

*Strategic Acquisitions Strategies for  
Small and Mid-Size Businesses or*

# **Grow Your Business so *You Can Leave In Style With a Pile***

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**G**rowth through acquisition should not be considered an option reserved solely for large or Public Companies. Small and mid-size businesses that opt to grow by acquiring other companies, rather than growing one new customer at a time, can gain benefits in addition to increased sales and profits.

## **Timing is Right**

Two elements have combined making growth through acquisition an attractive option for small and middle market companies.

*Demographics* - The maturing of the Baby Boom generation, many of whom own their own businesses, will increase the number of owners willing to consider selling to an historic high.

*Financing* - Money is available to finance small and middle market acquisitions. Banks and non-traditional lenders are aggressively pursuing acquisition lending at a level we have not seen in twenty years. Cash required to do a deal is at an all time low.

## **Profit Pays the Bills**

Profit and Value are two main financial components of every business. Profits are essential and therefore on every businessperson's front burner. Value, on the other hand, is an elusive and intangible issue. Unlike Public company presidents, whose effectiveness is measured daily in their firm's share price, private and family business presidents need not be concerned with their company's value as their shareholders, if any, typically focus upon profit only.

## **Value Measures the Size of Your Pile**

Shareholders of Public Companies measure their wealth (or the size of their pile) using share value not earnings per share. Successful CEOs, therefore, develop strategic plans for growth and profit that maximize shareholder's value. Mergers and Acquisitions is a fundamental element of most strategic plans to grow profits and value simultaneously.

What follows is an overview of Public Company strategies to grow profits and value through acquisitions and how to adapt these strategies to private and family businesses. Although the topic may seem technical and complex it is really quite basic and straightforward.

## **An Overview**

Adding earnings or profits is self-explanatory. We will, therefore, focus primarily on the value component of growth through acquisitions.

We know a Public Company's Price/Earnings Ratio measures the amount investors are willing to pay for \$1 of company earnings and that a P/E ratio of 15 for a well-run company is not unusual. Consequently, company BIG with 100 million dollars of earnings and a P/E Ratio of 15 has a value of 1.5 billion dollars. We also know private company P/E Ratios are much lower than those of Public Companies.

### **Strategy #1** - Acquire companies with a smaller P/E ratio than yours

Example:

*The Transaction* -- Company BIG with a P/E Ratio of 15 acquires company SMALLER and pays 10 times earnings (P/E ratio = 10). Company SMALLER's 10 million dollar of earnings are added to those of company BIG.

*Increases in Value Calculation* -- SMALLER's earnings are now worth 15X instead of 10 times earnings resulting in an immediate increase in value of 5X earnings or \$50,000,000 (5 times \$10,000,000) over and above the value paid by company BIG.

### **Strategy #2** - Reduce expenses through economies of scale

The picture gets even better if eliminating duplications and other economies of scale will reduce company SMALLER's expenses. Every dollar reduction in expenses translates into \$15 of value (P/E Ratio of 15 X \$1).

*Increases in Value Calculation* -- Company BIG is able to eliminate 1 million dollars of redundant expense -  $\$1,000,000 \times 15 = \$15$  million dollar increase in value.

### **Strategy #3** - Acquire according to a strategic plan

BIG's acquisition of a company in order to gain specific benefits such as: proprietary products, technology, channels of distribution or talent base for example, can result in an improved outlook for company BIG. Whereas the P/E ratio usually reflects expectations of future profits, a strategic acquisition often produces a P/E ratio increase. In this example company BIG's P/E ratio increases by a dollar from 15X to 16 times earnings after the acquisition was announced.

*Increases in Value Calculation* -- Every point increase in company BIG's P/E ratio equates to 111 million dollars of added value (original \$100 million in earnings plus addition of SMALLER's \$10 million plus \$1 million in reduced expenses times 1).

