

**Top Mistakes Made During an Acquisition -  
and How to Avoid Them**

**National Business Institute Seminar  
May 11, 2015**



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**IronHorse is a K.C. based special situation professional services firm with practice specialties in business valuation & appraisal, forensic services & litigation support, CFO services, due diligence, and complex financial & operations restructuring/turnaround consulting.**

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**IronHorse has performed numerous due diligence, valuation, litigation support and restructuring engagements for clients in a variety of industries. Tony has extensive M & A experience on dozens of transactions, especially with financially distressed enterprises.**



## Motivations for the Aquisition

### PARAMETERS OF SUCCESS MEASUREMENT





## Deloitte 2014 M & A Trends Report

- Private equity firms expect portfolio exits to increase. Almost two-thirds of private equity respondents forecast a pickup in exits — with 36 percent looking at initial public offerings (IPO).
- Companies anticipate deal activity to increase most heavily within the technology sector, followed by health care providers and plans, energy (both alternative energy and oil and gas), and banking and securities.
- Sixty-eight percent of private equity executives expect their firms to become more industry-focused in the coming year.
- Survey findings indicate that 84 percent of corporate executives anticipate a sustained, if not accelerated, pace of M&A activity in the next 24 months.
- Thirty two percent of corporate respondents said their strategy will involve seeking smaller strategic deals.
- For strategic acquirers, Almost three-fourths of corporate respondents ranked the objective of garnering new customers in their existing geography as a critical motivation of transactions.



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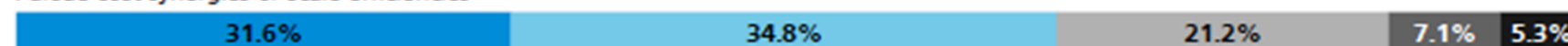




## Deloitte 2014 M & A Trends Report

Please rate the following objectives in terms of their importance with respect to your company's M&A strategy.

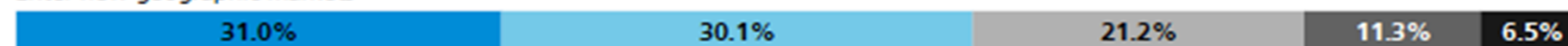
Pursue cost synergies or scale efficiencies



Expand customer base in existing geographic markets



Enter new geographic markets



Product/service diversification



Obtain bargain-priced assets



Talent acquisition



Technology acquisition



Other



■ Extremely important   ■ Somewhat important   ■ Neutral   ■ Somewhat unimportant   ■ Not at all important



## Deloitte 2014 M & A Trends Report

- Expectations are high for stepped-up divestment of portfolio companies, as about two-thirds of the private equity respondents anticipate accelerating the pace of exits within the next 12 months.
- Almost two-thirds of private equity respondents expect a strategic sale will be the primary form of portfolio exits.

**PEs: what is your expectation regarding the level of portfolio company investment exits in the market over the next 12 months?**



Significantly increase:	20.5%
Somewhat increase:	43.9%
Neutral:	28.1%
Somewhat decrease:	6.1%
Significantly decrease:	1.4%



## Deloitte 2014 M & A Trends Report-Top Reasons for Acquisitions

**What is your company's M&A strategy for the next 12-18 months?**

Seeking smaller strategic deals now to take advantage of favorable opportunities



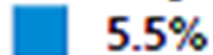
Reactively responding to any opportunities that arise



Seeking major transformational deals now to take advantage of favorable opportunities



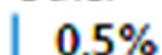
Deferring major deals in anticipation of better opportunities and/or valuations in the future



