Acquiring A Building Service Company

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THE FOLLOWING IS THE FIRST ARTICLE IN A SERIES OF THREE discussing issues associated with the mergers and acquisitions sector of the building service industry. While some of the hard or technical issues will be put forth, it is my attempt in this series to also discuss some of the softer or human issues that arise during the lead up to deciding to sell one's business or to acquire a company; those that arise during the sale process and those that may arise during the transition, after closing. The first of the series deals with the acquisition process from a buyer's perspective. —G.P.

Whether a strategic or investor buyer, acquiring a company engaged in providing cleaning and other services for commercial buildings can be a good way to supplement a strategic group's growth effort, or if an investor group, a good addition to the investor's portfolio. The industry is solid, is recession resistant, and has recurring monthly revenue. Strategic buyers already know that, and investor buyers seem to be realizing that now, too.

More than in years past, investor buyers are acquiring interest and appreciation for the building services industry, perhaps because the Great Recession of 2008 made them take a hard look at industries that can survive hard times. They found what they were looking for in the building services industry—an industry with frequent recurring income and one that is recession resistant. Whatever the reason, investor buyers are here now and probably here to stay. While they may be here to stay, their requirements are usually a little different from those of strategic buyers who are often quite willing to acquire smaller companies so long as it fits their model. Remember, at least 70 percent of the industry in the U.S. is comprised of companies with annual sales under $2 million. Investor buyers tend to gravitate toward companies with adjusted ebitda of at least $1.5 million. Some will consider only those companies with $3 million-plus adjusted ebitda. So, that leaves the smaller companies with the strategic buyer option, unless the smaller company is viewed by the investor buyer as a “lock on” to a company already in their portfolio. Many of the equity fund groups have gained knowledge of the industry, in some cases having included in their portfolios building services groups with total revenues approaching several hundred million dollars. They tend to stay within specific market sectors, probably because of a comfort level gained with a certain market

sector through their earlier acquired companies.

THE BUYERS

Strategic acquirers tend to acquire for the long term, whereas, investor buyers frequently look at keeping the acquired company for five or six years, selling it to another equity fund or a strategic buyer after achieving growth and a fair return on their original investment. The experience data available for this is slim; however,it is felt that this has been a successful endeavor in the past as evidenced by the number of transactions now being done by equity fund groups, following in the footsteps of those successful transactions that preceded them. These buyers tend to be very precise in their financial modeling, basing their valuations on those models and leaving very little room for variance. They are also quite fixed on the notion that the managing shareholder of the acquired group stay on for two or three years, often requiring an investment in the Newco that will be formed, continuing on in place of the acquired company. Going forward after the sale, the investor-buyer will have and exercise financial control, leaving the day-to-day operations to the management group that has been operating the company. They will, of course, maintain strong interest in the success of the acquired company, often advising management, but usually never interfering with management operational or personnel decisions. Most experience indicates that this arrangement is a good thing and can lead to the success of the project. It goes without saying that for this to work, both groups have to work together in harmony, appreciating each other's role and recognizing that the success of the project requires both groups.

The strategic buyer will often approach acquisition differently than the investor buyer. They may or may not have the financial sophistication of the investor buyer and they may or may not have acquisition experience; however, they will have had industry experience and a feel for how well the company to be acquired will fit their corporate culture and philosophy and the degree to which the selling company will make a positive impact on their goals. While concerned with the financial aspects of the company to be acquired, there is a tendency to look, too, at the softer aspects that include market sectors served, customer retention rate, marketing success rate, key management personnel, market areas served, and more. This is not to say that investor buyers do not look at these aspects; they do, but perhaps not quite as much as the strategic buyer. They know the industry intimately, so they will tend to look thoroughly into the operations, marketing plans and management personnel.

WHY ACQUIRE?

Why acquire any company in the first place? Sometimes it makes sense; other times it may not. It depends on the prospective acquirer's resources, financial goals, acquisition maturity timing goal, and the perceived risk. The acquirer must have enough resources to comfortably complete the transaction without causing financial stress to its on-going operation. Cash flows have to work, while providing adequate cash for organic growth both for the acquiring and acquired company. Financial goals have to be met, starting at closing and being accomplished with newly integrated management groups and software systems. Acquisition integration has to start upon closing with myriad tasks and planning, with a goal of full integration sometime in the future. How long is "sometime in the future?" It depends on the planning and its execution. Frequently, if the acquisition does not work well in the long term, it is because of poor integration planning, goal setting, and implementation. Full integration can sometimes take years, and that is acceptable if, in retrospect, the acquirer can say, "This was a good move. I am glad that I did it." Most acquisitions work out well for both the acquirer and the seller, but sadly, sometimes it does not work out that way. When that happens, much of the time it is the result of a good acquisition failing because of poor integration planning and implementation. Acquirers that expect a newly acquired company's value to be reflected in the acquirer's overall market valuation immediately may be disappointed since the full integration status must be achieved for that to happen. Acquirers that purchase a company, expecting to flip the acquired company in a package with the sale of their company soon thereafter, are making a mistake. Not only will they still have debt for the purchase and perhaps some earn-out obligations, but also the recently acquired company will not have been fully integrated, so seasoned prospective buyers will discount their valuation accordingly. While there may be some exceptions, this scenario does not usually work for the original acquirer.

A prospective buyer must decide whether or not an acquisition makes sense based on the individual prospective buyer's circumstances. Is it to eliminate a competitor? Is it to increase sales? These are not necessarily good reasons. Competition is a good thing. Businesses stay sharp because of good competition. What about new sales? Some think that ramping up sales can be accomplished the old fashioned way, that is, through the development and implementation of a good marketing plan. It does work! Usually, it works better than a frivolous acquisition made for the wrong reason when the only expense is capital expenditures and start-up costs. However, sometimes a purchase to simply ramp up sales can be a good reason to acquire, especially if the acquired company is performing well, is growing, and has a proven, energetic management group.

