

DUE DILIGENCE FOR ADD-ON ACQUISITIONS *by Sharon Bromberg, Partner, and Michael Katz, Director*

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 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 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 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.

(continued on page 2)

In This Issue

Due Diligence for Add-On Acquisitions

Are Your Portfolio Companies Taking Advantage of Cost Segregation Studies?

Service Spotlight: Improving Bottom-Line Performance for Private Equity Funds

Recent Private Equity Engagements

Private Equity Comprehensive Lifecycle Services

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.

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. 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

When embarking on an add-on strategy, make sure the due diligence team is experienced and comfortable with the issues inherent to such acquisitions.

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

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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ARE YOUR PORTFOLIO COMPANIES TAKING ADVANTAGE OF COST SEGREGATION STUDIES?

by David Grant, Partner

In light of the current recession, companies and investors are looking for every opportunity to maximize return by cutting costs. One of the best ways to maximize after-tax returns from investments in real estate is by taking advantage of Cost Segregation Studies (CSS).

What is a CSS?

A CSS is a combination of both engineering and a tax analysis of the costs relating to real estate acquisitions or construction. This analysis allocates costs into the appropriate asset classes to maximize

tax depreciation. A properly performed CSS will identify property costs that have shorter tax lives (5, 7, and 15 years) than the building life (39 or 27.5 years). The result is an accelerated write-off of costs previously included as part of the building.

What Qualifies?

- Purchases of previously existing property
- Construction of new property
- Expansion or renovation of existing property

- Tenant leasehold improvement fit-out
- Real estate basis step-ups (such as Partnership and LLC ownership changes)
- Real estate basis step-ups for estates

Who is a CSS Candidate?

If the answer to these questions is YES, you are a CSS candidate:

- Can your organization benefit from accelerating tax depreciation deductions?
- Does the property have a tax basis of more than \$1,000,000?
- Will the property be held for at least two years from acquisition?

What if the Property Was Acquired in a Prior Year?

Based on the current rules promulgated by the Internal Revenue Service under

(continued on page 4)

Service Spotlight

IMPROVING BOTTOM-LINE PERFORMANCE FOR PRIVATE EQUITY FUNDS

Insurance coverage is a perennial cost of doing business. Many private equity portfolio companies are in search of the right coverage at the right price for the full range of business-related risks, but many firms may be overpaying for their insurance coverage. Premium overpayments may occur because portfolio companies are at a significant disadvantage when dealing with brokers and insurers. Depending on the size of the portfolio, as well as the number of funds a company has, these excess premiums can add up, reducing earnings and a fund's total return.

Fortunately, there is a solution to this problem. Cohn-UIC Insurance Consulting (Cohn-UIC), a joint venture of J.H. Cohn and UIC, Inc., is a consulting firm dedicated to providing clients with timely, unbiased advice that cuts through the mystique of risk management and helps them

make informed decisions about their coverage. Cohn-UIC is paid solely for risk management consulting services—there are no contracts or agreements with any brokerage or insurance carrier and therefore, no commissions or fees are received from brokers, insurers, or agents. In most cases, this commitment helps clients minimize risks while reducing expenses.

Products and Services

- Perform risk management audits to help clients clearly understand their coverage and determine whether their policies fully address their operational risks and hazards.
- Review and analyze insurance contracts, developing specifications for coverage.
- Oversee commercial insurance program marketing including

pre-renewal strategy, marketing negotiations, decision and implementation, and post-renewal strategy.

- Conduct comprehensive pre-acquisition due diligence.
- We have consistently helped client companies achieve insurance premium savings averaging 30 percent to 50 percent, while providing the most appropriate insurance coverage. Furthermore, we have consistently delivered a significant ROI to our clients on the consulting fees they pay us. In the case of one major private equity fund we have been working with for several years, they have indicated that their ROI has been 12:1. Cohn-UIC will provide clients with a high-level review of their risk management program. For more information, please contact Thomas Kovatch at tkovatch@uici.com or 201-661-5010. ■

(continued from page 3)

Rev. Proc. 2008-52, a CSS can be performed with the cumulative effect of catching-up all the prior year's missed depreciation in the current year, without the need to amend any prior-year tax returns. And there is no limit to the number of years you can go back, even to closed tax years. In addition to the catch-up of prior years under depreciated amounts, the segregated assets continue to be depreciated over their remaining shorter tax life, providing additional benefits to future years as well.