Not applicable – we do not have an M&A strategy



Other

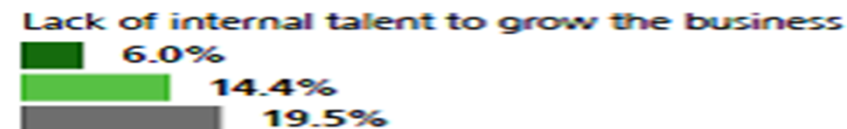
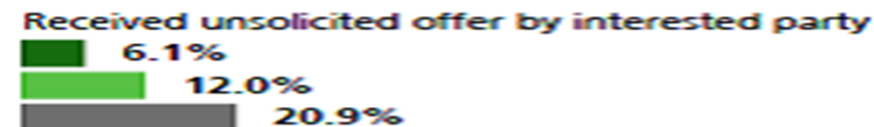
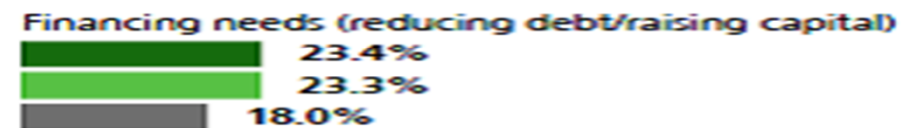
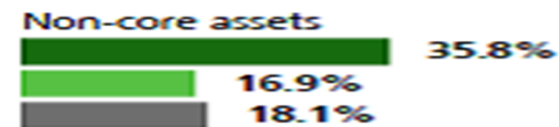






## Deloitte 2014 M & A Trends Report-Top Reasons for Divestitures

Regardless of your current divestiture plans, please rank in order of importance the top 3 reasons for divesting a business as they apply to your company. Please type a 1, 2 or 3 next to each of your top reasons (1 = top; 2 = second; 3 = third).



■ Top  
■ Second  
■ Third



## **Top Acquisition Mistakes-Identifying & Avoiding the Hidden Traps**

1. GETTING THE DEAL STRUCTURE OR PRICE WRONG; OVER-PAYMENT FOR ACQUISITIONS AND/OR OVER-LEVERAGING THE DEAL
2. MISREADING THE NEW COMPANY'S CULTURE-A BAD MARRIAGE
3. INTEGRATION PLAN NOT DEVELOPED IN ADVANCE; OR BLINDLY FOCUSING ON INTEGRATION FOR ITS OWN SAKE
4. FLAWED, UNDISCIPLINED CORPORATE DEVELOPMENT
5. GETTING EMOTIONAL; LOSING PERSPECTIVE, IGNORING RED FLAGS AND ROMANCE OF THE DEAL



## **GETTING THE DEAL STRUCTURE OR PRICE WRONG; OVER-PAYMENT FOR ACQUISITIONS AND/OR OVER-LEVERAGING THE DEAL**

- Deals go bad at an alarming rate; 50% “fail”, 80% “disappoint”.
- Importance of being focused, disciplined and industry/market niche driven.
- Extremely easy to lose focus, objectivity and discipline.
- Tendency to defer to the market to determine price, capital structure/leverage and transaction timing. Hot markets contribute to a competitive urge to move aggressively/quickly out of competitive urge and the fear of letting opportunities slip away.
- Tepid markets can produce just the opposite pressures.
- Private equity respondents to the Deloitte survey cited several critical areas of concern when pursuing a transaction, including not valuing the target accurately (55 percent).



## **GETTING THE DEAL STRUCTURE OR PRICE WRONG; OVER-PAYMENT FOR ACQUISITIONS AND/OR OVER-LEVERAGING THE DEAL**

- From a valuation perspective, two of the most important concerns when accurately valuing a target are overstated revenue forecasts and understated expenses.
- Understated capital needs frequently lead to acquisitions that lack “dry powder,” additional post-closing working capital requirements, and too much leverage vis a vis trailing 60-month historical operating cash flows.
- Assuming historical financial markets, costs of financing and underwriting absent unprecedented federal subsidies, costs of commercial debt, bond and subordinated financing might be 60% to 100% under the “true” risk and associated required rates of return.
- The perfect storm of lack of dry powder/working capital availability, too much leverage and reversion back to historical interest rates could dramatically impair the projected accretion to value from a deal and lead to impaired solvency rather quickly.



## **GETTING THE DEAL STRUCTURE OR PRICE WRONG; OVER-PAYMENT FOR ACQUISITIONS AND/OR OVER-LEVERAGING THE DEAL**

- Failure to clearly identify and assess their own exit strategy, probability of exit, and availability of exit alternatives given their desired investment holding period.
- Failure to properly assess and evaluate risk.
- Inadequate, incomplete and incorrect evaluation and analysis of customer and product profitability.
- Target company cost management, product costing weaknesses.
- Failure to thoroughly perform due diligence .
- Failure to perform reasonableness and sanity checks on value inference estimations.
- Improper assessment of market reactions, competitive responses to the acquisition or business competition, and flawed assumptions regarding relative market share and competitive conditions within the marketplace.
- Failure to critically evaluate the reasonableness of industry transaction multiple trends for comparable businesses.
- Poor timing.





