Practitioner Perspectives

WOLF DEN ASSOCIATES, LLC

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M&A Sourcing Myths and Realities

1. ***Myth: Only the "greater fool" can win a broad M&A auction***
2. ***Reality: Winners often have superior information and/or a more compelling strategic rationale***
3. ***Myth: Anonymous "Dear Seller" letters to M&A targets are effective outreach***
4. ***Reality: Tailored "acquirer of choice" stories hook Sellers and build momentum***
5. ***Myth: Bankers unrealistically inflate financial forecasts***
6. ***Reality: Sellers have an obligation to cast themselves in the most favorable light; clear-eyed diligence is required regardless of the sale process***
7. ***Myth: It is cheaper to eschew formal auction processes in favor of proactive M&A***
8. ***Reality: The all-in, probability-weighted cost may be lower with formal processes***
9. ***Myth: All formal M&A processes devolve into broad-based "bake-offs"***
10. ***Reality: Bankers are increasingly using targeted processes that minimize exposure and distraction while preserving "competitive tension" for their clients***

Sealing the Deal

- Anonymous "Dear Seller" letters are ignored by Sellers — tailor messaging and sell them on a bigger vision and their place within it
- Once contact has been made, be relentless in the pursuit — work it with constant contact; merely tracking it lets other suitors catch up
- Organize integration approach, diligence concerns, financing commitments, and required approvals early to press the advantage
- Deputize a deal lead with the authority to commit the company — Sellers have little patience for "Mother May I" with go-betweens
- Understand and empathize with Sellers, because winning suitors are good listeners who craft their message and structure accordingly
- Reputation matters — how Sellers interpret Buyer words and actions can have greater impact than the words or actions themselves

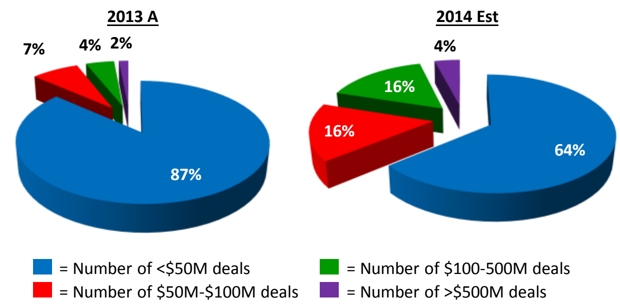
Scylla and Charybdis

Buyers in the federal M&A marketplace typically self-identify as devotees of either unbanked (proactive) or banked (reactive) sourcing approaches. The allure of proactive M&A sourcing is the promise of off-market targets that can be acquired for lower prices, but they come with increased time to close, lower probability of success, and the need for far greater dedicated resources. Conversely, reactive sourcing may come at a higher notional price, but also a higher speed and certainty of close, and potentially an all-in lower level of effort. The reality is that steering too close to either approach carries definitive risk and reward tradeoffs. In order to maximize the probability of success and minimize the risk of ruin, Buyers must deftly balance between the two extremes.

The Siren's Song

Standard success fees and fee minimums can be prohibitively expensive at the smaller end of the M&A market. As a result, while transactions with less than $50M in enterprise value comprise the majority of federal M&A deals, this segment of the market is relatively underbanked. The prospect of landing the right tuck-in acquisition or executing the "string of pearls" approach without competition from other bidders can be irresistible. However, the process of identifying, courting, and acquiring a company outside of a formal process is unwieldy: there is no assurance that the company wants to sell, there can be many false starts as incidence of cold feet is rampant, and few targets have adequate documentation prepared to support due diligence needs. This approach is best suited to Buyers with patience and the dual luxuries of time and resources to sustain multi-year lead times with many false starts. For those with scarce time and resources, a proactive approach may not offer superior risk-adjusted returns or sufficient probability of success.

Federal M&A Transactions By Enterprise Value



Source: Houlihan Lokey; est. annualized as of 5/30/2014

The majority of approximately 100 annual Federal M&A transactions are sub $50M of Enterprise Value. While proactive approaches may hold better prospects for this segment of the market, larger transactions are typically reactive.

The Cyclops' Cave

For Buyers with a sense of urgency or the appetite for larger transactions, the surest path to success is through formal sale processes. For those looking to quickly cover a gap in organic growth, retool their portfolio to respond to current federal spending priorities, or who have simply reached a point where smaller transactions provide insufficient bang for the buck, joining the herd is the best approach. While the procedural rigor of a formal process can be restrictive and at times the metered flow of information can be frustrating, do not underestimate the value of having necessary documentation prepared for you in advance. Similarly, while the competitive tension of an auction typically results in a higher notional price, there are very real indirect and opportunity cost savings.

Dispatch the Suitors

Whether proactive or reactive in their approach, the successful Buyers are the ones that effectively differentiate themselves from other suitors. On the front end, a proactive courtship can prove successful in separating a Buyer from the pack even if the target in question ultimately elects to kick off a formal sale process with multiple parties. The early goodwill and superior knowledge of strategic fit and financial performance gives the stalking horse Buyer a leg up in the competition. Towards the end of the process, speed and certainty are a Buyer's best weapons. Clean deal structures with transparent due diligence, approval, and financing requirements can carry the day. Situational awareness around near-term growth prospects has seldom been harder to discern and Sellers are increasingly sensitive to structure, so manage your courtship accordingly. Lastly, remember that Sellers are incentivized to cast themselves in the most favorable light. Just like Penelope's final test of Odysseus, Buyers must trust but verify even the targets they have come to know the best.

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