July 2012 Newsletter

PUTTING THE "M" BACK INTO M&A
OR
"Amalgamate or Die"

When it comes to M&A between small private companies the dominant type of transaction has always been the all-cash acquisition. However, the credit crunch and the understandable need of companies to preserve cash reserves have relegated all-cash transactions to "rare species" status.

The most pressing challenges faced by companies today are to cut costs, increase productivity, retire idle assets, tap new markets, achieve economies of scale – definitely not to expand with cash-hungry acquisitions. So, we should hopefully see a new trend for mergers with no cash (or negligible cash) consideration, which for the purposes of the present we will call amalgamations.

The word "amalgamation" implies a combination, a joining of forces, between roughly equal partners – in contrast to a classic merger in which one of the two sides obtains control. There are numerous scenaria under which an amalgamation makes sense for all sides (in an amalgamation there may be more than two sides, after all). We outline below some typical cases:

a. **Direct Competitors:** During the stock-market bubble, these were very popular – for the wrong reasons. The idea was that, if you could slap together enough small businesses, then you could achieve an IPO and unload at a huge profit. Everyone would make a bundle, except those stuck with the shares, of course. Fortunately, very few of these deals ever materialized, mostly because there is a big difference between simple arithmetic (1+1 = 2) and M&A of substance (1+1 may be 0, or it may be 4, it depends on how well you put it together).

   Nowadays in saturated markets, with too many businesses chasing too few deals, an amalgamation between **local, direct competitors** may be the only way to secure viability and solvency for both sides. As long as it's done right. It's complicated and egos often get in the way, but the prospect of imminent insolvency concentrates the mind beautifully!

   An experienced intermediary is a must, not only to advise on deal structuring, but also to make sure traditional mistrust between competitors does not kill the deal.

b. **Professional Services:** We single out professional services (architects, engineers, doctors, accountants, lawyers, etc) as a special case, because we see the serious problems they face daily – especially those professionals that depend on the construction industry. Regardless of the current situation, professionals always had a **scale problem** (a professional practice is usually an one-man-show or just a couple of partners) plus a **succession problem** (classic example, the children of an architect do not want – or cannot - become architects). All the value of a personal practice, created over many years of hard work, is lost when the professional retires. So, there was always a compelling case for professionals to team up and build a practice which has a brand and an indefinite economic life beyond the useful working-life of the founder.

Now that business is slow and clients bargain hard, there is even more of a need for professional practice mergers. To take an example from engineering consultants, several non-competing specialties (civil, mechanical, electrical, QS) could merge to save on overhead, diversify revenue sources and present a more compelling case to clients. But even seemingly competing professionals have an excellent incentive to merge, as can be demonstrated from highly successful partnerships of Lawyers or Accountants.

c. **Vertical Integration:** Merging of companies with complementary activities on the same value-chain is a relatively simple proposition, as long as the benefits for both sides are immediately realizable. We stress the word “immediate” as, too often, vague and long-term strategic synergies are never realized. Plus, in the urgency which characterizes the current situation, it’s only the prospect of immediate benefits that can motivate companies to amalgamate. Otherwise, mergers of this kind are probably the most common, e.g. between raw materials supplier and manufacturer, or importer/wholesaler and retailer. A good pre-existing commercial relationship, interdependence and mutual trust, are the perfect ingredients for an amalgamation.

d. **International Expansion:** Cross-border mergers between small companies in similar lines of business make a lot of sense, but are probably the most difficult to achieve. The motivation on both sides is strong: neither company can penetrate each other’s domestic market or expand anywhere else abroad on its own, both are simply too small. A cross-border merger opens up the home markets of both companies and it may also help them expand to third countries, if the size of the combined entity allows it. If you add to the benefits a combination of knowhow, technology, management skills, geographical diversification and a bigger product line, you have all the ingredients for a happy marriage. Of course there will be problems with business culture, distance, miscommunication and control issues. Which is why, in most cross-border mergers, one of the two sides obtains majority control - even if it is a small majority.

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