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Private equity add-ons on the rise, small deals face challenges

By Mark Greenfield and Katherine Andreeff

Market uncertainty is further depressing merger-and-acquisition activity. To maximize deal flow, private equity sponsors have paid increased attention to smaller add-on acquisitions, which create a unique set of challenges.

As evidence of the pivot, deals having less than US$25 million in enterprise value composed 43 percent of private equity add-ons in 2024. Sponsors understand add-ons complement an existing platform and the potential benefits include diversifying product lines, expanding geographic reach, accessing new customers and improving operational efficiency.

However, the small deal poses problems that require special planning, attention to budget, innovative purchase price structures, modified but creative due diligence and integration strategies to ensure successful outcomes.

Higher transaction costs

High transaction costs relative to deal size present a challenge. Smaller transactions involve greater expenses, proportionally, than larger ones. Smaller deals put pressure on the acquiror's financials and management then puts pressure on fees. Sponsors and platform executives seek advisers who can manage the transaction spend.

We have found our private equity clients appreciate slimmed down budgets, based largely on efficient delivery service and modest discounts on fees, with caps when possible.

Due diligence

A lack of reliable and comprehensive data about the target company is a common hurdle when acquiring smaller companies. These businesses typically have incomplete financial statements or inconsistent reporting, which yields gaps in financial information and frustrates a comparative review.

Sellers also may have less transparency on their operations, governance, compliance and risk management practices, making it difficult to conduct thorough due diligence and assess quality of earnings, growth potential and valuation of the target.

Our clients routinely use forensic support during diligence regardless of deal size. However, we regularly recommend experts with special capabilities to handle smaller transactions, both with an understanding of which underlying factors require deeper investigation and what issues really matter.

The challenge is to deliver top-tier legal services on a reduced budget, so use of subject matter experts must be judicious.

Expectations vs. reality

Sellers often have an unrealistic view of their value, but that disparity can be resolved in creative ways. Most common is using an earn-out pegged to later performance, which can be teased successfully with waterfall hurdles, providing a negotiation tool that focuses the seller on a higher number.

Deferred consideration mitigates cash constraints and provides hold-back funds for any contractual breach that might arise, which is useful in smaller deals when reps and warranties insurance may not be economical.

Commonly, there is a mismatch between the capabilities of sellers and the demands and standards of sponsors. Smaller sellers typically have less experience and sophistication with M&A and may not understand or appreciate the complexity and rigor of the process.

Their advisers also are typically not well-versed in the nuance of M&A and lack the resources and expertise to handle the deal effectively. This can lead to delays, disputes or deal breakers.

Human resources

Smaller companies usually have inadequate human resources capabilities and lack proper policies and procedures to ensure compliance with laws and regulations. They are more likely to have exposure to wage and hour violations or wrongful termination.

These factors can create legal and reputational risks for the sponsor and the acquiring company and may require significant remedial expenditures. To mitigate this exposure, attorneys must pay particular attention to the heightened risks and align the target with the best practices and standards of the portfolio company.

Financing

Notwithstanding established banking relationships, sponsors find traditional bank financing can be limited. Commercial banks typically impose lower leverage ratios, higher interest rates, more restrictive covenants or less favorable terms than for larger transactions.

To overcome this challenge, sponsors often seek alternative financing sources, such as nonbank, mezzanine or seller financing.

Seamless synthesis

Integration into the existing platform is problematic in every transaction, big or small, and many deals fail for lack of attention to this post-closing challenge that deserves pre-closing planning. In the smaller deal, the seller is critical to the business but usually is exiting into retirement without succession planning, creating a gap in leadership, culture and customer loyalty.

To mitigate this challenge, we recommend a short-term consulting agreement with the seller, providing transition of corporate know-how and institutional memory as well as customer retention. Transition planning is commonplace for all acquisitions but essential when the selling entrepreneur is the one key employee.

The seller often has deep emotional ties to the business and, if they stay, may be reluctant to relinquish control or adapt to the new culture and standards of the buyer. Sometimes it works, but most times it doesn't and the retained seller often becomes a terminated employee.

The business is still viable so long as the stay is synchronous with the need for transition and we have found it can be mitigated with a strong severance package. The cost of the severance can be built into the cost of the transaction for purposes of projecting return on investment.

Despite these challenges, smaller add-ons provide valuable synergies and growth opportunities for private equity platforms if they are planned, executed and integrated effectively. Sponsors' attention to smaller deals can strengthen current platforms and address key gaps in M&A activity.

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