What Happens When I Sell?

The benefit of a CSS on a sale depends on a number of factors.

- If the sale of the property is part of a §1031 fully tax-free exchange, there will be little or no recapture of the previously deducted tax depreciation.
- If the property is sold in a taxable gain transaction, there may be recapture of the tax depreciation deducted during the ownership period. The recaptured depreciation can reduce some of the

In our experience, we have found that a CSS typically provides tax benefits of between 2.5 percent and 5 percent of the property basis.

benefits of CSS, however the time value of money benefit of being able to deduct depreciation at ordinary tax rates of 35 percent is never lost. Even if some of the gain on the sale of the property may be taxed at 35 percent or 25 percent, as compared to the 15 percent capital gains rate, the benefits of CSS are certainly worth considering.

CSS has generated millions of dollars in current Federal and state income tax savings. In our experience, we have found that a CSS typically provides tax benefits of between 2.5 percent and 5 percent of the property basis.

CSS is a dual discipline service. There is the requisite knowledge of the tax laws that determine which assets

can be depreciated over a shorter tax life. And there is the engineering knowledge required to properly allocate those assets from a purchased or constructed property. A qualified CSS professional service firm should have both of these tax and engineering skills. ■

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RECENT PRIVATE EQUITY ENGAGEMENTS

We are proud to have assisted clients with a variety of private equity transactions. These illustrations are representative of the scope and depth of our capabilities.



Verax Capital Partners, L.P.
completed the
recapitalization of

GoodRadio.TV

J.H. Cohn LLP provided
financial, accounting, and
tax due diligence in support
of this transaction

P E R S E U S

has acquired substantially
all of the assets and
assumed certain liabilities of



a division of
**Allscripts Healthcare
Solutions, Inc.**

J.H. Cohn LLP provided
financial, accounting, and
tax due diligence in support
of this transaction

**GreenStar
Services Corporation**

has been formed as a
result of the merger of

FIVE STAR ELECTRIC
WE MAKE IT HAPPEN

and



EOS

has made a further investment
in GreenStar in support of
this transaction

J.H. Cohn LLP provided
financial, employee benefits,
tax, and information technology
due diligence in support of
this transaction



led an investor group
in the acquisition of all
issued and outstanding
capital stock of

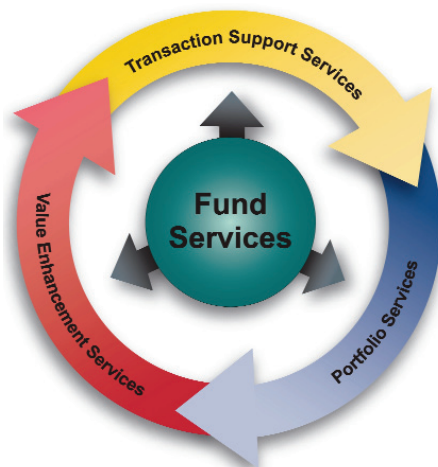
Tread Corporation

J. H. Cohn LLP provided the
financial, accounting, and tax
due diligence in support
of this transaction

PRIVATE EQUITY COMPREHENSIVE LIFECYCLE SERVICES

Fund Services

- Accounting and auditing
- Consulting on entity agreements, private placement memorandums, and other offering documents
- Entity structure advice
- Tax compliance and planning



Transaction Support Services

- Due diligence
- Financial modeling and valuation services
- M&A advisory services
- Post-acquisition integration
- Tax structure evaluation

Value Enhancement Services

- Accounting and transaction consulting
- Benefits consulting
- Executive search
- Information technology
- Internal audit
- Management advisory services
- Real estate consulting
- Risk management and corporate insurance

Portfolio Services

- Accounting and auditing
- Corporate governance
- Exit strategy execution/support
- International services
- Management consulting
- Recapitalization and restructuring
- SEC services, including IPO support
- Tax compliance and planning

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