Feldman Associates

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Middle Market Acquisitions: What's So Hard?©

Seventy Voices of Experience
on Meeting the Challenges
of Middle Market Acquisitions

Findings from an Online Interview of Middle Market
Executives, Investors, and Advisors

May 2012

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"Countless acquisition publications recount case studies and recommendations pertaining to multi-billion dollar firms, which fundamentally do not speak to the challenges faced by middle market firms. This report fills a conspicuous gap for middle market executives generating value through acquisitions."

Aaron Kase
Partner
Levenfeld Pearlstein, Chicago-based law firm

"This is the first acquisitions study I've seen that directly addresses the important issues faced by the middle market executive who will live with the numerous decisions made during an acquisition campaign."

Bill Goldberg
Chief Executive Officer
MediMedia, a leader in healthcare communications.

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May 2012

"If I have seen further, it is by standing on the shoulders of giants"
Sir Isaac Newton

Thank you for your interest in "Middle Market Acquisitions: What's So Hard?"

Many middle market executives gained their acquisition experience while working for multi-billion dollar companies. But for middle market owners and executives without such experience, the work of acquisitions reveals both extraordinary opportunity and daunting challenges. The many books and articles on effective acquisition management rarely speak to the unique nature of middle market acquirers.

Earlier this year, I reached out to over seventy middle market executives and advisors who generously shared their experience on the challenges of acquisitions. This report is our opportunity to share their observations, cautions and optimism for how the challenges of middle market acquisitions are met.

These executives and advisors were asked about these nine areas of acquisition work shown on the cover page: strategy, deal flow, team, engaging sellers, valuation, financing, negotiation, diligence, and integration. Their responses form the core of what you'll find in this report, including:

- Executive summary (pages 3 – 4)
- An examination of the nine different elements of acquisition work (pages 5 - 13)
- Acquisition leadership… final words of advice (page 14)

My hope is that the insights here are valuable to middle market company executives and their internal teams, as well as to advisors of and investors in middle market companies. Of course, you are welcome to share this with colleagues or friends.

Finally, your feedback is welcome. Please send comments, suggestions and any questions about the study to me at jf@josephfeldman.com. Good luck with your acquisitions work!

Sincerely,

Joseph Feldman
President

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Executive summary

This report provides an extraordinary peer-to-peer learning opportunity for middle market executives, their investors and advisors* regarding middle market companies as acquirers. Specifically, this report presents feedback from over seventy practitioners who shared their views and recommendations for succeeding with middle market acquisitions *and* avoiding numerous pitfalls through the acquisition process.

While successful growth through acquisitions is notoriously difficult, the "game-changing" potential of acquisitions makes this growth strategy highly attractive to many company leaders. The voices of experience featured in this report provide no "silver bullets," but several actionable themes emerge:

- Field the right team – the multi-faceted work of acquisitions likely requires a blended team of internal and external experts; selecting the right team is a make-or-break decision.

- Anticipate upfront investments – setting the stage for a successful acquisition will require preparatory investments of time and money ahead of spending on any particular deal: setting strategy, generating deal flow and assuring financing to close a transaction. These upfront investments will generate high "returns" when the right opportunity is found.

- Avoid common sources of failure – there are many opportunities to learn from others' mistakes with regard to how acquisitions can and do fail; the voices in this study describe numerous "watch-outs" particular to middle market companies.

Among those "watch-outs", this study identified a range of leadership styles particular to middle market companies that may prove counter-productive in the case of acquisitions.

Specifically, leaders of middle market companies are, by reputation, an optimistic group: having a can-do attitude, getting more done with less, and being resistant to the processes typical of much larger organizations. And these leaders have a bias for working with advisors who operate with these same characteristics.

(continued)

* "Advisors" refers to investment bankers, business brokers, lawyers, accountants, consultants, and external experts who may be engaged to complement the company's own resources dedicated to pursuing acquisitions.

