Acquiring Businesses

Strategy, Tactics & Finances

What to Know & Various Methods Described

Scope:

In the contracting trades not a great deal has been written regarding acquisition of companies and the overall strategy itself.

What has been written has focused on the financial models or suggestions for how to “Value” the enterprise. Most of it is well thought out and has a great deal of value.

Not a great deal has been written about the strategy. This material is focused on both the “**Why**”, and married to the processes required in acquisition. Simply put, strategy and execution can influence the valuation process. So they work together.

In considering this fact, my belief is the industry is still so fragmented and stratified.

A small percentage of companies have made the leap into retailing and business process development, contrasted against the vast majority of contractors still working “**IN**” their businesses as opposed to “**ON**” their businesses.

As consolidation demonstrated acquisition as a strategy can be executed very well or poorly.

**What defined the success or failure in acquisition during consolidation?**

There were several determining factors in those acquisitions, which we intend to explore and share from direct experience of doing so, and learning from the errors.

*History can be a great teacher.*

This article and the web sites support materials are based on:

1. Strategic considerations of acquisition.
2. Execution materials to support a strategy of acquisition.
3. The financial models to support the strategy.

**Why do we do it?**

**Why do we buy companies? What makes us want to acquire the company with working capital as opposed to applying the money to organic growth of our existing companies?**

**Is it Power? Ego? Greed? Lust for growth?**

General Notes on Acquisitions:

The acquisition of a business may be the best single strategy for growth!

If the process is executed well, it can produce dramatic results. It is a form of marketing in the purest sense. The key is execution, which is largely lacking in the HVAC / Plumbing business environment today.

On the other end of the spectrum is the plain fact that many acquisitions are fraught with perilous traps and landmines.

* **Having to change the existing culture.**
* **Customer based issues.**
* **Diversion of owner energy and focus.**
* **Employees starting competitive companies with customers.**
* **EGO.**
* **Outright fraud.**

Each acquisition is very different.

* Is it a stock purchase or simply asset only?
* Is it a satellite strategy or a tuck-in to your existing operation?

The type and degree of challenges you may face when acquiring a company are based on the strategy and expectations you place on yourself before you acquire the company.

The important fact for anyone contemplating an acquisition **is to have a defined plan** to execute the acquisition, and understand first and foremost “Why” you want to acquire.

Having **a clear set of objectives that follow a strategy** for executing the acquisition, and understanding the nature of the company is a key to successful acquisition.

* There will be challenges. Plan on it!
* There may be setbacks. Plan on it!
* Likely the deal will not go through – Most don’t!

You’re pre-planning and preparation is an essential element in the successful completion of any acquisition. Most items can be accomplished well ahead of the acquisition. Though even then, as you begin to truly lift up and peek under the rock, issues can and do arise requiring a great deal of thought and energy. The reason we do this? **The reward is quick and often very profitable growth.**

Here are some considerations:

What are the objectives of an acquisition?

Why are you really buying this company?

1. Marketing – Gaining customers cheaply.
2. New markets.
3. New Competency – They are good at something you’re not.

Understanding your deep rooted reasoning for doing so can help you in your preparations for negotiation, and possibly your disciplines to buy it at a proper price or even walk-away.

A lack of focus on the “Why” often leads to cloudy judgment later on in the negotiation process.

One of the single biggest mistakes is there is NO PLAN! The objectives were not focused and so the plan is either non-existent or it is unfocused as well.

