Should You Buy Before You Sell?

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While counterintuitive, it may make sense to invest in your own acquisition ahead of an exit.

When most middle market business owners begin to think seriously about selling, the instinct is to de-risk. Pursuing more modest growth initiatives, paying down debt, deferring capital projects, slowing hiring. Above all, avoiding anything that might create noise or raise questions in the years a buyer will scrutinize most closely.

It is an understandable approach, but it is incomplete. While buyers may pay good prices for tidy, steady businesses, great valuations are achieved based on trajectory, defensibility, and a credible story about what the business can become under new ownership. A well-chosen and carefully executed acquisition, or series of acquisitions, in the years leading up to a sale can change not only what a company earns, but what kind of opportunity a buyer believes it is buying.

We would never advocate for growth by any available means. As we discussed in "Every Company Needs a Growth Story, Fall 2017", growth is not only about getting bigger, it is about getting better. An acquisition made for the wrong reasons is more likely to destroy than to create value, and consumes valuable time and attention the base business cannot spare. The difference between the two outcomes is almost entirely driven by the discipline applied before ever contacting the first target.

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The Valuation Paradigm

Buyers underwrite to both recent performance history and the likelihood that performance continues, declines, or improves in the future. In the buyer's eyes, that future plan frequently involves an inorganic growth strategy using M&A to rapidly transform a business within the relatively short ownership period of most investors today. This "buy-and-build" strategy centers on acquiring a platform, adding smaller companies to it, and exiting a larger, more diversified business for a higher multiple. The whole becomes greater than the sum of the parts.

When an owner has already completed an acquisition, that theoretical future plan becomes more real. The abilities to identify a target, engage that target in a productive discussion, close a transaction, and successfully integrate the acquired company are not abilities that most founder- and family-owned businesses possess. Those that have evidenced those capabilities stand out clearly from the rest of the pack.

Let's take an example of a family-owned regional distributor that acquires a smaller competitor in an adjacent growing market. Of course the financial profile changes, but what changes even more is the image and perceived future potential of the business. It is no longer only a solid local distributor with a good reputation, it is a platform for regional expansion with a demonstrated ability to acquire. Those are two different valuation pictures for a buyer.

Scale gained from an acquisition also impacts the available buyer pool. While there are a growing number of lower middle market private equity firms, many established firms will not consider a new platform below $5 million of EBITDA. The universe of well-funded acquirors further expands beyond $10 million of EBITDA. A business sitting just under one of those seemingly arbitrary lines has a much shallower buyer pool than one sitting just above it. Said differently, adding $2 million of acquired EBITDA to a $4 million business does not simply make it a $6 million business. It makes it a business that a larger group of capitalized buyers can seriously pursue.

De-Risking Viewed Differently

Acquisitions can also address the discounts most commonly applied to founder- and family-owned businesses. Customer concentration is one of the most common issues. When one or two customers account for a significant share of revenue, a buyer's natural tendency is to focus on the downside scenario if one or both of those customers leave.

Acquisitions that are pursued superficially are doomed to fail. It is critical that an owner knows exactly what strategic attributes they are looking for and risks they are looking to mitigate.

An acquisition that expands the customer base, adds a different market, or opens a new geography can directly mitigate that concentration risk. Owner-dependence and key-person risk are also common culprits of valuation discounts. An acquisition that brings a deeper management bench can allow an owner to reduce their involvement ahead of the sale.

It is important to note that the highest premiums are paid for integrated results and outcomes, not just announced transactions. Executing the transaction with enough runway to demonstrate six-to-twelve months of integrated performance will allow buyers to fully assess the success of the acquisition. To the extent the strategic benefits will take longer to materialize, even more lead time may be necessary. If it comes across as a rushed transaction two months before pursuing a sale, the value will be scrutinized and discounted.

Knowing Your Why

Acquisitions that are pursued superficially are doomed to fail. It is critical that an owner knows exactly what strategic attributes they are looking for and risks they are looking to mitigate.Any acquisition should be evaluated for whether or not it helps the company in four specific categories:

1. Capabilities: Products, talent, certifications, or manufacturing processes that would take years and significant capital to build internally. Examples include control of a scarce resource or supply chain, access to skilled labor, lower unit cost of production or service, or technology that can change the core value proposition.

2. Customers: Entry into relationships or channels that are otherwise not attainable through organic growth.

3. Concentration: Bringing concentration in a customer, channel, product, or end market down under a buyer group's risk threshold.

4. Coverage: Expanded geographic reach or density in an existing region for businesses where those features can drive improved economics.

You will notice that size itself is not on the criteria list. Neither are simply buying it for a good price, forcing a competitor's retirement, or temporarily buying market share. The acquired business needs to align with the platform's long-term strategic vision and be additive to more than just the financial statements. A best practice is to write down the goals and criteria before looking at any targets. Criteria set in advance can allow you to pass on opportunities that might be distracting, and avoid reverse engineering the criteria to match an opportunity already on the radar. A simple test is to ask yourself "Would I want to acquire this business if I never sell?"

Don't Go It Alone

The main reason that a buyer is able to take a platform that has never done an acquisition and immediately embark on a series of strategic add-ons is simply that the buyer is staffed around that objective. Private equity firms are filled with experienced personnel who know how to approach and execute transactions. Those skills are distinctly different from the skills it takes to operate a business. The right team can level the playing field between a founder- or family-owned business and an experienced serial acquiror.

A successful acquisition team involves an M&A advisor for strategy development, target evaluation, valuation, and negotiation; a transaction attorney for documenting and advising on all legal aspects, an accounting and tax team for diligence and structuring support, an owner who knows what will and won't fit with their business, and a management team that can support the necessary integration planning pre- and post-closing. Valuation, execution, and integration are challenging elements to get right, and the likelihood of success in each of those phases increases dramatically with the right support sitting around the table.

The M&A advisor's most valuable contribution is often the deal that does not happen. But when the stars align and the strategic case is justified, owners who acquire with discipline will find themselves with a better business, a more credible growth story, and more buyers at the table when the time comes to explore a sale.

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