

DR. TOM MCKASKILL

Ultimate Acquisitions

*UNLOCK HIGH
GROWTH POTENTIAL
THROUGH SMART
ACQUISITIONS*

Testimonials

“The ability to successfully source and execute acquisitions will become a key capability of growth oriented companies in future. Tom’s book covers all of the major issues and provides a very practical methodology that will be extremely helpful for businesses about to undertake an acquisition.”

Michael Kerr, Director, KerrCapital

“Young and growing industries sooner or later consolidate or merge – and that means you will either sell your business to an acquirer or become an acquirer yourself. This book will help you with both of those challenges, and in particular show you how to optimise your result – whichever option you choose. A sound acquisition.”

Adolph M Hanich, Senior Trustee, Telematics Fund (A long established seed capital fund)

“The art of making the right purchase decision is often overlooked and frequently buried in just a set of formulas to calculate purchase prices and related issues. This book moves beyond that – and it will give entrepreneurs some very useful, original insights into how to optimise the acquisition process.”

Dr Michael Schaper, Former Dean, Murdoch Business School

“This book will change the way you think about acquisitions and it should improve your ability to select, evaluate and manage acquisitions.

Too often the acquisition literature uses a ‘one size fits all’ approach to how acquisitions are evaluated and integrated. I found the way that Dr McKaskill dealt with the various types of acquisitions the most useful aspect of this book. It certainly made me think about the acquisitions we have done in a different way. I think there is a natural assumption that the acquired business must be integrated, but this book breaks that paradigm. The pragmatic approach set out in this book should greatly help companies grow and prosper.”

Christian Larsen, Executive Director, Runge Limited

“I commend this text as a very practical guide for entrepreneurs looking to grow by acquisition. Tom stresses the need for the acquirer to be ‘match fit’ and for there to be a good cultural fit between the businesses to be merged. My experience is that without these foundations, your acquisition is very unlikely to succeed.”

Jim McElwain, Director, McElwain Consulting Limited

“Having worked through a merger since 2000, as CEO of the merged entity I can really relate to what I’ve read in Ultimate Acquisitions. Shortly after our merger I searched Amazon for something to guide me. Nothing of use was available except a wordy treatise written for large corporations that was totally useless for small businesses. Your book struck a chord with me and would have been a real god send if I had had the opportunity to read it five or six years ago. You’ve filled an important market gap.”

Ken Fife, CEO, Auto-IT

“Acquisitions can play an important role for entrepreneurs seeking to grow a firm. Tom’s book provides valuable guidelines for those wishing to pursue this growth strategy.”

Jason Fitzsimmons, Brisbane Graduate School of Business

“Tom’s book is just as valuable for the large enterprise as an entrepreneurial venture. The cultural and ethical assessment identifies key issues that are all too often overlooked in the acquisition process.”

Christopher Slack, Business Development Manager – Components, TAE (subsidiary of Air New Zealand Ltd)

Dr. Tom McKaskill



Global serial entrepreneur, consultant, educator and author, Dr. McKaskill has established a reputation for providing insights into how entrepreneurs start, develop and harvest their ventures. Acknowledged as the world's leading authority on exit strategies for high growth enterprises, Dr. McKaskill provides both real world experience with a professional educator's talent for explaining complex management problems that confront entrepreneurs. His talent for teaching executives and his pragmatic approach to management education has gained him a reputation as a popular speaker at conferences, workshops and seminars. His approaches to building sustainable, profitable ventures and to selling businesses at a significant premium, has gained him considerable respect within the entrepreneurial community.

Upon completing his doctorate at London Business School, Dr. McKaskill worked as a management consultant, later co-founding Pioneer Computer Systems in Northampton, UK. After being its President for 13 years, it was sold to Ross Systems Inc. During his tenure at Pioneer, the company grew from 3 to 160 people with offices in England, New Zealand and USA, raised venture capital, undertook two acquisitions and acquired over 2,000 customers. Following the sale of Pioneer to Ross Systems, Dr. McKaskill stayed with Ross for three years and then left to form another company, Distinction Software Inc. In 1997 Atlanta based Distinction raised \$US 2 million in venture capital and after five years, with a staff of 30, a subsidiary in New Zealand and distributors in five countries, was sold to Peoplesoft Inc. In 1994 Dr. McKaskill started a consulting business in Kansas which was successfully sold in the following year.

After a year as visiting Professor of International Business at Georgia State University, Dr. McKaskill was appointed Professor of Entrepreneurship at the Australian Graduate School of Entrepreneurship (AGSE) in June 2001. Professor McKaskill was the Academic Director of the Master of Entrepreneurship and Innovation program at AGSE for the following 5 years. In 2006 Dr. McKaskill was appointed the Richard Pratt Chair in Entrepreneurship at AGSE. Dr. McKaskill retired from Swinburne University in February 2008.

Dr. McKaskill is the author of eight books for entrepreneurs covering such topics as new venture growth, raising venture capital, selling a business, acquisitions strategy and angel investing. He conducts workshops and seminars on these topics for entrepreneurs around the world. He has conducted

workshops and seminars for educational institutions, associations, private firms and public corporations, including KPMG, St George Bank, AMP, AICD and PWC. Dr. McKaskill is a successful columnist and writer for popular business magazines and entrepreneur portals.

To assist Angel and Venture Capital investors create strategic exits for their investee firms, Dr. McKaskill conducts seminars, workshops and individual strategy sessions for the investor and their investee management teams.

Dr. McKaskill completed six e-books for worldwide distribution. He has also produced over 150 YouTube videos to assist entrepreneurs develop and exit their ventures.

Tom McKaskill is a member of the Apollo 13 Angel Group on the Gold Coast, the Melbourne Angels and the Australian Association of Angel Investors.

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The Ultimate Deal 1

Selling your business

This book is aimed at those businesses which need to maximise their profit and growth opportunities in a sale to a financial buyer to leverage the best sales price. It sets out a breakthrough process which includes reducing risk, improving sustainable profits and building growth potential in the business to maximise the sales price. This world first process can increase the value of the business between two and ten times the conventional sales value of a firm.



The Ultimate Deal 2

Get an unbelievable price

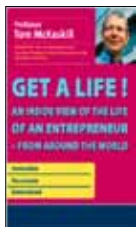
This book uncovers the secret of how to leverage strategic value in the business to create a large revenue opportunity for a strategic buyer. Dr. McKaskill's is the world's leading authority on selling a business to a strategic buyer and sets out a comprehensive and systematic process for selling a business to a large corporation. Sales values of 40 times EBIT and/or many times revenue are highly probable using his Strategic Sale Strategy for a business with underlying strategic assets or capabilities.



Angel Investing

Wealth creation through investments in entrepreneurial ventures

Designed to help high net worth individuals become successful Angel Investors. Angel investing involves active mentoring and coaching of an early stage management team towards sustainable profitability or additional funding, probably from a venture capital firm. This book sets out a comprehensive and rigorous process that will help the Angel generate deal flow, evaluate investment proposals and manage the investment and subsequent harvest. The book also provides a useful guide to managing operational risks in the venture.



Get A Life!

An inside view of the life of an entrepreneur - from around the world

This book is a collection of stories from entrepreneurs around the world where they describe their work and their lives. They explain what it is like to be an entrepreneur, how they got started, the successes and failures of their ventures and the highs and lows of their personal and business lives. The stories are rich in content and provide deep insights into how entrepreneurs think. If you are an entrepreneur this will resonate with your inner being. If you are not, this will provide you with a great understanding of entrepreneurs.



Finding the Money *How to raise venture capital*

The purpose of this book is to educate the entrepreneur on how Venture Capital firms work, what they seek in an investment and how they manage that investment through to an exit transaction. It helps the entrepreneur judge whether they have a venture suitable for VC investment and whether they wish to be part of such an activity. It lays out a comprehensive process that the entrepreneur can follow which will assist them in raising VC funding.



Winning Ventures *14 principals of high growth businesses*

Explains the major contributors to high growth success. Includes a comprehensive Growth Check list for each principle as well as a robust Growth Potential Index to help the reader judge the growth potential of their venture. Based on established theories of growth, venture capital selection criteria and the author's personal experience, this is a must for entrepreneurs.



Masterclass for Entrepreneurs

Creative solutions for resilience, growth and profitability

This book is a collection of published articles by Dr. Tom McKaskill. This volume expands on 30 of those articles to provide a wide-ranging guide for entrepreneurs on how they can manage their businesses more effectively.



Fast Forward

Acquisition strategies for entrepreneurs

In this book, Dr. McKaskill sets out a systematic and pragmatic process for identifying, evaluating, valuing and integrating financial and strategic acquisitions. He draws extensively on his own experiences as a CPA, entrepreneur and academic, as well as his experience with acquiring and selling his own businesses. He brings a systematic and comprehensive approach to growing business through acquisitions.



Raising Angel & Venture Capital Finance

An entrepreneur's guide to securing venture finance

This book is aimed at those entrepreneurs who have high growth potential ventures and seek to raise finance to assist them to develop their business. To secure the finance, the entrepreneur will have to demonstrate that their business is capable of achieving a premium on exit, usually through a strategic sale. The book provides a checklist for the entrepreneur to assist in developing a strategy to raise finance.



An Introduction to Angel Investing

A guide to investing in early stage entrepreneurial ventures

Designed to help high net worth individuals become successful Angel Investors. Angel investing involves active mentoring and coaching of an early stage management team towards sustainable profitability or additional funding, probably from a venture capital firm. This book sets out a comprehensive and rigorous process which will help the Angel generate deal flow, evaluate investment proposals and manage the investment and subsequent harvest. The book also provides a useful guide to managing operational risks in the venture.



Invest to Exit

A pragmatic strategy for Angel and Venture Capital investors

Investors in early stage ventures need to focus on strategic exits if they are to achieve a high return on their investments. This book explains the characteristics of strategic value, how the investor should negotiate the investment and then how they should manage the process to a strategic trade sale. The book includes a very detailed discussion on the problems of high growth ventures, the unrealistic expectations associated with IPOs and the advantages of investing in strategic value ventures.

Order from www.investtoexit.com

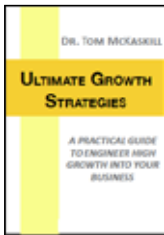


Ultimate Exits

The secret behind selling entrepreneurial ventures at staggering prices

High growth potential ventures have the opportunity to capture a premium on sale if they prepare their business for sale by reducing risk and package their business so that the buyer can readily exploit its potential. The entrepreneur should forget the EBIT multiple and historical performance and concentrate on building potential for the buyer. A financial sale exploits the revenue and profit growth within the business. A strategic sale enables the buyer to exploit an underlying asset or capability to counter a threat or exploit a large revenue opportunity through their own organisation.

Order from www.ultimateexits.com



Ultimate Growth Strategies

A practical guide to engineer high growth into your business

High growth ventures all have a set of underlying principals which drive transaction velocity and operational management. Entrepreneurs who wish to engineer growth into their business need to incorporate these basic principals into their business. This guide steps you through each principal and offers pragmatic ways in which they can be incorporated into your business strategy.

Order from www.ultimategrowthstrategies.com



Ultimate Acquisitions

Unlock high growth potential through smart acquisitions

High growth potential ventures are often constrained by a lack of resources or distribution channels. With the right approach to the selection, evaluation, negotiation, integration and post acquisition management, acquisitions can be a very strategic way to overcoming these growth constraints. However, acquisitions need careful planning and management to be successful. This book is a very pragmatic guide to developing a successful acquisition program.

Order from www.ultimateacquisitions.com

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Preface

When it comes to acquisitions, I have truly been in the middle of the action. Over a period of years while I was actively working as an entrepreneur, I undertook two acquisitions and was the target of two. Unlike many executives who participate in the process, I initiated these transactions, drove the negotiations and, in the case of the businesses we purchased, managed the integration. Thus, whatever the outcomes achieved, I would certainly claim a good part of the responsibility.

My track record was no better than the average. Of the two occasions I was the buyer, one was a major disaster and one a complete success. On the two occasions I was acquired, one was appallingly badly handled and perhaps created the seeds of its subsequent downfall. The other trade sale was poorly handled but I don't think they were overly bothered by the poor integration as significant benefits accrued to the buyer anyway.

With this as my acquisition experience, you can see why I have been interested in discovering more about the process and especially about how this activity can be substantially improved.

My first experience of acquisitions came when my UK based software development business decided that it should approach our main software tools supplier to see if they would be interested in selling their business to us. Our reason for wanting to do so stemmed from the fact that their future development strategy was inconsistent with our own and we wanted to gain control over their development activity. At the time they also acted as one of our distributors and we also wanted to increase the level of effort that was being put into that activity. At the time our business employed around 35 people while theirs had 54 employees. We were about to absorb a business much larger than our own. Truly a brave step.

We had been working with this supplier for about three years prior to our approach to them and thus knew the owners and senior management very well.

Over a relatively short meeting in which we were provided with their unaudited management accounts, we agreed a price of US\$2 million to buy the business. This was about six times their net earnings. We did not have the funds available at the time and so they agreed to give us six months to raise the money. After spending many months attempting to raise venture capital we finally succeeded in raising \$1.5 million from a corporate investment fund. This meant that we were short \$500,000 although we had a cash reserve of \$250,000 we could use. We went back to the two owners and negotiated a lower price but with a three year consulting contract. It did mean that we were stretched to the limit.

Once we knew we could meet the purchase price, we appointed a local US lawyer to act on our behalf and arranged for a US based national accounting firm to undertake an acquisition audit. The audit came back verifying the accounts and so we finalised the deal.

We decided that my wife, who was responsible for product development, I and our two young children would move to San Diego for six months to settle the business into the new ownership and change of strategy. We also transferred three developers from our Northampton office to San Diego. The plan was to take formal control of the business, terminate the two former owners as agreed and put myself in charge of the overall business with my wife taking control of the software development part of the business. We assumed that we would be able to leave most of the business alone. Our major objective was to put new effort into developing an emerging part of the business which had been distributing our own products for about two years.

Everything went very well for about two months until we finalised the opening balance sheet audit with the same accountants who had undertaken the acquisition audit. They discovered during the subsequent audit that there were a number of irregularities in the accounts which had the effect of reducing the value of the firm by about 40%. As I had used external funds to finance the acquisition, I was under extreme pressure by my investors to recover the excess paid for the business. This ultimately turned into litigation against the two former owners and the auditing firm. Instead of returning to the UK at the end of six months, I found myself a frequent commuter over the next two years spending about 50% of my time in San Diego and most of that time working on the litigation. It would take five years before the action was finally heard in the US Federal Court.

The impact of the litigation on the San Diego business was dramatic. It completely polarised the employees between those who thought the action was warranted and those who thought I should allow the two former owners to keep the money. The business was completely disrupted; people took sides and

spent endless hours debating the issue instead of working. I had to spend much of my time working on the litigation as I felt I could not trust the local staff to undertake the work because of their loyalty to the former owners. Also, I could not promote people within the company as they would then need to represent the company in the litigation.

The impact on the UK business was not as dramatic but it still left a gap in management. Because the US business was no longer effective, it also meant that it was not making a profit or paying its way. We ended up subsidising the business in the US from our profits in the UK thus draining our business development funds. In the end we terminated about 20 employees in the US to bring the business back into profit and it was not for several years that the US business regained the ground it had lost.

It is difficult to imagine how such a sequence of events could have been planned for especially since I had engaged a professional services firm to undertake the investigation. Perhaps the lesson is to expect the unexpected and to ensure that you have enough of a buffer in the business to cope with events that go wrong. Fortunately we were able to bring the business back into profit, complete the change in development strategy and gain a foothold in the USA. In many ways this acquisition enabled us to produce the innovations that were the key to selling the entire business some years later.

My next acquisition occurred only a few years later and while we were still involved in the litigation in the USA. Because the business results were so bad, mainly due to the disruption in the USA, our overall valuation had fallen to near zero. Our corporate investor had itself been acquired and the new owner saw no need to have an investment in a completely unrelated business. We were thus able to negotiate a buy back of the investor's shares for about \$40,000. At the same time we desired to merge our business with that of our London distributor. We used this opportunity to allow the two owners of the London distributor to buy out the investor giving them 20% of our business while at the same time we purchased the assets in their business excluding the building which we subsequently rented back from them.

We had been working with this distributor for about five years, had a high regard for their manner of doing business and felt that we could work well together. We constructed a new organisation splitting the major roles between their senior management and our own. Our UK business at the time had about 60 employees while theirs had about 30. We moved their business over to our administration system but in fact had it administered out of London. We moved all the employees onto a common payroll also administered out of the London office.

The merger went without a single problem. In hindsight I think it worked because everyone wanted it to work and because their culture was almost identical to our own. We had enough growth in the business to absorb all the employees. Perhaps the major reason it worked was because the two London executives undertook complementary roles to our own managers so there was no duplication of roles that needed to be resolved.

Two years later we decided that the time was right to sell the total business. After a long search we found a corporation in the USA which could significantly benefit from our products and underlying technologies. The negotiations and the subsequent due diligence by the buyer took about six weeks. What I learned from this acquisition was what not to do.

This was my first experience of being acquired and I was not sure what to expect. What I didn't expect was to be told that we had basically mismanaged our business and that the way in which the business would be managed in the future would be very different. The executive sent to the UK from the USA had never worked outside the USA but wanted to run the UK business in the same manner as a USA company would be run in the USA. He simply was not open to hearing about the different ways of doing business in England.

The next major change was that they wished to move all product development to the USA and break up our integrated enterprise application across three different development teams working in three different cities in the USA. At the same time, they aggressively started selling our products in the USA but were not willing to make the investment in project management, implementation and support resources we recommended. Basically they knew better than we did because they were bigger and they were now the boss. My own staff found this insulting, frustrating and sometimes embarrassing.

By the end of the first year my former COO had been put in charge of the UK operations and that stabilised the UK business and settled the staff down. I moved with my wife and the development team to Atlanta in a deal that kept the development group together. The new owners really had not properly investigated our products and were completely surprised when the success of our products in the USA resulted in their products being relegated to the sidelines putting many of their current employees in a situation where they were no longer involved in software development of the company's flagship product. This created extreme power politics which was very stressful. Unfortunately, the success in sales was not supported by an appropriate after sales support effort and the sales momentum ended in a crisis where new sales abruptly stopped because of the lack of progress with former sales. The business went into a loss situation from which it never really recovered. The business staggered on

for about ten years but never managed to gain traction and eventually it was acquired for a fraction of its former value.

In reflecting on this acquisition after I resigned, I saw that our two businesses really had very different cultures. Where we valued customers, staff and suppliers highly and treated them as part of our business family, the new owners treated everyone very badly. Their approach was to always win, never to admit a mistake and always take advantage of the situation for personal gain. We could not have found a worse fit!

The manner in which the acquisition and integration was managed could easily have resulted in the mass resignations of my former employees. Perhaps the only reason this did not happen was that I had insisted on three year management agreements for the seven top executives and these executives managed to convince people to stay while we worked through the problems. However, we were no longer in charge and so this process was quite stressful. We were left in no doubt that they clearly knew better than we did and that they were not about to take our advice. My guess is that most senior people would have resigned in this situation; however, we felt a strong loyalty to our former staff and, in effect, created a buffer between the old employees and the new management. Fortunately for most of our employees, they remained located in their former offices and had little interaction with the new management.

My final experience of being acquired happened in the late 90s. I had started a new business in Atlanta in 1996 developing supply chain optimisation software. This business was successful in raising \$2 million in venture capital to fund market expansion and to complete a suite of products. We decided to sell the business in 1998 when the market for independent optimisation software collapsed. The buyer was PeopleSoft, since acquired in a hostile takeover by Oracle.

PeopleSoft needed our optimisation products to compete with SAP. In hindsight they probably achieved the benefit of the acquisition on the day they announced the acquisition. By acquiring already completed and implemented supply chain optimisation software products they had an effective competitive advantage over SAP who was still developing their own solution. The deal with PeopleSoft was 40% up front with 60% on completion of certain development activities. The earnout was in three stages based on development milestones plus a commission on product sales. The earnout period was for a year after the agreement was signed.

The business was to be managed as a separate entity for one year while the earnout was in place. During this period PeopleSoft funded the business.

At the end of that year PeopleSoft would integrate the business into its own organisation. In the end, we completed the first stage and then PeopleSoft changed their mind as to what they wished us to undertake for the balance of the earnout. We insisted on sticking to the original agreement and they agreed to pay out the development portion of the earnout rather than have us waste development time completing something they no longer wanted. Because we argued that the product was not fully complete and therefore sales would suffer, they agreed to pay 50% of the revenue earnout as well.

PeopleSoft badly managed the post acquisition activity. They expected us to simply get on and complete the development activity and not worry about what would happen to us at the end of the earnout. Of the 30 employees at the time of the deal, 17 were retained through the development phase. This included a couple who were transferred across to PeopleSoft to help with sales and marketing. The balance stayed in Atlanta to complete the development activity. However, people were much more concerned about their futures than the development task. They wanted to know whether they would have a job at the end of the development phase, who they would be working for, what their terms and conditions of employment would be, if they would need to relocate to PeopleSoft's head office in California and so on. They were consumed by these questions and were highly unsettled.

Over the first six months after the deal was signed, I spent countless hours trying to resolve these questions on behalf of my employees. However, we were a tiny part of a business that employed 7,500 people. We were simply unimportant. At the same time they were going through one of their endless reorganisations and so no one at the PeopleSoft end knew what was happening or where my group would end up in the new structure. PeopleSoft expected the development team to relocate to San Francisco at the end of the earnout period but had never bothered to work out what that might mean for the individuals concerned. It turned out that most individuals lived in large outer suburban houses in Atlanta and, for the same price, they could buy a small apartment near PeopleSoft in San Francisco. This placed great strain on our relationship with PeopleSoft senior management as individuals decided not to relocate.

In the end PeopleSoft left the entire team in Atlanta. Five years later all the developers were still employed by PeopleSoft. Clearly during that one year transition period we were able to resolve personal issues and settle the staff into regular PeopleSoft functions. It is interesting to note that most of them left PeopleSoft soon after the hostile takeover of PeopleSoft by Oracle. Most explained to me that they simply could not work in the culture of Oracle.

I was not offered a position at PeopleSoft which was what I had expected. My expertise for many years had been to manage an entire business and my skills weren't needed by PeopleSoft. A year later I took up a position as a Visiting Professor of International Business at Georgia State University. In 2001 I was appointed Professor of Entrepreneurship at the Australian Graduate School of Entrepreneurship.

As an academic I have a very strong interest in growth through acquisitions and my own experience has shown me just how difficult and how fickle the process is. Over the last several years I have read many textbooks and many popular business books on the subject and have read numerous academic articles that have reported research activities in this area. I realise now that I have considerable personal experience in this area and I am now better able to understand what I did wrong and what I did right. It also showed me why the two businesses I sold were so badly handled after the acquisition.

My concern with this body of literature is that it fails to provide a pragmatic guide for entrepreneurs who manage growth oriented, medium size businesses. You can either read how to buy a small business, such as a franchise or corner store, or you can read how to do a mega merger. Thus, you can find out either how to buy a business with no complexity which you wish to hold as an owner manager and which will not involve any integration issues, or you can discover how to buy a mega business and how to put your M&A (mergers & acquisitions) department to the task of negotiating the deal and managing the integration of the thousands of employees you acquire. But if you are a 100 person firm seeking to buy a 40 person firm and you will personally manage the deal, there is no literature designed to help you.

I also found that the most important topic, cultural fit, was treated at a very theoretical level with little insight into how a medium sized firm would identify a cultural problem. There are numerous textbooks which talk about cultural issues but assume the reader already understands what that means. As part of this book, I wanted to develop a pragmatic method by which the entrepreneur could readily identify a situation where the target firm had a different culture and/or ethical values from their own business.

Most of the popular books on M&A are written by consultants who warn you of all the problems which you will experience in an acquisition and give you a small insight into how you might go about resolving problems but, of course, the full solution is only available if you hire them. I wanted to provide a complete guide for the entrepreneur although recognising that professional firms would be engaged to support the activity.

My objective with this book is to provide a pragmatic acquisition guide to the growth oriented, medium sized business. I have set out the book in a manner which will provide an overview of both the evaluation and the integration issues. I have also tackled the cultural fit issue through the development of a cultural and ethical assessment instrument which I think will provide an early warning system for the entrepreneur. Basically, if you know what you are getting into, you can decide to terminate the negotiations or start planning for how you are going to manage the situation.

I have assumed throughout this book that the entrepreneur will hire professionals to undertake specialist activities in such areas as valuation, due diligence, taxation, legal and human resources issues.

Acquisitions can be a major catalyst in business growth if handled well. If you go about the activity in a systematic manner and ensure that you deal with the issues objectively and fairly, you have every reason to believe that your acquisition objectives will be realised.

I wish you every luck in your ventures.

Tom McKaskill

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Acknowledgements

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Adjunct Professor Adolph Hanich, former Director of the Australian Graduate School of Entrepreneurship and a well seasoned business adviser, provided very useful comments on the book's content and also recommended a change in structure to the book which involved reordering the chapters into what is now a much more logical sequence.

I was very fortunate to have the opportunity of meeting with John Sunderland, Partner with PriceWaterhouseCoopers, in London while I was reviewing the issues involved in integration. This is John's specialisation within the M&A practice of PWC and so his insights were especially pertinent. John identified to me the importance of looking at the intersection of internal processes and culture and mapping these together onto the target firm.

Other individuals who reviewed the draft and provided feedback were entrepreneur Adam Hodgson, academic Jason Fitzimmons, Professor Michael Schaper, business adviser Jim McElwain and corporate finance consultant Geoff Green. Each identified areas where additional clarification was needed or provided feedback to improve the content.

Finally, my life partner Katalin Johnson has once again checked and rechecked the content to identify errors, omissions and grammar and sought clarification where the meaning was not obvious to her. There is no question that a book of this size would be a herculean task without such assistance.

Part A: Acquisition Strategies

Section One: Managing Growth

Chapter One

Introduction

Acquisitions are not for the meek at heart. They are undertaken by those who are willing to step out of their comfort zone to take on the challenge of changing their business by bringing in resources from the outside. In doing so, they will introduce change which itself is a disruptive process. There is a vast body of accumulated evidence to show that only a minority of acquisitions result in positive shareholder value. Most acquisitions suffer from poor analysis and ineffective integration processes. Whether you are buying a business to own and manage personally or you are buying a business to add to your existing organisation, the process which most entrepreneurs follow is poorly constructed and poorly executed.

In this book I am going to concentrate on those acquisitions which are undertaken to enhance an existing organisation although the evaluation process and the change management aspects involved in a personal acquisition are very similar and the process provided in this book will certainly provide a very good basis for a personal acquisition.

As can be expected, the impact on the target business of being acquired can be significant. The new employees can expect to have their job responsibilities changed, report to new managers and have new remuneration and benefits packages. In the worst cases they may be terminated or relocated. Their level of stress, frustration and anxiety will increase dramatically leading up to the sale and can be expected to continue for some period beyond it depending on how well the integration process is managed. Some will take the opportunity to look for new jobs and leave with a potentially damaging impact on the business. Others who stay experience the loss of friends and colleagues and are left to cope with a wave of new hires. This period of change normally results in a deterioration of productivity, disruption to customer service and a period of reduced profits.

The buyer also rarely escapes untouched by this process. Initially there is the tension involved in the decision to proceed with the acquisition and

the resultant concentration of effort involved in the due diligence. After the deal is done, there is the stress of integration and the concern over whether the acquisition objectives will be achieved. Normal business can be disrupted during the negotiation and integration phases as senior executives cope with the additional workload of the acquisition process. If there are segments of the business which are merged, employees may experience similar changes to that of the seller. Inevitably some loss of employees will occur within the buyer's organisation due to uncertainties. In many cases, new positions are created or old ones changed, new structures are created to absorb the new activities and management teams are often fully or partly integrated.

It is a time of tension and stress. Not everyone will cope well with the additional workload and not everyone will be happy at the end of the process. Change in itself is a stressful activity which few organisations handle well. Acquisitions involve abrupt change and therefore put more pressure on organisations than other corporate activities. This is probably why so many result in failures. Few companies have experience in planning such abrupt changes and most get it wrong.

However, acquisitions can significantly improve the effectiveness and profitability of a business if handled properly. They can provide resources which will increase the capability and capacity of the enterprise. If undertaken as part of an overall growth strategy, they can fill gaps in product lines, open up new markets, access technologies and skills to facilitate growth and so on. Smart acquisitions increase competitive advantage, increase margins and provide greater resilience to the enterprise. But such acquisitions rarely happen by accident. Smart acquirers have systematic processes for identifying the right acquisitions and undertake comprehensive investigations of both the potential contribution of the acquisition and the ability of the acquirer to undertake the management and possible integration of the new business. Of course, all this has to be undertaken while not unduly disrupting ongoing revenue generation.

The aim of this book is to set out a systematic process for acquisitions which will significantly improve the probability of success of the entrepreneur of a medium size company acquiring and integrating another business.

Chapter Two

Organic Growth vs Growth by Acquisition

Overview: Organic growth is difficult to achieve for any long period of time. Acquisitions can provide the buyer with fast access to established capabilities or assets which can enable it to counter threats or pursue timely revenue opportunities. Acquisitions which provide step increases in size can also deliver economies of scale benefits.

The vast majority of private businesses never grow beyond a small number of employees. In the majority of cases this is intentional but even those which desire to grow may not be able to gain the traction to move beyond a dozen staff. While market forces may explain the lack of success of most, the few which have outstanding products and services may still be constrained by their own capacity and capability to grow. For many of these entrepreneurs, acquisitions can often provide a means of facilitating expansion.

Overcoming Growth Constraints

Few businesses are able to pursue aggressive growth for more than a limited period. Apart from the need to restructure and regroup in order to manage larger operations, the business simply encounters any one of a number of internal or external constraints. The rate of growth slows and the business then must stay within its limitations until a new set of internal or external conditions allow it to push the growth rate up again.

The rate of growth is governed by the rate at which the business can access the resources to grow. At the same time it must gain new customers or extract additional business from existing customers at an ever faster rate. When you consider these two boundary conditions, it is relatively easy to see why organic

growth is limited. The entrepreneur who desires additional growth will find they are frustrated in their objectives due to a number of major constraints.

Staged investments

Many of the resources which the business needs for growth are only available in fixed increments. Thus a new factory or warehouse must be constructed before it can be used. New office space may require a commitment to much more space than is currently needed. A new communication system or a new enterprise application software system may be a major expense but is capable of handling a business many times larger than the current one. These investments absorb available cash or borrowing capacity which is then not available to make other necessary investments in working capital or new personnel.

Not only are major fixed assets and infrastructure investments lumpy in nature, they also take considerable time to acquire and put into production. Thus a new plant or warehouse might take one to two years to construct. A new information system might take nine months to evaluate and two years to install.

Revenue Growth

Gaining new customers, especially at an ever faster rate, normally requires an increasing level of marketing and advertising expenditure. In addition, there needs to be an investment in sales staff. If you then add the lead time for marketing and advertising expenditure to become effective and the lead time to recruit, train and deploy new sales staff, this can become a significant investment. If the business is not fortunate enough to have excess demand and high margins, such investments will no doubt be constrained as few lenders are willing to lend purely for market development, especially without some form of security against business assets. New customers could potentially be acquired faster with aggressive price cutting and promotions but this can be self-defeating as it can fail to generate the margins needed to make longer term investments. Price cutting can also lead to competitor retaliation and escalate into deeper discounting which might erode the profit base of the business.

A more aggressive approach to gaining business may also lead the company into accepting less desirable business. This might lead to higher risks, more problem customers and more disputes. These in turn tie up valuable productive resources and in turn lead to lower revenue productivity and lower profits. Thus chasing marginal business can often be sub-optimal and self-defeating.

The marketplace for large scale capital investments often requires prospects to have access to referral customers in order to close the deal. If the product or service being sold takes many months to implement and/or train, this can slow down the rate at which new referrals can be generated. This in turn will slow down the rate at which new customers can be gained.

Working Capital

Increased levels of business require additional working capital. Funds are tied up in work in progress, inventory and accounts receivable. In addition to these investments in transaction-based activities, there are complementary investments in personnel and infrastructure which service new levels of business. Some of these investments can be used to secure loans but normally only at some percentage of the investment. The business is left to generate the funds needed to cover the balance. Thus working capital demands eventually constrain the business unless it has a very high margin activity.

Management Capacity

Every business has its own special way of doing business. This includes the way in which decisions are made, funds allocated, problems resolved, activities organised and so on. Someone coming into the business for the first time will need to become familiar with the manner in which the business operates and where to access various types of information and resources. The rate at which this transition is made is itself a constraint on growth. The more complex the business, the longer this process will take. If, in addition, the business has a decision-making process where numerous decisions need to be reviewed and authorised before action can take place, the pace at which the business can proceed will be constrained.

The business will be further constrained to the extent that the company has difficulties in sourcing and recruiting people with the right experience, skills and cultural orientation. If the company has sales demand but cannot recruit people to service that demand, its rate of growth will be severely limited.

Organisational Structure

As organisations grow they evolve new structures and systems to cope with increasing size and complexity. However, such changes are not necessarily smooth or continuous. Periodically the organisation needs to go through a major overhaul as it changes the overall structure. Such changes are very disruptive and often stressful for employees. During such periods, productivity falls and growth stalls.

The Pursuit of Growth

Why is growth necessary or even desirable? Entrepreneurs seek growth as a means to an end rather than an end in itself. Larger businesses have a number of key benefits including:

Greater Resilience

A larger business can generally withstand a setback better than a small one. Once a business gets to a certain size, there is normally some flexibility in the number and mix of the labour force. Some employees can be terminated without necessarily threatening the survival of the business. If the level of recurring revenue has increased over time, new revenue generation may reduce when the business hits a major problem but continuing business will keep the business alive. As a larger business, essential fixed costs are spread over larger volumes and thus can be more easily funded.

Specialisation

A larger business allows greater specialisation of tasks and this in turn normally leads to greater productivity. This will lead to reduced costs per unit of output and thus greater room for discounting if the business gets into difficulty. On the other hand, it can also lead to a competitive price but at a higher margin thus improving profits.

Higher Margins

At higher volumes the minimum fixed costs can be spread over a higher volume of transactions thus resulting in higher margins. Higher margins in turn allow the business to pay better salaries thus attracting higher quality employees or make additional investments in innovation and thereby increase competitive advantage. Higher volumes may allow lower costs in procurement through volume discounts.

Pursuit of Opportunities

A larger resource base and higher profits can allow the business the freedom to take risks in the pursuit of new opportunities. While not all will result in positive returns, the chances are that some will succeed and lead to additional profitable growth. Some opportunities which require significant investments may simply not be possible for smaller businesses. Whether this is because of the amount which needs to be invested or the level of risk which the business has to absorb, larger companies have the capacity to undertake such investments and risks.

Larger Deals

The size of the business often influences the size of the customer transactions. From a customer perspective, a small business may not have the resources or credibility or may represent too high a risk to undertake a large contract or order.

Maintain or Build Market Share

In a situation where company growth is less than industry growth, acquisitions can assist the company to maintain or increase their market share.

Equity Investment

In order to attract private equity or to be able to pursue a public listing, the company may have to achieve a larger size. Smaller companies generally present too high a risk for private equity investment or a public listing unless they have exceptional management and intellectual property.

Borrowing Capacity

Smaller businesses have special difficulties in borrowing funds. Either their asset base is too small or their resilience is too low to convince lenders to lend money. As the business gets larger and its net asset base grows, it is able to use these to access larger commercial loans.

Recruiting

As a business grows, its ability to recruit higher quality employees improves. It is not just that better people work for larger companies; it is simply that better people attract higher salaries and expect a range of benefits with their employment. Such benefits and job security are really only able to be offered by a larger enterprise.

Entrepreneurs normally desire to grow. In simplistic terms, a larger entity enables them to achieve more. They have a greater capability to make things happen with greater resources. Entrepreneurs are therefore motivated to pursue growth as a means to an end rather than an end in itself. The larger organisation has greater capacity and capability to undertake activities which allow the entrepreneur to achieve his or her own goals. Thus the pursuit of growth is both natural and desirable for the entrepreneur.

Using Acquisitions as a Vehicle for Growth

As the former explanation shows, growth is often hindered or constrained by the rate at which the business itself can fund or provide the resources to underpin growth. Faced with limitations through organic growth, entrepreneurs often turn to acquisitions to overcome constraints or to provide the capacity and capabilities to pursue opportunities. The entrepreneur will often see an acquisition strategy as a way of breaking out of an organic growth restraint.

Unlike the slow pace of organic growth, acquisitions can provide a step change in size. Many entrepreneurs look favourably on acquisitions because they represent a ready made growth increment. Acquisitions represent the following advantages:

- The business already exists and so the entrepreneur is able to avoid the time to recruit, train and organise staff into a functioning unit.
- The business is a going concern. The entrepreneur thinks that because the business already exists, he can fund the growth through asset lending or equity. In many cases the acquisition will be able to fund itself if it is profitable and cash flow positive. An existing business will have assets and or cash generation capability which will allow some or all of the finance required to acquire the business to be borrowed. Even if cash is not used to buy the business, the entrepreneur may be able to use a share swap thereby avoiding further borrowings on the company's own assets. Even if further borrowings are required, the new acquisition should be able to assist in servicing the new borrowings.
- An existing business already has infrastructure in place and therefore the company may not need to make an additional investment to expand its own infrastructure to incorporate the new personnel.
- An existing business can substantially reduce time to market.

Many of these characteristics would apply to an acquisition although how the company can take advantage of these will depend on the situation. Generally speaking, it is far less risky and more time effective to acquire an existing capacity and/or capability than to build it. This simplistic approach, however, suggests that any acquisition can deliver growth. Unless the company has the management resources and skills to take on an acquisition, it may be highly problematic and disruptive to the company's existing business. What is really important with an acquisition is whether it can enhance or deliver a specific business strategy.

Acquisitions can be an ideal source or facilitator of growth, however, the entrepreneur should approach the issue from a strategy point of view. That is, to what extent can I use acquisitions to enhance the strategy I wish to pursue? This approach recommends that acquisitions are used to fill in gaps in the strategy which cannot be readily undertaken internally. As part of an overall strategy, the acquisition should complement the existing business.

Executives were asked what external factors are most important when pursuing mergers or acquisitions. Top three answers:

Gaining new products	31%	
Attractive prices	24%	
Reducing competition	13%	

Interviews of 384 executives at companies in the USA with annual revenues of \$100 million to \$3 billion.

Source: Corporate Board Member magazine as reported in USA Today, 10th August 2005

Acquiring Capacity and Capabilities

The most common characterisation of acquisitions is that they enhance the capacity or capability of the buyer. The objective of an acquisition is to enable the buyer to gain access to a capability or asset (capacity) which it is able to exploit in order to achieve its main objectives. The capability or capacity acquired can be utilised for many different reasons, all of which provide benefits to the buyer. Specific objectives might include any of the following:

Acquire Customers

The target may have an established customer base which could offer a number of different possibilities. It might offer the company a new channel for its existing products and services. It might provide a vehicle for the company to enter a new market or new geography. The customers might include highly reputable customers which will enhance the reputation of the company.

Acquire Products or Services

The target may have existing products or services which can be offered by the company through its own customer base or distribution channel. This may provide additional revenue generation capability within the existing channel or may allow it to access new customers with a combination of its own products and services combined with those of the target.

Access to Brand, Intellectual Property, Specialist Knowledge or Technology Processes

The target may have specialist capabilities based on deep expertise or specialist knowledge or rights represented through brands, copyrights, patents, trademarks or licences which can be exploited by the company.

Acquire Capacity

A firm might be acquired because it has facilities which the company can utilise to expand its own business. These might include facilities such as a warehouse, location, plant or specialised equipment which might be underutilised or be better able to be exploited in the hands of the acquirer.

Acquire Capability

A common reason for acquisitions is to gain access to skilled personnel, trained management, special knowledge, unique skills or licensed practitioners who are in limited supply. Where such skill or knowledge is in limited supply or where it is difficult to assemble into organised teams or operating units, an acquisition can be an effective short cut to acquire a ready made capability.

Enter New Markets

An acquisition might be used to move the company towards a marketplace which has higher potential. The company might use its funding ability to buy its way into a higher growth market or an emerging market where the company might have a better future.

Overcome a Threat

An acquisition may be undertaken to overcome a threat. These can come in many forms and might result in acquiring a customer to protect revenue, a supplier to protect access to components, a competitor to protect market erosion or to acquire a better product or a partner to access complementary resources.

We typically think of an acquisition as a way in which a company can gain access to products, services, technology or knowledge for its own use. However, there are many forms of acquisitions which deliver benefits through the acquisition directly rather than through the buyer. These include acquisitions which are purchased at a price lower than their inherent profitability would normally justify, perhaps due to the owner's pressure to sell or for other personal reasons. A well funded buyer might also be able to buy firms in a downturn at lower than normal valuations and be able to hold onto them though better

times. An acquisition might also be made in order for the acquisition itself to be able to take advantage of IP or processes of the buyer.

Larger firms with lots of resources have established business development offices to execute corporate growth strategies through acquisition. These experienced buyers search for companies that fit their well-defined acquisition criteria. In most cases they are attempting to buy companies that are not actively for sale. If a strategic company is for sale and is being represented by an M&A firm, the M&A firm's job is to sell that strategic value to the marketplace. If properly done, the buyers are competing with several other buyers that recognise the strategic value and the price tends to be bid way up. The win for the successful corporate acquirer is to target several candidates that have many of the characteristics from above, buy them at financial valuation multiples (traditional valuation techniques like discounted cash flow or EBITDA multiples), integrate to strength and achieve strategic performance.

Source: <http://www.e-syndicate.net/a65930.htm> Accessed 18th February 2006

Acquisitions may also be made so that the company can take advantage of economies of scale.

Consolidation

A consolidation strategy assembles a number of companies which serve the same market. By bringing a number of companies together many administrative, central services and head office expenses can be spread across the group thus reducing the per unit cost of transactions. This strategy should increase the transaction margins and therefore profits. Consolidations can also better utilise excess capacity by consolidating capacity into a smaller number of resource units with the excess being disposed of. The resultant higher utilisation of the remaining resources will result in a lower per unit cost per transaction and higher profits.

Purchasing Power

Larger businesses have a number of benefits which are not readily available to smaller companies. Cost of capital is normally reduced and procurement costs are lower with higher volume discounts. Larger companies gain more attention from strategic partners, access larger professional services firms and more creditable bankers. Greater size may also allow the company to pursue a public listing which it might not have been able to do as a smaller entity.

Another form of acquisition is justified on the basis that it is cheaper and quicker to buy a capability or asset than build it. In this scenario, the justification for the investment arises from two sources of benefit.

Lower Cost

One approach is to seek to acquire something the company is already committed to but at a lower price than it would otherwise take to create, assemble or build. Thus a technology might be purchased rather than developed. A business with an existing factory might be acquired as an alternative to building a new factory. A firm with a proven specialist team may be acquired at a cheaper cost than it would take to find, recruit and train an equivalent team. Small firms are often acquired for their innovations or their R&D capability. It is well recognised that smaller companies are often better able to develop new innovations and these can often be acquired at considerably less cost than a large corporation would need to spend to develop a similar innovation or capability.

Time to Market

Even though the company has the capability and funds to build a specific asset or to develop a required capability, the opportunity cost of delaying the availability of such an asset or capability might justify buying a business which would allow the buyer to exploit this earlier. For example, a company might be able to develop a new technology but it might take two years to bring to market. Within the same two years, the company might be able to take a leadership position within the market and generate significant profit. However, this might only occur if the company could immediately enter the market with an established capability or capacity.

Enabling Corporate Strategy

In terms of strategy fulfilment, there can be no question that acquisitions should be driven by the company strategy. It is hard to see how random opportunistic buying can drive growth in any reliable manner. Just because a business can be acquired for below its market price should not be the major consideration behind an acquisition. The test of whether a specific acquisition should be considered should be the following:

- Does it enable our company strategy? That is, does it provide a capacity or capability we need which allows us to achieve a corporate objective or to do so earlier than we could otherwise?

- Do we have the capability in management expertise and time to properly evaluate, negotiate and integrate the acquisition?
- Can we acquire the business at a price which allows us to achieve a reasonable return on the investment?
- Are the risks associated with integration and exploitation of the acquisition acceptable even if the acquisition experiences an unusual level of problems, delays, loss of key personnel and so on?
- Is this the best use of available funds and resources compared to available alternatives?

Too often entrepreneurs enter into acquisitions without really giving proper consideration to the longer term objectives of the business. Given that their own time is often the scarcest resource, once an acquisition process is entered into, their time will be heavily committed and therefore other opportunities, or even their current business, may suffer as a result.

Conclusion

While organic growth can deliver incremental changes in the size of a firm, it is inherently difficult to dramatically change the size of the business due to numerous internal and external inhibitors. Acquisitions offer a business a strategy which can overcome many of the constraints to growth, especially if pursued in a rational and realistic manner.

Key Points

- The growth of most businesses is limited by internal and external factors over which the business may have little control, thus pursuing an acquisition strategy may provide the business with a growth catalyst.
- Acquisitions can be used to build additional capacity and capability and can therefore be a major source of growth.
- Service based businesses and businesses which have low levels of fixed assets may have difficulty financing organic growth but may be able to leverage the revenue generating power of an acquisition to finance growth.
- Acquisitions should be driven by business strategy rather than by opportunistic buying.

Chapter Three

Types of Acquisitions

Overview: Acquisitions can vary greatly depending on what has been purchased and the objectives of the investment. On one extreme are companies which are purchased for financial investment and are not changed other than acquiring a new owner. On the other extreme are firms which are purchased for their strategic value and are fully integrated into the buyer's organisation. It is important for an understanding of the investment evaluation and for the management of any intervention and integration activities to have a clear understanding of the different forms of investment, the level of intervention to be applied and the extent to which functions of the acquired business are integrated into the buyer's organisation.

There is considerable confusion within the acquisition literature because authors often fail to define exactly what type of acquisition they are referring to. When they say that 70% of mergers fail to improve shareholder value, they are in fact referring to a subset of acquisitions, those which require a high level of integration. But there are many forms of acquisitions including those which are little changed after the purchase. For instance, there are situations where there are no integration activities apart from the imposition of a new owner and changes which might stem from new governance and financial reporting.

Acquisitions may deliver benefits through a variety of sources which may or may not include changes in the acquisition, the buyer or both. In order to understand how to evaluate a potential acquisition and to provide some insight into the level of intervention and integration which might be required, it is worth classifying acquisitions by the level of integration required and the impact on both the buyer and the acquired business. In order to provide a framework for this classification, I am going to use a set of definitions which will help provide a more refined analysis of the acquisition issues.

In this classification I will be using the following terms:

Strategic Benefits	Strategic benefits occur where something acquired from the seller can be utilised by the buyer to generate revenue or cost saving benefits within the buyer. The buyer's business is changed as a result of the acquisition. The selling business may or may not be changed as a result of the acquisition. It is also strategic if the acquisition itself counters a real or potential threat to the buyer's business. The benefits from such an acquisition are intended to be generated through new capabilities or activities within the buyer's business.
Financial Benefits	In this situation the acquisition itself is changed through the provision of some new facility or capability from the buyer. The business of the buyer is not changed other than perhaps additional administration involved in supervising another acquisition. The benefits from the acquisition are intended to be generated through the revenue generation and/or cost levels within the acquired business.
Non-Intervention	Where the operations and management of the acquisition continue without significant change, other than reporting and governance requirements, this would constitute a non-intervention arrangement. Also the operations within the buyer itself are not materially changed with the acquisition.
Intervention	Intervention occurs when the operations of the seller and/or the buyer are materially changed as a result of the acquisition.
Autonomous	The acquisition would be autonomous if the seller's business continued to operate as a stand-alone business. The intention is, within reason, to allow the acquisition to continue to operate normally within its own marketplace. With the exception of some minor functions, the operations of the acquired firm would not be integrated with that of the buyer.
Non-Integrated	The operations of the buyer are not impacted by the acquisition.

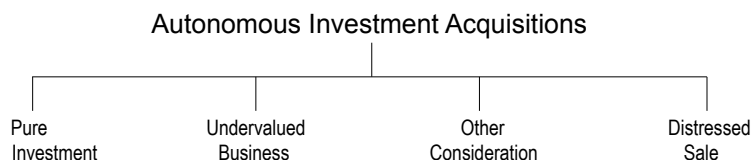
Integrated Some or all of the functions of the acquired company are taken over or integrated into the buyer’s organisation. Operations within the buyer are impacted by the acquisition.

Acquisitions sometimes involve a combination of these elements. The manner in which the acquisition will be managed will substantially depend on the nature of the acquisition and the source of benefits.

A. Non-Integrated Acquisitions

Many acquisitions are made with no immediate intention of undertaking any integration of the acquired business.

Type of Acquisition	Impact on Buyer	Impact on Acquisition	Return on Investment
Autonomous Investment Acquisition	None	None	Profits of acquired firm
Autonomous Strategic Acquisition	Buyer sources product, inventions or services from acquired firm or locks in customer or neutralises a competitor.	None except competitor may be constrained or closed down.	Elimination of threat or new revenue from sourced products, services or R&D.
Autonomous Financial Acquisition (low intervention)	None	Takes on new products, brand and/or excess demand from buyer.	Higher profits from acquisition.
Autonomous Financial Acquisition (high intervention)	None	Business is substantially changed with new management and/or processes.	Higher profits from acquisition.



Investment acquisitions are made purely for the return which they will generate on the investment. There is no intention to intervene in the management of the company, apart from perhaps a change in Board of Directors and financial reporting requirements. The acquisitions are selected because they are able to provide a target rate of return based on their current financial performance. The buyer sees no need to replace management or to interfere in the manner in which the business is operating, providing of course that it continues to deliver reasonable profits.

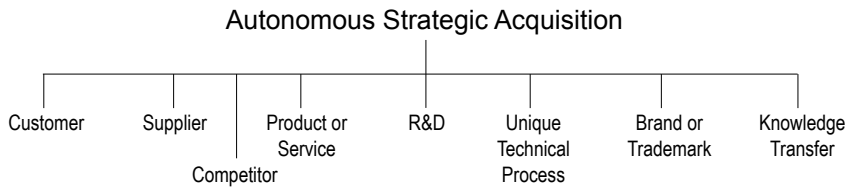
The business itself may have unusually good prospects and thus be able to provide an assurance of good returns or might be in an industry which already typically provides good returns. Alternatively, it may be undervalued as the sector is out of favour with mainstream investors or the business is not able to be adequately assessed by potential investors who do not understand the industry.

An undervalued business might also be acquired because the current owners do not understand its true value or it has been valued incorrectly. It may also be undervalued because economic and/or industry circumstances have depressed current valuations. A longer term buyer might see that the situation will reverse over time and valuations will improve.

A business may be sold where non-financial reasons on the part of the seller are a condition of the sale. For example, a family business may have no successor and the family may wish to pass control into the hands of a buyer that will meet certain conditions, such as providing employment in the region, continuing a long standing brand or providing employment for younger family members.

A business may be up for sale due to unfortunate circumstances which require an urgent sale. For example, the owner may need to spend time away from the business for family or personal reasons such as a divorce or urgent medical treatment. The owner may not be prepared to wait to sell and thus discount the price to find a quick buyer. The buyer may need to find a new manager but otherwise the intention of the buyer is for the business to continue operating as before.

In these situations, the buyer has no intention of intervening in the business nor integrating the business with that of the buyer. The evaluation of this class of acquisition would be based on the expected profits of the stand alone business.



A strategic acquisition delivers benefits through changes to the buyer. That is, the buyer takes advantage of something which can be sourced from the seller which the buyer can use to cut its own costs or generate new revenue. This would be an autonomous acquisition if, after the acquisition, the acquired firm continued as before, although normally this would be with a set of reporting and governance obligations to its new owner.

There is a class of acquisition which is driven by threats to the buyer’s business. A buyer might acquire a supplier, customer or competitor to protect its existing revenue.

A company may decide to buy vertically to protect its supply chain. This could come about for a number of reasons. A critical supplier may be in financial difficulties and the buyer may wish to avoid disruption to its own business if the supplier’s business fails or the supplier may be undertaking a business strategy which is incompatible with that of the buyer. Alternatively, the supplier may be up for sale and, if acquired by a competitor, the company may be denied access.

Similar situations can exist with critical customers. A major customer may be in difficulty and their failure might threaten revenue levels or the customer may be changing the direction of their business and may not require the products or services of the company. Alternatively, the customer may be open to an offer to purchase them from a competitor of the company which would deny revenue to the company.

In these situations, the company may have no intention of changing the operations of the acquired firm other than to ensure that it continues to be part of the company’s supply chain.

A company might acquire a competitor to contain its impact on the company’s revenue by denying it further growth funding, limiting its market access or by closing it down. Alternatively, it might be allowed to grow but market share

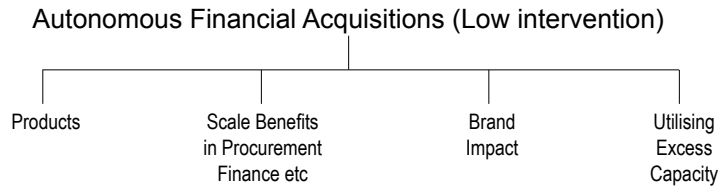
stolen from the company ends up within the group. The competitor might still continue as an independent business.

A different type of acquisition occurs where the seller has a unique product, technology process or capability which the buyer desires to offer through its own distribution channels or to its own extensive customer base. In this situation, the acquired business may be left to continue as it is. The buyer might become a strategic customer of the acquired firm, but be able to reach a much greater market through its own distribution channels. Alternatively, the product may be licensed from the new acquisition to be manufactured by the buyer. Where knowledge is acquired, the knowledge of the acquired business might be used by the buyer to deliver new products or services to its own customers.

It is not uncommon for large corporations to acquire innovative product development firms. Often the seller has a R&D capability which is highly specialised and difficult for the buyer to build for themselves. In such a situation, the R&D facility is often left to continue as it was, except now it has a new strategic customer, the buyer. The buyer may have access to the products exclusively or may allow the acquired firm to continue to service other customers.

Acquisitions can be made simply to acquire the benefit of the use of some unique characteristic of the acquired firm. The strategic value to the buyer derives from being able to use some unique intellectual property such as a brand, trademark, documented knowledge or technical process that the seller has. Where the intellectual property can be utilised across a larger entity without interfering in the operations of the acquired business, except for the period when the knowledge transfer is taking place, the seller's business operations may be left to continue as it was. This is not to say that there may be some synergies generated in other areas, but the rationale for the acquisition is focused on the knowledge and/or technology transfer.