**What is the strategy for the acquired business going forward?**

**Once you have acquired this business, what are you going to do with it?**

**What is the plan of attack to make this acquisition a winning Return on Investment?**

This needs to be based on the objectives. Depending on what your goals are here, there is a significant difference in what has to be done, and of course the price that is paid.

|  |  |  |
| --- | --- | --- |
| **Satellite Geographic Play** | **Customer Acquisition** | **Adding Competency** |
| Leadership – Local Management | No Leadership Required | Leadership Required and Cooperation |
| Measurement of Progress | No Measurements  ROI of Customer Base | Measurements |
| Marketing Retention Strategy Required | Marketing Retention Strategy Required | Marketing Retention Strategy Required |
| Employee Retention Required | No Employee Retention Required | Employee Retention Required |
| Operational Changes Required to Match Your Leadership | No Requirement | Operational Learning Required by You |
| Employee Agreements – No Competes-No Solicitations | No Requirements | Employee Agreements – No Competes-No Solicitations |
| Due Diligence Must be Deep and Thorough | Due Diligence on Customers | Due Diligence Must be Extremely Intensive |

What are the opportunities within the acquired company?

Setting up the discussion of “Why” you are buying a company or its assets, comes the discussion of opportunity.

1. Is there a brand name and what do you do with it?
2. Are there Service Agreements and recurring revenues that make you think the company has a tangible set of customers to come back?
3. Are the Customers active – Inactive – to what degree?
4. What is the potential for large ticket replacement dollars?
5. Do you have a marketing model to “Produce” GP$ or are we just hoping the names of customers will call us from the number and we will win because of buying the assets right?
6. Are you gaining access to skills or markets?
7. Is the company in a market that is growing and makes economic sense to be a part of either as a satellite or through marketing model?

How are you planning to structure the acquisition?

Once we know what our goals are, and we understand the strategy we are choosing, the decision for structure is next.

* Is this a stock purchase? Are you acquiring all the liabilities and payables as well?
* Is this an asset buy only?
* Are we buying over time? Payments?
* Is there an ESOP involved?

Companies that are financially troubled are generally available in the market. Be very cautious about what they are stating and marketing to you.

Consulting with a State Attorney, a CPA/Tax Specialist can focus your efforts on what may make the most sense for structuring the purchase agreement.

In most cases, it pays to begin your acquisition strategy with smaller roll-ups where assets only are acquired, and you are focused on gaining new customers and not get carried away on larger acquisitions.

They can be very complicated and pull energy and focus away from your day –to-day operations. New culture and employees often take valuable time from what you do best.

What is your plan for conducting due diligence?

You need a plan for due diligence. As noted in the table above, the due diligence is based on what kind of strategy you are executing.

Here are some ideas for your due diligence procedures:

* Have a list of questions prepared (see the questions in the site). Ask them. Do NOT be shy. Be thorough. Understand what you are getting. It will help you make a better plan. This is a thorough “Operational Review” of the company to determine how profit/loss has been created and changes that may be required as operational due diligence unfolds.
* Analyze the financial statements (see the models in the site). 5 years is good. 3 Years is okay, but you can doctor the last two in preparation for the sale.

1. Analyze the 5 years of Profit and Loss.
2. Use a Ratio Tool to analyze the ratios of the company performance.
3. Use a Free Cash Flow Model – to figure the real cash flow and of course deal with any “Add-Backs” that come up in the discussions.
4. Use of DuPont Profit Model to tie the Profit and Lass history to the Balance sheet and calculate a return on Net Assets.
5. Consider the Net Present Value of money – as payment options over time become a consideration.

