

## ICT SMB M&A Deal Sourcing and Execution

***“Where the Rubber Meets the Road”***

# Executive Summary

Summary:	<p>We've previously explored how M&amp;A transactions fit into the growth process for SMEs in Australian ICT, as well as how transactions differ from what's commonly reported in the media. Hopefully, this has provided some insights that apply to your business.</p> <p>In this briefing, we look at the deal-making process, identify key issues for the Small and Medium Enterprise (SME) market in the IT and Communications (ICT) industry in Australia, and describe how special attributes of such firms drive the process for the best possible outcomes for our customers.</p>
Audience:	<p>This is not intended to replace specialist assistance, but to explain what we do.</p> <hr data-bbox="721 772 1649 782"/> <p>Equity owners, chief executives of second-tier ICT firms in the \$1-30M revenue range, and those who might wish to acquire such firms.</p>
Purpose:	<hr data-bbox="721 978 1649 988"/> <p>M&amp;A requires specialist skills and knowledge, and usually outside assistance - our speciality - and we would like you to use us when working in this area.</p>
Further Information:	<hr data-bbox="721 1135 1649 1145"/> <p>Available from ICTSC directly, including subsequent briefs in this series, or direct discussions of this topic, your prospects, and how we can help.</p>

# Agenda

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## Different Triggers, One Process

*Many motivations drive our clients, but deal processes are fairly consistent.*

## Key Factors Driving the Process

*A few key points drive the process – distilled learning from years of specialised effort in this market.*

## Process Stages & How They Work

*Phase I: Preparation*

*Phase II: Go To Market*

*Phase III: Negotiation & Execution*

*Phase IV: Completion & Settlement*

*Phase V: Integration & Growth (Realising Earn-Outs)*

## Tricks, Traps, and 3<sup>rd</sup> Party Assistance

*You can't both run and sell the business – you need expert external help.*

## How Long Does It Take, And How Much Does It Cost?

# Deal Drivers: Pro-Active vs Reactive

## Reactive Deals

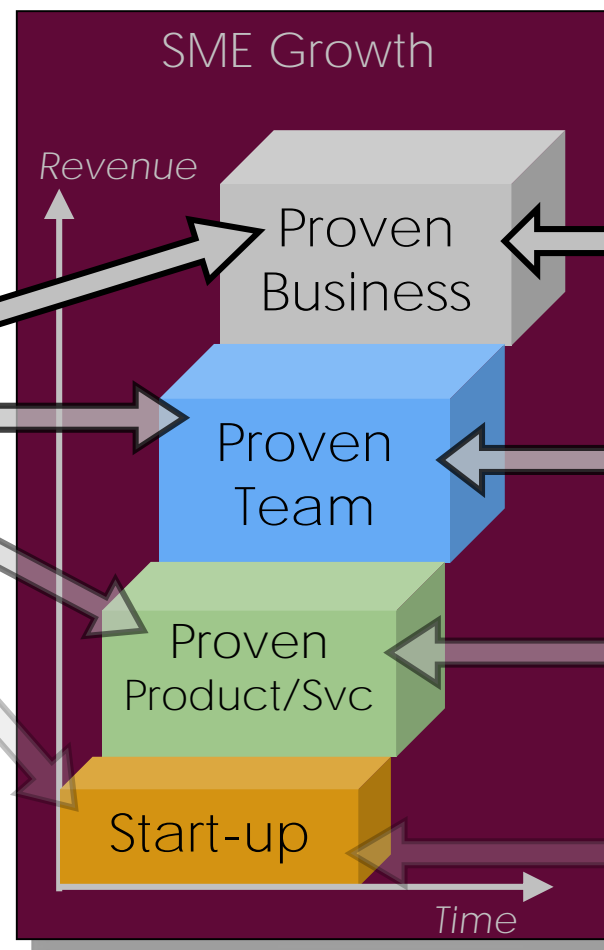
**"A Knock on the Door"**



Any firm can be targeted by a pro-active buyer at any time.

Deal initiators have a clear advantage, knowing about other available opportunities.

Unprepared vendors lack knowledge to negotiate well.



## Pro-Active Deals

Small Corporates – Scale for a big exit or to 'play the game on the next level' with a larger firm.


Sales Strugglers – Build scale for growth initiatives: sales & marketing, international expansion, new products/services.

