Documento de Trabajo

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Small Business Acquisitions: «Starting the House from the Roof»

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Departamento de Economía de la Empresa

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PREFACE

The traditional "due diligence's" acquisition process, with its set of assumptions, is the root of many mistaken deals. During the due diligence's, the acquisition advisor plays the role of an architect that begins to build a house from its roof: performing a deductive process that departs from the final consequences (the target's financial statements) in the search of the corporate foundations (the company's value).

When the acquiring and the target companies are competitors, the buyer usually has enough information to correctly appraise the targets real attractiveness and worth. But when it's a business diversification there is a dangerous information asymmetry between both sides. What happens if the financial statements had a previous "make-up"?, or if competition changes make the company's past performance an irrelevant indicator of future prospects? Insufficient understanding of the target company and its business can lead to costly mistakes.

In the case of small businesses, especially if they operate in reduced markets, the traditional acquisition process gets more complicated as information is scarce and can be unreliable. The greater impact of the advisors fees on the overall cost of small deals is an additional factor that favors superficial acquisition procedures and leads to high risk decisions.

Acquisitions Results

The acquisitions performance has been traditionally measured by future divestment ratios and surveys on acquirers personal impressions; not very reliable methods. A corporate divestment isn't always a signal of a mistaken deal, because a strategic repositioning or the need to reinforce a troubled core business may force to sell a successfully acquired subsidiary. In the case of executives surveys, they avoid the divestment interpretation problem, but leave the decision about each acquisition success to the very personal judgment of the survey: judge and party of his company's decisions.

In a 1987 *Harvard Business Review* article, Professor Michael Porter reported that a 56% of the acquisitions made by 33 large US. companies in new industries were divested during the following 25 years; the percentage increased to a 61% when the new industry was in an entirely new field.

An executive survey published in the *HBR* by the consultant John Kitching in 1974, noted that a 59% of the acquisitions made in the same business were successful, while 21% weren't worth doing and 20% were failures. When considering conglomerate purchases, only 35% of the deals were per-ceived as a success, while 29% weren't worth doing and 36% were considered as failures.

1. The Due Diligence's Process

The due diligence's is a checklist of tasks to be performed by the prospective acquirer and its advisors. Almost every professional has his own version, but all generally include the analysis of the company's financial statements, an industry study, interviews with key employees, checking of property rights and the appraisal of possible legal liabilities, among others. A list of minimum diligences for assuring a correct deal.

The Discounted Cash Flow Method (D.C.F.)

This method uses future estimates of income, expenses, investment and amortization to determine yearly "free cash flows" (the money that the ownership can freely retire from the company every year without harming the necessary future investments). In the past, ten year estimates were the general rule, but now, most acquirers only try to forecast the next five years figures. Another task is to estimate the company's terminal value: its value at the end of the forecasted period. The yearly free cash flows and the company's terminal value are discounted at an interest rate to determine the company's present value.

The D.C.F. method is based on a business plan that estimates future sales, expenditures, investments and amortization's. The key success factor of the valuation is setting those hypothesis, because their reality determines the accuracy of the value estimate.

When looking at the future, past performance is the main working tool. The company, its clients and its competitors tend to maintain certain trends, and past sales and expenses usually indicate well the immediate future (1-2 years) figures. Forecasting further, the differences between expectations and reality may be huge.

The D.C.F. methodology is the generally accepted valuation method, so the price discussions focus on the assumptions used; in this respect, the reality of the company's financial statements play a corner stone role in the valuation development, because they are the base for the business plan estimates. If the financial statements and the forecasts are realistic, the estimated value will be accurate and the probability of closing a good deal will be high. The intent to assure the correctness of estimates is the main goal of a due diligence's process.

The due diligences process departs from the study of the target's financial statements. The first task is a review of the company's past performance through the study of its recent financial trends —normally the past five years— and a

ratio analysis. Theoretically, the analysis of the financial statements offer plenty of information about corporate characteristics such as growth, profitability, cost structure, liabilities or assets book value.

The next steps are directed to the attainment of complementary information about different aspects of the company and its environment that can confirm and complement the financial information. All this additional data is used to make the target's valuation and have a first impression about the possibility of reaching a price agreement with the owners.

The valuations are made through an approximation of the money that the company may provide in the future to its new owner. This value is generally calculated through a mathematical method called Discounted Cash Flow (D.C.F.).

2. The Dangers of Deducting Value

The problem of any deductive process is that if you depart from wrong basic assumptions you'll get mistaken results. In the case of the due diligence's approach, the acquirer's team relies in the trustworthiness of the financial statements and on the reality of the information provided by the target company. An approach that has to watch for the following dangers:

2.1. Financial Statements "Make-Up"

Like brides looking for a candidate, companies try to look as nice as possible when offered for sale. Owners "make-up" the company's numbers by different procedures to improve the company's accounting image.

