

Strategic M&A for 2nd- and 3rd-Tier ICT SMEs:

"More Opportunity Than You Think"

ICT Strategic Consulting provides corporate advisory services to ICT businesses in Australia with a unique focus on eventual equity transactions:

- Preparation over the months or years before a transaction
- Execution to help you put a strategic exit/acquisition/merger together

Executive Summary



Unlike large-scale transactions in mainstream media, Mergers, Acquisitions and Divestments (M&A) in Small and Medium Enterprises (SMEs) in the Australian ICT sector are generally focused on a few key strategic drivers and growth objectives. Most SME transactions involve privately owned firms and not subject to continuous disclosure rules, so much less information is available about them. Misconceptions Summary: about smaller transactions are rife and few corporate advisors support in them. ICTSC have experienced how these transactions can succeed and fail in achieving the goals that originally motivated them. In this document, we attempt to share some of that learning. Equity owners & CEOs of 2nd- and 3rd-tier ICT firms (\$1-30M revenue) and those Audience: wishing to acquire such firms. M&A requires specialist skills and knowledge, and usually outside assistance -ICTSC would like to help you when working in this area.

Agenda



- Key Drivers of Difference
 - ✓SMEs are not Small Corporations
 - ✓ Strategic M&A vs. Capital Raising (PE/VC)
 - ✓ Mergers & Equity Swaps Ideal vs Reality
 - ✓ Exits & Buyouts SME Home Truths
 - ✓ Public Listing vs Trade Sale
- Strategic Growth Transactions: SME Core Focus
- Acquisitions: Pro-Active 'Inorganic Growth'
- What & How
 - ✓ Deal Structure Example
 - ✓ Deal Process Overview
- Key Take-Aways

SMEs are not 'mini' big corporates...





- SME value is often in growth potential, not current equity M&A is about growth strategy, not 'financial engineering';
- SMEs operate differently, and focus on skills, reach, and niches;
- SMEs fund transactions with equity, earn-outs, cash flow, houses/mortgages, personal guarantees – seldom bank debt;
- SME shareholders work in the business control, roles, personal responsibility and emotional impact are key;
- SMEs have more (& less) potential counterparties deal sourcing must be pro-active and comprehensive;
- SME valuations vary widely, with no standards getting the best deal means turning over all the rocks;
- SME record-keeping may be 'less formal' due diligence and 'conditions precedent' are often key.

...and are more personal to those involved.

Funding: M&A vs. VC/PE investment...





Fund Option:



Raise Venture Capital/Private Equity

- Requires larger and/or stronger firm
- Value business at, say, 3-4X EBIT
- Acquire up to 51% (shares or rights)
- Strong Terms & Conditions may want control

Provides

- Provides 1 or more board members
- Funds to implement your plans over time
- Strong pressure to achieve goals
- Business connections and directions

M&A Option:



Buy/Sell/Merge With a Perth-Based Partner Firm

- Requires complimentary match People + Business
- Agreed (relative) valuations for both businesses
- Shareholdings based on relative scale & desire to 'stay in'
- Agreed, shared goals and directions for future growth
- Agreed roles and responsibilities for (executive) principals

Provides

- Immediate boost into new areas or to new goals
- Additional principals working in the business
- Scale immediately boosts the value of equity

...focus on strategic value and immediate impact.

Ideal 'mergers' of 'equals'...



'Acquisition' offers will value the target business in dollar terms, eg:

- 2-7 X most recent EBIT (equivalent to ~3-10 Price/Earnings or 'P/E' multiple of NPAT); or
- .5-2 X Revenue (most recent historic)

A-co Pty Ltd			
P&L (A\$000's)	2017		
Revenue	\$	2,486	
COS	\$	860	
Gross Profit	\$	1,626	
Expenses	\$	1,219	
EBIT	\$	406	

	B-co Pty
A-co	Ltd 🔓
Pty Ltd 🚽	

B-co Pty Ltd	
P&L (A\$000's)	2017
Revenue	\$ 4,197
COS	\$ 504
Gross Profit	\$ 3,693
Expenses	\$ 3,213
EBIT	\$ 480

