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Good Opportunities Despite Inherent Difficulties:

Meeting the Challenges Presented to Private Equity Sponsors by Smaller Acquisitions

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Smaller acquisitions are, and should continue to be, the bread and butter of many private equity sponsors. For others writing larger check sizes, the smaller acquisition may arise as an add-on to an existing portfolio company. Regardless the reason for stepping into the fray of the smaller deal, these acquisitions present a unique set of challenges. If the sponsor needs or wants to play in this sandbox, navigating the challenges becomes an opportunity.

While private equity sponsors have increased their spend for individual acquisitions during the past four years, buys under $25 million still account for more than a quarter of all private equity transactions. And, to paint a stark contrast, Pitchbook reports that while more than 30 percent of last year's deals broke the billion dollar threshold, for every billion-dollar-plus transaction in 2018 there were 11 under the $25 million mark. Of those smaller acquisitions, the average transaction price tended to hover around $6 million.

Targets requiring a lesser check size have provided many private equity sponsors with excellent opportunities for growth and deal flow. In many cases these purchases are accretive to already existing portfolio companies by creating synergies. Frequent examples include adding new product lines to an existing suite of products with complementary channels of distribution, entries into new geographic markets or expansion to new key customers. In some situations the sponsor has been able to acquire the manufacture of a key component presently sourced from a vendor that later became the acquisition target. Some acquisitions fit a profile for sponsors seeking opportunities that need more hands on attention and the ability to influence growth. Other purchases involve companies that are under-performing. Companies meeting this profile may have weak existing management that would benefit from a stronger and more experienced management team, which the investor can provide through an operating partner or an add-on purchase. Sometimes it's in reverse. In one series of transactions with which we had recent involvement the sponsor acquired a new platform that was grossly underperforming and created growth by later acquiring a competitor with a strong management team. Call it the mouse that roared, but it led to a massive home run at exit. While the circumstances may vary, synergies are a common denominator, frequently leading to lower production costs, increased product offerings, more efficient channels of distribution, greater buying power and a larger market share, among others.

But, the small spend for these transactions does not translate into faster or easier. A small dollar price tag does not mean a simpler transaction. Virtually none of these deals is without challenges, some unique to the size and others similar to many larger acquisitions but exacerbated by features typical to the smaller enterprise. With care and planning, however, most can be overcome.

Often the target will be the product of the lifelong enterprise of an entrepreneur who now seeks an exit. The entrepreneur most often is unsophisticated in M&A and has an attorney who is similarly inexperienced. They may not hire an advisory investment banker or may hire an inexperienced broker. Challenges are imposed by the seller that do not typically arise with a more sophisticated counterpart. As an example, in a recent deal the seller objected to all of the reps and warranties. He commented that, as for the financial reps, we should get the representation from his accounting firm! Reps and warranties insurance often is not practical given the size of the acquisition, as was the case in this example. So, we were tasked with providing the seller with an education that the representations are not a matter of veracity but rather a benchmark from which value, i.e. the purchase price, is derived. Even that explanation was difficult for the entrepreneur to absorb, requiring patience at the negotiating table. The PE firm on the buy-side of this dilemma may suggest to the seller that they bring in special M&A counsel. We've done it, and it works; but often later in the transaction after everyone has suffered a few stumbles. On those occasions where an M&A advisory banker is involved, they will be an ally in support of the seller using a more experienced attorney.

While some strategic add-on acquisitions can provide a welcomed alternative to the pricing frenzy that can arise in an auction process, often an exiting entrepreneur has an inflated or unrealistic sense of market value for his company. An entrepreneur often seeks to justify his price, above market, with an unusual rationale. It is not infrequent that the entrepreneur will dig-in his heels arguing his price is based on an amount of money he needs to retire. Creative negotiation can often solve the dilemma this imposes. An earn-out, carefully crafted, often can be the solution. A higher price can be justified, and paid for, with better than anticipated future results. And, if results are not as anticipated, the higher price is obviated.

Retention of customer relationships presents another challenge. Care must be taken to preserve key customers. Identification of the customer base may be guarded during due diligence. This can be overcome by use of an independent third party, often a respected accounting firm. The names won't be vetted, but the numbers certainly can. But this can be an issue in any size transaction, especially where competitors are involved and often with antitrust implications. In the smaller deal, the retiring founder likely holds most or perhaps all of the important customer relationships. Holding onto the founder may be critical to support customer retention and transition. Putting a portion of the purchase price into a consulting agreement with a one or two year tail seeks to assure the entrepreneur will be around to provide transition services. And, of course, an earn-out helps here, too.

Many smaller companies suffer deficiencies in their financial reporting and accounting systems. Financial statements may not be audited, but rather reviewed. In some infrequent cases financial reporting may be based on a receipts and disbursements method rather than an accrual method of accounting. We have found it worthwhile in many instances to recreate three years of accounting history by completing audited comparative financials. Sometimes easier said than done, as performing an audit retroactively is time consuming and expensive – but often worthy of the time and expense. The administrative burden of merging accounting systems cannot be overlooked or minimized, including the integration of different software systems and line item reporting. Here, too, the three year look back can support integration by recharacterizing the report and creating line item consistency.

Multifaceted and complex integration challenges beyond accounting will also arise. Most importantly, culture matters. Search for a culture fit is paramount, but rare is the acquisition that has the same corporate culture as the company, or companies as the case may be, into which it needs to be integrated. Integration can be difficult and can lead to losses of management or other important talent, and changes in business style run the risk of driving away key customers and frustrating important vendors. Human resources generally, and benefits and personnel differences specifically, can be addressed during due diligence, making the acquisition more seamless and less costly. Post-closing is not the time to first address these issues. They should be met head-on by developing an integration plan during due diligence and, if possible, with implementation prior to closing.

Notwithstanding the lesser price tag, the smaller transaction generally requires the same amount of due diligence and professional services expenses. This puts downward pressure on the professional fees, especially if the investor needs to conduct a series of acquisitions. Alternative fee arrangements have become more common albeit not widespread. We have seen increasing use of fixed fees and fee caps. We would caution, however, that fixed fees often carry the burden of a cushion to protect against unforeseen circumstances, so hourly rates tend to provide lower overall cost. Fixed fees become more in line with actual anticipated costs when the law firm can carefully delineate the scope of the work. Many firms, including ours, have adopted tighter budgets with more frequent fee reporting to manage expectations, keep the legal spend in line, and avoid unnecessary surprises.

Preparation, forethought and the right team will address the challenges presented by smaller acquisitions by anticipating bumps in the road ahead. It's certainly not as easy as just avoiding an auction process or increasing deal flow. But, a successful smaller acquisition, or program of multiple such acquisitions, can be extremely accretive for the sponsored fund leading to exits with strong multiples of return on investment.

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