



**Newbury Piret – Sounding Board  
June 2006**

**Newbury, Piret & Co., Inc.**  
One Boston Place  
Boston, MA 02108  
Tel: 617-367-7300  
[www.newburypiret.com](http://www.newburypiret.com)

**Alan V. Fullerton, Jr.**  
Vice President  
(617) 367-7300 Ext. 105  
[afullerton@newburypiret.com](mailto:afullerton@newburypiret.com)

**T**ransaction experience has been shown to be the most important factor in predicting the success of acquisitions. The old adage “learn to walk before you run” certainly applies to the world of M&A.

Those companies who:

- are constantly in the market considering acquisition opportunities,
- are “frequent buyers”, and who
- pursue a number of small transactions

fare much better than those who pursue one “big deal” [1].

With some 60 percent of deals destroying shareholder value, ***can acquirers new to the game learn the hard lessons of experience without going through a few failures first?***

Headline-grabbing debacles such as the Time Warner – AOL merger in 2000, which managed to destroy over \$100 billion of shareholder value in less than two years, provide case study material of the risks of making big bets on big deals. With so much focus on mega-mergers gone bad, it seems the risks associated with large transactions should be fairly well understood by Boards, CEOs and business owners. But what about the middle-market experience? Can the lessons of billion-dollar failures be applied to smaller companies?

Middle-market acquisitions tend to fall in to the following situations and rationales:

- Acquiring a direct competitor – market share; operating consolidation
- Acquiring to expand adjacently – cross-selling; bundling
- Acquiring a supplier – reliable supply; margin capture
- Acquiring a customer/distributor – margin capture

The first two deal categories are the most frequent type of transactions. The consolidation and market benefits of acquiring a direct competitor can be compelling drivers for a deal. With the buyer’s first-hand knowledge of the business, risks are lower than with other types of transactions. Acquiring adjacently, to create a more complete solution for the customer, is another common strategy.

[1] Bain & Company research: “Turning Deal Smarts Into M&A Payoffs: Frequent buyers usually score the best deals, provided that they add skills in each transaction” Mergers & Acquisitions: The Dealmakers Journal 9/1/2003. Acquirers in this study had at least \$500 million in revenue in 2000.

Acquiring a supplier tends to be a strategic alternative to do-it-yourself. This is a classic buy vs. build decision and comes up often in the manufacturing sector.

Acquiring a customer or distributor is the least frequent type of deal, principally because of the conflict this can cause with other customers. In some cases, there is logic to acquiring distribution for one product line which does not conflict with distribution for the company's other products.

What we don't see often in the middle-market are the diversification deals – the leveraging of senior management and access to capital across a conglomerate of smaller businesses.

From an investment thesis point of view, acquiring a supplier for margin capture alone can be a risky strategy. The key rationale should be a strategic one – will this new asset create more value in the future, e.g. as a first step to expansion – rather than the financial one of “saving” margin (while paying for it up front in the purchase price). One way to frame the decision is: you are adding risk to the business by removing flexibility to reduce purchasing in a downturn and potentially reducing the competitiveness of the supplier by making it captive; is the potential upside from consolidating other purchases, or ramping up from growth, worth the trade-off? Is the value creation and capture in the industry shifting to suppliers?

Another risky strategy, the roll-up, was once a fashionable investment thesis, and is now so out of favor that any discussion of a consolidation play had better get to the operating or market synergies fast, lest investors hear “financial engineering” ringing in their ears and block out the rest of the discussion. Consolidating a fragmented industry (one with many smaller players) may be a winning strategy, but don't rely on the arithmetic of M&A alone to drive value.

**How is it that experience counts for so much, but the wrong type of experience (e.g. the roll-up) can fail so spectacularly?** There are a few key factors:

- Executive incentives
- Industry dynamics
- Strategic vs. financial rationales for the deal

Executives in roll-ups often derive the bulk of their compensation from doing deals. In effect, the roll-up strategy is fast-moving and expansion driven – without deals there is little growth, little interest from investors, and little incentive for management. Acquisition decisions can become driven by financial considerations to the detriment of strategic considerations. In addition, industries are fragmented for a reason – consolidation may bring benefits, but may also bring compromises.

Buying a business means assuming the risk for the business going forward, even when a good part of the deal is done with earn-outs and equity. The buyer should be in a significantly stronger position to manage those risks than the seller.

#### **The best buyers share a number of traits:**

- Analyzing, understanding, and performing due diligence on the key risks and opportunities of an acquisitions – through a disciplined process and based on a well thought out investment thesis – are the hallmarks of a good acquisition process.
- The best acquirers focus on confirming or rejecting the investment thesis in the due diligence process and have the negotiating skills to close the good deals and discipline to reject the bad deals.
- Frequent buyers develop an institutionalized sense of their ability to manage integration risk and to realize opportunities.
- A great acquirer knows how to screen deal opportunities efficiently and how to develop alternative means to achieving strategic goals. Rather than passively reacting to deals as they come on the market, the best buyers have a road map developed which identifies their strategic requirements and drives their acquisition and partnership discussions.

Investment banks and other M&A advisors play a critical role in the middle-market by bringing the cumulative experience of many transactions and the discipline of the strategy, financing and due diligence process to bear for the benefit of their clients.

*Alan Fullerton is a Vice President at Newbury Piret, a leading private investment bank to growth companies in business services, manufacturing healthcare, and technology.*