'Merger' values target shares in buyer's shares – eg: A-co & B-co to merge*:

- A-co prefer EBIT-based valuation, having earned 45.8% of combined EBIT;
- B-co favour revenue-based valuation, having earned 62.8% of combined revenue;
- Averaging the two valuations: A-co: 41.5%/B-co: 58.5%;
- 1 A share = .71 B share, while 1 B share = 1.41 A share (either can 'buy' the other);

Buying shares with shares merges the equity pool via an 'Equity Swap';

valuation multiples apply to both, and the same number of shares on issue.

* Assumes similar

...via 'equity swaps' allow buying without cash.

Good mergers combine likes...



Ideally, merged operations fit neatly together. Overlaps are rationalised to harvest cost synergies. This is never easy!

One key area of complimentary fit can extend the business into a new product or market. Two is dangerous, 3 is a 'no go.'

Strategic Fit - must tick all the boxes

- ☑ Management Structure: Corporate vs. Partnership Partners all have similar jobs, input into all decision vs Corporates with specialised roles and reporting lines.
- Sell to Similar Customers: Target Roles & Functions 'C-level' direct selling vs buyers in line management, online, government, consumer or retail sales.
- Sales & Delivery Modes (Product/Project/Relationship)
 Selling fixed Products, malleable Projects, and ongoing
 Relationships are not usually inter-compatible.
- ☑ Product Development Resources & IP Cross-Support
- ☑ Shareholder/Company Goals & Expectations Align

Complementary - <u>ONE</u> key to growth

- ☐ Customer Base same targets in new markets;
- ☐ Geography new state, national international;
- □ Products/Services extend the range/line;
- ☐ Different Businesses leveraging corporate skills

"The better part of valour is discretion..."*

Find the right match - fixing an imperfect fit takes years.

* Falstaff, Henry IV, Part One, Shakespeare 1596.

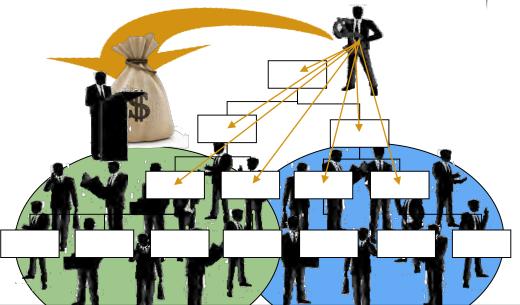
...compatible in all facets & complimentary in one.

True equity swap mergers are rare...



"Who pays the piper, calls the tune" -

buyer allocates roles in the newly merged company.



Technical founders
often take a CTO or
BD role, letting
professional managers
take over running the
business.

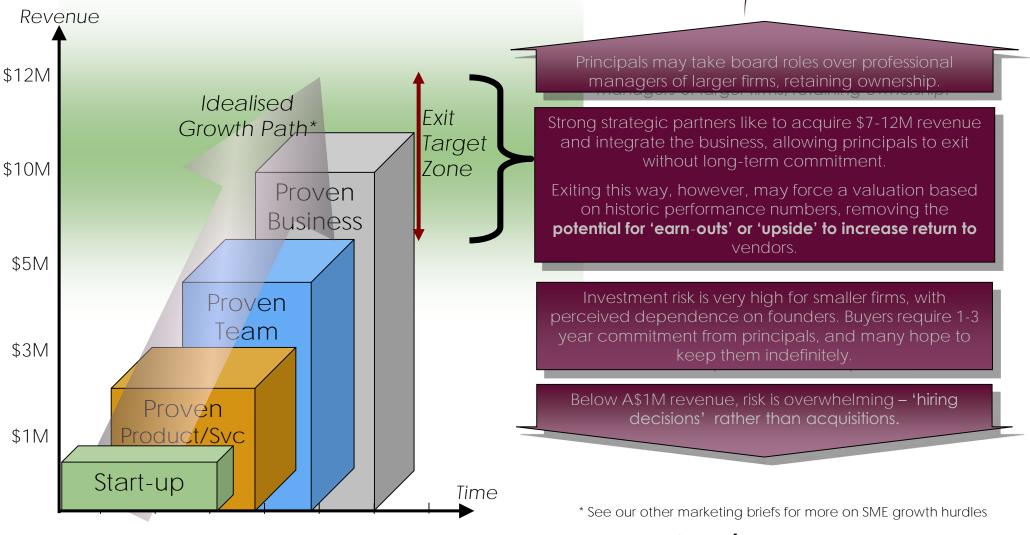
- 'Paper' transactions may not seem real, if no money changes hands
- Establishing buyer/target clarity helps to establish clear authorities
- 'Equity swap' may seem a consolation prize, not the 'real deal'
- "Meet the new boss/Same as the old boss..." *