Among the most common tricks are:

— The "date renovation" of old unpaid bills so they seem collectable. This increases accounts receivables.

— The accounting of non-existent finished goods inventories at the end of the last year. This creates accounting benefits under some European accounting standards.

— Not including part of the real wages in the company's accounting, and paying them unofficially to the employees. This decreases the operational costs and gives a false impression of the company's competitiveness. Additionally, in

Europe, each employee's social security costs is a large proportion of its official salary, so paying employees unofficially means paying less to the government for public health care and pensions.

This and other hidden skeletons are difficult to detect without a good understanding of the company and its industry. Double accounting is standard in many companies, especially if they are in the lower waters of the value chain —close to users and consumers— and if personal income taxes are very high in the country, as it is in Western Europe.

2.2. Sellers that Have "Prepared" the Deal

When the company's sale has been considered well in advance, the official financial statements can be prepared to present a better look. There are some legitimate decisions that the seller can make for increasing the value of a company appraised by the D.C.F. method.

The acceleration or delay of investments can seriously change the company's numbers and affect the price prospects. The owners of companies operating in growing markets usually accelerate capacity investments or even over invest for increasing sale forecasts and incrementing the company's D.C.F. valuation. In the other hand, companies in mature markets may delay needed replacement investments, which inflates the past benefits used as indicators of future results.

Other well known tricks are to reduce advertising expenditures during the last few years or artificially increase last few months sales through higher salesmen commissions (payable at the end of the year by the new owner) and longer payment periods for the client (also due to the new owner). In this last example, good recent news can have a strong impact on nervous buyers, which may extrapolate fresh sales data and may want to accelerate the deal afraid that the seller changes his mind or increases the price.

The prepared sales are more difficult to detect than the "make-ups" because there is no accounting manipulation. In this case everything is legal and can be argued with more or less orthodox managerial explanations.

2.3. Low Forecasting Value of Financial Statements

Financial statements always have been the corner stone of valuations, but often don't reflect real future prospects. When the statements are reliable and both the market and the competition are stable, this data is a good indicator of value. The problems arrive when the company has a fast changing environment and the prospective acquirer doesn't know well the industry and market.

Despite an excellent offering price, a troubled wine producer didn't find a buyer for several years. The company went into trouble because of its externally financed over investment in production capacity and the artificial revaluation of the Spanish peseta during the late eighties. Looking at its figures, the company showed a progressive decline in all financial indicators, plus losses in market share at home and abroad. The owners had refused to enter the price war caused by the generalized decrease of all wine exports and insisted in not selling their vineyards and redundant plant capacity. Prospective buyers thought that the company was in such a bad shape that the turnaround would be too risky and didn't study it in depth.

When in 1992 the Spanish government did three successive currency devaluation's for restoring the peseta's normal exchange rate, there was a fast increase in the demand of Rioja wine, and this company made a spectacular turnaround; they had the production capacity to export, and the preservation of their brand image allowed them to charge premium prices to the distributors. Today the company is still kept by its family owners.

Past financial statements may well represent past performance, but the uncertainties of competitors behavior and the general economy may make them useless as an indicator of the future.

3. Small Companies in Small Markets

Small companies should be valued considering their specificities. The heterodox corporate strategies of many of them and their usual operation in small markets or niches require of special approaches for discovering their true value.

Privately held companies, especially when they are family controlled and small in size, can play the role of savings-boxes where the owners accumulate their wealth. Instead of the profit maximization strategies of large corporations, the owners can pursue low taxes policies. The managers of tightly controlled

companies don't have to give explanations to a large group of stockholders and can manipulate the firms accounts for paying as little taxes as possible. It is a contrary sign "make-up"; accelerate depreciation's, report some investments as expenses or writing off receivables that are still collectable, reducing taxable earnings and apparent corporate value.

In this kind of companies the border between the company's assets and the owners estate is confusing. Owners may charge many personal expenses to the company: the private plane, holidays, cars or domestic employees salaries, are some of the unnecessary investments and expenses that you may find in a small company's financial statements; cash outlays that don't have to be met by the new ownership and that should be accounted for a proper valuation.

In countries where personal income taxes are very high, real sales may be 30% higher than official revenues. The company's owners try to make as much "black money" as possible, not accounting payments to employees and suppliers, and collecting from customers in the same way. In businesses located at the end of the value chain, especially if their clients are non-corporate final consumers or users, this "black earnings" are difficult to track by tax authorities.

In a recent consulting project in the food trading business in Southern Spain, the author found that all the three competing companies in a certain geographical area were in bankruptcy terms. The surprise was that they kept operating normally, the owners maintained expensive lifestyles, and demanded astronomical prices for apparently worthless companies; it was also strange that the performance of two of them changed widely from one year to another with no apparent reason. Many profits never enter the companies, that accumulate losses until they merge with newly formed companies for tax deduction purposes.