However, these management styles commonly associated with day-to-day operating success in middle market companies may bring substantial risk in the case of acquisitions, including misalignment with and unmet expectations from external advisors.

Day-to-day success drivers	Related potential acquisition risks and failure drivers
Can-do attitude	• Inadequate planning • Executive team over-stretched • Insufficient care in vetting opportunities
Get more done with less	• Under-investment in external advisors • Business integration overwhelming
Resistant to large-company processes	• Risk assessments too limited • "Agreed" deal fails to close • Frustration with due diligence and purchase agreement documentation

And so, a last theme for successful acquisition leadership:

➔ Communicate, communicate, communicate – active dialogue among the company leadership and all members of the acquisition team is essential to maintaining alignment, timely decisions during negotiations, and connection of these individual work efforts into a coherent overall program.

The communications-focused observations shared in this report reflect both good and bad examples… emulate the good and take caution from the bad!

In summary, the voices of experience assembled here are ultimately intended to support the CEO or company executive responsible for the success of an acquisition program.

The advice and insights shared here should help prepare the accountable executive to meet an acquisition effort's complex blend of strategic and tactical decisions, executed by a purpose-built team of internal and external experts, under time and competitive pressure.

Acquisition strategy

Challenge rating*:

Company executives **3.7**

Advisors **3.8**

5 = Very difficult
1 = Very easy

"An acquisition strategy is an outgrowth of the overall business strategy. If the business strategy is not clear then the acquisition path is very risky."
Middle market executive

Strategy development is challenging in general; in the context of an acquisition, having a strategy in place is essential.

- Strategy development is not necessarily a core skill for many middle market companies
- A defined strategy is a key driver of alignment (or not) between company executives and their advisors
  A growth strategy provides and enables prioritization, trade-offs, and confidence in an acquisition integration plan
- An acquisition responsive to an existing strategy is less challenging than one for entry to a new business.

"Opportunism" as acquisition strategy???:

Plus: no dedication of resources

Minus: failure to plan, including for financing, integration

Starting with business strategy	"Lack of experience with the development of strategy initiatives in general… the acquisition strategy ends up being too general, not enough emphasis on action-ability. Acquisition strategies tend to be unrealistic… too much focus on the deal-making and not enough realism in the level of difficulty to achieve synergies, execution of the integration, etc." *Middle market executive* "Making the acquisitions successful after closing begins with a good strategy and planning." *Investment banker*
Open-mindedness	"Understanding the target universe beyond direct competitors" and "Thinking strategically about vertical, horizontal as well as less obvious targets" *Investment banker*
Resources	"Everybody already has a full-time job." *Middle market executive* "[Need] resources to prosecute a deal without impacting their core business" *Investment banker*

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* See study methodology; page 14

** See Wordles™on page 14 about "world clouds"

Deal flow

Challenge rating:

Company executives **3.6**

Advisors **3.7**

5 = Very difficult
1 = Very easy

"Most middle market companies aren't in regular acquisition mode, which detracts from their ability to maintain deal flow. How much this matters depends on the strategic objectives of the acquirer and the ecology of their market. It can be easy to target acquisitions if the acquirer has significant industry knowledge, wants to expand into known space [into which] the players regularly interact. To the extent those aren't true, targeting and deal flow are more difficult."

Private equity investor

Gaining access to "deal flow" calls for a conscious effort that combines the communication and networking skills of sales prospecting, strategy articulation and recruiting. Taken as an exploratory and iterative process, the work of "deal flow" is also an opportunity for strategy refinement, market intelligence and (of course) identification of deal opportunities.

"Chance favors only the prepared mind."