*"We Won't Get Fooled Again", Who's Next The Who 1971

...cash payments help clarify relationships.

Exits/Buyouts: M&A stereotype, but...

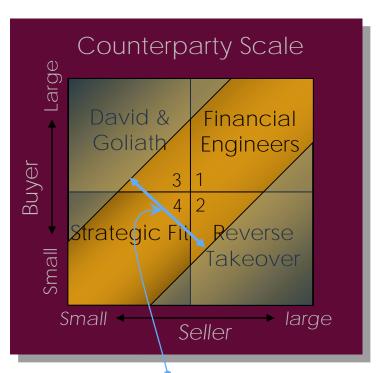




...work best with \$7-12+M revenue.

Multinationals don't buy small firms...





Your ideal counterparty is within 1 order of magnitude of your own size.

- 1 Large Buyers & Large Sellers
 Usually public equity transactions, large players seek to 'change the game' and have a major impact on the course of the firm and industry.
- 2 Small Buyers & Large Sellers
 Difficult deals, but small listed firms (micro-caps) can
 be acquired and funds raised to 'back door list' a
 growing firm via a 'Reverse Take-Over' ('RTO').
- 3 Large Buyers & Small Sellers
 Small firms don't have the impact on big firms to
 justify the effort and decision-makers focus on deals
 with more impact on the firm (and their career).
- 4 Small Buyers & Small Sellers
 Strategic transactions focused on building scale, growing, and positioning the combined firm.

Microsoft, Accenture, Google are unlikely to buy any SME – executives with power to acquire have larger tasks/deals to focus on and small deals languish in in-trays forever.

...most deals happen within 1 order of magnitude.

Public Listing/IPO: a nice clear goal... ICT STRATEGIC CONSULTING

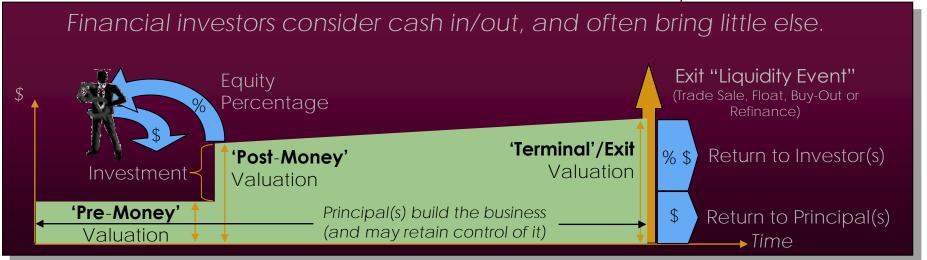


	Pros	Cons	Issues
Public Listing (IPO, Back- Door or Compliance)	Principals Keep Control Boost to the Brand Initial Capital Raising Staff Kudos/ESOP	Short-Term Focus Costs - IPO & Ongoing Shareholder Approvals Continuous Disclosure Market Management PR 'Micro-cap' Status Mandatory Auditing	IPOs are great for motivating staff, but 'micro-cap' life is expensive, difficult and very public. Listing enforces audit, reporting, continuous disclosure, minority shareholder protection, and other expensive inconveniences. Benefits are much more significant for larger firms (generally above \$100M revenue), less so for micro-caps.
Trade Sale	New Strategic Position Broader Mgt Team Longer Career Paths Reduce Business Risks Longer Term Focus Ongoing Capital Access Broader Market Scope	Loss of Control May Lose Product/Brand Disruptive Change Event	Trade sale may also provide a listing, and accomplish many of the same goals, without some drawbacks. The acquiring party will assume control, and vendor principals must establish their roles within the management team (if remaining involved). Financial outcomes are often quite similar for vendor principals.

