



Few events are more exciting for entrepreneurs (and their advisors, frankly) than making an acquisition.

Everyone is full of anticipation. The possibilities for the future seem boundless.

But is the deal a good idea for the buyer? (Or the seller for that matter--but we are going to focus on the buyer in this paper.)

In our advice to buyers, we are going to come back to our mantra – you need to do your homework.

Due diligence is certainly key, considering all the key aspects of the target: Its industry, management, systems, customers, suppliers, employees, other assets and liabilities, tangible and intangible.

But you need to back up a step. We are not going to focus on due diligence in this paper. We will leave that topic for a future date.

Our focus here is on the basic, core question of 'Should I or should I not do this deal'?

To start, you need to ask some key questions:

- Why am I thinking about doing this deal?
- What need, and whose need, am I fulfilling in doing it?
- Do I really understand the upside and the risks of the deal?
- Do I feel compelled to do this deal? Scared of passing on it? Why is this, exactly?

We submit that this is a worthy exercise to engage in before you even consider the target.

Once you do get to the target itself, the range of issues and opportunities widens considerably.

Next, we will address some of the key general reasons to do and to not do the deal based on our years of experience as advisors and principals. These lessons have often been learned the hard way!



Heed the "30% Rule"

A first key consideration is the effect on your existing business. A very good rule of thumb, coming out of years of experience, and learning the hard way, is that any year-over-year increase in your sales of over 30% can put an incredible strain on your company--your systems and employees.

If you are facing other challenges at the same time, an acquisition, or even hyper-aggressive organic growth, can be that fateful straw on the camel's back.

Assess Your Team Very Practically

First, if you are considering a relatively major acquisition, you need to assess the experience and sophistication of your senior team. Has anyone been through an acquisition, managed the integration process, including accounting and information systems, personnel systems, employee bases and all the various established (and perhaps documented) ways and practices of doing business in your core business, and applying them to the combined business?

The integration plan is critical. How do you determine which system or rule or way of doing things will be chosen, by rote? – for example, “buyer’s rules”.

This risks dissension among the acquired employees, and can create camps.

Or perhaps “take the best of both”. This can be preferable, but is also more complex to carry out, and can increase the risk of the buyer’s business.

Again, the buyer needs to be sure that its business is robust enough to weather the integration process. This can be a very complex issue.

Avoid the “Fix”

The worst case is a fundamentally troubled business buying another fundamentally troubled business in the attempt to fix or dilute its own problems.

In our experience, acquisitions tend to bring out or accentuate the weaknesses of the buyer, not hide or dilute them. It’s akin to the troubled couple thinking that having a baby will solve their problems. Not so much.

Conglomerates Are Out, At the Small End Anyway

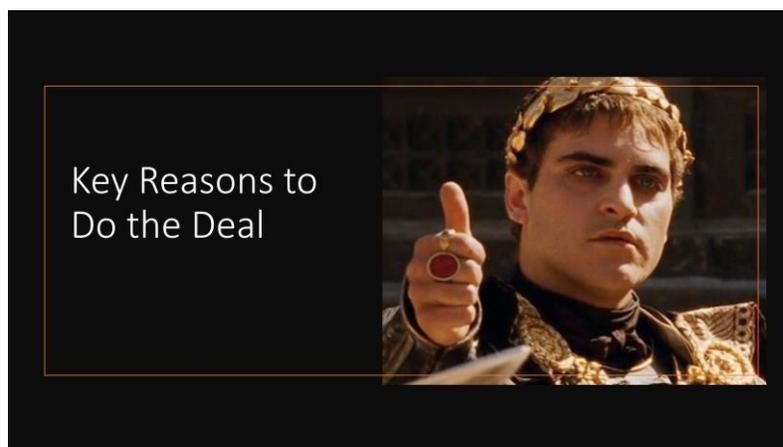
Another generally bad motivation for an acquisition is diversification, or the conglomerate strategy.

We generally counsel small- to medium-sized enterprises of \$50 million or less in sales to shed non-core businesses, not buy them.

They distract senior management, consume critical resources like skilled employees, cash and most simply, time and energy which could be devoted to the core business.

They can also complicate your financing strategies, your valuation, and even spook your bank!

All this being said, there are very good reasons to make acquisitions--and not just to keep your advisors entertained and well-paid.



Incremental can be Incredible

To be frank, our experience has been that acquisitions should be incremental and not earth-shattering in almost every way.

The earth-shattering ones have a troubled track record. (Which is tough to say as an advisor. It is the blockbuster deals that are often the most exciting and fun, and profitable, for the advisor . . .)

Add Only 1 or 2 Key Features

We see great value in starting small, with tuck-under acquisitions that may add only one or two key features to your company:

- Attractive customers;
- Skilled employees or teams;

- Geographic markets;
- Needed technologies;
- Products or services that fill specific, identified gaps in your existing offering; or
- Hidden but valuable assets like surplus real estate, non-core patents or tax losses.

This approach allows the buyer's team to gain valuable experience with acquisitions and the integration process in a controlled way, frankly learning some lessons the hard way, without imperiling or killing the buyer!

We have found that a good first acquisition should not comprise much more than 10-20% of your sales or employee base – the key measures of relative size in our opinion.

The percentage can be higher the more experienced your team and the deeper your bench.

Tightly run and resourced entrepreneurial companies often just don't have the added bandwidth to manage relatively large acquisitions and the existing core business plan at the same time.

The percentage can also be higher for simpler businesses, which are often distributors or service companies versus manufacturers or vertically integrated companies.

The dividing line between simple and complex is not this black-and-white of course, with the answer depending on the facts of the situation.

Spread Acquisitions Out

We generally don't recommend doing more than one deal at a time, or more than one deal in any given year or audit period, until the team is experience-hardened in the acquisition game.

Piling deals up on each other can turn good deals into bad ones. Goes back to getting the integration process right.

Stick to Simple Deal Structures

Multi-party deals and overly-clever transaction structures can be devilishly complex and expensive to pull off. They can also distract from and delay the critical integration process, and create counterproductive performance incentives post-deal.

One of our other mantras at Sapiient is to keep it simple. Trite, but really, honestly true.

Complexity often comes back to haunt you, in your next acquisition deal, or perhaps when you are raising capital or selling your company. It can often be a deal killer, or cause a break in a key link in your deal, with the same effect.

Do Deals with Good People

Whether or not the seller will remain in the picture post-deal, we don't recommend doing deals with people you are uncomfortable with for any reason.

Pretty common-sense stuff, like when buying a used car, but critical in our minds.

This goes for choosing your advisors, as well.

To conclude, we leave you with two general guiding rules:

First, keep the analysis of the opportunity and the deal structure as clear, uncluttered and simple as possible. Don't rush into a transaction--you can do the analysis and contemplations quickly and efficiently, but don't cut corners or shut your eyes hard and hope for the best. Be honest with yourself when assessing the potential synergies of an acquisition – don't let the momentum of the deal cloud your otherwise sage approach to business. Acquisitions are detail-oriented processes, both in the conception and in the execution.

Second, get good advice – legal, tax, corporate finance. You need all three. Really. And make sure all three choices have done acquisition-related work before, and recently.

We would be very pleased to discuss any of this further with you as you figure out your plans for the future.

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We hope this paper is helpful, but stress that it is for your general information only. We urge you to obtain proper professional advice, be it legal, tax or corporate finance, before making any decisions regarding your business.



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