

## DUE DILIGENCE FOR ADD-ON ACQUISITIONS

In today's economy, where financing opportunities are all but gone, and organic growth is difficult to achieve, Private Equity Groups (PEGs) have focused their efforts on add-on acquisitions instead of investing in new platform acquisitions. Although add-on acquisitions are typically smaller in size, they complement the original platform investment in that the synergies of the combined entity create a more efficient whole, both operationally and financially. Typically, add-ons are identified shortly after the initial platform company is acquired and tend to be small-to-middle market, privately held companies. Performing due diligence on such targets presents a new set of challenges not previously seen in the acquisition process of the platform company.

### Unique Challenges of Add-On (or Tuck-In) Acquisitions

Add-on challenges include, but are not limited to, the following:

**Unaudited/Unreviewed Financial Statements**—Many smaller privately held companies do not engage an independent accounting firm to audit or review their financial statements. As a result, the target's financial statements may not be in accordance with accounting principles generally accepted in the United States of America (GAAP). For example, the target may prepare its financial statements on the cash basis of accounting whereby revenues are recorded when received and expenses recorded when paid, or the target may not properly capitalize software development costs.

**Unsophisticated Management Team and/or Accounting Group**—The management team and/or personnel responsible for the accounting function may not be familiar with the due diligence process. In addition, the target may not have competent advisors to assist it with the transaction process. As a result, expectations related to document requests, deadlines, and other steps in the

with respect to non-business expenditures as well as to identify possible additional non-business expenses.

**Corporate Culture Issues**—Unlike platform acquisitions, add-ons offer a unique complexity with regard to matching corporate culture with the acquiring entity. It is very important to perform a comparative analysis of both

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diligence process may not be met. It is important to quickly identify any potential concerns related to this matter to mitigate delays and properly guide the target's management team.

**Lack of Financial Data**—Most small companies do not have robust accounting systems that allow for granular levels of financial analyses (e.g., gross margin by product line, gross profit by region, concentrations by product line, etc.). As a result, it may be difficult to obtain the analyses necessary for benchmarking against the platform company. Without this data, the PEG may not be able to appropriately identify the synergies that may exist with the platform company.

**Personal and Non-Business Expenses**—It is common for small business owners to charge personal and/or non-business-related expenses to the company. Careful analyses of the income statements should be performed to verify any assertions made by the target

the quantitative and qualitative aspects of corporate culture. Quantitative aspects include compensation ranges, benefits, and vacation policies. Qualitative aspects include areas such as company activities, dress code, competition, and flexible work hours.

**Animosity Born from Historical Competition**—By their very nature, add-ons tend to be competitors of the platform company. This creates an inherent distrust during the due diligence process. As a result, certain information is provided grudgingly or sometimes not at all until a certain level of trust is established. The due diligence provider must be seen as an "honest broker" in the process.

### Search for Synergies

Normal course accounting and financial due diligence (e.g., quality of earnings, working capital analyses, etc.) should be performed prior to the closing of the add-on acquisition. The following areas

should be considered during the due diligence process in an effort to identify possible synergies and/or concerns that could arise from the add-on acquisition:

**Common Customers**—Inquiries should be made with all significant common customers to determine if the customers are comfortable with increasing their purchasing concentration.

**Suppliers**—Increased volume of material purchases may open up the possibility to negotiate better rates and/or volume discounts.

**Operational/ Manufacturing**—Understand the production needs of the add-on company relative to the current capabilities of the platform company. For example, the platform company may be able to facilitate the production of the add-on company's product via minor modifications and/or adding a shift.

**Management Team and Infrastructure**—Determine if the management team and infrastructure of the platform company are capable of handling the additional responsibilities post-acquisition. Any synergies will allow for the reduction of redundant positions.

**Distribution Channels**—Often add-on acquisitions are pursued because of complementary or supplementary distribution channels. For example, the platform company may have a strong retail presence but may lack an internet capability. The acquisition of a strong internet player can immediately open up new sales channels for existing products. Different distribution strategies can also work against the acquisition if the opening of new distribution channels creates channel conflict. For example, if one company sells through a dedicated sales force and the other through sales reps, the two systems may become incompatible and lead to greater issues post-acquisition.

**Post-Acquisition Considerations**—Understand any scalability limitations and/or reporting capabilities of the platform

company's information technology systems prior to integration of the add-on company.

**Reverse Synergies**—While many synergies are applied to the target company in assessing its valuation, the acquisition team should also understand the impact that the acquisition may have on the platform company. Several areas

such as distribution channels, supplier volume and customer consolidation can have both positive and negative effects on the combined entity.

### Add-On Acquisitions Require Add-On Tailored Due Diligence Teams

As discussed above, there are distinct and sometimes significant differences between the platform acquisition and future add-ons. When embarking on an add-on strategy, make sure the due diligence team is experienced and comfortable with the issues inherent to such acquisitions.

**Team Size**—Because of the relative small size of many add-on acquisitions and the sophistication, or lack thereof, of its accounting personnel, it is important that the acquirer size its due diligence team accordingly. If a team of six is sent in to perform financial due diligence, the probability is fairly high that at any given time four of them are sitting around waiting for information from an overwhelmed controller. This will add to both increased costs and frustration.

**Try a Little Tenderness**—As previously stated, the add-on target is often a competitor of the platform company. The due diligence team needs to be cognizant of this and act accordingly. The due diligence team leader should be able to identify when information is being withheld purposely versus just not available due to limited systems and

data. This often takes a little nurturing alongside creative persuasion.

**Where the Bones are Buried**—The counterintuitive aspect of the smaller add-on target is that it could take as much due diligence effort, if not more, as its larger platform company due to the lack of books, records, and sophistication.

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To control costs of the smaller target, the due diligence team should know where the problems typically lie in such smaller companies. This can only be accomplished through senior professionals on site.

While the challenges that PEGs face when undertaking add-on acquisitions are many, the potential benefits of such acquisitions often balance the scales by offering these investors targets that not only complement the original platform investment, but help to increase efficiencies in the combined new entity, both operationally and financially. Until the global economy rebounds, investors will continue to look at opportunities that are low in cost while supplying potential moderate upsides. To ensure that the PEG makes an investment in the appropriate add-on target, it is critical that its due diligence team be experienced and comfortable with the issues inherent to add-on acquisitions. ■

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