In a strategic acquisition, the objective is to generate the benefits of the investment through the buyer's organisation. In most cases, the buyer would change their own operations to take advantage of the newly acquired capability or asset. The evaluation of this class of acquisition includes the stand-alone profitability of the acquisition in addition to the benefits generated through the activities of the buyer as it exploits the assets and/or capabilities acquired from the acquisition.



A business may be acquired in order to provide the buyer with another outlet for its products, brand or excess demand. An acquired business may be able to take on products or services from the buyer and distribute them to its own customers or through its own distribution channels without any significant change in the seller's organisation. The intended impact is to increase revenue and profits of the buyer without changing its operations and increase the revenue throughput of the seller without changing its operations. There is also the possibility that a wider portfolio of products may allow the acquired firm to access new customers or markets.

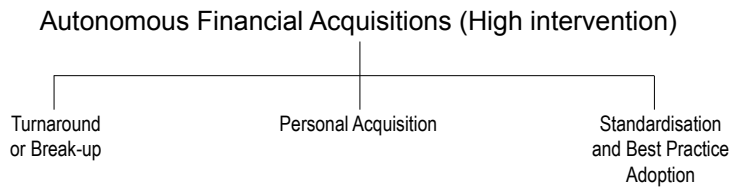
A business may be purchased where the benefits of simply belonging to the parent organisation are sufficient to generate synergistic benefits to the acquired business. Thus the new member of the group may be able to immediately take advantage of better prices for raw materials, services and parts or may be able to access suppliers which it was not able to access previously. On the revenue side, the acquired business may be able to trade using brands, trademarks and strategic partners of the parent company and access larger customers, larger deals, better prices or new markets through the association. The combination of lower procurement costs and/or better revenue productivity may, in and of itself, significantly improve its financial results.

There may be an intention to provide central services and other scaled benefits at some time in the future, but the justification for the acquisition is based on the improvements which can be driven through membership of the group.

Another form of profit improvement may be achieved by utilising excess capacity within the acquired organisation. So, for example, the new owners might take up spare capacity within the acquired business by providing additional volumes of transactions or by directing excess demand to them. The additional capacity might be in manufacturing, warehousing, logistics, administrative services, sales operations and so on. The new owner could divert some of its own excess demand into the new acquisition or assist the acquisition to find new business to take up excess capacity. Such a strategy may leave the

operations of the acquisition unchanged but the increased volume of activity would generate improved profitability.

The evaluation of this class of acquisition is made wholly through the profits generated by the acquisition. The intention is for the acquired business to take advantage of the size, products, intellectual property (IP) and capabilities of the buyer and through these transfers improve its profitability. This class of acquisition is not expected to change the operations of the buyer.



This class of acquisition involves substantial change to the management practices of the acquired business. This form of acquisition would include an acquisition where the buyer was a sole investor, or group of private investors, who wished to acquire a business to manage. This form of investment often occurs where an owner/manager sells to an individual who replaces him or her as the new owner/manager. A cashed up entrepreneur or a retired executive with pension funds to invest, for example, might decide to buy an established business which can be substantially improved through personal knowledge, skills, networks and additional funding.

There are many opportunities where superior size, additional funding and/or knowledge can be used to improve the performance of an acquired business. This might be a turnaround where significant management practices are changed, often associated with changes in the senior management team. The acquirer usually has expertise within the industry of the acquired business and is able to bring this knowledge to the business. The profitability of the business might be improved by stripping out underperforming business units or products, disposing of excess assets and using higher levels of debt.

An acquisition may be substantially improved through the introduction of best practices and/or through standardisation of products and services. Complexity and costs may be taken out of the business through such interventions.

B. Integrated Acquisitions

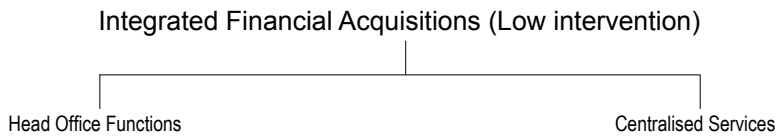
There is considerable confusion in the literature about the desired or necessary level of integration. It is clear from the accumulated literature that there has been a concentration of research and advice on large scale mergers which involve significant integration efforts, yet many acquisitions have little or highly contained integration objectives. Understanding the various forms of integration effort can provide the entrepreneur with a much better understanding of the level of effort required in integration as well as the scale of risks involved.

I have separated financial and strategic acquisitions as the impact on the acquired firm and the company can be significantly different. With a financial acquisition, the impact is substantially on the acquired business. Many corporations have developed an acquisition strategy which regularly adds new firms to their business with little impact on their core organisation. In these situations, the risks are contained and the acquisition processes are often well rehearsed.

With strategic acquisitions, there are situations where the level of integration is limited. Not all strategic acquisitions need to have large scale integration efforts. However, there are acquisitions which are intended to fully absorb the acquired business. These are probably the higher risk acquisitions and the integration effort needs more pre-acquisition evaluation to ascertain whether the company can really contain the risks and deliver the benefits.

Type of Acquisition	Impact on Buyer	Impact on Acquisition	ROI
Integrated Financial Acquisition (low intervention)	Takes over Head Office administrative processes and central services.	Sources central services from parent.	Cost saving synergies.
Integrated Financial Acquisition (high intervention)	Takes over central services and some functional activities such as sales, warehousing and/or manufacturing.	Loses some functionality but then operates by outsourcing to parent.	Costs saving synergies.

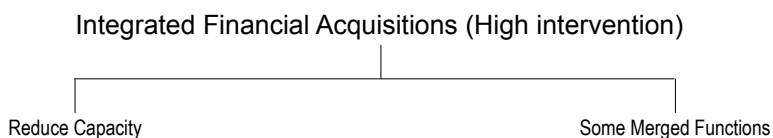
Integrated Strategic Acquisition (low intervention)	Merges some functions such as R&D and/or adapts to take on products, channels or processes of acquisition.	Merges some functions with buyer. Will still continue as separate entity.	Higher profits by using acquired R&D, products and/or processes within buyer.
Integrated Strategic Acquisition (high intervention)	Fully absorbs substantial parts of the acquired firm.	Merged in with buyer. Ceases to be a separate entity.	Higher profits from economies of scale and/or new revenue opportunities.



A very common cost saving which is often used to justify acquisition investment benefits is to impose centralised services on the new acquisition. This normally includes such functions as treasury, legal, human resources, external shareholder relationships and external professional services. Other activities which might be centralised are quality control, marketing, internal auditing and recruiting. The buyer is often able to absorb these activities with no or minimal increase in costs to the buyer.

The impact of these changes on the acquired firm would be similar to the changes which would occur if the acquired firm outsourced these activities. The basic assumption is that the acquired firm will continue with its major operations as before but under the new outsourced arrangements. In this type of integration effort, few individuals might be displaced or those who are may be able to be absorbed somewhere else in the acquired firm or within the buyer's business. The acquisition benefits are, however, mostly in headcount savings, thus it is critical to identify exactly how those are to be achieved, over what timescale and how the individuals impacted are to be treated.

Other acquisition benefits may be achieved alongside the cost savings synergies. These would normally include those listed in the autonomous acquisitions.



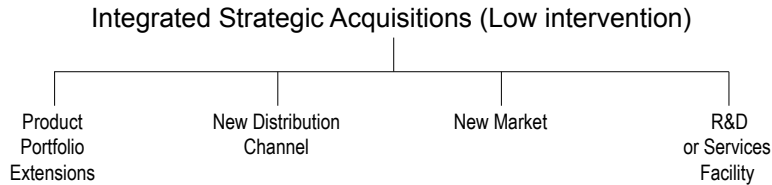
Some acquisitions utilise the capabilities and capacity of the buyer to bring new capabilities to the acquired business. In order to achieve those benefits, the acquired firm needs to undertake major changes. In turn, the buyer will be absorbing some of the activities of the acquired business and so it also may need to undergo changes. Changes within the two businesses will almost certainly require changes in responsibilities, structure and employment. The loss of functions in the acquired business will result in transition arrangements where activities are being transferred to the buyer and employees are being terminated throughout the process of integration.

The combination of the acquired business and that of the buyer might result in excess capacity in areas where operations can be combined and spare facilities closed down or sold off resulting in significant cost savings. This often happens with specialised equipment or services, manufacturing, warehouse and logistics capacity and customer support. The resultant capacity may be either under the management of the acquired firm or the seller. The assumption in this type of acquisition is that at least some of the operations are transferred to the buyer.

Common to this type of acquisition is the transfer of sales activities to the buyer where new products are able to be incorporated into existing distribution channels. Because sales activities need to be closely co-ordinated with other functions within the company, it is common for sales activities to be taken over or merged. Sometimes the only activity which needs to be merged is the customer interface leaving manufacturing and procurement in the hands of the acquired business. In this type of situation, the remainder of the acquired business is mainly left untouched. It is as if the acquired business outsourced its sales activity.

Similar arrangements could be entered into with other supply chain functions. For example, manufacturing could be taken on by the buyer with the sales activities left with the acquired business. This might work where the acquired business serves a specialised market but products are able to be produced at lower costs elsewhere in the company.

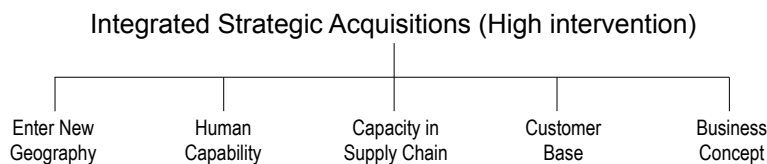
This form of integration is contained and thus is more easily managed than large scale integration activities. The major benefit associated with the acquisition is the reduced costs or greater reach of the merged activity which can deliver improved financial performance within the acquired business. With the exception of the limited functions transferred to the buyer, the rest of the acquired business is left more or less as it was. The buyer's organisation itself is, however, little changed as a result of the acquisition.



The nature of strategic acquisitions (as defined here) is that the acquisition changes the operations of the buyer. Thus the buyer takes advantage of the acquisition to do something it could not or was not doing before. Typically such acquisitions are made to drive significant increases in revenue within the buyer. Thus a business might be acquired to gain access to a product or service that the buyer could sell into its existing customer base or through its existing distribution channel or the acquisition could be made to gain access to a new distribution channel for its existing products. Thus a business which sold to major companies could acquire a firm which had an extensive network of smaller retailers or agents who could sell the products of the buyer. The new business would be integrated to some extent into the buyer's in order for the buyer to execute on the opportunity.

Acquisitions are often made to gain access to a new market, often through the acquisition of a capability or a product which the buyer will use to open up a new market. This would result in changes to the buyer's business to incorporate the new activity. In this type of acquisition, some activities of the acquired business are brought inside the buyer's in order to properly leverage the new capability or product into the new marketplace. It is anticipated that, in doing so, major benefits accrue to the buyer itself. As a result of the new capabilities or assets transferred, the buyer may need to change the structure of their own organisation. These changes are in addition to those being made in the acquired business. In the transition arrangements, organisation structures within both businesses might change, employees might be reassigned and/or relocated and some terminations in both businesses might occur as new functions are created.

Specialised knowledge contained within an R&D unit or customer services unit might be integrated back into the buyer to bring that knowledge to the benefit of the existing buyer's employees. The remainder of the acquired business may be left to continue as before. When this happens, the buyer's organisation will change in order to take advantage of the new capability.



The most difficult of all integration efforts occurs when the acquired business is fully absorbed in order to enable the company to take advantage of the acquired assets or capabilities. In this situation, a major integration activity would be undertaken which would merge the two businesses. At the same time, the company would need to make changes within its own organisation to ensure that the new capabilities and assets are exploited.

A common acquisition which fully engages the buyer is where the buyer seeks to enter a new geography through the acquisition. Often the objective is to use the acquired business to bring the buyer's products and services to the new market. In such a situation, the acquired firm might be substantially altered in order for it to offer new products and services. At the same time, the buyer needs to add new activities to enable it to support the new market. A similar situation exists where the buyer seeks to acquire an existing customer base. The objective is often to leverage its existing products and services into that channel.

Where the acquired business is being purchased in order to secure access to specialised human assets, these are often fully absorbed into the buyer. This type of acquisition often occurs in sectors where there is a limited supply of trained personnel. The buyer seeks out firms which have accumulated trained individuals who it can absorb into its own business thus speeding its rate of recruitment. This frequently occurs with companies which have excess demand it cannot service without additional trained personnel, and where it is unable to recruit trained individuals at the rate it needs to in order to service its growing business.

A similar situation can occur in parts of the supply chain. Thus a business which is growing aggressively and needs to develop capacity within distribution, warehousing and/or manufacturing may decide to acquire the capacity rather than build it. Of course, there is the consideration of what to do with the existing business of the acquired firm, but providing the buyer's business has higher margins, the costs of terminating or marginalising the existing acquired business may be justified.

Another type of merger which has a significant impact on the buyer is where the acquired business has a unique business concept which can deliver higher

profits to the buyer. In this situation the buyer itself will undergo significant change as it adapts itself to the new way of doing business.

Conclusion

What is clearly apparent from this classification is that there are many types of acquisitions and many ways in which the buyer can achieve a return on investment. Far too often acquisitions are lumped together and treated as if the problems associated with achieving benefits all arise from managing integration activities. It is clear that there are many forms of acquisitions where no integration is required or even justified. Also, there are many acquisitions which can deliver benefits where integration can be contained to a few functions leaving both businesses substantially as they were before.

Then there are acquisitions which are, in essence, mergers, where major functions within the acquired business are absorbed into the buyer. In these acquisitions there are major integration activities and thus major risks of possible slippages, problems and misalignment. In these acquisitions, integration experience clearly counts. If the buyer does not have the experience associated with acquisitions, then the risks are higher although buying in experience would seem to mitigate such risks. Going it alone, however, would seem to be the risky strategy.

The advantage of this classification is that it sets out the many ways in which a company can gain the advantages of acquisitions. This can help a company define the type of acquisitions which it would have the best chance of managing. It also provides insights into acquisition benefits which may easily be overlooked. All too often acquisitions are seen to be associated with integration problems and cultural issues but many acquisitions can deliver substantial benefits without integration.

Acquisitions may not necessarily fit neatly into the classification which I have devised. A specific acquisition may have aspects of more than one type. For example, a business might be acquired in order that corporate products may be distributed through the seller's distribution channels but at the same time an activity may be brought back into the buyer's business where it can be undertaken more cost effectively.

Separating acquisitions into financial and strategic acquisitions is a very useful mechanism for defining where benefits are to be sourced and thus how the acquisition project itself should be evaluated and managed. Financial acquisitions focus attention on how the acquired business will perform under new ownership. This focus greatly aids the investment evaluation as only the

future revenues and profits arising from the acquisition are important. While there may be costs associated with the deal and the subsequent management of the acquisition, these can be incorporated into the financial evaluation.

Strategic acquisitions can sometimes be difficult to evaluate as the benefits are often associated with major changes in the buyer's business. Taking on new products or taking over supply chain capacity is relatively easy to evaluate but changing the business to undertake new business processes or a new business concept may be much more difficult.

In this treatment I have not attempted to deal with the issue of whether it is assets which are being acquired through a purchase transaction or whether ownership is being transferred through the purchase of owner shares as this decision is often made on legal and tax treatment reasons and often depends on whether the whole or only part of a business is being acquired. This decision is best taken in conjunction with the buyer's professional advisers.

Key Points

- Financial acquisitions achieve their return on investment substantially through the operations of the acquired firm while strategic acquisitions achieve their investment return by utilising assets or capabilities of the acquired firm within the buyer's operations.
- Acquisitions may be changed through intervention where products, services, technology processes or management processes are applied to the acquired firm.
- Acquisitions are integrated when functions within the acquired firm are merged or transferred to the buyer's organisation.
- An acquired firm which is left substantially to manage its own activities is regarded as an autonomous acquisition. However it may still be substantially changed through intervention activities of the new owner.

Chapter Four

Failure Rates Are High

Overview: Acquisitions are complex projects which stretch the capabilities of most businesses thus it is not unreasonable to find a high rate of failure. Many companies undertake acquisitions with inadequate preparation and with inadequate resources. The reasons for failures are many. An appreciation of the root causes of the most common failures can help the entrepreneur appreciate the nature of the acquisition activity and the type and scope of resources needed to succeed.

Most surveys of acquisition performance report that about 70% fail to deliver positive shareholder value. There can be few other management activities which have such a high failure rate and yet decades of acquisition activity does not seem to have improved the situation. While this failure rate might be somewhat biased towards first time acquirers, the evidence would seem to suggest that even those undertaking multiple acquisitions still experience a reasonably high level of failures.

‘Several studies covering M&A activity in the past 75 years have concluded that well over half of mergers and acquisitions failed to create their expected value. In many cases, value was destroyed, and the company’s performance after the deal was significantly below what it had been before the deal. The success rate is not much better today than it was 75 years ago, despite numerous, well-publicised studies illuminating the high failure rates.’

Source: Are You Paying Too Much for That Acquisition? by: Eccles, Robert G., Lanes, Kersten L., Wilson, Thomas C., Harvard Business Review, 00178012, Jul/Aug99, Vol. 77, Issue 4

There are four major areas where problems occur in acquisitions which result in a failure to achieve the benefits anticipated. The first relates to inherent problems in the business being acquired. The second occurs in the integration of the acquired business into that of the buyer. The third relates to

how anticipated benefits have been miscalculated and the last involves external events that derail the process. With the exception of the last, these are all tied into the acquisition process itself which is managed by the buyer.

There have been a large number of studies of mergers and acquisitions. Many are studies of acquisitions within national boundaries while others have looked at international acquisitions. However, these studies have, in the main, focused on M&A activities of large corporations. There is very little data on M&A activities within the SME sector where buyers have fewer resources to undertake investigations or to cope with post acquisitions problems. The overwhelming literature does, however, suggest that similar problems will arise in the SME sector.

The literature in the M&A area provides numerous examples of failures and their causes. It is worth reflecting on these at the outset as we often learn more from our mistakes than we do from our successes. I have set out in this chapter a brief explanation of what appears to be the major causes of acquisition failure. This list provides a very good platform for the acquisition strategy I will outline in the rest of the book.

Fire Sale Purchase

Many entrepreneurs set out to look for undervalued companies, especially those in difficulty. While this is a possible strategy for acquisitions, it does bring with it a unique set of problems.

A business that gets into financial difficulty often does so for very good reasons and these need to be uncovered during the due diligence process. While there may be external events which caused the target firm to get into trouble, more often than not, the problems are with its management. This may be a problem if the buyer is expecting to rely on the existing management to continue to run the business. Whenever a business is not being run efficiently and effectively there will be legacy problems for the acquirer. The purpose of the internal due diligence is to uncover these and to work out if the buyer can effectively overcome them within the capabilities and resources of the buyer. In addition, the buyer needs to be assured that in light of the problems exposed, it can achieve its target return on investment.

All too often entrepreneurs assume they can fix whatever is wrong with the businesses they opportunistically buy without spending the time to really appreciate how the business got into trouble in the first place. It may be that the business has lost a key customer, supplier or employee and the business is no longer viable. Alternatively, the competitive environment may have changed

and the business is unable to compete. It is only by uncovering the cause of failure that entrepreneurs can work out whether they have the capability to bring the business back into profit and growth. They may of course be able to do this by combining the assets and capabilities of the acquired business with their existing business. But without a thorough investigation this can not be established.

Businesses which get into trouble often strip away assets and capabilities in their pursuit of survival. Equipment may be run down and not maintained properly, safety stock may have been sold off, intellectual property may have been disposed of and key staff may have left. The impact of these changes may not have fully worked their way into the financial results and thus the historical revenue and profit may understate the level of deterioration of the business. Unless these changes are identified and the forecasts revised to incorporate the change in capabilities, the buyer will almost certainly be overpaying for the business.

The buyer may simply be unaware of how deep the problems are. With the reduction in capability and the deterioration in revenue and profit generation, considerable work may need to be undertaken to bring the business back into a reasonable level of performance. This may require additional investment of both money and manpower. Scarce executive time may have to be allocated to the new acquisition to stem the deterioration and this may negatively impact other parts of the buyer's operations.

Most acquirers fail to fully appreciate the level of disruption that an underperforming business has on group activities. When you need to take senior executives out of the front line to fight fires, their normal contribution is lost. This can have both short-term and long-term disruptive effects on the overall business.

Most M&A specialists will agree that turn-around situations require specialist skills which are not normally present in most management teams. Thus the acquirer needs to be certain that it has, or can acquire, the specialist management talent needed to bring an ailing business back to profitability.

It's All About the Deal

Many acquisitions are undertaken by company M&A executives who see themselves as deal makers. With the deal concluded, they then move on to the next deal leaving the problems of integration and management of the new acquisition in the hands of others. However, often the follow-up does not happen effectively and the newly acquired firm is left like a boat with no anchor,

drifting with the tide. When a crisis occurs, management suddenly wakes up to the fact that they need to do something with their newest acquisition but by then the acquisition has significantly deteriorated through a loss of key employees and customers.

All too often the major effort is put into sewing up the deal and the executives who make the deal then assume that all will be well once they have done their part. While integration issues may be raised during the pre-acquisition due diligence, no one is given executive responsibility to actually see that these activities are managed properly after the event. This situation frequently occurs where M&A executives undertake the acquisition negotiation but line management must actually take over the acquisition after the deal is consummated. Often line managers have not been involved in the deal negotiations and consequently are unprepared for the new responsibilities or they are deeply involved in some other critical activity and simply don't have the time to allocate to settling in the new business.

Alternatively, there are post-acquisition issues which have to be worked through before the new business unit can be handed over to regular line management but this activity is not given sufficient priority or resources once the deal is done. In the post-acquisition process there is often a blurring of responsibility. The M&A people don't really have responsibility because the deal is now done and line management don't because the unit has yet to be handed over to them. In this limbo period the new business unit may experience a series of problems that go unresolved due to lack of attention or because the acquired management lacks the authority to deal with the problems. During this period critical capabilities may be lost. By the time line management assumes responsibility they have a crisis on their hands which disrupts their regular business.

Getting a deal done is often the sole incentive of the external advisers who make their fees and commissions on the deal whether it makes long-term sense or not. Thus companies are often encouraged to seek acquisitions by advisers who might be more motivated by short-term personal goals than assisting the long-term success of their client.

Lack of Proper Financial Evaluation

A considerable number of acquisitions fail to generate the expected returns because of inadequate financial evaluation during the due diligence stage. This can be partly due to problems with the financial records of the firm being purchased but more often it is because the forecasts are based on invalid assumptions or the costs and delays through the integration activities have been

considerably underestimated. In order to build a case for the acquisition, many assumptions will be made of the external and internal environment within which the new acquisition will operate. Often these assumptions are optimistic and are not properly validated or tested.

Few executives have personally been through an acquisition experience and thus do not have a good feeling for the level of disruption that occurs within the acquired business and to the buyer's operations. Because of this lack of personal experience, the costs of such disruptions are normally underestimated.

A rigorous process of evaluation should estimate the various risk conditions associated with the acquisition. These might include, for example, the loss of key customers, suppliers, executives and employees. While these may only be remotely probable, they can seriously impact the return on the investment. Normally an allowance for risk factors should be built into the financial evaluation to account for probable risks.

Poor Due Diligence

There is no substitute for proper due diligence. If the acquirer skimps on the professional services needed to undertake a proper financial and legal audit and fails to adequately review the business case, it is highly likely that subsequent events will uncover something that should have been picked up during due diligence. In some cases, the target firm will be dressed up for a sale and only thorough due diligence will uncover the true situation. Sellers may alter their normal trading patterns to reduce expenditure and push sales to inflate revenue and profit projections to make the business look more attractive.

The purpose of the internal due diligence process is to place the buyer in a position to fully appreciate the inherent risks in the acquisition. This would include such things as inadequate internal controls, inadequacies in reporting and performance monitoring systems, compliance problems, actual and potential liabilities and so on. The buyer needs to know what risks they are going to take on in order to work out what they will need to do to manage the acquisition. In addition to the internal audit, the buyer needs to fully evaluate the contribution of the new firm to the buyer's operations. This would include its contribution to the buyer's product/market position as well as various contributions it might make to various capabilities and capacities of the buyer. Unless this is done in a thorough manner, mistakes will be made and the resultant projections of contributions will not be achieved.

The final due diligence review is undertaken on the integration tasks. The buyer needs to have a good understanding of what costs and disruptions to both

businesses will be incurred through the transition period. Often such activities are poorly understood and frequently underestimated. However, delays in bringing the new resources into the mainstream business can greatly impact the return on investment.

Businesses which have systematic and rigorous acquisition processes also have well defined methods for undertaking due diligence investigations. This would include long checklists of items to be reviewed. They typically use professional service providers who have extensive experience both within the industry of the target acquisition as well as with M&A investigations. Experienced acquirers will walk away from a deal where they are uncertain of the outcome or where the return does not meet their minimum hurdle rate.

Unrealistic Expectations of Synergies

Acquisitions are often justified on the cost savings that result from cutting out duplicate services, overlapping functions or headcount reductions through combining central services such as procurement, recruitment, marketing, accounting, financing and so on. Often these savings are made without a full understanding of the acquired business or without validating the likelihood of such savings.

Even where these costs savings are potentially possible, they tend to take longer to achieve than most people expect. Transition periods are extended where internal transactions systems are incompatible, supplier and customer agreements are incompatible with those of the buyer, remuneration systems are structured differently and knowledge is inadequately documented to allow it to be passed to another business unit. During the anticipated period of transition, key staff in both organisations may leave resulting in a loss of momentum.

Few organisations properly consider the impact of such functional transfers on current personnel. There is an increased rate of resignations in both the acquired firm as well as in the buyer's. Sometimes this is due to uncertainty around future job allocations or it might be due to an increased workload due to the transition activities. There is an expectation that some of the acquired executives may leave but the reality is that the majority will leave within nine months of the acquisition, that is, if they don't leave before the deal is done or at the time of purchase. This loss of key knowledge can seriously delay integration activities while their roles are being reassigned or new hires are being made.

Cost savings often include reductions in office, warehouse and plant capacity and yet these often cannot be reduced without considerable notice or penalties. Relocations are often not adequately planned for and often take considerably

longer and cost significantly more than expected. Transfer of business systems often require major data conversion exercises as well as retraining. Staff redundancy costs are often higher than anticipated. Costs and timescales often greatly exceed estimates and few acquirers achieve the savings anticipated.

Synergies Unrealised

Synergies may have been overestimated right from the outset in the drive to get a deal done by the negotiating executives. Synergies are not just related to costs savings, which themselves may have been seriously overestimated, but can also be sourced through additional revenue opportunities generated through the acquisition.

Headcount reductions are often used to generate costs savings but these are often not achieved to the extent expected. Just because both businesses have similar functions does not, of itself, mean they can be combined and staff made redundant. If the administrative staff in both businesses are already working at a reasonable level of effectiveness, there should be a presumption that they are needed, not that some can be terminated. In fact, more often than not, administrative services increase with larger organisations and with additional complexity due to increased product portfolios, distribution channels and locations.

Revenue estimates for cross selling and additional account penetration may not be achieved to the extent estimated. While there may be real possibilities of revenue synergies they may not occur at the rate and to the extent estimated. Sales executives are typically optimistic and keen to have additional products or markets to pursue but inadequate attention may have been given to the costs and delays in bringing about such results.

Some synergies may be expected to be generated from products still in the development phase. However, technical problems or market trials may delay or terminate completion.

Task Integration Issues not Properly Investigated

Most acquirers fail to fully appreciate how much work and time is involved in integrating a new acquisition. Just because each business unit has similar functions does not mean they operate in a similar manner or that they can be readily combined. Integration issues would include many of the following:

- Procurement systems,
- Financial reporting systems,
- Banking arrangements,

- Customer relationships,
- Hiring, training and performance evaluation processes,
- Remuneration systems,
- Outsourced arrangements,
- Decision-making and decision review systems,
- Costing and estimating systems,
- Scheduling systems,
- Strategic relationships; and so on.

When businesses have been established for some time, their internal systems develop in a somewhat spasmodic process. Systems are introduced to solve a specific problem and then integrated into the existing infrastructure. This tends to result in some level of compromise and inconsistencies often exist between systems. Anyone looking in from the outside will simply see a set of working systems without having any real appreciation of the difficulty of unravelling the components or of sorting out the inconsistencies in order for them to be ported across to a common platform. This process is often exacerbated where data is defined differently both within the internal systems and between those of the buyer and the acquired firm. Such problems can take years to resolve.

Generally the buyer makes the assumption that systems and processes can be integrated, however, there are often situations where this may not be easily achieved. For example:

- Employees may be locked into a pension arrangement that will penalise them if they change.
- Suppliers may offer cumulative discount arrangements and long-term supply conditions which have early termination penalties associated with them.
- Leases may not be able to be terminated without severe penalties.
- Relocation costs of employees may have been greatly underestimated.
- Sales staff may have incompatible commission arrangements which would severely change the expected remuneration for the acquired sales staff.
- Product formulae or fabrication methods may be heavily dependent on specific equipment.

- Essential knowledge needed to transfer responsibility may not be documented and staff with the knowledge may not be willing to be relocated.

Often such issues will not be uncovered during the due diligence investigation unless operational staff are involved in the due diligence process. Even then, the time available for due diligence may be limited or the seller's activities may be spread over several locations which limit the scope of the investigation. Thus some problems are not uncovered until well after the acquisition has been made.

Integration may involve shifting activities across to the buyer's facilities and systems. Often the buyer has not adequately investigated the capacity of their own facilities and systems to absorb the new level of activities. Unless adequate capacity is available to allow the new workload to be moved, the integration activity will be frustrated. Consideration needs to be given to both physical capacity such as warehousing, manufacturing and office accommodation, as well as to personnel capacity to undertake the new level of work. Another consideration is whether the existing staff have the knowledge and skill to support higher levels of workload and, potentially, higher levels of complexity. The ability and capacity of IT systems is often not adequately investigated to see if they can handle the increased volume and complexity of transactions.

Lack of Integration Process Management

Most acquisitions involve some level of integration between the buyer and the acquired business. The level of integration will normally have been defined as part of the investment justification; often because the synergies underpinning the investment are only achieved once full integration has been completed. However, many companies fail to implement a project management program to ensure the integration results are achieved.

Imagine the situation that exists prior to the acquisition. There are two companies presumably actively engaged in pursuing their own activities and neither of them with undue spare resources. Each has on-going activities necessary to keep the wheels turning and necessary to bring in the business that pays the salaries and overheads. Now consider the situation immediately after the acquisition. In order to integrate the two businesses, there will be numerous projects which will need to be scheduled, staffed and funded. Who is going to carry out these activities and who is going to manage the process?

Undertaking the integration activities is one of the most difficult tasks that a business will undergo. Too often the acquiring business assumes that each department will be able to absorb the additional investigation and integration

tasks within their own resources. They fail to take into account that their employees may already be working at their limit or, in some cases, may in fact be overworked. At the same time, the task of co-ordinating the integration activities is often left with whoever negotiated the deal without considering whether they are the best person to undertake the job or even if they have the desire, inclination or skills to do so.

This is a very common scenario in acquisitions. Ultimately the most obvious tasks eventually get done, but not without some collateral damage in loss of personnel or goodwill. However, many tasks are left undone as they have not been identified, assigned or tracked. It is not uncommon to find that, one year on, many activities associated with the integration are still not completed; some are in fact not even started. The chances of the buyer realising the anticipated synergies in such circumstances are very low.

Clash of Cultures

Most experienced acquirers point to a culture mismatch when they identify the prime reason why an acquisition failed. Even where such a mismatch has been identified in advance, the buyer may not be able to resolve the differences.

Where the level of integration is relatively low, differences in culture may not have a marked impact on the acquisition's results, however, a high level of integration almost always requires that the two organisations have similar organisational cultures if acquisition benefits are to be achieved. Basically, individuals are attracted to organisations which support their personal values and the manner in which they prefer to interact with their fellow employees. Where a considerable difference exists between what the individual is comfortable with and what they are newly confronted with, a large number of people physically or psychologically withdraw their support. A physical withdrawal would result in a resignation whereas a psychological withdrawal might result in poor performance, lack of cooperation or even activities which undermine the operations of the business.

Identifying differences in culture is a critical part of the due diligence activity. Unfortunately, few companies identify cultural differences in their due diligence and/or understand how to deal with it even if they recognise this as an integration issue. Alternatively, the benefits of the acquisition are so compelling that the buyer's management convince themselves that they will be able to overcome the differences. There is, however, considerable evidence to show that few acquisitions are able to overcome major differences in culture.

Loss of Key Management and Employees

You can normally assume that some key senior management of the acquired firm will be lost during the transition period. They may leave because it was agreed that they would not be needed or they may leave because they do not see themselves settling into the new company. Often little attention has been given to succession planning during the transition period and thus key knowledge and contacts are lost.

It is estimated that approximately 40% of acquired executives will depart within nine months of an acquisition and 70% will leave within three years. At the same time, the attrition rate of executives in the acquiring firm also increases as individuals worry about their future promotion or experience increased workload as a result of the acquisition. While many buyers anticipate some loss, few plan for such high levels. This loss of key executives and the loss of their corporate intelligence can undermine the acquisition benefits as well as the normal operations of both businesses.

The major loss occurs throughout the acquired business where information is not documented and key employees leave before or immediately after the acquisition. These individuals are often overlooked during the investigation as they are neither senior nor recognised as being a critical resource within their own firm, however, they often hold information key to relationships with customers or suppliers or have information necessary to support key intellectual property on which the acquisition has been justified. Since few smaller firms document their processes especially well, the acquisition benefits rely on these individuals continuing with the business.

Only a small proportion of businesses prepare themselves adequately for sale by ensuring key business knowledge is documented and key employees are identified and incentivised to remain with the acquirer. One of the outcomes of the buyer's due diligence is to identify gaps in documentation and individuals who are key to the on-going operations or to the synergies being achieved. Once such data is at hand, the buyer can then estimate the risks associated with the loss of such individuals or put in place agreed incentives to encourage them to stay while their knowledge and skills are being transitioned.

Changes in the External Environment

Not everything will go according to plan and changes in the external environment can work against the buyer achieving the acquisition results they hoped for. Major changes might include:

- New regulations governing the industry,
- New competitor coming into the market,
- Existing competitor changing strategy which negates the anticipated benefits of the acquisition,
- Changes in the economic environment, such as interest rate, inflation rate or currency exchange rate,
- Man made or natural disasters,
- New inventions making acquired technology obsolete,
- Major shift in consumer spending patterns.

The investment results may have been based on certain assumptions which later prove to be invalidated by subsequent events outside the influence or control of the company.

Failure to Manage Post Acquisition Performance

Even where integration activities have been successfully completed, the benefits of the acquisition may not be achieved if inadequate attention has been given to managing post acquisition activities.

Most often, acquired firms are smaller entrepreneurial businesses which have not implemented sophisticated operations management performance systems. The business may well be managed by individuals with deep seated knowledge of the business who are able to achieve successful results because of their intimate knowledge of the business. However, these are also the same individuals who normally leave when the business is sold. Thus a well performing business may well flounder because the acquirer does not have in place systems which can cope with the loss of the former leader.

Often the buyer relies on their existing management taking on the additional responsibilities for the newly acquired business units. These business units may have different business methods or processes which may not be familiar to the company's executives. In some cases, the integration of the new business units may change the nature of the company's business itself. This may require new performance systems to be put in place with new metrics and new performance incentives and rewards. Without new performance metrics being installed, the anticipated benefits may not be readily achieved.

Frequently firms are acquired to add new products or services to existing distribution channels, however, the operations to support those new product and services need to be modified to exploit them. Salesmen need to be trained,

marketing literature modified, territories resized and sales targets updated. Warehouse operations may need to be modified, manufacturing schedules changed, supplier arrangements updated and so on. Part of the integration activities should be to identify how the new business will be managed after the integration effort has been completed. Often buyers concentrate on the integration itself without looking after the long-term management of the combined business.

Disputes with Prior Owners

It is not unusual for disputes to arise over the interpretation of clauses in the purchase agreement which effects how much the prior owners receive for their firm. Often these situations arise some time after the deal has been signed and the new owners have taken over. The resultant disagreement, stress and ultimate litigation can be very unsettling, stressful and disruptive for both businesses, but especially those former shareholders of the acquired business who are in continued employment with the buyer.

As part of the purchase agreement, the shareholders of the acquired business will agree certain warranties and representations, may enter into an escrow arrangement for certain unresolved issues and could agree to an earnout based on events or activities which could occur in the near future, or may enter into a performance based earnout relating to profit and/or revenue achievements. As events unfold and various issues come to light, there may be disputes around exactly what was warranted or represented and how this would impact the purchase price. Earnouts are especially difficult to manage and the components of the earnout may be subject to a dispute over how the formula works or whether each party has put their best efforts into making it effective.

Once a dispute arises, it can escalate into a standoff where the two parties are unable to work cooperatively together. Communication becomes heated, parties take sides and work is put aside while individuals deal with their personal interests. In such a situation, business can be disrupted and progress on integration and opportunity exploitation may be severely delayed or come to a halt.

Even where the dispute is with former shareholders who have left the business, former employees of the acquired company may feel a sense of loyalty to the prior owners and become uncooperative or fail to put their best efforts into making the new business a success.

Problems with Earnout

Earnouts are especially difficult to make effective. Earnouts should be used where the two parties cannot agree on a price and the seller believes that the future potential of the business, perhaps due to events which are unfolding or are yet to crystallise, are not fairly represented in the price offered by the buyer. As a compromise, the buyer agrees to pay the sellers more under certain conditions or if certain events materialise or if certain performance targets are met.

Where future events are relatively certain or outside the influence of both parties, earnouts generally work reasonably well. Where the earnout requires the active cooperation of both parties to work, any lack of effort on the part of the buyer can quickly escalate into a dispute which can severely distract executives as they work through the issues.

If the earnout has been poorly constructed it can result in the sellers putting effort into activities which are not in the best interests of the overall business. Thus an earnout based on product sales may have the sellers' focus purely on their own product sales, neglecting to provide assistance to the overall company to set up new opportunities for wider marketing. Their reasons will be that they need to focus on their short-term goals to the exclusion of longer term corporate benefits as the short-term targets directly impact their personal remuneration.

In some cases the set targets will have been based on a strategy that the overall company no longer wishes to pursue, however, the sellers wish to continue with the out dated plan as it is in their personal best interests to do so. Only by renegotiating the earnout or paying the balance will the buyer bring their efforts into line with the new desired goals.

Emotion Overriding Proper Evaluation

Deals are often done in a climate of high emotion. Where the benefits to both parties are obvious, the seller can be overly excited about getting the deal done and not allowing it to slip through their fingers to be snapped up by someone else. In the rush to conclude the deal, the buyer may well fail to consider all the issues that will be involved in realising the benefits from the deal and achieving a proper return on their investment.

Often deals are done by just a few senior people on both sides. Thus the buyer's exposure to the seller's organisation may be limited to a few meetings with the seller's senior executives. The buyer may be very comfortable with the people they meet and be convinced they can work together. The buyer may be excited about the vision of the new business and the possibilities for growth which will stem from the acquisition. In fact, the buyer may be so keen to get

the deal done that their excitement overrides caution and they agree to proceed to a deal without taking time to do the necessary due diligence to ensure there is substance behind the claims, that the business can be integrated effectively or that the benefits claimed can be achieved.

By the time problems are uncovered in the deal, commitments may have been made, or the deal may already have been done. Now the buyer has to make it work in a situation where they are still uncovering problems. In this type of situation, the full due diligence may occur after the deal has already been done, or it may simply move from crisis to crisis as issues arise.

Applying the Wrong Integration Model

There are well-documented instances where even experienced acquirers have got it wrong. It is generally acknowledged that corporations which have extensive experience of buying similar businesses learn how to do it better over time. They build up knowledge within their executive team of how to go about the acquisition and how to undertake effective integration. Their acquisitions are guided by extensive checklists, financial models and processes. However, where the same corporations have acquired a business in a different sector, they have often failed to gain integration benefits because they have applied a common acquisition and integration process which turned out to be inappropriate for the new situation.

Individuals are often blindsided by their own assumptions and apply a previous acquisition model to a very different situation. Each situation needs to be examined in its own right in order to uncover potential problems.

In line with behavioral learning theory, we found evidence for both positive and negative effects of acquisition experience. First, in the majority of cases, when a firm's current acquisition was dissimilar to its prior acquisitions, acquisition experience had a negative influence on acquisition performance (for slightly and moderately experienced acquirers). When experience across all acquirers was examined, the effect of acquisition experience was U-shaped. The best performers appeared to be either those without experience who, therefore, did not make an inappropriate generalisation error or those who had a significant amount of experience and appropriately discriminated. Second, in the minority of cases, when a firm's current acquisition was similar to its prior acquisitions, acquisition experience had a positive influence on acquisition performance. The results suggest that those firms that make multiple acquisitions within the same industry benefit by generalising past acquisition knowledge.

Source: The Influence of Organizational Acquisition Experience on Acquisition Performance: A Behavioral Learning Perspective, by Haleblan, Jerayr, Finkelstein, Sydney, Administrative Science Quarterly, 00018392, Mar1999, Vol. 44, Issue 1

Lack of Management Expertise

A business may have been purchased to enable the buyer to enter a new market; however, they may not have sufficient expertise operating in the new market to manage the acquisition properly. Given that it can be anticipated that most of the senior management team of the acquired company will leave soon after the acquisition, the acquirer may be left with inadequate knowledge of how to operate the business or how to deal with the marketplace dynamics in their new business.

A similar problem might occur where management had inadequate experience in managing a geographically distant business or a number of businesses across different sectors. Thus a firm which acquires its first offshore business might be completely unprepared for the problems of dealing with an overseas entity. Similarly, a business made up of a number of similar businesses may flounder when a new business is added to the mix which requires very different strategies and reporting processes.

Overly Large Debt Burden

The business being acquired may have a large amount of debt or the acquirer may raise more debt to enable it to make the acquisition. The resultant debt, however, may put undue pressure on the new business and the constant need to service the debt may place an unreasonable burden on management. Very little has to go wrong in the core business or in the acquired business for there to be a cash shortfall, however, the debt servicing obligations will still exist.

An acquirer who fails to simulate potential problems with an acquisition, particularly delays in meeting integration targets, can readily move into a cash crisis situation. The resultant cash drain can then place the entire company at risk, not just the recently acquired business.

Over-integrating

Some companies make the mistake of over-integrating, that is, integrating functions where there is no obvious benefit. There is sometimes a failure to appreciate that different cultures and processes can exist inside a large organisation or that a company may in fact work more effectively if some parts are left to work independently. In fact, in most large organisations, a number of subcultures will exist based on the functions they provide or the type of person who works there. Thus sales departments look very different from IT departments and they in turn look very different to a finance department.

There is a good argument that 'less is more' when integrating and many companies have found that the less they change, the greater the likelihood of the on-going business working. Companies which desire to have everyone look and feel the same miss out on the benefits that come with diversity. As long as employees accept that parts of their organisation can be different and that this situation is normal and causes no stress within the business, there is little reason to make changes.

Avoiding Failure

Even with all the obvious advantages associated with acquisitions, it seems that few corporations have been successful in their merger and acquisitions activity. The general consensus through numerous research studies and anecdotal evidence suggests that about 70% of larger scale acquisitions fail to deliver positive shareholder value. In summary, these stem mainly from a lack of formal process and a failure to anticipate and deal with cultural differences. Thus, acquisitions are entered into too quickly with insufficient attention to an investigative process or the acquirer has failed to anticipate the human dimension of the changes which will have to take place for the acquisition to be successful.

Based on the overwhelming evidence of the risks associated with acquisitions, it begs the question as to whether the entrepreneur would be wise to pursue such a strategy. The answer is not that acquisitions are inherently bad or are destined to fail but that they are risky and therefore should be approached with caution, systematic planning and adequate knowledge and resources. With the proper approach and an awareness of the issues which need to be dealt with, there is certainly no reason why an acquisition strategy should not be pursued. While careful attention to detail and a proper evaluation and integration process will not guarantee the success of any specific acquisition, it should enable the entrepreneur to avoid those which are destined to fail and significantly improve the probability of success of those which have the best potential.

There are always going to be situations which cannot be anticipated or situations which are so unlikely that management will not have planned for them. However, most problems with acquisitions can be anticipated and acquirers can prepare themselves for the most likely scenarios.

The sections above indicate that acquirers have three major areas of preparation:

- Ensuring they have the skills and knowledge to undertake the acquisition as well as the capacity and capability to absorb the new business,

- Undertaking good comprehensive and objective due diligence, and
- Undertaking extensive planning and operational management of the integration process after the deal is done.

Each of these areas will be examined in this book.

Key Points

- There is considerable evidence to show that the majority of mergers and acquisitions fail to deliver positive shareholder value.
- Most failures are due to a lack of adequate due diligence and to poor post-acquisition integration processes.
- Many organisations fail to appreciate the problems of cultural fit and of human integration.
- Often the buyer's own management is inadequately skilled or resourced to take on the tasks required of them to integrate and manage new business units.

Section Two: Pre Acquisition Tasks

Chapter Five

Developing an Acquisition Strategy

Overview: An acquisition strategy starts with education and the development of evaluation and integration capabilities within the buyer's organisation. Next, targets are identified which clearly contribute to the overall strategy of the business. Once the target firm has agreed to be acquired, the due diligence of the target business and its impact on the company is undertaken. Finally, integration activities are completed.

The research in the M&A area states that the most effective manner of avoiding acquisition failures is to have a systematic plan for identifying, evaluating, valuing, acquiring and integrating a new business unit. However, the literature also shows convincingly that experience counts. That is, more experienced acquirers, especially those who acquire on a consistent and regular basis, are generally better acquirers than those who acquire periodically.

If experience counts and companies with proven processes for acquiring new business units achieve more positive results, it does not bode well for the entrepreneur who has no experience in this activity and is about to undertake the first acquisition, or has little experience with larger acquisitions and is considering a major growth thrust through a sizeable acquisition.

Even with this background, the smart entrepreneur can build a highly credible acquisition strategy by following a plan which acknowledges gaps in knowledge, capabilities and processes and sets out to put in place a plan which can substantially overcome these deficiencies. The plan would have the following elements:

- A Acquire knowledge of the acquisition process.
- B Build expertise and develop strategic relationships with others which will bring experience into the process.
- C Develop a growth strategy for the business which identifies where acquisitions would bring significant value and where the company has the capability to undertake the acquisition.
- D Map and periodically monitor potential acquisition targets and develop relationships.
- E Set out an evaluation, valuation and purchase process that ensures that the company only acquires the right businesses.
- F Develop an integration capability and plan which reduces the risk of failure in bringing the newly acquired firm's resources into the company.
- G Put in place a project management and review process that can track progress in integration which will provide an early warning system for integration activities which are out of control.

A. Education

Most acquisitions are between 15% and 50% of the current size of the company as measured in terms of employees or revenue. Occasionally, companies will buy firms larger than themselves, especially if they are undervalued or if the buyer has a very high market capitalisation. What this shows is that this investment may well be the largest the company will ever make. Few other investment decisions have such high profile within an organisation or have such a low probability of success. Given this background, it would seem only sensible that the senior executive team educate themselves as much as is reasonably possible on the normal process which acquisitions follow.

Apart from buying books on the subject and reading a selection of articles from the popular business magazines and journals, the executive team should take advantage of the education that professional advisers can provide them as a part of their pre-sales activity. Most acquisitions require the services of at least an accountant and a lawyer and some will need an investment bank if the deal is a large one. The company need not use their regular accountant and legal firm, especially if M&A work is not one of their core competencies. Thus several local and regionally based firms might be asked to pitch for the business and show how they would advise the firm. Most firms have established processes for M&A work and these can be presented to the company as part of the sales pitch. Some will have acquisition guides to help their clients and these should

be provided by the services firms as part of their sales presentations or certainly once their services are engaged.

In addition to services firms, the company should seek out individuals with acquisition experience. Within their own industry there are likely to be a number of executives who have either been involved in undertaking an acquisition or have been the target of an acquisition. Both views should be sought as much can be learnt from the mistakes encountered on each side of an acquisition.

There are also executive education seminars and workshops which are offered by private firms as well as industry associations. These will often provide documentation on the acquisition process which can form part of a library of material to be shared within the executive team.

B. Build an Acquisition Capability

The company needs to undertake a skills inventory within the executive team to establish how much acquisition expertise already exists within the company. Acquisition tasks involve long range planning, identifying gaps where acquisitions would make a contribution, identifying target firms, developing relationships with target firms, evaluating acquisitions including due diligence project management, negotiating the deal and managing professional advisers throughout the process. The other major area of expertise needed is project managing acquisition integration. Few individuals have experience in more than one of these areas and, in fact, it is probably wise to look for negotiation expertise in one person and project management experience in another. Executives assigned to these tasks should have familiarity with the company's industry.

Unless the company has an experienced acquisition executive already on the team, the company should hire or engage an M&A adviser who has knowledge of their industry, significant M&A experience with firms of their size and with deals involving acquisitions of the intended target size. Where there is significant integration activity involved, it would be better if this person was on the management team. If the advice is expected to be mostly periodic with little full-time activity, it may be better to hire a consultant on an hourly or daily basis for the duration of the activity.

Most acquisitions absorb a good part of the time of the responsible executive once an acquisition target has been engaged. There are endless meetings with the seller's executives, visits to their premises and interviews with customers, suppliers, partners and employees. In addition, the services of accountants, lawyers and bankers need to be negotiated and managed. Within the company,

many executives will be involved actively or peripherally in the process. Executives who will be responsible for managing the newly acquired business activities will need to be involved in the evaluation and the integration planning. Even before the deal is done, a significant amount of time is spent managing and coordinating the numerous activities associated with the acquisition. Unless an existing member of the senior executive team can delegate a large portion of their responsibilities, it is unlikely that a current member of the senior executive team has the time to undertake such a detailed activity.

Perhaps this is the first cautionary note to the entrepreneur. Expect to spend a good deal of money and time preparing for an acquisition, even if it is not successful. Once the target has agreed to a deal in principle, the amount of senior executive time which will be devoted to the acquisition activity will grow significantly. Even after the purchase agreement is signed, there are numerous activities which have to be managed to ensure the benefits of the investment are achieved. It is very difficult for senior management to take on such an investment if they have not built in some additional executive capacity.

C. Develop a Growth Strategy

One of the most important questions to be answered is ‘Why?’. That is, ‘Why are you undertaking an acquisition rather than putting your efforts into organic growth?’ Given the high rate of failure and the costs associated with undertaking an acquisition, there should be a strong case prepared for why the company wants to embark on an acquisition rather than develop size through investments in assets and capabilities which would develop the business organically. The starting point must be the strategy of the business. Without a plan for growth, any acquisition is simply opportunistic and this is not a strategy – this is growth by hope. The strategic plan should clearly identify:

- What business are we in?
- What is our competitive advantage?
- What are our core capabilities which reinforce our competitive position?
- What are we good at which we could invest in further with a high probability of managing the expansion successfully?
- What opportunities do we see which we should be taking advantage of?

The plan should identify gaps which need to be filled organically or through acquisitions:

- What threats do we face which need to be addressed?

- What capabilities do we need to build to successfully compete?
- What are our competitors doing which require us to make investments to counter their activity or to secure our current or proposed advantage?

If the intention is to stimulate or facilitate growth, then you need to address these questions:

- Where do we have market demand which could be filled with additional capacity?
- Where are the opportunities for expansion where we could take away market share from competitors?
- What additional assets or capabilities would enhance our competitive positioning and generate additional revenue and/or profit margins?

In terms of horizontal expansion, the questions which could be asked include the following:

- Are there complementary products which we could sell into our existing customers using our existing sales channel expertise?
- Which additional sales channels could we add to handle our existing products?
- Which other geographic or industry sector markets could we compete in if we had additional capacity, capabilities or channels?
- Which capabilities would we need in order to expand the volume of business we are doing with our existing products and services within our chosen markets and geographies?

In terms of vertical integration, the company might review the following:

- Which sources of supply are posing a risk to the company which would be better owned?
- Does the company have the capabilities and experience to develop these internally or would they need to be acquired?
- Which forward supply chain businesses pose a risk to the company or represent an opportunity to improve competitive position, additional revenue capability or an opportunity to improve overall profit margins?

Other assets or capabilities might be developed or acquired which could change the core business of the company.

- Which customer/product markets would complement the current ones and represent an opportunity to improve competitive positioning or enhance revenue generation or reduce revenue volatility?
- Which customer/product markets exist which could utilise underlying assets or capabilities of the company even if not associated with current customers or current distribution channels?

Naturally there are risks in taking on activities where the current executive team does not have experience and capabilities. However, this deficiency should be identified in any acquisition evaluation and might then be resolved through acquired experience and knowledge. But it is prudent to remember that the ability to execute is a critical factor in achieving a positive return on investment.

Ability/Opportunity Matrix

Ability to Execute	Quality of Opportunity Low	Quality of Opportunity High
High	Consider if there is no better use for the funds and returns are reasonable.	Seriously evaluate. Good use of executive time and high probability of good ROI.
Low	Avoid. Would use up limited executive time and has a high probability of a negative return on investment.	Consider if additional expertise can be acquired with the acquisition or from an external source.

With most investments, the company has a choice of developing the capability or asset itself or of buying it through an acquisition. Even where an internal asset or capability can be developed with less investment, there still may be a case for an acquisition if the acquisition can generate early revenue sufficient to justify the investment. In some cases, the asset or capability cannot be developed internally where it is based on proprietary intellectual property or knowledge or rights which cannot be readily acquired.

D. Identify Acquisition Targets

The next stage in developing an acquisition strategy is to map the most attractive acquisition targets. Generally this is limited to mapping companies within your industry and those which interact in a complementary manner with industry firms. Once the map has been created, the next step is for the firm to investigate each one using a set of acquisition criteria.

The selection criteria might state preferred location, size, product/market characteristics, age, profitability, reasons for selling and so on. Many frequent acquirers publicise their acquisition criteria in order to encourage potential sellers to contact them. Others provide their criteria to business advisers, professional services firms and investment banks in order to assist them to find buyers for clients who are selling all or part of their businesses.

Once a refined list has been developed, further investigation of the product/market and capabilities of the firms will further reduce the list to a manageable number. At this stage, many acquirers seek out external information to further develop their understanding of the target firms. Those which satisfy further criteria with respect to size, location and reputation receive further attention.

Once the set of potential targets has been identified, company executives need to begin the process of getting to know the potential targets. Most acquisitions are undertaken where there is a prior relationship between the parties. This should not be unexpected as most acquisitions are undertaken with customers, suppliers, partners and competitors. Within any industry, the number of independent businesses is relatively small compared to the total population of businesses in any geography. Many businesses which might complement or compete with each other often participate in industry events where their executives have chance meetings. Some businesses actively engage in industry associations where individual executives get to know each other.

