THE NEWSLETTER OF THE BDO MANUFACTURING & DISTRIBUTION PRACTICE

BDO MANUFACTURING OUTPUT

BDO Manufacturing Output regularly examines how manufacturers are rethinking strategies, operations, supply chains, workforces, business systems, products and markets to achieve competitive advantage. This issue — *Buyer Beware* — will help midmarket manufacturers considering an acquisition. BDO offers guidelines to move quickly *and* carefully as a buyer searches for targets and minimizes acquisition risk.

CONSIDERING M&A

Manufacturing is on the move — with sales, hiring and profits on the rise. Indeed, the challenge for many executives isn't how to improve performance, but how to keep up with growing demand.

Many firms are looking at mergers and acquisitions to bolster capabilities and to leverage new opportunities. "For senior executives at small and medium-sized manufacturers, this may be their first time considering an acquisition," says Lee Duran, Assurance partner and Private Equity practice leader for BDO. "Unlike executives at larger organizations who occasionally encounter offers or meet with sellers, leaders of midmarket organizations have less experience in deciding how — or even *if* — they should proceed with an acquisition."

DO YOU NEED AN ACQUISITION?

Any acquisition by a midmarket company has sweeping ramifications. On one hand, it represents vast potential benefit for the company — but also myriad opportunities for disaster (mergers have a failure rate of 50 percent to 85 percent[1]). Because of its strategic importance, a midmarket firm's owner or key executive should lead the acquisition process — from exploration to negotiation to integration. The process starts by identifying one or more reasons to look for an acquisition:

- **Expanded capabilities:** Adding on to existing strengths can help a manufacturer boost sales among current customers and distribution channels. For example, adding a plating technology to a stamping operation can expand the company's offerings horizontally, allowing the manufacturer to add value to an existing product — and increasing customer reliance on those products.
- **Increased capacities:** Acquiring a company with complementary facilities can help a manufacturer boost production immediately while offering long-term opportunities to

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CONSIDERING M&A

share best practices and improve overall efficiency. Acquisitions for capacity in foreign markets are a common approach to global expansion, combining the advantages of lower shipping costs and in-country production and marketing expertise.

- **Access to technologies:** Growth is increasingly predicated on innovation, both in new technologies and the products that leverage them. But developing new technologies — additive manufacturing, nanotechnology, etc. — requires long-term commitment and significant investment, unless a firm can obtain them through an acquisition. For example, a manufacturer reliant on multiple dies may avoid expensive re-tooling with an acquisition rich in 3D printing expertise and equipment.
- **Access to intellectual property (IP):** Technology isn't the only IP worth acquiring. For example, an organization proficient in continuous improvement can bring process skills to an acquirer. Other IP targets may include research and development capabilities, supply-chain management skills, and marketing and sales expertise. It's important to determine, however, whether the IP resides *within* the company — or with executives who may leave after the acquisition.
- **Acquire a competitor:** If you can't beat 'em, buy 'em. Many smaller companies have baby-boomer owners ready to retire; they may be open to an acquisition that allows them to recoup their investment while securing the futures of their employees.

Another compelling reason to make an acquisition is to obtain a specific product, but this can also present long-term risks (e.g., will demand rise or fall?). Smart product-driven acquisitions address one or more of the following needs:

- **Expanded product lines:** Acquirers often look for new products that can be manufactured on existing equipment, offering new sales at efficient production costs.
- **Complementary product line(s):** Acquisitions to acquire additional products in a company's core market can leverage in-house marketing expertise.
- **New territories and/or distribution channels for existing products:** Often a product can be modified to meet the demands of a parallel market or a different region or country. An acquisition target with marketing expertise and connections in those markets can quickly drive profitable new sales.

Whatever the reasons, it's important to quantify opportunities, costs and risks. For example, how much production capacity is required and for how long? Will long-term demand justify a product-centric acquisition? Could a contract manufacturer provide a better short-term solution?

It's also critical that leaders examine their own company's financial position in light of the quantified opportunities and risks, including the likely availability and cost of internal funding and external financing.

"This type of pre-acquisition accounting gives confidence to executives that it really is time to explore a deal, or, conversely, can save them time, money and resources by killing an acquisition initiative before they exhaust too much effort," says Howard Sosoff, Assurance partner and Manufacturing & Distribution practice leader for BDO. "There can be value in 'window shopping,' but eventually executive and management time is often better spent elsewhere."