* Validate Add-backs. If a seller CANNOT validate the Add-Back, then do not pay for it. If it cannot be directly traced to an add-back based on operating income from the company, then how will you be sure you can get that income back? Trust, but verify!
* Hidden shop the company you are acquiring. Amazing what comes up!
* Conduct a Random Customer Base Audit – 5% or Customer Base is sufficient to find a percentage of customers happy or not happy.
* Ask directly about warranty obligations and make this part of the legal agreement with an escrow for warranty.
* Ask directly about extended warranty agreements and if they were sold – if so there ought to be a balance sheet reserve account – containing cash for the accrued liability and this is either yours at closing, or you get a reduction in purchase price if you do not get this as part of the agreement. A real trick is to sell these, keep the cash, never book the reserves, and then sell the company leaving the new owner with the liability and labor cost. Happens all the time!
* Count the inventory – it is MUNDANE – but it will save you money. There is a lot of obsolete stuff in the warehouse and in those trucks. You are paying for this unless you count it and can substantiate the obsolescence! So count it!
* Have an escrow provision for accounts receivables. Basically anything over 60 days is considered non-collectible. So any receivable that is past 60, you can assign an escrow account and pay a purchase adder if and when they are collected. A good rule is to pay for 100% current, 90% over 30 days, 80% 31-60 and nothing over 60 days. Use the escrow fund and allow the previous owner to collect these and keep them for a reduced price, or pay the adder when you receive them.
* Employee receivables if there are any – are worth ZERO! Let the seller keep them. They were his loans and when an employee leaves – it’s gone!
* Develop a working capital plan for your acquisition implementation. What needs done and how will you do it? Plan your working capital process (see the site for the capital plan layout).
* Are you keeping employees – then structure non-compete non-solicitation agreements that meet your state legal requirements. Have your legal advisor review these. (Once again check the web site for the sample documents).
* Depending upon “how” you are buying the company – perhaps you may want to validate the Chamber of Commerce. Also check services like Angie’s List, or other local services that rate contracting companies for bad marks in the customer domain. If you are buying customers, you are also buying the brand.
* While you are conducting your questioning process and operational due diligence – be formulating your battle plan and opportunity plan to develop the return on your investment. As you expend these monies, you’ll want to be learning how to get it back as quickly as you can. We always recommend you create a list of priorities based on:

1. Must Do’s – Immediate changes.
2. Need to Do’s – Items that are important but not mission critical.
3. Nice to Do’s – Items that need attention – but rank low on change quotient.

It is somewhat of an art, and somewhat science to formulate the battle plan as you review a company, changes, and how you may attack the issues to integrate into your company. This is where you need to check your strategy. Strategy drives change. Also check your personal ego at the door. Emotional and cultural baggage is what dooms almost all acquisitions. You may be tempted to view yourself as a leader who can **“Fix” people. Think again!**

* WIP – Work in Process. Be sure to find out if the company has an accrual accounting method and may have work in process underway and ascertain the impact of that work in process on the valuation.

Depending on how the company has treated work in process, that future billing may be worth more to you than you know. Areas such as commercial projects may fall under this umbrella. Also a larger new home project could create work in process issue as well.

If I am the seller, and know I was selling, I would over-bill my WIP demonstrating a larger than common profit to improve the sale price, leaving no profit out there for those jobs. This would impact your results in a negative manner having potentially paid more for the value of the company, with jobs that will need finished and have less profit or no profit but the liability to finish the work.

Ask up front and find out what is going on for billing procedures. Get this into the agreement as to “HOW” WIP will be treated in the sale of the company, and so long as the standard is known, the valuation can be handled by both parties accounting support.

If there is any WIP on the company balance sheet and have your accountant advice you on the best method to treat this WIP.

What is the plan for transition if you acquire?

**The Acquisition Checklist (see the web site under support and resources for the full list)**

**Do you have one? Should you have one?**

Get one, and go over it with your CPA and Attorney BEFORE you start negotiating!

* Clear strategy for “WHY” you are doing the deal?
* Who is running the company if it is a satellite?

1. What is the buy-sell arrangement up front?
2. Is there equity position for the satellite manager?
3. How are you compensating the geographical satellite leader?