Outside normal trading relationships, frequent acquirers have found that the process of getting to know potential acquisitions allows them the opportunity to better understand the capabilities and culture of the firm and the willingness of the senior management and shareholders to entertain an acquisition. Clearly an acquisition which is made with a willing seller has a lot less stress and is more likely to succeed.

Once a firm has been selected for greater attention, frequent acquirers often assign senior executives the task of getting to know the potential target's senior executives. This might be done casually at first through industry events, charity functions and personal contacts but later would be developed into more formal contacts where the company's acquisition intentions might be discussed. At some point, the company will make a formal approach to a potential acquisition in order to gauge whether to allocate further time and effort to the candidate.

There are considerable advantages in an extended period of review of a target firm. The buyer's management team can be asked to gather information on the target in their normal business engagements on an informal basis. This will build intelligence on the target itself and also on how it is viewed by others

in the industry. An evaluation over an extended period can be undertaken in a situation where the target is undertaking normal business and is not setting itself up for a sale.

Other processes often used by frequent acquirers include:

- Publicly stating an acquisition strategy, often with preferred criteria.
- Searching 'For Sale' business magazines and web sites.
- Requesting senior executives to look for possible acquisitions.
- Engaging professional services firms, investment bankers and business advisers to seek out specific acquisitions.
- Requesting their suppliers, customers and strategic partners to look out for acquisitions which suit their acquisition criteria.
- Responding to external enquiries with regard to businesses for sale.

At some point in the search process, a potential acquisition target will attract sufficient interest to be given serious attention by the company and be subject to a formal evaluation process.

E. Evaluation

Many acquisitions fail at this point because the company neglects to properly and objectively take the potential acquisition through a systematic process of evaluation. Within an evaluation process, the company may decide to withdraw at any stage if the risks are unacceptable or the return is less than their hurdle rate. In summary, the evaluation process should include the following:

Seller Interest

Unless there is an active interest from the seller, the time and cost to undertake a proper evaluation is likely to be wasted. Further, the buyer needs to ensure that the seller's major shareholders, Board of Directors (if one) and senior management are in favour of the acquisition. The process of due diligence will consume significant time of the seller's senior executives and thus a positive and cooperative attitude needs to be present if the activity is to be effective. At this point, some indicative valuation should be gained from the seller in order for the buyer to begin to evaluate the potential acquisition.

Acquisition Benefits

The buyer should set out exactly why the acquisition is being undertaken and define where the benefits are to be gained. These benefits should then be subjected to realistic expectations to see whether they are reasonable. A financial

model should be developed to identify if the anticipated benefits produce a reasonable return on the costs involved in undertaking the purchase and the integration activities. At this point, the acquisition benefits are estimates only and will need to be verified in the due diligence stage.

A major consideration at this point must be whether the company has the ability to deliver the acquisition benefits. Research shows that businesses which stray from their core competencies substantially reduce their probability of success in acquisitions. Thus a key factor in the evaluation of the acquisition must be whether the company has the capacity and capability to undertake the acquisition and subsequent post-acquisition intervention and integration activities. While it may be possible to acquire some expertise with the acquisition, this cannot be wholly relied upon as acquired executives often leave within a relatively short period of a change of ownership.

Valuation

The company should develop a valuation model which indicates the likely range within which the sale would be approved. The valuation might be based initially on the current financial results of the target but would then be adjusted for costs and additional synergies gained through integration. An alternative scenario for selective acquisitions would be to identify what it would cost the company to develop an equivalent capability or asset and compare this to the additional revenue and profit which could be generated by buying the target firm. The valuation developed would form the basis of contract negotiation with the target. At this point, the company might decide to call off the negotiation if it does not believe it can generate an adequate return on the likely purchase price.

Negotiation

The formal negotiation process will establish an agreed purchase price and the terms and conditions of the deal. This should also establish who of the target senior executives are expected to join the company and what arrangements will be made for those who don't. The negotiations should establish the process of finalising the agreement including access arrangements for due diligence and the activities to be undertaken by each party and their professional advisers to conclude the deal.

Due Diligence

The due diligence activity should cover the investigation of the target firm as well as the evaluation of the integration issues. The purpose of the internal due diligence is to verify the information provided by the firm and to uncover any

inherent risks which would present themselves if the company proceeded with the purchase. The integration due diligence is designed to identify which issues, problems and activities would be involved in any integration activities.

GE Capital found that being sensitive to integration issues during the due diligence phase began to foster better decisions about whether to proceed with an acquisition at all. During the final stages of due diligence for the acquisition of a British leasing-equipment company, for example, two senior business leaders from GE Capital had a working lunch with the CEO and CFO of the company, expressly to discuss some of GE Capital's expectations for how the merged company would be run. During lunch, significant differences in basic management styles and values became clear. The conversation led GE Capital to take a harder look at the management culture of the target company and to realise that integration could be difficult and contentious. On that basis, despite very favorable financials, GE Capital walked away from the transaction.

Source: Making the Deal Real: How GE Capital Integrates Acquisitions, by Ashkenas, Ronald N., DeMonaco, Lawrence J., Francis, Suzanne C., Harvard Business Review, 00178012, Jan/Feb98, Vol. 76, Issue 1

The outcome of the due diligence activity should allow the company to firm up the valuation and terms and conditions of purchase, to identify the major integration activities with their associated timescales and costs, to validate any underlying assumptions in the valuation model and integration plan, to confirm that integration activities will produce the benefits and synergies estimated or to revise the estimates and to identify the key employees who will need to be secured for the acquisition to be successful.

Integration Planning

Even while the due diligence investigation is being undertaken, the company should be starting the planning of integration activity. The reason for this being undertaken at this point is to allow the company and the acquired firm to make announcements as soon as possible after the acquisition about the manner in which the acquisition will be integrated, if at all, into the company. This process should identify each significant benefit to be obtained from the acquisition and then estimate the integration activities which would need to be undertaken for each one. This process might also uncover further synergies. If it is undertaken before the deal is finalised, it gives the company the opportunity to further investigate the integration activities in both the buyer and acquired businesses to ensure it has not overlooked any major costs or obstacles.

The integration planning pre-acquisition should set out a timescale and list of major activities which need to be achieved to justify the purchase and/or to deliver the benefits of the acquisition. The plan should also show how continued business, within both the buyer and the acquired businesses, will be stabilised and protected during the integration process.

Final Negotiations

Once the results of the due diligence are known, the company can decide whether to proceed with the acquisition. While the deal would follow the initial Heads of Agreement or Letter of Intent, arrived at prior to detailed due diligence, the company should be adjusting the deal based on the results of the due diligence investigation. It is critical that the company structures the deal in such a way that a reasonable return can be made on their investment. If issues or problems uncovered during due diligence suggest that the price is too high or that the benefits will take longer to achieve, this should be reflected in a revised offer.

Special consideration should be given to the warranties and representations provided by the sellers. Many buyers consider wide ranging warranties and representations to be an adequate protection for some uncertainties in the information provided by the sellers. However, a claim against the warranties which puts the company into litigation for many years is little compensation. Smaller entrepreneurial firms lack the depth of executive coverage which large firms have and the loss of key executive time on litigation can be very damaging to the business. If there are serious gaps in the information provided, the company should work on a worst case scenario as the basis for proceeding.

Earnouts can be used to cover a gap between the valuations of the business by the two parties. However, earnouts are especially difficult to construct, and often end up in dispute or in protracted litigation. Earnouts can be used successfully where the events defined for payout are well defined and activities are in progress which require little effort by either party to bring to fruition.

F. Integration Program

Once the final contract has been signed, the company needs to move quickly to develop an overall integration plan and announce this to the employees of both companies. The integration plan should include the following:

- Protection of existing customer relationships and income streams.
- Communications with customers, suppliers, distributors and strategic partners of the acquisition as well as details on how these parties will be kept informed of changes and issues which arise in the integration program.
- Communications with the employees of both the buyer and the acquired businesses informing them of the acquisition, the benefits the company is seeking from the acquisition, an outline of integration activities with benefits, impact and timescales and the manner in which decisions on new structures and employment will be undertaken.
- An Integration Manager should be assigned to provide overall management and decision support for the integration effort. This person should be sufficiently senior to be able to resolve issues quickly.
- An integration plan should set out the projects to be undertaken by each business, the persons responsible and the targets to be achieved. Stage and intermediate goals should be identified and a reporting system for progress reporting and problem escalation should be developed.
- Individuals impacted by the acquisition, whether in the company or the acquired business, should be identified and a program of communication, counselling and assistance should be provided to help them with retraining, relocation and new employment.
- The company, in conjunction with acquired executives, should identify key executives in both companies who are at risk of leaving due to integration activities. A special effort needs to be taken to contact these individuals, explain why they are important to the business strategy and devise new incentive plans to ensure they stay.
- Benefits identified in the investment justification should receive special attention as the achievement of those is critical to the overall financial performance of the company. These should be allocated to specific individuals who should report on progress periodically.
- A frequent update on integration activities should be made available to all employees so that rumours, misinformation and unrest over changes do not fester and disrupt progress.

G. Post-integration Review

Companies which intend to grow through acquisitions need to learn from the experiences of each acquisition. A review of the deal and its outcomes is a useful way of learning from both the pre-acquisition process as well as the subsequent integration activities. Companies which are frequent acquirers build up corporate knowledge and wisdom in regard to acquisitions and implement their best practice into checklists, guidelines, policies and management training. Even the best of them will make mistakes or suffer unexpected setbacks; however, the probability of success increases with each successive acquisition, provided of course they learn from each transaction.

Conclusion

Acquisitions really have three major components; identifying the right business to buy which clearly adds value to the core business, doing the deal and then integrating the essential parts of the acquisition so that the benefits identified are achieved. Many firms make significant mistakes in one or several of these areas. They often undertake an insufficient evaluation or are not rigorous enough in their acquisition decision. Secondly, they often fail to appreciate that integration of an acquired business is a major change management activity and underestimate the amount of work involved or the sensitivity with which it needs to be undertaken.

The first time acquirer is in an especially risky position. The accumulated evidence suggests that the best acquirers have significant experience across numerous acquisitions and build up an accumulated corporate wisdom about how to do it. Interestingly, they rarely undertake large acquisitions. The risks associated with larger acquisitions, especially where significant benefits ride on large integration efforts, are both numerous and large. Smaller acquisitions can be better managed and have less impact on the overall business if things go wrong. The more successful acquirers tend to start small, acquire often and gradually move to larger acquisitions. Many frequent acquirers stick with smaller businesses and grow at a consistent pace by absorbing new businesses on a regular basis.

Providing the evaluation is undertaken with care, the risks are clearly in the integration process, especially where there are significant cultural differences. The smart entrepreneur undertaking his or her initial acquisition would be wise to avoid such situations and concentrate on acquisitions which can deliver benefits without any significant integration activities. There are many forms of acquisitions which can bring significant benefits without integration and there are also those which have minor integration activities which pose lower risks. This should be the preferred strategy of the entrepreneur until the company has built up some acquisition experience.

Key Points

- Acquisitions should be part of the overall company strategy and not something that is done on an ad hoc or unplanned basis.
- The major risks occur in inadequate evaluation and poor integration planning. Both these areas require considerable effort and a systematic approach.
- Communications with all the stakeholders as soon as possible and on a frequent basis is essential if disruption is to be minimised.
- A special program to encourage key employees from both the buyer and seller's companies to stay should be developed and implemented as soon as possible after the deal has been completed.

Chapter Six

Evaluating Financial Acquisitions

Overview: Financial acquisitions create benefits through the acquired business directly rather than through the buyer's. The acquired firm may be acquired in order for the buyer to make changes in it which are designed to significantly increase its profitability. The investment is evaluated on the basis of the future net cash flow stemming solely from the profits generated through the acquisition. Generally little or no integration activities are involved except perhaps some outsourcing of limited functions to the buyer.

Of the two acquisition types, financial acquisitions are probably the easiest to evaluate as they are judged almost solely on their inherent profitability. The nature of the financial acquisition is that it produces its return from its revenue and profit capability through its own sales and marketing efforts even if these are improved through intervention from the new owner. I will also consider later in this chapter a special case of acquisition, under the heading Build vs Buy Acquisition, simply because the alternative of building is itself a financial hurdle.

Based on the different forms of acquisitions set out earlier, the major types of financial acquisitions are those which are purchased for current profitability and those which are purchased with the intention to intervene to improve profitability. It is implied in this classification that the buyer accrues little benefit within its own operations. That is, the profitability of the buyer's operations itself is not changed directly although there may be some group benefits from the larger size. The return on investment is sought through the operations of the acquired firm not those of the company itself. The increased profits from the acquisition would of course accrue to the buyer. This is in contrast to a strategic acquisition where the company intends to benefit within its own operations through acquiring assets or capabilities from the acquisition. The nature of a financial acquisition also suggests that the buyer would have little

or no organisational changes as a result of the acquisition whereas a strategic acquisition might well result in substantial changes in the buyer's organisation depending on how the strategic value was exploited.

Businesses which are purchased for their current profitability and where little intervention is anticipated would include those acquisitions classified as:

- Pure investments,
- Undervalued,
- Fire sale,
- Vendor seeks other consideration,
- Use of spare capacity of the vendor,
- Distribution of buyer products through vendor distribution channels.

These acquisitions are intended to be left substantially unchanged. The buyer gains a return on investment through the normal activities of the acquired firm. In the case where spare capacity is utilised or buyer's products are distributed by the acquisition, some changes might be made by the buyer but these are expected to be managed by the acquired executives without intervention.

Most financial acquisitions, however, are undertaken where the buyer has the intention of making changes in order to achieve the required investment return. These would include:

- Turnaround,
- Use of buyer brand, trademarks or technology processes,
- Implementation of internal management processes.

Some transfer of administrative activity and head office functions to the buyer may occur in rationalising the operations of the acquisition. These functions are then effectively undertaken as if they were outsourced to the buyer and a head office management charge could be imputed or charged in the evaluation of the potential acquisition. This form of intervention still intends the acquisition to be separately managed.

There is a fine line between a financial and a strategic acquisition as more and more functions are outsourced to the buyer. More substantial functions may be transferred to the buyer where the intention is to consolidate facilities. Thus capacity in warehousing, distribution or manufacturing might be reduced within the acquisition and absorbed within the buyer's organisation. These could then be treated within the acquisition as outsourced functions. However,

as the level of consolidation increases, the direct benefits to the buyer increase and the acquisition takes on more of a strategic form than a financial one.

The evaluation of the proposed acquisition, the 'target', should first review the firm as a stand-alone business and then show the impact of the intervention and integration activities on the profitability of the business.

Current Business Evaluation

The current operations of the business are evaluated to determine the size and volatility of its current profit and to ascertain any internal risks which might create delays, problems, stress, disruptions, embarrassments or costs to the buyer. The initial evaluation is undertaken at a product/market and overall operational level to ascertain if the company wishes to proceed further with the negotiations. Once an outline agreement is reached, the company would proceed with a detailed due diligence investigation.

The product/market and operations evaluation would include at least the following major components:

- Markets addressed, products offered and the nature of the customer base,
- The size of the target markets, their anticipated growth and the competitive position of the target business within its chosen markets,
- Revenue breakdown between new and recurring business,
- Competitive position, level of differentiation and the nature of product protection,
- Sustainability of the business through referrals, IP, customer loyalty schemes, preferred purchasing agreements and so on.

The current business should be valued prior to the company assessing the impact of any intervention. The objective of the company should be to purchase the business based on the value of its current operations. Any increases in valuation through intervention or integration are benefits which properly belong to the buyer and should not form part of the purchase price offered to the seller. However, a smart seller who understands the potential of the business in the hands of the buyer may hold out for a higher price in order to extract part of the buyer's future improvements. This would be especially effective if the seller was able to find several potential buyers and construct a competitive bid for the business.

Valuation of the Current Business

In the absence of an independent offer to buy the firm, the valuation of a private firm is a highly judgemental process. Valuation models are each designed with different purposes in mind. Like the problem of identifying cost, (historical cost, replacement cost, market price, incremental cost, inflation adjusted cost, depreciated cost), it depends on what you want to use it for.

The major valuation models are:

1. Earnings based

- Capitalisation of future maintainable earnings
- Discounted future cash flows (DCF)

2. Asset based

- Going concern value
- Realisation value

3. Industry specific based

- Market value
- Rules of thumb

Traditional valuation methods, which are set out below, have been established to value existing business where historical data can be used to show revenue and profit trends and where established products have a market presence. However, acquisitions are often undertaken of emerging ventures with limited life, little financial history and a somewhat speculative future. Thus while traditional methods of valuation don't really apply, the buyer should be familiar with their use as valuation discussions may involve them. The conventional approach to valuation is to develop a forward projecting business plan and to use this as the basis for discussion.

Acquisitions by entrepreneurs will often be of other smaller emerging entrepreneurial firms. These present very difficult valuation challenges due to the nature of their businesses.

For example, an emerging business will typically display the following attributes:

- Uncertain cash flows,
- Few tangible assets,
- Some specialised equipment which quickly becomes technically obsolete,

- Few debtors,
- Little inventory,
- New and sometimes unproven products or services,
- Often an immature management team,
- An emerging market which is yet to be stabilised,
- No established market for shares, especially a minority holding,
- Uncertain timing of revenue and profitability.

Valuations based on current or future profitability are somewhat judgemental in these circumstances.

This next section sets out a range of conventional valuation methods and shows where they might best be used in an acquisition process.

1. Earnings Based Valuations

Capitalisation of Future Maintainable Earnings

- Capitalisation of future maintainable earnings methodologies include:
 - i. Price Earnings Ratio (PER); and
 - ii. Pre-tax earnings multiples such as Earnings before Interest, Tax, Depreciation and Amortisation (EBITDA), Earnings before Interest, Tax and Amortisation (EBITA) and Earnings before Interest and Tax (EBIT)

Earnings based valuations are used as a proxy for the Discounted Cash Flow (DCF) methodology.

The PER can be applied in two ways:

1. Total value of the firm: PE multiple x net profit after tax (NPAT)
2. Value per share: PE multiple x earnings per share (EPS)

The PER is applied to an estimate of earnings after tax. The value derived using a PER is a valuation of the ordinary shareholders' interest. This is described as an equity value.

Valuations based on EBITDA, EBITA or EBIT multiples calculate the Enterprise Value of the firm before factoring in the way it is funded. The Enterprise Value is typically adjusted for the following items to calculate an Equity Value:

- Interest bearing debt,
- Surplus assets,
- Contingent liabilities,
- Future capital expenditure.

To further explain the difference between Enterprise Value and Equity Value consider the following example of somebody's house:

Item	\$	Value
Market Value	500,000	Enterprise Value
Bank Debt	400,000	
	100,000	Equity Value

Often sectors have established valuation norms. These can vary with the economic cycles reflecting likely growth or depression trends. Multiples applied to mature industries with little likelihood of growth are generally lower than multiples applied to growth sectors. Firms which have experienced higher than average historical growth will usually command a higher multiple on the basis that future growth is also expected to continue at higher than average rates i.e. history is often used as a prediction of the future.

The assumption underlying the P/E Ratio method is that the firm has stable or predictable earnings, that these will continue on a linear path for some years and that the business will not change from its current business model and that there is an appropriate debt/equity mix.

It is useful to set valuation expectations prior to going into a valuation negotiation. If the sector is currently valuing listed corporations at ten times EBIT and the firm is seeking something higher, they have unrealistic expectations. If on the other hand, they are seeking five times EBIT, you probably have a basis for negotiation.

The earnings used in a valuation need not be the actual historical earnings. Earnings should be adjusted for abnormal, extraordinary and non-recurring items to determine a normal level of earnings. If the vendor can show highly probable growth with achievable revenue and profit targets, future earnings might be used to calculate a market valuation. However, it is important to avoid double counting growth by using future earnings and applying a 'growth multiple'.

Discounted Cash Flow (DCF)

A DCF has two elements:

- Forecast of future cash flows of the firm for a number of years into the future
- Discounting the forecast cash flows back to a net present value (NPV) using a discount rate that reflects the riskiness of those cash flows

The preparation of a DCF can be challenging as it can be difficult to:

- accurately forecast cash flows for a number of years into the future,
- select an appropriate discount rate.

The discount rate should represent the risks associated with generating the expected earnings of the firm.

This method is somewhat more problematic. It is based on discounting future free cash flow to a present value. The free cash flow, or uncommitted cash surplus, represents the cash that is available to pay off the initial investment plus provide a return on that investment.

Most high growth businesses, however, invest heavily in growth capacity. This might be R&D, sales force, promotion, channel expansion and so on. Few entrepreneurial ventures have spare cash.

The DCF discount rate in an emerging business valuation is likely to be 35-40%.

2. Asset Based Valuations

Asset Based valuations are appropriate in a few circumstances such as:

- Where a company is making continuous losses,
- A company is close to liquidation,
- Where assets are readily saleable and their tradeable value best reflects their ongoing value.

Two types of Asset Based Valuation methods are:

Going Concern Value

This values the tangible and intangible assets individually and then aggregates them to a valuation. The valuation of the individual asset is based on the firm continuing in business. The valuation could be seen as a replacement cost valuation.

High growth entrepreneurial firms often achieve growth through their business model rather than their underlying assets. It is the uniqueness of the product or service and the way it has been taken to market that generates growth rather than the underlying assets used. This method does not take into account high future growth and thus is unlikely to be appropriate for high growth entrepreneurial firms.

Realisation Value

This is the value which could be achieved by liquidating the business and is not appropriate for the purpose of valuing an ongoing business. It provides a 'worst case' valuation and should not be used as a primary valuation methodology.

3. Industry Specific Based Valuations

Market Value

Some industries have market values based on convention. This could be a specific P/E ratio. Generally this applies to very stable, regulated or controlled environments. This method could be used as a cross check to discounted cash flow valuation models in certain industries or circumstances.

Rules of Thumb

Valuation methods in some sectors are based on guidelines established from a reasonably high number of similar transactions. This often applies to professional practices or franchises. This is inappropriate for an early stage valuation.

If the business is unprofitable, then some form of liquidation value will almost certainly be used. If the business is profitable, while a number of techniques could be used, most valuations are done using an earnings multiple. Multiples are surrogates for a valuation based on net present value techniques where the internal rate of return (IRR) used should reflect the inherent risk in the target as well as the extent of visibility of forward profits. Thus a two times multiple equates to a discount rate of 50%, four times to a rate of 25% and six times to a rate of 15%. As the volatility of earnings decreases and the forward visibility of profit forecasts extends so the discount rate decreases. However, early stage ventures might still attract a 55% discount rate with more advanced ventures attracting 20-40% depending on the expected risk.

For popular businesses, there will be an earning multiple norm established for the industry. That multiple is generally applicable for an average business

within the sector. The company should be able to establish the level of volatility of earnings, profit growth and revenue visibility for such a norm and then adjust the multiple for their target business up or down based on the target's volatility, anticipated profit growth and forward visibility of earnings. Earnings multiples which operate in the market are often influenced by macro economic factors. It is critical that the buyer appreciate that economic cycles can change the prevailing industry valuation norms and that they should avoid buying in a peak period.

On the basis of the data they will have analysed, the buyer should settle on a target valuation of the current business. If this exceeds the valuation suggested by the vendors, the buyer might decide to proceed to a more detailed due diligence.

If the vendor's valuation exceeds that of the buyer, discussions might then be undertaken with the vendors as to the methods they have used to arrive at a valuation. The buyer at this point might be willing to disclose the valuation technique they used in order to identify differences in assumptions or to bring forth new information not presently in the hands of the buyer.

If the valuations are still somewhat apart, the buyer needs to examine the impact on their target valuation through their own intervention. If the vendor anticipates that a possible buyer might be able to improve the profitability and has alternative buyers, the vendor might be using such potential to extract a higher price for the business.

Adjustments for Intervention

Unless the business is undervalued, involved in a distressed sale or the vendor is seeking other consideration, the buyer should be seeking areas where additional profitability can be achieved as it is highly unlikely that current profit levels will continue after the acquisition without intervention. Consider the following:

- The major shareholders are most likely to leave. They are likely to be cashed up, wish to continue in a senior position which they may not be able to do within the new structure, have alternatives to pursue or not wish to join a business with a different culture. When they leave, new managers will need to be promoted or recruited. This will disrupt the flow of business until the new organisation settles down.
- Some employees will take the opportunity to leave or to retire on the change of ownership. If key employees leave, operations and profitability

are likely to suffer. It will take some time before new employees can be recruited and trained.

- Some customer and supplier relationships will probably be disrupted during the changeover of ownership and these may take some time to recover.
- Any changes in systems, policies and processes will take time to implement and there is likely to be a loss of productivity during the transition time.
- If the changeover is handled badly from a change management perspective, resentment, frustration and even hostility might result, in which case operations will be disrupted and profitability will drop.
- Departing managers might have special knowledge of the market and the business operations which are undocumented and this will negatively impact operations until the knowledge is relearned.

So even if the intention of the buyer was to leave the business untouched, this desire is unlikely to be achieved and some change in personnel is almost inevitable. These changes will disrupt the normal flow of business and the profitability is likely to suffer as a result.

It is far more common for an acquisition to be made where there is an intention to utilise the newly acquired firm in some way within a group structure. This may be as a vehicle for selling company products or services, a way of servicing excess demand or another outlet for exploiting existing brand, trademarks, processes or economies of size. A special case of intervention would be the imposition of improved management processes and perhaps replacement of some or all of the management team.

Interventions may take many forms of which the most common are:

New Management

It is likely that some management will depart with the sale, however, even if that is not the case, the buyer may wish to change some of the management to increase the quality of the management. If the buyer is introducing new systems, products or processes into the acquired business, they may wish to insert someone with experience of those activities.

Use of Brands, Trademarks and Technical Processes

The acquisition may be made to provide an outlet for unique IP or technical processes that the buyer has which are designed to lift the profitability of the target firm.

New Management Processes

Most small firms are not managed well at an operational level. The buyer may wish to introduce new performance setting and reporting systems as well as new systems in quality control, OH&S, manufacturing management and so on. These are implemented to improve the quality of management visibility and to provide the basis for better management intervention in problem areas. Overall, they should result in improved profitability. Benchmark studies by the buyer of the industry and of their own operations should be able to identify how much impact the buyer might have on the profitability of the target firm through such intervention.

Use of Excess Capacity

The buyer may be in a position of having excess demand and wish to divert some of this into the buyer's business thus increasing the productivity of its fixed asset base. This should improve the profitability of the business.

Sale of Excess Assets

The buyer may see where operations can be improved and current assets released for sale and/or identify surplus assets which could be sold. The proceeds from the sale will reduce the net investment the buyer has to make to acquire the business.

Cost Synergies through Integration

The buyer may be able to absorb certain head office and central services operations of the target without increasing their own operating costs by the same amount. The net decrease in combined costs can then be set against the benefits arising from the acquisition.

Sale of Buyer's Products or Services

The objective of the acquisition may be to provide the buyer with direct access into another market or to an established customer base or distribution channel. The increased sales of the buyer's products and services should make the acquisition more profitable.

In undertaking the investment justification exercise, the buyer assigns to the target firm the increased net revenue as a result of the intervention activities. In order to properly assess the revised business, the buyer will need to translate the current business and the changes as a result of intervention into a new business projection. The new revenue and profit projections can then be used to establish a new valuation. Effectively, this is the business which the buyer will create from the foundation of the business purchased.

If at this stage the new valuation still does not exceed the sale price sought by the vendor, the buyer has a number of alternatives. They can again open up discussions with the vendor and declare the changes they would make and the expected impact of those on the business to show that the valuation by the vendor is unrealistic and hope to persuade them to reduce the asking price. Alternatively, the buyer could seek to agree on an earnout formula to bridge the gap. Lastly, the buyer can terminate the negotiations on the basis that they are wasting their time. The vendor may be unrealistic or have a better offer.

Additional Costs

Before the buyer settles on an offer price for the target business it should adjust its own valuation for the costs associated with doing the deal and managing the business after the acquisition. Unless these are taken into account, the investment in the new business will be understated.

Additional costs which should be added to the original investment include:

- Professional legal and accounting costs associated with due diligence and preparing the purchase agreement, non-compete and employment agreements.
- External consultants' fees associated with specialist evaluations of markets, manufacturing processes, IP, OH&S and other compliance requirements.
- Internal costs for undertaking initial due diligence, managing the professional service providers, negotiating the deal and gaining internal management and board approval.

Acquisitions are never without their problems and are certainly not without ongoing expenses to supervise. Additional costs which need to be added to the forward expense estimates include:

- Buyer's senior management time to review operational reports and respond to requests for capital expenditure approval and so on.
- Time of the buyer's Board of Directors to review acquisition results.
- Time and expenses of buyer's employees to visit or meet with the acquisition to review operations.
- Time and expense of the acquisition employees to visit or meet with the buyer's representatives.
- Any additional complexity costs within the buyer as a result of the acquisition.

Negotiating the Final Purchase Price

Unless the vendor has a fixed target price and is unwilling to move from that point, any final purchase price is a negotiated price where the two parties need to arrive at some point where both are satisfied with the outcome. The buyer should try to ascertain from the vendors the key elements to their decision as not all items included within the deal are in terms of money. To the extent that the buyer can provide other benefits to the vendors, this may reduce the target price the vendors are seeking.

Normally the vendors will suggest a price they are willing to accept. If this price is acceptable to the buyer based on their initial due diligence, the buyer could enter into a tentative agreement but subject to detailed due diligence. The results of the due diligence might disclose further items which impact the risk in the deal for the buyer, a change in the anticipated level and volatility of the revenue and profits or a change in the visibility of future revenues. These will alter the buyer's assessment of the business and may stimulate a discussion on valuation with the vendors.

The buyer will want to make their own assessment of the value of the business both before and after intervention. The valuation of the current business should be used as the starting point for their valuation discussions. If this does not arrive at an acceptable purchase price with the vendors, the buyer will have to consider whether they are willing to pay some of the additional value they believe they can extract from the business through their own intervention. Hopefully this can result in an agreed price.

Buyers should be very reluctant to pay above the current valuation as their own intervention will require changes in the acquisition and these will take time to show impact. Also, estimating the extent to which intervention will impact the business is problematic unless the buyer has experience of such an activity in the past and therefore has a strong basis on which to make such estimates.

Build vs Buy

A company may be willing to undertake an acquisition as an alternative to building an asset or capability itself. This might be very attractive if it would cost less to buy than to build or if they could enter a strategic market early by acquiring the right product, process, or intellectual capital. For example, large companies generally have very high R&D costs due to their overhead costs, bureaucratic processes and higher remuneration and benefit levels compared to smaller firms, thus small firms can often develop innovative assets or capabilities

for much less. The research also shows that large corporations are not good at developing breakthrough technologies or processes.

Small firms often bring new products to market faster and with more creativity than large companies, thus they offer large corporations a possible supply of innovation. The small firm which can provide a proven solution, often developed at a fraction of the cost by a large company, can sometimes be acquired for less than the company would have to spend developing a comparable product.

A major consideration which often drives such acquisitions is the time to market for new innovations. The company needs to consider the additional revenue they might be able to achieve by bringing an acquired product to market early. With a much larger existing customer base and/or distribution channel, they may be able to recoup their investment quickly, even if they pay considerably more than what they might otherwise incur as their own development cost of the product.

The evaluation of a build vs buy acquisition is similar to the above except that an additional benefit would be the opportunity cost of the development of the asset or capability which is acquired in the purchase transaction.

Conclusion

Many advisers recommend that corporations only buy undervalued businesses as they have higher margins to absorb problems in the acquisition. The problem with such advice is that such acquisitions also bring with them a need for considerable intervention by the acquirer's management team which can distract them from managing their core business. An acquisition which is well managed and able to be left to manage itself has a lot of advantages to a buyer already working at full capacity. However, few acquisitions come without some level of intervention and therefore a company which is already working at full capacity needs to take great care to not overstretching itself by taking on the additional workload of an acquisition.

There can be little doubt that buyers are clearly better off buying businesses which have significant upside through intervention; however, it also should be said that such intervention requires time and effort of the buyer and may distract them from their own business. Many buyers prefer to buy well run firms where they undertake little intervention in the management operations. They seek businesses which can quickly benefit from taking on the IP, products, services and technical processes or excess demand of the buyer and where management intervention is not required.

The problem of taking on acquisitions where management intervention is required is that the buyer needs to have experience in such intervention if it is to have a reasonable chance of success. The buyer also has to have spare management resources available to undertake the intervention. Since few high growth entrepreneurial businesses have spare management capacity, this is probably a path few should be willing to tread.

A business which is already well managed and can take advantage of products, IP and processes or excess demand sourced from the buyer can be an excellent investment. This can work well if the existing vendor management is willing to stay on and work to grow the business. Alternatively, this can also work well if the buyer knows of management capable of growing the business and who can be brought into the acquisition soon after the deal is finalised.

Strategic acquisitions which require integration into the buyer's business represent a major challenge for any company and especially one that has limited spare executive capacity. Not only will the company need to acquire acquisition and integration experience but it will also require the depth of management and financial resources to absorb some period of disruption. Since few large corporations are competent at this even given their capacity to fund and staff such activities, the smaller firm needs to take great care before embarking on this type of transaction. Typically financial acquisitions require little or no integration although they often require intervention. Even so, they represent a much easier and less problematic path to growth for the smaller acquirer.

Key Points

- A financial acquisition provides a return on its investment through its own operations rather than those of the buyer. The evaluation of this type of acquisition is undertaken by modelling the net present value of the future free cash flow of the acquisition.
- There are a number of different valuation methods which could be used but the most appropriate is the net present value technique. In the absence of reasonable future cash flow information, an industry norm is probably the best alternative.
- There may be synergies associated with transferring some functions to the buyer or with economies of scale through purchasing and marketing. However, these are additional benefits over and above the valuation of the inherent profitability of the acquisition.
- The buyer may be forced to pay more than the inherent valuation if the vendor is aware of the additional benefits the buyer can exploit and if the vendor has managed to find competitive bidders.

Chapter Seven

Evaluating Strategic Acquisitions

Overview: A strategic acquisition delivers substantial benefits through the operations of the buyer. While there may be profits derived from the acquisition itself, the main justification for the acquisition lies in the additional revenue and profits achieved within the buyer's organisation. The major objective of the acquisition is to transfer assets or capabilities from the seller into the buyer's organisation and for the buyer to exploit these in a much larger market than the seller can access. The valuation of this type of acquisition combines the inherent profit of the acquisition with the additional incremental profit of the buyer.

Unlike a financial acquisition, a strategic acquisition changes the operations and often the structure and strategy of the buyer. The buyer intends to take the assets and capabilities of the acquisition into its own organisation in order to change its own market position. The impact on the buyer is thus incremental and as such can be more difficult to evaluate than dealing with a stand-alone acquisition. It is therefore easier to evaluate a strategic acquisition in stages.

The nature of a strategic acquisition is that it provides benefits to the company through the company's organisation rather than through the target's own organisation; it is the combination of resources from both organisations which provides the source of benefits. Strategic acquisitions change the nature of the company's business by providing assets or capabilities that it did not have previously. In some situations, the buyer will be acquiring unique assets or capabilities based on IP. These may not be available to the company other than through an acquisition. Alternatively, the company may be able to assemble or build the IP but the time and cost required may justify an acquisition where it can be provided much earlier through an acquisition.

A strategic acquisition may or may not involve integration of the acquired business with that of the buyer. If the benefits gained through the acquisition can be achieved without integration, this can provide a much easier path to

benefit realisation. Integration activities are typically problematic and should be undertaken if they are the only manner in which the benefits can be achieved.

Strategic acquisitions can be divided into two major classes. They either solve a threat to the company or they present the company with an opportunity for revenue and profit generation. In some cases an acquisition might provide both, that is, it may solve a serious problem that threatens existing revenue and it may also present an opportunity for new revenue growth.

A. Overcoming Threats

To better understand the circumstances which drive this type of acquisition, consider a 'problem' which the company has which will reduce current revenue unless it is negated or mitigated. A threat is a problem which is seen by the company as a potential or actual reduction in current or forecast revenue if no counter action is undertaken. Normal business life is littered with such activities including price wars, introduction of new technology, new legislation, the loss of a major distribution channel and so on. The strategic task is to identify a target which has assets or capabilities which can counter an existing or emerging threat, which has both the capacity and willingness to enter into an acquisition and where the company has the skills and resources to undertake and manage the acquisition so that it results in the elimination of the threat.

External threats occur when the company has no effective control over an event and where it will impact on their ability to compete or execute. The other form of threat is from internal situations which disrupt the business, reduce capability or create a change in its future capabilities.

External Threats (examples):

- Major customer defaults,
- Major supplier defaults,
- A major supplier is likely to be purchased by a competitor,
- New competitors enter the market,
- A competitor introduces a more advanced product,
- Current competitor becomes more effective,
- Change in legislation,
- Disaster (natural or terrorist),
- Loss of major contract,

- Loss of distribution channel,
- Changing customer buying patterns.

Internal Threats (examples):

- Loss of key employees,
- Lack of funding,
- Major delays on product development,
- Serious personal health or family issues of senior executives,
- Urgent need to buy out investor or partner,
- Need to liquidate to retire.

Acquisitions which are made to overcome threats can be grouped into a number of different types.

Vertical Acquisitions

Acquisitions are often made to protect a source of supply or a source of revenue. Others are undertaken to counter a competitive threat. Consider these examples.

Pioneer Computer Systems acquired a supplier to gain control over a strategic component of their product development infrastructure.

Example (Author's italics)

In 1984 Pioneer Computer Group (PCS) utilised a 4th generation language from North County Computer Services (NCCS) in Escondido, California. At the time the language USER11 ran on the RESTS/E operating system on the Digital Equipment Company's PDP 11/70. With the introduction of the VAX series of computers, the USER 11 product was ported over to the VAX to provide an identical programming and end user environment. However this failed to use any of the new features inherent in the VAX and thus PCS faced a decline in its market acceptance. NCCS were determined to stay with a transparent interface thus threatening the survival of the PCS applications written in USER 11. **To solve the problem PCS raised \$1.5 million in venture capital, acquired NCCS and rewrote the USER 11 product to utilise the advanced features of the VAX.**

Source: Dr. Tom McKaskill, Former CEO, Pioneer Computer Systems

Agere Systems acquired Massana rather than let their initial investment be lost.

Example (Author's italics)

Agere Systems announced Monday the acquisition of an Irish semiconductor-maker that designs broadband network chips that are ten times faster than current technology.

The startup has only produced a prototype, which several companies are sampling, including possibly Cisco Systems and Apple. The privately held company has not turned a profit. It has received about \$30 million from U.S. and overseas venture capital firms. Agere will have to inject cash to cover research and employee salaries, without revenue coming in immediately. It will assume a small amount of debt.

The Dublin company is a startup venture founded in 1996 that began as a provider of engineering services. It has collaborated with Agere for the last year on developing gigabit Ethernet chips used in high-speed broadband networks. Agere produces chips for slower speed Ethernet connections.

Massana was on track to fulfil its contract, ***but Agere decided it wanted more control over the project so it decided to buy the company***, said Sohail Khan, executive vice president of Agere's Infrastructure Systems.

Source: <http://www.mcall.com/business/> accessed 7th September 2003

Chinadotcom acquired Ross Systems Inc., a supplier of ERP systems. Ross Systems had a history of poor management which made them vulnerable to takeover. Chinadotcom may have decided to acquire rather than let them pass into a competitor's hands.

Example (Author's italics)

ATLANTA (Dow Jones – Chinadotcom Corp.'s CDC Software unit signed a definitive agreement to acquire Ross Systems Inc. (NasdaqNM:ROSS – News) for \$5 in cash and \$14 worth of chinadotcom common shares.

In addition, ***CDC Software has been a master distributor of Ross Systems' enterprise business solution, iRenaissance suite, in the Greater China region.***

Source: <http://www.rosssystems.com/> accessed 6th September 2003

PeopleSoft acquired Distinction Software as a counter to the announcement by SAP of a suite of supply chain optimisation products.

Example

In early 1998 SAP announced a suite of supply chain optimisation products replacing their alliances with a number of small software companies. Within a few months their major competitors including PeopleSoft, J D Edwards, Oracle and Baan all made similar announcements. However these were mostly development initiatives and not completed products. PeopleSoft took the opportunity in late 1998 to acquire a small software house, Distinction Software Inc. which had a complete suite of products in order to counter the move by SAP.

Source: Dr. Tom McKaskill, former CEO, Distinction Software Inc.

Overcoming Constraints

A company's desire for growth may be hampered by lack of access to a specific capability or asset. This then threatens its strategic plans and may threaten its existing competitive position if the constraint is unable to be removed.

This list might include the following:

Access Rights, Licences, Patents or Brand Names

Companies can sometimes be frustrated in expansion plans within a sector through the lack of intellectual property. This might be a licence to operate, a recognised brand or access to technology which is protected by patents. A lack of such rights when competitors have rights, or acceptable alternatives, can be a threat to future revenues.

Technical Expertise or Specialist Knowledge

In areas of emerging knowledge, the number of experts or specialists is often limited. Where competitors have such expertise and are leveraging it to gain market share, a company is threatened unless they can also acquire such expertise. Sometimes the only way for a critical mass to be acquired quickly is to buy a firm which already employs such people or has developed such capability.

Gateway Capacity or Technology

Often in a specific sector, the ability to compete may depend on owning a share of a channel or access path. If, for example, capacity within a channel is only able to grow at a limited rate, the company which has control over part or all of that capacity has considerable influence over market share. The same logic would apply to a market where existing suppliers have effective control

over the market due to high switching costs to their customers of moving to a new entrant.

High Profile Customers or Hard to Acquire Customers

Entry into a market or expansion beyond a certain point may require the company to secure the business of certain key accounts. If these are already being serviced by another firm, the only way forward may be to acquire the existing supplier.

Key Locations or Launching Pad for Expansion

The costs of entering a new market from scratch may be prohibitively high in terms of time and/or investment. Existing businesses may, however, already have built sufficient critical mass and infrastructure that they can provide a launching pad for further expansion into the market.

Example

Axon Group plc, the business transformation consultancy, announced that it has agreed to acquire the entire issued share capital of MyDruid Services SDN. BHD, an offshore services partner based in Kuala Lumpur

Axon says the acquisition supports its strategy in two key areas. Firstly, it provides a beachhead into Asia, from which Axon intends to grow the local client base, focused initially in Malaysia, Singapore, China and Korea. Secondly, the Applications Management centre in Malaysia will become Axon's off-shore and on-shore capability centre for the region, providing resource to support both local and global clients. The acquisition will not have a material effect on the Group in 2004.

Source: http://www.consultant-news.com/Article_Display.asp?ID=1420. Accessed 7th April 2004

Products which Can Fill Out a Portfolio

In markets where the number of products is large, channel members try to limit their administration load by working with partners which can offer a wide range of complimentary products. A firm may be faced with erosion in its market if competitors can offer wider ranges of products. Thus acquiring a firm which can complement a product line and counter competitor pressure may be a successful method of retaining existing business.

A similar argument can be applied to integrated solutions in engineering and software. The success of the large ERP vendors such as SAP, Oracle and PeopleSoft has come from their wide portfolio of products. Such firms often make acquisitions to provide a more comprehensive solution to customers'

needs. Thus they may be forced to seek an acquisition to counter a development by a competitor.

Highly Networked or Well Known Industry Leaders

A company threatened with a loss of contracts may seek to acquire a firm with highly networked management or high profile individuals who can secure them a place on tender processes.

Experienced Management Team

A company with a poor performing business unit or a situation which requires unusual expertise might seek to acquire a smaller firm just to be able to acquire a fully operational management team.

Reduce Risk

A business might be acquired in order to provide a better spread of business across a number of revenue categories to reduce dependence on major customers or provide a buffer to currency fluctuations.

Example

Malaysian conglomerate Sime Darby has agreed to buy a controlling stake in three companies involved in auto distribution and parts manufacturing as part of moves to expand its motor vehicle business.

It said the proposed acquisitions were expected to give its motor vehicle business a boost as Hyundai was one of the best-selling and fastest growing brands in Malaysia.

Sime Darby chief executive Nik Mohamed Yakcop said the proposed acquisitions would provide a more balanced portfolio of marques and reduce its exposure to the euro.

Source: http://www.channelnewsasia.com/stories/afp_asiapacific_business/view/78679/11.html Accessed 7th April 2004

The examples shown above demonstrated that acquisitions are often undertaken to resolve a difficulty. The acquiring firm's task is to take control of the situation by proactively seeking acquisitions which can counter the threat.

Competitive Impact

In assessing the value of a potential acquisition, the buyer also needs to consider the impact on their business if a competitor acquired the target firm rather than themselves. If the selling firm has on offer some unique product or technology which is heavily protected by patents, the company may not be able

to counter the competitive effect of another company aggressively marketing the products into their marketplace. By forgoing the opportunity to acquire the firm, they may hand over to their competitor a weapon which will be used against them.

Timing

Timing is always relative to the impact of the threat on the firm. Where the firm has a choice to delay doing something about a threat or problem, the strategic value is reduced. However, where a threat exists, the impact of not doing something to counter or mitigate it may be very serious. The time factor is most impacted by the resilience of the firm to withstand the threat. The lower the damage forecast, the less the need to look for alternative courses of action. The longer the time available to seek an alternative or to manage the situation, the more likely the damage can be minimised.

B. Enabling Revenue Opportunities

Strategic acquisitions often enable the buyer to exploit a market opportunity which they otherwise would not be able to do, or do as quickly, without the assets and capabilities sourced from the acquisition. A business is faced with an opportunity when a favourable set of circumstances is presented in which they are able to achieve an increase in revenue. Because opportunities are often situation and time specific, it is the combination of capabilities and assets of the company and of the acquisition which creates the opportunity for revenue generation. An opportunity for one firm may not be open to another due to the knowledge possessed or the assets or capabilities needed to execute and deliver the benefits. This situation often means that one potential buyer can better exploit a specific acquisition than others.

Opportunities present themselves through environmental changes. It is through the company's strategic planning that such opportunities are identified. Acquisitions are then considered where the company sees the opportunity but does not have the assets or capabilities available to pursue it. The objective of a strategic acquisition is to acquire the resources needed to exploit the opportunity. Opportunities themselves come from many sources, for example:

- Changing needs of customers,
- New legislation,
- Failure of competitor,
- New technology,

- Disaster (natural or terrorist).

The rewards for the acquiring company are to take advantage of an opportunity. In negotiating the deal, the buyer needs to have a good idea of the size of the opportunity in order to assess the investment returns. To the extent that the selling firm is more able to provide the solution (better fit, more timely, less problems in the acquisition), or more able to enhance the opportunity (fit, scalability, less problems in the acquisition), the more the buyer may be willing to pay to acquire the assets or capabilities required to pursue the opportunity. The valuation of the acquisition relative to the opportunity is thus a factor of the size and timing of the net profit which can be generated through the assets and capabilities acquired.

Opportunities can often be very large in potential returns if circumstances permit. Here the key to the price the buyer may be willing to bid is scalability of the opportunity and rarity of the solution. The more the activity can be scaled, the greater the potential financial reward to the buyer. The earlier such scalability can occur, the higher its net present value. The more unique the solution relative to market conditions, the greater the competitive impact and therefore the higher the margins and thus the higher the potential profits.

Opportunities can be seen as a combination of time and risk. Thus the earlier the opportunity can be exploited, the higher its value. Similarly, the lower the risk associated with pursuing the opportunity, the higher the probability of the target revenues being achieved. Opportunities can be described using a business development matrix:

Market Development Strategy	Existing Markets	New Markets
New Products	Cross-sell	New business creation
Existing Products	Increase frequency Increase margins	Expand markets New customers

Existing products and existing markets represent lower risk situations. New products and new markets represent higher risk situations but also can be expected to take longer to exploit. Where the buyer is able to leverage the acquired assets and capabilities into more than one of these categories, it has greater possibilities with the acquisition and therefore may be more willing to pay a higher purchase price.

Enhancing Existing Products/Markets

The seller may provide the capability for the company to reduce costs and/or enhance the sales value of their existing products thereby increasing margins. This may be through technology, better processes or capabilities in sales or marketing. Additional benefits may come from combining operations to gain lower costs through economies of scale or learning curve effects.

Increased customer penetration or frequency of use may come from finding additional uses of an existing product by incorporating new components, replacing components, changing packaging or changing the marketing messages. The buyer may be able to use the acquired technologies, processes or knowledge to enhance existing products to create new business within existing markets.

Example (Author's italics)

San Jose, CA, July 8, 2003 -- Pericom Semiconductor Company (Nasdaq National Market:PSEM) today announced that it has signed a definitive purchase option agreement to acquire the net assets of privately held SaRonix LLC of Menlo Park, CA., subject to the completion of due diligence and customary closing conditions. SaRonix and Pericom are executing joint marketing and product development initiatives for crystal based products including clock recovery, frequency translator and timing modules.

The acquisition will add to our core competencies by enabling technologies for new products, enhancing customer service and streamlining value added solutions for the combined customer base. Both Pericom and SaRonix focus on the computer, networking, telecom and storage markets, have many common major customers and complementary geographic strengths

Source: <http://www.pericom.com/corporate/> accessed 8th September 2003

A very common reason for an acquisition is to reduce costs through new technologies or to build additional differentiation or competitive advantage into existing product offerings.

Example (Author's italics)

Software mergers are notoriously difficult to pull off, from both technology-integration and go-to-market perspectives. PeopleSoft certainly said all the right things: its products and customers seldom overlap, its sales force is in training and is ready to go, ***it will realise more than \$200 million in merger-related cost savings and some of the most popular products will be integrated by year's end.***

Even if the truth is a little less optimistic, a stream of PeopleSoft executives made a compelling case for a successful integration. Indeed, PeopleSoft focuses mainly on sales to large companies while J.D. Edwards' expertise is in the mid-market, or companies with \$1 billion or less in revenue. According to Phil Wilmington, executive vice president of PeopleSoft's Americas business, that means more cross-sell and up-sell opportunities. 'More products mean more revenue,' he says.

Michael Gregoire, head of services at PeopleSoft, says 'JD Edwards looks like PeopleSoft did three years go.' He says only one-quarter of JD Edwards sales come from existing customers. 'This is too small. They need to upgrade.'

Source: <http://forbes.com/2003/09/05/> accessed 7th September 2003

Both businesses have their own niche markets. The question is – did PeopleSoft really achieve the cost savings it predicted?

New Products to Existing Customers

Many acquisitions are made by companies to acquire additional products which they are able to sell through their current distribution channels to their existing customers. Expanding the portfolio of products can be very cost effective as relationships with customers are already in place or their brand is already known. Creating differentiated products through an expanded solution set may be a very effective hedge to competition. Alternatively, adding complementary products may allow the company to increase its penetration into existing market sectors.

Current Products to New Customers

The selling firm may have access to a customer base where the buyer has none or little presence. This could be a new geographical area or a new sector. Often firms buy their competitors for this reason. They can then switch the customer solution across to their own products providing economies of scale benefits as well as taking out a competitor. This strategy is also used to increase coverage within a sector, especially expansion overseas where the buyer will be acquiring a presence in a market, local knowledge, local capability, distribution channel and critical mass. This strategy can be especially effective where the selling firm has a very large customer base but few products. A company with a wide range of products which can be sold to the same customer base is effectively buying a developed channel to market.

Another form of expansion is to find a new mission for existing products by selling into a different sector where the product might be used differently. Often with this type of acquisition, the buyer is seeking to acquire knowledge

of the sector. Every market has its own way of doing business. Acquiring a firm, for example, which undertakes government contracts, would allow a firm to acquire deep knowledge of how to secure new business in that sector.

Cross-selling of Products to Both Customer Bases

The selling firm may have a set of products which can be sold into the existing distribution channels of the acquiring company. At the same time, the buying company may have products which are able to be sold back into the customer base of the firm being acquired. Such an acquisition is especially attractive where little additional resources have to be expended to introduce the new products into the existing distribution channels. In these situations the return on investment for the acquirer can be especially high and the payback on their investment relatively short.

This strategy can also be used to effect an entry into a new market where local knowledge and local products can be readily enhanced with the company's own set of products. At the same time, the acquired products can be brought back to benefit the company's existing distribution channels.

Example (Author's italics)

San Jose, CA, July 8, 2003 -- Pericom Semiconductor Company (Nasdaq National Market:PSEM) today announced that it has signed a definitive purchase option agreement to acquire the net assets of privately held SaRonix LLC of Menlo Park, CA., subject to the completion of due diligence and customary closing conditions.

Both Pericom and SaRonix focus on the computer, networking, telecom and storage markets, have ***many common major customers and complementary geographic strengths.***

Source: <http://www.pericom.com/corporate/> accessed 8th September 2003

New Products to New Customers

This type of acquisition is an expansion strategy where the firm desires to break into a new sector but requires a new capability to do so. This could be in a related sector where there is some commonality in market approach or could be very different where the firm has no synergy to leverage. This strategy is often used by firms aggressively seeking growth or by companies trapped in declining sectors and needing to find new sources of revenue.

Example (Author's italics)

Also buying their way deeper into EBPP are InteliData and Avolent. The former announced earlier this month that it is acquiring Home Account Holdings Inc., of Emeryville, Calif., its Home Account Network Inc. subsidiary and ***its suite of Unix-based Internet banking and EBPP products.***

InteliData, of Reston, Va., already offers remote banking services to financial institutions. The deal *gives the company a broader customer base*—including credit card issuers—and a fast handle on Home Account's current client roster, including some of the country's top financial institutions, such as Bank of America Corp., Citigroup Inc. and First United Corp.

Source: Acquisitions Help Spur EBPP, by Renee Boucher Ferguson January 22, 2001, <http://www.eweek.com/> accessed 6th September 2003

Current Products and New Product Potential

The selling firm may have products which the company can utilise immediately within its existing distribution channel. This alone may be sufficient to justify the acquisition. A firm which, in addition, has products under development and which can open up new markets or technology that can be used over a longer period to enhance existing products from either company, can offer very attractive long-term benefits to the acquirer. While the buyer may not be willing to increase its purchase price for the longer term potential, the acquisition may gain greater favour within the company thus ensuring a greater commitment to complete a deal.

A solution which offers new products to existing customers while opening up new customer sectors can be very rewarding to an acquiring firm. The initial investment may often be recovered quickly by selling into the existing customer base while a new customer base is being evaluated and a strategy to penetrate it put into place.

Threat and Opportunity Synergy Acquisitions

Sometimes the buyer can be lucky to find a solution which plays to multiple needs, especially in reducing a threat while offering access to new markets. The threat places time pressure on the buyer to seek out an acquisition while the rewards of new products or new markets allow them to more easily justify the acquisition price. Threat solutions can sometimes be resented by the buyer when they feel compelled to complete the acquisition but may feel no upside in the deal. Reward deals are more readily accepted as the buyer can demonstrate how the investment can be recovered through increased sales.

