How to Conduct a Successful Acquisition Search

A Guide for Strategic Acquisition Search

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For many middle-market companies, finding great acquisition targets is luck of the draw.

- Do you find yourself with your ear to the ground, hoping that when a great target becomes available-for-sale you will be on the list of potential buyers that receives a phone call from an investment banker?
- Do you consistently reach out to a handful of companies in your industry that appear to have no interest in selling in the near future?
- Did you put some effort into creating a target list, but find that you don't have time to reach out and follow up consistently?
- Are you relatively new to acquisitions and just aren't sure where to start looking for that great acquisition target?

If you answered yes to any of these questions, you should read on.

Finding great acquisition targets requires a disciplined approach and some finesse. It's difficult to capture finesse in a guidebook, but we'll share with you Third Coast Capital Advisors' proven approach.

The Case for Strategic Acquisition Search

Companies generally pursue acquisitions in three different ways. These sourcing approaches are defined in the graphic below.

This will come as no surprise; **Opportunistic Acquisitions** have the lowest probability of closure and the lowest probability to add value after execution. As you can imagine, responding to an opportunity that falls into your lap, that doesn't relate to your stated acquisition strategy, could work out, but is really a role of the dice.

Reactive Acquisitions have a higher probability of closure and value addition because the buyer has taken the time to think through the market strategy. However, the fact that the buyer is approached by the seller means that the seller is likely circulating the opportunity to a number of potential buyers. This can put the buyer in a position of weakness when it comes to negotiating—especially when the seller has initiated a competitive process.

Proactive Acquisitions, which are identified through a strategic acquisition search process, have a high probability of success (success being defined as both deal closure at a reasonable price and achievement of effective post acquisition integration). The focus of this guide is to describe the proactive approach that we call **Strategic Acquisition Search.**

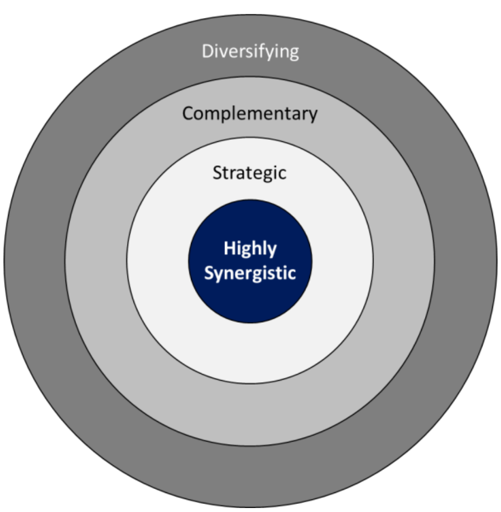
Implementing Strategic Acquisition Search Process

The strategic acquisition search process is not rocket science, but most middle-market companies that we interact with who have pursued this on their own, have missed critical parts of this process. Here are the process steps:

- Define your acquisition strategy
- Test your investment criteria
- Build the target list
- Begin target outreach
- Manage the funnel

Start with Strategy

Companies generally take one or more of the following strategic approaches to acquisitions, as illustrated in the target graphic below. The purpose of the target graphic is to show how close or far away these approaches are to the company's core competencies.



The first strategic approach, which is closest to the company's core competencies involves the search for "**Highly Synergistic**" acquisitions. An example of a highly synergistic acquisition target could be a competitor or a company that may or may not compete directly in the same geographic market, but is in the same business as they provide similar products or services to similar end markets and customers. When acquiring these companies, there are immediate synergies in terms of added customers and market share, reduced back office, and operational and purchasing efficiencies. A perfect example of this is with one of our clients, DGI Industrial Supply. DGI is very focused on a particular niche within industrial distribution. DGI's strategy was to acquire smaller companies that were distributing similar products that were sourced from similar vendors. Acquiring additional companies in their industry allowed for greater purchasing power from their key vendors and increased revenue through their national sales group. They executed and successfully integrated 4 acquisitions in a period of 12 months. The highly synergistic nature of the acquisitions led to accelerated deal timing and smooth post-acquisition integration.

The next approach is "**Strategic**," where the buyer seeks targets where synergies are evident, but require some work to achieve. Examples would include a target that has similar products, but sells to other end markets or a target that offers different products, but sells to the same end markets. While the cost synergies between the two companies are less significant, the potential revenue synergies and growth opportunities may be very high. A good example of the "strategic" approach is our client The HallStar Company. HallStar produces specialty ingredients for personal care products and was seeking to expand into naturally derived ingredients for the same personal care customers. Based on this strategy, we were successful in identifying and closing three acquisitions with targets that fit this criteria.