Louis Pasteur

Networking

"Deals can happen in two ways – companies become available for sale (opportunistic) or the acquirer can pursue a strategic target. In the case of [the] former, it is a matter of getting in the 'network'. For private equity companies the firm is typically part of a network of deal flow. In other cases, the amount of deal flow will be determined by the quality of the network the company can build with lawyers, bankers, trade groups, etc." *Middle market executive*

"For strategic deals where a target is being pursued, the idea/target should be determined by the business leadership inside the company." *Middle market executive*

"Middle market companies generally do not hire professional deal-makers, and therefore tend to either underestimate the difficulty in making contact with prospective targets – come across as 'amateurs' by not having a detailed strategic rationale for a deal or just want to talk about 'how we could work together' with the target." *Middle market executive*

Committing resources

"Good prospecting takes time and follow-up and can be time-consuming." *Investment banker*

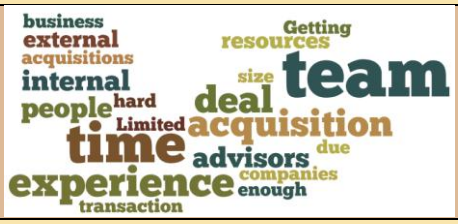
"Ability of management to stay focused and committed over a period of time that is much longer than management expected." *Middle market deal attorney*

Team formation

Challenge rating:	
Company executives **3.3**	"Owners/managers believe they can do anything, including acquisitions in their companies and are loathe to pay transaction fees. The buyer's internal staff already have full plates and have a hard time re-allocating their time to accommodate the fast pace and intensity of an acquisition transaction." *Investment banker*
Advisors **3.7**	
5 = Very difficult 1 = Very easy	

Acquisition teams must rise to times demanding intensity, coordination, trust, and candor. For a company, it is perhaps the ultimate occasion for an top-tier team of internal and external experts.	"Teamwork is the ability to work together toward a common vision. The ability to direct individual accomplishments toward organizational objectives. It is the fuel that allows common people to attain uncommon results." *Andrew Carnegie*

Internal team challenges	"Internal talent with experience in negotiation with and analyzing the operations of the size being acquired are hard to find." *Middle market executive* "It is easier to identify the people and expertise required than it is to engage them in the task, as they usually have other full-time job responsibilities." *Middle market executive* Middle market companies tend to overly rely on 'in-house' expertise; usually do not hire external advisors until something goes wrong, *e.g.*, the deal falls apart due to disagreements over valuation, contract negotiation, etc." *Middle market executive*
Accessing external support	"Not many specialists in this gap between 'business brokers' and investment banks due to deal size and time required." *Middle market executive* "Finding external advisors you can trust that are not just trying to get any deal done." *Middle market executive* "The company's long-time professional advisors, accountants and lawyers, can often introduce the company to appropriate additional acquisition team members." *Middle market deal attorney*
Looking to integration phase	"Must identify an integration manager during the due diligence phase." *Middle market executive* "It also helps tremendously if the deal team has a significant role… in doing post-acquisition integration in the business." *Investment banker*



Engaging sellers

Challenge rating:

Company executive	**3.3**
Advisors	**3.6**

5 = Very difficult
1 = Very easy

"Conversations on outright sale of business really hinge on valuation, whereas mergers/deals for stock consideration involve coalescing seller objectives and finding structure to suit."
Private equity investor

It is critical to understand the potential motivations of a company's owner (or its Board of Directors) to consider a possible sale; motivations vary from situation to situation and over time. Potential drivers include:

- Liquidity
- Diversification
- Access to growth capital
- New growth opportunities
- Absence of viable succession plan
- Alternative to liquidation

While "engaging sellers" requires buyer teamwork, the CEO must expect personal, intimate involvement with key seller contacts.