Small Teams – Often seek skills, scope, or capability for specific business goals and future growth.

Micro-Businesses – Tend to focus on business limitations, or have gotten tired of 'flying solo.'

*About 50% of vendors are taken by surprise & unprepared.*

# Deal Processes: Formal vs Informal



Process	Method	Pros	Cons	Outcome Risk
Passive	Wait for, or respond <b>to a 'door knock'</b> with 1-on-1 discussions.	Cheap & Easy, No Risk	Weak negotiating position, little information about options	Clever, pro-active buyers seldom provide the best deal for vendors.
Reactive	Once approached, assess some other options as well.	Provides a bit more information for negotiating.	Unlikely to find the best counterparty - limited to whom you know.	Better than just talking 1-on-1, but luck still drives the outcome.
Connections	Reach out to personal network and their direct connections.	Broader reach provides more information.	Information may leak to the market and staff quickly; limited scope.	Confined to closely-aligned firms; risks staff finding out prematurely.
Short List	Identify the firms with the most obvious fit and approach them.	Broader reach provides more information.	Relatively narrow scope ignores unusual drivers.	Likely to achieve a fair value in a positive market.
Pro-Active	Identify a broad spectrum of counterparties for approach.	Assured of finding the best available deal.	Requires considerable time and effort.	If unassisted, effort invested can detract from other business operations during process.

*Vendors often lack commitment & control – and suffer.*

# Counterparty numbers dictate process

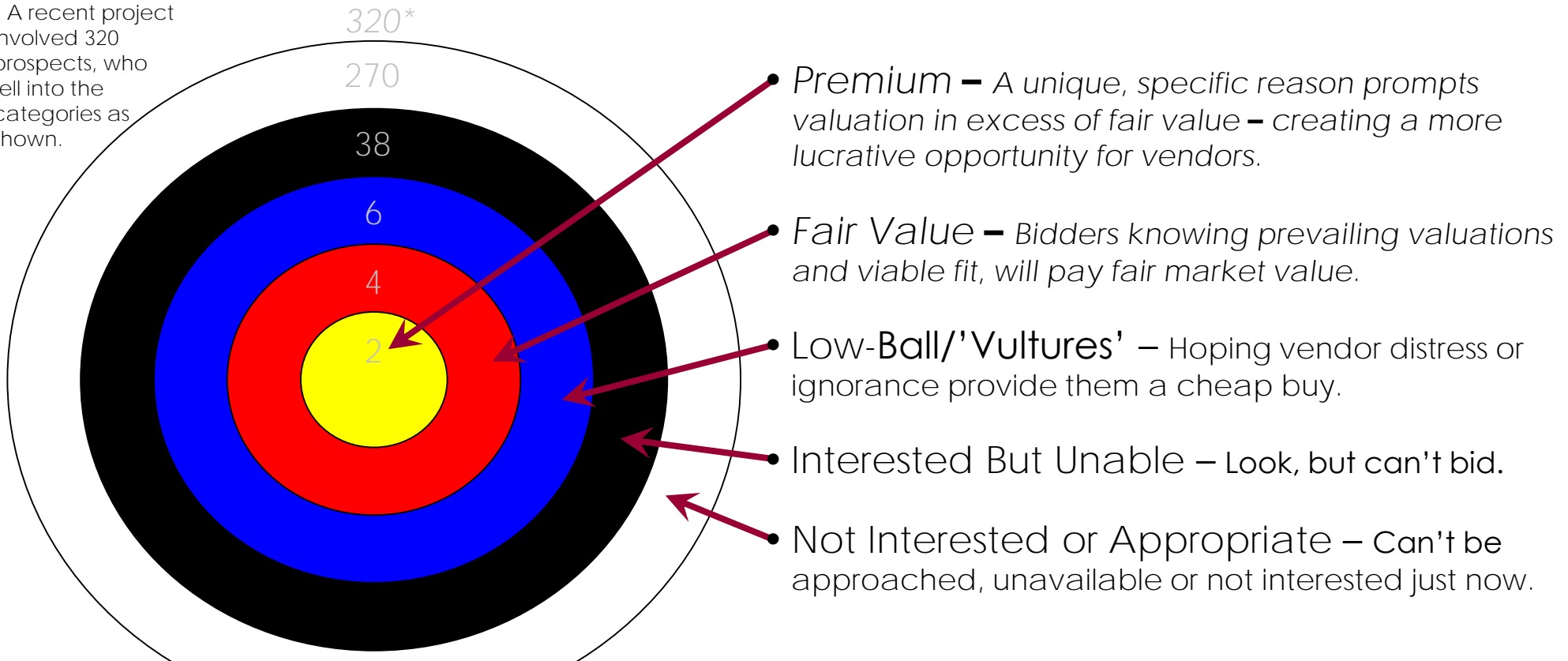
Deal Value	Counterparties	Number	Method	Assistance
\$0-500k (Startup)	<ul style="list-style-type: none"> <li>• “Friends, family, and fools”</li> <li>• Banks (house, personal guarantee)</li> <li>• Business angels</li> </ul>	10-25	Personal Approach	-
\$0-500k (Exit)	Only viable for ‘generic’ business or franchise, suitable for anyone.	500,000	Mass Market	Business Brokers, Classifieds
\$500k-5M	<ul style="list-style-type: none"> <li>• Domestic Strategic Partners</li> <li>• Industry Specialists</li> <li>• Investors, PE, VC</li> </ul>	50-500	Professional Pro-Active Approach	ICT Strategic Consulting
\$5M-15+M	<ul style="list-style-type: none"> <li>• International Strategic Partners</li> <li>• Financial Consortia</li> <li>• Investment Groups</li> </ul>	25-100		
\$50+M	<ul style="list-style-type: none"> <li>• Industry Multinationals</li> </ul>	5	Personal Connections	Investment Banks
\$15+M	<ul style="list-style-type: none"> <li>• ‘Mum and Dad’ Investors</li> <li>• Institutional Investors</li> </ul>	500,000	Public Listing	