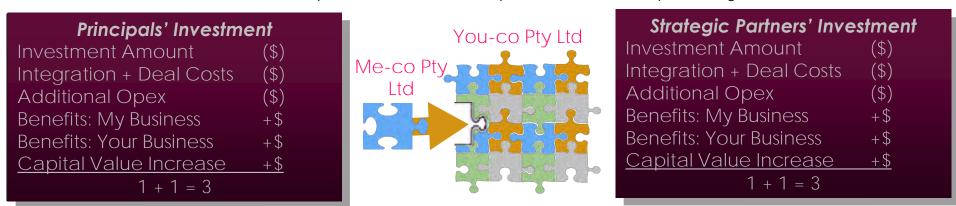
...but a trade sale is often a better outcome.

SME M&A: strategic, not just financial... ICT STRATEGIC CONSULTING





Strategic partners value growth of their business & yours and bring scope, scale, experience and operational capability.



...more about driving growth than extracting funds.

SME M&A is mostly about growth...



Acquisition targets for larger firms as credible market entry from overseas or other product/market focus, or high risk investment (Growth/VC).

Divestment

Proven Business Acquire complimentary products, services, or markets, to build scale towards public listing or international growth or sale.

Sell to slightly larger businesses, to achieve combined critical mass to supporting building an effective Sales & Marketing team of 4-5 FTEs.

Proven Team Acquire to fill capability holes, or seek critical mass scale, often with earnout or equity-based deals to retain principals and key staff.

Larger firms may acquire for specific skills, assets, products or services, or a build-vs.-buy decision for entry into new markets.

Proven
Product/Svc

Acquisitions are rare, may merge to build team specialization.

Generally only acquired for specific ideas or products.

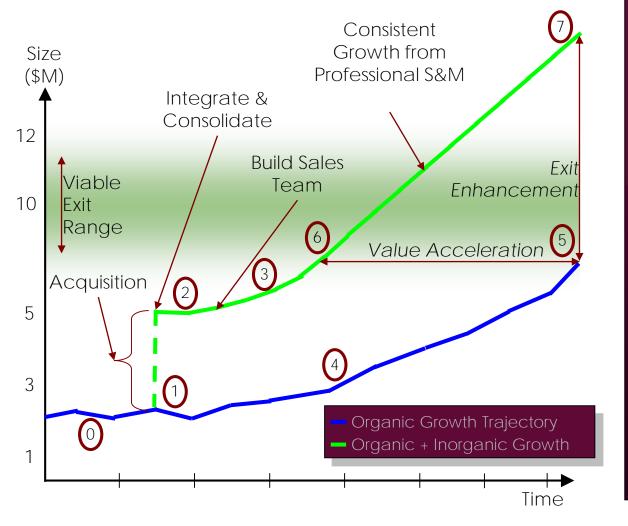
Start-up

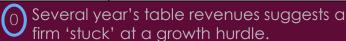
Acquisitions are rare.

A steady revenue/profit level for several years can indicate a 'stable' and 'secure' business – but one that's failing to grow organically. Inorganic (M&A) growth can 'kick-start' the growth process, bypassing the current sticking point.

...getting past key growth hurdles.

Strategic transactions position a firm...