## **GETTING THE DEAL STRUCTURE OR PRICE WRONG; OVER-PAYMENT FOR ACQUISITIONS AND/OR OVER-LEVERAGING THE DEAL**

Preventive Measure Alternatives:

- Most often, there are a number of contributing factors at play in disappointing and/or failed deals. Preventive measures may address more than one of these causes.
- Formalize and structure, adequately resource the on-going corporate development effort
- Engagement of investment bankers, buy or sell side advisors and intermediaries.
- Commit to a very formal, written acquisition/divestiture policy and process that codifies authority, resource allocation to the corporate development and/or investment bankers and specifies the expected deal parameters, target profiles, search and screening activities, decision criteria, data model elements, markets/industries to focus on, others to avoid.



## **GETTING THE DEAL STRUCTURE OR PRICE WRONG; OVER-PAYMENT FOR ACQUISITIONS AND/OR OVER-LEVERAGING THE DEAL**

### Preventive Measure Alternatives:

- Extensive stress and sensitivity testing to model projections utilizing a variety of combinations of critical underlying assumptions. Especially debt service capability, cap ex needs, working capital velocity and liquidity, competitive reactions, etc.
- The “1/3” sanity check.
- The ROI of the enterprise value inference using trailing 60-month performance sanity check.
- Objective and critical audit of “bridge” strategies/plans between trailing & projected performance. Perform in conjunction with stress and sensitivity analysis



## MISREADING THE NEW COMPANY'S CULTURE-A BAD MARRIAGE

- In particular, with the acquisition of small-middle and mid-market, privately/closely held firms; especially the acquisition of family-owned enterprises purchased from the founder.
- Compounded when the founder expects to stay on in some capacity, and that expectation is shared by the acquirer.
- If the acquirer is a “financial” buyer (private equity firm), this cultural integration challenge can be compounded-especially if the multiple paid was too high and/or over leveraged.
- Most deals are with closely-held firms, many if not most in transition.
- Volume of businesses changing hands will dramatically accelerate to historically unprecedented levels. Overwhelmingly, the majority of these firms have little to no formal succession and exit planning in place.
- Emotional value component to the seller as compared to the cold, objective perspective of a financial buyer. Mergers with a strategic, larger acquirer can impose considerable hurdles in stirring the melting pot.



## MISREADING THE NEW COMPANY'S CULTURE-A BAD MARRIAGE

- One common challenge for these firms is the entrepreneurial, rather free-wheeling nature of the culture, run highly autocratically by the founder himself.
- The founder and other key executives may in fact be central to the customer relationships.
- It may be the appeal of this informal and highly responsive culture that appeals to critical customers-not so much the idea of a larger mini "conglomero".



## **MISREADING THE NEW COMPANY'S CULTURE-A BAD MARRIAGE**

- Primary burden for assessing these cultural dynamics, for determining the extent of key associate risk lies on the acquirer.
- Each firm has a social organization, a culture and personality, and an orientation that is unique to them and an essential component to a successful merging together of two organizations.
- Suggest to our buy and sell-side clients to consider the merits of the deal assuming the former owners and key associates will be leaving at the close.
- Attrition rate is quite high in key positions post-closing; even with successful deals and transitions.
- Due diligence team should be tasked with assessing culture, but this responsibility ultimately lies with the CEO of the acquirer and it might at time be best to pass on the deal, or ensure that each of the due diligence and post-closing integration team be resourced with associates from both firms.
- Should the ownership be retained in some capacity, it imperative the incoming executive and predecessor organizations embrace the cultural integration as their primary responsibilities. This can not be delegated-it's leadership.