- Business Brokers generally support reactive listings to reach the general market;
- Investment Banks construct large deals where contracts, not counterparties, are key;
- ICTSC specialise in sourcing optimal counterparties and contracting in the middle tier.

*SMEs often have 100-300 potential counterparties.*

# Obvious Buyers are Not the Best Buyers

\* A recent project involved 320 prospects, who fell into the categories as shown.



*Premium valuations result from diverse and unpredictable drivers – the only way to find them is to ask.*

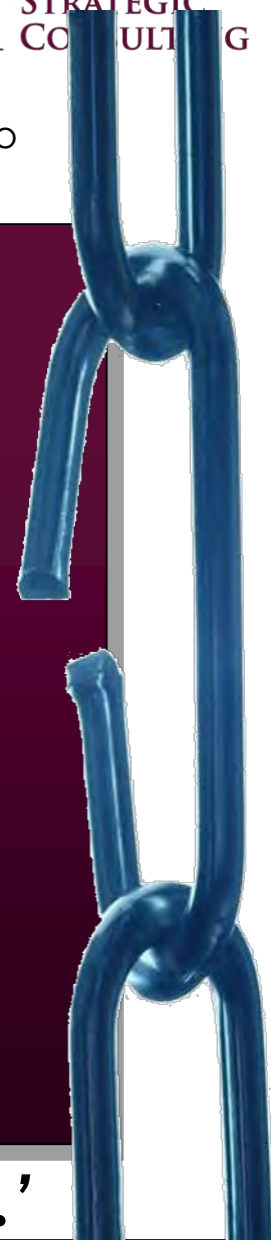
*Targeting a sale premium – not just fair value.*

# Valuation premiums are unpredictable...

Narrowing your search to a 'short list' of 'most likely' buyers, only serves to limit your outcome to fair value – without a premium – and does not reduce process cost.

- Buyers may be under time pressures and in a hurry to complete;
- Complimentary products, services, customers, may increase potential market impact of your business;
- Benefit from favourable exchange rates or taxation regimes;
- Government or corporate programs may encourage (or require) acquisition, or may help fund it;
- Buyers may have broader plans into which your business fits;
- Removing a potential competitor or new technology from the market may be critical;
- Key technologies, skills, locations, customers or staff may add value;
- Unusual legal issues or requirements may force transactions;
- Many other unusual drivers, which are impossible to predict.