The next approach falls further away from the buyer's core competencies, which is to seek "**Complementary**" acquisitions. These types of acquisitions may have some minor overlap in products, markets or capabilities, but do not provide any real synergy value. An example of a complementary acquisition would be a company that manufactures engineered industrial products that is acquiring a target company that also manufactures engineered industrial products, but for different applications in alternative end markets. The synergies tend to be indirect and may involve sharing engineering resources and know how or operational best practices.

The final approach, is to seek out **"Diversifying"** transactions where the target company has no overlap whatsoever with the acquiring company. We sometimes meet companies that believe they should diversify their business through acquisition, but struggle to indentify alternative industries of interest and related target companies. As you would expect, these types of acquisitions have the lowest probability of success, both in terms of finding and closing a transaction and in post closing satisfaction.

*The key to effective **Strategic Acquisition Search** is to pursue an acquisition strategy, such that when you approach a target company, the owner immediately understands the strategic benefits available through the business combination.*

In many cases, the seller will even be familiar with your company before you approach them. In other cases where the seller is not familiar with your company, a simple perusal of your website will result in immediate clarity for the seller as to your strategic intentions.

So back to our four approaches to **Strategic Acquisition Search**, we recommend that you focus on **Highly Synergistic** and **Strategic** acquisitions. This is not to say that certain companies can't succeed in taking a complementary or diversifying approach to acquisitions, however, our experience is that the likelihood of enticing a target company to sell and the likelihood that an acquisition is ultimately successful is significantly increased when you are pursuing acquisitions that are closer to the company's core. For evidence of this difference, look no further than the inevitable increase in corporate divestitures in a slow economy when companies focus on their core activities and decide to sell off non-core businesses.

Believe it or not, many companies struggle with this step. We've seen many companies start with a stated goal to only pursue strategic acquisitions, but then somewhere along the way they lose their focus and begin to pursue anything and everything that might be for sale. Alternatively, we sometimes have new clients who believe they should diversify through acquisition, but typically conclude that the risks outweigh the benefits once we discuss the factors noted above.

Rounding out the Strategy

If you make the decision to focus on **Highly Synergistic** and **Strategic** acquisitions, you've already come a long way to establishing a viable acquisition strategy. The next step is to really flush out some of the details.

- Which growth objectives can be achieved more successfully with an acquisition versus internal sales and marketing resources or a greenfield start up?
- What product or service area do you intend to be the focus of your first acquisition campaign?
- What types of synergies do you expect from acquiring a company in this industry segment?
- Do you have a minimum profitability hurdle in mind?
- What is the maximum size you are comfortable acquiring? You should talk with your lender to get a sense for borrowing capacity.
- What is the minimum size of a company you might acquire? Buy too small and you'll incur a high relative cost to getting the deal done.
- How many companies do you believe meet the criteria from your answers to the two questions above? This can be a guess at this point, but it is important to think through.
- How many acquisitions can your team execute and integrate in a given year?
- What acquisition pace makes sense over the next five years?

For your reference, we'll speak to one important investment criterion mentioned above—acquisition size. Our clients are typically middle-market companies that have revenues ranging from $100 million to $1 billion per year. The size of acquisitions can vary widely, but as a point of reference, our clients have been comfortable acquiring companies that are roughly 10% of their size. So a company with $200 million in revenue would be very comfortable buying a company with $20 million in revenue. While this benchmark can easily range from 5% to 15% of revenue, we don't often see middle-market companies acquire targets over 25% of revenue.

On the low end of the scale, our clients typically don't like to acquire companies with revenue less than about $5 million. There is a baseline fixed cost to doing acquisitions in terms of both out-of-pocket expenses and internal bandwidth, so relatively small acquisitions can be very difficult to justify.

After answering the bulleted questions above, you should have some sense for whether or not your investment criteria match up with a high probability of success. For instance, if you believe that there are only 10 companies that meet your acquisition criteria, and you hope to close one acquisition per year for the next five years, then there is a disconnect between your aspirations and reality.

Conversely, if you believe there are more than 50 companies that could potentially meet your criteria, and your goal is one acquisition per year for the next five years, you may have a viable path forward.

Note that in both of these examples we focus on the number of potential acquisition targets. In the end, a successful strategic acquisition search and execution strategy depends on the laws of probability and the strategic quality of the targets.

That being said, rules of probability still apply. Some targets will be perfect, but not for sale. Other targets will be open to a sale, but won't quite meet your investment criteria. Other targets will be interested in talking with you, but ultimately the timing won't be quite right. A few targets will meet your investment criteria and will be open to the idea of a sale.

This concept of probability is also why we mentioned above that the key to strategic acquisition search is to seek out highly synergistic and strategic targets, so that the seller fully understands why you would want to acquire their company. This is important when you begin making calls to prospective targets—these are business owners who get a dozen calls a month from callers who purport to represent an unidentified "buyer with a lot of cash." If you want the odds in your favor, the seller needs to understand your strategic rationale.