The small markets and the niches of larger markets offer additional barriers for correct corporate valuations. Official statistics usually don't cover small markets or don't have enough disaggregation, and its difficult to get estimates of basic data such as market size or client segmentation. In this cases, the only solution is to make estimates.

4. Build the Value from the Ground

Given that the value deduction of the due diligence's process is risky, an alternative way is to induce the target's value from basic data and relationships. Build the valuation on a solid ground.

4.1. Start Building a Tentative Income Statement...

Given that the D.C.F. valuation relies basically on the income statement, the best way to get a good understanding of the business and minimize possible distortions caused by accounting make-ups and other manipulations is to build your own income statement. The goal is to estimate how should be the sales and expenses of a company with the target's size, efficiency and present resources.

The simulated statement is a rough estimate of the probable numbers of a company under the target's circumstances. Many acquirers are aware of valuations low reliability and prefer to assure certain key data such as the target's product costs compared to its competitors, average operational earnings, demand volatility or value and cost drivers.

This approach has several advantages:

1. Key data has been directly obtained from several sources, not deduced from the target's financial statements.

2. You can get a first impression of the target's and its business most relevant magnitudes, enabling the buyer to decide whether it's worth continuing the acquisition process. When hiring accountants or corporate brokers, the advisor heavily depends on the success fee and will press to continue with the deal as long as there is any hope of agreement.

3. This first step can be a short and inexpensive consulting project. The low cost stimulates the study of companies and doesn't put pressure for continuing with the deal. The implementation of the study by management consultants has an additional advantage; auditors and financial analysts are seldom industry specialists and don't have the consultants experience in studying the multiple aspects of a company, especially referring to the operational, marketing and human resources functions.

4. Being a consulting project there is no success fee, and the advisor won't have any conflict of interests with its client. Under pressure, corporate brokers may develop "hockey stick" sales projections, that optimistically try to reflect the target's improvements under the acquirers management. Others forecast optimistic increases in the price of the good and services, based in expected quality improvements.

5. The data collected and the simulation can be used in the study of another company of the same business, reducing future costs.

6. The exercise of building an income statement has strong educational consequences for the acquirer, that is getting operational insights from the business.

When working on small single business companies the simulation tasks are fairly simple. With basic spread sheet skills and 2-3 weeks of data collection from the target's functional managers and external experts (industry association, consultants, clients and suppliers) the acquiring team can be able to figure out the key information.

Simulating the Income Statement

The spread sheet simulation is founded on a few key figures and qualitative data. The model's success factor is to include the most relevant cost and value drivers and to represent the logical proportions of costs with an average level of efficiency.

The main source of information are the targets functional executives (human resources will give data on average salaries of different kinds of employees, sales will speak about prices and payment conditions, etc.). It is difficult that all mid level employees lie about the specifics of their jobs. Lies can be detected after a while, because subsequent questioning will uncover inconsistencies between sources.

4.2. ...Test Your Results with the Target's Owners...

If the company and the business looks as expected, sharing the simulation with the target's owners is a good way of testing it. They have the opportunity of contributing to the valuation, offering additional information and debating the rules and proportions used for the estimates.

The reaction of the owner towards the income statement simulation is usually very critical. They point the defects, some of them real, and offer alternative explanations and data. It is also common that they ask why do we build new income statements if they have offered theirs; in this case, the best answer is to say that it is a "new technique", assuring that there is no reluctancy towards their accounts.

While discussing the simulation and comparing it with the actual accounting statements, many of the company's weaknesses and past mistakes

arise. The simulated income statement works as a benchmark to which compare the target's strengths and weaknesses; as the management give explanation they can be included in the simulation, normally arising new questions.

At this point, it is possible to make a first D.C.F. valuation and decide if there is a possibility of agreement with the seller. The owners of small businesses usually approach the deal with a fixed price in mind, and are usually less open to technical valuation arguments than the management of large corporations; if the distance is too big, it is not worth continuing. But there is plenty of data available to approach a new target.

4.3. ...And End Performing the Traditional Due Diligence's

Once there is a good understanding of the company and its business, and there are possibilities of agreement between both sides, it is the moment for performing the traditional checking of assets and liabilities. A much shorter list of basic tasks, usually an accounting audit supported by a lawyer.

5. CONCLUSION

Longer lists of diligence's is not the answer for the great uncertainty of corporate acquisitions. The problem with due diligence's is that it is an illogical approach to the value of a company, especially if it's a small privately held company, where the owners can distort the target's true value in several ways and the amount of market and industry information is scarce.

The most logical approach to small acquisitions is to get right the basic operational and market numbers and achieve a good understanding of cost relationships and key success factors. This enables the implementation of an income statement simulation that can serve as a benchmark of the company's performance and as a discussion tool with the owners.

A short list of traditional due diligence's will be the last step. The difference is that the strategic and operational study of the company is done by consultants and the accounting and legal diligence's are performed by auditors and lawyers ≈

Reader's Notes

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