Example (Author's italics)

eTime Capital Inc., IntelliData Technologies Corp. and Avolent Inc. are acquiring companies to jump-start their respective EBPP offerings, while iPlanet E-Commerce Solutions and MetraTech Corp. have announced EBPP ***additions to their applications.***

EBPP lets companies send bills over the Internet to business and consumer customers and allows those customers to pay online.

eTime Capital, which provides transaction reconciliation and settlement services, will announce this week its acquisition of Dynamic Transactions Inc. The purchase of DTI, best known for its PayPlace service, which settles payments between online buyers and sellers, ***will propel eTime Capital into the EBPP space and shave months off product development time,*** according to officials of the Sunnyvale, Calif., company.

For its part, San Francisco-based Avolent last week said it had completed the acquisition of Solant Inc., which ***has expertise in business-to-business electronic bill payment, reporting and analysis.***

Source: Acquisitions Help Spur EBPP, by Renee Boucher Ferguson January 22, 2001, <http://www.eweek.com/> accessed 6th September 2003

Many companies pursue a build out policy to offer more products to existing customers as well as to break into new markets.

Expanding into New Markets

Often it will be easier and potentially less risky for a corporation to buy its way into a new market through an acquisition. This could either be a similar business but in a new geography or a different business where the acquisition already has market knowledge and capabilities.

Limitations on Scalability

The key to opportunity exploitation for a larger enterprise is to acquire an asset or capability which can be readily replicated or scaled to meet the coverage or volume needs of the buyer. However, there are circumstances which can severely limit the scalability of an acquired asset or capability. This is something the buyer needs to be especially sensitive to in undertaking its investigation. Here are some examples of situations which inhibit scalability:

Location

A firm located in a region or section of a city with difficult access or lacks good infrastructure and is unable to be relocated.

Tied to Culture

A product or service which is tightly tied to one limited culture.

Tied to Legislation

A product or service tightly coupled to local, state or national legislation which cannot be ported to another jurisdiction.

Locked into One Customer

Products or services contracted to one customer or custom designed to suit one customer's specific requirements.

Un-codified Knowledge

Firms which do business out of their heads rather than using a systematic procedure or process which can be readily passed on to new employees are limited in scope.

Highly Dependent on One or Few Individuals

This occurs where a small number of individuals are critical to making a business work and are linked closely to specific customer solutions. This can be difficult for the buyer as they face a risk of losing the capability if the key individuals leave.

Incomplete Solutions

Scalability requires that the product or service be complete, tested and stabilised in customer reference sites.

Lack of Standardisation

Firms which customise their solutions for every customer often require a high intellectual input. This requires high calibre staff with deep knowledge. The best situations for scalability are where the products are standardised and the level of intellect required to sell, install and support the product is relatively low.

In order for the opportunity to be exploited by a large company within a relatively short period, the buyer needs to ensure that the buyer and/or the seller has the capability which allows the acquired asset or capability to be readily replicated or scaled. If the buyer, and/or the seller, is unable to provide the support to exploit the asset or capability properly, the company may decide not to undertake the acquisition. Few large companies are willing to take on products or processes which can only be easily used in a small part of their business. Scalability would normally mean that increased capacity can be quickly added, essential knowledge is well documented, there are people available who

are capable and able to quickly train large numbers of staff to use the newly acquired products or processes and so on.

Timing Relative to an Opportunity

Timing is relative to the impact of the opportunity on the company and whether the opportunity will evaporate or decline if not acted upon. The opportunity cost, that is the cost of not doing something, might be high, but it may not reduce current revenue.

In essence, the more time the potential buyer has to find an alternative solution, the lower the strategic value of the acquisition. In turn, where companies are forced to seek solutions externally to a potential opportunity and where time is short, the more likely they are to pay a premium on the acquisition.

A company may aggressively seek an acquisition if the window for exploiting the opportunity is closing and the company does not have the resources or the distribution channels to exploit it. Rather than see the opportunity expire, the company may seek out targets which have the resources, channels or complementary technology or capabilities which would allow the company to exploit the potential opportunity.

Evaluation of the Acquisition

The evaluation of strategic acquisitions should start by evaluating the target firm in isolation. This process places a value on the firm as a stand-alone investment. Once this has been completed, the target acquisition is then evaluated in combination with the acquirer, that is, what additional revenue and profits are generated through the buyer's organisation as a result of the acquisition.

The first stage of an evaluation of a strategic acquisition should be to investigate it as if it were a financial acquisition. This evaluation is simpler and more straightforward than an evaluation of strategic benefits. If the target is able to provide an adequate return based on its inherent profitability and the business can be secured for a purchase price which provides a positive return without taking into account its strategic impact, this promises to be a very worthwhile investment. An investigation based on the process outlined for a financial acquisition will also ensure that the target is investigated properly as a stand-alone business. This evaluation may be quite useful when it comes to determining the level and timing of integration efforts. To the extent that the business is able to provide positive cash flow, the pressure on the company to speed up integration efforts or to rush to exploit the acquisition for its strategic benefits is lessened.

A threat has the potential to reduce current revenue and/or increase costs. Thus an acquisition which has as its objective the elimination or mitigation of a threat, should be seen alongside the net impact on the company. For example, if a threat was estimated to reduce future short-term contribution by \$10 million and the acquisition could reduce this to \$4 million, then any purchase price, inclusive of costs and integration expenses, less than \$6 million would justify the acquisition.

In terms of opportunity exploitation, the company needs to estimate the future net cash flow generated from the acquisition. Provided the net present value of such cash flow, using an appropriate discount rate to reflect the risks in the deal, is greater than the purchase price for the acquisition, the investment is justified.

With financial acquisitions only limited integration is undertaken, generally in the area of central services and administration activities. Strategic acquisitions may or may not involve integration activities. There are some types of strategic acquisitions where the assets and capabilities acquired can be transferred to the buyer without integration. This may be where the acquired brand, copyright, patents, trademarks, expert knowledge and so on are able to be used by the company without interfering in the operations of the acquired business. Such acquisitions are somewhat easier to evaluate as the lack of integration activity substantially reduces the potential of disruption due to organisational changes resulting from merging organisation units.

Where integration activities are insignificant, the evaluation can readily separate the valuation of the stand-alone acquired firm from the benefits sourced through the buyer's organisation.

However, many strategic acquisitions do require some, if not substantial, integration. This aspect of the acquisition substantially increases the possibility of failure but also extends the time before opportunities can be exploited or threats eliminated. Of major importance is the degree of cultural change which has to be achieved in one or both of the merging units. To the extent that internal cultures are different, major risks present themselves and more extensive change control processes need to be used to achieve benefits. Such culture change will increase costs of integration as well as delay or disrupt one or both of the businesses. Such negative impacts need to be taken into account in the net cash flow projections.

There are many strategic acquisitions undertaken where the target firm was making losses prior to the acquisition or where substantial funds need to be injected into the operation in order to stabilise it. These acquisitions may be justified on the basis of access to unique assets or capabilities, but the

company needs to be sensitive to the fact that such acquisitions will require funds considerably greater than the purchase price in order for positive benefits to be achieved.

Many acquisitions are justified solely on their cost synergies but these cost savings are often illusory. Just because something looks possible in theory does not mean it can be achieved in practice, nor at the level expected or within the time estimated. Anticipated benefits may be in headcount savings but often more people leave than intended and recruitment costs escalate. At the same time, the acquirer underestimates the level of disruption to existing business, the loss of corporate knowledge and the impact of terminations and resignations on those who remain. Research shows that few acquirers realistically estimate the costs of integrating infrastructure or realistically estimate the length of time it takes to finish the integration tasks.

The synergies of cost savings, revenue enhancements, and process improvements may be easy to understand conceptually, but our research demonstrates how hard they are to forecast accurately. Why? Most calculations of synergy value occur under horrendous conditions: time pressure is intense, information is limited, and confidentiality must be maintained. Since conditions are so far from ideal, the managers and board members responsible for the final decision should always scrutinise the assumptions underlying the numbers.

Source: Are You Paying Too Much for That Acquisition?, by Eccles, Robert G., Lanes, Kersten L., Wilson, Thomas C., Harvard Business Review, 00178012, Jul/Aug99, Vol. 77, Issue 4

If cost synergies are the only benefits arising from an acquisition, it is probably going to result in a failure. Few acquisitions achieve the cost synergies they set out to achieve. They neglect to take into account the impediments which hinder headcount reduction, change of systems, terminating leases, selling off excess assets, relocating staff and so on. Realistically, integration probably costs more than it saves. Thus an acquisition which cannot contribute to revenue generation is unlikely to achieve its investment return.

In many cases competitive bidding for a strategic acquisition will push the purchase price up to a point where a premium over the industry norm earnings multiple will be paid. This often leads to a situation where the acquisition is dilutive of earnings in the first year of the acquisition. However, it would seem that the market is prepared to positively view strategic acquisitions which deliver substantial future earnings capability. In their book *Mastering the Merger*, David Harding and Sam Rovit investigated earnings dilution and found that corporations undertaking dilutive deals outperformed accretive deals, perhaps

because such deals involved buying 'higher growth assets'. (Harvard Business School Press, 2004)

Conclusion

There are many types of strategic acquisitions and they cannot be lumped together and evaluated using the same model. Those which negate or mitigate threats need to be evaluated against the impact of the potential threat. On the other hand, those acquisitions which enable the company to exploit an opportunity should be evaluated against the net present value of the future net cash flow generated through the acquisition.

Integration is often involved in a strategic acquisition since by definition the benefits are achieved through the company's organisation. Integration activities pose major problems for acquirers as they involve change processes often in the acquired as well as the buyer's firm. The changes imposed on the organisation create stress and tension in all areas impacted by the integration activity. These activities need to be handled with great care otherwise the acquisition can quickly spiral into a crisis where good people resign, productivity suffers, revenue reduces and costs escalate.

Where a potential acquisition requires an integration effort, the entrepreneur needs to bring in the skills and knowledge to support such an activity. Detailed plans need to be constructed for managing the human and task integration and care needs to be taken to retain key employees.

Strategic acquisitions can significantly contribute to growth capacity and capabilities and for that reason are worth investigating, but unless the company can reliably undertake the management of the new business and the integration activities needed to achieve the benefits of the acquisition, it should look to other strategies to achieve growth.

Key Points

- Most acquisitions are referred to as 'strategic' but there is considerable confusion as many different forms of acquisitions are grouped together. The key to a strategic acquisition is that the benefits of the acquisition are substantially achieved through the operations of the buyer rather than those of the acquired firm.
- There are two major forms of strategic acquisitions; those which mitigate or eliminate threats and those which allow the buyer to exploit an opportunity.
- The valuation of a strategic acquisition can be problematic as it often requires the buyer to identify the impact of the acquired business on its own operations. An acquisition which can be justified as a stand-alone business before taking into account the synergistic benefits is easier to justify.
- In the case of opportunity exploitation, the buyer needs to ensure that it has the capability to manage and fund the scalability of the assets and capabilities required to secure the benefits.

Chapter Eight

Evaluating Cultural Fit

Overview: Many acquisitions fail because the human side of the acquisition has not been properly considered nor managed well. The culture of an organisation determines how it functions, what choices it makes and what it promotes or sanctions. Coupled with the manner in which the organisation works are the underlying ethical values of the organisation which determine the manner in which it acts and reacts to difficult situations involving judgement about what it considers proper or right. Where the culture of the buyer and seller are very different, individuals who join the buyer through an acquisition will often find it very difficult to make the transition and many will leave or suffer stress, disengagement or resentment. Managing cultural transition is the most difficult of all the tasks facing an acquirer.

In acquisitions where acquiring knowledge or capabilities is an important aspect of the investment justification, the ability to manage the human dimension of the acquisition is critical to achieving a return on the investment. Professional advisers typically concentrate on the financial and legal aspects of the due diligence neglecting the organisational and human aspects. However, as numerous studies of acquisitions and mergers have shown, the major cause of failure to achieve the target return on investment in the acquisition stems from a failure to resolve the integration of business units. While there are often resource integration issues which are problematic, these can usually be overcome. People integration issues, however, seem to present a greater challenge and sometimes are unable to be resolved during the integration process. Thus it is imperative that an evaluation of the human aspects of the acquisition is undertaken if the acquirer is to avoid this common cause of failure.

In their book *The Complete Guide to Mergers and Acquisitions*, Timothy J. Galpin and Mark Herndon provide a list of references to studies of mergers and acquisition failures where cultural fit has been the major cause of the failure.

The overwhelming conclusion of these studies was that the human integration activity was the most problematic of all acquisition integration activities. (Jossey-Bass, 2000)

In a major study of organisational cultural differences in 73 acquisitions, Weber and Menipaz were able to show that cultural differences increased acquired executive turnover and reduced shareholder returns. Their conclusion was that ‘cultural fit is an important factor that should be considered in all stages of M&As.’

(Weber, Yaakov and Menipaz, Ehud., (2003) Measuring cultural fit in mergers and acquisitions, International Journal of Performance Management, Vol. 5 no. 1)

The difficulty facing the entrepreneur intent on an acquisition strategy is that the definition of a firm’s culture is a somewhat vague dimension. The questions of ‘What is it?’ and ‘Is it different from my own?’ are hard to answer without first gaining an appreciation of what culture is and how it impacts on the integration of two organisations.

The issue which the entrepreneurs must ultimately deal with is not what the culture is, but whether the proposed integration will confront a major difference in culture. Thus an understanding of those factors which underpin culture can help highlight where differences exist and where problems may arise.

What is Organisational Culture?

Organisational culture defines the ‘soft’ characteristics of an organisation and helps us understand why individuals within an organisation act the way they do. Thus culture includes such things as values, beliefs, ideologies and ethical standards. These are supported by rites, rituals and ceremonies and reinforced by stories about heroes; those people held up for admiration and respect in the organisation’s history. Culture helps define acceptable behaviour within the organisation and indicates which behaviours will be approved and supported and which will be unacceptable or discouraged.

Typically, members within an organisation will have shared goals for the organisation and shared beliefs about how the organisation will achieve those goals. These beliefs will include the way in which the organisation deals with its own members and with parties external to it. In this regard, the ethics of the organisation can be seen at play in the way it makes decisions or reacts to problems. One might simply say that we can define an organisation’s culture by the phrase ‘this is how we do things around here!’

Many people see organisational culture simply in terms of values. While values are the key to an understanding of an organisational culture, they are only a part of the culture structure which the acquirer must deal with. Any organisation which has been established for some time will have embedded values into its fabric, but values are only part of the picture.

Culture is often borne out of common experiences where executives have jointly resolved a problem. This shared experience will reinforce the way in which they will approach the same decision situation in the future. The group also learns to interpret information using a common set of assumptions, thus two different groups of executives may interpret a similar situation quite differently.

The preferred culture is reinforced by a system of rewards, recognition, promotion and favours while unacceptable practice will be associated with punishments, isolation, demotion or termination. Thus an organisation tends to retain those who conform to the dominant culture and discard those who don't 'fit in'.

'Values are our fundamental beliefs or principles,' he says. 'They define what we think is right, good, fair, and just. Ethics are behaviors and tell people how to act in ways that meet the standard our values set for us. The crux of that distinction for organisations is this: It's not the company's place to tell you what your values ought to be; they come with you when you enter the workplace. But it is the company's responsibility to set behavioral standards and its obligation to train employees in what those standards are.'

Source: Do the Right Thing, Salopek, Jennifer J., T+D, 15357740, Jul2001, Vol. 55, Issue 7

Cultural differences readily exist within organisations between business units. Thus an R&D department may encourage informality, flexible hours, innovation and professional development while a manufacturing unit might require rigid adherence to a dress code, working hours, conformity and team support. The integration problem arises when an individual is required to move from one working environment to another where a very different culture exists.

Individuals often choose employment based on an alignment of their personal values with those of the place where they work. Changing the culture can create a conflict between their personal values and those of the new place of employment. If the difference is perceived to be too great to be acceptable, their reaction might be hostile, uncooperative, intractable or they may simply resign. The entrepreneur therefore needs to identify possible situations where this culture clash may occur in the proposed integration to decide if acquisition benefits can still be achieved with the loss of employees or in the presence of a hostile workforce. Alternatively, the entrepreneur might decide to proceed

with the acquisition but to structure the acquired business in such a way as to retain the culture elements needed to retain key individuals. Finally, the decision might be made to terminate acquisition discussions if the anticipated culture conflict is unlikely to be overcome.

The Influence of Structure and Environment

Values are often supported by the structure and environment in which the business exists and evolve in part as a result of the manner in which the organisation was formed and developed. Thus most new ventures have an entrepreneurial culture which stems from the character of the founder. Over time this approach to business moderates as the business grows and new employees join who have experience within larger organisations where more formal systems are the norm. As the founders depart and retire and the business grows further, there gradually becomes a separation between ownership and management. Managers gradually impose their own aspirations on the business and the organisational culture adapts to the new objectives.

Thus culture is not static. It adapts to changing conditions and to the size and complexity of the business. Businesses which require a high degree of integration between value adding functions can be expected to be managed very differently from a business built around a series of one off projects which require the assembly of functional experts.

There are numerous characteristics of the firm which define its structural or environmental dimensions which will influence the nature of values present.

Size

One would expect the nature of the interaction between individuals, the manner of selection, advancement opportunities, benefits and decision-making processes would be very different as the business increases in size.

Location

The geographic location of the business can help identify possible values of the employees. Thus a business located within the central business district of a large city is likely to have a very different working climate than one located in the country or in a beach resort.

Dispersion

A business organised over different locations, especially if located at some distance from each other, will have developed processes of decision-making which are likely to be very different to a business located on one site.

Diversification

Some companies are segmented into a number of business units. Those which have disparate businesses with little interaction can be expected to have quite different planning and decision-making processes than one which is organised around an integrated activity or one which has only one core function.

Age

The age of the business can be very important in determining the likely level of entrepreneurial or innovative activity and the level of risk tolerance. The presence in the business of the founders will have a marked impact on the orientation of the firm in terms of tolerance for uncertainty and ambiguity as well as deference and respect for the founders.

Family Involvement

Family businesses typically have very different decision-making processes than non-family businesses. Consideration of the views of non-working family members in major decisions and aspects of succession planning are generally very different in a family business.

Product vs Project

Product based businesses are typically organised around supply chain activities with line and staff delineations and authorities clearly defined. Project based businesses, on the other hand, are often structured as matrix organisations where functional or professional expertise is the dominant base for promotion and rewards.

Product vs Service

Product based businesses are typically structured around physical facilities which are the basis of product construction, storage and despatch. Intellectual property is typically well-documented and implemented in formal systems and processes. Usually business processes are highly structured and tightly integrated between departments. Service organisations, on the other hand, are most often built on individual expertise and knowledge. Personal relationships both within the business and externally are often critical to achieving business success. Business processes are often undocumented or limited to administrative functions.

Foreign Culture

It should be anticipated that a business located in a different country will involve a vast array of different cultural characteristics.

These environmental characteristics tend to suggest that businesses with similar environmental and structural characteristics would evolve similar cultures. While this is true to a limited extent, there are many other elements of culture which determine how an organisation functions. If the target acquisition has a similar structure and business environment, these issues, themselves, should present few problems in the integration of the two organisations. However, to the extent that they are very different, it is likely that many other characteristics of culture will be different and therefore the evaluation of potential integration problems should be sensitive to this information.

Working Environment

Anyone who has worked in an open plan office and has moved to one which is composed of isolated offices and long unfriendly corridors has experienced culture shock. The way we interact with our co-workers has a great influence on our satisfaction with our time at work. Thus major differences in the working environment and in social interactions at work and outside work impact on our sense of comfort.

Open Plan vs Offices

Personal interaction with those around you is greatly influenced by physical distances and physical structures. The nature of personal conversations is different as is the content. Norms are established in terms of personal and business discussions, external contact, personal interactions, personal space and freedom to interrupt others.

Personal Space

In some organisations individuals are encouraged or tolerated to have personal mementoes adorn their work space. In other organisations such behaviour is discouraged.

Informal or Formal Environment

Whether first names or nicknames can be used within a work context very much depends on the office culture. This especially applies to those above and below you in the structure. Some organisations have a very informal environment where everyone is referred to by their familiar name while others are quite rigid with respect to titles and surnames. Dress codes can

vary greatly between organisations. Some adhere to a strict code of formal business attire while others allow casual and informal dress.

Flexible Hours and Hours Worked

Some organisations allow individuals to vary their hours of employment to suit personal commitments while others are very rigid. This also applies to the number of expected hours worked. Some organisations expect employees to put in additional hours, often with no compensation.

Home Working

Working from home is a common practice for many project based organisations. It is also common with knowledge based workers who can undertake activities in isolation or through an internet connection.

When Monsanto agreed to a \$35 billion buy-out by New Jersey based American Home Products, the business synergies seemed ideal: The companies even recognised some cultural differences and hired consultants to help them navigate those differences and anticipate potential bumps along the way. Yet, it became clear as they moved toward consolidation that this was not a merger of equals and AHP's culture would predominate. One of several last straws came when AHP refused to support telecommuting in the way Monsanto had encouraged it and demanded that some key employees move to the New Jersey office. Many of them simply said, 'No thanks,' and found other work near their homes. This quickly became a problem because a portion of the creative talent that was key to Monsanto's continued success had telecommuted to work. The end result was a drastic talent drain and the subsequent break up of the deal costing both Monsanto and AHP millions of dollars in fines and lost revenues and forcing them to further cut thousands of jobs within both companies.

Source: <http://gbr.pepperdine.edu/041/mergers.html> Accessed 2nd June 2006

In the matter of working environment, there is no question here of what is right or wrong, but individuals become used to a specific manner of interacting and this can become a matter of comfort for them. Some are able to adapt to a different situation while others may find it stressful and decide to leave. The issue here for the entrepreneur is to be sensitive to the changes which might be introduced during integration. Individuals who are comfortable in one context may be very uncomfortable in another. Individuals who prefer a formal working environment may be like a fish out of water when suddenly thrown into a very informal environment as would be the case the other way around.

Decision-making Processes

If you have been used to making your own decisions and organising your own work activity and you are transferred to a very bureaucratic organisation, you will experience culture shock. It is very difficult for an individual who has become used to a great deal of freedom in determining their own work pattern to suddenly have to seek direction, justify their actions and then explain their outcomes to someone who has the task of reviewing their performance. The way in which organisations make decisions, empower workers and oversee performance can vary greatly.

Command and Control

The classic bureaucratic organisation is highly prescriptive as to how decisions are to be made in terms of who can make the decision, what information is required before the decision can be made and how the decision is to be approved. Little room is left for individual initiative or innovation. The essence of such an environment is predictability. Other work environments encourage individual initiative, provide space for personal input into decisions and activities and promote innovation.

Tolerance of Mistakes

Reaction to employee mistakes varies greatly between organisations. Those which encourage innovation and risk taking need to also tolerate mistakes if individuals are to be encouraged to step out of their comfort zones. If mistakes are penalised, employees quickly learn not to take risks or to depart from the norm.

Personal Empowerment

Many organisations set overall targets for activities and let employees decide on how they are to be achieved. This often occurs with knowledge workers but could also be applied to sales, customer relationships and design. However, other organisations find this too difficult to manage and severely limit individual freedom and action.

Core knowledge workers such as scientists, engineers, and professionals need to be managed very carefully during the integration process. Such people are used to doing things their own way. They like some guidance, but hate direct orders; they like to be consulted, but don't necessarily want a high level of responsibility. Managing them can be difficult at the best of times, requiring great patience, give-and-take, and a high level of trust to be effective. But such qualities are seldom in evidence in the early days of an acquisition. Consequently,

effective acquirers in such situations tend to move very circumspectly and with enormous respect for the knowledge workers they are acquiring.

Source: Acquiring Intellect: Managing the Integration of Knowledge-Intensive Acquisitions, by Birkinshaw, Julian, Business Horizons, 00076813, May/Jun99, Vol. 42, Issue 3

Locus of Control

Freedom to determine strategy and/or tactics may be devolved to business units and/or departments where overall target performance is reported. Alternatively, very detailed plans of activities may be prepared for the unit or department and approved by a higher authority.

Individuals who have been used to some level of freedom to determine the way in which they undertake their tasks are often very resistant to any change in their arrangements. Imposing a new structure on them may simply encourage them to seek alternative employment where they can retain the level of flexibility or freedom they are used to. Alternatively, suddenly providing much greater freedom may be threatening to individuals who have been used to being instructed in their duties. Either way, any major change may have negative consequences for the acquirer.

Remuneration and Benefits

The source of many cultural problems occurs in personal rewards, benefits and motivations. Organisations can vary greatly in terms of the formality of their structures, job descriptions, salary determination and benefit entitlements and so on. Individuals are often attracted to businesses which have remuneration and benefits which meet their personal needs. Where these are subject to any significant change, deep resentment and unrest can result or individuals may leave to find employment which better suits their personal circumstances.

Commissions, Bonuses and Personal Rewards

Some businesses are aggressive in the way they motivate individuals through personal rather than group rewards. Commissions and bonuses can be tied to specific performance rather than team or department results. Some businesses pay bonuses based on company profits, offer discounted prices on company share purchases and/or offer options as incentives and rewards. These reward systems can be in direct contrast to organisations which offer only salaries as compensation or tie bonuses and other rewards to team or department performance.

For example, a company with only 10 grade levels will have to integrate the acquired company's 23 grade levels. And the companies may have very different methods for determining merit increases, as well as short and long-term incentives.

Source: Merging Compensation Strategies, by Wells, Susan J., HR Magazine, 10473149, May2004, Vol. 49, Issue 5

Promotion

The manner in which individuals are recruited, inducted, trained and promoted can vary greatly between organisations. Some organisations only believe in training for a specific job and undertake little personal training outside of the job requirements. Other businesses offer extensive educational and training opportunities both inside the business and through external education opportunities. Promotion can be based on performance, seniority, formal qualifications or personal relationships.

Staff Retention

Some companies put extensive effort into retaining individuals and in finding the best opportunities for them within the organisation. They acknowledge individual differences and work hard to find the appropriate position which best suit the individual's skills and career desires. Others see employees as work units to be exploited while they are with the business and to be readily replaced if they wish to leave.

Other Benefits

Most companies have a range of additional benefits which form part of the overall employment package. These can be wide ranging and include purchase discounts on company products and services, insurance, education costs, childcare, car allowance or a company car, private health insurance, additional pension or superannuation contributions, uniform allowance, allowance for personal time, generous sickness benefits, flexible hours, time off in lieu and so on. Depending on the individual and their personal, family and financial circumstances, such benefits may be very important to them. Any changes, even if other benefits are offered in compensation, may not be received with enthusiasm.

Individuals plan their personal lives around their anticipated remuneration. If the acquirer has a very different system of remuneration and benefits and desires to alter the seller's remuneration systems, they need to be very sensitive to how this will impact the individuals concerned. If the newly merged

employees are going to be better off across the board, this may not be a problem, although there will still be a good deal of unrest until they are convinced of its implementation.

If, however, the buyer desires to make substantial changes in the rewards systems and those changes fundamentally alter the way people are motivated and rewarded, this may not suit many of the new employees. In this scenario, many could decide to leave rather than take the risk of being worse off. For example, outstanding workers who normally receive large personal bonuses may be very reluctant to work in a situation where they are dependent on others in their team or department for their bonuses. Alternatively, those used to working in teams may be very unwilling to work in a situation where their personal contribution is the basis for their commissions or bonuses.

External Relationships

Attitudes to customers, suppliers and partners vary greatly between organisations. Some businesses attribute their success to their relationships with external parties. They treat them as valued parts of the business and treat them with honesty, respect and service. They build value through close partnerships with their external partners and include them in their strategic planning. These companies tend to have high levels of account penetration, cross selling levels and referrals.

Other businesses work at the other extreme. Customers are there to be exploited, suppliers are treated as transitory and are pushed to provide the lowest cost and distributors and agents are simply another channel to market to be used when convenient. These companies have low referral rates, high levels of complaints and a high turnover of partners.

Handling Mistakes

Some businesses freely admit when they have made a mistake with an external partner and will do anything to bring the situation under control and compensate the partner for their mistake. This attitude dominates their customer relationships where customers are valued and treated with respect and honesty. Other companies are highly reluctant to admit a mistake, will find fault with the other party and will use legal agreements and loopholes to prevent having to compensate the external party.

Inclusiveness

Customers, suppliers and strategic partners are often included in planning discussions in some companies as those businesses try to find solutions to

growth which will impact all their stakeholders. They take advice from their partners and ensure their partners understand the issues they are dealing with and ask their partners to take an active part in discussions so they may all share in the risks and rewards associated with their joint activity. Other companies exclude external parties from any planning discussions and will freely change direction to the disadvantage of their partners if it suits their personal plans.

The external interfaces to customers, suppliers, partners, professional service firms, bankers and others can indicate much about the way companies deal with problems, opportunities and business interactions. Individuals are encouraged to work and collaborate with external parties in a preferred manner. This in turn impacts on the way in which external parties deal with the company. Thus a company which deals with external parties in an adversarial manner will find it very difficult to change its working style to deal with external parties in a collaborative way. A business which approaches its customers with an expectation that the customer will take advantage of them and where they expect to deal with the customer only once will find it very difficult to switch over to a collaborative mode. You can imagine how difficult it would be to suddenly change the manner of doing business where you now are expected to trust the customer to deal with you in an honest and forthright manner and where doing the right thing by the customer is expected to lead to further business and referrals.

The Integration Problem

The objective of an acquisition is to bring benefits to the acquirer which justifies the investment made. There are benefits which arise from an acquisition which are independent of the human component. These would include such elements as better utilisation of plant and equipment, IP, brands and reputation of the acquired business, savings and funds which arise from closing down facilities, selling off underutilised plant and equipment and disposing of business units which are not wanted. However, most acquisitions expect to realise benefits from the knowledge and skills of the acquired employees. This is where the greatest difficulties arise.

Integration of acquired businesses can take place at many different levels and in many different forms. For example:

- No Integration – the business is held as an investment.
- Financial Integration – the business is managed at a gross financial level only. Major financial decisions on how to use funds, such as capital

expenditures, borrowings and investments are subject to approval. Financial reporting would be modified to conform to corporate standards.

- Corporate Administrative Functions – various administrative functions such as treasury, human resources, health and safety, legal, auditing and so on would be taken over by a corporate office.
- External Relationships – administrative functions such as those involved in dealing with suppliers, distributors, agents and strategic partners may be combined to avoid duplication of effort and overlap of relationships.
- Sales and Marketing – if the benefits of the acquisition are to acquire new products or services to be sold through common channels, these groups would be integrated under a common function.
- Manufacturing and Distribution – if the benefits arise from acquiring plant and equipment and/or manufacturing capacity, it is likely that these functions would be reorganised to optimise the overall output. Thus product lines might be combined or moved, some facilities might be closed or expanded and so on. Logistics consolidation might involve closing warehouses and combining transportation facilities.
- Research and Development – combining knowledge based workers where some level of creativity and individual initiative is important for productivity can be extremely difficult if cultures are different. In this situation product design and development might be combined to take advantage of unique capabilities of each of the businesses.
- Service Delivery – consulting firms or service based firms depend on the skill and knowledge of the individuals to deliver services and solutions to customers, thus combining such groups depends on finding acceptable employment conditions to retain employees.

The general consensus among integration specialists is that it is anticipated change and uncertainty which create the greatest problems in acquisitions. Where business units are able to be left as they are, acquisitions tend to have a higher probability of success. The seller's employees will be anticipating changes, often to a greater extent than necessary to achieve the benefits of the acquisition. Employees expect the buyer to replace their senior management and they anticipate that the buyer will wish to change their remunerations systems to align them with its own remuneration systems and benefits. The problem is that they probably have little knowledge of what that might mean to them personally. In the absence of information, they will imagine the worst. They will be concerned not only about what they will be doing and who they

will be reporting to, but will have concerns for their very employment and all the associated benefits they have built their personal lives around.

Employees who experience real concerns about possible changes often decide to leave prior to the takeover, or soon after, rather than take the risk of being worse off. This can be a very stressful time for employees. Thus good people can leave even though there may be no intention by the buyer to alter their terms of employment.

Employees who know they are to have changes made to their employment but are unsure of the details may well experience a considerable sense of unease. Where they work, who they will be working for and what their new jobs might be are all uncertain. Those who are uncertain about how they will be treated, or are somewhat insecure, will be under the greatest stress and may decide to leave rather than face a period of uncertainty.

Often the reasons for the acquisition and the planned integration changes are widely known within the firm being acquired. This may have been formally communicated to employees, but just as likely, it may have been spread informally. Since integration often requires downsizing of some business units and the closure of facilities, those employees who are impacted by the planned changes will be under the greatest stress where they are unsure of which employees will be retained and which will be terminated. Those who have concerns about whether they will be terminated will almost certainly start looking for a new position rather than face a period of unemployment. Even before terminations are announced, some will have found alternative employment.

Playing opposite the new managers are all the employees of the acquired company – from senior management to shipping – dock staff. Their script tells them that when companies are purchased, the acquiring company often puts its own people in charge, changes policies and procedures, restructures, consolidates, and generally takes over. So they walk onto the stage of the new company feeling anxious, insecure, uncertain, and even angry. Who are these new owners? What are their intentions? Can we trust what they say? Do we still have jobs, and are they the same as before? Why did our previous owners sell? Did we do a bad job, or did they betray us?

Source: Acquiring Intellect: Managing the Integration of Knowledge-Intensive Acquisitions, by Birkinshaw, Julian, Business Horizons, 00076813, May/Jun99, Vol. 42, Issue 3

Knowledgeable acquirers anticipate these situations and are very sensitive to the fears of the employees being acquired. However, similar fears can exist within the buyer's organisation. When two firms are merged, some positions will inevitably be made redundant, acquired management needs to be integrated into the merged organisation and new products and services need to find

a home within the new company. There is no guarantee that the acquirer's managers and staff are the best people for the newly created organisation. Thus, while the fears of the acquired business are easy to appreciate, often losses occur within the buyer's business as a result of unrest there.

Where business units and departments are to be merged and it is essential to retain the knowledge and skill of both organisations, the buyer needs to be very sensitive to imposing their managers and practices unilaterally onto the seller. Such a change will almost certainly lose large numbers of the acquired employees. At the same time, the buyer's managers may feel they should benefit personally from being the 'superior' business; a situation which needs special care.

A further consideration for management is to take care of the ramifications of terminations on those who remain in continued employment. In any merger there is the possibility of employees from both organisations being terminated as the new business absorbs the employees of the acquired business. The manner in which employees are selected for termination, the process used, the way in which it is announced and the support given to those who are terminated are activities which will be under intense scrutiny from those who are retained. There will be some disruption in work, some grieving for lost friendships and established working relationships and concern over who might be next if the acquisition fails to deliver the results anticipated. Often corporate knowledge is lost, workloads are temporarily increased and work disrupted. If these changes are not handled well, the termination program can have long lasting negative effects in the newly merged business.

Managing Cultural Issues

There is widespread acknowledgement by acquisition advisers that there are some situations where integration will not work. While there are always individuals who have a decided preference for certain types of organisations and working environments, many of these can be persuaded to give the new environment a chance given sufficient incentives. There are, however, those situations where there are fundamental differences, especially at an ethical level, where individuals will place their personal values ahead of those of the organisation and will not be willing to compromise on fundamental issues. This issue is especially true in relation to how individuals are treated and how one defines the 'right thing to do'.

There are also those individuals who are highly employable, who can readily find the type of employment they prefer and who are not willing to compromise on their employment conditions. These people can leave at will and take their accumulated knowledge and skills with them.

The task of the evaluation team should be to assess what changes are necessary to achieve the major benefits stemming from the potential acquisition. This should then be mapped onto a new company structure to determine which parts of both organisations would need to change in order to achieve those benefits. This should allow the evaluation team to isolate those parts of both organisations which would need to change and to identify what changes would need to occur. This mapping process should then identify those departments or business units which will undergo integration changes.

Within the changed business units or departments, it should then be possible to forecast what changes will need to occur and how this will impact those individuals employed within those entities. At this point the evaluation team will need to gain knowledge of the cultural environment of the effected entities.

Clearly where personal knowledge and skills are essential to deliver acquisition benefits, the less change imposed, the more likely it is that individuals will be retained. In some cases, additional benefits over and above those which the acquired individuals already possess can assist to encourage people to stay.

While there are a variety of processes which are recommended in dealing with cultural change, there is a consensus that the following are important elements in such a process.

Terminate the Acquisition Process

There is wide acknowledgement that some acquisitions are not meant to be. If the two companies have very different cultures and a high level of integration is necessary to achieve the acquisition benefit, it may be better to withdraw and seek an acquisition with a better fit.

Map the Changes as Early as Possible

It is critical that the changes necessary to achieve the major acquisition benefits are identified as soon as possible in the evaluation stage. This way the focus on cultural issues can be concentrated on those parts of both companies which will experience significant changes and work can begin on how those changes are to be managed. The cultural environment of each business unit or department expected to undergo significant change needs to be identified and mapped onto the target culture. This will provide a background against which cultural change can be estimated and risks identified. Where risks are high, special consideration needs to be given to leaving the units as they are and not integrating them, delaying the integration or slowing it down in

order to better cope with potential problems or recruiting new employees to take over functions at risk.

Involve the Seller's Management

Hostile environments are very difficult to integrate so, as soon as possible, management representatives of the seller should be invited into evaluation discussions in order to assist in identifying likely cultural and integration problems.

Don't Break What Works

Where possible, business units which are functioning efficiently and where little would be gained by changing them should be left intact and as few changes as possible imposed. Thus a highly informal R&D unit might be tolerated within a very bureaucratic company if it can work effectively as a stand-alone department.

Change as Little as Possible

Unless the change is essential to realise the major acquisition benefits, the recommendation is to leave the situation as it is.

Change Things which Impact the Fewest People

There are some types of integration which are limited to only a few people in administration. These functions could be readily merged with little impact on the overall productivity of the business. However, care needs to be taken to retain corporate knowledge. While some functions are of a professional or functional nature and therefore should be able to be taken on by a similar group, corporate knowledge needs to be documented.

Identify the Key Employees

Within any organisation there will be individuals who have key roles based on their position, knowledge, relationships or skills. These are very different from those who can be readily replaced with individuals of similar training and experience. Those who are key to achieving integration benefits should be identified during the pre-acquisition due diligence process. These individuals may include employees from both companies as losses will also occur within the buyer's organisation as a result of integration activities. Once these key individuals have been identified, a plan should be developed to encourage them to stay with the merged organisation. A risk analysis of their contribution and relationships should be developed and then time should be taken to decide if there are cultural issues which could put their retention at risk.

Key individuals may be offered special incentives to stay with the new organisation and/or consideration may be given to limiting the changes imposed on business units where key employees work. The buyer needs to estimate how long such key individuals need to be retained in order to effect a transition of knowledge, relationships and skills. It may be sufficient to keep these individuals for a year to effect the transfer. In such a situation, a significant bonus could be assigned to retain key individuals for a set period.

Develop an Integration Plan

Senior management in both companies should construct a plan for integration activities taking into account the need to achieve the major integration benefits as soon as possible but with making as few changes as necessary. Integration activities should be mapped out in a project plan identifying activities, responsibilities, timescales, stage goals and final results. The focus here should be on completing tasks essential to achieving integration benefits rather than on creating one company. Once integration benefits have been achieved and stabilised, other changes can proceed in the background at a slower pace.

Focus on Human Integration First

Where task integration involves merging groups of individuals into a common unit, the level of perceived change is going to be high resulting in high levels of fear, unrest and uncertainty. Without dealing with the human issues first, it is likely that the resultant task integration will fail.

The relationship between the task integration process and acquisition success is mediated by the level of human integration already in place. Thus, a very low level of human integration will limit the effectiveness of task integration as a driver of acquisition success.

Source: Managing The Post-Acquisition Integration Process: How The Human Integration And Task Integration Processes Interact To Foster Value Creation, by Birkinshaw, Julian, Bresman, Henrik, Håxanson, Lars, Journal of Management Studies, 00222380, May2000, Vol. 37, Issue 3

Communicate Changes Early

Individuals anticipate change and fear the worst. The biggest risk for any integration effort is that key individuals will leave because they anticipate change. Some prefer to leave for a certain job rather than wait to find out what actual changes will take place. As soon as the acquisition deal is firm, senior management of both companies should communicate the anticipated changes to all employees with an indication as soon as possible about the impact of those changes on individuals. Those who are negatively impacted

need to have personal attention to assist them to cope with the changes that will happen to them. For those who are being made redundant, special attention needs to be given to assisting them to plan the timing of their departure and to help them find new employment. If the buyer has employees who themselves have come from acquired businesses, these individuals can instil a sense of security and fair treatment for the newly acquired employees and so they should be used to assist in communicating the integration plan to the new employees.

Move Quickly

Where significant changes need to be made in order to achieve integration benefits, the consensus of opinion of experienced acquirers is that the changes should be made as soon as possible. Delay is thought to increase the level of unrest and uncertainty and this in turn leads to a lowering of productivity and a loss of employees unable to wait for the changes to take place. Once the changes have been made, the newly merged company can settle down to regular business where individuals again have a sense of stability and certainty. This activity needs to be done with sensitivity and respect as changes will impact individual work habits, reporting lines, job descriptions, remuneration and so on.

Terminate Negative Individuals

Change itself will be stressful on employees and during this process it is important for the focus to be on the future and the benefits stemming from the acquisition and the changes which need to be made. Individuals who are hostile to the changes and undermine the process can seriously harm progress and therefore should be terminated as soon as possible.

Instil the New Culture

Where differences exist between the business units being merged, it is important that the dominant or new culture be reinforced throughout the merged entity. This means communicating the vision of the unit, the objectives of the changes being made, the values which drive behaviour, policies and processes to be used in decision-making and the changes to rewards and sanctions which will be used to drive the new culture. Senior management of the merged entity must be seen to follow the approved values and act to reinforce them through their decisions.

During the transition period it is important that behaviours which reinforce and support the desired culture are recognised, rewarded and result in promotions if appropriate. At the same time, negative behaviours need

to be addressed quickly, fairly but decisively. In cases of hostile attitudes or activities which undermine the process, those individuals should lose privileges, have sanctions imposed on them or be dismissed.

Conclusion

Cultural issues are the most difficult problems the acquirer will have to resolve. Unlike closing plants or selling off equipment where the employee may be terminated, the integration of business units involves the merging together of two different groups with different pasts and experiences. In addition to high levels of stress created by the uncertainties of their future jobs, acquired employees are placed in a position where their normal working environment, the way they interact with others in the work place and the manner in which they deal with business issues can be dramatically changed. It is both the fear of such changes and the confrontation of the changes when they occur that creates frustration, sometimes anger, a lowering of self esteem, a sense of isolation and helplessness and a negative view of their future with the acquiring corporation. It is therefore not unusual to see a lowering of productivity and a heightened level of resignations.

With forward planning and forewarning of possible problems, much of these problems can be resolved or dramatically reduced. Prepared acquirers already know where changes will need to be made to achieve integration benefits and these can be set out with the expected changes well before the deal is complete. Key employees can be encouraged to stay with incentives and those areas unaffected by the acquisition changes can be assured of continued employment. Where changes do need to be made, they should be declared and changes made with some haste so that those employees continuing on with the new business can be settled down into their new roles. Individuals who are to be terminated should be treated with respect and assisted to move onto new employment or retirement.

However, it does need to be said that not all situations can be easily resolved and there are circumstances where major cultural differences will undermine the likelihood of gaining integration benefits. Where this is foreseen, the company should terminate acquisition discussions and wait until they can find a seller with a more compatible culture.

Key Points

- Cultural issues are the most difficult to resolve in integration activity and should be given a good deal of attention both in the pre-acquisition evaluation and in the post-acquisition planning.
- Where possible, acquired business units should be left substantially unaltered as this will best protect the capabilities and knowledge acquired.
- If integration is necessary, key individuals should be identified as early as possible and special incentives should be developed to retain them.
- Communication of changes, acting quickly and acting in a fair and respectful manner are critical aspects of managing changes associated with integration activities.

Section Three: The Acquisition

Chapter Nine

Finalising the Deal

Overview: In many ways the easy part of the deal is the initial agreement. Once this has been reached the hard work of evaluation, valuation and final deal structure begins. The purpose of due diligence is to verify the information provided by the seller and to assess the risks inherent in the business. The next stage of due diligence is to investigate which activities would be involved in achieving the benefits of the acquisition. This includes both intervention and integration activities. With this information at hand the final deal can be settled. There are numerous elements to a purchase agreement including the potential for an earnout by the selling shareholders.

Most large companies which have undertaken a number of acquisitions will have experienced acquisition disasters. Sometimes the causes of such problems were known by the buyer going into the deal, but were not considered important at the time. Other problems were caused by situations which were unavoidable and were things they were forced to accept as part of the transaction. More often, however, they are things uncovered after the deal has been consummated and turn up progressively over time. The smart ones learn from their mistakes and have a rigorous due diligence process which they undertake prior to finalising the deal. They also have legal remedies and a project control system following the acquisition to manage surprises.

For the buyer, risks in the deal are anything which will cause the overall investment return to be reduced. The investment value includes the actual purchase price but also anything which creates costs, reduces effectiveness or impacts on time to integrate the acquisition or to take advantage of the assets and capabilities acquired. The buyer sets out to identify as many potential problems which they can during the due diligence investigation. These are then factored into the final purchase price in order to ensure the company is able to achieve its target return on investment. Sometimes information will be

uncovered during the investigation which indicates that a potential risk exists but insufficient information has been uncovered or provided to assess the size of the problem. This often leads to a more extensive investigation or, if the potential risk is too high or unknown, a withdrawal from the deal.

Risks are both things which can be seen and things which cannot be seen. For example, an employee intellectual property (IP) agreement may show that the firm owns all inventions from its employees. Missing signed IP agreements from past employees may, however, create a potential claim later on.

Some risks are assessed through the information provided. These are observed risks.

Observed risks:

- Non-standard customer contracts,
- Non standard supplier agreements,
- Harsh lease conditions,
- Loose IP agreements,
- Overly generous reward and remuneration systems,
- Generous options schemes,
- Generous health or vacations benefits,
- Poor reporting systems,
- Harsh compliance requirements.
- Out of date equipment or poor quality products.

Other risks are estimated from missing information. Often these carry the higher potential risk.

Missing information:

- Lack of clear IP ownership,
- Lack of documented processes, procedures or instructions,
- Unclear customer obligations,
- Missing performance information,
- Successes and failures not understood,
- Information on cost structures or recurring revenue,
- Data about sales process, sales cycles, closure rates,

- Intentions of key employees.

It is important to keep in mind that the buyer is interested in the target firm only to the extent that it produces an acceptable level of profits or resolves a threat or enables the company to exploit an opportunity. To the extent that uncovered risks reduce their ability to reach the desired outcome or delays their time to execute, the net benefit of the potential acquisition declines.

Preparation for Negotiations

Hopefully the company has had time to build some form of relationship with the target firm so that there is a meeting of minds in terms of a positive attitude in both organisations to doing a deal. However, the detailed negotiation still needs to be undertaken. The seller's management will be anxious about the terms of the deal as well as the impact on their business as a result of the acquisition and potential subsequent integration. It is, therefore, in the best interests of the company's negotiators to have given considerable thought to how the benefits of the acquisition will be achieved and have answers to the questions that the target firm's managers will put.

By working through post-acquisition scenarios, the company can predict where problems might be encountered in the negotiation. By working through how these might be resolved, the company can take the initiative in the negotiations. Acquiring firms, especially those which have experience in M&A, assume they will have a lot of issues to deal with after the acquisition. These are generally associated with the integration of the two firms as well as securing the best use of the strategic asset or competency they were after. In considering the likely situation after the sale, consider the following questions:

- Where will the acquired firm be located?
- What will happen to existing facilities, plants, warehouses, offices not required?
- Which positions are duplicated and therefore which staff will be made redundant?
- Which employees are key to the acquisition benefits being realised? How are those staff to be retained?
- What will the new terms of conditions of employment be?
- What happens to employee options and any share purchase schemes?
- How will health insurance, vacation entitlements and existing bonus systems be translated?

- How is the buyer to leverage the new acquisition?
- What will happen to existing customers, suppliers and distributors?
- Which partnerships, alliances and joint ventures need to be terminated or protected?
- What are the former owner/managers going to do in the merged company?
- What if you don't want some, or all, of the senior management?
- What potential litigation will be outstanding which will need to be resolved?

While the buyer can assume the selling shareholders would like to finalise a deal, they will still have many concerns and questions about how the business will operate after the change of ownership. The key to a successful negotiation is to have thought through these questions in advance of entering the negotiation. To the extent that these issues can be resolved in advance or options can be presented, the negotiations will proceed more smoothly and the seller's management will be more positive about the sale of their business.

Some situations are relatively easy to anticipate. While not all acquisitions involve integration activities, many do and this is one area of negotiation which creates the most stress for the vendor management. The due diligence investigation will uncover many of the issues which will need to be dealt with in an integration project. For example, generally speaking, it is easier to merge a firm which has standard conditions throughout its operations. So industry standard contracts with suppliers, customers, distributors and employees should normally not present an integration problem. Overly generous terms of employment (salaries, benefits, bonuses, options, health cover, etc) can seriously damage a potential merger. Since the company will most often have to integrate new employees with their own, any marked differences where the new employees are better off, will be a serious impediment. It is always better to have a situation where employees gain through the merger rather than lose. Discretionary bonuses and rewards can be used post acquisition to align remuneration and benefits or provide motivation without any guarantee that these will be continued in the future. Alternatively, terms of employment can be agreed where aspects can be subject to review on a periodic basis. Without undertaking the detailed due diligence, it is very difficult to estimate just how easy or difficult it would be to integrate various functions from the acquired firm.

Based on the initial discussions and on the financial information provided by the seller, the buyer can arrive at a decision whether to proceed further with the negotiations. At this stage the company would produce a letter of intent and a request for exclusivity in dealing with the selling firm. The letter of intent outlines the key points of a potential deal. It may also set out an outline of conditions of the deal and of the undertakings required from the selling shareholders.

Note: For an example of a USA Letter of Intent see <http://library.findlaw.com/2003/Apr/2/132672.html>. Accessed 4th June 2006.

The buyer will incur considerable costs in the next stage of the investigation and will want to ensure that the selling firm is acting in good faith during this period. To protect themselves, the company should request the seller execute an exclusivity agreement where the seller agrees not to proceed with acquisition discussions with any other party during the due diligence period. A penalty may be agreed for a breach of this condition. Alternatively, in a competitive bidding process, there may be a shortlist of potential buyers who undertake the due diligence assessment concurrently.

Business Due Diligence

Once the parties have agreed the business terms of the acquisition, the acquirer will proceed to a full analysis of the investment opportunity. At this point analysts, lawyers and accountants acting on behalf of the acquirer will undertake a due diligence investigation.

The major objective of the business due diligence is to investigate the operations of the firm to see if the business itself has any major problems which have not already been identified in the information provided to the acquirer. The due diligence process will undertake a validation of all aspects of the existing business as presented in the documents supplied (information memorandum, business plan, prior financial reports and so on). This investigation would include most of the following (dependent on whether the purchase was a share or asset sale):

- Background checks on the key executives and key employees (subject to privacy laws).
- Review of all corporate documents including Board Minutes.
- An examination of all shareholder information including share classes, rights, obligations, options, warrants, covenants and minority interests.

- All material agreements with external parties, especially those which impact revenue or expenses or involve guarantees or restrictions on trade.
- Any employee agreements including management contracts, option schemes, remuneration arrangements, pension arrangements, commission and bonus payments.
- Review of all financial information and additional investigations where necessary to validate key numbers in financial reports and budgets.
- Inspection of all key contracts including leases, mortgages and debentures.
- Review of all compliance requirements.
- Review of all taxation filings and liabilities.
- Review of any current and potential litigation.
- Review of all insurance and any outstanding claims.
- Validation of all intellectual property ownership.
- Examination and verification of all real property ownership.
- Interviews with major customers, suppliers and distributors.
- Verification of costs, expense levels and purchase commitments.
- Assessment of plant and equipment and capital expenditure requirements.
- Review of intellectual property rights, including patents.
- Assessment of key employees.
- Review of inventory holdings including ageing.

This process will check the integrity and honesty of the target firm as well as provide a view on how well the business is managed and the adequacy and accuracy of the information which is being used in the business. It will also uncover how well the key executives understand their own business and the ease with which they are able to access and provide additional details necessary to the analysis.

Example

Investigative Due Diligence Can Expose Trouble Before It Strikes

In many industries, this process has become standard operating procedure, triggered by a flurry of horror stories that could have been avoided with the proper pre-deal due diligence.

Online broadcast network Pixelon is perhaps the best known case in VC circles. Investors are now suing the company for \$4.85 million charging fraud after the company's founder and former chief technology officer, David Kim Stanley, was arrested.

One large firm specialising in background checks recently estimated that 15% of its cases produced information that affected the deal and a few of the checks generated enough negative information to kill the deal altogether. The offenses ranged from padded resumes to criminal records.

Consider this case: A computer company hired a due diligence investigator to look into the backgrounds of directors at an acquisition candidate. The investigation revealed that one of the board members was going through a bitter divorce - a fact that was never previously disclosed by the director. The wife planned to win a large portion of the director's stock in the divorce settlement and was planning to use that leverage to insist on a board seat – a battle that the client was not interested in fighting. Result: the deal was shelved.

Two other well-reported cases that revealed startling findings worth noting include a background check of a key executive of a tech start-up firm that uncovered a civil litigation case, criminal associations and an indecent-exposure conviction and the case of a chief executive officer who was in jail at the time he was negotiating a deal.

Source: <http://www.findarticles.com/> accessed 8th September 2003

A key part of the due diligence process is for the buyer to identify anything which would incur additional costs, create delays or expose the buyer to actual or potential liabilities not identified in the information provided to the buyer. This may lead to price adjustment or additional clauses in the sale document. Items which frequently create problems include:

- Non-standard customer contracts,
- Non-standard supplier agreements,
- Harsh lease conditions,
- Loose IP agreements,
- Overly generous reward and remuneration systems,
- Generous health or vacations benefits,
- Poor reporting systems,
- Out of date equipment or evidence of poor quality outputs,
- Use of company funds or resources for personal use,
- Pre-existing obligations, rights, commitments or restrictions,

- Unusual shareholders' rights, legal structures, joint ventures option schemes or anti-dilution arrangements,
- Punitive rights of existing debt holders,
- Excess inventory,
- Overvalued assets,
- Understated provisions.

