

SMEs – the overlooked side of M&A

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There's more to the M&A world's hostile or headline-grabbing mega-deals. Most deals attract little attention and involve small to medium-sized enterprises, the backbone of the New Zealand economy. Acquisitions easily outnumber mergers. While the 15 M&A advisers who topped the Thomson Financial league tables for New Zealand M&A work last year averaged six announced deals and five completed deals, it's a different story in the SME market.

Max Heron, a director of business broker Corporate Link, says he has been involved in the sale of 71 \$1 million-plus businesses over the past three years.

His main problem is not finding businesses to sell but finding businesses which are saleable.

"It is in the acquisition market for medium-sized enterprises that investor interest remains high and continues to fuel a demand level significantly higher than the available SME business vehicles," he says.

On the sell side, the driving force is the current owners who want to retire or move on. On the buy side, it is the company which has all but exhausted its potential for organic growth and is eyeing growth through acquisition or entrepreneurs spotting a niche opportunity to move into a sector.

Heron adds another trend is starting to emerge: people cashing up out of the property market because of low yields and moving into into business.

He is "dismayed" at how many business owners don't prepare an exit strategy for themselves.

His bête noire is "one-man bands with little or no applied sound governance principles relative to capital wealth gain.

"One of the biggest problems we have is the lack of good governance in SMEs. There is a remarkable lack of good governance in medium-sized enterprises.

"Businesses which have revenue levels in excess of, say, \$5 million and realistic profitability should have a small board of directors with preferably an independent chairman or one outside director who can advise on a capital wealth gain management philosophy," he says.

He cites a recent case where a business owner nearing retirement took his wife on an all expenses-paid business trip to the US costing \$30,000.

"If he had gone by himself the after-tax bottom line could have improved by \$12,000 and using a PE multiple of, say, five, then the business value would have improved by about \$60,000. He paid a heavy price for the so-called tax benefit. People need to plan the exit and stop pinching money off the business," Heron says.

Auckland risk adviser and estate planner Cecilia Farrow also thinks small business owners need to spend far more time planning their exit strategies.

The issue is not just creating an income stream, but also about creating transferable value, she says.

In a presentation to the Financial Planners and Insurance Advisers Association's annual conference last year, she cited statistics showing only 26% of New Zealand professional practices have an exit strategy.

She added she knew of legal firms with practitioners still working into their 70s because their practices didn't have the funding arrangements in place enabling them to exit for what they think their partnerships are worth.

"Once you get to the point where your business is surviving and you're starting to succeed, you should be starting to think about how you're going to exit," she says. Merchant bankers and business brokers Ashe Morgan Young Securities work more in business-growth-through-acquisition than business sale/exit strategy area.

What SMEs often think is a money problem is more a case of needing to grow through acquisition, director Tony Warren says.

His job is to find suitable companies for his clients to buy. That's the hard part. Getting the funding sorted out is the easy part.

"Money is not the problem. It comes down to people in the business," he says.

The obvious place to start looking is competitors with synergies, he says. That's not as easy as it sounds. There's more to synergy than just being in the same line of business. Warren stresses the potential buyer and the target need to have compatible cultures.

"If it's not similar, something has to change," he says.

Despite all the best planning that money can buy, a significant number of mergers or acquisitions fail or don't deliver the planned efficiency gains within the first three years, he says.

It's not just an issue with SMEs.

AMP's multi-billion dollar write-downs of the UK acquisitions it ended up spinning off are a case in point.

"Real synergy in corporate acquisitions goes well beyond cost savings and cuts right to the heart of realising true value from buying and owning another business," he says.

As he sees it, for an M&A deal to work, four cornerstones or "interdependent critical factors" of synergy need to be in place: strategic vision, operating strategy, systems integration, culture.

"If any of these four cornerstones is missing when the deal is done, synergy will be a trap. The premium is likely to represent a total loss for the acquirer," he says.

Warren and Heron caution would-be buyers and sellers to choose their advisers carefully.

Warren says there are too many so-called advisers seeing M&A work as another gravy train. He likens it to the advisory/advocacy industries which have grown up around treaty claims, forestry and fisheries.

"We see this in valuations," he says. An accountant or business adviser who is asked to value a business then thinks he can sell it as well. "Numerically they're competent, but I don't think they know how to ask the right questions outside accounting," he says.

In short, his advice is to bring in advice from lawyers and accountants when it's needed but don't look to them to put together the whole deal.

Selling a business means working out and finding a suitable buyer. This means asking a lot of questions to identify the issues and what it will take to make the deal work.

Warren doesn't think that's a job lawyers or accountants are automatically qualified to do.

He thinks M&A work needs more of the likes of engineers and people with track records in running businesses, not just offering advice to them.

"There aren't any quick fixes in the M&A area. When it comes to adding value and achieving growth, it's hard work," he says.

David Belcher, co-principal of Clavell Capital and an investment banker of more than 20 years, is blunter.

"There are a lot of people setting themselves up as consultants, especially around the real estate agent side. Some of them can't even read a balance sheet," he says.

While they may be able to handle small deals, anything past the \$5 million mark and they run out of steam, he says.

His advice to would-be M&A consultants is to stick to their knitting – as his firm does.

"We're a clean M&A, capital-raising business," he says.