Often, acquisition does make good business sense. The acquirer that wants to gain credentials for working in a market sector not currently engaged in may want to acquire a company that works within that sector successfully. Doing so will provide the acquirer access to that market sector with the credentials and reputation of the acquired company. Additionally, the management expertise of the acquired company can continue, perhaps even opening other market areas.

Another good reason to acquire can be to expand one's operating area to another market area, perhaps to a contiguous market area or to a market area in another region of the country where it is felt that "the grass is greener." Some market areas do offer more opportunity than others, so acquiring a company in that market can provide instant access to the area, without being looked upon as an invader from another region. It is even better if the acquired company in the new market area is engaged in a market sector in which the acquired company is not engaged, opening that door for the acquirer.

ACQUIRING A TROUBLED COMPANY

What about acquiring a company that is troubled, requiring a very strong turnaround effort? These situations do exist and sometimes it can make good business sense for the shareholders of both groups to attempt to develop a transaction that works. The first thing that each group must determine is whether it makes economic sense to even try to resurrect the company. Sometimes the odds are so great that it makes no sense to do anything except start over. However, many times it is worth the effort and a transaction and subsequent implementation of a workable plan will allow both the acquirer and the seller to come out whole, even if it does take three or four years. For a situation like this to work, it must end well for each group, working in concert and in good faith.

OPPORTUNITY FOR SMALLER COMPANIES

The building services industry is huge and very fragmented, so even though many of the transactions are made public and are well known, they are by no means the only ones that take place. If 70 percent of the industry is comprised of small companies with annual revenues of $2 million or less, those small companies are bought and sold too, often for the same reasons that the larger transactions take place. These smaller transactions—while not necessarily known by many—do occur and are often very successful. They can provide the endplay for the smaller, successful building services entrepreneur that, for any reason, wants to move on.

ACQUISITION FINANCING

How does one finance the purchase of another company, assuming that the reasons are sound and that the acquisition going forward makes good business sense? First, the acquirer must possess resources that will partially fund the acquisition. If a commercial lender is required, the acquiring company must be deemed by the lender to be qualified to undertake their financial and management role. Second, the company to be acquired has to be viewed by the acquirer and the lender as being worthy of the valuation and structure that is being put forth. Thirdly, the seller must be flexible enough to accept the role as financier, which, in many cases, will mean accepting a subordinated note for a portion of the purchase price and, probably, a earn-out lasting three to five years, providing the acquirer some share in the risk. In many transactions, the earn- out is for 20 to 25 percent of the purchase price and is uncapped, that is, if goals are exceeded, the seller has the opportunity to earn above the agreed upon price. Or, if goals are not met, the amount at risk is reduced accordingly. Price components can vary significantly, but often the cash portion represents 60 to 70 percent of the price. There may be a subordinated note that will bridge the gap between the cash component and the earn-out component. While this scenario is somewhat common, it is by no means the only structure. Each structure is unique to the acquirer's and the seller's particular circumstance and good-faith negotiation.

VALUATION

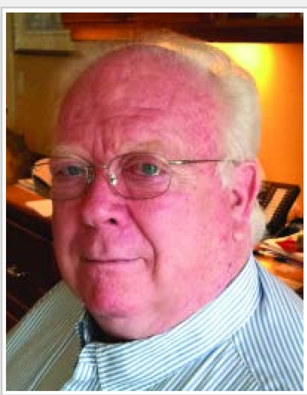
What is the market valuation for a given company? In part, it is the value as perceived by a prospective buyer, taking into consideration the cash requirement, indebtedness requirement, and risk as measured against the company's revenue, earnings, cash flow, and opportunity. Risk must be assessed and measured against certain risk-sharing arrangements with the seller in the form of escrowed holdbacks, earn-outs or some other method in which both parties share risk. Of course, value is influenced by the prospective buyer's perception of how well the company will help to achieve the buyer's overall goals. Each prospective buyer is unique; therefore, the perception among different buyers may conclude the valuation process, arriving at different valuations. There is no right or wrong; each is correct, depending on their model and perspective. Weighing all aspects of a proposed transaction, the seller may agree to accept one prospective buyer's valuation assessment and structure. The price amount on which the buyer and the seller agree is the market valuation. The process is somewhat subjective, but it has been working that way for a long time across all business sectors, in all industries, and in all parts of the world. It is no different in the M&A sector building services industry today and the process will likely continue that way for a long time to come.

ADVISORS

As in the case of a seller, the acquirer must have expert advisors that include a transactional attorney, financial advisors, and, perhaps, other M&A intermediary specialists. Costs associated with acquiring a company can be significant. It is the acquirer that develops all of the closing documents, conducts the due diligence process, plus the time and energy needed to conclude with a transaction that works. Each group is responsible for their advisors' fees.

Acquiring a company can be a good strategic move for a developing company, but it is not a substitute for organic growth. Ideally, the acquisition of any company will be strategic and in conjunction with a well-planned and implemented marketing effort. The acquisition process can be complicated and is not without risk, but if executed properly, followed by a well-planned transition and integration; it can work out very well for both the acquirer and the acquired.

The second article in this series of three articles, to be published in a subsequent issue of Services, will deal with the M&A process as it applies to a seller. When should a company owner consider selling? What are the pitfalls? How does one find the right buyer? How much risk does a sale entail? How will my company be valued?



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