As the business becomes older and more complex, the data needed to support a full due diligence becomes more extensive and probably harder to uncover. Few early stage businesses have the filing disciplines to keep adequate records or to file them in a manner which allows ready retrieval many years later. Smaller businesses may not take the trouble to document management or board decisions and then later find they cannot find the authorities which allowed them to make significant decisions which may have affected stakeholder rights. This opens the door for possible litigation from minority shareholders or other vested interests.

It is unlikely that any firm can submit to the due diligence inspection without there being some issues which need to be resolved. Firms which have not considered due diligence and have let compliance slide, are late with meeting new regulations or have inadequate internal information systems, may have trouble meeting due diligence information needs.

A business which is effectively and efficiently run, has good customer, distributor and supplier relationships and has good internal reporting systems which monitor performance, ensure adherence to compliance regulations and protect the business from mistakes should have few problems in satisfying the buyer.

Acquisition Management and Integration Due Diligence

After the buyer has satisfied itself with regard to the seller's current operations, the buyer should then examine those aspects of the future potential business which are critical to achieving the integration synergy and/or exploitation of opportunities presented by the acquisition.

For example, the buyer may wish to validate the business projections and other planned targets and milestones which underpin the seller's business plan. Or they may wish to validate the size and viability of the opportunity to generate new revenue based on the acquired assets and capabilities of the seller's business. If achieving these targets is critical to meeting the ROI conditions of

the investment, this is the area which exposes the buyer to the greatest risks. This investigation will review the following:

- The identification of the prospective customer and the quality of the benefits the customer gains from the product or service,
- The size and growth rate of the prospective market,
- The size, strength and strategies of current and potential competitors,
- The quality of the intellectual property underpinning the projections,
- The quality of the sales, marketing and distribution strategies proposed,
- The likely ability of the management team to be able to execute the plan,
- Availability of executive and specialised staff needed to deliver on the plan,
- A detailed review of the likely cash flow over the expected investment period.

The acquisition may be based on some level of integration of the seller's business with the acquirer's existing business. The due diligence process needs to identify where integration needs to occur, the likely priority and timing of such integration and the capability and willingness of the respective staff to make it happen. Included in the review will be issues such as:

- The need to open or close new offices, warehouses and manufacturing locations.
- The extent to which staff will be relocated, reassigned or have conditions of employment, remuneration, health benefits, entitlements, responsibilities or reporting lines changed.
- The extent to which information systems need to be integrated, merged or interfaced.
- The extent to which the cultures (of those units needed to be integrated) are alike.
- Whether suppliers, agents and distributors will continue and what costs and disruptions will occur if they are not.

Integration will take time, utilise senior executive time and require funding. These costs and delays need to be factored into the investment evaluation. Aspects of integration might include:

- Moving customers and suppliers over to new relationships and systems, perhaps redoing contracts, agreements and trading arrangements.

- Shifting business from some distributors and suppliers to those which have pre-existing arrangements with the acquirer.
- Closing down duplicate offices, warehouses and manufacturing facilities. This might include redundancies or relocating staff.
- Shifting financial reporting systems and transactions systems across to a common administrative system.
- Realigning remuneration, health, pension, vacation and other entitlements.
- Replacing staff who left during the transition period.
- Changing job descriptions, responsibilities and reporting lines.
- Re-branding products and services and redesigning sales collateral.

Example

As mergers and acquisitions make a comeback, a recent study shows that an overwhelming 75 percent of large company M&A deals fail to increase shareholder value.

'Accelerate M&A Success: A Guide to Post-Merger Integration,' a 138-page report, reveals that one of the primary factors for M&A failure is poor evaluation of internal strengths and weaknesses, according to business intelligence firm Cutting Edge Information.

'Many mergers and acquisitions in recent years have been a huge failure,' said Cutting Edge Information CEO Jason Richardson. 'Too often, consolidating companies have only focused on how their financials match up and neglect to inspect all other crucial aspects.'

Companies must conduct thorough due diligence practices to prevent post-merger surprises, the report contends. Culture clashes and technology incompatibility often go overlooked during due diligence and drain cost-savings once companies merge.

Source: <http://accounting.pro2net.com/> accessed 7th September 2003

To the extent that uncovered risks reduce the probability of achieving the desired outcome or delay the time to execute, the value of the potential investment declines. In some cases the problems can be overcome by installing additional controls, renegotiating agreements and putting in place alternative strategies. However, these may result in additional costs or delays in executing the plan. To the extent that problems cannot be easily resolved or structural changes are difficult to implement, the investment will incur greater risks. At

some point the buyer needs to consider whether the risks are too great and whether or not to make the investment.

Deal Structure

You may be approached by a potential acquirer or you might take the initiative to approach a target firm. However, once there is an agreement to proceed to a negotiated agreement, you will end up negotiating a deal with many dimensions. Generally in this type of process it is important to meet somewhere on the same page and in the same book. If you are on another planet with respect to price and conditions, the time will be entirely wasted and both parties will end up frustrated.

In a majority of cases, most elements of a deal are negotiable. Whatever constraints you have and whatever constraints they have in negotiating a deal should be uncovered as soon as possible. For example, it may be important to the seller to have some guarantees of future employment for some of the staff. The company may wish to have a guarantee that certain key staff stay on for some minimum period. Whatever these issues are, they should be set out before the serious process of negotiation begins because you should first determine whether those can be met.

I like to think of a deal as representing a certain target value to the buyer. That value represents their view of the balance between the risks in the deal and what they are prepared to pay for the opportunities it represents to them. They will have built into their estimate of investment returns, assumptions about risks they are likely to incur based on industry and personal experience. They will have tentative estimates of the opportunity and they will see issues in realising its full potential. The purpose of the initial discussions and of the due diligence process is to firm up both the risks and the opportunity.

Once you have verified both the risks and the opportunity, you need to settle on a price. Once you have achieved the best price you can reasonably expect, you can start to break that value, the 'deal value', up into deal elements. The deal value can be carved up in any number of ways but, at this point, the pie does not get any bigger. With that approach, both parties can start to set out where they want that value to be consumed.

Sometimes the size of the opportunity to the buyer will depend on future events. This is where the seller and buyer may differ in terms of what the business is currently worth. The seller may have more confidence in the future than the buyer. The buyer may, however, be willing to pay more but only if those future events materialise. Thus the seller's deal value may only be achieved by the seller at some period in the future based on certain conditions being met.

To the extent that those conditions can be met, a buyer is normally willing to make available a higher deal value. However, to the extent that these events do not materialise or cannot be met, the buyer does not wish to be committed to the higher value. Basically the buyer wants the deal value to be reduced by some amount representing the cost of correcting the shortfall or the opportunity cost of not having that advantage.

The process of negotiation tries to set out what can be delivered by the sellers immediately with what may possibly be delivered in the future. A buyer is normally willing to pay full value for the benefits it can count on but is reluctant to pay for something which may not materialise. Thus the process of negotiation assigns value components to each element of the deal.

Some minimum level of performance may not be negotiable. So, for example, if the deal depends on certain key employees staying after the acquisition, additional incentives may be offered to them to gain such assurance. Such incentives reduce the available funds for the base purchase price. Some period of non-compete may also be required to prevent the key managers and shareholders from joining the competition or setting up a new company in competition. If three years was the desirable period but the sellers want only two, the deal value should be reduced by some amount representing the additional risk faced by the buyer.

This framework can provide a workable method for negotiating elements of the deal. Any reduction in risk moves the final deal value up, although this may appear as an increase in the purchase price to the seller. Any increase in risk or reduction in the ability to exploit the opportunity simply reduces the deal value.

In order to fully achieve the value from the deal, the buyer may wish the seller to complete R&D projects, sign up key customer contracts, cancel or negotiate out of specific obligations, negotiate redundancies or relocate staff. These could be framed as staged payments, earnout or fixed payments on achievements. In other words, the final acquisition price can be made up of many elements, each of which has a fixed or calculated value, which can be paid out in stages or accumulated to an end point and then paid out in some mixture of shares and cash. The earnout period can be relatively short if it is expected that key objectives can be determined quickly, or it could be over a number of years if it requires a considerable period for the objectives to be achieved.

Elements of the final deal may include the following:

Base Price

This should represent the minimum which will be paid for the firm. It may be subject to adjustments through a balance sheet audit which will verify valuations and liabilities. It also may be subject to adjustment through warranties and representations for some specified period of time. The base price might be offered in the form of shares in the acquiring corporation, or cash or some combination of both.

Escrow

An escrow sets aside some portion of the purchase price against adjustments and warranty claims. Generally this will be held by an escrow agent and may be claimed against by providing specific evidence of claims. Usually it is limited in time, such as one year. At the end of the escrow period, the remaining shares or cash are returned to the selling shareholders.

Options

Options of selling employees may be converted to ordinary vendor shares prior to the sale being consummated or may be carried over into options of the acquiring corporation. Options carried forward provide incentives for employees to stay with the buyer. Additional options may be offered to key employees to retain them.

Stage Payments

Stage payments are normally aligned to the achievement of objectives. So, for example, they could be aligned to the delivery of certain key R&D milestones, or completion of certain contracts, or the signing of certain key contracts.

Earnout

An earnout aligns the purchase price with the achievement of specified revenue targets or other milestones. This may be set at specified increases in the purchase price or a percentage of the purchase price based on specified targets. The additional earnout would normally be for a set period and may or may not be capped. The earnout may be for all shareholders or limited to key shareholders who stay with the buyer.

Continued Employment

Continued employment of former owner/managers and/or key employees may be sought by either or both of the parties depending on how important

those staff are to achieving future objectives. Specific jobs could be negotiated. Specific management agreements and remuneration and incentive deals might be included in the deal. Some staff may prefer a short-term consulting agreement.

Director Position

Either or both parties may want former key executives to continue on a Board of Directors for some period.

Warranties and Representations

The acquirer will not be able to verify everything in the deal. To overcome this limitation, they would normally require the Directors and/or shareholders, or some subset of them, to provide warranties and representations about key elements of the firm. This might be asset valuations, contingent liabilities, incomplete litigation, prior balance sheet and revenue statement assurances and so on. Any claims in this area might be taken against an escrow account if that is set up, adjust the final purchase price if some balance is still to be paid, or might be subject to a recall of value through arbitration or litigation.

Non-Compete

Generally a buyer wants to protect itself from competition from former key shareholders and executives of the selling firm. This is usually set for a limited period, for example, two to three years. It would normally exclude the individual from working with a competitor or from undertaking a start-up which may compete.

Holding Period

Where publicly listed shares are taken as part of the purchase price, these may be subject to registration. The process may take some months. During this period the selling shareholders will not be able to sell their shares. There also may be further restrictions on the sale of shares which the buyer requires in order not to flood the market or not to show a lack of faith in the future of the corporation. Shareholders who are continuing as key executives may also be subject to non-trading or blackout periods or limited sale conditions due to insider trading restrictions.

Specific Liabilities

The selling shareholder may be asked to take over specific liabilities or contingent liabilities. This may happen where key shareholders have personal loans to the firm. A buyer may regard their repayment as an obligation of the sellers and not theirs. They may also decide that the risks inherent in

specific contingent liabilities are too difficult to assess and ask that the sellers absorb whatever is the eventual outcome. Since contingent liabilities represent potentially unlimited risk for the buyer, these are often deal killers. This is something which buyers need to give special consideration to. If the alternatives are no deal or a deal with some possible downside, the latter may still be worth doing. At other times the contingent liabilities might be capped on either side or might be handled through the escrow. Difficulties dealing with outstanding liabilities may also be handled by constructing the deal as an asset purchase rather than an outright equity purchase.

Costs

Legal and accounting professional fees incurred by each party are normally borne by the respective parties. However, these costs may be assigned in some proportion to one or both of the parties depending on the deal structure.

Use of Intellectual Property

Normally full rights to any IP passes to the new owner, but this need not necessarily exclude use by the seller. It may be possible for selling shareholders to negotiate the use of IP for personal or non-competing purposes post sale.

In negotiating the deal, both sides have issues which need to be addressed and both sides usually have some flexibility to trade. Thus a higher risk taken by one side should result in a change in the purchase price. If the sellers absorb some contingent liability risk, this should result in some other advantage to them, such as a higher price or more options etc.

Andrew J. Sherman and Milledge A. Hart in their book *Mergers and Acquisitions: From A to Z* provide comprehensive examples of various US legal documents associated with an acquisition. (2nd Edition, Amacom, 2006). Similar legal documents will be used in most western economies although care needs to be taken of local regulations associated with changes in conditions of employment, terminations and taxation rules.

Earnout

Shareholders of the selling firm often seek an earnout as a way of securing additional compensation for the business they are selling. This frequently occurs where the fair market value is seen by the selling shareholders as inadequate compensation for the potential of the business. Circumstances where this might occur are:

- Significant expenses have been incurred in recent research and development which has been written off but has not yet translated into revenue.
- The owners have taken either very low salaries, excessive salaries or benefits which are not able to be easily calculated.
- Large contracts have been secured, or are about to be secured, where the benefits have not flowed back into the accounts.
- The sector is experiencing significant growth and the firm is well poised to take advantage of that.
- The potential acquirer is able to remove an impediment to growth which will return premium profits to the acquirer.

The selling shareholders argue for a higher valuation on the basis of potential. The buyer would normally be reluctant to agree to the higher value arguing that the benefits may not be realised. The compromise is often negotiated as an earnout based on the future performance of the acquired firm or the combined entity.

Another reason for an earnout type arrangement is a performance based purchase price where other activities or achievements other than revenue or profits may be the basis for such payments. This might include:

- Completion of development milestones,
- Acceptance of products by named customers,
- Completion of key contracts,
- Signing of key agreements by customers, suppliers, partners or distributors,
- Approval of products by licensing authorities,
- Granting of rights under patents, trade marks, or licences,
- Achievement of various quality targets.

Earnouts should be used where there is a reasonable level of uncertainty of some future event or future performance which can have a material impact on the value of the acquisition. There should also exist the possibility that none of the earnout will be earned if the anticipated events or targets are not met in a material manner.

Where events are more certain, such as the outcome of a litigation settlement, lease payout, warranty claim and so on, these are better handled through escrow arrangements and under warranties and representations. In these situations,

the valuation is set on a positive note where all outstanding items are worth zero. A portion of the purchase price is then set aside, generally in escrow and claims are made against that portion as each item is finalised or settled. These items are generally discreet in nature, often able to be calculated and not overly subject to effort by either party and will normally be limited in time.

The earnout approach is best used when the parties are not able to agree on a purchase price because future events, which could materially affect the value acquired, cannot be determined with any certainty. Alternatively, the buyer is willing to pay more but only if the seller can achieve certain predetermined performance or event objectives.

As a general rule, a good earnout formula is one where the buyer is very willing to pay the earnout if objectives are achieved and the seller has a reasonable degree of influence over the events which contribute to that level of achievement. A good earnout formula is also easily defined, measured and objective and not capable of manipulation by either party at the expense of the other.

Earnouts are however not as common as may be expected.

Example

In an article in *CFO* magazine titled 'Caution: Earnouts Ahead', the author Roy Harris notes that contingency terms were found in 4 percent of all announced U.S. M&A deals, with over 10 percent of all deals valued at or below \$250 million, encompassing such terms. More than two hundred acquisitions in the U.S. have contained earnout agreements in each of the five years to 2000, with a total value of such transactions peaking at \$27.9 billion in the year 2000.

Source: <http://www.indiaonline.com/nevi/earn.html> Accessed 9th May 2004

Term of the Earnout

There is considerable disagreement among practitioners about the most workable term of an earnout. On the one hand, shorter terms have higher degrees of likely achievement while longer terms allow for too many influencing events to occur. Also longer earnouts reflect lower present day values due to the discounted cash flow impact of distant payments. Thus the further out the potential payout, the less value it has for the sellers and the more likely it is to be disputed or not achieved.

Example

Baltimore-based Sylvan Learning Systems Inc. certainly found it so. The company, a prolific acquirer of educational companies in recent years, started out by setting up one-year earnouts. For the managers Sylvan retained, 'the natural response was to go gangbusters in terms of revenues and not spend for future growth,' says senior vice president and CFO Sean Creamer. Sylvan now designs earnouts for three years or more and monitors the deals carefully, sometimes using special audits to make sure the managers aren't 'gaming the system.'

Source: <http://www.cfo.com/article/1,5309,7261|0|C|2|,00.html> Accessed 9th May 2004

To a certain extent, it depends on which party has the greatest influence over the target achievements. The longer the buyer is in effective control, the more influence, positively or negatively, they can impact on performance.

How Large Should the Earnout Be?

Conventional wisdom suggests that earnouts should be limited to 10-25% of the ultimate purchase price. One of the issues which both parties should be aware of is that earnouts are really only appropriate where there is some degree of uncertainty in achieving defined potential targets. If the events or targets were guaranteed, these can be factored into the base price. Where probable outcomes may in fact not be achieved, both parties need to think through the consequences if the earnout is not achieved or substantially not achieved.

An earnout element based on specific large events may be quite reasonable if the final determination cannot be readily influenced by either party. This could be, for example, FDA approval which is awaiting final determination. This might significantly change the valuation and both parties may agree a significant earnout on the conclusion. However, if the earnout requires active co-operation of all parties and is based on many contingencies, it simply opens the gates to a claim by the seller of lack of effort on the part of the buyer.

How Should the Earnout Be Calculated?

There is no magic formula for earnout calculations especially those which may be paid in stages based on performance. Should they be based on a cumulative achievement or on stage targets? The problem is one of uncertainty for both parties. The seller will want to ensure that payments, once achieved, are not subject to clawback while protecting against events outside their influence, while the buyer wants to reach certain long-term objectives.

The biggest problem in all earnout calculations is finding an objective formula that is not subject to manipulation or re-interpretation by either party.

For example:

Revenue

May be boosted by promotions, discounts, poor contracts, early shipments, false invoicing, manipulated stage payments, etc. Revenue may also be negatively impacted by cutbacks in allowable marketing expenses, promotion of competing products, interference or delays in completing contracts through approval cycles or newly imposed conditions.

Expenses

Can be reduced by terminating staff, delaying staff replacements, delaying purchases, cutting back on R&D, delaying performance bonuses, buying lower quality stock or components, fighting warranty claims and so on. Additional costs may be imposed for redundancies, implementation of new systems, additional reporting and budgeting requirements and so on.

Net Profit

Calculations can be influenced by changing depreciation methods, how goodwill is expensed, reclassifying expenses as capital items, excluding some payments as extraordinary items and so on.

Even where the manner of calculation has been specified, there can be alternative calculations. The words 'According to GAAP' (Generally Accepted Accounting Principles) need not ensure that a particular method is used if the auditors recommend a change due to legislation or a new accounting standard. Even 'as applied at the time of the agreement' will not necessarily cater for an unforeseen event. The terms 'consistently applied' are often used to overcome changes. Setting out the method of calculation during the earnout discussions may help bring out any differences in treatment. The measurement issues become increasingly complex as operations are merged with those of the buyer or central services are undertaken by the parent which results in disputes over transfer prices between entities.

Where competing products are being offered, the earnout may be calculated on both product lines in order to avoid any issue of deliberate bias.

Targets should be kept simple, easily and unambiguously calculated and subject to objective measurement by an independent auditor if necessary. Revenue, for example, is easier to calculate than profits. Specific milestones are easier to determine than profits. Earnouts can be based across a range of events or targets, some financial and others based on specific events.

Example

SAL's former shareholders and creditors have an earnout that is contingent upon three events in 2002: 1) an earnout note, due in twenty-four months, for \$500,000 will be issued if the SAL Model 5 stepper's performance satisfies stated stepper throughput and mechanical performance criteria by no later than March 31, 2002; 2) a second earnout note, due in twenty-four months, for \$500,000 will be issued if the combined Model 5 stepper and JMAR X-ray source demonstrates X-ray lithography exposures which satisfy stated performance criteria by September 30, 2002; and 3) a total of 354,736 JMAR shares and an earnout note, due in twenty-four months, for \$1.2 million will be issued if an order from a commercial semiconductor manufacturer is received by December 31, 2002 (with pro rated reduction of the payment to zero if the order is received between December 31, 2002 and March 31, 2003).

Source: http://www.bristoldirect.com/adobe/JMAR_Research_1-22-02.pdf. Accessed 9th may 2004

How Should the Earnout Be Paid?

The parties need to agree how the additional valuation created through the earnout will be paid. Sometimes this is done in cash, other times in cash and shares, or just in additional shares. When shares are used for the earnout, both parties need to agree a formula for how the number of shares is to be determined. This might be at the same market price as for the base compensation, or it might be the price on the day of the payout. Sometimes it is hard to judge where the sellers might be better off. What would happen, for example, if there was a major change in the share price?

Example

The last round of Nasdaq listings was triggered by the success of Chinadotcom's listing, which having both 'China' and 'dotcom' in its name ensured it had a very hot reception. Who could have guessed at the time that it would trade down from a peak value of \$73.43 to a 39th of that (\$1.86) at its low?

Source: <http://www.financeasia.com/Articles/1B395183-969A-41CD-A63F80D95A44D208.cfm>
Accessed 9th May 2004

How Much Freedom to Operate Should the Seller Have?

This is an area of much dispute between buyer and seller. If the earnout is based on operating the business as a continuing concern to achieve the performance targets, this may not sit comfortably with the buyer. The buyer is exposed to expense blowouts, capital project commitments and agreement obligations. Also the buyer will want the business run so that it reduces risk exposure while putting the business on a good footing for the time it takes over effective control.

This potential conflict of interest often results in the acquired business being subject to numerous reporting requirements, expenditure approvals and restrictions on borrowings, capital commitments and so on. Working out the operating conditions and then recalculating the earnout on the new basis can help. It may be appropriate to work out various critical factors such as headcount, expense budgets, capital expenditure allowance, marketing spend and so on.

A more serious issue is conflict of interest over where the efforts of the newly acquired business should be directed. With an earnout in place, acquired management will have a focus on maximising their earnout. At the same time, the reason for the acquisition may be to integrate the businesses or to leverage the assets or capabilities across a wider corporate entity. It is difficult to do both at the same time. The most capable people and those with the most knowledge in the acquired business will want to focus on the earnout. However, it is these same people who need to be involved in assisting the roll-out of the newly acquired assets or capabilities.

The new owners have to decide one way or the other. Either they leave the business alone during the earnout or they compensate the prior owners for the time required to work with the new larger entity. This may ultimately result in the new owners paying out all, or most, of the anticipated earnout in advance.

Earnout or Employment Compensation?

Where the selling shareholders argue that the business being acquired has unrealised potential and they wish to be compensated for that – the earnout is correctly paid out to all shareholders. However, where the new owners wish to motivate the newly employed managers to achieve certain objectives or targets, the additional value should be included within employment agreements as additional bonuses or compensation.

The difficulty here is to separate that which rightly belongs to the shareholders as a group and that which is reasonably held to be personal effort. Shareholders may well object to one of their number being offered an overly generous package where they think the compensation should go to them all for creating the foundation on which the near term benefits are being achieved. Where business deals or significant milestones are clearly in progress, the shareholders could argue that the benefits should accrue to all shareholders even if some additional compensation was paid to an individual to see it through to completion.

As a general rule, the more certain the target is to being achieved, the more the compensation should be directed to the selling shareholders as a group. Alternatively, where significant effort is still required, compensation should be directed to the individuals who can best deliver the results.

Whatever is agreed, it is best if all the selling shareholders, or at least the larger non-continuing owner/managers, sign off on the deal as this should avoid future litigation.

Example

Billabong International Ltd., Australia's largest publicly traded surfwear manufacturer, has acquired the Honolua Surf Co. apparel brand and its 19-store retail network.

Depending on the eventual payout, the acquisition will cost Billabong between \$10 million and \$15 million.

The acquisition will be funded by debt and paid in two instalments, according to Billabong. The initial payment to Honolua is 75 percent of the agreed purchase price. After three years, Honolua will receive 25 percent of the initial purchase price plus an incentive-based payment calculated on the increase in retail profits over the period. In addition, Honolua's co-founders, Tom Knapp and Randy Blumer, receive an annual earnout over three years based upon continued employment.

Source: <http://www.insider.com.au/inside/html/modules.php?name=News&file=article&id=1724> Accessed 9th May 2004

Renegotiation or Payout

Not all events can be forecast and thus there will be occasions when the earnout is frustrated by events outside one or both parties' influence. Some of these may be anticipated, such as the resale of the acquired firm and an agreement entered into about the resulting impact on the earnout.

What happens, for example, if the prior management is unable to continue due to ill health or if actions of the buyer cause the acquired business to be severely disrupted?

Earnouts are frequently renegotiated as events unfold. This however requires goodwill on both sides.

Example

In July we indicated that 100% of the Group's total potential earnout liabilities had been realised, renegotiated or capped. Further progress has been made in renegotiating Parsec's earnout due to some major changes in that business.

Agreement has therefore been reached with the vendors of Parsec to settle their outstanding earnout (maximum total of £6.8m payable in Anite's financial year 2005/6) for £873,000, to be paid in guaranteed loan notes, repayable after one year. This, together with other minor adjustments, has reduced the total future cash earnout liability from £25.4m to £19.5m, whilst bringing forward all

remaining 2005/6 financial year liabilities, thus ensuring that all outstanding earnouts will have been paid out by the year ended 30 April 2005, subject to performance.

Source: <http://www.pressi.com/int/release/74044.html> Accessed 8th May 2004

Example

Brooktrout Inc., a provider of telecommunications hardware and software, tried earnouts in an acquisition in the early 1990s and discovered that a demotivated workforce can destroy all the supposed benefits of the approach. In its case, says CEO Eric Giler, Brooktrout agreed to assume the liabilities of a Texas company and to make contingency payments to the selling executives if they hit certain sales goals they set for themselves.

'Entrepreneurs are their own worst enemies,' often setting targets that are too ambitious, says Giler. And they did that here, falling far short of the earnout goals. While conventional wisdom may say that this would be good because Brooktrout wouldn't have to pay the earnout amounts, Giler soon learned otherwise. 'As you start to miss your targets, the incentive goes way down and you have to fix that' so the employees will stay committed, he says. In Brooktrout's case, that meant 'resweetening the deal' with a whole new set of stock options and cash bonuses for the very employees who had failed to achieve their original goals.

Source: <http://www.cfo.com/article/1,5309,7261%7C10%7CC%7C2%7C,00.html> Accessed 9th May 2004

'Best Efforts'

Where the owner/managers are not employed by the new owner, they are very dependent on the buyer following through with agreed programs of promoting the product or services to achieve potential revenue and profit targets. However, many times the buyer has other priorities and the potential may not be realised. This is a recipe for litigation.

Example

Even if the seller is successful in getting the buyer to accept sales revenue as the appropriate target, problems can persist. For example, in *J. Bloor v. Falstaff Brewing Company*, 601 F.2d 609 (2d Cir. 1979), Falstaff acquired Ballantine's brewing business and agreed to pay the Ballantine sellers a royalty of \$0.50 per barrel for six years after closing. Post-closing, Falstaff slashed the annual advertising budget from \$1,000,000 to \$115,000 and reduced distribution centers. Profits rose dramatically, but sales dropped 29% in one year and 45% in the next year. Nevertheless, the seller was successful in its breach suit

against the buyer since the contract required the buyer to 'use its best efforts to promote and maintain a high volume of sales.'

Source: http://www.imakenews.com/techyvent/e_article000100532.cfm

Accessed 8th May 2004

Example

Melbourne, Australia, 5 May 2004

Biota Holdings Limited (ASX:BTA) announced today that it had issued a writ in the Victorian Supreme Court, claiming breaches of contract and fiduciary duties by the worldwide GlaxoSmithKline (GSK) group for failing to promote and support Relenza™. The writ seeks unspecified damages for lost royalty revenues to date, as well as future losses through the life of the product's patents.

'Relenza was a breakthrough influenza drug that had great potential, but it was effectively abandoned at birth,' said Biota's CEO, Peter Molloy. Biota claims that the product failed not because of any inherent disadvantages or deficiencies, but principally because support for the product was withdrawn immediately after the launch year.'

Source: <http://www.biota.com.au/announcements/2004/press120.html>. Accessed 6th May 2004

Taxation Implications

The payment of cash or shares after the closing date of the acquisition may be treated as income or capital gains depending on the way in which the compensation is worded, calculated and timed. Different rulings may apply in different states and countries. Before any earnout is agreed, both parties should take professional advice on the matter. With some change in structure, the same end result may be achieved with different tax consequences.

Key Points

- The buyer will need to investigate the operations of the target firm to verify the information provided as well as to identify potential risks.
- The buyer will also need to identify the level of intervention or integration needed to achieve the benefits of the acquisition. The buyer will need to validate if these activities can be undertaken within reasonable time and cost.
- The final deal can be constructed of many different elements and conditions. The key to a fair deal for all parties is to be open to finding ways for each party to achieve their own objectives.
- An earnout can be used where future events or performance can materially change the value of the acquired business. Earnouts are particularly difficult to construct and care needs to be taken in defining what has to be achieved and how the activity is to be resourced and managed.

Chapter Ten

Financing the Acquisition

Overview: Somehow the purchase price for the acquisition needs to be funded by the buyer. However, the buyer actually has many potential sources of finance including utilising the assets and borrowing capacity of the acquired firm. While the company's equity should be considered, this form of consideration may not be attractive to the sellers, especially if the buyer is a private company. Other forms of finance include cash reserves, borrowing against the assets of both businesses, the sale of assets and equity investments into one or both of the businesses. The buyer must, however, be careful not to overextend their debt level.

Prior to entering into an acquisition process the company should establish just how much finance it can raise. Different sources of consideration can be used to structure the payment of an acquisition, each one with its own advantages and disadvantages. Some funding may come from the buyer's organisation while part may come from leveraging assets or cash flows from the acquired firm. The entrepreneur needs to know which facilities might be open to him prior to entering into a negotiation so a deal can be closed without undue delay in seeking finance once discussions have commenced.

The purchase price in cash or equity sourced from the buyer's side might include:

- Cash,
- Sale of assets,
- Sale and lease back of fixed assets,
- Equity in the buyer,
- Options in the buyer,
- Bank line of credit or overdraft,

- Loans secured on fixed assets, inventory and/or debtors,
- Unsecured loans,
- Loans with personal guarantees from executives and/or shareholders,
- Shareholder loans,
- Angel investment,
- Venture capital investment,
- The sale of shares to the public through a public capital raising.

Finance sourced from the acquisition might include:

- Cash,
- Sale of excess assets,
- Sale and lease back of fixed assets,
- Bank line of credit or overdraft,
- Loans secured on acquired fixed assets, inventory and/or debtors,
- Unsecured loans,
- Vendor finance either secured or unsecured,
- Vendor retains part of the ownership,
- Part purchase by another interested party such as a strategic partner.

Other forms of consideration might include:

- Continued salary for retired or semi-retired executives,
- Use of facilities by prior owner for some period,
- Use of IP by departing shareholders,
- Continued medical insurance,
- Position on Board of Directors,
- Agreement on employee terminations, relocation and/or use of trademarks, brands etc.,
- Earnouts,
- Deferred payment.

It is clear from the extensive list of potential sources of finance and other considerations that the entrepreneur has some flexibility in how the purchase price can be met. The initial task of the company is to establish which facilities

are available to it and the terms and conditions attached to their use. While the expense of any form of debt is a consideration, the risks associated with over commitment and the possibility of defaulting on an interest payment or a capital repayment must be of greater concern.

Cash, Line of Credit or Overdraft

The buyer may have built up excess cash in anticipation of undertaking some acquisitions. This is often the case where the company has undertaken a public capital raising or has had a venture capital finance injection. Cash is thus available for large capital expenditures. Alternatively, the business may have experienced strong margins which have allowed the company to build a war chest for such expenditures.

In addition to the cash available from the buyer, the vendor may also have cash reserves. These can be used after the sale to pay down loans used to finance the acquisition.

The danger in using available cash is that the company needs to ensure it has adequate reserves to fund working capital as well as to cover any delays or problems experienced in the acquired firm's performance or in the integration program.

The company may have an existing rotating line of credit or overdraft facility which is partly underutilised and may be willing to use some part of it to assist in financing the acquisition. The danger of using such a facility is that it may need to be used for working capital in the business or may be subject to operating performance conditions which might require its immediate repayment if conditions are not met.

Equity

Equity is the most common form of consideration used by high growth firms. They normally have valuations based on higher multiple of earning than the acquired business and are therefore able to leverage this difference to effect what seems to be a cheap deal. Publicly listed corporations in this situation gain an immediate advantage as their own valuation will be lifted by the differential between their own multiple and that used for the acquisition. Public corporations might use their fund raising potential to issue additional shares to the public to finance acquisitions.

Private companies are not in such an advantageous position when it comes to using stock as consideration. The lack of liquidity of the stock will normally be seen by the sellers as a serious disadvantage. Not only will they lose control

over their venture but they are then dependent on some unknown exit event to allow them to liquidate their investment. This may still work if they have no better offers and need to sell but it rarely is a preferred path to selling out. On the other hand, a firm which desires to be part of a larger entity in order to assist in creating an exit event for all shareholders might be willing to accept shares. This often happens when the acquisition is more like a merger of equals who desire to work together to create a joint trade sale or IPO.

Pricing of shares in a private company is, however, problematic. There will be numerous assumptions which underpin the valuation associated with future cash flows, discount rates and economic and industry performance. Unless an agreement can be reached on the valuation of the buyer, little progress will be made on using stock as consideration. If the company has little choice but to use stock, it might consider appointing an independent expert, acceptable to both parties, to determine a valuation.

Where private company shares are used for all or part of the consideration, the vendors may insist on all or part of the equity in preferred shares, with or without the option to convert to ordinary shares on a liquidation event. The preferred shares may give them greater comfort in their ability to receive their purchase price in the event that the buyer gets into trouble and has to sell the whole business for less than the valuation agreed at the time of the acquisition. Preferred shares may be with or without a preferred dividend and with or without a cumulative dividend entitlement.

Some vendors may be prepared to continue to hold part of their original shareholding in the acquired business in order to assist the buyer to meet the consideration. Alternatively, they may agree to sell the balance at some future date based on a formula.

Options in the buyer's company can be offered to the vendors as part of the consideration but this is unlikely to reduce the cash consideration unless the vendors are convinced that the value of the company is likely to increase significantly in the near term. Options are, however, often used to lock in vendor executives after the acquisition. The objective is to provide additional incentives to key executives to stay with the company even though they may have received considerable value for their share of the sale proceeds.

Loans

There are several sources of loans for acquisition financing although they rarely come without conditions. The difficulty of relying on loans to finance acquisitions is that it can restrict the ability of the company to use its borrowing

capacity for ordinary activity. Thus, once the capacity for loan servicing is used up, the business is constrained.

Short-term loans secured against the working capital assets of either or both businesses may be used to provide part of the cash consideration. Thus debtors and inventory might be used to access a loan facility.

Even with debtor finance, the solution may not be straight forward. Often lenders will only provide part finance and only for debts within a limit of a specified number of days outstanding, such as 60 days. If the overall value of debtors declines or if the average age of the accounts receivable extends, the company may end up having to pay down part of the loan. With resources stretched to finance the acquisition, this may not be a very good time to have to find additional cash.

Raising finance secured on inventory can have similar problems. The lender may not be prepared to advance more than what might be raised at an auction and may exclude inventory over a certain age.

Longer term loans might be secured on the fixed assets of either or both businesses. Banks and other financial institutions tend to prefer marketable property although plant and equipment can also be used to raise loans but the terms are often not very attractive as the institutions will be concerned about the level of security offered as these assets often have a very low recovery at auction.

The financing problem which many high growth entrepreneurs face is that they often have little invested in fixed assets and so their ability to borrow is limited. Alternatively, the fixed assets they have are probably being used as security for existing business loans. They might get lucky with their acquisition and find that the acquired firm has loan capacity but this cannot be assured when they are arranging facilities in advance of identifying target firms to acquire. In fact, they might find that the acquired firm is overcommitted to debt and the company needs to pay down some of that debt to reduce the risk in the acquisition.

In addition to interest and capital repayment obligations, lenders often impose operating performance conditions on the borrower. Thus the company might find that it has a monthly obligation to produce management accounts for bank review, needs to ensure that certain performance ratios, such as net assets, debtor days, inventory turns and so on, are met and that loan periods are short and subject to periodic review and renewal. The company basically has little certainty that it will have the facility beyond the immediate period even though it negotiates a long-term loan.

Smaller companies or younger businesses may not be able to secure loan facilities without also providing Directors' or shareholder guarantees. Guarantees are sometimes limited to majority shareholders, especially where there are many shareholders with small holdings. Personal guarantees can sometimes be negotiated away based on certain targets being reached. The entrepreneur needs to negotiate this phase-out condition during loan negotiation.

Companies which use debt finance need to be very certain they will be able to meet the interest and capital repayment obligations as well as the other performance conditions. Lenders are not known to be kind if payments or ratio targets are missed. A failure by the company could well result in a loan being called for repayment. If this comes at a time when the company has no other ready source of finance, it could result in a fire sale of the business or a sale of equity at a hefty discount.

Companies with existing debt may have a problem dealing with the security required to raise further debt. If assets have already been pledged against existing debt there may not be sufficient protection for secondary debt. Once a lender has secured a priority position over an asset or asset class, it is highly unlikely they will be willing to allow another lender to take a superior position over them in the event that the business is wound up. Even where there is a default on a loan, the secured asset may need to be sold but the more senior debt would have to be paid off before the next lender can take their share.

Clearly the company needs to evaluate the level of additional debt it can service before considering further debt finance. It needs to set up relationships with potential lenders and receive assurances that facilities will be made available to them to finance acquisitions before it enters into serious acquisition discussions. Unless agreement is reached in advance, it can be very difficult to raise the money after the event or at short notice.

Sale or Sale and Leaseback of Assets

Companies often sell off parts of their business to fund new initiatives including acquisitions. Thus, if part of the business is not performing or is not part of the core strategy of the business, it may be sold off to secure the cash to undertake an acquisition. This approach takes some considerable preparation if the sale is to be undertaken at a good market price. If the intention is to follow this path to financing an acquisition then a long lead time needs to be built into the sale. The company will have little time to prepare a business unit for sale, take it through the sale process while also negotiating and investigating an acquisition. Alternatively, the company may decide to raise short-term finance

in order to undertake an acquisition on the understanding with the lender that it will divest part of the business after the acquisition to repay the debt.

Excess plant and equipment, unused facilities or land might also be sold to raise cash for acquisitions. This may be the case where the business has grown over a long period and has changed in character to a point where some facilities are no longer being used. The excess plant and equipment can be sold to release funds for an acquisition.

A refinement on selling fixed assets is to undertake a sale and leaseback of a freehold facility. This is somewhat more flexible than a loan secured on the building as the business can always terminate the lease and move to cheaper facilities. The major advantage of this approach is that it changes the characteristic of the asset to one with greater liquidity. Instead of value being locked up in a fixed asset, the value is turned into cash but this change still allows the company to use the facilities. It does set up an obligation to pay the lease payments but this may be funded through normal operating cash generation.

Assets of the newly acquired business may also be used with similar effect. Thus excess plant and equipment might be auctioned off and unused land and excess inventory might be sold. Additional cash might be generated by reducing inventory levels or reducing debtor days and by increasing supplier credit days. Freehold of the acquired business can also be sold and leased back. These actions may generate a large pool of cash immediately. The sale and leaseback option may generate immediate cash while spreading out the cost of using the facility over many years.

Vendor Finance

Many owner/managers are prepared to consider providing all or part finance for the acquisition if there are acceptable conditions for repayment and adequate security associated with the loan. This often happens where the vendor desires to sell the business quickly for business or personal reasons. In the absence of a pool of buyers with ready cash, the vendor may have little option but to assist with vendor finance.

Vendor finance can work well for both buyer and seller if constructed in a positive manner. If the seller passes the business onto a buyer better able to manage it, provide additional resources to develop it or take it into a larger market, the vendor's business may be in much better hands than with the current owners. The vendor may have more security with the wealth in the hands of the buyer than in his own hands, especially if his or her health is failing or he or she has other pressing obligations.

Additional consideration may be offered to the vendor to encourage him to finance all or part of the deal. He might be offered a higher than normal interest rate, some lien over assets in the business, the right to take back the business on a default, a repayment escalation clause on not meeting certain performance targets and so on. In addition to the loan repayment, some extra future compensation might be offered with warrants or options which would allow the vendor to participate in the future success of the company.

Vendor Retained Shareholding

A buyer unable to raise all the consideration might agree to buy only part of the business with the remainder left open to future discussion or based on a purchase formula. The difficulty with such an acquisition is that the company is forced to keep the operations of the business separate from its own and is unable to undertake any integration other than various forms of clearly defined out-sourcing arrangements.

As a separate legal entity, the partial acquisition must be managed on behalf of its own shareholders and not as part of a wider group entity. As such, the Board of Directors of the acquisition must place the interests of the shareholders, especially the vendor shareholders, in front of the interests of the buyer where there is a conflict of interest. This can severely limit the flexibility of the buyer to exploit the potential of the acquired business.

There may, however, be circumstances where such a proposition suits the buyer and the vendor. The partial ownership in the business by the buyer liquidates part of the value for the selling shareholders and gives them direct access to the buyer. The buyer gains access to the firm and can set up an arrangement whereby it can take advantage of a privileged relationship. If the vendor, for example, has valuable IP, brands or trademarks which are of interest to the buyer which the buyer can license, then a partial ownership formalises the relationship. Where the buyer is then able to deny access to such rights to its competitors, this might be a very strategic partial acquisition.

The parties may agree the manner under which further shares in the firm are acquired. This might be time based, performance based or subject to certain events occurring. Alternatively, both parties might agree to leave the issue open as each achieves its own objectives through the partial acquisition.

Joint Venture

The company might join together with another interested party to finance the acquisition. This might be the case where the acquired business can be

broken up at a later time with each party taking the part they are interested in. Another common form of this type of acquisition is where the vendor has some unique IP which the parties want to gain privileged access to. By entering into a consortium purchase, each party gains access to the IP it needs for its own business. In this situation, the vendor business is often continued as a going concern with minor changes in governance. At a later stage, one of the parties might be willing to buy out the other parties. This might occur when the reason for the original acquisition no longer exists or the other parties are able to negotiate licensing deals to provide them with the access they need.

Another form of joint venture might be arranged in association with strategic partners of the buyer. If the partners feel it is in their own best interest to assist the buyer to secure the IP rights held by the vendor or to secure the business of the vendor, they might be willing to step in to provide part of the finance required. Rather than establish this funding as a loan, they might be willing to take part interest in the vendor's business. Such an arrangement could be set up in the form of a pure investment where the partner is willing to take a risk on an eventual exit or it could be set up under an arrangement where the company buys out the partner under certain circumstances or conditions.

Angel Finance

Angel finance may be an option for sourcing all or part of the consideration to undertake the acquisition. Angel finance is provided by high net worth individuals who take an active interest in their investments. They often act as mentors to the entrepreneurs they invest with and would normally have a board position with the company. Angel finance would be set up as an equity investment in the buyer's company. The funds invested would then be used to finance all or part of the acquisition.

A company which has not raised angel venture capital finance before faces considerable hurdles when it attempts to raise angel finance for the first time. Angels typically only invest in high growth ventures which can return between 25-50% on their investment within, say, five to seven years. Angels require a liquidity event in order for them to achieve a repayment of their capital and a capital gain on their investment. Thus an entrepreneur who enters into angel investment is destined to either sell their business or list the business on a stock exchange. The probability of listing is relatively low so the entrepreneur needs to accept that the business might be sold in the medium term to repay the angel investor.

Angels provide considerable investment capital in most established economies. In their book *Angel Capital*, Benjamin and Margulis describe the typical US Angel as follows:

- 46-65 years of age, male,
- Postgraduate degree, often technical,
- Previous management experience, started up, operates or has sold a successful business,
- Invests between \$25,000 and \$1,000,000 per transaction,
- Prefers participation with other financially sophisticated individuals,
- Strong preference for transactions which match with technical expertise,
- 23% prefer to invest close to home,
- Maintain an active professional relationship with portfolio investments,
- Invests in one to two transactions per year,
- Diversification and tax shelter income are not the most important objectives,
- Term for holding investment is eight years,
- Looks for rates of return from 22% to 50%; minimum portfolio return 20%,
- Learns of investment opportunities primarily from friends and trusted associates; however majority would like to look at more investment opportunities than present informal referral system permits,
- Income is \$100,000/year minimum,
- Self-made millionaire.

Similar profiles exist in most other established economies. Angels typically only invest where they feel comfortable working with the management team and where they believe they can bring additional value to the investment beyond their money. When they do invest, Angels will impose similar conditions on their investments to those common in venture capital investments. Therefore the entrepreneur can expect to encounter the following conditions:

- A position on the Board of Directors,
- Remuneration for their time spent on the business,
- Veto power over the issue of new shares,

- Adjustment to the number of shares issued to the investor if milestones are missed and/or a lower valuation is set in a subsequent round of investment,
- Veto power over further long-term debt,
- Approval rights over executive remuneration,
- Approval rights over the issue of options,
- The right to put the business up for sale if certain milestones are not achieved,
- The right to replace the CEO if certain milestones are not achieved.

Angels are normally active ‘hands-on’ investors. They expect and often enjoy being directly involved in the management of the venture. In fact, this is often one of their prime reasons for investing. They typically spend time with each of their investments on a regular basis.

Angels typically provide private equity in the gap between family and friends and venture capital. Usually they are unprepared to invest below US\$50,000 and are unlikely to make a personal investment beyond US\$1 million. Sometimes angels will form a consortium to fund larger investments but this generally does not exceed US\$2 million in total. Since Venture Capital firms typically only invest in amounts above US\$5 million, this can leave a funding gap for certain types of acquisition transactions where private equity investment is being sourced to meet the purchase price.

Even if the entrepreneur has an outstanding growth business and an excellent acquisition proposal, it might take three to six months to source Angel finance. If the entrepreneur already has contacts within the Angel sector or already has existing angel finance, this will speed up the process. Angel finance will require the company to give up equity and therefore the problem of valuation of the company will have to be dealt with.

Venture Capital

Venture Capital is the most formalised form of private equity investments. Unlike most Angel investments where the Angel takes a personal role in deal due diligence and management, Venture Capital provides a channel whereby high net worth investors can participate in higher risk ventures without having to personally undertake the burden of venture evaluation and management. The VC fund itself provides the expertise in sourcing, evaluating, investing, managing and harvesting the venture investments.

Whereas most Angels invest in their own right, VC investment is through a Fund. The common structure of a Private Equity Fund or Venture Capital Fund is the Limited Partnership. This structure is commonplace in most advanced western economies and is the prevalent form of VC investment in the US, UK and Australia. The benefit of this structure is the fund itself is not a legal entity for tax purposes for the private investor. There is a pass through treatment of any gains for tax purposes. Consequently any gains and losses pass directly to the investor and are taxed in their hands. The investor also has the benefit of limited liability at the level of the fund itself. No liability from the investee firms can pass back to the investor. A comprehensive description of a Limited Partnership Agreement can be found on the British Venture Capital Association web site (<http://www.bvca.co.uk/>).

Even when a proposition looks attractive, extensive time will be spent by the VC managers with the company's executive team evaluating them as well as the merits of the business. Considerable due diligence will be undertaken before any investment is made. Often 20, 30 or more proposals will be investigated in some detail for every single offer that is made. Many others are rejected after a brief review. Overall the average rate of investment is around 1% of proposals received, ie the probability of the entrepreneur being able to meet the VC requirements are very low.

Due to the complexity of the business proposals, VC firms will often limit themselves to specific industry sectors where they have both the expertise to evaluate the deal as well as the experience and networks to add value to the investment. In the US and UK markets some Funds have a single industry focus, however, in Australia most Funds have a more general focus.

VC firms will also often limit themselves to certain development stages, such as start-up, expansion or buyout, where they can add real value. VC firms which spread themselves across too many sectors or too many stages will often be viewed less favorably by investors as they will see higher risks in such a spread. At the same time, larger funds prefer only to invest larger amounts as they can only support a limited number of investments. A typical fund invests in approximately 10-12 investee companies with individual investments of between 5-15% of the individual fund's total investment capital. The increasing cost of proposal analysis and subsequent due diligence is itself an inhibiting factor. If only one in ten proposals investigated are being invested in, the average cost of investigation of an investee firm is quite high. Therefore small investments are simply not economic.

Usually the VC fund is a minority investor which normally would give it little power or authority to force a sale of the investee firm. However, the investment

agreement would typically provide the VC Fund with the power to intervene to ensure they are able to exit under certain circumstances. Typical provisions would include the following:

1. Voting Trust – You hand over your shares if you don't perform. The VC has the ability to take control notwithstanding it is initially in a minority position.
2. Unlocking Provision – You get an offer you don't want to accept but the VC does – you must buy the VC out.
3. Put Provision – The VC might have the right to sell you to the 'highest bidder' if no exit is achieved by a given date.
4. Registration and Public Offering Provision – they may require an IPO after a given date. If this is not possible, the firm will be sold.
5. Piggy-back Option – The VC firm can sell their shares anytime the firm sells shares either in a public offering or in a trade sale.
6. Come Along – The VC can force you to sell your shares if the VC receives an acceptable offer for its shares.
7. Drag Along – The VC can force all shareholders to sell their shares if the VC receives an acceptable offer for its shares.
8. Tag Along – If a shareholder receives a favourable offer for its shares, other shareholders have an option to notify the purchaser that they too wish to sell their shares

For additional details see: Gladstone, D and Gladstone, L, 2002, Venture Capital Handbook – An Entrepreneur's Guide to Raising Venture Capital, Prentice Hall, PP 180- 208 and Ferris, B, Nothing Ventured, Nothing Gained: Thrills and Spills in Venture Capital, Allen & Unwin. Also see McKaskill, T, Finding the Money – How to Raise Venture Capital, Wilkinson Publishing, Melbourne

Venture capital is basically rare. It is a very special kind of financing vehicle which has a very limited role in financing growth. Overall you can expect about four in 10,000 firms to have venture capital at any one point in time in most western economies. If the company already has venture capital or angel investment, then seeking additional finance from a venture capital firm makes good sense, however, if that is not the case, accessing VC money will take time and has a low probability of success.

Other Considerations

Private business owners often seek benefits beyond those represented by the actual purchase price as represented in the monetary value of the cash or shares they receive. Very often the firms which are available to buy are owner managed and represent many years of dedicated effort by the founder, therefore, the owner may well want other benefits for himself, his family, his employees or his community as part of the deal.

The business may be up for sale as a result of a personal or family crisis and there may have been little thought or preparation as to what happens to the owner, his employed family members or his employees after the sale. Often such businesses have long-serving employees and founders often have a strong sense of obligation towards them. Sometimes the owner may wish for family members to be able to continue in employment for some period beyond the sale.

It is not unusual for business owners to seek assurances about continued employment for loyal employees or that the business won't be relocated away from the local community in which most workers live. Some owners desire that the business name remains or that product names or trademarks continue.

The owner may wish to licence back products or processes in order to continue working within the sector. This may not be a problem for the new buyer if it complements their activities. Normally, however, the buyer would be seeking some period of non-compete from the major selling shareholders. Owners often wish to gain access to private health insurance through the business as this can sometimes be difficult for self-employed or retired persons.

A company which is unwilling to pay the full consideration or is unable to do so might be willing to continue paying the former owners a salary for some period of time. This gives the selling shareholders continued income and spreads out the cash flow drain on the company over an extended period. On their part, the former owners may undertake some limited consulting or public relations work for the company to legitimise the arrangement.

If the owner has undertaken little preparation before selling the business, he may be seeking continued employment for himself, perhaps in a consulting role or Board position. The personal desires of the former owner very much depend on what other opportunities he has or whether there are activities he wants to pursue which the sale would allow. Many owners fail to plan for life after the sale of their business and so buyers often find themselves dealing with these personal issues in order to get a deal agreed.

The main consideration for the buyer is that the buyer has to make it work for the seller in the same way that the seller has to make it work for the buyer. If

there are aspects of the sale that the buyer can include which are meaningful to the vendor but have little impact on the buyer, then these should be given serious consideration. The manner in which the prior owner/managers are dealt with can have a considerable effect on the willingness of the vendor's employees to accept the sale and certainly will influence their attitude to the new owners.

Conclusion

The company has a wide range of potential sources of finance available to it which it should consider including those which can be sourced from both the company and through the new acquisition. Furthermore, the consideration can be a mixture of financing sources including cash, loans, asset sales and shares. In addition, the vendors may be seeking other considerations as part of their deal which are not paid in shares or cash. The buyer needs to be open to a little creativity in the deal which can make it a better arrangement for both parties.

The major risk the buyer needs to be sensitive to is that transactions of this type frequently experience disruptions, delays and additional costs during the transition period of stabilising and integrating the new acquisition. It should be expected that the change of ownership will cause revenue generating activities in both businesses to be disrupted. In addition, loss of staff, intended or unintended, in the acquisition may well impact debtor collection as well as general productivity. These will all absorb additional cash.

Undertaking a sensitivity analysis on cash flow for the period of intervention and integration is critical if the company is to have some idea of the likely worst case cash needs. These then need to be factored into the cash needed to service new loan facilities. The worst situation that the company can get itself into is to be over stretched on cash and find that it compromises its own business as a result.

Key Points

- There are many forms of finance which the buyer can access using the assets and cash generation capacities of both the company and the acquired business.
- Additional loans may be available but the company needs to be very sensitive to additional cash needs which stem from possible disruptions in both businesses.
- The company should provide the opportunity for the selling shareholders to express their personal needs as these may open up some flexibility in how consideration is constructed.
- Angel finance or venture capital finance is really only possible if the company can meet the high growth and liquidity needs of the investor.

Section Four: Post Acquisition Tasks

Chapter Eleven

Managing Intervention and Integration

Overview: Intervention and integration are change processes and should be managed as such. There is a vast body of literature which has been developed in the area of change management which can be applied to these processes. While there are special aspects of acquisitions involving task integration, all acquisitions involve some element of human integration. The process of managing such an activity involves a detailed staged plan, extensive communication, assignment of responsibility for integration tasks, a performance monitoring system and a process for problem resolution.

Integration involves the merging of functions between the buyer and the seller, but not all acquisitions involve extensive integration. However, almost all acquisitions do result in changes being made to the acquired firm. The buyer may impose changes on the acquired firm in order to ensure that the investment benefits are achieved. This intervention activity creates change within the acquired business and needs to be managed in the same manner as integration activities.