**...so you need to 'turn over all the rocks.'**



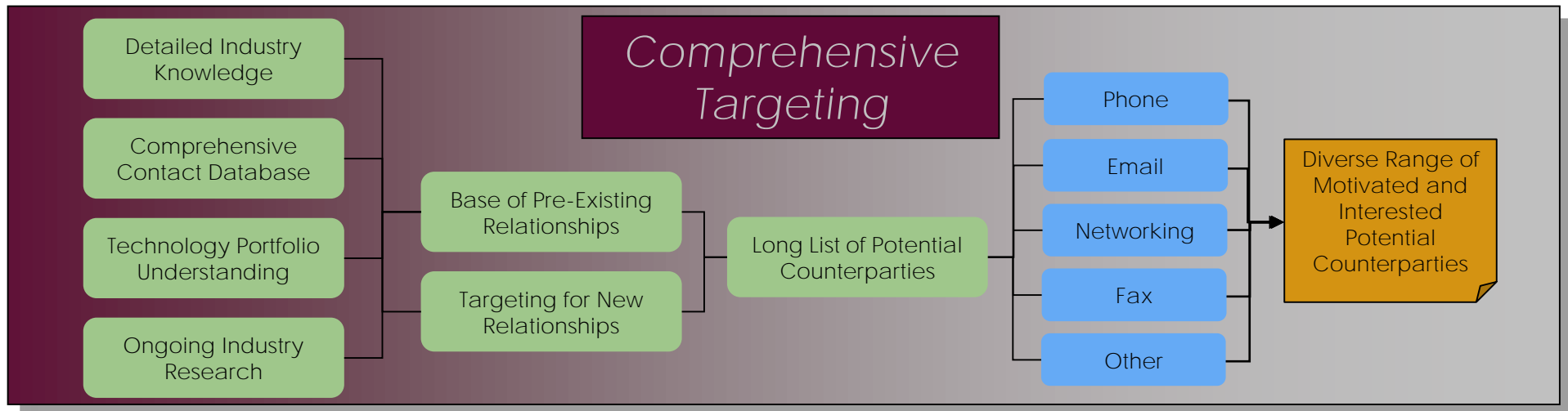


# Approach the whole market at once...



**...develop many options and 'fall-back' positions.**

# Prepare for holding many discussions



*Effort at the start of the process is crucial.*

# Long-term preparation is fundamental.

The discipline of building a firm for sale can encourage positive habits and avoid common pitfalls of 'hobby' or 'lifestyle' businesses.

Actively targeting the four growth stages defines a clear progression of goals:

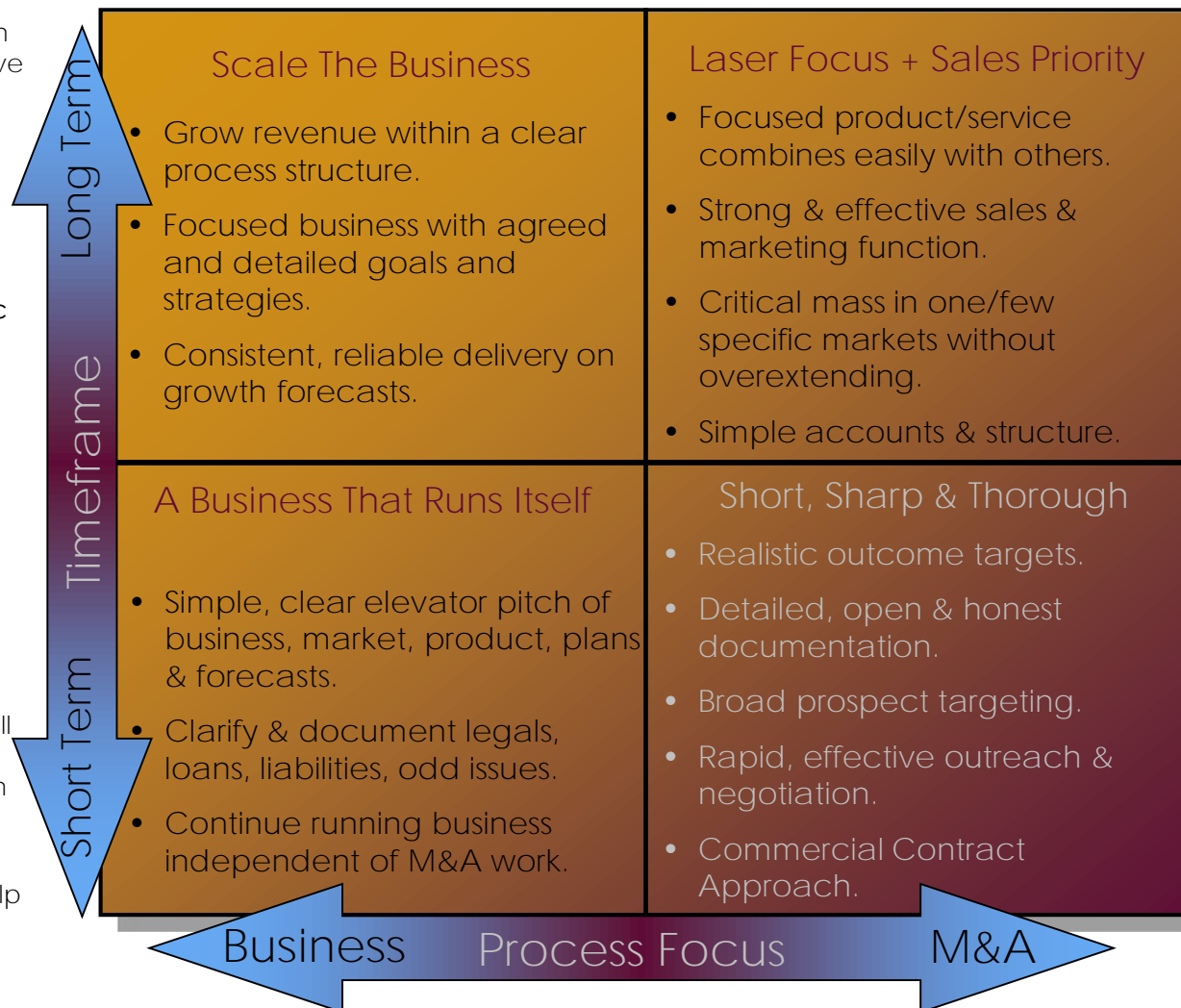
- I. Commercialise Prod't/Svc
- II. Build Core Team
- III. Revenue Critical Mass
- IV. Maximise Profitability
- V. Exit/Succession

Corporate structures must be easy to integrate, ideally modular, with tight, focused teams.

Minimise working capital with outsourced services in lieu of internal resource investment.

Avoid over-extending – a small overseas office will not be valued, and may detract from your strategic focus definition.

Broad connections into the market and other firms, will help establish clear leadership.



Narrow focus improves competitive position – a big fish in a small pond is better than a small fish in a large pond.

Non-core activities may conflict with a buyer, and reduce overall value.

Strong Sales & Marketing is the single most sought-after functional capability.

A great customer base may be better than a great product, to buyers.