* Operational Due Diligence checklist?
* Do you have a “Team” to give you unbiased reviews of issues or are you going at it alone – risking emotional bias and lack check and balance?
* Do you have a Negotiation Strategy for the Acquisition backed with your position, and ability to state why your offer is inside the reasonable envelope?
* Financial Valuation Models Understood and documented?
* Is your Plan mapped out for “What” are the Must/Need/Nice Do’s with timelines?
* Letter of Intent Sent and Accepted with specified dates and an out or termination of the deal clause?
* Attorney Closing Paperwork completed?
* Agreement for Disposition for Treatment of Receivables/Prepaid Expenses/Accrued Liabilities/Warranty Reserves/extended Warranties.
* Non-Compete & Non-Solicitation Agreement Signed
* Changing the Legal Name of the Company
* Filing for a New Vendor Number if Needed
* State Tax Information
* Financial Controls and Banking Relationships in place

1. Accounts if Needed/Checks with New Accounts and Name
2. Credit cards destroyed – Old/New Vendor Accounts created or transferred to acquiring company.

*The site contains a detailed list. Go over yours. Add to it. Make sure you put dates and timelines to the details so you know who is doing what, when, where and why!*

How are you valuing the company?

Always the big question…what is it worth?

Sort of depends on your perspective. The seller almost always thinks it’s worth more than the buyer, and visa-versa. Why, emotional attachment, plus the obvious reason…greed.

Below are some basic methods of valuation. The spread-sheets in the web site under training and support resources more carefully create actual valuation models.

Categories of Company Performance determine strategy for valuation method

1. **Businesses that are Profitable:**

**Method 1 – Simple Financial Model**

* Assets - Liabilities = Book Value
* Book Value + FREE Cash Flow x a Multiplier (Including add-backs)
* (Free cash flow is defined as Operating EBIT adding back depreciation)
* The multipliers during **consolidation’s “Buying Phase”** were 3 to 6. The better companies got 6, the weaker profit companies less. Today, a 2 to 4 multiplier of expected free cash flow is “normal” though is no set rule.
* Businesses that are profitable want you to see their full potential. Typically an owner knows he/she is selling a year or two in reverse, so you really need to gauge a 5-year window to see how the business has really operated. No less than 3-years of financial evaluation.
* Also remember Work in Process, inventory, warranties and receivables all factor into the valuation models here. As you review the company, the modifiers listed above either add-to or subtract in value for the company.

|  |  |
| --- | --- |
|  | Book Value (assets minus liabilities from balance sheet) |
| + | Free Cash Flow Multiple |
|  | **Defined as (Operating Profit Ave. +Ad-Backs) x a Multiple)** |
| - | Minus – (Escrows or Hold backs) |
| = | Sales Price (Buyer and Seller) |

Seller has a higher level here – buyer has a lower level.

You should prepare to calculate both. You should also prepare to justify your negotiating position with “How”, and ask the same of the seller. This is a process by which parties can begin to negotiate (see later on the negotiating strategy) and come to some agreement.

**Method 2 – Sales Multiplier Model**

* Multiplier of Sales Revenues – commonly 1 to 2 times sales volume. This generally applies to companies that are marginally profitable. Lots of sales, but no profit resulting from the sales of the company and the way it operates.
* Where the profit valuation model does not yield a “Higher” valuation price, sales multipliers are used by the seller. Why? Simple enough, it makes the package look better from their point of view.
* If you can manage to fix the operational models, then it may be worth evaluating the company. Due diligence is particularly important to a model that is being based on sales multipliers.

|  |  |
| --- | --- |
|  | Sales Revenue Average 3/5 years |
| x | Multiple (1, or 2) |
| = | Base Sale Price |
| +/- | Escrows (warranty/Receivables, Bad Debts, WIP etc...) |
| = | Sale Price |

1. **Businesses that are not profitable:**

**Method 1 – Asset Purchase – Financial Model based on Asset only**

Assets Purchase – only acquire the assets and no liabilities

An asset purchase is very attractive for the buyer. It allows the purchaser to buy only the asset valuation, with no assumption of any liabilities past or present.

A few areas that you should consider in an asset purchase agreement:

1. Do not pay for cash
2. Accounts Receivables Valuation – validate receivables
3. Inventory Valuation – count it
4. Review Tangible Assets Less Depreciation
5. The fleet - Trucks
6. Equipment & Machinery
7. Office Furniture
8. Brand – paying for brand is known as “Goodwill” and it is generally not a good idea to pay for goodwill.