Cultivating a relationship	"If a motivated seller … it's pretty easy. For an unmotivated, hostile seller, it's difficult and expensive. Most companies aren't deep in deal talent, so it can be a resource waster to chase some deals." *Middle market executive* "Best done by operating people, who have multiple reasons to have discussions with the decision-maker." *Middle market executive* "Staying in contact until the moment is right for the sale." *Middle market deal attorney*
Unmotivated seller	"Unsolicited approaches can be time consuming without successful conclusions." *Middle market executive* "Key issue here is really understanding seller motivation, especially when privately held. If not truly motivated, the whole process can be a useless time drain." *Middle market private equity investor*
Valuation	"Sellers tend to over-value their companies. Sellers tend not to have gone through the [diligence and sale] process and are not prepared, getting upset over requests that are normal, but unusual to them." *Middle market executive*

Business valuation

Challenge rating:

Company Executives **3.8**

Advisors **3.5**

5 = Very difficult
1 = Very easy

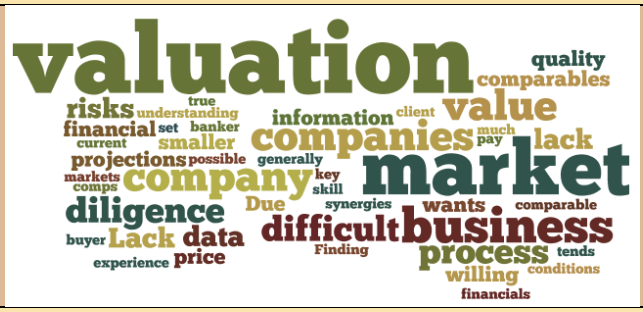
"Assuming the target is in a related industry, the business valuation process is one aspect of the task where industry participants are at an advantage. Having said that, there are generally very few people within a mid-sized company who are trained in corporate finance and valuation."

Middle market executive

What is the importance of "market comparables" among other methodologies when determining the valuation of a company to be acquired? A potential mis-alignment between company executives and investment bankers could exist regarding the relative importance of "market comparables" to valuing a business. In the online interviews, "comparables" were referred to by 6 of 9 bankers though *only* 1 of 18 company executives. A major challenge is calibrating the relevance of a "comparable" valuation based on industry, business model, market timing, and other transaction particulars.

The difference in challenge rating by executives (3.8) vs. advisors (3.5) was widest for "business valuation" among all nine acquisitions areas.

Valuation expertise	"Most middle market companies do not possess this capacity in-house and do not understand / appreciate the importance or relevance of this critical skill set." *Middle market executive* "Business valuation often resides with external resources, like investment banker or M&A advisor. Usually a lack of internal resource for an in-depth analytical effort." *Middle market executive*
Valuation confidence	"The further away from the core business, the more difficult the forecasting and valuation process is." *Private equity investor* "Two important considerations upfront: (1) understand the 2 or 3 value drivers and test them in diligence to the extent possible, (2) make sure the downside business case is acceptable." *Middle market executive*
Additional considerations	"…appropriately accounting for synergies and associated integration costs." *Private equity investor* "…information asymmetry; impact of leverage; 'irrational bidder'" *Middle market private equity investor*



Financing

Challenge rating:	
Company executives **3.8** **Advisors** **3.7** 5 = Very difficult 1 = Very easy	"It can be a challenge for a middle market company to understand HOW to present an acquisition financing opportunity to a financier in a way that the financier would like to see the opportunity analyzed." *Middle market executive* "No company should start the process unless it is confident that is has the financing to affect the acquisition strategy." *Middle market deal attorney*

Financing an acquisition will depend on the same elements as financing other growth opportunities. Bankers and other investors are concerned with financial projections/commitments, track record, relationship, clear description of opportunity and realistic assessment of risk. For acquisition financing in particular, attention is paid to management team experience, business strategy driving the acquisition, quality of due diligence and integration plan.