MOVE QUICKLY — BUT CAREFULLY — WITH AN ACQUISITION

The search for an acquisition will focus first on organizations that align with identified needs. But how to find them? Networking among industry associations, state and local business organizations, and professional services firms is often a good first step; brokers can help as well, but may not be as focused on a company's long-term requirements.

Smart executives prioritize potential acquisitions based on readily available public information: revenues, customers, products, assets, regions of operation, etc. Once a manageable pool of candidates has been identified, informal discussions will uncover clues as to whether a deal will succeed or not, including:

- **Process-specific expertise:** research and development, continuous improvement, enterprise systems, etc.
- **Management team:** experience, cohesiveness, performance, etc.
- **Corporate culture:** ability to integrate with buyer's culture, employee-to-management trust and respect, union relationships, etc.
- **Customers:** short-term and long-term base, key accounts, etc.
- **Financials:** profitability (overall, by product, region, etc.), debt, etc.

It's important to surface potential risks (e.g., expiring patents, pending loss of a big customer) or hidden value early in the process, before formal due diligence occurs. "But remember that each and every deal presents unique circumstances, so take the time to consider how the findings to date influence potential success or failure," says Ryan Guthrie, Transaction Advisory Services partner for BDO. "For example, just because a company has been identified as having a poor management team may present an upside — if those same corporate assets were placed in the hands of experienced management, how would that organization perform?"

Once a target acquisition has been identified, outside accounting and legal expertise is required to analyze the deal, develop a non-binding proposal with which to negotiate, and then formalize interest with the seller via a letter of intent (LOI). Some elements of the LOI may be as binding as a contract, while other may not. A good LOI will:

- Identify purchase price and assets to be acquired
- Detail necessary steps and actions prior to completing the deal (e.g., conduct due diligence and buyer's access to information)
- Incorporate restrictions on buyers and/or sellers through the process (e.g. non-disclosure)
- Establish key criteria post-deal (e.g., transfer or patents, executive obligations)
- Push the process toward a binding acquisition agreement

The LOI sets the stage for due diligence work (see *Before You Buy*) and establishes a legal framework for completing the acquisition (see *Four Steps to Close the Deal*).

1 Margaret Heffernan, "Why Mergers Fail," *Moneywatch,* April 24, 2012.

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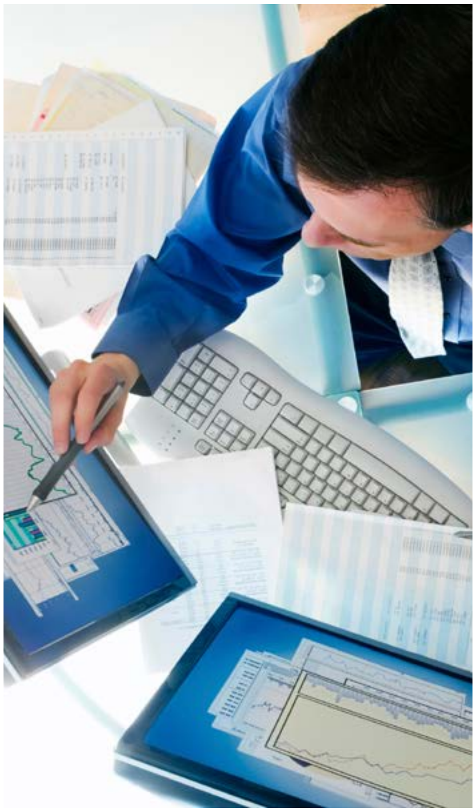
BEFORE YOU BUY

Buy-side due diligence brings confidence, and consists primarily of financial due diligence, tax due diligence and an operational assessment.



FINANCIAL DUE DILIGENCE

Financial due diligence is a blend of exploratory, analytic and financial skills. It establishes the critical *facts* for negotiations with a buyer, as well as laying groundwork for the future. "Good financial due diligence should help executives develop strategies for leveraging the acquisition during integration," says Guthrie, "such as identifying key players who need to be on board and untapped growth opportunities." Financial due diligence will focus on factors such as:

- Adherence to GAAP
- Sales and earnings analysis (profitability by customer, product, service, region, etc.)
- Analysis of working capital components
- Understanding liabilities on and off the balance sheet
- Purchase price adjustments
- Abnormalities that may skew reported earnings
- Financial issues that may impact current and future earnings
- Contingent liabilities affecting financial outcomes (positively or negatively)

TAX DUE DILIGENCE

The financial value delivered by an acquisition often hinges on how well the target entity has managed its tax accounting, as well as how the *two* taxable parties entering the M&A process emerge as a *single* tax entity post-deal. All deals present various tax exposures and implications, and require expert guidance in structuring alternatives to address these issues. But to deliver optimum tax outcomes, due diligence is required to thoroughly understand the seller's tax position.