Do NOT Pay for Goodwill.

Assets of the company are simply valued. Use of third party independent standards to do this helps the negotiation go more smoothly. Your CPA will help in this process, especially with depreciation values.

**Method 2 – Tuck-in – Buy only the customer base**

A “Tuck-in” is simply where you acquire the phone number, the company name, and perhaps absorb certain aspects of the company obligations.

As a part of the deal such as the Yellow Pages contract.

The structure of the agreement is fundamentally an asset purchase agreement, but will include negotiated components that may include existing advertising agreements.

How you structure the agreement is wide open to interpretation, but should be based on the strategy discussed earlier in the article.

There is NO set valuation methodology for buying a customer base. There are numerous articles and opinions and most of them work. They do so because the customer base valuation is almost always the least expensive way to acquire and grow. Secondly, they work because the strategy is low risk and provides a reasonable payback. It takes relatively few sales and Gross Profit Dollars to overcome a small purchase price outlay.

Our preferred method of acquiring “Tuck-Ins” is to use Gross Profit dollars. Since we are not adding additional overhead to our company by virtue of the purchase, we see the best valuation as gross profit dollars that will create added profit for the company.

Some use “Sales”. But sales do not necessarily guarantee anything. You can sell poorly and not make additional profit. Effectively getting more sales, but not adding profit by the gross profit dollars being low.

**The method looks like this:**

|  |  |
| --- | --- |
|  | Estimated active Customer Base (Audit this as suggested earlier) |
| x | 50% |
| = | Realistic Customer Base that is Potential |
| x | 10% - the number of customer likely to replacement |
| = | Replacement Sales |
| x | Company Sales Closure Rate |
| = | Number of Actual Sales/Jobs |
| x | Average Sale Price |
| = | Replacement Sales Revenues |
| x | Your GP based on Your Pricing |
| = | Gross Profit Dollars Expected – best case |

We make the same calculation for Service. We then add the two together and cut in half to establish our offer price.

**This is a sample – in practice:**

|  |  |
| --- | --- |
|  | 2000 Estimated Active Customer Base |
| x | 50% |
| = | 1000 Realistic Customer Base that is Potential |
| x | 10% - the number of customer likely to replacement |
| = | 100 Leads for Replacement Sales |
| x | Closure Rate 40% |
| = | 40 Sales Transactions |
| x | $ 4000 Average Sale Price |
| = | $160,000 Replacement Sales Revenues |
| x | 40% Gross Margin Based on Your Pricing |
| = | $64,000 Gross Profit Dollars in Contract |

**Add – The Same for Service and Maintenance:**

|  |  |
| --- | --- |
|  | 2000 Estimated Active Customer Base |
| x | 50% |
| = | 1000 Realistic Customer Base that is Potential |
| x | 10% - the number of customer likely to call this year |
| = | 100 Service Calls for the Next Year |
| x | Closure Rate 100% |
| = | 100 Sales Transactions |
| x | $250 Average Sale Price |
| = | $25,000 Replacement Sales Revenues |
| x | 60% Gross Margin Based on Your Pricing |
| = | $15,000 Gross Profit Dollars in Contract |
| $ | $64,000 Gross Profit Dollars - AOR |
| + | $15,000 Gross Profit Service & Maintenance |
| = | $79,000 Total GP$ |

We cut this in half to establish a “Negotiating Position” and value each name in the database with the intention of never paying more than ½ of the expected 1st year gross profit for expense of our capital.

So the negotiation price we would offer is:

$38,500 for the 2,000 names plus any agreements for assumed contracts such as Yellow Pages etc.… to keep the flow of leads from the company’s database. That is $19.00 a name. The payback is calculated by assuming a profit figure from these sales, and then divided by the sale price. We target 1 year and always evaluate the opportunity cost of the money?