## **INTEGRATION PLAN NOT DEVELOPED IN ADVANCE; OR BLINDLY FOCUSING ON INTEGRATION FOR ITS OWN SAKE**

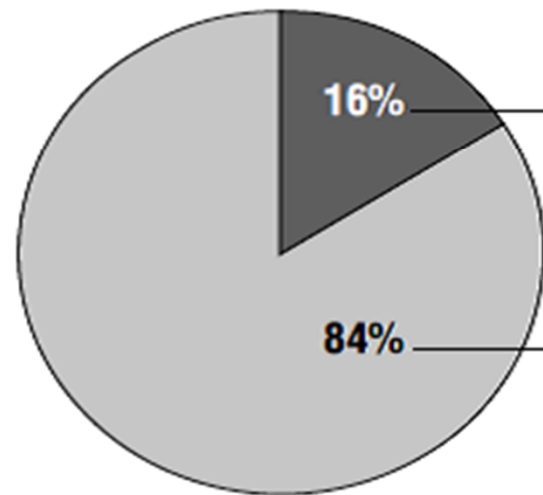
- Relative to structuring the transaction, the real work begins as soon as the ink has dried on the APA.
- An element of instability if not chaos can be the norm post-close.
- Critical considerations:
  - How do you deliver upon the promises from the deal while at the same time making sure the business itself does not become impaired?
  - How do you keep the focus on the customer in the midst of the extraordinary demands of the integration?



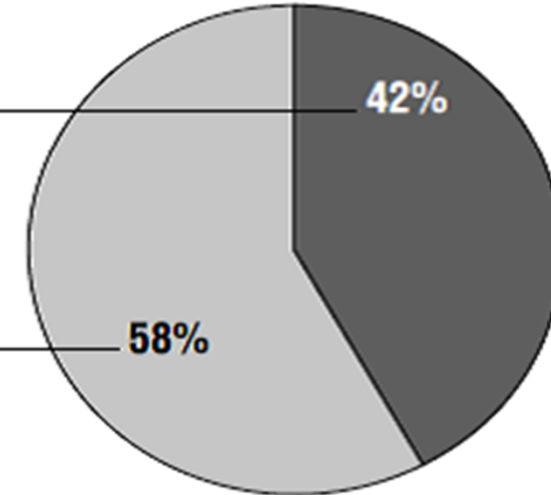
## INTEGRATION PLAN NOT DEVELOPED IN ADVANCE; OR BLINDLY FOCUSING ON INTEGRATION FOR ITS OWN SAKE

### Exhibit 2. Poor Merger Performance Leads to CEO Departures

#### Mergers That Met Expectations



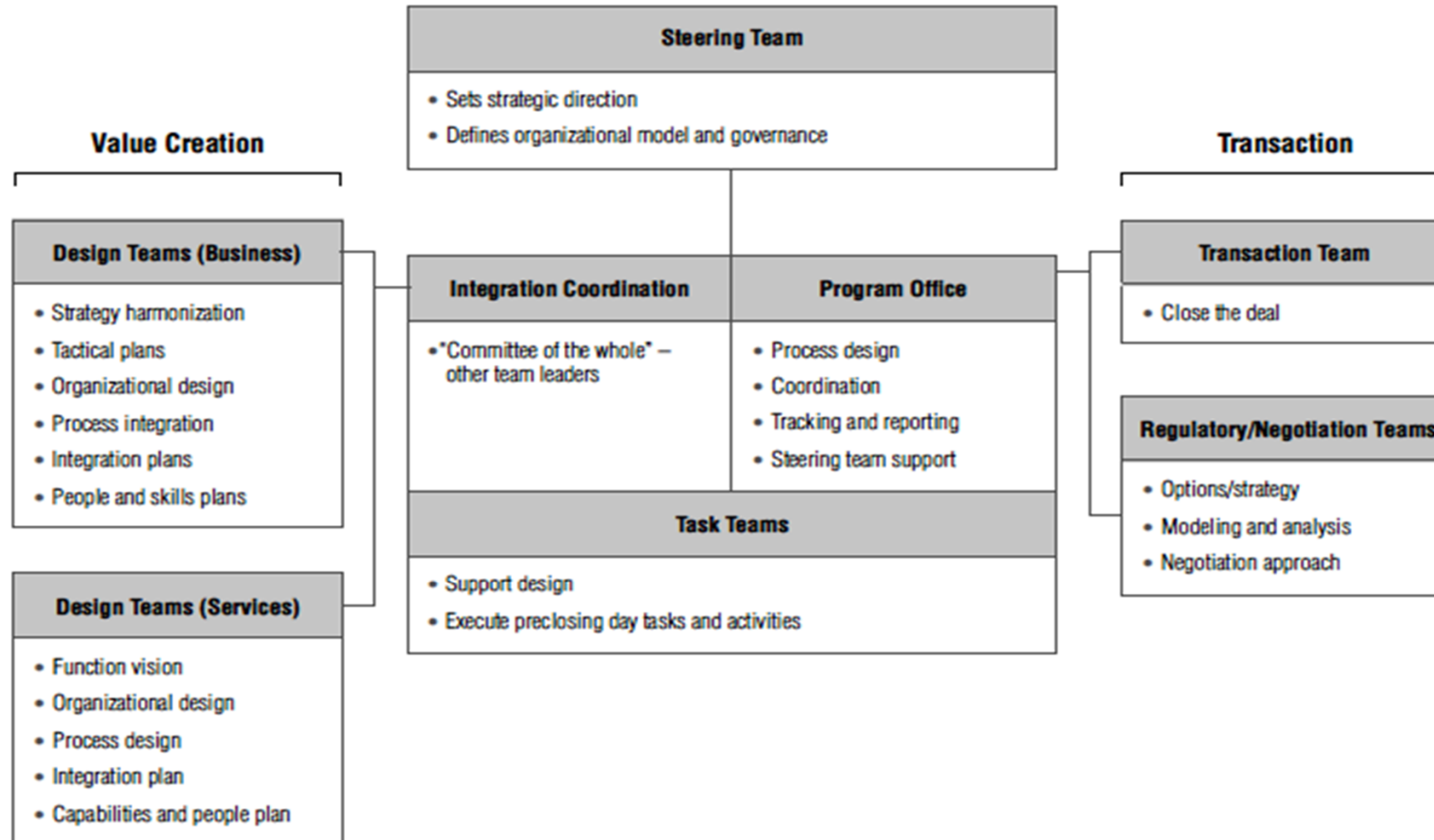
#### Mergers That Did Not Meet Expectations