- Struggling to exceed 2.5M revenue, a compatible partner is identified and the firms combined.
- While difficult, integration must be as quick as possible what is not done quickly, will not be done at all.
- Post-integration, combined scale allows investing in sales & marketing to drive growth.
- Independence means a struggle to build sales without major investment, often with high staff turnover.
- Commonly, the independent path may afford an exit in 5-6 years.
- 6 Accelerated growth provides an exit at similar value in far less time.
- Medium term returns are considerably greater, despite sharing ownership.

...for a more lucrative exit in 1-3+ years.

'Buying' vs 'selling' is not critical...



- ☑ Compatible & Complimentary two firms fit operationally, and extend one another (safely);
- One principal initiates operational consolidation, and begins equity discussions with the other(s);
- ? Some shareholders want to remain invested, while others may want to exit;
- Stayers acquire shares from those exiting, at agreed prices, as part of the deal.
- ? Who is the buyer, who the seller? Acting first is key.

...it's more about who initiates the transaction.

"We don't have money to buy..."



Strategic acquisitions in the SME space are rarely 'cash up front.'

A variety of techniques help to share benefits and risks, while funding a deal over several years:

- Earn-Out Payments from profits over time;
- Equity Swaps of shares for shares:
- Management Buy-Out or Buy-In;
- JV Agreements;
- Vendor Finance and Deferred Payments;
- Convertible Notes and other instruments.

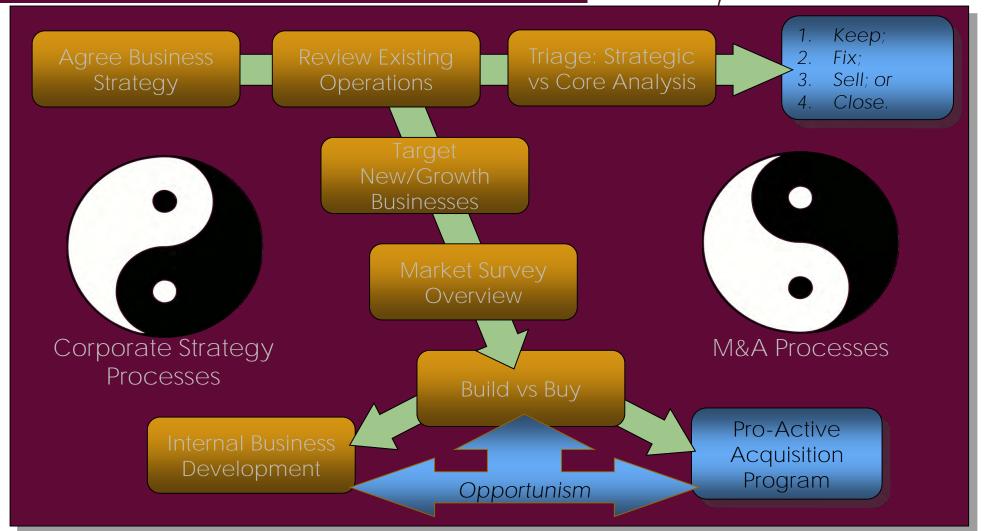
Acquisition Process - high Level

- 1. Agree strategic goals, capability targets and 'fit' criteria;
- Search the market for appropriate target firms;
- 3. Approach potential targets to assess interest & expectations;
- 4. Review and establish valuation model and 'ballpark' parameters;
- Rank and short-list targets;
- 6. Explore several top prospects, forecast combined operations;
- From forecasts, value prospects & identify risks;
- Design offers to share ongoing risks and rewards while accounting for variable performance outcomes;
- 9. Negotiate high level acquisition offer, based around model;
- 10. Elaborate & detail offer into contracts, check facts in due diligence;
- 11. Sign contracts, fulfil conditions precedent, complete transaction;
- 12. Integrate businesses per "100-day plan."

...but most SME deal issues are not about cash.

Acquisitions must serve strategy...





...executed with 'aggressive opportunism.'

SME needs create negotiating room...





...making tools available to construct deals.