## Calculation of Increased Value to Shareholders:

In the above example, company BIG's acquisition of company SMALLER not only has increased earnings by \$10 million but has increase company BIG's value as follows.

●	Increased value of \$10 million in earnings	\$ 50,000,000
●	Reduced SMALLER's expenses by \$1 million	15,000,000
●	Increase of BIG's P/E Ratio from 15 to 16	<u>111,000,000</u>
●	Total Increase in SIZE of PILE (VALUE)	\$176,000,000

This CEO has made the kind of a deal that makes shareholders happy.

No wonder there is so much M&A activity in the marketplace. A well conceived acquisition should produce wondrous results. These dynamics are not reserved exclusively for Public Companies. Private and family businesses can and should take advantage of the opportunities presented by growth through acquisitions. We will now apply these principles to smaller businesses and analyze the results.

## Value Building Strategies for Small and Middle Market Businesses

Private companies can employ the same three strategies used in the above Public Company example given an understanding of a few basic principles.

### General Principles:

#### *Financial*

Small companies generally have small P/E ratios. P/E ratios increase as companies grow and develop structure. P/E ratios increase as dependency upon owner decrease.

#### *Valuation Principles*

Two major value determiners are:

- Perception of risk and
- Expectation of future profit

Businesses with essentially identical earnings, therefore, can have widely diverse values

### "Round Ball" Principle - Non Financial

None of us are equally talented in all directions. We are not round balls, footballs or Frisbees perhaps, but no one can "do it all" well. Company strengths and weaknesses will therefore generally mirror those of its owner.

Armed with a basic understanding of the ground rules we can begin to formulate a strategic plan to grow and build wealth through acquisitions. Table A summarizes P/E ratios, level of earnings, definition of earnings and management style by company size. We can use Table A as reference as we develop our plan.

**Table A**

	<b>P/E Ratio</b>	<b>Usual level of Earnings and Definition of Earnings</b>	<b>Type of Management</b>
Wall Street	15X to OMG*	Typically measured in millions Definition of Earnings: After Tax * Oh My God	Professional management with many levels of responsibility. - Management's objective is to maximize profits and value to satisfy stockholder demands.
Middle Market	3 to 15X	\$500,000 to small millions Definition of Earnings: Pre/after tax and various EBITs unless the company represents a unique opportunity, (proprietary product, technology, channels of distribution, talent base etc.), the all cash, high multiple Wall Street price is unattainable. Otherwise, dynamics found when selling Upper Main Street apply.	Segmentation of responsibilities and management structure well defined. Owner may or may not be involved in operations to a significant degree.
Upper Main Street	3 to 7X	More than \$100,000 but less than \$500,000  Definition of Earnings: Adjusted EBIT ~ Earnings Before Interest, Taxes plus Depreciation and Adjustments (less an Appropriate Manager's salary)	Owner still major element of company's success. Levels of responsibilities and management structure are evolving.
Main Street	1 to 4X	Typically 100K, more or less Definition of Earnings: Discretionary Earnings - Dollars available for: new owner's compensation, acquisition debt service, actual depreciation reserves and return on invested capital.	Owner is vital to operations. "Wears all the hats" - little to no management depth.

## Develop your Plan

The plan should begin with an honest assessment of your company's strengths, weaknesses and the opportunities your business and industry represent. Picture a bell curve representing your company's strength and weaknesses. The top of the curve represents what has gotten you where you are. The outer extremes represent areas of opportunity. Your ideal acquisition should be a firm whose bell curve is the inverse of yours and by acquisition, both companies benefit.

*Example:*

Your areas of strength are:

- Quality workmanship,
- On time delivery,
- Good management with
- Excellent systems and controls plus,
- A loyal customer base.

Areas of opportunity are:

- Need quality sales force,
- Additional capabilities along with
- Competent personnel and
- Access to new customer base.