Avoiding surprises remains the key: established financing relationships and candid communication

Importance of a financing track record	"Solid businesses already have lines of credit or borrowing bases. Smaller companies will find it hard in today's environment if they don't have a track record. Starting small helps." *Middle market executive* "If track record is strong, [buyer] will likely be able to find financing." *Deal attorney* "If company has an existing facility that can be upsized for acquisition, [this] often streamlines [deal financing]." *Private equity investor* "If the banking relationship is strong, then securing financing is not that hard." *Middle market lender*
Deal-specific financing	"Lack of acquisition experience makes M&A loans risky from lender perspective." *Investment banker* "Most middle market companies do not adequately explore financing options and therefore rely on expensive or limited sources of capital." *Middle market executive*

Negotiation

Challenge rating:

Company executives **3.7**

Advisors **3.6**

5 = Very difficult
1 = Very easy

"Most middle market companies tend to rely on in-house advisors (*e.g.,* in-house counsel) and then tend to have a VERY difficult time closing transactions."

Middle market executive

"You need good advisors for negotiation … beginning with the initial indication of interest…. These set the foundation for the purchase agreement discussions and [final] negotiations.

Investment banker

While the proverbial "hand-shake" may reflect an agreement on price, the potential for a deal not to close is very real during negotiation of the final, definitive purchase agreement. Inexperience with the complexity of such documents by buyer or seller can derail an otherwise "agreed" deal. Absence of highly experienced deal advisors, for buyer or seller, is another common source of failure of negotiations not resulting in a signed contract.

Negotiations must be inseparable from the business valuation and due diligence efforts

Value of competent, experienced advisors

"Without the advice/input of experienced M&A attorneys and deal advisors, most middle market companies tend to appear amateurish to sellers, since they are completely unfamiliar with common terms and conditions, and try to mis-allocate risk between buyer and seller." *Middle market executive*

"Middle market targets often retain less experienced advisors (financial and legal), making the negotiation and documentation process very painful at times." *Middle market executive*

Deal terms for managing risks

Key is "knowing when to use earn-outs; how to overcome/manage due diligence risk." *Middle market executive*

Advisors provide "comfort around representations and warranties and which fall in baskets of escrow vs. capped at purchase price; experience in terms of which terms are 'market' (reps and warranties, escrow terms, and provisions) simplifies." *Middle market private equity investor*

Due diligence

Challenge rating:

Company executives **3.6**

Advisors **3.6**

5 = Very difficult
1 = Very easy

"The challenge is not with the information. The challenge is often with the lack of information, as the target company often does not have good records, good organization and hands-on management. In such circumstances, the target company can become quite defensive and the political aspects of the due diligence process can be delicate."
Middle market deal attorney

A buyer's due diligence can be mistakenly focused on confirmatory work with financial records. Rather, it should be broadly viewed as an activity that informs valuation of the target company and as well as how uncertainties can be addressed in the negotiation of escrows, representations, warranties, and other purchase agreement provisions.

Eight interviewees commented on risks associated with information quality; only one referred to "hidden" information.

More on quality of seller information	"Middle market target records can be practically non-existent in some areas. Need to essentially recreate." *Middle market deal attorney* "Smaller companies typically have less sophisticated systems, processes and financial reporting." *Middle market private equity investor*
Diligence team members	"The challenge is not with the information. The challenge is often with the lack of information, as the target company often does not have good records, good organization and hands-on management. In such circumstances, the target company can become quite defensive and the political aspects of the due diligence process can be delicate." *Middle market executive* "Thorough diligence should include subject matter experts, which can be expensive. Good acquisitions involve a broad diligence team and internal resources that will be responsible for managing the acquired business post-closing." *Investment banker*
Experience of diligence team	"Middle market companies tend to overlook key risks in due diligence by relying on in-house or inexperienced due diligence advisors." *Middle market executive*

Merger integration

Challenge rating:	
Company executives **4.2** **Advisors** **4.0** 5 = Very difficult 1 = Very easy	"Unless the middle market company has integrated companies previously, this is one of the most difficult steps. It is also typically when the company's external advisors have stepped out of the mix. Bringing in experienced integration support would make great sense." *Middle market executive*

Merger "integration" is when the potential of an acquisition is realized, or not. By a significant margin, integration received the highest challenge ratings from company executives, investment bankers, lawyers, accountants, *and* private equity investors. Common recommendations highlighted: (a) the importance of integration planning at the very beginning of an acquisition process, (b) the risk of mis-placed optimism and overconfidence in managing integration, and (c) the benefit of designating a single executive for leadership of integration activities.