Deal Structure: Up-Fronts, Earn-Outs... ICT STRATEGIC CONSULTING

Example 'Earn-out': 2X EBIT Up-Front + 2-year earn-out at 100% EBIT

How it works: On completion, the buyer pays the vendor a cash lump sum (twice the firm's EBIT from last year) and takes control of the company. After 12 months, annual accounts are reviewed and agreed, and the vendors paid the EBIT earned over that year (by the buyers or the company itself). The process is repeated after the second year. Vendors are usually contracted to work for the firm for this period.

Vendor Issues: Dependence on the buyers' management and funding, as well as the market, and other issues, once control is handed over. Allows vendors to share in the growth and success of the combined business over a fixed period. Guarantees, safeguards and warranties about conduct of the business over the earn-out will be key in negotiating contracts.

Buyer Issues: Buyers must pay vendors for profits they both create, but reduces buyers' exposure to the vendors' optimistic forecasts (not 'buying promises'). Also defers some payments by 1-2 years, and allows the business to help fund its own purchase. Motivates short-term & integration performance.

Valuation: Discount future payments by time-value-of-money + risk, use Net Present Value:

Discount Factor (example): 30% = 10% Cost of Capital + 20% Performance Risk

* NPV() or XNPV() in spreadsheets.

...tools to balance risks, rewards and roles.

Critical Mass SMEs: many viable partners...



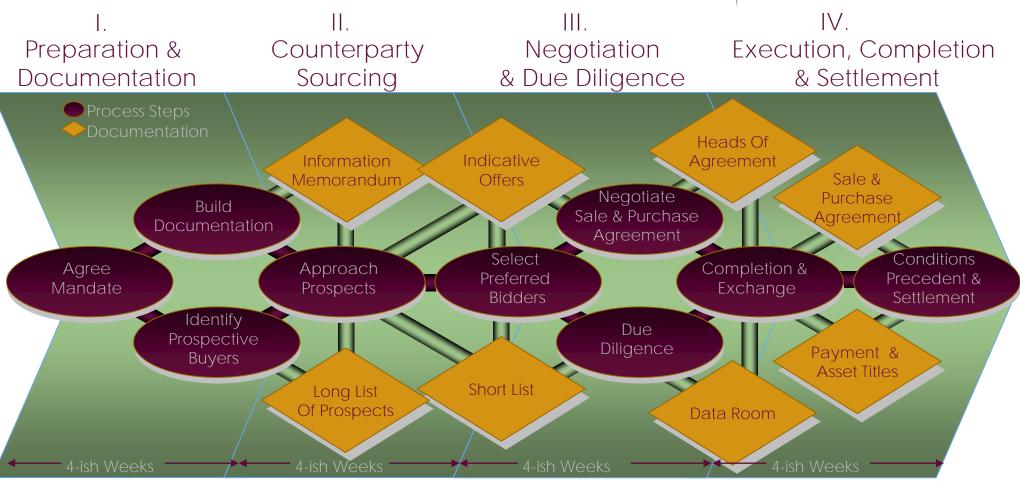
Deal Value	Counterparties	Number	Method
\$0-500k (Startup) • "Friends, Family, Fools" • Banks • Business Angels		10-50	Personal Pro-Active Approach
\$0-500k (Exit)	Only viable for 'generic' business or franchises operable by anyone.	500,000	Business Broker, Classified Ads
\$500-5M	 Domestic Strategic Partners Industry Specialists Investors, PE, VC 	50-500	Professional Pro-Active Approach
\$5M-15+M	 Domestic & International Strategic Partners \$5M-15+M Financial Consortia Investment Groups 		Professional Pro-Active Approach
\$50+M	Industry Multinationals	5	Personal Connections
\$15+M	 'Mum and Dad' Investors Institutional Investors	500,000	Public Listing

ICTSC Specialise in Professional Pro-Active Approaches, which require unique skills and knowledge of the industry, process and people – where we add the most value.

...larger or smaller firms have very few, or very many.