Assume for this example that you own a Printing company with annual revenues of 10 million dollars. Your specialty is high speed black and white 8 1/2 X 11 with some spot color. You produce manuals and provide forms management services for the computer industry and others however you serve predominantly high tech companies.

You develop a plan to acquire a smaller printer with a quality sales and work force serving a completely different customer base. You decide the company should provide the color and graphic design capabilities your firm lacks and the company should represent opportunity for improvement through upgraded systems, controls and stronger management.

## Further Define and Search

Online and other computer databases make finding your acquisition easier than ever. Additional search criteria usually includes:

- Geographic area
- Number of employees
- Annual sales or revenues
- Specific SIC # for type business sought
- Single or multiple locations

Once your list of possible acquisitions is completed the fun part of mailing, calling, visiting and touring, negotiating and finally completing the transaction can begin. You can attempt doing the job yourself or you can engage professional intermediaries to act as your in house M&A department.

### The Transaction and the Benefit

You had your firm valued prior to the acquisition and determined a value of \$7,500,000 (P/E ratio of 7.5 with an Adjusted EBIT of \$1,000,000) -- Size of your pile = \$7,500,000.

You acquire a firm that fits your criteria with \$3 million in revenues and an Adjusted EBIT of \$400,000. You pay 4 times Adjusted EBIT or \$1,600,000. After the acquisition the combined firms develop a P/E multiple of 10 or a combined value of 15,000,000 (Earnings of 1,000,000 + 500,000 or 1,500,000 X 10). Improved systems and controls plus elimination of redundant expenses increased income 100,000.

### Calculate Increased in Size of Pile (Value)

In the above example, the acquisition not only has increased earnings by \$600,000 but has increase the combined company's value as follows.

	<b>Value</b>
● New multiple of 10 X combined earnings of \$1,600,00	16,000,000
● Old Value of 7.5MM plus Acquisition Value of 1.6MM	- <u>9,100,000</u>
● Total Increase in SIZE of PILE (VALUE)	\$6,900,000

Improvements in management, capabilities, sales force and customer base plus the ability to cross sell printing should further enable the combined company to increase sales, profits and value even further.

### Do It Again

Management determines that if all of the mailing and fulfillment jobs Combined company now farms out (about \$300,000/yr) are brought in house, earnings would increase and additional customers attracted to Combined company for the same reasons mentioned above. A small mailing service with \$750,000 in revenue and \$150,000 in earnings is purchased for \$450,000 or a P/E ratio of 3. Management calculates earnings to increase from \$150,000 to 215,000 with the addition of their \$300,000 of volume and small economies of scale.

Management calculates an increase in value of the \$750,000 purchase as follows:

- Purchased earnings @ \$150,000 plus
- Added earnings of \$65,000 from work previously outsourced
- Produces \$215,000 in earnings to be added to Combined company earnings
- Multiplied by Combined companies P/E ratio of 10
- Produces a new VALUE of (\$215,000 X 10) \$2,150,000

This acquisition added \$215,000 in earnings but produces an increase in the size of the pile (value) by \$1,400,000 to a new value of \$2,150,000.

## Summary

Let's measure the height of the pile after applying these Growth Through Acquisition principles.

Value of original company	\$7,500,000
Price paid for first acquisition	1,600,000
Benefit of first acquisition	6,900,000
Price paid second acquisition	750,000
Benefit of second acquisition	<u>1,400,000</u>
Total Pile (Value)	\$18,150,000

You may be wondering how long would it take to achieve these results.- less than a year with professional help. Do not be discouraged because your business is not generating 10 million in revenues. The principles we have outlined work regardless of the present size of your business although the larger you are the easier it is to achieve dramatic results.

Perhaps you are one of the thousands of "Baby Boomers" who in several years will be at the usual retirement age. You have built a fine company and perhaps the thought of maybe selling it someday is distasteful. Maybe it would be fun to take a page out of the Public company CEO's playbook. Focus on value and grow your business so you can leave in style with a pile.

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