**Each deal is different based on the statistics. But the model allows you to grasp an evaluation system that uses your capital well. You may elect to pay more, but you better have a payback plan. Opportunity cost – what could you do with that money elsewhere in your company to produce profit?**

Any acquisition is a “Negotiation” with the seller trying to realize the highest possible sale price based on what is being marketed.

You may want to refer to the “Negotiating Article and Manual” on the web site.

The buyer is virtually always in an opposing position when negotiating a sale, and the seller at the highest possible transaction price.

This sets up the traditional positional negotiation model (refer the web site under company strategy and planning for the negotiation practices article and manual).

What is the plan for integration?

Once the agreement has been reached, it is important you structure a timeline and begin a process to have milestones met through the process.

We use the action plan listed on the site to create the timeline, the responsible person(s) and the milestone deadlines.

This is a part of the transition plan.

The rest of the transition plan needs to organize around the principle that once you agree to an acquisition you get to “**LOOK UNDER THE ROCK**”.

What we thought we were buying often does not exactly match with our pre-acquisition due diligence.

The mistake of not conducting due diligence with “Operational Experience” present in the due diligence phase will show itself clearly during transition.

*Transition is 100% based on what you learned during due diligence.*

*Good or bad!*

The purpose of due diligence is two-fold:

1. Ask the questions to learn about valuation and purchase choice.
2. To use as a transition model - for changes if you do buy it.

Refer to the questions on Due Diligence in the site under Training Tools and Resources for the acquisition better practices to make up your own list.

Steps to Implementation of Acquisition:

1. Know your strategy for why you’re considering this opportunity.
2. Know your expected outcome – what are your goals or objectives?
3. What is success? Define it before you move forward so you will know how to evaluate this without emotional baggage.
4. Use a proper CPA and Legal advisor. They will SAVE you money and aggravation and they ARE smarter than you about their disciplines! Use them. If you can’t afford them you cannot afford to acquire!
5. Sign an LOI giving you the rights to due diligence and confidentiality on both sides with termination dates and clauses agreeable to you. Limit the seller to only you during the process so you are not used as a shopping mechanism for the company.
6. Have a pre-acquisition checklist readied and prepared so you don’t forget to ask the questions.
7. Conduct due diligence – NO EXCEPTIONS!
8. Meet with owners and any key employees
9. Audit the customer files in detail
10. Follow your intuition from the due diligence process– eliminate emotional baggage.
11. Bring “Operational Experience” to the due diligence process .
12. Capture 5 years profit and loss and balance sheet data and conduct the best evaluation process on the financial reports as is possible – they are often weak and incomplete but use the financial metrics to create your financial analysis.
13. Audit the customer base for validity, customer satisfaction, and service agreements (potential and existing figures).
14. Audit the accounts receivables and inventory, Work-in-Process, Warranty Records, Add-backs, and any liability.
15. Validate 100% any add-back being stated by a seller – if there is no valid documentation you should not pay for this in the valuation. How will you justify the spending of money later if it turns out to not be accurate?
16. Any employees that come over to you must be interviewed and accepted as employees of a new company. Do not accept employee agreements without having termination rights and agreements that allow you to operate a business without the handicap of poorly performing holdovers from a former leader.
17. Conduct a financial model based on figures that consider the Best Case, the Worst Case, and the Most Likely Case scenarios.
18. Always ask yourself this question before you acquire: Can I spend this money somewhere in my company and improve productivity and profitability – software would be such an example? Consider the opportunity cost of the capital, your time, the effort and all the details that go into making a successful acquisition.

***You have to have a strategy that is focused.***

***You have to have the people processes designed and organized.***

***You need to have the operational processes organized.***

And then, you have to want to expend leadership energy to execute. It is a great path to growth, but it is far from easy!

**Good Luck!**