82% rated the challenge of integration as either "very challenging" or "challenging."

Importance of planning	"The company needs to understand the key value drivers of the transaction and build detailed execution plans around them." *Middle market executive* "Middle market companies tend to overestimate the ease of integration, and therefore fail to adequately plan for key risks and challenges in executing on the integration." *Middle market executive*
Communi-cation	Critical to success are "…planning, communicating, and following through with the integration plan. Clearly articulating roles and responsibilities to the teams at both the acquirer and target. Communicating quickly and efficiently with customers and suppliers and having a plan to work with them post-closing." *Investment banker*
Integration team	"Most companies do not feel they need to bring in outside expertise (consultants) to help them integrate the acquired target." *Investment banker* Success requires "…having someone take this as a champion" *Middle market executive*
Misplaced optimism	"Middle market companies tend to over-estimate the ease of integration, and therefore fail to adequately plan for key risks and challenges in executing on the integration." *Middle market executive* "Everyone thinks they can do this and very few do it well." *Acquisition consultant*
Loyalties, mistrust	"…mid-market acquisitions often involve competitors, which can add to the mistrust and angst of the process." *Middle market executive* "Integration is never easy… there can be no distractions based on politics." *Middle market executive*

Leadership of an acquisition process… some final words

In addition to the many experiences shared throughout this study, below is a final selection of, perhaps, the most salient learnings for CEOs or other leaders of acquisition processes for middle market companies:

> "When [acquisitions are] difficult, here are some of the reasons: 1. Identifying targets with real potential for value creation, strategic fit with appropriately pricing for execution difficulty, 2. Managing egos – in everything from deal-making / motivation to post-acquisition integration, 3. Not letting the acquisition and post-acquisition work detract from carrying on the business." *Middle market private equity investor*

> "Be well advised and choose advisors for whom your business is important. Understand the risks and be ready to 'walk away' when the costs or risks exceed the benefits. Plan in more detail than you might typically and value the experience of your team and advisors. Successful acquirers tend to be the ones that make or have made multiple acquisitions. Measure your progress against your pre-acquisition goals and objectives." *Investment banker*

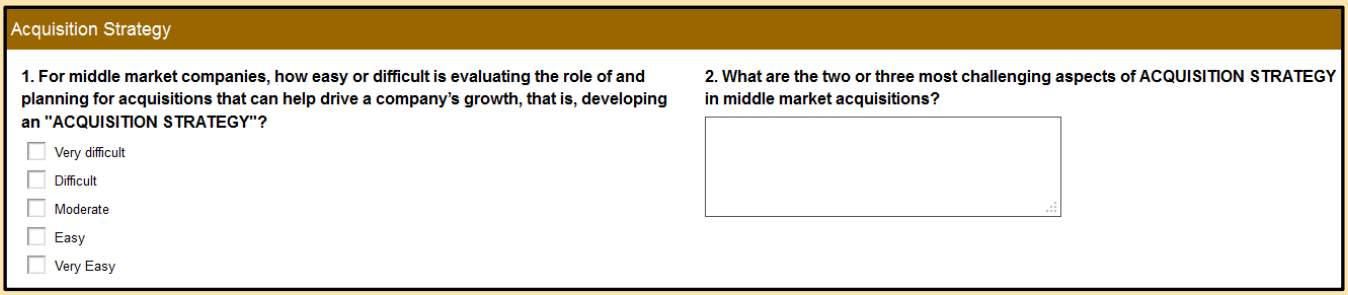
> "Emphasize investment in the right people, at the right time and for the right reasons." *Middle market deal attorney*