Source: Booz • Allen & Hamilton

## INTEGRATION PLAN NOT DEVELOPED IN ADVANCE; OR BLINDLY FOCUSING ON INTEGRATION FOR ITS OWN SAKE

**Exhibit 11. Separate Value Creation, Task, and Transaction Teams**





## **INTEGRATION PLAN NOT DEVELOPED IN ADVANCE; OR BLINDLY FOCUSING ON INTEGRATION FOR ITS OWN SAKE**

Most important considerations:

- Leadership and commitment
- Communication
- Participation and involvement
- Resource priority and allocation
- Frequent/transparent/credible status updates up and down the organizational structure.
- A cross-functional steering team made of the “acquirers” as well as the “acquired” tasked with thorough pre-closing planning and careful execution.



## FLAWED, UNDISCIPLINED CORPORATE DEVELOPMENT

- Most successful deals flow from a very disciplined, committed, and consistent approach to corporate development.
- Far too often, firms lack the expertise, the demonstrated success and experience in corporate development; planning for, resourcing for, committing to, and executing a disciplined corporate development effort.
- Who are we, who are we not???





## **FLAWED, UNDISCIPLINED CORPORATE DEVELOPMENT**

Primary keys to effective corporate development include:

- An M & A business case process and modeling that provides a foundation of insight and confidence to guide the corporate development efforts and the critical decisions that flow from that.
- Utilization of advanced data analytics, screening tools and new technologies that provide cutting-edge perspectives and visibility to targets.
- Strategic clarity, top leadership commitment and ready access to decision makers and other critical decision resources.
- Clarity as to objectives, written codification of acquisition policy and highly-disciplined decision frameworks to ensure an efficient deal pipeline process and flow.
- Dedicated and committed human and other resource requirements.
- The discipline and focus required to say “No,” and the courage and decisiveness to say, “Yes”.



## **GETTING EMOTIONAL; LOSING PERSPECTIVE, IGNORING RED FLAGS AND ROMANCE OF THE DEAL**

- CEO “disease”
- Abilene Paradox syndrome
- Hubris
- Sycophants
- Information once readily available to the senior executive often becomes filtered. Few subordinates want to deliver the bad news
- Inner agenda centers on an executive's needs for self-esteem and control over people and events.



## **GETTING EMOTIONAL; LOSING PERSPECTIVE, IGNORING RED FLAGS AND ROMANCE OF THE DEAL**

Preventive measures:

- Effective corporate development.
- Utilization of teams, steering committees and an involved process.
- Thorough and objective due diligence.
- Discipline. Lots and lots of discipline.