Test Your Investment Criteria

You have completed building your acquisition target profile. You now have to go out into the real world and see how many targets exist. You not only have to see if that target exists, but you have to get a sense for how many of them may exist. And at some point during this process, you will reconcile yourself to the fact that no acquisition target will be perfect.

From this point in the **Strategic Acquisition Search** process onward, we're assuming that you have enlisted someone in your company to do some of the detailed legwork that will be required. The guidance that follows is more for their sake than yours.

We've found that there are four ways to search for potential target ideas. Any combination of these approaches can be productive in identifying viable targets.

- Industry association lists
- Conference exhibitor lists
- Subscriber databases
- Google

The first is to look to industry association lists. You probably belong to an industry Association that has many members that may fit the profile you're seeking. Although it can be very time consuming, you should review each of the companies in the member directory to determine if they meet your acquisition criteria.

The second is to look for recent industry conferences. The conference websites usually publish exhibitor information. In all likelihood, you or someone in your company is attending relevant conferences. We've had more success pulling company info from exhibitor lists than walking conference floors, but either way is an option to finding targets.

The third method is to use subscriber databases. We find that one of the most effective ways to create a broader list of acquisition targets is to access a paid database such as Capital IQ or FactSet. With a service like Capital IQ or FactSet, you can search for companies based on business description, primary industry classification, SIC codes, keywords, ownership details, revenue, profit, contact names, and a whole host of other company details that can't often be found publicly. Services like these are comprehensive but can also be expensive, with license fees in the tens of thousands of dollars per license, per year.

If you are serious about managing the acquisition search process on your own, you may be willing to pay the license fees. Another option is to look to an investment banker for help. At Third Coast, we subscribe to multiple paid databases that we use for our search work. These databases are Capital IQ, Fact Set, Bloomberg and OneSource.

This database search is critical not only to help you to expand your target list, but to also deepen your intelligence on all of the targets on the list including financial data, and company information. For example, if one of the companies on your list was recently acquired by another company, you're wasting your time to pursue this target. This kind of information is rarely evident after a search through publicly available information, but is almost immediately available in Capital IQ.

The last approach is to use Google. It sounds overly simplistic, but Google really is a wonderful thing. Take a look at your own website, consider some of the keywords that relate to the industry and the target profile you're seeking. Conduct a Google search on those keywords and see how many companies you find that appear to meet your high-level criteria. If based on that search, you have immediately found 10 to 15 companies, the chances are that there are 30 to 40 other companies that meet or come close to your criteria that for whatever reason didn't display in the search results. We will say that a Google search is the least effective way of identifying targets versus other approaches.

If after pursuing the approaches noted above, you have a target list of 20 to 30 or more companies that appear to match your investment criteria, you may have just enough to proceed. What if you only found 5 or 10 companies that appear to meet the profile parameters? You may need to go back to the drawing board. Some questions to ask yourself include:

- When we conducted the search, did we use the right search terms and apply the search criteria appropriately?
- Could we expand our investment criteria to cast a wider net?
- Does a systematic search process make sense, or does our short list already represent 80-90% of the possible targets in this space

If the best you can do is 5 or 10 targets, then you either postpone your acquisition aspirations, or you take a long-term approach where most of your effort is spent deepening relationships with those 5 or 10 target companies to be ready for the moment they come available for sale.

Begin Target Outreach

Now the heavy lifting begins. First you'll want to research and obtain target contact information. Don't bother contacting anyone but the CEO or President (in most smaller companies the owner and CEO/President are one in the same). Sometimes if you can't reach the CEO, it makes sense to reach down into the organization to enlist someone to help you get the CEO's attention, but most of the time this isn't necessary.

CEO/owner contact information is most accurate by accessing the databases that we mentioned above, but may also be obtained from a number of lead sources such as Lead411 or Bloomberg Businessweek. Assuming you have contact names, phone numbers, and that you've done your company research, you are ready to go.

This may be a good time to raise this point again. If you are the CEO or CFO of your company and you're reading this guide, we realize you will have delegated this responsibility, because you'll never have time to reach out to these targets and do all of the follow-up on your own.

If you have a Corporate Development director in your company, he or she may be the perfect person to conduct this outreach. If you don't have a dedicated corporate development person in your company, who has sufficient time to dedicate to this target outreach, your acquisition campaign will come to a screeching halt. Beyond the significant time commitment required to be successful, please consider that whoever is making this outreach is going to be speaking with CEO/owners of businesses. You don't want to choose a junior-level person to make these kinds of calls. This is where some professional wisdom and finesse are required to make a strong connection with your target.

