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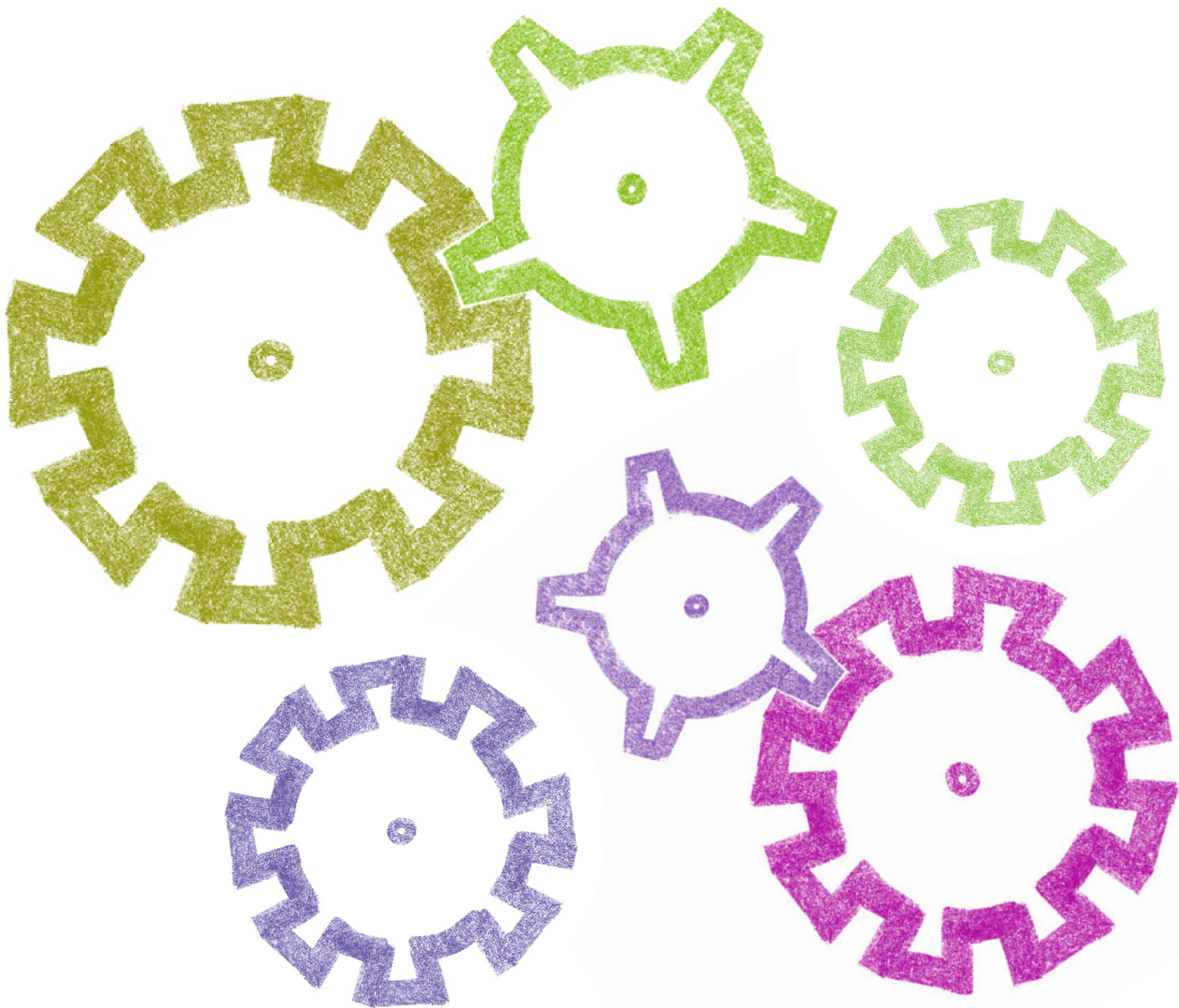
M&A as a core growth strategy

Manufacturing



Manufacturers employ M&A as core growth strategy

Manufacturers are making the most of the reinvigorated economy, and many are employing M&A as a way to grow shareholder value.

"M&A is fairly healthy," says Ian Cookson, managing director of Grant Thornton Corporate Finance LLC. "It's not at the level of activity that we saw at the peak of 2007, but it is fairly robust. Thanks in good part to the recovering economy, manufacturing executives are now looking for acquisitions as a core growth strategy."