Not all acquisitions result in integration activities, however, many of the early stages of integration planning and integration processes apply to every acquisition. Acquisitions mean change and change, or the anticipation of change, can be unsettling on employees in the acquired as well as the buyer's business. Vendor employees anticipate change as a result of a sale of their business and will be somewhat unsettled during the final stages of the sale activity as well as in the early stages of the new ownership until they know how their personal situation will be resolved.

Employees within the buyer's organisation may also feel some level of unrest if they are unsure of the impact of the new acquisition on their own jobs. The

acquisition might result in a new organisation structure, new positions, new reporting lines, new individuals within their immediate working environment and so on. Until they know, they might well be restless.

Even with an autonomous financial acquisition where the business is to be continued in its current form, it is easy to make the assumption that no changes will need to be made and that a change process need not be implemented. However, some employees will take the opportunity to leave. Others will be unsettled by the process, anticipate changes which may be negative to them personally and decide to take another job with more apparent security.

Even if changes are not planned, some will occur anyway. For example, consider the situation of the prior owners and senior executives of the acquired business. There is a considerable body of evidence to suggest that, on average, 40% will leave within nine months of the acquisition and up to 70% will have left by the fourth year after the acquisition. However, these statistics are derived predominantly from large corporate acquisitions and perhaps fail to reflect the characteristics of an SME acquisition.

Whether the founder shareholders stay or leave is more likely to depend on the consideration in the deal, the culture of the acquirer and whether there is an earnout involved. Major shareholders who receive cash and are therefore 'cashed up' and have other activities they wish to pursue are likely to leave. Executives who receive shares in a private company as consideration and who wish to work to assist in the growth of the merged business and who are comfortable with the culture are most likely to stay providing they are given meaningful roles. Earnouts based on effort rather than independent events are most likely to retain senior executives.

Where large corporations acquire small firms they often fail to appreciate the impact of the acquisition payout on the major shareholders. Cashed up executives from small firms are probably going to want to continue in a similar role and not wish to be absorbed into a large corporation. Of course, they are usually not offered a comparable decision-making role in the buyer's organisation and will most likely decide to leave to pursue their career where they can once again hold a senior executive position even if that is with a smaller firm.

Therefore, there may well be changes which take place in an acquired firm even if the intention is for it to remain autonomous. If the firm is intended to continue in operation after the acquisition, then a plan still needs to be put in place to deal with employee fears, terminations, resignations and a potential change of senior executives.

Few acquisitions, however, result in no integration or intervention. Almost certainly the financial reporting requirements will change, some functions will be taken over by the parent company and some employees will be working alongside employees from the buyer to extract benefits from the acquisition even if that only involves a transfer of knowledge. Thus a process for the change of ownership and potential change of management needs to be developed, communicated and executed in a timely manner so that the company does not lose good employees and the knowledge needed to exploit the benefits out of the investment.

Personal Transitions

Organisational change is often seen as a timeline where one structure is changed through a series of planned events into a new structure. It is a formalised process where actions are planned, resources allocated, responsibilities assigned and performance monitored. With the right supporting systems, capabilities and resources, there is no reason to suggest that the planned outcome will not be achieved.

Personal transition into a new role or a new structure is, however, highly unstructured, messy, emotional and somewhat unpredictable. The manner in which individuals cope with change varies greatly and the outcomes are not always what was anticipated or hoped for. For organisational change to be successful it requires that the individuals involved complete their personal journey of change to arrive ready and willing to take on their new responsibilities by the time the formal organisational changes have taken place. Without managing these personal transitions, the organisation itself cannot achieve the outcomes it desires.

Successful change requires many individual transitions. Since unmanaged transitions lead to unmanaged change, transition management must rank as one of the key executive skills that will be needed in the years ahead.

Source: Organizational Dynamics, Bridges, William, (1986), Managing Organisation Transitions, Vol. 15 Issue 1, p24-33

When staff are confronted with a significant change, which is often the case with high levels of anticipated intervention or integration, their concerns focus on these issues:

Do our leaders know what they are doing?

Do they care about what happens to us?

Are they telling us the truth?

Thus individuals will question the competence, benevolence and integrity of their leaders before and after the acquisition. They anticipate change and are anxious to know what will happen to them and to those around them. By delaying or ignoring this need for information, management fosters a climate of unrest, stress and disengagement.

William Bridges defined three stages which individuals need to move through in order to complete their personal transition:

1. Endings

Individuals recognise that the current state will disappear. They will mourn the loss of the familiar. They need to let go of the past and accept that they need to move on.

2. Neutral Zone

This is the transition state where there is a lot of confusion about what is going to happen, a search for meaning about who they are and what contribution they make. This is a period of confusion as they begin to accept the new reality.

3. New Beginnings

This is a time of revitalisation as the individual accepts the new state, begins to work in harmony with the changes and sees new hope for themselves within the new context.

Individuals all react differently through these stages and thus one cannot use a 'one size fits all' approach to this process. This means that part of the change management process needs to focus on individual needs and individual transitions. Management at all levels needs to watch out for people who are stuck, in denial, moving backwards or checking out. Because individual responses will vary and the time taken for each person to deal with these stages of change can vary greatly, time and resources must be allocated to allow this process to be completed.

The process of transition support needs to be personal; it cannot be done in groups using a herd approach. Each individual needs to have the opportunity of being briefed on the changes and given the opportunity and time with their manager and the assigned project manager to raise questions about what is happening to them at a personal level.

Integration Planning

A provisional integration plan should be developed as part of the evaluation. Throughout the acquisition evaluation, the investigating team should be identifying where benefits can be extracted and outlining a provisional plan to achieve those. These will, in some cases, identify a need for intervention in the activities of the acquired firm or integration of activities from the acquired business.

Changes within the acquired firm which do not impact the buyer's organisation in any meaningful manner will involve some level of intervention in the affairs of the acquired firm. In most cases, even an autonomous acquisition would have minor changes made to its senior management as a result of departures of prior management or the need to establish ownership. Other autonomous acquisitions could involve substantial changes where new products, markets and internal processes are being introduced. These changes should be mapped out in a provisional plan during the pre-acquisition investigation.

Other acquisitions will involve the integration of some or all of the functions of the acquired firm into the buyer's organisation. In order to implement a higher degree of integration, changes may need to be made to both the acquired and the buyer's organisations with changes in functions, processes and reporting structures and therefore need to be handled with sensitivity and care.

When considering how to implement extensive change, there should be consideration of the need to change cultures in either or both of the businesses in order to achieve the benefits of the acquisition. Depending on the nature of the different decision and operational processes used within the targeted departments and the differences in cultures to be merged, the manner of integration and the pace of integration will need to be modified. In some cases it may be necessary to rethink the desired level of integration where substantial differences exist in both decision and operational processes and culture.

The sequence and pace of change may well depend on the nature and extent of these differences. The following table suggests a strategy which might be taken to cope with different environments.

	Different Culture	Similar Culture
Similar Processes	Change culture first. Terminate dissenters. Retrain employees. Long change project. Medium failure rates.	Retrain staff. Short change project. High success rates.
Different Processes	Very difficult to integrate. Keep activities separate. High failure levels when integrated.	Change process. Retrain employees. Long change project. Medium success rates.

Within the planning framework, planners need to ensure that momentum within the existing businesses to be retained is not lost and the source of benefits to be derived from the acquisition is protected. Thus key employees essential to the exploitation of the benefits need to be handled with care or else they might leave and take the knowledge with them thus denying the company of the benefits of the acquisition.

More specifically, this study suggests that managers should be explicit in their consideration of how sufficient value is to be created in an acquisition while simultaneously preserving the foundation for that value creation.

Source: Determinants Of Acquisition Integration Level: A Decision-Making Perspective, by Pablo, Amy L., Academy of Management Journal, 00014273, Aug94, Vol. 37, Issue 4

Merging of departments with different cultures will always be difficult and so the potential loss of key employees is a high risk factor. Research data from these types of integration activities strongly suggests that the company first concentrates on the cultural issues in order to harmonise the two different organisational units and then proceeds with the integration of the functions.

Post Acquisition Planning

Once the acquisition has been completed, the detailed planning stage needs to be undertaken. The pre-acquisition planning process should have identified the major integration tasks but these need to be confirmed and detailed. After the acquisition has been completed, the company needs to form an integration team composed of representatives of both businesses. Their purpose will be to produce a detailed plan for integration. This plan should include the following:

- Identification of an integration project manager with a specification of their role and responsibility.
- Formation of an integration committee to oversee integration activities and approve changes and expenditures. The committee will also review progress and make recommendations for changes to the integration plan as progress, or lack of it, dictates.

- A communication plan which will detail how the various stakeholders to the integration will be informed of changes and progress. This should include customers, suppliers, distributors, strategic partners, shareholders and employees in both businesses.
- A decision process and a problem escalation process to ensure that decisions are taken promptly and at the right level within the organisation. This should include a contact list of all key personnel in both companies and a decision tree which indicates who has authority to make key decisions.
- A task list with anticipated actions, responsibilities and timescales. Against each action might also be a list of executives from each business who form the task team responsible for the activities. Where feasible, this should identify the anticipated costs and benefits associated with the changes so that progress can be assessed. Some priority should be given to activities which will show early success and thus reinforce the justification for the acquisition.
- A human resources plan which identifies employees who will be impacted by the changes with details of the process which will be followed for terminations, changes in roles, reporting structures and relocations.
- A plan for the existing businesses so that the disruption due to the change of ownership and subsequent integration tasks do not materially harm the existing revenue.
- A system of activity monitoring and feedback which will enable senior executives to monitor both the existing businesses as well as the acquisition related activities.

A key objective of the detailed planning phase is to validate assumptions made during the pre-planning stage. Prior to the acquisition being completed, it may not have been possible to have full access to information and people within the acquired business. With full access to information and employees, the assumptions on which the provisional integration plan was developed need to be validated. Access to more detailed information might uncover additional areas of synergy, add further integration activities or result in some integration activities being withdrawn. Once the detailed plan has been developed in conjunction with acquired management, this should be communicated widely within the acquired business and those parts of the company which are impacted.

Special attention needs to be given to those areas of the acquired business which are essential to producing the benefits to be generated through the

acquisition. These should be clearly identified and specific responsibilities assigned to those who have to deliver the benefits to the merged business.

An Integration Manager should be appointed to act as a focal point for all integration activities. The objective of this appointment is to put in place an informed resource able to look across all integration and intervention activities to ensure that progress is being made, problems resolved and individual's questions answered. The person chosen for this role should be a senior member of the buyer's executive team, have the time available to undertake the role effectively and have the respect of all parties. The Integration Manager represents the buyer within the acquired business until the integration process is complete. They should be highly accessible and be willing to respect the confidences of those who have personal questions or are concerned with the actions or non-actions of others. They need to constantly focus on the reasons for the acquisition and ensure these remain uppermost in the minds of all the employees.

Organisational Change Management

Managing the change process is the most difficult of all the intervention and integration tasks confronting the new owners. Not only do they need to deal with the personal transitions of acquired employees, but this may also have to be undertaken for existing employees impacted by any new structural or responsibility changes.

Individuals need a clearly articulated path to follow with robust communication, performance monitoring and corrective action. As it is highly unlikely that an organisation will reach a desired outcome through random individual actions, a systematic process needs to be implemented at all levels of the organisation.

The following steps are recommended:

- Clearly state what the desired outcome should be. People then know what they are working towards.
- Focus on what is important and what can be achieved within the capacity and capability of the organisation.
- Set up a series of short-term goals which will take you to the desired end position. This provides clear milestones which can be reached within limited periods of time and allows frequent feedback on progress.
- Understand where the major resistance points are to change and focus energy on those.

- Train managers and team leaders in change management and provide them with an understanding of personal transitions.
- Identify champions and create a critical mass of momentum through short-term activities.
- Form teams to tackle problems and put leaders in charge who enthusiastically support the new vision.
- Look for short-term wins which can demonstrate that the process of change is working.
- Celebrate success to garner additional support.
- Identify all the stakeholders and their positions and work to gain alignment with the overall outcomes.
- Ensure that adequate authority has been given to remove obstacles and allow momentum to continue.
- Reinforce new ways of doing things and institutionalise new approaches which support the desired changes.
- Measure progress frequently and take corrective action quickly.
- Continuously communicate the new vision, the reasons for the changes and the benefits which will come to the organisation and the individuals.
- Ensure that individual transitions are given support and that adequate time is provided for personal issues.

There must be a blend between organisational activity and personal transition and these must be able to work in harmony and at a pace that ensures that both meet on the same page at the same place at the same time. Rushing one will only be to the detriment of the other.

Managing Existing Business

A change of ownership will often slow down the pace of business as individuals deal with their personal uncertainties about their future within the new organisation. This problem does not just exist within the acquired business, it can also occur within the buyer's organisation as individuals are distracted, temporarily assigned to evaluation or integration activities or concerned about the changes within their own business unit. In order to preserve existing revenue momentum, the company needs to put in place processes and rewards to ensure that business is disrupted as little as possible while integration activities are being firmed and executed.

Special attention should be given to informing customers and prospects of the acquisition and the manner in which this will impact on the products and services from the new organisation. Incentives can also be offered to existing salespeople to maintain or exceed short-term revenue targets. Key accounts may be visited by the buyer's senior management to give assurances of continued support. Any disruption in service levels could provide an opportunity for competitors or encourage customers and prospects to look elsewhere for support.

A similar program needs to be entered into with respect to suppliers, distributors and strategic partners. These should be contacted as soon as possible with news of the acquisition and an assurance that their business is valued and will be continued for the foreseeable future. Key suppliers, distributors and partners may warrant a visit from the buyer's senior management to ensure continued support.

Within the acquired business there will be key employees who are essential to the immediate and on-going operation of the business. These individuals need to be identified and special attention given to retaining them for sufficient time to put in place transition arrangements. Special incentives may be used to encourage them to stay for a specified period of time.

In order to manage the disruption caused by post-acquisition activities, the company should establish performance monitors for all major external and internal functions. Normal business levels for these should be set and then monitored on a frequent basis to provide an early warning system of problem situations. For example, indicators might be established for daily production levels, despatch quantities, returns, complaints, quality control, absenteeism, resignations, and so on. It is only by having such early warning systems in place that senior management can identify a problem area which needs immediate attention.

Many integration efforts involve the buyer taking on products or services from the acquired business and introducing these into their existing sales force and distribution channels. While this is expected to generate new revenue from existing customers, such changes are disruptive to sales force personnel. Special attention needs to be given to the amount of time for sales staff to be trained on new products and services while they are still expected to meet normal quotas. Also it needs to be said that existing customers will not necessarily enthusiastically embrace a set of new products and services from their existing supplier. They may be concerned about an increasing level of dependence or a resultant lack of choice and resist new sales efforts. Sales personnel might also

be reluctant to seek out new types of customers or different buying units within existing customers.

Handling Changes in Employment

Impending change can be highly unsettling for employees who often fear the worst. Many will be consumed by questions about their personal circumstances.

- Will I have a job after the sale?
- What will my job be?
- Will I be able to perform any new functions and responsibilities assigned to me?
- Who will I report to?
- Will I be relocated?
- What will my remuneration be and will I be better or worse off in the new organisation?
- Will I like the new people I have to work with?
- How soon will I know what is to happen to me?
- How will the new situation affect my working situation including time off, flexible hours, vacation, educational benefits and so on?
- Can I trust the information I am getting from both my current management and from the new owners?

Some individuals will be unable to handle the stress of the uncertainties surrounding the anticipated changes. Even with firm information and reassurances from their own management, they will feel stressed and worried about the new situation and look for a new position. Others will think they will not be overly impacted and wait to hear of the changes. Once the changes are known, however, some will decide to leave and work actively to find a new position. Some will wait until they have a better understanding of the culture of the new owners and then decide if the new environment is not to their liking and take their time to find a new position. However, once they have made the decision to leave, mentally they will not be putting serious effort into their current job.

Clearly the most important task of the integration team is to move rapidly to provide all employees with an understanding of the likely changes. As soon as possible individual employees should be briefed as to the impact on their own job.

Those individuals to be made redundant should have special arrangements made for them to encourage them to remain until the business can cope with their loss. Arrangements may include special incentive payments to remain for a limited period, retraining, assistance to seek new employment and special termination payments.

Individuals the company desires to retain, but who need to relocate, must be handled with care as relocation is rarely a simple process. Each individual should be provided with counselling to solicit their concerns and assist them to get the information they need to plan their relocation. Special relocation packages need to be devised which assist the individual with relocation activities and expenses.

Where terminations are planned, special care needs to be taken to ensure that those individuals are handled with care and dignity. Those employees who remain with the company will need to be convinced that the terminations were commercially justified and their work colleagues were treated fairly and with respect. Remaining employees will be losing contact with friends at the same time they are coping with changes in their own situation. The situation is thus volatile and a disruptive and a hostile situation can readily develop if not handled well. Where the process is poorly handled, some key individuals may well leave if they feel that the process was undertaken unfairly or incompetently. Key employees may have considerable market potential and might be poached by competitors who see that they can take advantage of the unsettled situation. These individuals are especially at risk where they are personally unsettled or frustrated by the lack of communication or progress.

It is of critical importance that individual employees have a simple and quick process which they can follow to resolve personal questions. This is best handled by assigning a senior human resources person just for this task. Individuals need to know that they are valued and that their fears are valid and will be addressed quickly and honestly.

Arenson says the importance of a central employee communications mechanism throughout a merger cannot be overstated. For one thing, it offers a single point of contact to avoid confusion or contradictions regarding policies and procedures throughout the transitions. It also enables the company to conveniently track trends regarding questions and concerns throughout the integration process. But most importantly, it ensures that issues are being addressed beyond departmental boundaries. Says Arenson, 'If new employees feel like their concerns are not being addressed by an existing Old Kent employee, they have a central point of access from which they can be heard.'

Source: The Quiet Acquirer, by Hollidays, Karen Kahler, ABA Banking Journal, 01945947, May2000, Vol. 92, Issue 5

The company needs to be sensitive to local legal obligations with respect to terminations. It may also need to involve union representatives in order to ensure that unions support the process.

Communication

Early, frequent and honest communication is essential to stem unrest, uncertainties and disruption within both the acquired and the buyer's businesses. Employees in both businesses will be anticipating changes and delays in communicating these can only heighten unrest. Everyone will be seeking answers as to why the acquisition took place and what impact the change in ownership will have.

'Historically, the big mistake is for companies to say 'we don't know' or 'we haven't made any decisions yet,' says Hewitt's Kompare. 'The worst thing is to say nothing. Whatever decisions you do know, tell them as soon as possible. For those you don't know, describe the factors involved in the decision-making and give employees a best estimate for having an answer.'

Source: Merging Compensation Strategies, by Wells, Susan J., HR Magazine, 10473149, May2004, Vol. 49, Issue 5

The first communication to all employees should explain the logic behind the acquisition, the changes anticipated and the benefits which will stem from the planned changes. Employees will be expecting a clear commercial justification for the acquisition and for the changes and will not readily give their trust to an organisation which withholds essential information or makes statements which employees do not believe. Changes which employees feel are unjustified can also result in distrust and withholding of support.

The early communications should remind all employees of the unique characteristics of the acquisition and of those capabilities and assets the company values which need to be preserved. This is also a reminder to all employees that these are the source of future benefit to the company and thus should be preserved and treated with care. Where the acquirer has a good track record of working with new acquisitions and of retaining and motivating acquired staff, this should be reinforced.

It is important that acquired employees understand the logic of integration, the activities to be undertaken and the benefits which will accrue to the company and to the individuals as a result. Frequent and honest updates, including information about delays and unresolved issues, should be communicated to all affected employees.

A variety of communication processes can and should be used. Face to face communication is important to provide employees with an opportunity to hear

first hand of the acquisition and integration process. This should be supported with regular updates through group meetings, meetings between opposite numbers, bulletins, e-mail updates and displayed notices.

An important part of the transition of the integrated parts of the acquired business into the merged company is the adoption of the vision and values of the new owners by the acquired employees. This process needs to be reinforced by senior management of the merged business so there is no misunderstanding of the expected manner in which the organisation is to work. Reinforcement occurs through a combination of elements:

- Senior management needs to devote additional time to explaining and reinforcing their vision and values.
- The questions management asks and responses they provide to questions should show which values are important to the company.
- The manner in which management deals with problems, assignments and situations should demonstrate their values.
- The system of rewards, promotions, public recognition and sanctions and the process by which they are used should reinforce company values.
- Publish successes and recognise and reward those who contribute to achieving the integration objectives.

Values need to be declared, observable and reinforced within the newly acquired business if this is an important part of the integration process.

Kevin Kabat, Old Kent Financial Corp. vice-chairman and president of Old Kent Bank, says much of the company's energy is focused on execution. 'Almost immediately, we set up a 'partnership process' meeting with counterparts at the acquired banks, discussing cultural values and treating their people as our own,' Kabat states. Throughout various levels of the organisation, employees observe their counterparts in action to determine the best means of meeting customer needs throughout the transition. Throughout the process, a strong customer focus remains in place and the company limits execution risk with an integrated training program and the maintenance of one central repository to solve potential issues and problems quickly. The company places a high priority on retaining high-value customers and to minimise the risk associated with integrations, Old Kent executes mock conversions to test for problems before proceeding.

Source: The Quiet Acquirer, by Hollidays, Karen Kahler, ABA Banking Journal, 01945947, May2000, Vol. 92, Issue 5

Task Integration

Some acquisitions will involve the integration of facilities and/or infrastructure systems. These are significant activities and can involve thousands of sub-tasks, terminations, changes in suppliers, relocations and retraining. They need to be planned with care and attention to detail. Changes in supply chain components normally involve changes to physical facilities, organisational structures and employment as well as the transfer of significant information to the surviving information systems. Any one of those changes would be considered a major task. Acquisition integration programs often involve many of these changes concurrently; the combined activities are highly susceptible to delays, disruptions and cost overruns.

Major changes need to have a dedicated resource just to project manage the changes. In addition, there will need to be significant resources allocated to undertake some of the activities involved in the integration. Resourcing such projects poses challenges for most organisations as few have individuals with experience in the functional activity being changed as well as skills in change management and project management. Also, the best individuals for managing or undertaking integration tasks might well be those who are already actively involved in managing current operations and have little time available to see to the detail of the integration program. Failure to provide adequate resources, however, is an almost certain path to delays and disruptions. This often results in consultants being brought in to handle some of the project management and activities of the integration.

Major projects need to have a senior member of the executive team accountable for the results. This normally would be the person who will be responsible for the combined function once the integration activity is completed. Additional incentives might be put in place for the achievement of integration activities and resultant benefits.

Projects should have detailed tasks and activities defined, intermediate and final goals to be achieved and responsibilities identified. Processes for measuring progress and taking corrective action need to be implemented. Project plans should involve risk projections and worst case scenarios so that plans can be modified to reduce potential risks. Progress monitoring processes should be implemented so that problem situations can be identified. Problem resolution and decision escalation processes need to be defined and implemented.

If the company does not have internal integration expertise, the company should consider having their integration plans reviewed by external advisers. Major projects should be reviewed by integration experts to ensure that all activities have been identified and resourced appropriately. Consultants or

executives who have been involved in such integration activities in the past will be much more sensitive to what might go wrong and to the human issues which need to be dealt with.

The pace of integration is often of concern to acquirers. An integration process which proceeds too quickly can result in high levels of stress and loss of key employees. A plan which is hastily constructed and implemented also has a reasonable chance of not providing adequate detail to ensure the integration benefits are achieved. A process which takes too long can be equally frustrating as individuals impacted by the anticipated changes wait to discover the final impact on their personal situation. Delay can create a loss of key employees, a high level of unrest and disruption and a sense of distrust. While integration tasks do not need to be rushed, individuals who are involved in the planning and implementation of changes at least are involved and are less likely to be uninformed or disengaged.

Conclusion

Many companies assume that an acquired business needs to be integrated when in fact only those functions critical to delivering the benefits of the acquisition really need to be. The fewer changes made to both organisations, the more likely it is that benefits will be achieved. Communication throughout the acquisition and integration process is critical to meeting the investment justification. Too often the deal is done and little effort is made to devote the same level of attention to the integration effort. At other times, extensive planning is made to integrating functions and facilities but too little effort is made to the human integration or termination issues.

Entrepreneurs involved in SME acquisitions have little spare resources to throw at integration exercises and thus should proceed with caution. Additional resources might need to be acquired in order to tackle the size of the integration project. At a minimum, the integration plan should be reviewed by knowledgeable integration consultants to ensure the timescales and tasks involved are reasonable and are likely to achieve the integration benefits.

Key Points

- Intervention in the operations of the acquired business is almost inevitable and should be anticipated.
- Where possible integration activities should be kept to a minimum.
- Integration programs often involve many activities and therefore detailed plans with assigned milestones and responsibilities are essential to provide a platform for resource allocation and progress monitoring.
- As part of the intervention and/or integration effort, communications with all stakeholders is critical.

Section Five: Other Considerations

Chapter Twelve

Using Advisers and Professional Services Firms

Overview: Few business owners have been through the process of acquiring a business. Only a small number have acquired several businesses or have been acquired themselves and been through an integration project. Therefore, very few have built up knowledge of the most effective way to purchase and integrate a business. Working with professional advisers who participate in these transactions on a regular basis can provide the entrepreneur with access to how best to prepare their business for an acquisition. Not only can this save time but it should lead to a higher probability that the investment benefits will be achieved. The adviser, a business broker, an investment bank or the corporate finance division of a large professional services firm, should be able to advise on how the deal should be undertaken and how many of the common integration problems can best be managed.

Few entrepreneurs have the experience of undertaking an acquisition more than once. Therefore very few have built up knowledge of the acquisition process. While relatively small businesses undertaking an acquisition might be well served by a business broker, larger firms are best served by more sophisticated and specialised financial advisory firms. Working with professional financial advisers who participate in these transactions on a regular basis can provide the entrepreneur with access to how best to prepare for discussions with the seller and the due diligence investigation. They should also be able to advise on how the company should implement the management processes of intervention and integration. Not only can this save time, but it should lead to a better deal for the entrepreneur. For the larger firm, the adviser, either an investment bank or corporate finance division of a large adviser, should be able to assist in identifying potential acquisitions, provide introductions to complementary advisers, assist with building relationships with potential sellers, ensure the deal is fair and

reasonable and set the right expectations so that all parties understand how best to work together for mutual gain.

Most of the larger professional advisers undertake considerable merger and acquisition work for both buyers and sellers, thus they should be very familiar with how the seller will approach the transaction. This is of considerable benefit to the buyer as they can use this expertise to ensure they are fully prepared and can extract the best value out of the deal.

The type of advice and help that a professional financial adviser can provide includes assistance in the following areas:

Valuation

If the firm has already prepared a valuation of the target business and a projected valuation of the business opportunities arising from the potential acquisition, this will contribute considerably to the discussion with the potential seller. The adviser can review the seller's financial projections, provide conventional valuations and brief the buyer on how best to present their case. Professional services firms understand how sophisticated acquirers undertake valuations and will ensure that the company has taken into account the proper information, assessed the risks correctly and identified and validated the underlying assumptions and values.

Evaluate the Seller's Information Memorandum

An Information Memorandum (IM) is the document most vendors use to solicit interest in their business. It describes the business, sets out the historical and projected financials and provides background information on the industry, the competitors and the investment opportunity to allow a potential buyer to decide if they wish to proceed to a more detailed examination of the business. It is the foundation document which will be used by the potential buyer to evaluate the investment. It is important that the buyer fully understand the information prepared in the seller's IM and be sensitive to what has not been disclosed or included. The IM will be used by the buyer to prepare for their due diligence. The adviser can assist the buyer by identifying information in the IM which needs additional investigation.

Restating Financial Information

The seller's current financial information may not have been prepared according to generally accepted accounting principles or presented in a conventional format which allows easy analysis. Your adviser can ensure that the statements are restated correctly and can request additional information to ensure the accompanying data fully supports a detailed investigation. The

information can also be reviewed by the adviser to ensure that financial information is presented on a consistent basis from year to year and that any extraordinary or abnormal items are fully explored.

Helping with Introductions and Referrals

Well established accounting firms and legal firms participate regularly in transactions involving buyers. They are therefore in a good position to know most local large business advisers, consulting firms and investment banks. If they consider that you have a good business proposition, they can help with introductions to other firms which can assist in a transaction. Since many professional firms have national and international offices and affiliate networks, this can assist with distant national and international acquisitions. Having the right advisers in the final bid process and due diligence investigation can make a huge difference to the ultimate purchase price.

Reviewing Purchase Terms and Conditions

While purchase agreements are often set out in a conventional format, the buyer is not normally in a position to know which terms would be reasonable for their business. The adviser should be able to guide you on where terms should be renegotiated; however, you should always obtain proper legal advice on contract terms.

Assisting in Negotiations

The firm which is represented by a well established and respected adviser is likely to be better prepared for the negotiation. At the same time, a well prepared seller knows that the terms are going to be reviewed by a knowledgeable party. This should result in more productive discussions and the result is likely to be better for both parties. The seller may prefer to deal with a business represented by a professional adviser as they know that the buyer will not need to be educated about conventional terms and conditions or which warranties and representations are reasonable under a normal deal.

Advice on Preparation

Preparation for an acquisition is much more than simply finding a business to buy. The adviser will lay out an acquisition process and provide input on the resources the buyer will need to undertake due diligence, negotiation and integration of the target business.

Due Diligence

Due diligence will be carried out by the buyer as part of their initial evaluation of the investment opportunity. This is mostly a product/market evaluation to see if the business can support the potential growth claims of the seller. After the business terms of the acquisition are agreed, the buyer will then carry out an extensive review to further ensure that it has a thorough understanding of the business and the management and has uncovered any data discrepancies and investment risks. Your adviser can assist in the design of the due diligence process to ensure you are fully prepared and help source any specialist consultants who may be required to supplement the work of the buyer and the professional services firms.

Advice on Pensions, Options Schemes and Remuneration

Once the deal has been negotiated, the buyer will need to deal with any changes to the remuneration and benefits of the acquired staff. A professional accounting firm can review these to ensure pension schemes are protected, option schemes can be legally transferred and new remuneration schemes are fair and reasonable and in line with the buyer's own remuneration systems.

Tax Advice

Few firms are structured from the outset to be optimal for a sale. Over time the tax regime will most likely have changed, especially with regard to retirement strategies, trusts, capital gains and options. The corporate structure of the business may not be suitable for an outright sale or be optimal if there is an earnout portion. A professional accounting firm can also review the current business structure for compliance, tax collection and reporting. Outstanding tax liabilities will need to be verified and agreed with the selling shareholders. Some tax planning may be offered to the major selling shareholders in order to provide additional value in the acquisition. The buyer may also need some tax advice depending on local tax rules and options open to the buyer to account for various assets and liabilities acquired in the purchase.

Acquisition Strategy Assistance

From their knowledge of prior acquisitions, your adviser can help with how the deal should be negotiated, how potential sellers should be approached, identify integration issues and/or show how the company can best position itself for a competitive bid.

Your financial adviser should also work closely with a legal firm.

The type of advice and assistance a professional legal firm can provide includes help in the following areas:

Prepare Confidentiality Agreement

You may wish potential vendors to sign a confidentiality agreement before you allow them access to detailed information about your business.

Prepare Heads of Agreement and/or Letters of Intent

It is critical that the vendors are well informed about exactly what type of deal they are getting into and are confident that they understand the conditions attached to the deal. A well designed Heads of Agreement or letter of intent greatly assists the negotiation and deal closing process by setting the right expectations.

Prepare or Review Purchase Agreement

The purchase agreement would normally be prepared by the vendor's lawyers; however, this protocol varies in different countries. Some buyers prefer to have their lawyers prepare the contract. This is a complex legal document which few entrepreneurs will have ever seen and certainly few would understand in any depth. The professional legal firm can either draft the documents for you or review the terms and conditions and identify any harsh or unusual conditions that the seller has requested and assist in the renegotiation of those where the seller prepares the document.

Review Warranties and Indemnities

The vendor would normally be expected to provide warranties and representations and indemnities to the buyer. These can often be renegotiated to provide better coverage and risk protection. The professional legal firm will know what is reasonable and what is not. This is one area where poor preparation, inadequate reporting and compliance systems and poor governance on the part of the seller can significantly increase the exposure of the buyer.

Review Employment or Non-compete Agreements

The buyer will expect the key executives and major shareholders of the acquisition to enter into employment agreements and/or non-compete or restraint of trade agreements. The legal firm can prepare these and ensure the terms and conditions associated with these agreements are reasonable.

Review Disclosure Letter

The vendor should be prepared to disclose any issues which may affect the decision of the buyer to purchase. They should also identify any potential liabilities of the business. The legal firm can advise on the types of disclosures the buyer should receive and review the disclosure letter received to ensure the disclosures are adequate. They may also raise additional questions that the buyer should be seeking clarification on.

Review Corporate Documents

As part of the preparation for the sale, the legal firm will review the corporate documents which authorise the vendor to undertake the sale of their business and ensure that they meet the requirements of the buyer. This review would normally extend to board minutes, shareholder agreements, option schemes and any material contracts the vendor has entered into.

Depending upon the size of the transaction, the buyer should plan for approximately 5-10% of the purchase price to be spent on their professional services fees, noting that smaller transactions are likely to have a higher percentage associated with adviser fees. Professional services firms will often take on an assignment where part of the fee is contingent on the successful outcome of the deal.

Not all professional services firms have the necessary experience to undertake this type of work effectively. The entrepreneur should not assume that their current professional services provider has the expertise to properly advise them in this area. They should seek independent advice as to which professional services firms are best equipped to handle the transaction they wish to enter into. Before they start to incur costs for this service, they should undertake some due diligence and investigate the extent to which the referred firm has a track record of success in working with clients on sales and acquisitions of similar sized businesses or similar sized acquirers. Asking for references would not be unreasonable and the company should also ask for a list of transactions the professional services firms have participated in and some details of the work performed for the clients involved. People move between professional firms and so the company should also ensure that the expertise is still with the professional services firms. They should ask to be allocated an adviser with personal experience in these types of transactions.

Experienced professional advisers working in the M&A sector would typically have very good standard due diligence checklists and evaluation methodologies which can be readily adapted to suit a specific transaction.

Other Considerations

Some advisers, whether they be accounting, legal or corporate finance executives, are so locked into a traditional earnings multiple valuation model of firm value that they are not able to distinguish between a financial acquisition and a strategic acquisition. That is they 'don't get it'. They really don't understand the difference between vendor profits and cost synergies from acquisitions which are justified on the basis of leveraging strategic value to overcome threats or generate significant revenue. They will want you to undertake a conventional valuation based on vendor historical earnings and won't grasp the impact of vendor strategic assets and capabilities on your business.

If you are considering a strategic acquisition, you need to find a professional adviser who is able to see the inherent potential within the vendor firm but also the strategic value where it exists. If your initial discussions with a professional adviser show you that they want to take you down a conventional historical vendor profit path, you should move on and find one that you feel can best represent the potential you can see in the target business. Ask them to provide you with references to transactions they have advised on which have involved strategic value to the buyer.

Smaller business owners are often concerned about entering into relationships with investment banks or larger accounting and legal firms and often hesitate because they feel that the larger firms carry considerable overheads which are passed back to the client in higher fees. It is certainly true that the larger firms typically have higher charge-out rates but they also need to compete for services of the smaller clients and so it is not unreasonable to ask for a smaller charge-out fee given the size of the transaction, the size of the buyer or the relatively lower level of complexity associated with a transaction. The larger professional services firms do have an advantage of being national and international organisations with specialists in most areas and this can be of benefit to the smaller firm involved in complex trading transactions. When it comes to contracts and agreements which can materially affect value dilution, a little more up front may better protect the buyer avoid risks or undertaking a bad deal. This would certainly apply to IP agreements, option schemes, shareholder agreements and any international acquisitions that the company entered into.

The larger professional advisers have a decided advantage in M&A transactions. They see them often and regularly advise on both acquisitions and sales. Larger accounting and legal firms are often asked to undertake due diligence work on behalf of larger corporations and thus are very familiar with the entire process. Larger firms are taken seriously when it comes to negotiations

and thus can better protect the entrepreneur with little or no experience of these types of deals.

In the end, it may come down to spending a little more over a longer period to be better prepared to undertake acquisitions rather than spending a lot near the end closer to the transaction. The company is likely to be better managed and be less risky as a result of that preparation. At the same time, the impact of a large professional firm in the deal process can enhance the reputation of the buyer and may result in a better price being negotiated. Certainly, it should improve the quality of the due diligence process which in itself can have a significant positive effect on deal price. It should also speed up negotiations as the seller knows it does not have to educate the buyer about normal terms and conditions of a sale.

Building relationships with good professional services firms, like building relationships with potential sellers, takes time and is all part of the process of preparing the firm for an acquisition. But it may be critically important when the time comes to buy a business.

Key Points

- When you engage a professional services firm, make sure they assign someone you can work with who is going to work for you to make the deal happen. There are 'deal makers' and 'deal breakers' and you need the former. An over-zealous adviser can stall negotiations or make it impossible for the seller to accept.
- If you follow this process, you should manage the evaluation, negotiation and integration processes more effectively and, as a result, avoid common risks and improve your return on your investment. You can therefore afford good advice.
- Don't leave working with professional advisers to the last moment. Bring them into the process early on and get their advice about how to best prepare the company for an acquisition.
- Work with professional services firms familiar with your industry who work frequently with corporations your size and with acquisitions of the size you intend to buy.

Chapter Thirteen

International Acquisitions

Overview: International acquisitions are especially difficult. Not only do they contain all the risks of a domestic acquisition but they involve business and individual issues a domestic company may have no experience with. Almost without exception, the buyer can expect the manner of doing business in a foreign country to be different, thus the buyer cannot make any assumptions about what might work in a foreign environment. There are also significant difficulties with sending company executives to offshore locations.

Acquiring a business in another country greatly complicates the acquisition and integration process. Not only do you have to deal with all the usual risks in evaluating and integrating a business into your own organisation but you may have to do it in a different legal system, culture, currency, language, business rules of engagement and time zone. Each one of these characteristics will complicate the transaction and subsequent operations management. With several of them acting concurrently, this dramatically heightens the risk of failure.

Once you have identified your foreign target acquisition, the process of dealing with buying abroad starts. The first mistake most domestic companies make is to assume that business is done the same way in another country. They incorrectly assume that they can go about the buying transaction as if the business was located in another state. They also assume that the seller will deal with them in the same way that one of their domestic compatriots would. You can almost guarantee that every assumption you make about doing business in another country will be wrong. In fact, that is a good place to start.

Preparation

Buying a foreign business requires you to assemble a range of skills and resources. Some of these you will be able to source in your own country while others will have to be contracted in the target country.

Professional Services

You will not be able to use your domestic professional service providers to represent you in the foreign country. You will need to appoint legal, accounting and tax advisers to act on your behalf. They would normally act under instruction from your domestic advisers but you will need to meet them and be comfortable with them acting on your behalf. You should choose local representatives who have experience with international transactions, are familiar with acquisitions sourced from your own country and be able to work with you in your own language.

The transactions will need to be reviewed for local tax compliance as well as any other foreign transaction regulations which may apply. Various countries in the past have imposed specific requirements on foreign acquirers including a need for local partners, local shareholders, local Board of Directors representation and so on.

You need to be sensitive to the fact that the company you are buying is a local legal entity and must be managed as such. Any assets owned by the local firm cannot simply be stripped and shipped abroad. This reduces the tax basis of the local tax authority and so they keep an eye out for such transactions. If you do decide to engage your foreign acquisition in inter-company international business transactions, you may need to satisfy the local tax authority that the pricing of such transactions is fair and that local tax revenue is not being eroded.

Your local Board of Directors will be required to act in the best interests of the local business even if you own 100% of it. That means they need to be assured that the business is solvent and that the rights of the local authorities are being upheld.

The manner in which the transaction can be structured may be affected by local foreign transaction regulations, tax implications for both buyers and sellers and the method of financing being used. The structure of the deal may be impacted depending on the compensation arrangements available. For example, local executives may not be able to hold options or shares in a foreign company.

Due Diligence

Evaluation of the local operation may need to be carried out by local advisers if there are cultural or language issues involved in investigating external relationships. Surveys of customers, suppliers, partners and ex-employees may

need to be handled with care and sensitivity. Change of control may trigger termination or option clauses in various contracts and these will need to be identified and the risk of changes assessed. Some contracts may be essential for the value in the acquisition to be protected. These will have to be addressed before the transaction can be completed.

Local accounting regulations may be different to your own country and tax reporting may determine how certain transactions are accounted for. You cannot make any assumptions about the profitability of the business until the financial data has been translated into your own accounting rules. Unless you are dealing with a sophisticated seller, such translation may not be possible as it is unlikely they will be able to access the underlying data in the form required. The likelihood of different reporting rules means that you will need to have the accounts validated first in the local environment to ensure the data is accurate. Next, you will need to have the data translated to your own system if that is possible.

Other areas of due diligence will encounter similar problems. The due diligence needs to ensure that the business is satisfying the local regulations in areas such as compliance reporting, OH&S, tax reporting and so on. You will then have to make your own determination whether these assurances are sufficient for your purposes.

Deal Structure

Payment to a domestic seller may be much more flexible than to an overseas seller. Professional advisers will need to advise on which terms can apply in the local acquisition. In some cases the ideal structure may not be able to be used. There might be restrictions on which mixture of shares, options, cash, deferred payment, escrow clawbacks and earnouts can be used. Termination payments may have to be changed to conform to local employment regulations. Retention bonuses and performance commissions may not apply as expected and need to be restructured.

Where only part of the business is being acquired, perhaps where local retained management has been allowed a share of the business, the structure of the transaction may need to be altered for tax reasons or for local shareholding regulations. Also, once a minority interest is present, the acquirer needs to be very careful to run the local company in a way which protects the interests of the minority shareholders. For example, surplus cash may not be able to be remitted to the parent in such a case.

Operations Governance

In many countries a small private firm has no requirement for an annual professional audit. However, once the business is owned by a foreign corporation, there may be regulations which require such an audit either from the local jurisdiction or from the jurisdiction of the acquirer. This can fundamentally change the internal reporting systems of the acquired business and bring with it a considerable increase in local infrastructure expenses. The local firm may not have had a formal Board of Directors but may require one in the future. This will also increase the formality of decision-making but also increase the expenses associated with managing the local business.

Financing

Borrowing against the local assets to partly finance the deal or continuing existing loans may not be possible without some prior negotiation. Where local loans are guaranteed by the local shareholders, the lending institution may not be willing to accept guarantees from foreign corporations or foreign nationals. These loans may need to be renegotiated, transferred to another lending institution or paid off. An acquirer cannot make an assumption that local assets can be leveraged to finance part of the deal. Even where adequate cover is available through the assets of the local firm, the local institutions may be uncomfortable with a foreign owner. If such financing is expected to assist with the acquisition, the buyer would need to establish the availability of such finance very early in the negotiations.

Transfer of Company Executives

It is very normal for foreign acquirers to relocate senior executives from their own company to oversee the operations of a newly acquired overseas business. In many situations this arrangement is somewhat permanent where the chief executive always comes from the parent company. Often several of the senior management team will have been employees of the acquiring company. However, few companies manage well the process of relocating executives and the rate of failure of such transfers is relatively high. The research shows that about 70% of transferred executives return to their home country within nine months.

Unless you have personally worked abroad, you can have little real understanding of the changes which a transferred executive will go through. Most corporations make the mistake of choosing the person who they think can best undertake the tasks being assigned rather than the person who can do a reasonable job of undertaking the task at hand but who has a high probability of surviving the transfer.

Visas

Few countries allow executives to take up local employment without subjecting them to a long and bureaucratic visa application process. Issues the executive may have to deal with include:

- Qualifications may not be recognised.
- Domestic police reports may be required from each former state of residence.
- Proof of financial support may be required.
- Credit history may be required.
- An interview may be required at the Embassy of the target country.
- Extensive details of the acquiring company may be required.
- Details of spouse and children and their financial support may be required.

Relocation

The incoming executive may need to buy a local residence but this may not be easy since prior credit history may not be accepted by the local mortgage institutions. There are countries where foreigners are not able to purchase property. The former home will need to be sold, personal effects packed and shipped, temporary accommodation arranged during the shipping time, children relocated to new schools and a new home found which is acceptable to the family.

Problems which are likely to arise may include:

- Credit cards may not be able to be transferred.
- No local credit history may deny purchasing on credit.
- Cars may not be suited to different driving conditions and may not be legal or suitable (eg. driving on the other side of the road).
- Voltage change may mean household electrical equipment needs to be replaced.
- School records may not be acceptable (for instance, children may be set back a year in school).
- The acquired business may need to guarantee debts of the incoming executive.

- The executive may not be able to work in the host country until a visa has been issued (this can take over a year in some cases).
- Spouses may not be able to obtain a work permit.
- Foreign executives are often paid additional allowances or a foreign salary well in excess of local equivalents. This can be resented by local executives.
- Local vacation entitlements may be more or less generous than the executive is used to. Whatever the difference, this can create tension between the executive and the other local employees.

Transferred executives find that they have an increased burden of personal paperwork associated with loans, credit transactions, employment regulations, taxation requirements in both countries, registration for social security, insurance, pensions and so on. At the same time they have disruptions to ongoing benefits such as pensions, retirement entitlements, insurance benefits, credit arrangements and so on, which are impacted by their time abroad. Companies are often not sensitive to the personal issues executives have to deal with in going abroad and this can create stress in the domestic lives of relocated executives.

Failure rates for executives transferred overseas are high mostly because the executives experience problems outside the office which are problematic or insurmountable. For example:

- Spouses who have been employed find the idleness of being forced into non employment stressful.
- Children may not be able to be relocated to an acceptable school or they may not be able to adapt to a foreign language.
- Families which have always relied on local relatives for support may find the isolation from their support system difficult to bear.
- The executive and their family may find they are unable to adapt to a very different foreign culture, especially if this involves learning a new language.
- Children used to a certain style of life, perhaps with animals or wide open spaces or warm weather, may not be able to readily adapt to something very different.
- Children who have left school friends at home or older siblings who have not moved with them might find the change very difficult.

- Transferred executives often need to work long hours to become familiar with the new business or make extended trips to manage the new activity. This can isolate their family leaving them feeling abandoned in a strange environment.
- Some locations are relatively dangerous requiring intense personal security measures. The denial of normal freedom can place considerable stress on both the executive and the family.

Unless you have personally experienced an extended period in a country where you don't speak the local language, you can have little idea of the isolation which new arrivals feel. This permeates every aspect of their lives and is especially demonstrated when they have a home maintenance problem or an emergency involving a sick child where they feel powerless to resolve the problem. The level of frustration and stress can be very high and many spouses at this stage decide to return to their home countries. As a simple example, imagine that the only English language TV channel you can receive is CNN. How would you feel if day after day the only TV you could understand is the ever repeated news on CNN? Not everyone has the capability or time to learn the local language before they are posted abroad. For the spouse this can be an extremely trying experience and many of them decide to return home well before the agreed assignment period is complete.

Return to the Parent Company

Executives who have been transferred for a period abroad often find themselves displaced when they return to the parent company. Some returning executives find it hard to settle into a local job if they have had the experience of managing a subsidiary at some distance from the parent company. They may also miss the additional salary allowances and, perhaps, the domestic support they were able to afford in their foreign location.

Returning executives have often stepped out of the mainstream career path and therefore have not been around when succession plans have been settled. They come back home to find all the good jobs taken and no one has really thought about what to do with them on their return. Sometimes their return is unexpected due to personal circumstances which required them to return or the foreign business may have found a local manager thus greatly reducing costs to the parent company.

Once back in the home country, the returning executive has a similar number of situations to resolve. A new home must be purchased, children put into school, furniture and effects shipped back from overseas and so on. Children may have trouble returning to their normal education level due to differences

in syllabuses, differing school calendars and problems of verification of grades. It is not uncommon for children to be held back a year to ‘catch up’.

Freeing oneself from the foreign legal situation is not as easy as hopping on the plane. The local tax authorities may well insist that the returning executive continue sending in tax returns as long as the executive has part year residence or property in their jurisdiction. Then there is the problem of possible double taxation where each tax authority wishes to claim the full year income in the year of return. Where tax years are different, this can require specialist tax expertise to sort through the complications and it may take several years before each tax authority is satisfied with the outcome.

Management

Few executives appreciate just how complex it is to operate a foreign subsidiary or joint venture. They make the assumption that the business will be able to be managed as if it were in another state within their own country without really appreciating the impact of different cultures, times zones, currency and ways of doing business.

We all tend to assume that business is done the same way everywhere unless we have been personally exposed to different environments.

When my UK based business acquired a firm in San Diego, California, I relocated there to settle in the new ownership with the intention of promoting one of the local executives to President. However my stay extended to two years as I slowly came to grips with a business culture that was very different to the one I left behind. I never before appreciated just how vast the USA was or how differently this impacted on how business was done.

Where we were located in Northampton in England, customers could readily drive to our office for a day long meeting. Rarely did we ever go to the office of a prospect for an extended product demonstration or contract negotiation. Imagine my surprise when my US salesperson asked me for permission to fly from San Diego to New York for an hour ‘get to know you’ meeting. I was shocked at the cost involved. However, once I understood that the salesperson would use this meeting as a cornerstone to make numerous other visits over a few days, the logic became obvious. I simply hadn’t thought through how business would be done in a different geographical situation.

Other problems are equally confronting:

Distance

Imagine you are dealing with an office which is over ten hours different in local time. You cannot simply phone their office whenever you feel like it as no one will be there. You can't readily phone people at home as that is fairly intrusive and they deserve their break from the office as well. As we all know e-mail is a poor substitute for conversation and often leads to misunderstandings. Any information you want is generally going to take at least a day to get back to you. This tends to frustrate management at both ends.

If verbal communication is difficult, consider the problem of personal face to face meetings. Anything over four hours flying is going to require a minimum of two days travelling and often more. Once you have a time zone change of nine hours or more you have extensive travelling time as well as jet lag to cope with. Then of course there are expenses of travel, accommodation and meals. To gain any form of assimilation requires frequent visits by executives at similar levels and functions. Thus an executive team of five may have a bi-monthly visit to their opposite number to ensure smooth co-ordination and effective personal communications.

Guarantees

Domestic suppliers have rights under local law to seek redress for unpaid bills or lack of performance under contracts. Often they can access the personal assets of Directors or shareholders in exceptional circumstances. When the owner is an overseas company, their rights are somewhat limited. In this situation they may decide to change the terms of business to cash and to require personal guarantees of local Directors or senior managers before doing business. This can be very confronting for a foreign executive to be required to put up personal guarantees in a foreign country.

Local banks may be reluctant to extend loans to foreign owned subsidiaries. Even where personal guarantees are offered, this may be against their policy. Thus the new owners are forced to seek out new debt facilities as part of the takeover process. This can take time and may result in higher fees due to the ownership issue. In extreme cases, the new owner may have to fund the operation from off shore. This can also create problems as lenders are generally reluctant to lend against assets outside their national boundaries.

Change of Control in Contracts

Some contracts with suppliers, distributors and agents will have termination clauses or other provisions attached to a change of control of the acquired firm. The impact of such changes needs to be scoped and a plan put in place to

manage the changes. Often the other party will agree to continue doing business as normal but cannot be guaranteed without investigation and negotiation.

Loss of Key Staff

Some local staff may not wish to work for a foreign owner. This can put the operation at risk. This is a sensitive situation which must be handled with care. Even where the firms have a long standing relationship and executives know each other reasonably well, this problem can arise.

Reducing Acquisition Risks

Clearly international acquisitions present an additional set of problems over a local domestic acquisition. Even though there has been considerable research in this area, there are no clear guidelines as to how these unique problems can be overcome as the circumstances surrounding each incident are often so unique as to defy grouping. However, anticipating problems and working through the issues which might arise can uncover potential problems which can be planned for. There are, however, some approaches to help avoid the worst mistakes.

Selecting the Right Executive

Choose relocating executives with care.

Many of the problems associated with the failure of foreign investments are associated with choosing the wrong executives to be relocated. Some individuals will never settle away from their home country. Others find the changes too dramatic and decide to give up. For most, it is difficulties with their families which create the problems. A number of approaches have been tried with some success:

- Relocate single individuals or couples without children.
- Use individuals who are fluent in the local language. Perhaps they are children of immigrants, have studied the language in school or spent time in a country with the same language.
- The selected individuals should be open to new ideas and ways of conducting business. Persons with strong opinions or set ways are unlikely to adapt to new business environments.
- The chosen executives should not fear for their jobs or their promotion within the company if they take an overseas assignment which has risks associated with it. Thus you need people who are well respected within the firm and have a proven track record.

- Avoid narrow specialists. Most transferred executives have to deal with many issues in the new acquisition and thus a general business background across a number of business units is preferable to a person who is a functional specialist.
- You need a people person. The transferred executive should be good at networking and establishing personal relationships.
- Choose a diplomatic person. Many of the existing relationships will have to be nurtured. There will be some negative reaction to a change in control and especially with an overseas buyer.
- Use a person who has a set of values which will best align with the target firm.

The key to this selection is to find an individual or family which will readily adapt to the foreign assignment, is able to undertake the assignment and will be acceptable to the acquired firm's retained management team. Many companies make the mistake of using someone who is currently available or who would be the right choice to undertake similar activities in their own company without taking into account the foreign aspects of the assignment.

Use a Trial Period

While it is expensive and disruptive to have to switch executives once the ownership has changed, it is better to do that than have the wrong person in place. The selected executive should be given the opportunity of working in the acquisition for a limited period to 'audit' the activity. Make as few changes as possible during this period while the executive is finding out about the business, the market and the external relationships. This period allows the new owners to assess the planned integration changes and allows the executive time to assess his or her willingness to take on the foreign assignment.

If the executive has a family, the next stage should be to have the family members also undertake a trial period in the foreign location and allow them to assess whether they can establish a reasonable level of security and harmony with local conditions. This will give the family time to assess schools, houses and social conditions.

Have the foreign management assess the selected executives. Unless local management is willing to actively work with the buyer's representative, it is unlikely the acquisition will achieve the benefits hoped for. While local management does not have the final say in who is transferred, this should be a clear indication of whether the selected person is likely to fit in.

Appoint a Local Board of Advisers

Foreign executives can be very isolated in a new overseas position and the job itself may be very stressful as changes are implemented. It can help to have trusted external advisers available to review activities and advise on local culture and conditions. Because we inevitably bring our preconceived notions of how to do business from our home culture, there may be things that surprise us. Rather than immediately make changes, it is very beneficial for the executive to have access to local business people and professional advisers where these issues can be reviewed before changes are made. This also gives the corporate owner another source of information to check whether the changes being made and the pace of change is appropriate to local culture.

