, project milestone completions, approvals, prospect tracking and so on reflect not only what is happening but what is likely to happen. It is important to be able to predict from current data and trends where the business will be in a week, month, quarter and a year in the future.

If you have competent staff at the distant location, you don't need to micro manage but you do need to monitor and provide advice and assistance when it is needed. For you to be confident that you can manage at a distance and not have to spend your time on the phone or plane trying to ascertain what is going on, you do need to put in place an activity and financial reporting system which identifies where you need to take action. Don't do this by trial and error. Have this ready to go as soon as the deal is done.

CUSTOMER DISRUPTION

Managing customer disruption

We have all heard the mantra of the new owners; ‘ We are the good guys, trust us, we are here to help you’. However, we have all been disappointed when product lines change, the business is relocated and the prices go up. Even worse, the business is closed so the new owners can take the bits they want and sell the rest. So it is not unusual for customers to approach the impending sale of a supplier with skepticism. Smart acquirers who value the current customer relationships know this and set out to ensure that current customers are retained.

Very few acquisitions leave current customers with the confidence that life after the sale will improve. Companies buy competitors to close them down and increase their own prices. Buyers strip out assets and sell them off with little consideration for the current customers. Business operations are relocated to low cost countries severing personal relationship between supplier and customer. Good staff leave the vendor when new remuneration systems are implemented and existing team relationships change. Basically, there is often little good news for the current customers.

Of course, there are situations where the acquisition objectives are achieved without needing to accommodate current customers and their loss is factored into the investment model. Some businesses are purchased solely to exploit them in a very different manner to the business model used the vendor. Bad luck for the customers. But this isn’t always the case and valued customers can be lost because inadequate attention was given to retaining them by the vendor or the acquirer.

If current customers are important, retaining them needs to be high on the acquisition objectives and plans needs to be implemented well before the new owners settle in. A process of communication and interaction needs to be undertaken as soon as possible. It starts by ensuring that everyone inside the vendor and acquiring companies understand the importance of retaining current customers so that the informal networks communicate this to customers and the local community. In addition, a very clear formal statement about continued operations needs to be released to customers as soon as possible. Key customers should have a personal visit from the new owner, usually in the company of vendor management. Customers need to understand the business logic for why they are important to the future of the combined business not just the marketing spin.

Customers want to be told that the current products will be retained, if not improved. They want to know that their business relationships will continue without disruption. Customers who have a choice of suppliers need to be convinced they should not be examining alternatives.

The acquirer who neglects current customers risks significant disruption to the revenue of the acquired business. Yet, it does not take a lot of effort to ensure they know what is going on, understand their importance to the future of the business and have their concerns addressed. Value in the acquisition can be easily lost if this activity is neglected.

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