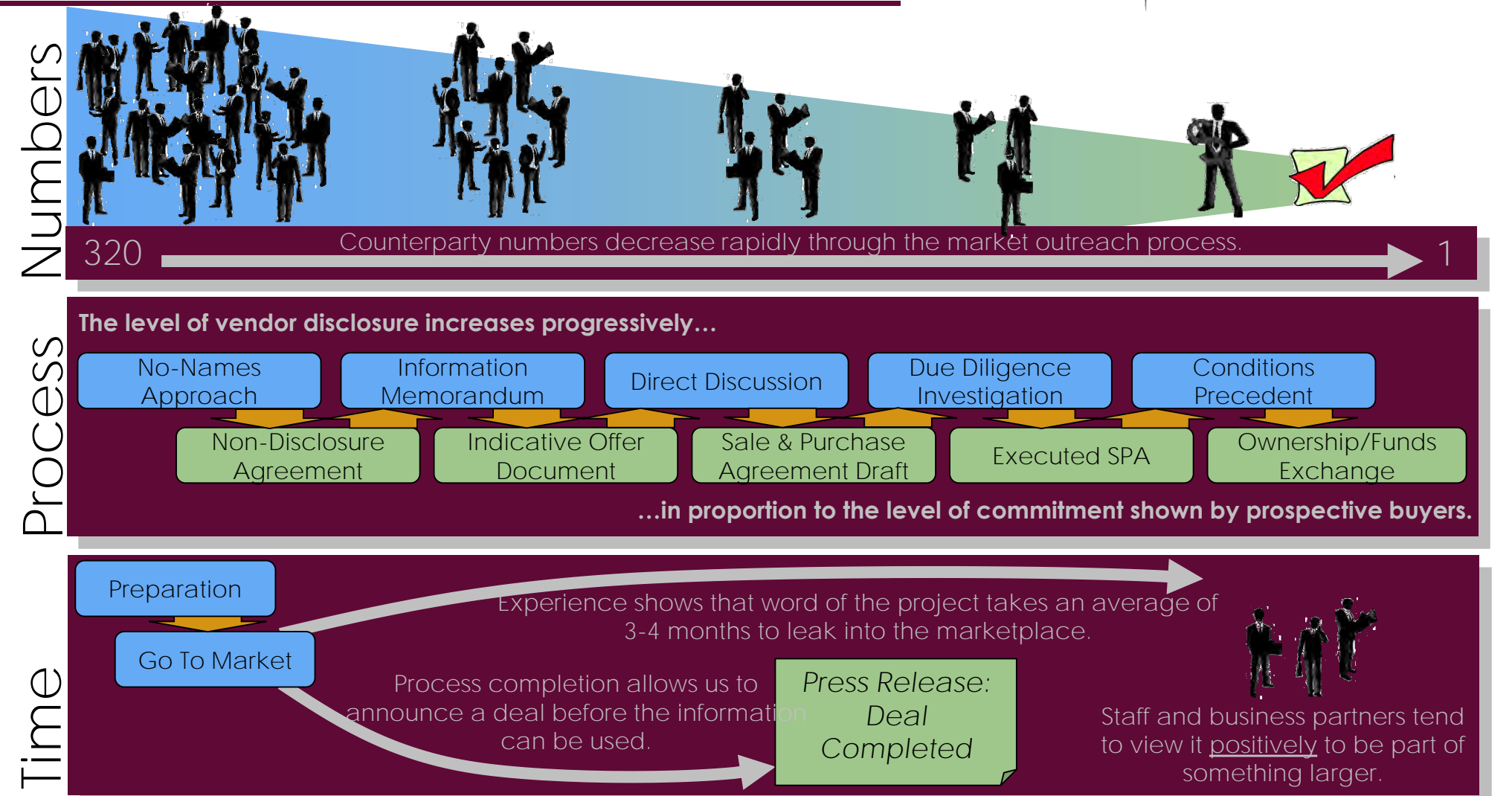
Outside assistance ensures business performance is not impacted by the project.

3<sup>rd</sup> Party 'middlemen' have more freedom of discussion than principals, which helps the process.

Lawyers & accountants must be managed to avoid over-working contracts, due diligence.