Appoint Local Management

Few transferred executives are prepared to undertake long-term overseas assignments. Even with the additional allowances for relocation and local assimilation, they will want to return to their home country for personal reasons. This may be to educate their children, look after aged parents, pursue personal hobbies or to advance their professional status. Assignments typically last only two to three years. When this period is over, the company must go through the whole exercise again.

In the long term, it makes more sense to have a foreign corporation managed by locals. There is a greater sense of loyalty to a local manager and the probability of them staying longer is certainly higher. With this in mind, the corporation should be grooming local successors for the top jobs. Many corporations plan such successions by having possible successors work at the home country corporate office for a period of time. This helps them develop personal networks within the senior management team, allows them time to understand the corporate culture and the culture of the host country and gives them time to improve their host country language skills if they speak a different native language.

At the same time that succession is being investigated, the corporation should be building links into all sections and levels of management. Thus managers undertaking similar roles in both the foreign firm and the corporation should be encouraged to work together on common assignments, meet periodically and communicate regularly. Team projects should be set up in various areas to develop approaches to common problems. Superior practices within the acquisition should be investigated and foreign executives requested to assist in knowledge transfer.

The foreign business needs to understand clearly why they were acquired and how they are expected to contribute to group results. They also need to have a sense of identity and sense of pride as well and so it is important to assist them to make a contribution to the overall corporation beyond the immediate acquisition gains.

Long-term Success

If local acquisitions have low rates of success, imagine the difficulties associated with an acquisition at a significant distance in a very different national culture. The number and size of the problems to be overcome can be huge. This is not to say that it cannot be done or that the benefits are not worth the effort, but few first time overseas acquirers have any idea of what they are getting into and fail to do their homework before they proceed with the deal.

Probably the best overseas acquisitions are those which have considerable upside and few anticipated problems. To the extent that the business can be left more or less as it is, acquisition risks are reduced considerably. If, at the same time, current management is prepared to stay on for some reasonable period of time, this will reduce the level of stress and uncertainty associated with the change of ownership.

In the end, however, the benefits associated with the investment in the new business need to be achieved. If those benefits require widespread changes and business disruption, the acquisition might be doomed from the outset. Great care needs to be made with due diligence and integration planning before the contract is finalised in order to ensure that the benefits can be achieved.

Long-term success will only be achieved when the business settles down to normal operations as part of the new corporation. If this is able to be realised with minimal disruption and changes can be undertaken in a relatively short period of time, the acquisition is likely to be successful.

Key Points

- Many companies make the mistake of assuming that they can acquire and manage a foreign business as if it was a domestic business. The opposite is more likely to be true. Every aspect of the foreign business is likely to be different and consequently special care needs to be taken with the selection and evaluation of the target firm.
- The major problem with foreign acquisitions is that few transferred executives cope well with the assignment. Many return because they don't fit the local culture or their families find the change too difficult.
- Managing a foreign business in a different time zone, culture, language and business environment is very difficult. The manner in which a foreign business is managed will be very different to a local domestic acquisition.
- Where possible local managers should be trained and/or recruited to take over the top positions.

Chapter Fourteen

Conclusion – Meeting the Challenge

For most entrepreneurs, buying a business is probably the most important decision they will make in the development of their venture. Few other single transactions are as large and few have as many dimensions and potential complications. Of particular importance in an acquisition transaction is the compressed timescale over which so many events occur and the dramatic impact it has on the company as soon as the transaction is consummated. The business suddenly expands with many new employees all seeking answers to very real personal questions. Many activities seem to take place in rapid time and there is little time for contemplation. Decisions have to be made and made quickly to protect existing revenue and to hold onto key employees. At the same time, some executives will see this as an opportunity to grab power or to gain greater influence. Many personal agendas will be in play and this creates a level of uncertainty within both the company and the acquired business.

The accumulated evidence suggests that most acquisitions fail to add positive shareholder value, thus the entrepreneur undertaking an acquisition faces a somewhat uphill task. That is not to say that the benefits cannot be secured but that real benefits are unlikely without a proper evaluation process and a good system for post-acquisition intervention and integration, to the extent that such activities are necessary.

If done successfully, most acquisitions provide the basis for substantial step growth and often provide the catalyst for longer term continuous growth where strategic assets or capabilities are acquired. Acquisitions force businesses to adopt more formal processes. You cannot bring on a large number of new employees in one step without formalising many aspects of structure and communications within the business. To manage such a process, you need to have well defined tasks, good performance setting and review systems and human resources

policies which can deal with a larger entity. An acquisition will end up creating major changes in the business.

The mistake many businesses make is that they fail to take as much care in buying a business as they would in purchasing a major piece of equipment or entering a new market. While they feel comfortable planning an expansion of their own business, they fail to approach buying a business with the same rigor or with the same level of objectivity. Those who do bother to educate themselves about the complexities of acquiring a business and develop a systematic process for doing so are, therefore, in a very strong position to acquire the right business and exploit it properly.

Many entrepreneurs undertake an acquisition because they discovered the target business was going cheap or they thought it would be a good sector to enter. Most often they have not thought about which would be the right acquisition to make for their current business or which type of acquisition would fill gaps in the business they already have. They take on activities for which they have no experience or where they have little appreciation of the risks and then wonder why they get into trouble when the former owner departs and leaves them with a business which they own but are unable to manage. Often the decision is made between business friends or colleagues who think it would be a good idea to combine businesses but without really considering whether those businesses actually do complement each other. For example, just because two businesses sell to the same customer does not mean they should be combined.

Preparing for an acquisition is more than just working out how to negotiate the best deal. The first thing to consider is when to walk away from the deal. This is more than just about price, it is also about risks, cultural fit and whether the benefits can be extracted by the management resources the entrepreneur has at his disposal. Sometimes the best deal you will ever do is the one you don't do. Not every available business should be bought. There are some situations which could substantially undermine your own business and it is better to wait until a better acquisition comes along.

Few entrepreneurs really consider what can go wrong in an acquisition. The best deals which are done have considerable upside but sufficient resilience in them that they can withstand numerous shocks. While it is good to be positive and optimistic, it is also good to plan for the worst. If the worst case still shows a good result, that is an acquisition that probably should be undertaken.

A good acquisition is a great way for a business to achieve substantial growth. It can bring new talent into the business, provide new capabilities and generate the basis for increased competitive advantage. A successful acquisition can bring

stronger margins and the benefits associated with larger size. Good acquisition skills are a definite advantage to the growth oriented entrepreneur.

Sometimes you cannot plan when a target business will become available and so the processes of acquisition evaluation and integration should be developed in advance so they can be called upon when needed. There are often situations where growth can be readily achieved through an acquisition of one of several alternative target firms. Therefore, a continuing watching brief and monitoring of target firms is a key part of an overall acquisitions strategy. Some of the resources you will need to monitor, evaluate and integrate may be developed internally but others might be sourced from consultants, professional service firms and investment banks. Once the entrepreneur has decided that an acquisition strategy would provide benefit to the company, the process of education and development of an acquisition capability should be implemented.

As you can see from this book, there are considerable benefits in developing a strategy to prepare the business for an acquisition. Once the entrepreneur appreciates where the risks are and how these can be minimised with a proper acquisition process, the company can start to prepare itself for an acquisition activity. For acquisitions to be part of a growth strategy, it also means that the entrepreneur needs to develop a longer term view of the business and identify where acquisitions can play a meaningful role. The entrepreneur should also start developing a strategic map of the industry in which they belong in order to begin the process of identifying which firms could be potential targets for an acquisition. It is far better to be proactive about which firms would fit with the existing business than wait to see what comes on the market. Many private firms may be open to a purchase if approached in the right manner and if they can see good commercial reasons for such a combination.

The entrepreneur also needs to have a better understanding of their own culture. Cultural fit has proven to be the biggest stumbling block to successful acquisitions. Thus in order to be successful, the entrepreneur should first understand the values which drive their own business and the way in which they would approach difficult ethical or business decisions. Only by understanding how they would do it themselves can they really have an appreciation of what they should be seeking in another firm. Also, where they do perceive a cultural gap, they are at least on warning to walk away from the deal or to put additional effort into the cultural issues involved in an intervention or integration effort.

When acquisitions are planned, the entrepreneur will need to access additional executive resources as there will be many extra tasks for the senior management team to undertake throughout the negotiation and due

diligence period. Extra management resources will also be needed in the period immediately after the acquisition. Employees in both businesses will have serious concerns about their future and this will take careful and timely communications as well as on the ground resources. This cannot be undertaken easily alongside normal daily operations. Smart acquirers know this and allocate additional management resources and external consultants to assist with the change of ownership and early intervention and integration activities.

The difference in outcome between an unplanned acquisition and poorly planned integration effort compared to a systematic evaluation process and well managed integration effort can often be the difference between company failure and company success. Smaller firms do not have the management resources to suddenly dedicate senior management time to sorting out an acquisition which has gone dreadfully wrong because of a lack of planning and resource allocation. Only by providing a competent support resource throughout the pre-acquisition and post-acquisition process can risks be minimised and benefits easily achieved.

A business which prepares itself for an acquisition strategy will also end up being better managed, have a clearer growth strategy and have better focus. The process itself has major benefits associated with it even if no acquisition results from the effort. The business will have better communication, performance setting and review systems, better governance and compliance systems and should be more resilient as a result. In time, if the company proceeds to an acquisition, it should be in a very good position to choose the right business to buy and be better able to exploit the growth benefits from it.

Part B: Cultural and Ethical Assessment

Chapter Fifteen

Identifying Cultural and Environmental Differences

The following table identifies a number of characteristics of individual and organisational culture, organisational structure and working environment which pertain to a business. The purpose of this section is to give the entrepreneur a pragmatic way of highlighting cultural differences between their own business and that of a target acquisition. While ‘culture’ typically represents underlying values, those are established over time based on experiences, leadership, organisational size and structure and industry characteristics. By identifying these various characteristics of each business, the entrepreneur builds a picture of what the business looks like and how it operates. The objective is to find those things which are the same and those things which are different. To the extent that characteristics are the same, the company should have few problems in understanding the business or integrating it into their own.

Differences, however, are warning flags. Where differences exist, the manner in which the business operates and the way in which individuals work together will be different. These differences will need to be dealt with in an acquisition. The company needs to be confident that it is able to manage the acquisition where differences exist. In the area of integration, risks are higher when differences exist. The questions the entrepreneur needs to ask are:

- Are these differences sufficiently great that we should walk away from this deal?
- If we go ahead with the acquisition, can we integrate necessary functions successfully given the differences which exist?
- Should we change the way in which the acquisition is to be managed to absorb and support cultural differences?

Using the Cultural Assessment Instrument

The measurement instrument requires the buyer to grade its own organisation in each of the characteristics within the tables below. Once this is completed, the buyer then seeks out information about the target acquisition to grade that business.

The objective is to identify, where applicable, the extent to which the buyer and acquired organisation (seller) match the descriptors given. Two extreme positions are shown. An organisation which closely matches the description on the left would score a '1'. An organisation which matches the description on the right would score '5'. A business closer to one extreme than the other would score '2' or '4'. A business which is neither one nor the other or had some aspects of both would score '3'. The Diff. column would record the difference between the two scores.

Each characteristic is treated independently. The two extreme positions represent different situations, neither of which is right or wrong, it really depends on the context within which the business operates as to which is more effective. Specific combinations of structure and culture have been shown to be effective in certain situations. However, any specific structure put into a different context or with individuals with very different values may be completely dysfunctional. The purpose of this chart is to identify where cultural, environmental and structural differences may create integration problems. Where integration is not anticipated, significant difference may not only be tolerated, but may be necessary to achieve acquisition benefits. On the other hand, where absorption or full integration is necessary, any differences might present integration difficulties.

At some point the cultural differences in areas which require full integration to achieve acquisition benefits may be sufficient to cause termination of the acquisition negotiation. If, however, the acquisition is concluded, this chart should indicate where additional care and effort need be taken to overcome major cultural differences.

Where only parts of the acquired business are to be fully integrated, this survey may need to be completed at a business unit or department level. For example, integration of two research and development departments may create very different integration challenges than, say, the integration of two manufacturing departments.

Surveys should be completed by interviewing a sample of senior executives and employees within each organisation. An external consultant might be

contracted to conduct the interviews in order to ensure confidentiality of individual responses and to gain an objective assessment.

A. Organisational Structure

No.	Characteristic	Score 1	Score 5	Buyer	Seller	Diff.
1	Product vs Process	The business is organised in a matrix structure to deliver major one-off projects.	The business is organised in a hierarchical structure around supply chain and product delivery.			
2	External Collaboration	Company actively uses joint ventures, consortia, sub-contract and strategic partners.	Company only uses internal resources.			
3	Diversification	Core business only. Tight focus on one market and/or competency.	Diversified across a number of different product/markets and/or competencies.			
4	Vertical Integration	Highly integrated from raw materials to customer interface.	Operates at one point in the supply chain.			
5	Management Co-ordination	Seamless organisation.	Multiple autonomous businesses.			

B. External Interface

No.	Characteristic	Score 1	Score 5	Buyer	Seller	Diff.
1	Management of Suppliers	Suppliers are considered partners and are valued. Suppliers are involved in long-term planning.	Suppliers are dealt with at a distance and are treated without consideration or not considered when changes are planned.			
2	Customer Relationships	Customers are valued and treated as partners.	Customers are not seen as part of the business and are treated without care.			

3	Distributor & Agent Relationships	Treated as partners, risks shared and long-term relationships anticipated. We win when you win attitude.	Short-term exploitive relationship. We win – you lose attitude.			
4	Customer Satisfaction Feedback	Periodic customer surveys. Active complaints follow up. Bonuses based on customer satisfaction.	No systematic process of collecting customer satisfaction. Complaints not actively reviewed to improve processes.			
5	Customer Interface	Direct contact with consumer. Personal selling.	Through agents, distributors, wholesalers or independent retailers.			
6	Customer Retention	Customer retention rate is very high for the industry.	Customer retention is very low for the industry.			
7	Recurring Business	The % of revenue from current customers is very high for the industry.	The % of revenue from existing customers is very low for the industry.			
8	Customer Referrals	The level of customer referrals is very high for the industry.	The level of customer referrals is very low for the industry.			
9	Customer Mistakes	The company is quick to admit a mistake and works aggressively to fix problems at the company's cost.	The company never admits a mistake and works aggressively to ensure the customer pays to fix a mistake.			

C. Selection and Promotion Processes

No.	Characteristic	Score 1	Score 5	Buyer	Seller	Diff.
1	Employee Selection (Qualifications)	Work experience rather than qualifications are key to recruitment.	Formal qualifications are very important in selection.			
2	Employee Selection (References)	Personal recommendation from existing employees or contacts is considered very important.	Formal work references from creditable employers is considered more important.			
3	Employee Selection (Class/School)	Preference is given to which school or social class individual belongs.	Social class or prior school is not considered.			
4	Employee Selection (Formal)	The selection process is very informal.	A very formal process is followed.			
5	Promotion	Promotion is based on likes and dislikes of senior management.	Promotion is highly formal and based on performance evaluations and suitability for job.			
6	Succession Planning	Formal process for identifying and preparing successors for key positions.	No succession planning.			

D. Individual Motivation

No.	Characteristic	Score 1	Score 5	Buyer	Seller	Diff.
1	Senior Management Benefits	Senior management does not take advantage of the business to receive personal benefits.	Senior management frequently design work activities to gain personal benefits.			
2	Performance Based Remuneration	Commissions, bonuses, profit shares and other personal and company performance systems have little impact on the majority of employees.	Individual and company performance based commissions, bonuses and profit share are a significant part of all employee benefits.			
3	Employee Benefits	A wide range of benefits are available to all employees including generous vacation, health insurance, and subsidised work related expenses.	The company offers only the minimum benefits required under legislation.			
4	Salary Levels	The business pays very generous salaries compared to industry averages.	The company pays the least it can and well below industry averages.			
5	Share Ownership	Employees are encouraged to purchase company shares and a generous employee option scheme is in place.	No share purchase scheme or option plan exists.			
6	Employee Satisfaction	Regular employee satisfaction surveys. Active follow up.	No formal process for gathering employee satisfaction.			
7	Individual vs Team Incentives	Incentives are tied to team and business unit performance.	Incentives are tied to individual performance.			

E. Organisational Values and Ethics

No.	Characteristic	Score 1	Score 5	Buyer	Seller	Diff.
1	Social Interaction	Employees are active outside of work in social activities.	Employees live apart and few have social contact.			
2	Formal Values	Business has no declared list of values and employees are unable to agree on a list.	Business has a declared list of values which are supported by all employees.			
3	Treatment of Employees	Employees are valued and business works to develop and retain employees.	Employees see the business as a place to work; no effective system of development or retention is present.			
4	Education and Training	External education and training is encouraged and supported by the company.	No financial support or time off is given for external education and training.			
5	Mistakes	Mistakes made in the pursuit of business objectives are learning experiences and allowed.	Mistakes or failures within a business activity can severely negatively impact future promotion.			
6	Employee Empathy	Managers are sensitive to personal and family commitments and provide support where needed.	Family and personal issues are expected to be kept out of the work environment.			
7	Personal Space	Highly personalised with photos, mementoes, plants, personal colours etc.	Formal, institutional and clinical with few personal items allowed.			
8	Open Communication	Financial results, major successes and problems are shared with employees. Employees can openly ask questions about the company strategy.	Limited information is shared with lower level employees; company strategy is not shared.			

9	Executive Personality Profile	Conservative, reserved, quietly spoken.	Flamboyant, outspoken, domineering, aggressive.			
10	Respect for Other Industry Firms	Executives in the company have a genuine respect for the knowledge, capabilities and skills of other firms.	Executives in the company have little respect for the knowledge, capabilities and skills of other firms.			
11	Tolerance	Organisation encourages different values, philosophies and beliefs among its managers and employees.	Employees are expected to subscribe to one philosophy.			
12	Self Belief	Employees have a strong sense that their company is the best in their industry.	Employees have little belief in the industry leadership of their business.			
13	Corporate Citizenship	The company is very concerned about environmental issues and sustainable business practices.	The company does not consider environmental issues or sustainability in their corporate decisions.			
14	Home/Office Usage	Individuals work from home as normal practice.	Individuals are expected to work in the company office.			

F. Business Characteristics

No.	Characteristic	Score 1	Score 5	Buyer	Seller	Diff.
1	Family Ownership and Management	Family members have effective control of the business and several family members work actively in the business.	Business is broadly owned; managers represent only a small shareholding.			
2	Business Age	Business life spans many years; founders no longer active in business.	Business is relatively new; founders active in business.			

3	Business Location	Business is located in a rural setting where employees live locally.	Business is located in a large city; employees often commute long distances.			
4	Business Size	Business is small.	Business is a large corporation.			
5	Physical Dispersion	Business is located on one site where all employees can interact.	Business is spread over multiple locations some distance apart; most employees do not interact with others on different sites.			
6	Business Base	Business history is based on sales of products.	Business history is based on sales of services.			
7	Acquisition History	Business has never acquired another business.	Business has acquired many businesses.			
8	Industry Base	Business is based in a specific industry.	Business is based in an unrelated industry.			
9	Rate of Growth	Business has been highly stable or declining.	High growth business.			
10	Employee Retention	Retention rate is far above average for the industry.	Retention rate is very low for their industry.			
11	Price Position	Low cost.	High price.			
12	Differentiation	Commodity.	Highly differentiated; brand based.			
13	Volumes	Very high volumes.	Low volumes.			
14	Customisation	Highly Customised. Personalised.	Standard products.			
15	Marketing	Micro marketing. Personalised. Niche market magazines.	Mass marketing. TV, catalogues, mail order, mass market magazines.			
16	Technology Base	Operates to most common industry standards.	Proprietary standards or different industry standard.			

17	Quality Standard	Operates to industry standard ISO 9000 or similar; strongly reinforced throughout the business.	No quality standard established; no specific quality process enforced.			
18	Improvement Process	Benchmarking and/or continuous process improvement supported.	No systematic process improvement or benchmarking systems employed.			
19	Workday	Workday is typically 9-5 with some flexibility for personal time off with make-up time.	Executives are expected to willingly put in extensive overtime; weekend and evening work is common.			
20	Age Profile	Most employees are young and most executives are in mid-career.	Most employees are middle aged and senior executives are near retirement age.			

G. Decision-making Processes

No.	Characteristic	Score 1	Score 5	Buyer	Seller	Diff.
1	Vision	Business has no declared vision and employees are unable to clearly articulate one.	Business has a clearly articulated vision which is known and supported by all employees.			
2	Command and Control	Employees are given wide scope to resolve problems and to take initiative.	Authority is formal and hierarchical. Permission to act must be obtained from higher authority.			
3	Entrepreneurial Culture	Business is highly opportunity focused and will take limited risks to pursue ideas.	Business is highly risk averse and only highly certain and validated projects are undertaken.			

4	Decision Processes	Very informal; relies on personal feelings; little formal documentation used.	Very bureaucratic. Formal processes and procedures used to gain authority to use resources.			
5	Supervision	Employees have overall objectives but the manner in which they achieve results is left to them.	Employees are managed at a high level of detail. Processes are documented and employees expected to follow them closely.			
6	Alternative Views	Management is open to different views and encourages constructive criticism and feedback.	Employees expected to support management decisions without questioning.			
7	Key Performance Indicators	Individuals and business units have clearly defined and unambiguous performance metrics.	Responsibilities are vague; no specific targets are set for individuals or business units.			
8	Group Decision-making (meetings)	Open agendas, open discussion, common objectives, problem solving, open to ideas.	Formal, prepared briefs, formal presentations, rigid agendas, defensive positioning.			
9	Focus of Control	Highly centralised; decisions mostly made at HQ.	Highly decentralised; very small central HQ.			
10	Independent Views	Individuals are encouraged to put forward creative ideas and work towards consensus.	Decisions are made by superiors and individual thinking or suggestions are not encouraged.			
11	Ethical Orientation	Individuals are very concerned to do the 'right thing'.	Individuals are only concerned with obeying the law rather than doing the right thing.			
12	Tolerance for Uncertainty	Company is able to cope with high levels of ambiguity and uncertainty.	The employees have a strong desire for certainty and stability.			

13	Forward Focus	The business takes a long range view of product, market and employee development.	The business is highly focused on short-term results and short-term planning.			
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H. Office Environment

No.	Characteristic	Score 1	Score 5	Buyer	Seller	Diff.
1	Office environment	Office setting is informal (cubicles, open plan, free movement, shared spaces).	Formal closed offices are the norm; departments are in separate places.			
2	Office Interaction	Networking across the organisation and sharing of information is encouraged.	Interaction across the company is not encouraged; individuals use formal communication between departments.			
3	Cross Department Authority	Individuals work cooperatively at all levels to resolve problems.	Requests for information and support from another department are sent up the organisation to be resolved.			
4	System Support	Many independent systems are used; many IDs and passwords required. Data not shared between systems.	A single support system is used which integrates all information and data across the organisation			

Chapter Sixteen

Identifying Differences in Ethical Values

Often it is very difficult to ascertain the values of a company if they are not written down. Even if they are documented, they may not be implemented as intended. Values develop over time based on the personalities and attitudes of senior managers, especially the founders. Those values are then reinforced by the way sanctions and rewards are distributed within the organisation over time and are further reinforced by stories about heroes and incidents within the life of the company.

Most companies approach problems in a similar way throughout their organisation. This is particularly the case where difficult ethical decisions are being made. The 'right' answer within any specific organisation will be the one which most supports their core values. Over time, the organisation will build up a history of making similar decisions when confronted with the same problem. At some point, this might be reinforced by policies within the organisation about how a specific problem is to be dealt with.

Ethical decision scenarios are a useful way of soliciting these core values as ethical decisions do not have a single right answer. An ethical decision may have several different decision outcomes depending on the core values of the decision makers. Thus, for example, whether you decide to make redundant the most recent hires or the least productive will depend on your values around employee loyalty vs profitability.

The best ethics training is experiential or scenario-based, Gebler maintains, because those are most relevant to employees. Says Stempel, 'It lets them talk about things in a tangible way, about real situations, but it's not about them; it's about a character in a story.'

Through the scenarios, participants can

- choose the best action from a list of possibilities
- evaluate specific actions in light of such criteria as organisational values, the impact on stakeholders, or rules and the law
- suggest an appropriate action
- consider the impact of various actions
- discuss, through hindsight, how values have been compromised
- discuss what could have been done to prevent that situation from arising
- consider how the character in the story could apply his or her own values to the situation.

Source: Do The Right Thing, by Salopek, Jennifer J., T+D, 15357740, Jul2001, Vol. 55, Issue 7

The ethical decision-making scenarios set out below are not a test of which outcome is right. It is simply a means to discover how an organisation might resolve a difficult problem. The task the acquirer needs to undertake is to identify whether the two companies, the buyer and seller, would make different decisions given the same situation. To the extent that this exposes major differences in underlying values, this should warn the buyer that underlying cultural differences need to be addressed more thoroughly in the evaluation of the target company. As ethical positions are often different at different levels in the organisation, or as senior executives may wish to colour their responses to the buyer to influence the buyer's decision, it is important that a sample of responses be taken from different business units and organisational levels within the potential acquisition.

Using the Ethical Scenarios

The company should request members of its own executive team and a sample of lower level employees to respond to the situations described in these scenarios. It is critically important that their responses should be honest and not influenced by the identity of the interviewer. Where possible their responses should be anonymous as this is likely to solicit the most honest responses. The company may prefer to use an independent external interviewer rather than conduct this exercise with internal personnel.

Once the internal responses are assessed, these can be used to construct a list of corporate values.

The next part of the exercise is to have a target acquisition undertake a similar exercise. The purpose of the exercise is not to make a judgement as to whether the values of the target firm are right or wrong, just whether they are different. The buyer may need to fund this activity in order for the exercise to be acceptable to the target firm. Of course, the seller may be interested in the results if they have not undertaken a similar exercise themselves.

Ethical Scenarios

1. Redundancy

The company is faced with a downturn in sales orders and calculates that it needs to reduce manpower costs by 10%.

- What process would you use to decide who should be terminated?
- How would you announce the redundancies?
- What compensation would you offer those being made redundant?
- What support would you provide to the redundant employees?
- How would you announce this to customers?
- How would you deal with those employees who were not terminated but lost friends or colleagues through redundancies?

2. Personal Expenses Claimed

An exceptionally good salesperson has been making expense claims associated with personal entertainment. He has claimed trips and associated expenses for himself and his wife and recorded these as sales related expenses. The amount involved is \$10,000 or about 5% of his annual sales expenses.

- How would administration deal with the discovery?
- Who would address the problem – if at all?
- What action would sales management take?
- What action would the CFO or CEO take?

3. Customer Complaint

A customer has complained that they incurred excess cost on the installation of the company's product as the company's project manager resigned in the middle of the project and it took several weeks for a replacement to be assigned. The customer had to spend executive time briefing the new project manager and mistakes were made in the installation which had to be corrected. This also resulted in the loss of time of customer staff as well as delaying the value of the cost savings which had justified the purchase.

- Who would deal with the complaint?
- Would the company admit any error or fault in the issue?
- Would any compensation be negotiated with the customer?
- What type of compensation (if any) would be used?
- How would this problem be resolved with the customer and who would sign off on it?
- What changes (if any) would be made internally as a result of the claim?

4. Money Back Guarantee

The company has a policy of returning money if the customer is not satisfied with a product. The customer has purchased a \$20,000 item of equipment and has complained that the equipment would not undertake the job intended. On investigation the sales manager has ascertained that the equipment was not designed to undertake the task required and the brochure describing the equipment is vague on this specific application. The customer has taken four months to register his dissatisfaction as his new warehouse was not ready for the equipment to be used at the time of purchase. The normal terms for the money back guarantee is three months.

- Who would handle the complaint?
- What information would be requested from the customer?
- Would all or some money be refunded to the customer as a matter of policy?
- Would this specific circumstance change the way complaints or the guarantee was dealt with?
- How would the customer be informed of the decision?

5. Competitor Information Used in Sales Activities

The company's sales manager has been informed by sales staff that a key prospect may be in danger of being lost to a competitor. The company, however, knows that the competitor's senior development manager is about to leave to join their company and that this will severely weaken the competitor's position in the market and the competitor would lose the account if the prospect knew this information. At this point the development manager has not informed the competitor that he is leaving and has asked the company to keep this information confidential until after he receives his quarterly bonus in one month. The deal is, however, expected to close within the next week.

- How would the sales manager deal with this situation?
- What would be told to the prospect?
- Would the development manager be approached about the situation and what discussion would be had with him?
- What are the guidelines used by sales staff in regard to providing prospects with competitor information? What is the normal practice?

6. Treatment of Ex-employees

A senior marketing executive has left the company to join its arch rival. The marketing manager had been with the company for over ten years and was very familiar with the industry and with the company's competitive strategy. The company had tried to persuade the executive not to leave but was unable to match the salary and benefits offered by the competitor. The departed executive is well known to many of the senior staff and, in the past, has spent many social outings with company executives.

- How would such a departure be announced internally?
- What would be the reaction of senior management?
- Would past friends continue to socialise with him?
- If he was at an industry conference, how would he be dealt with by company executives?
- If approached by the industry association for a reference for the marketing executive for a senior industry association position, what impact would his departure have on the quality of the reference?

7. Sexual Harassment

A junior administrator has complained to the human resources manager that her supervisor is making inappropriate references to her in meetings calling her 'sweetie' and 'honey'. Her superior is an outstanding finance manager who would be difficult to replace. She has objected to the use of these names on several occasions but he persists.

- What would you have the HR manager advise her?
- What action would you take with her superior?
- What changes, if any, would you make in policy, training or hiring as a result of the incident?

8. Dealing with an Employee Mistake with a Customer

A supervisor has identified that an invoice was incorrectly prepared for a customer which resulted in the customer being overcharged by \$5,000 in an \$80,000 invoice. The customer has already paid the invoice. The company is suffering a setback in the market and cash is very tight.

- What action would you take with the supervisor?
- What changes would you make in systems and procedures as a result of discovering the error?
- What would you advise the customer (if anything)?

9. Discrimination on Cultural Differences

An internal review of employee benefits has identified that one of the business units has a decided preference for people of a specific ethnic background and consistently avoids hiring individuals with certain religious beliefs. There is local legislation which specifically forbids discrimination based on race or religion.

- What process would you follow once you had been notified of the issue?
- What action (if any) would you take with regard to the personnel involved in recruitment for the identified business unit?
- What changes (if any) would you make in recruitment processes as a result of the report?

10. Customer Mistake

An employee in customer service has been bumped by a customer who was distracted reading directions to the information desk. The employee at the time was returning to her office with a storage box which tore her dress when she was bumped. The customer apologised and left before the tear in the dress was noticed. On returning to her section, the employee discovered the tear and requested permission to go home early as the tear was embarrassing to her. The time was 2pm.

- If you were the employee's supervisor how would you handle the incident?

Part C: Acquisition-ready Indices

Chapter Seventeen

Operations Management

The Operations Management Index (OMI) has two roles it can play within an acquisitions strategy. It provides a checklist for the company's own operations as well as an initial screening tool for reviewing the state of operations management within a target acquisition.

Within the acquiring company, the OMI sets out a standard for the quality of governance and operations management the company should achieve before it enters into an acquisition. The initial objective for a company which sets out to engage in acquisitions is to set its own house in order. That is, it should put in the systems and processes to support an effective and efficient business. The reason for doing this in advance of undertaking an acquisition is to provide a level of efficiency and resilience which will support the complexity and resource needs of an acquisition project. The OMI can be used to evaluate the operations readiness of the business as well as provide a tool for measuring the progress over time of the development of internal systems towards the target performance level.

A business can only be run effectively if it has the measurement and reporting systems in place to set targets and review performance, thus the use of KPIs, budgets and proper reporting systems are critical. Governance issues deal with compliance and risk management and can be seen in good relationships with customers, suppliers, bankers and so on. Operational excellence should be an objective of the entrepreneur anyway but, in this context, it will provide a platform from which to launch an acquisition strategy.

Once the company has implemented a quality system of operations management, it will be in a very good position to specify the manner in which an acquired business should be managed. The systems and processes which are implemented within the company provide a template against which a target acquisition can be measured and provide a template for how systems should work once the business has been acquired.

The OMI can also play a role in the initial evaluation of a target acquisition. As part of the initial due diligence of the target firm, the OMI can help the entrepreneur assess the quality of the governance and internal reporting systems of the firm and use this information to identify areas of potential risk as well as areas where new systems will need to be installed post acquisition. When the entrepreneur enters into an acquisition investment, they are exposed to the trading risks of the acquired firm. They are also exposed to any current or contingent liabilities, current and potential employee disputes, customer issues and supplier disputes. Once the investment has been made, these risks will need to be managed by the installed management. Pre-existing conditions may be underwritten somewhat through warranties and representations and failure of the acquired business to perform may be somewhat compensated through an earnout or a claim against the selling shareholders, but these are little comfort to the entrepreneur who finds himself with a lemon.

The entrepreneur needs to establish the level of risks associated with the investment before doing the deal, not after. So an extensive investigation will often be undertaken to uncover any skeletons which may lay in wait for the unwary investor. Depending on the size and complexity of the firm, this process can take many months and be very expensive. While this cost is usually absorbed by the buyer, it is almost certainly factored into the purchase price.

The entrepreneur will be trying to estimate the costs and executive time which will be needed to be devoted by management within the company and what external costs for professional advisers will be incurred to bring the acquired firm up to the quality needed for an on-going stress-free operation. As items are uncovered, the entrepreneur will need to estimate the time and cost which will be incurred to resolve the issue. Of course, some may not be simple, cheap or quick to resolve. Other items may be serious and there may be no easy way to estimate the likely damage or cost to resolve. This is particularly true with contingent liabilities, intellectual property ownership doubts and unclear customer obligations which have not been fulfilled.

At some point, the entrepreneur may simply decide that the level of risk is too high to proceed, or they may decide that it will take too long and be too expensive to establish the level of exposure in the outstanding issues and break off negotiations.

The ultimate due diligence test which could be used by an entrepreneur is the following:

- Can I leave the acquired firm alone to continue managing its operations without incurring an unreasonable level of risk?

- Can I achieve my required ROI in the investment by devoting my effort to where I can add the most value without being distracted with having to clean up problems first?

The initial investigation can provide the entrepreneur with a quick checklist during the initial discussions. Once an agreement has been reached, a much more detailed due diligence investigation will be undertaken by the company's professional legal and accounting services firms. However, this initial screening can provide the entrepreneur with sufficient information to decide if they wish to move forward to more detailed negotiations. It will also provide a broad indication of the size of the investment which will need to be made post acquisition to install a quality system of operations management.

In a situation where the seller has a choice of buyer, the seller may undertake their own due diligence on the potential buyer. To the extent that they are dependent on the future performance of the buyer for their wealth protection or for achieving an earnout, the quality of the management and the efficiency and effectiveness of the supporting operations systems may well decide which buyer they choose. This is a further reason for the company to put in place good internal governance and management systems.

A1. Monthly Financial and Key Performance Indicator Reporting Exists

The existence of a comprehensive reporting system is important for several reasons. These are:

- It demonstrates that the company is well run,
- It shows that the management is effective,
- It shows attention to detail,
- It demonstrates that an underlying infrastructure is in place,
- If comprehensive, it should show that problems are identified early and addressed.

The financial reporting systems should produce Balance Sheet and Income Statements, Cash Flow projections, Aged Debtors and Aged Creditor reports.

More sophisticated systems go beyond monthly financial reporting. Every business has key performance indicators (KPIs) which demonstrate its health and competitive alertness. Reporting systems should be able to demonstrate that the company is operating efficiently in all major areas of operations. For example, in sales it might be an examination of tenders received, tenders

sent, contracts under review, contracts received and revenue to estimates. In production, it might refer to actual production vs planned production, overtime hours worked, rework hours, inventory levels and so on.

In regard to a potential acquisition, the company will be attempting to estimate the level of intervention which it will have to put in after the investment. To the extent that good management systems are in place, this should considerably reduce these costs.

Self-assessment

1. Internal reporting systems are unsophisticated and incomplete.
2. Monthly financial reporting exists but is not comprehensive.
3. Monthly reporting exists but few KPIs are tracked.
4. Monthly reporting systems and KPIs are tracked but have not been audited for completeness and effectiveness.
5. Comprehensive monthly financial and KPI reporting exists. Professional advice has been taken to ensure completeness and effectiveness.

A2. A Formal Business Plan Has Been Prepared and Is Updated Periodically

Most business people would agree that business plans are outdated as soon as they are printed. However, the discipline of preparing the business plan captures the holistic nature of the enterprise. This is one of the few times where management have the opportunity of rethinking the vision, goals and strategy of the firm. It is by pulling it all together that they will gain insights into areas of weakness and opportunities where the business can be improved.

For an external investor or lending institution, a good business plan provides insights into the business. For example,;

- What is the vision and how is this translated into strategy?
- What are the competitive assets and competencies of the company and how are these being leveraged into competitive advantage?
- Which markets do they compete in and how are they placed?
- What are the assumptions behind the numbers and have these been validated?
- What risks are present in the business and how are these being addressed?
- What is the worst case scenario?

- Do they understand their underlying cost and revenue structures and has this been translated into a breakeven analysis and a breakdown of recurring and new business?
- Can they demonstrate clearly where the business comes from and why?
- Do they have a clearly articulated marketing and sales plan with identified targets?
- Has the business growth been translated into a headcount plan and a funding plan?

The business plan demonstrates that the management team understands what it takes to be successful. It should be more than a spreadsheet; it is an explanation of why the business is successful and it should be backed up with validation of assumptions.

The business plan is often used to attract investment or to arrange debt finance. The question which should be asked by an investor or lending institution is:

Can this business be run successfully without us having to intervene to protect our investment or loan?

If an external party can see that the business is well run and has good potential, it is much more likely to invest or lend money to it. They are anticipating that the business can be left alone to run itself for some period of time.

The preparation of a business plan may also indicate to the entrepreneur where additional potential is for the company. Preparation of the business plan helps the entrepreneur bring all aspects of the business together where threats and opportunities can be assessed holistically. This helps the company to evaluate new opportunities and perhaps see how an opportunity may be developed with additional resources or assistance from an external investor or lending institution.

Self-assessment

1. No business plan exists.
2. There is a business plan but it is out of date and/or incomplete.
3. There is a comprehensive business plan but it simply projects past trends and is not a strategy document.
4. A comprehensive business plan exists and is up-to-date but does not have the depth or validation needed to provide a good explanation of strategy of how the business might perform in the longer term.

5. A very comprehensive business plan exists which is of professional quality and fully explains the business strategy, the capabilities and the likely outcome of the business in the longer term.

A3. A Formal Budget Is Prepared and Actual Performance Is Monitored Against Budget

The preparation of formal budgets (Profit & Loss, Cashflow and Balance Sheet) serves a number of purposes including:

- Quantification of formal business plans,
- Identification of projected profit & loss and cash flows,
- A basis for financial discussions with external parties such as debt and equity providers,
- A basis for monitoring the actual performance of the business against the business' forecast, and
- A basis for performance evaluation of key staff and departments.

The budget should provide the basis for monitoring actual performance against budget and should link the formal business plan to the actual performance of the business.

Budgets should be prepared and monitored on a monthly basis. Budgets should be prepared on a geographic and department basis in order to properly assign responsibility and facilitate the management of variances.

Preparation of a formal budget and analysis of actual performance against budgeted performance should provide the following benefits to the business:

- Assists in identifying under- or over-performance against budget,
- Enables timely actions to be taken where actual performance is significantly different to forecast performance,
- Ensures key financial information is monitored at various levels throughout the business, and
- Promotes accountability of key individuals and departments.

Regular budget preparation and analysis of performance by the business will provide lending institutions and potential investors with greater comfort that the business is being actively monitored and proactively managed and that business risks are being assessed on a regular basis.

Self-assessment

1. No budget is prepared and no analysis of actual results to budgeted results is performed.
2. There is a budget, but it is out of date, or not regularly monitored.
3. There is a summary budget, but it is not detailed enough; it does not link to the business plan; it does not ensure accountability of key staff/departments and is not regularly monitored.
4. A budget exists that partly assists in monitoring actual to forecasts of the business (including accountability of key staff/departments).
5. A comprehensive budget exists which supports the formal business plan and is a major tool in the on-going monitoring and assessment of business performance including monitoring accountability of key staff/departments.

A4. Full Compliance with Regulatory Issues (e.g. Environmental, Health and Safety)

The health of the business is determined by the quality of its underlying systems. These will include all the compliance areas which will vary from industry to industry but may include:

- Tax reporting (income, payroll and sales tax (BAS, VAT, GST, etc),
- Company financial reporting,
- Corporate governance (shareholder tracking, board minutes, etc),
- Employment law reporting,
- Mandatory insurance,
- Health and safety practices and accident reporting,
- Environmental compliance,
- Industry specific regulations,

These areas are critical to the effective and efficient management of a business. Any deficiency will indicate weak management, lack of concern for potential exposure and the possibility of litigation and penalties. The exposure may not be just for on-going practice, but may be retrospective in more severe cases such as environmental issues.

Self-assessment

1. Compliance is not treated seriously and its implementation is inconsistent.
2. The company is concerned about compliance and has some systems in place but no comprehensive program exists to ensure compliance or to ensure completeness of coverage.
3. Compliance is treated seriously but is left up to individual managers and there is no system in place to ensure that all areas are covered and that full compliance is occurring.
4. A full list of compliance issues exists, responsibilities are defined and some areas have reporting systems to ensure that compliance is being adhered to. Professional advice is being sought to undertake an audit in order to put a comprehensive reporting system in place.
5. Compliance reporting is comprehensive and effective and is audited by professional advisers on a periodic basis to ensure completeness and effectiveness. No outstanding or anticipated litigation exists.

A5. Customer Relationships Are Managed to Minimise Litigation

Litigation and potential litigation occurs when aspects of the business are not conducted fairly, transparently and according to accepted standards of good conduct. It is not sufficient to hope that external and internal relations are managed well; the entrepreneur should install policies, procedures and systems to ensure that they are doing so.

In the case of customers, the company needs to conduct its business so that customers clearly understand the obligations of the company, customer expectations are clearly understood and performance to documented and implied contractual conditions is monitored. Products and services need to be fit for purpose, of merchantable quality and sold with clear explanations of intended use. The company should be prepared to assist customers with help and assistance to ensure that effective intended use can be readily achieved. Failure to understand the customers' needs and intended use simply exposes the company to potential complaints, wasted resources and possible litigation.

The company should have in place fair and reasonable contracts or agreements with customers, complaints handling processes which are effective and monitoring systems to ensure obligations are met.

The entrepreneur needs to be concerned about potential risks. Poor customer handling and poor internal processes suggest exposure to potential litigation, workplace unrest and/or loss of customer retention and referenceability. These

seriously damage the company as a place to work or do business with, thus threatening the viability of the business. The entrepreneur does not want to be distracted by problems which may disrupt the acquisitions process. A business with underlying potential litigation can severely disrupt any major strategy.

Self-assessment

1. No special effort is taken by the company to avoid litigation in external customer relationships. Accounts are not reviewed for current or potential problems on any systematic basis. No escalation process exists to deal with unresolved issues.
2. The company acknowledges that it can do better. Staff have been advised of the implications of unresolved customer issues. A complaints system is in place.
3. A formal customer complaints system is in place with proper escalation procedures. Formal agreements which deal with outstanding unmet obligations and disputes exist with customers.
4. Professional advice has been taken on establishing formal systems of dispute resolution, complaints handling and problem escalation. Contracts have been reviewed by professional advisers. Relationship management training has been given to staff where appropriate.
5. Formal review systems are in place for all agreements with customers. The company is proactive in dealing with customers to ensure that expectations are set correctly and are monitored on an on-going basis. Formal complaint handling systems and dispute resolution systems are in place with staff trained and advisers available. Professional advisers review any serious disputes and provide advice on problem resolution.

A6. Supplier Relationships Are Managed to Minimise Litigation

Good supplier management is essential for the efficient operation of a business. Litigation and potential litigation occurs when aspects of the business are not conducted fairly, transparently and according to accepted standards of good conduct. It is not sufficient to hope that external and internal relations are managed well; the entrepreneur needs to install policies, procedures and systems to ensure they are doing so.

Some suppliers are more critical than others where they supply essential parts, where there are no effective substitutes or the switching costs of moving to another supplier is high. Thus managing supplier relationships is essential for the health and on-going effective operation of the business. The company should have fair and equitable agreements with suppliers and these should be

industry standard wherever possible. Supplier relationships should be managed by people in the company who understand that the relationship is more than simply placing purchase orders and negotiating the best price. The company needs to ensure that goodwill exists in those relationships; that suppliers value the business being done with them and their issues and complaints are being dealt with in a timely and reasonable manner.

The entrepreneur needs to be concerned about potential risks and disruption. Poor supplier relationship management and poor internal processes to resolve problems suggest exposure to potential litigation, workplace unrest and/or potential loss of key suppliers. Failure to monitor payables and resolve disputes may also affect credit rating. The entrepreneur needs to ensure that supplier problems do not distract the company from achieving the potential benefits in an acquisition investment. A company with underlying potential litigation can severely disrupt both the company as well as their acquisition strategy.

Self-assessment

1. No special effort is taken by the company to avoid litigation in supplier relationships. Accounts are not reviewed for current or potential problems on any systematic basis. No escalation process exists to deal with unresolved issues.
2. The company acknowledges that it can do better. Staff have been advised of the implications of unresolved issues. A complaints system is in place.
3. A formal complaints system is in place with proper escalation procedures. Formal agreements exist with suppliers to deal with outstanding unmet obligations and disputes.
4. Professional advice has been taken on establishing formal systems of dispute resolution, complaints handling and problem escalation. Contracts have been reviewed by professional advisers. Relationship management training has been given to staff where appropriate.
5. Formal review systems are in place for all agreements with suppliers. The company is proactive in dealing with suppliers to ensure that expectations are set correctly and monitored on an on-going basis. Formal complaint handling systems and dispute resolution systems are in place with staff trained and advisers available. Professional advisers review any serious dispute and provide advice on problem resolution.

A7. Employee Relationships Are Managed to Minimise Litigation

The entrepreneur should ensure that good management practice systems and fair and reasonable workplace conditions are in place for effective employee management. Employees should understand clearly what is expected of them, be provided with opportunities to provide feedback on their experience and be given performance appraisals to ensure they understand how they are meeting expectations. Processes should be in place to deal with harassment and discrimination in the workplace. Only through effective and systematic performance monitoring and corrective action can the company adequately deal with dismissals without creating situations which might lead to unfair dismissal claims and possible litigation.

Every business is dependent on its employees' goodwill and motivation. If the workplace conditions are not fair and reasonable at a minimum and if justice is not done and seen to be done, this creates a poor working environment. It is inevitable that the company will go through a series of changes of management, systems and direction as it grows through acquisitions. This is going to take a lot of goodwill and support from existing staff. An entrepreneur doesn't wish to start off an acquisition process at a disadvantage. In addition, poor performance management processes expose the company to claims of unfair dismissal or discrimination. No entrepreneur willingly allows their business to be exposed to potential unquantifiable future litigation costs and damages. Contingency liabilities are normally the death of a future external investment or external loan.

Self-assessment

1. No special effort is taken by the company to avoid litigation in employee relationships. Workplace issues are left to local supervisors and local management to resolve. There is no full time or dedicated employee responsible for compliance or to assist in resolving workplace relationship issues. No systematic process exists for setting and evaluating performance.
2. The company acknowledges the need to introduce more formal processes. Job descriptions are in place for most of the employees and an evaluation process is being used for performance review and for setting pay increases.
3. Performance targets and formal reviews of achievement are in place. A member of management is responsible for compliance. Management has been briefed on workplace issues of harassment, discrimination and performance review documentation and dismissal processes. These are, however, not systematically followed.

4. Formal processes exist for defining job descriptions, setting and assessing performance targets and dealing with employee workplace issues. Management has been trained on all aspects of compliance and workplace performance and dismissal processes. No external professional advice has been sought to audit the quality of the processes.
5. Systems and procedures are fully documented and audited to ensure full compliance with best practice in performance reviews, dismissal handling and workplace incident handling. The company has professional internal staff and/or external advisers to assist with any serious incident.

A8. Credit Worthiness with Suppliers Is Excellent

The quality of external relationships is often an indicator of the quality and integrity of the management team and the culture of the company. As the business grows through acquisitions some level of disruption to the business is likely to occur. During this period the goodwill of suppliers is going to be necessary so that additional problems don't create crisis events. By establishing good credit payment performance and working closely with suppliers, the business can develop some resilience which may be needed during acquisition projects.

Few companies are able to avoid some fluctuation in their cash flow. Problems, however, can often be mitigated by good relationships with suppliers. Suppliers who are normally paid promptly and dealt with fairly are often willing to extend additional credit for short periods during difficult times. This is especially true if the company has dealt with them honestly and shown past behaviour of bringing situations back to prompt payment.

Those businesses which keep their suppliers informed, proactively tell them about impending issues and show good management skills in correcting problems promptly, are much more likely to get extended credit to cover short-term situations.

Self-assessment

1. The company deals with suppliers at arms length and makes no special effort to value the relationship. The company makes no special effort to keep in regular touch with them or to keep them abreast of business issues.
2. The company is sensitive to dealing with suppliers and pays when possible on agreed terms. Suppliers are, however, only contacted when payments are already late.
3. The company has processes for reviewing credit with suppliers and keeps them informed of any issues where extended payment may be taken. The company has a member of management who meets with them on an informal basis when the occasion arises.

4. The company actively informs suppliers of account status and will pay early if cash permits. Suppliers are kept informed of the level of likely business to be placed with them. When payments have been delayed, senior management will personally contact the supplier to review the situation.
5. Professional advice has been sought on credit worthiness best practice and systems implemented. Senior management keeps suppliers informed of any payment issues well in advance and before payments are overdue.

A9. Banking Relationships Are Excellent

Banking relationships can be critical in securing funds for acquisitions investment or for securing additional credit for working capital when acquisitions disrupt current business. The quality of a firm's relationship with their bank is a very good indicator of the way in which they do most of their business. External relationships are often an indicator of the quality and integrity of the management team and the culture of the business. With any significant business development, which can be expected after an acquisition, some level of disruption to business is likely to occur. During this period the goodwill of suppliers, customers and bankers is going to be necessary so that additional problems don't create crisis events. By establishing good formal and informal contact with the bank, the entrepreneur can put in place a process which can assist in these situations.

Few companies are able to avoid some fluctuation in their cash flow. Problems, however, can often be mitigated by good relationships with suppliers and by working closely and honestly with the bank. Those companies which keep their bank informed, proactively tell their bank about impending issues and show good management skills in correcting problems promptly, are much more likely to receive an extended line of credit or a loan from the bank to deal with short-term fluctuations.

Self-assessment

1. The company deals with its bank at arms length and makes no special effort to value the relationship. The bank is simply treated as a facility and the company makes no special effort to keep in regular touch with the bank or keep them abreast of business issues.
2. The company is sensitive to dealing with its bank. However, the bank is only approached when a need arises.
3. The company has processes for reviewing its pattern of business with its bank and keeps them informed of any issues where cash flow might be seriously affected. The company has a named bank officer to work with and meets with them on an informal basis when the occasion arises.

4. Informal review arrangements are in place with the bank to review business performance and review banking requirements. The company also has periodic formal meetings with the bank to review their banking arrangements and banking facilities.
5. The company has established formal meetings with the bank on a regular basis where current and future banking requirements are reviewed. Senior management of the company are known to the Bank and informal social relationships are encouraged by the company.

A10. Customer Interaction, Contracts and Agreements Are Industry Standard

A company incurs problems and costs when obligations under contracts are unclear, incomplete, harsh, or overly generous. Risks escalate when procedures for handling disputes, complaints, claims or clarification are not clear and followed. When customers can make claims on the company which cannot be substantiated internally, where the obligations are not clearly set out or where the terms of payments are unclear, the company can be exposed to potential litigation, loss of resources or significant under payments.

A situation in which contracts can be customised to suit the customer becomes an administrative burden. Few companies have the processes in place to track individual contracts where obligations and terms vary from one contract to another and so the likelihood of making a mistake in this situation is very high. The problems can be greatly exacerbated if contracts are voluminous or held at a place away from where activity is being undertaken.

An entrepreneur with an intention to grow should be implementing a smooth administrative operation. If the contracts are not standard or vary from contract to contract, costs increase. Risks may occur if personal undocumented knowledge is required to manage the relationship. If the person with that intimate knowledge leaves, so does the ability to handle issues which arise.

Policies for dealing with customers should be clearly set out and staff trained in the various activities which require interaction with customers. Errors are easily made where inconsistencies in processes are allowed to occur.

Self-assessment

1. Interaction, contracts and agreements with customers are informal and vary in approach, terms and conditions.

2. Staff are advised on how to deal with customers but this is not formally supervised or reviewed. Contracts and agreements with customers are mostly written but variations exist and these are not well documented. Formal signoff of customer contracts is not in place where complex projects are undertaken.
3. Staff are trained to deal with customer issues. The company has policies in place for most customer interaction but these are out-of-date and compliance is not reviewed formally. Formal contracts and agreements are used with customers but variations are common. Variations are well documented and agreed by both parties. Formal progress monitoring is in place and signoff occurs at key stages in projects.
4. Formal policies are in place for interaction with customers and staff are trained on these. Compliance is monitored and issues dealt with promptly. Standard contracts and agreements are in place with customers and progress on long-term projects is monitored. However, no steps have been taken to ensure that contracts are industry standard and that best practices for monitoring are in place.
5. Professional advice has been taken and recommendations implemented to ensure that contracts with customers are industry standard and that progress monitoring and signoff procedures are in place and being followed. Periodic audit of customer contracts and progress tracking is in place. Formal policies for dealing with customers are in force and are regularly monitored.

A11. Supplier Contracts and Agreements Are Industry Standard

A company incurs problems and costs when obligations under supplier contracts are unclear, incomplete, harsh, or generous. Risks escalate when procedures for handling disputes, complaints, claims or clarification are not clear and followed. When suppliers can make claims on the company which cannot be substantiated internally, where obligations are not clearly set out or where the terms of payments are unclear, the company can be exposed to potential litigation, loss of resources or significant over payments.

A situation in which contracts can be customised for each supplier becomes an administrative burden. Few companies have the processes in place to track individual contracts where obligations and terms vary from one contract to another and the likelihood of making a mistake is very high. This situation is greatly exacerbated if contracts are voluminous or held at a place away from where activity is being undertaken.

Entrepreneurs who seek to grow through acquisitions need to have supporting systems which allow for efficient administrative operations. If contracts are not standard or vary from contract to contract, smooth operations are not possible. Further risks may occur if personal, undocumented knowledge is required to manage the relationship. If the person with that intimate knowledge leaves, so does the ability to handle issues which arise.