According to Cookson, M&A activity tends to follow economic activity, and this correlation occurs for two reasons. "Sellers sell when they're making record amounts of money and their valuation is at a high-water mark," he says. "And secondly, buyers tend to buy when they're feeling confident and willing to write big checks. People feel most confident at times when businesses are doing well."

Manufacturing M&A strengthened in 2012

Data for the U.S. manufacturing sector confirm Cookson's observations (see chart below). Manufacturing M&A volume in the United States has remained steady — about 25% of overall activity — for the past decade. After dropping substantially in the financial crisis years of 2008 and 2009,

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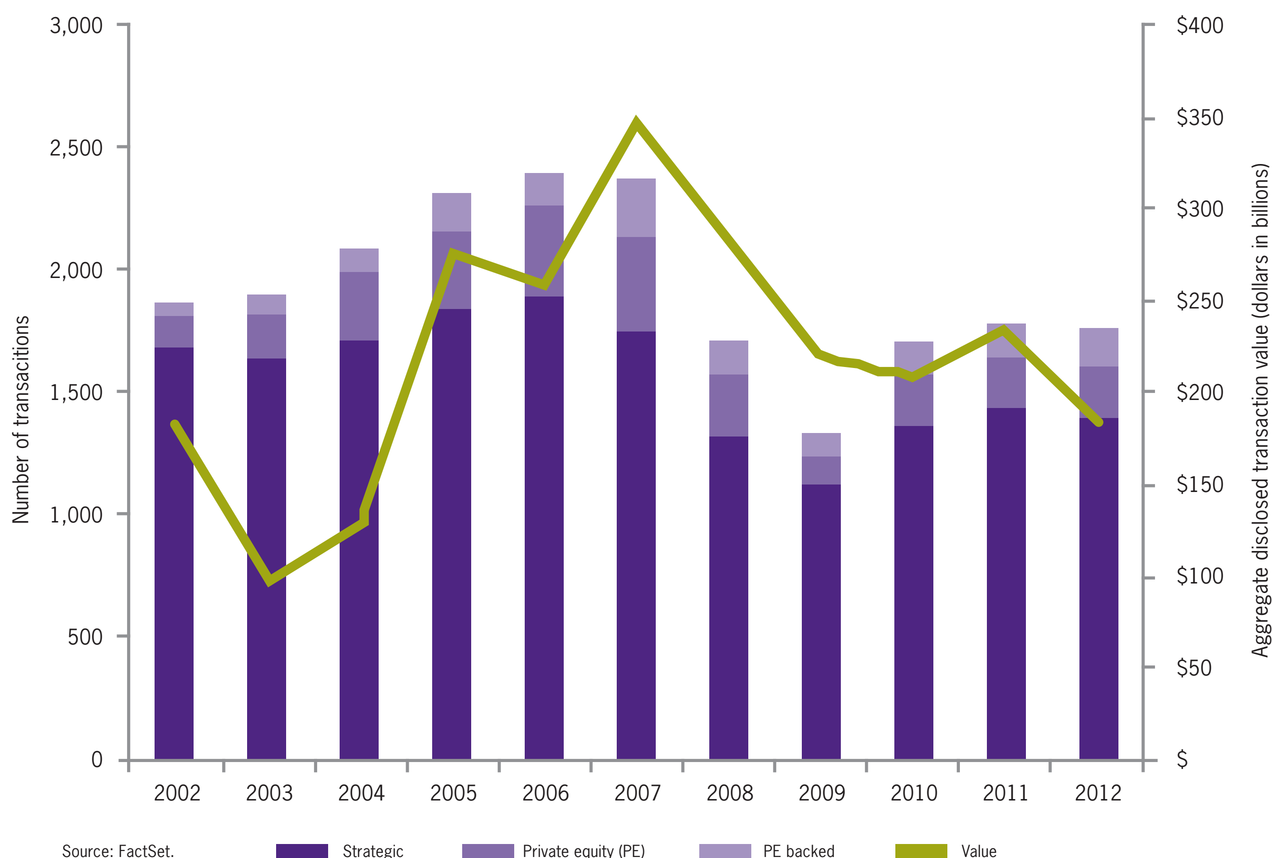
US manufacturing M&A activity, 2002–2012



Source: FactSet.