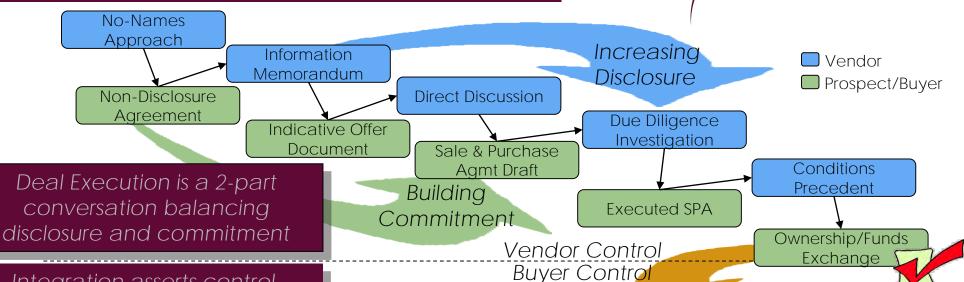
High level sale process is simple...





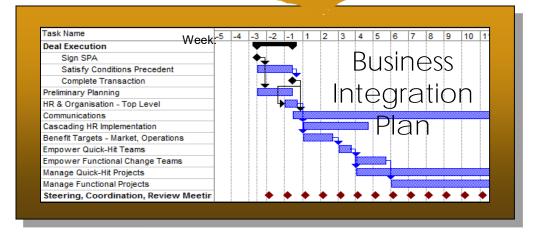
...key stages are common to all M&A deals.

Vendors control the process until...



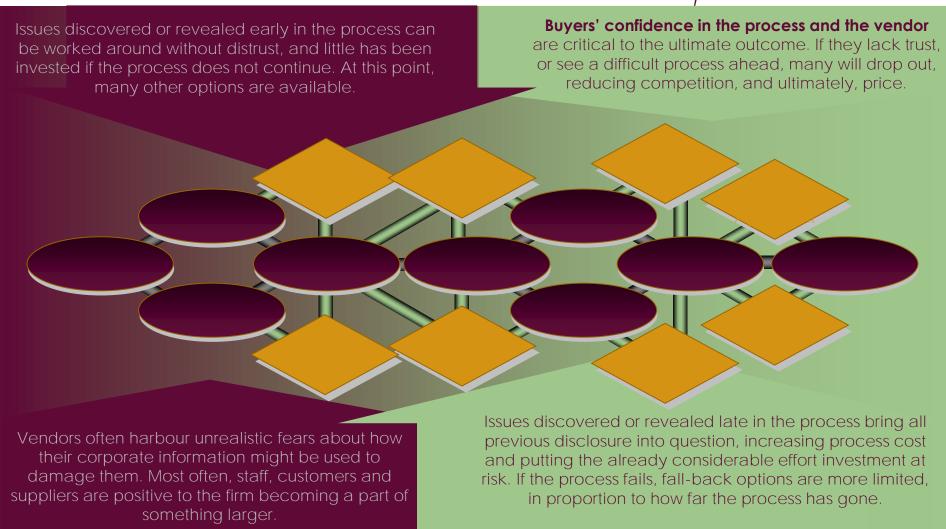
Integration asserts control, eliminates duplication, and implements growth plans

'If it's not done in the first 100 days, it probably never will be.'



...change-of-control to buyers for integration.

Open, honest, comprehensive process I ICT STRATEGIC CONSULTING



...brings best outcomes, lowest risk (& least stress).

Many SMEs are pleasantly surprised... ICT STRATEGIC CONSULTING



- M&A for SMEs is not like the newspaper stories;
- → If you're at A\$1-12M revenue, there are probably strategic opportunities available to you;
- → Inorganic growth can accelerate your strategy/exit by years;
- Understanding your transaction options is key to your strategic planning (keeping both eyes open);
- → You're going to want to know about this eventually why not now?
- → ICTSC have built a specialist capability to handle only this task set and we're happy to discuss how it might work for you.

...at the major, realistic benefits available via M&A.

We're keen to discuss possibilities...



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We're always happy to discuss your situation, issues, and prospects, or supply further information. We do this (partly) because we enjoy it, and appreciate the opportunity to help companies and people.

...and assist, if appropriate.