Self-assessment

1. Interaction, contracts and agreements with suppliers are informal and vary in approach, terms and conditions.
2. Staff are advised on how to deal with suppliers but this is not formally supervised or reviewed. Contracts and agreements with suppliers are mostly written but variations exist and these are not well documented. Formal signoff of supplier contracts is not undertaken where complex projects are undertaken.
3. Staff are trained to deal with supplier delays, missing or incomplete orders, quality issues and relationship problems. The company has policies in place for most supplier interaction situations but these are out of date and compliance is not reviewed formally. Formal contracts and agreements are used with suppliers but variations are common. Variations are well documented and agreed by both parties. Formal progress monitoring is in place and signoff occurs at key stages in projects.
4. Formal policies are in place for interaction with suppliers and staff are trained on these. Compliance is monitored and issues dealt with promptly. Standard contracts and agreements are in place with suppliers and progress on long-term projects is monitored. However, no steps have been taken to ensure that contracts are industry standard and best practices for monitoring are in place.
5. Professional advice has been taken and recommendations implemented to ensure that contracts with suppliers are industry standard and that progress monitoring and signoff procedures are in place and being followed. Periodic audit of supplier contracts and progress tracking is in place. Formal policies for dealing with suppliers are in force and are regularly monitored.

A12. Contracts Are Able to Be Assigned to an Acquirer

A company which intends to grow through acquisitions may well be involved in divestments in order to realign their core business or because the business unit is no longer desired. Companies with business units which may be sold must have the ability to assign the rights of their contracts, licenses and agreements to the new buyer. Agreements which do not allow this inhibit the ability of the

new owner to operate the business. Some agreements have clauses which allow assignment only with the permission of the other party. This agreement should be obtained prior to going into a divestment discussion.

Many agreements do not allow for assignment to a competitor. This is not an unreasonable condition if such a change could potentially harm their business. In this case, the company needs to have a contingency plan to be able to replace that part of their business if it is critical to their operation. Where such an agreement might stop the divestment from happening, the entrepreneur will need the ability to terminate the agreement and replace it with an alternative prior to preparing the business unit for sale.

Self-assessment

1. The company is not aware of this requirement and does not know the status of its various agreements in this regard.
2. The company acknowledges that this would be desirable but has not reviewed the contracts for compliance.
3. Contracts have been reviewed and those which do not allow assignment have been identified and responsibility given to an executive to renegotiate this condition.
4. Contracts have been renegotiated (where possible). The company does not see any situation which would inhibit a divestment. Contracts have not been reviewed by professional advisers.
5. Contracts, licences and agreements have been reviewed by professional advisers and no critical impediment remains to assignment of rights.

A13. Intellectual Property Is Able to be Traded and Is Appropriately Protected

Intellectual property (IP) covers those knowledge assets of the company which can be used and /or sold independent of the people who created that knowledge. Thus knowledge in the heads of employees which is not documented cannot be used if they leave and a business unit cannot be sold without the employees who have it. Documented knowledge where the ownership may be in dispute or where ownership is unclear, cannot be effectively traded and may put the company in dispute with former employees over ownership. Other IP rights which are purchased and are critical to the operation of products or services, need to be able to be sold or assigned to a new owner if a business unit is divested. Any contractual impediments to the use of internal or purchased IP will seriously inhibit a company's ability to exploit the IP and might seriously damage the potential of a sale of part of the business.

Many acquisitions are targeted at acquiring competitive advantage through the acquisition of firms which hold patent rights. Patents with considerable revenue generating potential can attract litigation over ownership rights if this has not been carefully managed from the outset of a research and development project as any employee who has worked on the project could potentially claim an ownership share. The only way for the company to protect itself from such a claim is to have employees assign all rights of any inventions, or those relevant to their workplace, to the company for the life of their employment. Alternatively, rights could be assigned to the company with acknowledgement of an ownership share but leave the company in a position to have full rights to exploit the patent subject to a royalty based on an agreed formula.

Another aspect of IP is that the company must ensure that the IP was adequately managed throughout the development process. IP management must ensure that IP does not infringe any other IP rights; that the IP is appropriately registered and that rights are kept current. Since many IP rights require registration in other countries, the company needs to have documentation of the extent of the registered rights and be able to show how these might be further protected in divestment negotiation.

Self-assessment

1. No IP management program exists.
2. The company acknowledges the importance of IP management but has no formal system to register or protect it.
3. IP management is considered important and the company has registered various IP but the ownership trail is incomplete and may be subject to dispute by current and/or past employees.
4. Formal IP management processes are in place. Rights are registered in countries deemed appropriate for the business. Employees are required to sign over IP rights as a condition of their employment. IP acquired externally and used in the business will be able to be traded by a new owner.
5. The company has undertaken an audit by a professional adviser and implemented systems and procedure recommendations to ensure full protection of its IP rights.

A14. Post Acquisition Changes in Employment Are Planned for

Detailed consideration of the organisation structure following a possible future acquisition will indicate which roles will need to change and which roles will be redundant. Rather than leave this issue to the last minute or for a time when the business is actively involved in post acquisition integration, the firm can negotiate potential changes with those employees likely to be affected and put in place agreements which will smooth the transition. Even where the exact changes cannot be predicted, the company needs to be sensitive to the fact that an integration activity may well displace existing employees.

A company pursuing acquisitions will almost certainly be confronted with the need to make organisational changes. These will involve changes of management, redundancies, changes of roles and reporting lines. Many of these changes could potentially affect compensation packages. Effecting these changes and avoiding unrest, disruption and de-motivation will be challenging. The potential for litigation is present where current conditions of employment are at odds with the new situation. An employee who feels he or she has been misled or feels constructively dismissed through the changes, may feel compelled to seek legal advice.

Managing expectations, providing acceptable options for employees who are affected and preparing staff for the likely change is all part of preparing the business for an acquisition strategy. Some employees may decide to take early retirement or seek alternative employment. Others may see the change as beneficial and want to participate in new opportunities generated through the acquisition. Key employees need to be retained and need to be handled carefully so that they are incentivised to stay during a transition period. Others might need to be given incentives to leave where their roles are being changed significantly or where they are being made redundant.

In anticipation that the business will change following a future acquisition, the company should put in place employment conditions which will ease the path of organisational change. For example, current terms and conditions of employment might include the option for the business to make an employee redundant following an acquisition and state the level of compensation to be paid. Alternatively, a retention bonus might be specified for key employees to encourage them to stay. Benefits may be able to be changed on a restructure of the business.

Self-assessment

1. No attempt has been made by the firm to implement changes in employment conditions to facilitate an acquisition strategy. No discussions have been had with employees about post acquisition roles.
2. The firm has reviewed its organisation structure and determined those positions likely to be changed, made redundant or are critical to any major organisational restructuring. Some informal discussion at management level has occurred. No formal changes have been made to employment conditions.
3. The firm has constructed post acquisition scenarios and identified employees who will be affected. Retirement, redundancy and key employee incentives have been constructed. Employment conditions have been changed to reflect the possible restructuring of the business.
4. Employee conditions have been discussed with key staff and as a result their conditions of employment have been changed to incorporate a retention bonus. A termination package has been incorporated into all employment agreements to cater for redundancies. Bonuses, commissions, profit schemes and share purchase arrangements have all been modified to allow changes on a major restructuring of the business. Professional advice has been sought on the arrangements.
5. Changes and incentives necessary to ensure a smooth change following an acquisition have been reviewed by a professional adviser and fully implemented.

A15. Employment Conditions, Salaries and Benefits Are Industry Standard

Following any future acquisition, employees of the acquired firm will normally be integrated into the employment, health benefits and bonus systems of the parent company. When this happens, any deviations between the two schemes will have to be resolved. This is normally a time of considerable change in the acquired firm with employees fearful of their jobs. The less change imposed, the smoother this transition will be.

Where remuneration systems are industry standard, few problems tend to arise. Staff are neither paid too much nor too little. If the health insurance is standard and bonuses are in line with industry standards, these can normally be continued or transferred. However, if (say) vacation entitlements are generous, this can create problems where they need to be curtailed or need to be continued alongside fellow employees who receive less.

The company needs to consider two different scenarios, that of an acquisition and that of a divestment. In an acquisition, the process of integration will

be smoother if the company can justify its terms of employment as industry standard. With a divestment, the company will face fewer problems with the potential buyer if the terms of employment are industry standard.

Self-assessment

1. No effort has been made to ensure employment conditions are industry standard.
2. The company has no formal process for setting pay scales or for performance evaluation. They believe they are paying reasonable levels to attract and retain employees.
3. The company recruits employees at competitive rates but internal procedures for advancement are not checked with industry norms.
4. The company is familiar with remuneration in their industry and tries to follow industry norms. No external review has been made of their practices.
5. The company uses an outside firm of specialists to assist in setting pay scales and conditions of employment.

A16. Option Schemes and Benefits Are Compliant with Stock Exchange Regulations

Many smaller firms offer incentives to attract and retain key employees. These include options, share purchase schemes, bonuses and a share allocation and so on. Often these deals are done privately between the owner and the new employee. Sometimes no advice is taken on the long-term implications of these schemes on a possible sale of the firm.

Share purchase schemes and option schemes have attracted attention by both the financial reporting agencies and tax authorities around the world and so there normally exists a vast body of regulations governing these schemes. While a scheme may be legal and even appropriate for a small unlisted firm, the same scheme may be non-compliant for a listed company. Many companies which embark on aggressive acquisitions will intend or need to undertake a public listing in order to generate the funds needed for acquisitions. A non-compliant option or benefit scheme can be a real problem for a future listing of the company. No employee will be happy losing benefits and may well resist any such change if they have a contract in place which protects their benefits.

Self-assessment

1. No effort has been made to ensure option schemes and benefits are compliant with stock exchange requirements
2. The company is familiar with the need to have compliant schemes but has made no effort to have their own schemes checked for compliance.
3. The company has sought professional advice to check the degree of compliance of their schemes and to advise of what changes may be necessary.
4. The company is implementing changes to their schemes to bring them into compliance.
5. Option and benefit schemes are compliant with stock exchange requirements.

A17. Due Diligence Files Are Complete and Up-to-date

A business which intends to seek external finance to pursue acquisitions will need to undergo extensive due diligence by potential investors and lending institutions. The purpose of due diligence is to check the health of the company and to identify any potential risks. It also checks that the information provided by the company is complete and accurate. Checks will include:

- Supplier and customer contracts,
- Licences, patents, trademarks and IP management systems,
- Leases, distribution agreements and hire purchase agreements,
- Employment contracts, health insurance and bonus systems,
- Complaints processing, dismissal processes and warranty systems,
- Quality control systems,
- Financial reporting systems, aged debtors and aged creditors,
- Reference checks with customers, suppliers and professional advisers,
- Background checks on key executives,
- R&D, manufacturing and distribution processes,
- Banking relationships and loan conditions,
- Shareholder agreements, option schemes and share purchase schemes.

The information required for a due diligence investigation is extensive and very time consuming to collect and collate. Often there are documents missing or incomplete. However, it is through this process that the external investor or

lending institution will uncover internal and external risks which can cause problems with their investment or loans. A check of the documents themselves can often be a long and exhaustive process. Every contract, every lease, every agreement is sometimes checked to ensure that it does not overly expose the investor or lender. To the extent that professional advice from industry knowledgeable legal and accounting firms has been used, this process can be dramatically shortened. Sometimes only a sample needs to be reviewed.

A seller who has a number of potential buyers may well wish to conduct its own due diligence on the buyer, especially if their future benefits through a share swap or an earnout is dependent on the health of the buyer. Where the company has already prepared itself for due diligence, this process will be more timely and less expensive.

Self-assessment

1. The company is not conversant with a due diligence process and no preparations have been made.
2. The company is aware of the requirements of a due diligence process but has no internal policies to ensure that records are complete and up-to-date.
3. The company has a policy of maintaining complete and up-to-date files but has not had this process audited or checked for compliance.
4. A professional audit has been conducted of the accuracy and completeness of the records and recommendations are being implemented.
5. A complete and up-to-date file has been assembled to enable a full due diligence audit to be undertaken.

Operations Management Index

Operations Management Index: Level of Attainment

Nothing done	Little progress	Reasonable progress	Significant progress	Fully attained	N.A
1	2	3	4	5	Not Applicable

Activity	1	2	3	4	5	N.A
A1. Monthly financial and key performance indicator reporting exists						
A2. A formal business plan has been prepared and is updated periodically						
A3. A formal budget is prepared and actual performance is monitored against budget						
A4. Full compliance with regulatory issues (eg. Environmental, Health and Safety)						
A5. Customer relationships are managed to minimise litigation						
A6. Supplier relationships are managed to minimise litigation						
A7. Employee relationships are managed to minimise litigation						
A8. Credit worthiness with suppliers is excellent						
A9. Banking relationships are excellent						
A10. Customer interaction, contracts and agreements are industry standard						
A11. Supplier contracts and agreements are industry standard						
A12. Contracts are able to be assigned to an acquirer						
A13. Intellectual Property is able to be traded and is appropriately protected						
A14. Post acquisition changes in employment are planned for						
A15. Employment conditions, salaries and benefits are industry standard						
A16. Option schemes and benefits are compliant with Stock Exchange regulations						
A17. Due diligence files are complete and up-to-date						

Chapter Eighteen

Acquisition Strategy

Acquisitions are very complex investment projects which can involve hundreds of activities, a significant number of company employees and significant company funds. Even a small acquisition can expose the company to substantial risks of disruptions, loss of key employees from both the buyer and vendor businesses and potential losses. In many situations an acquisition will be the largest undertaking a business has experienced. This should suggest to the entrepreneur that a well planned and systematic process should be used to ensure that risks are minimised and that acquisition benefits are achieved.

The Acquisition Strategy Index (ASI) is designed to set out the major elements of an efficient and effective acquisition process. It assumes the entrepreneur has already put in place an efficient operations management system. The recommended process is to place acquisitions within an overall business strategy. Too often entrepreneurs undertake acquisitions because the purchase price was low or they were emotionally committed to the acquisition before any proper evaluation was undertaken. By putting acquisitions into the context of an overall growth strategy, those firms selected for investigation should clearly add to the planned direction of the business.

Acquisitions are specialised transactions which involve many complex activities which few entrepreneurs will have experienced in any depth. Acknowledging a lack of awareness and experience is a good place to start and education in this type of transaction is essential if the entrepreneur is to become knowledgeable of the risks involved. Once the entrepreneur and key members of the management team understand the process and the sources of risks, a plan can be put into place to identify potential acquisitions. At this point, the company should be setting up a network of specialists who will be called on for advice and resources in the event that a target firm is identified.

An acquisition cannot be undertaken effectively unless there is a proper plan for evaluation and post-acquisition management. Often the post-acquisition process involves intervention and/or integration and these are not projects

which can be undertaken with any likelihood of success unless advance planning has been undertaken and knowledgeable personnel have been assembled.

Because acquisitions have such a poor track record of success, the company which proactively plans for acquisitions and assembles the right resources to undertake the evaluation and integration activities, stands a good chance of achieving the benefits of such investments. The ARI is designed to ensure that the entrepreneur understands what needs to be done to achieve a high level of acquisitions success.

B1. Well Articulated, Focused Vision of the Purpose of the Venture

More successful ventures have focus. They clearly know what problem they are solving and have a very good description of their customer. Thus they are able to articulate why they exist, often in very simple terms. The purpose of creating a short, focused vision of the venture is to ensure that all parts of the business are heading in the same direction and are supporting the various parts and not undermining them. Decision-making should become easier, actions are more targeted and results can be measured in terms of where the business should be heading.

Acquisitions need to fit into the overall vision of the enterprise. Few entrepreneurs or executive teams have the depth and breadth of knowledge to effectively manage a diverse group of businesses, therefore the more effective business acquires capacity and capability which is aligned with the overall vision of the enterprise and which can be managed through the knowledge and capabilities of the senior executive team.

The company also needs to be able to convince potential investors and institutional lenders that it has a manageable business. A well articulated vision in which acquisitions support that vision will be more convincing than an ad hoc purchase. Nothing is more off putting to an investor than an entrepreneur who has a business which attempts to provide products and services into too many markets. Nor do they appreciate the venture team who can't decide which of the many problems they are going to address first or which market they are targeting. A clear focused vision statement, which has been carefully crafted, matches the competitive advantages of the venture and is agreed by the venture team, is an essential platform for an acquisition strategy.

Self-assessment

1. The company has no vision statement.
2. The vision of the company is stated in broad terms, lacks focus and may be overly technical or lengthy.
3. The vision is overly technical, too brief or fails to clearly state who the customer is or what problem is being addressed. The vision may be stated in terms of a product for sale rather than a problem being addressed.
4. The vision clearly states the target customer, the problem being solved and is well focused and brief but is overly technical. The vision may be focused on a single product rather than a range of problems which may be addressed within a complimentary set of products or services to be developed and delivered over time.
5. The company has a well articulated vision of the business concept including the problems being addressed and the solutions offered. The vision is brief and to the point and is stated in terms that a non industry educated investor or institutional lender can clearly understand.

B2. A Long-term, Company-wide Business Strategy Has Been Prepared

The vision for the enterprise needs to be translated into specific strategies, tactics and targets if it is to drive longer term investment decision-making. Most businesses fail to document the way in which they will implement their vision, however, the discipline achieved through an extensive planning process greatly assists the company to identify and deal with threats and to identify and pursue opportunities. The business strategy should show clearly how proposed acquisitions will enable it to counter threats or exploit revenue opportunities. Also, those businesses which desire to raise external investment or borrow from institutional lenders will need to have prepared a business plan showing how they will implement their business strategy.

The business strategy drives internal decision-making with respect to acquisitions and provides supporting documentation for raising finance. Private equity investors and institutional lenders are unlikely to be familiar with the intricacies of the business and its marketplace, thus the business strategy needs to place the business into a context of customers, benefits, competitors and market dynamics. Within this context, the business strategy needs to show how and why the business will be able to achieve the revenue and profit projections over a number of years and show how these numbers have been validated.

Where the business strategy anticipates acquisition financing, the business strategy should include an executive summary for external investors and

institutional lenders. These entities often deal with hundreds of proposals and so a well articulated executive summary needs to encapsulate the essence of both the business opportunity, finance required and expected returns to the investor or repayment schedule for the lender. Unless the summary captures their attention, it is highly unlikely that the rest of the business strategy will be read.

Self-assessment

1. No business strategy has been prepared.
2. Financial projections and annual budgets for the next few years have been prepared but this does not contain sufficient detail to enable effective decision-making and performance evaluation and does not have sufficient information which would enable the impact of proposed acquisitions to be evaluated by an external party.
3. A business strategy has been prepared for the normal operations of the business but this does not show the impact of potential acquisitions and has not been prepared to reflect the special needs of external investors or institutional lenders.
4. A business strategy with an executive summary has been prepared to show the impact of acquisitions and contains information specifically for the purpose of raising acquisition finance but this has not been reviewed by a professional adviser.
5. A business strategy incorporating proposed acquisitions and including an executive summary has been prepared specifically for raising acquisition finance and has been reviewed by a professional adviser and adjusted based on their advice.

B3. Debt Capacity Has Been Documented

As part of an acquisition strategy, the business should understand the level of debt which it is able to service from its existing operations. While additional debt servicing capacity may be obtained through an acquisition, this cannot be assured and therefore the company needs to know its own capacity. The capacity to borrow has a number of elements. The first is the amount of asset backing and/or security that the company can provide to an institution for additional debt. This might be made up of a number of asset categories including land and building, plant and equipment, inventory and debtors. The next consideration is the extent to which the company can pay the interest on the debt raised. This will be a factor of future free cash flow and the reliability and variability of those projections. While a business may have assets, it may not have the cash flow to service the debt.

The last element to be considered is the extent to which the company can meet a repayment schedule involved in new debt. The repayment schedule needs to be factored into the free cash flow projections. Alternatively, the company needs to estimate its ability to refinance new debt as repayments are due.

The company needs to know the level of new debt it can comfortably raise as it moves into more detailed evaluation of potential acquisitions. That process will involve discussions with potential lenders, an assessment by those lenders of the amount of loans they are willing to consider and a tentative agreement of the terms and conditions of such loan facilities for the purpose of an acquisition. The company will not be able to actively pursue an acquisition, especially in the face of competitive bids, if it does not have finance facilities in place to finance the purchase.

The company may, in the end, decide to use equity to finance the purchase or it may use accumulated cash, however, it should be in a position to switch across to debt financing if that proves to be more attractive at the time.

Self-assessment

1. The company has not considered debt finance as part of its acquisitions strategy.
2. The company has considered debt finance for new acquisitions and has reviewed its current obligations and its projected free cash flow but has not approached any lending institutions.
3. The company has approached lending institutions to identify which facilities might be available to it in the event that it required finance to assist in the purchase of an acquisition but these discussions are in their early stages and no conclusions have been reached.
4. The company has negotiated with a number of lending institutions on the basis of the projected free cash flow and asset security it has available and has established the level of acquisition finance it might be able to access.
5. The company has reached agreement with one or more lending institutions on the amount of finance that would be made available to it in the event that the company needed acquisition finance.

B4. Use of Angel and Venture Capital Finance Is Understood

The company should clearly understand the manner in which Angel and Venture Capital (VC) finance operates. When the company is considering how to finance an acquisition, this form of finance might be considered. Rather than wait until the potential acquisition is imminent, the company should have

considered whether Angel or VC finance is acceptable and whether the company would be successful in raising this form of finance. Angel and VC investment is a form of private equity investment that is referred to as external negotiated private equity investment. That is, the investor is able to negotiate special terms associated with the investment which are designed to protect the rights of the investor. Because of these special conditions, Angel and VC investment may be beneficial for many businesses, but is not for everyone. In fact, it may directly contradict some shareholder's plans for the business. At the same time, the venture may be inappropriate for an external Angel or VC investment.

The shareholders and senior management team should understand how Angel and VC investors work and then seriously consider whether they are willing to meet the conditions and obligations inherent in that type of investment. The business which is able to show the business potential and growth performance sought by an Angel or VC investor would stand a good chance of gaining an investment, but the conditions associated with it may still be unacceptable. Some education in this area is certainly beneficial for anyone considering this type of investment.

Once the nature of an Angel and VC investment is understood, there needs to be a clear understanding on the part of the shareholders and management as to the objectives to be achieved through the investment. Those objectives need to be aligned closely with those of the Angel and VC investor.

The obvious implications of an Angel and VC investment are:

- A dilution in existing shareholders' equity.
- Some constraints on executive decision-making, especially with regard to the issue of shares, extensions of debt and executive remuneration.
- Management will be expected to agree various performance targets. Failure to achieve those may result in a loss of voting rights, termination of management contracts and the business being sold.
- Internal systems will become more formal and a higher emphasis will be placed on record keeping, governance and compliance.
- A formal Board of Directors will be required, if it does not exist already, and the investor will almost certainly want at least one position on the Board.
- An exit strategy for the investor will most likely have to be achieved within three to seven years. This may be in the form of a buy back, trade sale or IPO.

The majority shareholders need to seriously consider the implications for their own ownership positions and, where appropriate, their roles as managers and directors. The majority shareholders need to agree on the need for Angel and VC investment in order to have an effective plan to proceed to raise that form of acquisition finance.

Self-assessment

1. No discussions have been undertaken with or between the major shareholders about Angel and VC finance.
2. Majority shareholders have considered Angel and VC investment but have not taken the discussions seriously or established any consensus about timing or taken any steps to investigate what would be involved in raising this form of finance.
3. The shareholders have reviewed the conditions of raising Angel and VC finance and agreed they would be prepared to meet the conditions but have yet to make any approaches to investors to discover whether finance would be available.
4. The majority shareholders have agreed to consider Angel and VC investment and have approached potential investors but have yet to discover whether such finance would be available.
5. The majority shareholders have had detailed discussions with Angel and VC investors and have identified to what extent acquisition finance would be available from that source.

B5. A Debt/Equity Strategy Has Been Formulated

In order to finance an acquisition strategy, the company needs to have an overall finance strategy composed of various sources including cash, debt and equity. Each element should be part of the overall financing strategy of the business and the finance required for acquisitions should be seen as a component within the overall financing plan. Private equity (PE) investment may be part of an overall funding strategy being constructed for the business. While PE investment has the advantage that it has no repayment risk associated with it if the business is temporarily unable to fund dividends, it does dilute the founders' equity. On the other hand, debt while not diluting equity holdings, does carry a risk in the event of non payment of interest and principal. Failure to pay interest when due, or to make the periodic loan repayments, can result in the business being put into receivership and perhaps assets seized and sold off. Thus finding the right balance between equity dilution and repayment risk is essential for longer term growth funding of the business.

Such a plan may be required to show existing PE investors and lending institutions how the company will finance any new acquisitions. The company may already have conditions within its existing agreements with external investors or lenders which require it to seek permission before it can raise additional finance.

The firm should be prepared to discuss the financing strategy with new PE investors and lending institutions and be able to show how the current operations of the business and the potential acquisitions will be financed though the planned mix of debt and equity. They should be able to show how any external debt it intends to take on will be serviced and repaid. Generally, PE investors will require the firm to agree to obtain the PE investor's permission before committing to any additional external debt.

Self-assessment

1. No strategy for the use of debt and/or private equity has been formulated.
2. The firm has identified a need for funding but has not translated this into an amount or defined what mixture of debt and equity would be appropriate.
3. A plan incorporating a desired level of debt and equity has been constructed but this has not been tested against the business plan or an acquisition strategy to see if it will adequately cater for different levels of success in business outcomes.
4. The funding model has been incorporated into a business plan and an acquisition strategy and has been tested against various scenarios.
5. The funding model has been reviewed by a professional adviser and adjusted accordingly.

B6. Senior Management Understands the Acquisition Process

Acquisitions are highly complex major projects which can result in a major change in structure and direction of a business. Acquisition projects also require special expertise in evaluation of target firms, negotiation of the purchase agreement, coordination of external professional services and the management of change involved in intervention and integration projects. The company cannot expect that its senior executive team will have experience or skills in these areas and thus it should develop an education program to expose them to the requirements.

Even though the company might engage an external adviser to assist in the acquisition process, members of the executive team will be engaged in some

or all of the elements associated with the acquisition. As such, they need to understand what is going to happen and the role they need to play in such a project. Managers who are unfamiliar with the process could unintentionally undermine the efforts of the business by not coordinating their own actions with those of others or by taking decisions which are in conflict with the objectives of the acquisitions strategy.

Education of senior management can be achieved through personal reading, external seminars, briefings by consultants and discussions with executives who have been involved in selling or acquiring businesses. This process should identify where additional executive resources and external consultants will be needed when the company takes on an acquisition project.

Self-assessment

1. The company has not assessed the knowledge of its senior management team in regard to the acquisitions process.
2. The company is aware of the level of experience and knowledge of the acquisitions process of its senior management team, has identified deficiencies but has yet to develop an education program.
3. The company has developed an education program for its senior management team but has yet to fully implement it.
4. The company has made substantial progress on educating its senior management team about the acquisition process but is yet to complete the program.
5. The company has completed an education program on the acquisition process for its senior management team.

B7. The Role of Acquisition Has Been Identified

The company should identify specific objectives to be achieved through an acquisitions strategy. An examination of threats and opportunities confronting the business should provide a list of threats and opportunities which cannot be pursued through internal resources or through organic growth. In addition, the company may see where certain assets and capabilities it needs may be acquired at a lower cost than what it might take to develop the equivalent internally. Alternatively, the company may see that certain assets and capabilities, if acquired earlier than the equivalent could be developed internally, would provide positive benefits to the company.

Gaps in the company's growth plans may be filled through acquisitions. The company, however, needs to be convinced that it has the capacity and skills

as well as finance to undertake such acquisitions. For example, horizontal acquisitions which duplicate existing functions of the business may be easier to manage than vertical acquisitions or acquisitions which take the business into new markets. The key to acquisition growth is that it should be an integral part of the overall growth strategy and complement other activities the company is involved in.

Self-assessment

1. No acquisition strategy has been formulated.
2. The company has recognised that acquisitions may play a part in its growth strategy but has yet to consider specific gaps which may be filled using acquisitions.
3. The company has identified specific threats and opportunities within its overall business plan which might be satisfied through acquisitions but has not made any effort to consider the type of acquisition which might be considered and has not developed any process for refining this possibility.
4. The company has identified threats and opportunities which could be managed through acquisitions and has developed a decision process to refine these into acquisition criteria or a process of identifying potential acquisitions which may satisfy the need.
5. The company has identified specific threats and opportunities which could be satisfied through an acquisition, has developed specific criteria for each investment and has set out a program to identify specific target firms which could meet the respective need.

B8. Acquisition Strategy Adviser Appointed

Buying a business is a specialist task and few entrepreneurs have experienced such transactions and only a very limited number have been through the process more than once. Rather than second guess the best way to go about the process, it is worth bringing in an experienced adviser to help management understand the process and the activities they will need to undertake to achieve their acquisition objectives. An adviser can also set realistic expectations on the work to be undertaken, timescales involved and the terms and conditions attached to a purchase.

Given the preparation work involved, a generalised acquisition process should be developed with an adviser. It is expected that the adviser will need to assist with some of the tasks. The adviser should assist in drawing up a list of potential acquisitions and developing a set of acquisition criteria based on the capacity and skills the company has in managing such an activity. The adviser

can make discrete enquiries to industry participants on behalf of the company without providing the identity of the company. The adviser will also help the company with interpreting information (sale) memorandum it receives or solicits and can advise on valuation. Later on the company may also appoint a professional services firm, investment banker or corporate finance firm to manage the actual purchase.

When the company has entered into negotiations with a specific target firm, the adviser can help draw up a specific plan for the evaluation, negotiation and intervention and integration activities. The adviser may play an active role in the process where the company lacks the skills or capacity to undertake some of the activities.

Self-assessment

1. The company has made no effort to appoint an industry knowledgeable adviser.
2. The company has appointed an appropriate adviser but has not agreed a plan of activities for the company and the adviser.
3. The adviser has worked with the senior management to set out a plan of activities and has started working on some activities to assist the company.
4. The adviser has set out the requirements for an acquisition evaluation, negotiation and intervention and integration project and has identified the additional resources and external services the company will need to engage for specific transactions.
5. The firm has implemented the recommendations of the adviser, developed a plan for securing the additional resources and has identified the sources of external services it will need when a specific acquisition is undertaken. The company has prepared a briefing paper on the company and its acquisition process for use with external consultants and service providers.

B9. A Senior Executive Plan Has Been Developed to Manage the Acquisition Process

Preparing the business for an acquisition will involve many activities. Some of these will be small and easily undertaken, some will be incremental improvements within the company itself and will be undertaken by a variety of senior and junior staff but others will require dedicated effort by senior executives. It is critical that a plan be developed which sets out the various activities which will need to be undertaken and allocate these to the senior executive team in such a manner that normal operations are able to continue in their absence.

The senior management team is likely to be involved in many aspects of the pre-acquisition process and their time will be dedicated to this activity in an ad hoc intense manner over a limited period of time. Once the contract has been agreed, their time will also need to be dedicated at some level to the change management process which will be entered into immediately following the signing of the agreement. As the major risk in any acquisition is involved in communicating with both organisations and resolving the many details associated with the changes being effected, their time will be taken away from day to day operations. In this period it is important that they have successors who are able to act in their absence and that the company itself has additional capacity to step in to cope with the project requirements.

Self-assessment

1. No plan has been developed for managing the activities associated with preparing the business for an acquisition.
2. The firm has reviewed the activities associated with an acquisition and has agreed that a plan should be drawn up allocating responsibilities for the various tasks.
3. A detailed plan for preparing the company for an acquisition has been constructed and individual tasks have been assigned to senior executives, however, no consideration has been given to how normal operations will be managed in their absence.
4. A plan of assigned tasks associated with an acquisition has been prepared and agreed by the senior executives. Associated with this plan is one that identifies how responsibilities will be reassigned in the event that a senior executive is unable to deal with normal operational responsibilities.
5. The activity plan associated with undertaking an acquisition has been reviewed by the firm's professional adviser. Arrangements to source additional management and administrative resources have been put in place in order to cope with any anticipated overload situation.

B10. Potential Acquisitions Identified

A proactive acquisition strategy builds a map of potential acquisitions as the starting point of a long-term acquisitions plan. The vast majority of acquisitions are made within the industry in which the business operates or within its own supply chain members. The first part of the analysis is therefore to systematically review the industry and its own supply chain to determine the benefits each member firm could offer the company. This analysis should identify a list of potential acquisitions where the acquired firm can add some scalable benefit or solve a serious problem.

A full analysis should establish a set of likely acquisitions from within and outside the industry where the company has the capacity and skills to undertake the acquisition. The list might include customers, suppliers, alliance partners, competitors or similar business in other locations which do not compete.

The company needs to assign the target firms to the threats and opportunities the company faces and to consider the size and complexity of the target firm to see which of these the company could effectively manage in an acquisition project. Where an acquisition criterion has been developed as part of the acquisition strategy, these can be used to screen out the best of the potential targets.

Self-assessment

1. No list of potential acquisitions has been generated.
2. The firm understands that it needs to develop a list of potential acquisitions which are aligned to its overall business plan but has yet to undertake the process to do so.
3. The firm has developed a list of industry and supply chain firms and has started to assemble data on each one in order to screen out those which justify further investigation.
4. The firm has systematically reviewed its industry and supply chain firms and has identified which firms would be potential acquisitions. The list of firms has been mapped onto the threats and opportunities confronting the business but the process of refining a short list of potential acquisitions has not yet been developed.
5. The company has refined the list of potential acquisitions by reviewing which of these the company has the capacity and knowledge to manage. This refined list identifies the acquisition targets.

B11. Informal Contact Has Been Established with Potential Targets

A significant portion of acquisitions are made where contact has already been established between the parties even if this contact has been initiated by an independent professional working on behalf of the buyer. This contact establishes a point of communication for when an acquisition proposition might be floated. It is much easier to initiate a potential acquisition discussion when the parties have executives who know each other and where some level of understanding and trust has already been established.

Contact also allows the buyer to, over an extended period, quietly position the benefits of an acquisition. It is far better that the target firm be approached about an acquisition following an extended period of relationship building than

be approached without warning. When it comes to starting discussions around an acquisition, the seller might react very negatively if they have never heard of the potential acquirer or are not in the least interested in selling. It is far better for the buyer to have someone on the inside who is receptive to an approach as this will speed up the discussion at the time the company wishes to move the relationship to an acquisition discussion.

Most industries have forums where industry executives meet. This could be a trade conference or exhibition or an industry briefing by market analysts. Alternatively, executives might meet at a charity function or community function. Making personal contact away from the office and on a different topic than a possible acquisition allows both parties to establish personal relationships. These can then be used informally to move the conversation to an acquisition discussion.

It is not necessary to meet the CEO or CFO to establish the channel for communications. But the contact should be of sufficient seniority and credibility that they can effectively open the channels to the right people when the occasion calls for it.

Self-assessment

1. The company has made no effort to establish contacts with target firms.
2. The company understands the importance of establishing contacts but is not sure how this could be achieved.
3. The company has industry contacts with some target firms but these have not been established with a potential acquisition in mind. The company does not know how effective their contacts might be in setting up the right communication for an acquisition discussion.
4. The company has identified the target firms which need to have contacts established and is in the process of doing so. The company already has the right contacts with some of these firms.
5. The company has systematically established the right level of contact with the target firms.

B12. Company Internal Culture Defined

Many acquisitions fail because acquirers fail to account for cultural differences between the business units which are to be integrated following the completion of a purchase agreement with the selling shareholders. Extensive research has demonstrated that the success of human integration, that is the merging of individuals from two different organisations, is highly dependent on managing the cultural differences between the merged units.

Where organisational culture is similar, individuals can normally be encouraged to work together with members of the buyer's organisation. However, where cultural differences are significant, major change management processes need to be put in place to counter resistance, disruptions and losses caused through the merger. In some cases, the differences may be sufficiently large that a merger is highly unlikely to work and the company would be better to terminate negotiations or consider leaving the business units as independent operations.

Such considerations cannot be made unless the company understands its own culture. Culture is a critical element in achieving success in an acquisition and the characteristics of the company's culture is not something that should be guessed, thus identifying the underlying characteristics of the company's own culture is an important step in preparing for an acquisition. It is also not sufficient for the CEO or the senior executive team to decide what their culture is, the key is to find out what the actual culture is across the company. A sample of employees should be interviewed across the company to determine the culture and, perhaps, the sub-cultures which exist in different business units or departments.

The company may wish to employ an external consultant to undertake the interviews necessary to document its internal culture.

Self-assessment

1. The company has not considered its internal culture and is unable to define the characteristics of its culture.
2. The senior executive team have discussed company culture and have a view of their company culture but this is not comprehensive and has not been validated.
3. The senior executive team has undertaken an exercise to identify its company culture and has reached a consensus on a comprehensive description of the company culture but this investigation has not been undertaken outside the executive team.
4. The company has a documented set of values. Information has been solicited from the senior executive team and a sample of employees and a description of the company culture has been constructed. This description of company culture has not been validated by an independent consultant.
5. An independent consultant has been engaged to validate the company culture and has interviewed employees at all levels of the company. A set of values and environmental characteristics has been drawn up which comprehensively describes the company culture.

B13. Company Ethical Values Defined

While a business might have a documented set of organisational values and even a good description of its company culture, often the best way of assessing the likelihood of a culture fit with another business is to review how each business would resolve ethical decisions. These are business problems which do not have any specific right answer. Within the context of the operations of any organisation, these problems are resolved and decisions made based on the ethical position and the underlying values of the organisation. It is very difficult to simply ask an organisation what its ethical values are as it may not even have considered this issue.

Ethical values are the most fundamental of beliefs and often those which individuals are unwilling to compromise. Thus a major difference in ethical values between the company and an intended acquisition should provide a major warning to a buyer that significant cultural problems are ahead of it if it goes ahead with the acquisition. The research has shown that individuals who join the buyer from an acquisition are much more likely to resign if there is a significant difference in ethical positions, even in the face of considerable incentives to stay.

In order to be able to measure the difference in ethical values between the company and an intended acquisition, the company must first establish its own ethical values. To do this, it needs to ascertain how it would resolve a number of ethical decisions or problems. It is by examining these decisions that the company will uncover its own ethical values. This examination should not be limited to just the senior executives of the company but should extend to the various levels and departments within the company in order to evaluate how consistent the ethical values are across its operations.

Once these ethical values have been identified and documented, they can be used to compare the company's values with those of an intended acquisition.

Self-assessment

1. The company has not considered its ethical values and is unable to define the characteristics of its ethical values.
2. The senior executive team have discussed ethical values and have a view of their ethical values but this is not comprehensive and has not been validated.

3. The senior executive team has undertaken to identify its ethical values and has reached a consensus on a comprehensive description of the company's ethical values but this exercise has not been undertaken outside the executive team.
4. The company has a documented set of ethical values. Information has been solicited from the senior executive team and a sample of employees and a description of the company's ethical values has been constructed. This description of company's ethical values has not been validated by an independent consultant.
5. An independent consultant has been engaged to validate the company's ethical values and has interviewed employees at all levels of the company. A set of ethical values has been drawn up which comprehensively describes the company's ethical values.

B14. Evaluation Process Developed

Evaluating a potential acquisition requires the company to consider not only the inherent risks in the target firm, the risks and costs of intervention and integration but also whether the company has the capacity and skills to undertake the management of the new business once it is acquired. Too often only the first part of the process is undertaken and little thought is given to the assimilation and management issues. The only sure way the company can have that it is entering into an investment which will give it a reasonable return on its investment and expose it to limited risks, is to comprehensively and systematically undertake an evaluation of all three of these elements. If the proposal fails any one of them, the company should be prepared to reject the investment.

The problem with evaluations of this magnitude is that they require many different disciplines and individuals to work together on the process. It is highly unlikely that one person will have the knowledge and time to undertake all aspects of the evaluation. Thus there is both a knowledge component to be assembled as well as a significant project management activity to be resourced.

Before entering into an acquisition evaluation, the company should set out the process it is going to use to undertake these three tasks; evaluation, assimilation and management. The evaluation task will also require the coordination of various external consultants and service providers. The assimilation activity, whether intervention or integration or both, will potentially involve executives from across the company as well as change management experts. The final task of managing the new business will require a consideration of how the business will interact with the existing business and whether new management personnel will need to be recruited. The company needs to have a plan which it

can activate which will bring all these aspects of an acquisition together without overly disrupting the current business.

Self-assessment

1. The company has no evaluation plan.
2. The need for a plan has been expressed but no action has been undertaken to develop one.
3. A basic plan of evaluation has been developed and external resources have been considered but a firm plan has not been defined.
4. A well considered plan has been developed and external consultants and service providers have been contacted to solicit their interest in being involved. Individual executives have been allocated responsibilities under the plan.
5. A detailed plan has been developed and reviewed by acquisition and integration consultants. Specific responsibilities have been assigned to individual executives and external consultants and service providers have been contracted to provide supporting services where these are required.

B15. Acquisition Reporting and Governance Defined

Only a small portion of all acquisitions end up being fully integrated. Most are either left as independent businesses or are partly integrated. This means that the buyer ends up as the owner of another business which it must manage, often from a distance. This means that the company will have to define how the new acquisition will be managed and how it will report into the company.

This aspect of management and governance is especially critical when the selling shareholders retain a minority share or the business is located in a different legal jurisdiction, such as an overseas subsidiary. The company should be specifying the basic budgeting, performance setting and monitoring processes, the manner in which the Board of Directors will operate and the nature of the reports the company will require in order to monitor the health of the firm and the return on its investment.

Once the purchase agreement has been signed and the company takes over as owner, the new management should know exactly what they need to do to monitor the performance of the new acquisition as well as what reports are required of it by the company. They can immediately begin putting in place the necessary systems to achieve these objectives. Most emerging businesses have inadequate performance setting and monitoring systems and so it is likely that there will need to be some investment in installing new systems and training personnel to manage them. It is also often the case that smaller firms do not

operate with a formal Board of Directors but the company will almost certainly need to install one if it is to satisfy its own legal requirements and potential obligations to its external investors and institutional lenders.

Self-assessment

1. The company has given no thought to specifying the reporting and governance systems of a new acquisition.
2. The need for a reporting and governance system for an acquisition has been considered but the company has yet to specify what would be needed.
3. A basic management reporting and governance system has been specified and the company acknowledges that a more extensive and sophisticated system will be required.
4. A comprehensive reporting and governance system has been specified but this has not been reviewed by external accountants and lawyers to ensure this meets local financial reporting, compliance and tax requirements.
5. A formal management reporting and governance system has been specified and formally approved by the appropriate legal, compliance and accounting advisers.

B16. Intervention/Integration Process Developed

Few acquisitions are undertaken which do not involve some level of intervention or integration. Because of the risks associated with these activities, it is imperative that the company consider how it will undertake these activities and have a plan for how it will resource, manage and monitor the activity.

Intervention and integration activities involve changes to the acquired firm, the company or both. Most employees in the acquired firm will be expecting changes to be made by the new owners and will be anxious about their positions. At the same time, some employees within the company will be anticipating that some functions of the newly acquired firm will be integrated into the company and that some changes will occur as a result of such integration. In order to overcome potential losses of key employees, stress and anxiety on behalf of employees and disruptions and delays due to a fall in productivity, the company needs to be able to move quickly to implement a plan to manage any intervention and integration activities.

Few companies have excess resources sitting around waiting for an acquisition nor do they have plans in place to provide management support for executives who are suddenly called away from their daily tasks to assist with an acquisition activity. The failure to plan for such events can result in a considerable strain on

the executive team and almost certainly will substantially disrupt the company's business when it undertakes an acquisition. The only way in which this can be avoided is to have a plan which anticipates such an overload and puts in place a backup plan for the executive team. In addition, where specialised experts or consultants are needed to manage the organisational changes involved, these individuals need to be contracted in advance in order that they can be brought in as soon as required.

The intervention/integration plan should not only set out how the activity will be managed and resourced but also how progress will be monitored and how any problems which arise will be dealt with.

Self-assessment

1. The company has no plan for intervention and/or integration of an acquisition.
2. The management team acknowledges that an acquisition could severely disrupt the current operations and that specialist assistance might be required but have yet to put a plan in place.
3. The company has put in place a basic plan for intervention/integration and the associated management succession which will provide coverage for executives involved in intervention and integration activities but has not yet identified individuals who can provide such support for all the executives. It also has yet to resource specialist consultants who will be needed to assist in such a project.
4. A comprehensive project plan has been constructed. A management succession plan has been developed which identifies which individuals will provide support for the senior executive team in the event they are involved in intervention and integration activities. External consultants have been contacted to provide specialist assistance. The plan is yet to be reviewed by an acquisition/integration expert.
5. The intervention and acquisition plan has been reviewed by an external specialist and a final plan approved by the company.

B17. Target Firm Has Been Approached About an Acquisition

A large portion of acquisitions are undertaken where the buyer and seller have already established an informal or formal relationship. The interaction between the two businesses can provide a forum in which each party can get to know the other and where discussions around a potential acquisition can be made. Where there is a meeting of minds on a potential acquisition, the

likelihood is that a friendly acquisition will take place with the full support of both management teams. The chances of such an acquisition resulting in the successful realisation of investment return to the buyer are greatly increased in such a situation. A proactive strategy which involves developing contact with a potential acquisition and entering into a discussion about a potential acquisition is an essential stage in moving the proposal towards a successful conclusion. At some point in time, the potential seller needs to know that the company is interested in an acquisition.

The best position to be in is where the company has already developed an informal relationship with the target firm and already understands how the acquired business would be used to provide benefits to the company. The company should be in a position where it can show the benefits of an acquisition to the selling shareholders.

Where the company has not made the approach directly, it can use a professional intermediary like a market analyst group or a professional adviser. Generally it is better to use a creditable industry adviser or analyst rather than a business broker. An adviser who is not remunerated by a sales commission is likely to provide a better contact than one who is paid a commission. The company not only wants to achieve a good deal but it also needs a positive and willing seller if it is to manage the intervention and integration activity, thus the approach should be made by someone who wants the right deal done, not just any deal. A commission based broker may simply want to get a deal in order to make a commission.

Business owners or CEOs can be approached directly and either formal or informal discussions held to solicit likely interest in a sale of the entire business or parts of it. Again, this is better done sometime in advance of when the firm desires to buy as it takes the pressure off the discussion. Simply opening up the channel of communication allows the potential seller to know that the company is interested. This might lead to an approach later when the seller indicates a level of interest.

At the same time that communications are entered into with the potential seller, the company can establish what the seller might consider to be non-negotiable conditions or situations which need to be handled with care. For example, the firm's shareholders may be concerned about continuing employment for staff or the firm is not relocated. The target firm may have specific needs around the retirement of key executives and be seeking an accommodation.

Self-assessment

1. No potential target firms have been approached about an acquisition.
2. The company understands that establishing contact with the potential acquisition might be advantageous but has not undertaken any deliberate activity.
3. Some informal contact has been made with a potential target and the seller's management has indicated that an acquisition approach would be treated positively. Professional advice has not been taken regarding the terms and conditions to be considered or of items which might be constraints to the deal.
4. Formal contact has been made with senior executives in a potential acquisition and company executives have been told that the firm could be available for sale under the right terms and conditions but those have not been discussed in any meaningful manner. Professional advice has been received on how the deal might be structured to meet the requirements of the shareholders and key managers and employees.
5. A potential acquisition has been approached formally and discussions have been undertaken around a potential acquisition and the terms under which an acquisition would be positively considered.

B18. A Business Broker, Investment Bank or Professional Adviser Has Been Appointed to Manage the Purchase

The actual purchase of a firm will involve significant formal processes including a number of compliance, legal, tax and financial reporting issues. At the same time, the preparation work the company has undertaken should be reviewed for completeness by a party knowledgeable about acquisition processes and legal formalities. The sophistication of the professional service firm engaged will depend on the complexity and size of the target firm as well as the size and sophistication of the potential buyer. While a business broker might be appropriate for a small firm, a larger business may wish to appoint a large professional services firm or an investment bank to handle the transaction. The higher the risk for the company shareholders, the more critical it is to have the best advice possible.

A company considering an overseas acquisition might best be served by an international investment bank or professional services firm. The company should appoint a firm of professionals who have knowledge of the industry and experience in acquisitions and sales of firms within the industry.

Self-assessment

1. The company has made no effort to appoint an industry knowledgeable professional adviser to manage the purchase of the proposed acquisition.
2. The company has appointed a professional adviser but is yet to develop a strategy for evaluating, negotiating, integrating and managing the acquisition.
3. A professional adviser has been appointed and an acquisition strategy developed. Recommendations for the way the company should manage the acquisition project have been received but not yet implemented.
4. The professional adviser has reviewed the details of the target firm and developed a specific acquisition strategy in conjunction with the company's executives.
5. The professional adviser has developed a specific acquisition strategy for the target firm, prepared senior executives for the process, met with legal and accounting representatives to coordinate activities and developed a timescale and action plan for the process.

B19. Industry Knowledgeable and Respected Lawyers Have Been Appointed

Every industry has its own special set of problems and risks. The buyer wants to know that the acquisition project has taken these into account. Risks in the acquisition may be wide ranging and include customer and supplier contracts, management contracts, employee IP agreements, license agreements, environmental compliance and so on.

The company needs to appoint a respected and industry knowledgeable firm of lawyers as professional advisers as soon as an acquisition has been identified and the selling shareholders agree to enter into acquisition discussion. The legal firm will systematically work through the issues with the company executives and prepare them for the legal issues involved in the acquisition. The buyer will be better able to avoid risks if adequate professional advice has been sought and used prior to the acquisition. The company will also be in a better position to specify the warranties and representations it needs if the company has been professionally prepared for an acquisition.

Self-assessment

1. The company has made no efforts to appoint an industry knowledgeable and respected legal firm.
2. The company has appointed an appropriate legal firm but has not reviewed its own preparation or information about the target firm with them.

3. A review of the company's acquisition process and of the information available on the target firm has been undertaken by a respected and industry knowledgeable legal firm and recommendations for the acquisition strategy have been received but not yet fully implemented.
4. Recommendations have been implemented where possible but some areas still need attention. The legal firm has been engaged to undertake legal due diligence on the target firm.
5. The company has undertaken a review of its acquisition plan by a respected and industry knowledgeable legal firm and has fully implemented all their recommendations.

B20. Industry Knowledgeable and Respected Accountants Have Been Appointed

Each industry has its own special accounting and financial reporting rules for certain aspects of its business. This might be in the area of revenue recognition, inventory valuation, depreciation, tax reporting, costing and so on. The financial information of the target firm needs to be reviewed by a knowledgeable professional accounting firm if these are to be validated properly. The buyer will need to know of any weaknesses in the financial systems to be able to assess the health of the target firm and of the quality of the information provided by them. Any weaknesses in these systems could expose the company to risks and will extend the scope of the due diligence as the company works out how much work will be required to correct any deficiency or avoid risks.

As the final valuation is often based on internal financial reporting systems, any errors in those will be translated into the final sales price. Later analysis which finds deficiencies can end up with one or both parties disputing the valuation. This is simply a fast track to court, to be avoided wherever possible.

Many smaller companies only undertake tax reporting and fail to implement complete financial recording systems. They also tend to use a local accountant to keep their costs down. However, this tends to result in a lack of properly prepared and audited accounts. This can result in potentially higher risk for the buyer and could increase the risks or increase the costs of due diligence.

One of the most serious concerns of a buyer would be to find out that, because the firm used a local general practice CPA, the firm may not even be aware that they have not complied with specific industry requirements.

Self-assessment

1. The company has made no efforts to appoint an industry knowledgeable and respected accounting firm.

2. The company has appointed an appropriate accounting firm but has not yet requested them to review the company's acquisition process or the information provided by the target firm.
3. A review of the acquisition process of the company and the information provided by the target firm has been undertaken by a respected and industry knowledgeable accounting firm and recommendations for changes and due diligence have been received but not yet fully implemented.
4. Recommendations have been implemented where possible but some areas still need attention. The accounting firm has been engaged to undertake due diligence on the target firm.
5. The company has undertaken a review of their acquisition process and of the information received from the target firm by a respected and industry knowledgeable accounting firm and has fully implemented all their recommendations.

B21. Acquisition Project Manager Appointed

An acquisition project will require the company to undertake numerous activities internally across many of its departments and it will need to engage several external professional service providers and specialist consultants. It is highly unlikely that an executive with a current functional or staff management role will be able to undertake the management of this activity alongside their existing responsibilities. The person who undertakes this role will also need to have some knowledge of acquisitions and change management.

The task of the acquisitions project manager is to set out the numerous activities that will be undertaken by the company executives. They also need to have the respect of the senior executives of the company and have the ability to develop a positive relationship with the target firm's management. In addition to internal activities, the project manager will need to coordinate the activities of various professional advisers and external consultants.

Once the purchase agreement has been signed, the project manager will be the person who manages the overall intervention and integration activity, sets in place a progress reporting system and monitors progress to ensure the project is on track. When there is a problem, the project manager will be responsible for following up problem resolution to ensure that progress is made.

Self-assessment

1. Project manager has not been appointed.
2. The company acknowledges that it would be useful to appoint a project manager but have yet to identify an individual for the position.

3. The position of acquisitions project manager has been defined along with the terms of references of the position and the level of authority the position holds. Candidates for the position have been identified.
4. An individual has been selected for the project manager's position but has yet to take up the position.
5. An acquisitions project manager has been appointed.

Acquisition Strategy Index

Acquisition Strategy Index: Level of Attainment

Nothing done	Little progress	Reasonable progress	Significant progress	Fully attained	N.A
1	2	3	4	5	Not Applicable

Activity	1	2	3	4	5	N.A
B1. Well articulated, focused vision of the purpose of the venture						
B2. A long-term, company wide business strategy has been prepared						
B3. Debt capacity has been documented						
B4. Use of Angel and Venture Capital finance is understood						
B5. A Debt/Equity strategy has been formulated						
B6. Senior management understands the acquisition process						
B7. The role of acquisitions has been identified						
B8. Acquisition strategy adviser appointed						
B9. A senior executive plan has been developed to manage the acquisition process						
B10. Potential acquisitions identified						
B11. Informal contact has been established with potential targets						
B12. Company internal culture defined						
B13. Company ethical values defined						
B14. Evaluation process developed						
B15. Acquisition reporting and governance defined						
B16. Intervention/Integration process developed						
B17. Target firm has been approached about an acquisition						
B18. A business broker, investment bank or professional adviser has been appointed to manage the purchase						
B19. Industry knowledgeable and respected lawyers have been appointed						
B20. Industry knowledgeable and respected accountants have been appointed						
B21. Acquisition project manager appointed						