> "Manufacturing companies in 2012 saw M&A opportunities even amid the sometimes volatile business climate."
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> Sal Fira, Partner, Transaction Advisory Services

the number of transactions has grown to average about 1,750 annually from 2010 through 2012.

"Manufacturing companies in 2012 saw M&A opportunities even amid the sometimes volatile business climate," says Transaction Advisory Services Partner Sal Fira. "Many companies have high cash levels, and many businesses remain undervalued despite the recent rebound in stock prices. Industries that are integral to manufacturing, such as metals, chemicals and paper, are considering consolidation to control capacity and gain economies of scale."

Fira says the higher levels of manufacturing M&A activity have their roots in the 2007–2009 recession. Against a backdrop of declining revenues and earnings and low valuations, few companies were putting themselves on the market during those years.

With the Great Recession now in the rearview, abundant numbers of manufacturers trust they are back on track and ready to realize their worth. Many manufacturing companies have become attractive M&A targets.

At the same time, weakness and uncertainty in the overall economy continue to weigh heavily on growth prospects for some manufacturers. With consumers still anxious, they see limited opportunities for growth in their existing businesses, geographic markets and product lines. As a result, numerous executives are asking, "What about buying growth?"

Developing an M&A growth strategy

Acquisitions can make important contributions to a company's growth strategy. As manufacturing executives consider deals, they need to determine a clear, strategic rationale for an M&A decision and whether a deal makes sense for them.

"M&A for growth can be a wise strategy. However, there is a direct correlation between why and how leadership plans for an acquisition and where one ends up," Cookson says. "The value of a well-thought-out strategic plan should never be underestimated.

"So why do manufacturing companies pursue M&A deals?" he asks. "The answers are many, but we quite often see deals being done for purposes of expanding manufacturing capabilities — new product lines, acquiring new distribution channels, new and increased customer penetration, entering new markets, improving operational efficiencies, and/or optimizing brand awareness."

Whatever their strategy, manufacturers will find the M&A environment wrought with challenges and markedly different than in prerecession times.

"As we've studied successful deals and what leading companies are doing to overcome challenges, there are best practices emerging in prepurchase considerations, due diligence and post-transaction considerations," Cookson says.

Prepurchase considerations

Before manufacturing executives begin the purchase process, they need to assess their organizations and an array of potential, skilled deal professionals. Decision-makers would be wise to assess who can support them with the entire transaction life cycle — from prepurchase considerations to execution to post-transaction integration.

"It is fact that many companies are unprepared to cope with these and other aspects of a transaction," says Cookson, adding, "there's no reason for it to be that way."

There are three key factors to examine when considering an acquisition:

1. Correct fit
   A fundamental prerequisite for a successful acquisition is that it must fit into the company's broader corporate strategy and core competencies. An acquirer should conduct a fit analysis to screen potential candidates and determine their suitability for purchase. The assessment should cover factors that are specific to each company but may include the targets' product portfolio, competitive position, operating structure, supply chain, distribution channels and legal exposures, as well as tax and accounting issues. Fit analyses reveal the similarities between organizations and potential synergies resulting from the combination.

   "The overriding dynamic in assessing fit is gaining knowledge of the target's business, customers and operating model upfront and not waiting until an agreement is in place," Cookson says.

2. Timing
   Externally, timing affects the price potential for the company because it is dependent upon macroeconomic and microeconomic conditions. An acquirer needs to understand the current M&A environment, financing options and whether the target company has characteristics that are in demand at the time.

3. Pricing
   Sellers seek the highest price, as much cash as possible, the least tax burden and no additional risk. Buyers seek the best price, the most favorable tax treatment, advantageous purchase terms and little risk.

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Buy-and-build emerging as strong platform

Many private equity firms in recent years have adopted buy-and-build strategies, whereby smaller companies are bought and bolted on to a larger one.

According to Ian Cookson, managing director of Grant Thornton Corporate Finance LLC, "We find this is especially prevalent in the manufacturing environment where it helps them stay competitive with corporate acquirers."

Buy-and-build strategies are driven by a few factors:

Market and operations: Many manufacturing industry segments are fragmented. Consolidation strategies bring advantages to customers, including delivering an integrated product or system as well as supplier rationalization. Buyers may also benefit from leveraging their operational capabilities.

