PREPARATION: KEY TO NAVIGATING M&A DEAL

Overview: Mergers and acquisitions (M&A) between privately held companies are different animals from larger-cap and public company combinations. Because private companies have fewer reporting requirements and fewer staff personnel who are dedicated to maintaining financial and operating information for the business, they typically have less (and lower quality) financial and operating information—which can become a major stumbling block when contemplating M&A. This article suggests that the key to M&A success between private companies is preparation, particularly for business owners with no previous M&A experience.

Small-cap deals: Expected to grow in 2013

The small-cap (private company) M&A market (deals up to $50 million) was sluggish in the second half of 2012 because of economic uncertainty, primarily in Europe.

However, many observers expect small-cap M&A volume to increase in 2013. Middle-market companies hoping to wait out the recession are now in their fifth year on the sidelines. They're sitting on substantial cash piles, and, at some point, will have to start spending to grow. Their strategies are likely to include M&A.

Small-cap deals: Inherent obstacles

M&A between small-capitalized, privately held companies are different animals from larger-cap and public company combinations. Intuitively, we would think that deals involving private companies should run more smoothly than public company deals, and often they do—but they also can get bogged down in issues that neither party to the transaction could ever foresee.

The key to M&A success for private companies is preparation, particularly if the Seller does not have any previous M&A experience. Mergers and acquisitions (M&A) between privately held companies are different animals from large-cap and public company M&A.

Inadequate information on Sellers

Because private companies have fewer reporting requirements and fewer staff personnel who are dedicated to maintaining financial and operating information for the business, they typically less (and lower quality) financial and operating information—which can become a major stumbling block when a potential M&A deal arises.

Because of the uncertainty in the markets, many larger companies have been conserving their cash and don't need bank financing to do an M&A deal. Instead, the problem for Buyers often is finding quality information about potential Sellers.

This is especially true when Buyers approach small-cap businesses that aren't on the market and may not have considered selling. Even if potential Sellers are interested in making a deal, they might not have the historical financial data and other documentation that Buyers need to make a reasonable offer.

Companies that either want to sell or are considering selling within the next year should prepare reliable financial statements with the help of experienced CPA firms and other advisors and review their files and records to ensure they have the documentation that will be necessary to provide to a prospective Buyer in order for it to conduct reasonable due diligence on the prospective Seller. In particular, Sellers should:

- Verify and double-check all reported income — especially if revenue has been deferred or expenses pushed forward to reduce annual tax liabilities.

- Improve weak or missing documentation regarding key intangible assets, including important contracts, intellectual property (such as patents and trademarks), software and other licenses,, and employee and HR files.

- Review and strengthen internal controls, and standardize (preferably in writing) any operations that have formerly been ad hoc.

Even if a business is selling to a private company Buyer, that Buyer is likely to scrutinize the Seller during the due diligence stage to avoid potential post-deal surprises.

Preparing reliable financial statements in advance of an M&A deal also enables a Seller to identify opportunities for improving the Seller's business operations—potentially increasing the Seller's sale price. For example, the process of preparing and carefully analyzing reliable financial statements might identify ways for a potential Seller to increase its profit margins and ultimately increase its EBITDA (a very important metric in any M&A deal—particularly if the deal is priced based on a multiple of EBITDA).

Inadequate preparation by Buyers

Small-cap Sellers aren't the only ones that need help getting in shape. Buyers, particularly first-time buyers, are vulnerable to rookie errors and it's possible they won't recognize danger signs when they see them.

Every company making an acquisition should work with M&A advisors — especially during due diligence. Aside from reviewing financial statements, advisors can help buyers assess the operational value of the Seller's tangible and intangible assets and how the Seller's business assets might provide economies-of-scale after it is integrated with the Buyer's business.

Advisors also can spot hidden costs. For example, many inexperienced buyers don't realize how difficult and costly it can be to (i) train newly merged employees to use new procedures or (ii) integrate the two companies' information technology systems.

Acknowledging ignorance may be bliss

Ironically, private-company deals tend to be most successful when both Buyers and Sellers acknowledge that although they are successful at running their business (and have been doing so for many years), they will go through an M&A deal only once or twice during their business life-cycle. Therefore, M&A transactions require expertise that most business owners simply don't have. In contrast, M&A professionals are in the business of M&A and can provide valuable guidance (and assistance) with and during the M&A process. With M&A for small-cap deals expected to grow in 2013—private company owners who have contemplated selling their business should begin the preliminary stages of the M&A process.