Another option is to outsource the search work. There is tremendous merit to outsourcing your **Strategic Acquisition Search** work or in providing an additional resource to your Corporate Development Director to accelerate the process. This is the work that Third Coast Capital performs, day-in and day-out, for our clients. What you get when you hire a firm like Third Coast is a dedicated resource, a consistent approach, professional maturity, and someone with extensive experience in M&A. Food for thought.

Let's assume you have a dedicated Corporate Development person and they are responsible for this initiative. They must be well prepared with call scripts and email scripts to be consistently compelling and interesting. Just like you, these business owners get daily calls from private equity groups and business brokers that are fishing to determine whether a business owner is ready to sell or not. We consistently hear complaints from business owners that they are inundated with these kinds of calls. Having said that, we also consistently make contact with at least 60%-70% of the business owners we call, all thanks to the **Strategic Acquisition Search** process we are describing. Business owners are intrigued when we call them on behalf of our clients because we are very clear in articulating the strategic rationale for the inquiry which creates immediate credibility with the target. You should have a similar experience if you're committed to pursuing **highly synergistic** and **strategic** targets.

At Third Coast Capital we've made thousands of target outreach calls and have fine-tuned our own approach over time in order to increase our probability of success. We won't go into details on what the initial approach should sound like, but you only get one opportunity to make an impression so choose your words wisely.

Getting the Information You Need

So you've reached out to a business owner and they've indicated that they are interested in having a discussion about an acquisition. What now? What kinds of questions can you ask this person? The answer depends somewhat on who is making the calls. As a third-party professional, when we connect with the business owner, we ask a litany of questions regarding company operations, business strategy, growth opportunities and financial data. More than 90% of the time they are willing to answer our questions. Very rarely do we ever get pushback or a request for a confidentiality agreement.

One of our Directors at Third Coast, Matt Clarke, was a Corporate Development Director prior to joining the firm. In his experience, he got significantly more pushback when asking detailed and somewhat sensitive questions. Very understandably, when smaller companies are approached by a larger company in or around their industry, they are a bit guarded with the information they're willing to share. Interestingly, after Matt joined Third Coast Capital Advisors, he found that business owners were willing to share much more information. We chalk this up to a third-party professional buffer zone. This again speaks to some of the value that comes from using a third-party approach in **Strategic Acquisition Search**. Since we represent the buyer, we ask for as much as possible and hope that the target is comfortable sharing. As for information gathering on the first call, we ask a variety of general questions that provide detail around company history, operations, products/end markets, customers, growth opportunities, management, financial performance and shareholder objectives. In addition, we also ask questions that are customized to their industry and to the specific needs of our clients.

Communicating Lack of Interest

What should you do if after an initial call you aren't interested in moving forward with the target? The fair and professional thing to do, if someone has shared substantial information with you about their company and you are no longer interested, is to tell them the truth. They won't crumble, and they will appreciate your honesty. For them, your feedback may be just what they need to hear in order to make modifications or improvements to their business so that they are more marketable a few years down the road.

If, however, you are interested in moving forward with a target, there are several different ways that you can proceed. We won't go into that detail here, but we do use a time-tested approach that we have found to be very effective.

Manage the M&A Funnel

If you've ever managed a sales funnel, managing an M&A target funnel is not dissimilar. In fact, we use customer relationship management tools in order to maintain our database of contacts and to ensure that we follow up in an organized way. This outreach is quite time-consuming. It requires multiple touches by phone and email over an extended period of time.

Just as in a sales process, if you are managing the funnel properly you will naturally narrow your list of targets to a select few. These select few will represent the cream of the crop.

Over time, you can reach back out to those that may have been eliminated or chose not to move forward due to timing and in this way keep your funnel full of active opportunities. Every year, you should re-assess your strategy, consider investment criteria, and conduct another search. Inevitably, as your business grows through acquisition or you adjust your internal growth objectives, you will find new areas of investment that may not have been relevant in the past.

This marks the end of our **Strategic Acquisition Search** process and the beginning of acquisition evaluation and execution. Many M&A professionals have written excellent guides to M&A execution. In the end, there is no substitute for experience. If you are ready to ramp your acquisitions and have questions regarding how best to proceed, please contact any of the individuals listed below. You can also learn more about us by going to our website at www.thirdcoastca.com We are happy to provide you with guidance to get started and answer any questions you may have about how to effectively run a **Strategic Acquisition Search** process.

Third Coast Capital Advisors is a Chicago based buyside M&A firm focused exclusively on providing Strategic Acquisition Search services to public and privately-held companies. Specifically, we work with our clients to identify target companies, make contact with their owners and assist in negotiating proprietary acquisitions on their behalf. We have a long history of success in closing acquisition transactions with numerous clients across a variety of industries. If you are interested in learning more about how we can assist with your acquisition program, please contact any of the individuals listed below.

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