Financial: Smaller companies can be bought for lower prices than larger ones relative to earnings. By buying several smaller companies and putting them together, the buyer benefits from the relative pricing multiple difference between the two. They also benefit from adding financial leverage during the course of the investment.

Overall, private equity represents about 15% of acquisitions in midmarket manufacturing. Private equity firms bring several advantages: They have abundant experience using debt to finance transactions, and they're very good at managing capital in a way that drives growth in their business. They examine a myriad of deals, and all that accumulated know-how is invaluable in choosing winners. Private equity firms provide a focus on growth, rationalization and ambition.

Christopher Dalton, managing director of the Transaction Advisory Services practice, provides another perspective: "While financial results are important — whether buying or selling — the value of a company should be measured using more than a simple mathematical equation or financial model."

Manufacturers should be evaluated by analyzing additional factors, such as:

- culture,
- reliance on key members of management,
- sustainability and development of products,
- customer retention,
- ability to attract and retain key talent, and
- asset protection and risk management.

"The company's ability to memorialize its vision and strategy as well as communicate success against established benchmarks will be an important part of the buy- and sell-side evaluations," Dalton adds.

Decision-makers would be wise to assess who can support them with the entire transaction life cycle.

Due diligence

As manufacturing M&A ramps up in this postrecession environment, the need to get the deal right is mission critical.

"Corporate boards have increased their oversight of deals, given the criticality of M&A as a growth strategy," Fira says. "What this means is that acquirers are going to have to dig deeper to validate earnings and identify the significant risks in pursuing a transaction."

For example, most companies' revenues and earnings have been rising postrecession. One of the goals of due diligence should be to assess the quality and sustainability of that growth to support the contemplated purchase price.

Accordingly, the macroeconomic environment is causing companies to take a broader view of due diligence that examines customer, operational, financial, tax and information systems risks.

"In a recent deal we completed, not only did we do the traditional quality of earnings assessment, but we spent a considerable amount of time evaluating cost reductions made by the target during the recession," Fira says. "We needed to determine if the cost reductions created an unsustainable cost structure that would require incremental costs to return to normalized levels."

Other areas of increased focus include assessing the target's customer base, evaluating the forecast and its assumptions, reviewing anticipated synergies, and identifying contingent liabilities.

"Understanding the tax risks as well as opportunities also is critical," says Andrew Wilson, national Manufacturing Tax practice leader. "Although buyers and sellers need to understand their books, records, revenue and earnings streams, there are inevitable tax implications and audit requirements."

Russ Daniel, a managing director in the M&A Tax Services practice, suggests thorough due diligence on the target company to identify potential tax risks that may carry over to the buyer after a deal is closed.

"Manufacturing companies have distinct tax structures which should be considered when pursuing an M&A transaction. Tax structures are quite involved and not easy to decipher for the uninitiated or inexperienced," Daniel says. "The work you do in preparing and setting up a structure is critical. You can

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set up the greatest tax structure in the world, but if you get to the end of the deal and do not properly maintain that tax structure, you’ve wasted your time and money.”

There are several tax tips to consider for a successful M&A:

- Develop a global, national and state tax structure that establishes a favorable tax footprint for the manufacturing entity while keeping life as simple as possible for the operations team. For example, segregating manufacturing, research and development, and administrative functions into different entities and jurisdictions may allow the company to more effectively manage its overall tax rate.
- Consider local tax incentives for manufacturers. While it is well known that lawmakers offer incentives for relocating to their state, they may also offer sweeteners to encourage existing businesses to stay in their state.
- Consider the impact of the target company’s tax attributes: If they are an important part of the deal, spend as much time as necessary to be sure the attributes are usable following a transaction.
- Examine tax basis step-up options in structuring the deal. The potential tax shield of amortization deductions is very attractive, and the buyer also may be able to claim current deductions through the increased cost of goods sold.
- Focus on cash flow planning. Is the company taking the correct steps to maximize cash flow and pay the IRS only what is necessary? Cash flow is critical following any deal, so minimizing tax liabilities is a significant opportunity.

“There is a one-time opportunity to lock in tax benefits as part of a deal, but once the transaction closes, those tax opportunities may be gone forever,” Daniel adds. “I can’t emphasize enough that upfront tax planning is absolutely essential. There is no reason to spend hard-earned cash on unnecessary, unexpected tax liabilities.”

