MERGERS & ACQUISITIONS

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Opinion How mid-market companies can manage crossroads situations

By
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Across the spectrum of middle-market mergers and acquisitions, there's a great big middle ground that specialist investment banking firms handle very well.

The investment banking business model works when the market itself is working. In this context, a working market means that there are multiple sellers of relatively similar "goods" — professionally run middle-market companies with continuing management teams being traded by professional investors — as well as multiple viable buyers interested in competing with each other to complete a deal.

In these cases, there's a clear timeline for when shareholders want to generate cash returns, a professional board that identifies the best route, and a clear measurement of success, which is almost always that the seller completes a transaction at the highest available price.

There's a very accomplished service industry of investment bankers, lawyers and accountants that identifies potential buyers, manages transaction risks and completes the deals efficiently. From the seller's perspective, the traditional private company sale

continued on next page

process — a limited auction — identifies several acquirer options, creates competition among them and closes a transaction on the best available market terms.

But not every situation is like this. In my experience, the 80/20 rule apples. Eighty percent of situations are relatively uncomplicated and well served by the process outlined above. However, 20 percent are not clean enough for the model to work. I call them "crossroads" deals.

I use that term because the board members or investors find themselves at, truly, a crossroads. The path forward isn't so clear, sometimes time is of the essence, and the situation could ultimately play out in a variety of ways that complicate the normal sale processes for private companies.

In this spectrum of deals, "crossroads" situations are often at one extreme or the other. Sometimes the seller has too few options or, alternatively, has too many. In both places, from the perspective of advisors who work on the basis of success fees to efficiently complete transactions, they're stuck.

"Crossroads" situations turn potentially good companies into bad investment banking clients.

In these situations, it can become necessary for investment bankers to function less as executors of a transaction, and instead to help weigh the pros and cons of hard decisions in a counselor-like role. Here are some examples:

1. Too many options

We see "too many options" arise most often with middle-market companies that are neither succeeding or failing, whose investors are venture capital and growth equity funds holding minority positions.

As time creates urgency for cash returns, the board needs to do something. But what? Everything is on the table. Options might include a large revenue-based deal with a

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strategic customer, a new tranche of minority investment, a stock deal with another relatively small and cash-poor company, a sale of strategic assets or, ideally, a sale of the entire company for an amount of cash that generates acceptable returns.

If you can do anything with a business, how do you assess and weigh the full range of options? The story we hear from venture capital and growth equity investors is "I thought an investment banker might help with one or two of these options, but I don't know where to get help assessing all of them."

Assessing these potential opportunities is what investment bankers do. However, in some of these cases, you're asking investment bankers to weigh in with their expertise when it's possible that their business model — in which they receive a commission from closing a deal — isn't the best option. So, your service provider is put in the position of having to recommend something that's against his own economic interests. The relationship is inherently fraught.

2. Too few options, or chasing down one opportunity

The other end of the spectrum is when a board has a really limited set of options — sometimes fortuitously, sometimes not.

Take a situation where a small company loses a major client. My firm recently worked with a business that made the majority of its income from a single big-box client. Using this name recognition, they were able to bring in other, smaller customers.

If that company were to lose its major client, the steep loss in income would force it to dramatically reshape itself, if it was able to survive at all. For a board of directors, that would leave a limited set of options, ranging from cutting costs to liquidating assets.

In other cases, management and the board feel that they have a good sense of where a business belongs in the market, and just want to pursue a single opportunity as thoroughly as possible. For example, a client of ours recently linked up with a industry counterpart, building on a long history of working together to create a joint venture

continued on next page

that could execute on aggressive expansion plans. The terms of the deal reflected what both companies believe about the future — not the last 12 months' earnings, as is typical. This transaction was completed without any serious consideration of seeking competing offers.

For many investment bankers, these "do it or don't do it" situations — where a deal may happen but is in no way a certainty — also challenges the business model. If you're going to do the work to negotiate a transaction, success-fee engagements almost demand seeking multiple offers, which increases the possibility that a deal gets done.

The middle-market investment banking industry has many people who are incredibly efficient at executing transactions. But for some situations, the industry also needs people who are incredibly flexible, and whose own success doesn't depend on whether a deal ultimately takes place.

If you serve on the executive management team or board of directors of a middle-market company, it's important to identify among your investment banking relationships which are best suited to efficient execution and which are better suited to strategy consulting with a financial bias. You need to build relationships with both, so that you have them when you need them.

There's no better time than the present to begin the conversation about how you'll handle these "crossroads" issues if they arise. Doing so will at least give you a solid starting point.

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