> "The use of politeness, graciousness (towards the other side) and humor are greatly undervalued in acquisition settings. If [an M&A team] can relax and be polite and gracious towards the other side, it will achieve a lot more of its goals." *Middle market deal attorney*

> "It would be valuable for a 'soup-to-nuts' service which provides M&A strategy development through integration." *Middle market executive*

Study methodology

- The survey for this study was posted on Survey Monkey® from January 31, 2012 through March 23, 2012. Below are the questions related to "acquisition strategy" as shown on Survey Monkey; similar questions were included for the other eight areas.


Acquisition Strategy

1. For middle market companies, how easy or difficult is evaluating the role of and planning for acquisitions that can help drive a company's growth, that is, developing an "ACQUISITION STRATEGY"?

- Very difficult
- Difficult
- Moderate
- Easy
- Very Easy

2. What are the two or three most challenging aspects of ACQUISITION STRATEGY in middle market acquisitions?

- The "challenge rating" reported for each of the nine acquisition areas is an arithmetic average of all respondents to the "how easy or difficult" question, *e.g.,* for "acquisition strategy" shown above at left.
- Outreach to solicit participants included direct outreach to contacts of Joseph Feldman Associates, prompts for these contacts' support in extending the invitation to participate among their colleagues, posting on LinkedIn "status," and outreach to over thirty M&A-related LinkedIn groups.
- Sixty-nine individuals participated in the online survey, with additional comments received from three individuals by email or posting on LinkedIn groups.

"Middle market" definition

There is broad acknowledgement that the definition of "middle market" varies depending on who's offering a point of view. That said, this report is likely most relevant for companies with revenues in the range of $25 million on the low side and $1 billion on the high side.

Wordle™

According to www.wordle.net, Wordle "is a toy for generating 'word clouds' from text…. The clouds give greater prominence to words that appear more frequently in the source text." The Wordles™ that appear in this report were generated by the text responses to the specific question asked for each section of the survey. The Wordle™ on the following page is from the complete text provided to all survey questions.

Providing feedback

Feedback to this report would be greatly appreciated.

Please send ideas, reactions, suggestions and (especially) stories of acquisition-related experiences to Joe Feldman at jf@josephfeldman.com.

You are also welcome to join the LinkedIn group: "Middle Market Acquisitions: What's So Hard?" Members of the group have the opportunity to discuss their observations and experiences with middle market acquisitions.

With appreciation

The following individuals provided invaluable advice and support for the project, for which I am grateful: Dave Alexander, Len Gryn, David Kantor, Aaron Kase, Liz Robinson, Rob Rosenfeld, Michael St. Peter and Gaye van den Hombergh.

Special thanks to the seventy-plus individuals who contributed their time and shared their expertise through participation in the survey. They have enabled this report and the opportunity to benefit from their experience.

About Joseph Feldman Associates

Joseph Feldman Associates provides acquisition and other strategic transaction consulting for growing companies and their investors:

- We combine "large company" know-how and discipline with "start-up company" practicality, resourcefulness, and urgency.
- We deliver timely and effective results for our clients

Project scope may include all or some of the following activities, determined on a case-by-case basis to meet client requirements:

Acquisition Project Management

- Strategy development
- Deal flow generation
- Outreach to targets, bankers, and other resources supporting potential deals
- Development of internal and external presentations

Target-specific Work:

- Evaluation of strategic fit
- Contacts with targets
- Deal valuation
- Due diligence
- Negotiation support
- Documentation and closure
- Integration planning

Also available on request: "A Briefing for Owners of Middle Market Companies on Private Equity Firms as Potential Acquirers/Investors."

For further background, including a summary of completed projects, see www.josephfeldman.com.

Joe Feldman welcomes your call at 312.961.2099 or email to jf@josephfeldman.com.