Overall, the need for deeper and broader due diligence is imperative. Unfortunately, many companies have scaled back on M&A resources as mergers and acquisitions waned during the past few years. Companies may need to consider redeploying internal resources to cover the additional need or consider outside assistance.

Post-transaction considerations

While some may consider this M&A phase a post-purchase stage, nothing could be further from the truth.

“The term ‘post-transaction’ really is a misnomer because action on this (phase) cannot begin when the deal closes,” says Ed Kleinguetl, managing director of Transaction Advisory Services and leader of Grant Thornton’s Transaction Integration practice. “Integratability should be considered on the front end when the possibility of M&A is being considered.”

Successful M&A outcomes result when organizations come together to take advantage of synergies, Dalton says. “Combining businesses needs to be done through a systematic method that makes the most of their strengths and minimizes the fallout that is inevitable when merging two companies.”

According to Kleinguetl, “Just about everything hangs on two elements — value drivers and risk. At the least, those two elements must be part of due diligence planning. As one comes out of due diligence and is closing the deal, it’s time to turn the promise into performance. It’s not the time to plan how to do it.”

Kleinguetl offers three key points for post-transaction planning:

1. Develop a strategy to capture the value.
2. Address inherent risks so they can be mitigated (i.e., operational stability and aligning cultures).
3. Formulate steps to put a post-transaction infrastructure in place (i.e., financial reporting, payroll and IT functions).

When it comes to planning for and executing M&A, “Most businesspeople don’t do this well. M&A often fails because value and risk are not appropriately planned for and executed,” Kleinguetl says. “Outside parties who do this daily have seen it all. They offer recommendations and advice on how to take on such a monumental challenge. It’s a very different deal every time. ”

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Russ Daniel, Managing Director, M&A Tax Services

10 questions to identify, minimize valuation gap

The difference between a targeted transaction value and the achieved transaction value is known as the valuation gap. Following are 10 pre-due diligence questions to help identify and minimize the value gap:

1. Is there a well-defined business objective that a merger or acquisition would address (e.g., gain a new product or customer base, remove a major competitor)?
2. Have a sufficient number of manufacturers been vetted to identify the right M&A partner?
3. How much debt is too much? If you price the deal appropriately, it will take pressure off the required returns.
4. Is there potential for confusion and division among the combined ranks? To what degree can leadership effectively manage differences?
5. What is the likelihood that key executives would leave or join a competitor? Identify employees who are critical to a successful merger — both on the buyer and seller sides — and assess their receptivity.
6. Would your integration plan rapidly mobilize the merged company and create value in the short term while addressing long-term growth? Can the existing leadership excel at both?
7. How did the prospective target become successful? Can the buyer continue to make that happen without losing the company's unique and profitable attributes?
8. Should an acquisition remain independent? Too often, acquirers insist on integration instead of allowing a successful standalone.
9. Would the deal drain focus and resources from the existing business, current customers, competitors or core objectives?
10. Are the rewards and risks of the deal supported or diluted by current economic conditions?

Next steps

For those manufacturers contemplating an acquisition for the first time — and even for those with experience — the challenges of completing a successful transaction can be overwhelming.

As the deal moves through its various stages — beginning a dialogue with sellers, a letter of intent, due diligence, execution, integration and the post-merger audit — teamwork is essential.

"Based on Grant Thornton's involvement with thousands of M&A transactions, we often tell manufacturers that it's critical to start planning early and stay close to their advisers throughout the process and beyond," Fira says. "Have an idea of where you want to be in the next five to 10 years and work together to develop strategies for your company. Doing so gives you opportunities to achieve the success you're pursuing for your business."

Additionally, due to the global nature of current manufacturing operations, "It's especially important for manufacturers with international involvement to use the services of a mature, global practice that focuses on M&A within that space," Dalton advises. "Global M&A transaction requirements can be especially perplexing."

Regardless of whether a manufacturer is solely domestic or multinational, the best M&A tactics are those that are simple, clear, effective and take advantage of the correct fit, timing and price.

"From our current vantage point, as the manufacturing sector continues strengthening, the future looks promising for growing shareholder value through Mergers and acquisitions," Dalton says. "As with so many functions of business, preparation paves the path for success. Mergers and acquisitions transactions are no different. Plus, it's always good to keep in mind the adage 'success begets success.'"

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