Tax due diligence will review all manner of tax documents of the seller, including tax returns (federal, state, local and international), documents that drive tax figures (e.g., sales reports, payroll reports), and documentation with tax implications (e.g., liens, past or pending audits). "Through a tax review, we identify the seller's adherence to tax codes for the applicable years and jurisdictions," says John Marquardt, Tax partner and member of BDO's Manufacturing & Distribution practice. "In doing this we also search for overly aggressive tax positions, such as undervalued inventories, as well as tax liabilities that could be inherited by the buyer."

In addition to financial and tax due diligence, it may be necessary to research more deeply into a company and its leading executives. Investigative due diligence will search for unethical or corrupt business practices, improper relationships with vendors and/or customers, and unusual corporate or personal behaviors.

OPERATIONS-INTEGRATION ASSESSMENT

An operations-integration assessment is a sort of "compatibility test" for the seller and buyer. "Some issues that could prevent a merger may have emerged when building the list of candidates, but with more access within the seller's company, operational details stand out," says Sosoff. "You get to really see how an organization operates and the efficacy of systems and processes that support it on a day-to-day basis — and, with that, you revise the estimates of the cost and effort it will take to join the two entities."

In reviewing business processes and systems, buyers should look for *compatible* approaches to operations and process improvement. This doesn't necessarily mean that both organizations follow the *same* methodology (e.g., lean manufacturing), but that both have foundations in place (leadership commitment, workforce involvement, culture) that will allow them to operate as one. This may or may not be the buyer's approach, particularly if a deal is completed to access process-improvement expertise.

Similarly, information technologies (IT) should be compatible in the near term — or, if not, can be cost effectively replaced or upgraded. The security of a seller's IT systems and processes must also be assessed to prevent post-integration gaps in data protection.

The operations-integration assessment will identify other costs and challenges in combining the two organizations as well, including:

- Management and staff costs for those working on the integration
- Advisory costs for conducting due diligence, evaluating operations, coordinating IT systems and drafting legal documents
- Costs and challenges in addressing physical redundancies (office or facility closures) and management redundancies (duplicate roles and responsibilities)

MIDMARKET M&A IN 2014

71% Seventy-one percent of respondents to a *Mergers & Acquisitions* survey conducted in November and December said that 2014 will be a better year for midmarket M&A than 2013, and respondents expect healthcare, technology, energy and manufacturing to have the most growth. *

* Mary Kathleen Flynn, "Dealmakers Predict 2014 Will Be a Great Year for Middle-Market M&A," *Mergers & Acquisitions*, Dec. 11, 2013.

Read more

FOUR STEPS TO CLOSE THE DEAL

1

NEGOTIATE:

Use findings from due diligence and the operations assessment to negotiate appropriate terms with the seller. Although substantial work and investments have already occurred, be prepared to walk away rather than complete the purchase at the wrong price, or with an unfavorable deal structure. Allowing a third party to handle direct talks with the seller can protect a buyer from negative repercussions from a difficult negotiation or a failed deal.

2

SET FINANCING AND TAX STRUCTURE:

Determine the best way to finance the transaction — debt or equity — within the context of an overall tax strategy. An M&A tax structure will typically minimize and defer tax to the seller, and maximize and accelerate tax benefits to the buyer.

3

DEVELOP AND SIGN PURCHASE AND SALES AGREEMENT (PSA):

The PSA is the legally binding contract that weds buyer and seller. Before signing, ensure that the PSA accurately reflects the letter of intent (LOI) and any changes resulting from due diligence and negotiations.

4

INTEGRATE THE BUSINESSES:

Assign specialist teams to manage distinct aspects of the integration (e.g., sales forces, IT, supply-chain management). Also ensure that one executive or a small team is in place to establish milestones and objectives for the teams, regularly monitoring progress as integration proceeds.

FOR MORE INFORMATION

For more information on these and other service offerings for the manufacturing and distribution industry, please contact one of the service leaders below:

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