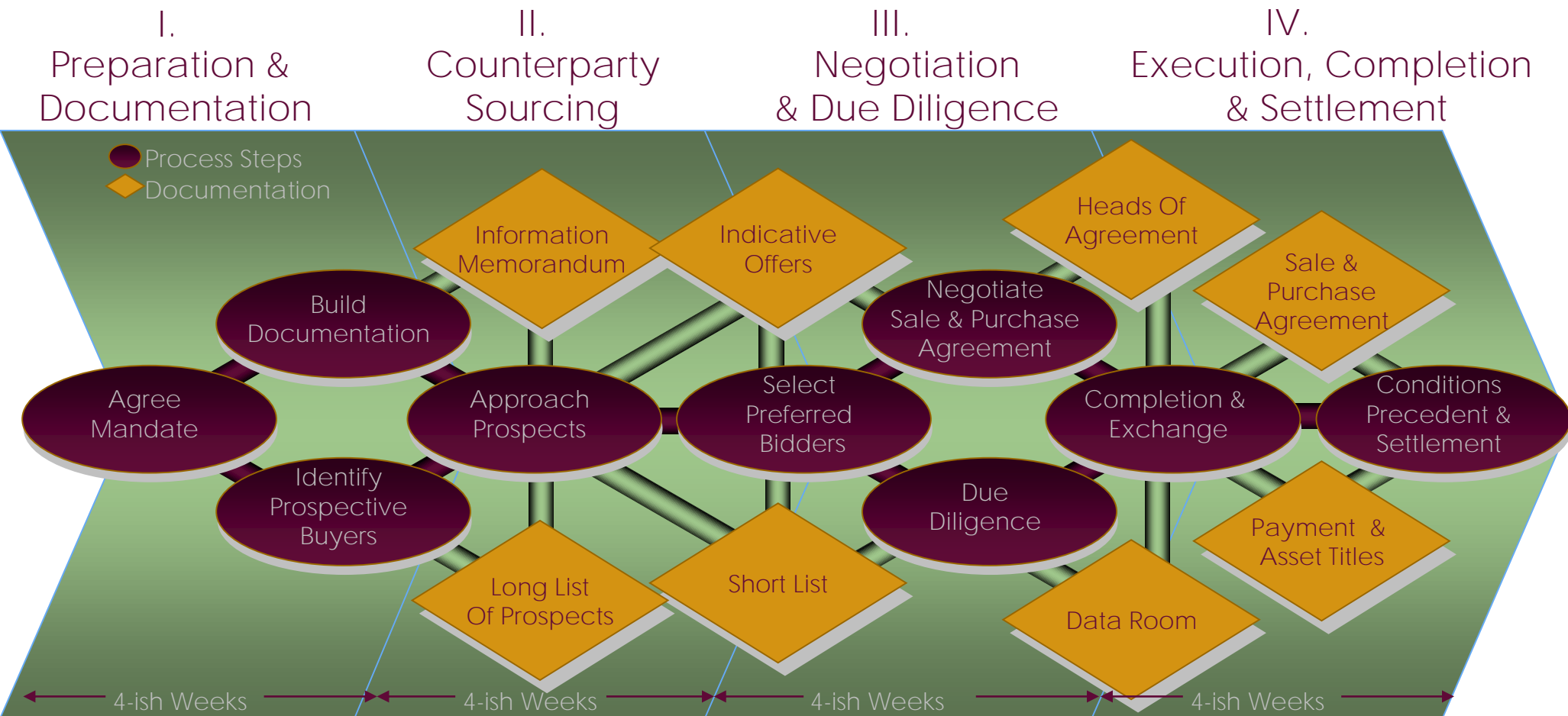
## Target your exit strategy from the start.

# Vendors worry about secrecy...



*...but with experience, security can be managed.*

# High Level: Strategic Sale Process...



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

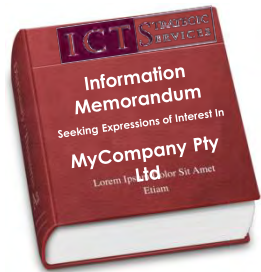


# Phase I: Preparation & Documentation



## Non-Disclosure Agreement (NDA)

A basic legal agreement, designed both to legally protect the parties, and to practically encourage respect for each others' confidentiality requirements. Commonly, ICTSC execute one agreement with the vendor, and an identical agreement with the suitors, such that they 'back-to-back' and cover both parties, but the vendor's name is not revealed before signing.



## Information Memorandum (IM)

A comprehensive document covering the whole business. It is designed to give a potential buyer the information they need to value the business, assess 'fit factors,' decide whether to bid, and discuss deal structure and parameters (eg price). The IM is only viewed under a Non-Disclosure Agreement, and must reflect a tone of openness and thoroughness that gives bidders confidence they have the whole story. It builds their trust to take information at face value until the due diligence stage. Often 50-75 pages with a thorough executive summary, the document also describes how potential buyers can make a bid, and the process and timings for the process to follow. Encapsulating the information in document form allows for many more counterparties to take a serious look at the business, as they don't require face-to-face meetings to make initial assessments.



## 'Teaser' Opportunity Introduction

A few paragraphs summarising the key parameters of the deal, in terms of market sector, business model, size, volume, industry position and a few other key factors suitable for determining a prospects initial interest level, without allowing them to identify the client firm.

## 'Long List' of Prospects

The goal is to provide a comprehensive review of the potential buyer space, including all reasonable counterparties that might have the interest and capability to do the deal. ICTSC construct the list by enumerating many potential strategic drivers which might drive a fit, and then working from an extensive internal database, as well as conducting external research to identify potential counterparties fitting each profile. The list is reviewed with clients to identify firms with which the client already has a relationship, and to ensure that all competitors, suppliers, and possibly customers and other related parties are included in the process. The target list is a living document, which grows and shrinks as targets are qualified out, or refer us to other likely prospects, during discussions.



***...laying the groundwork for a focused campaign.***

## Phase II: Go To Market (sourcing)

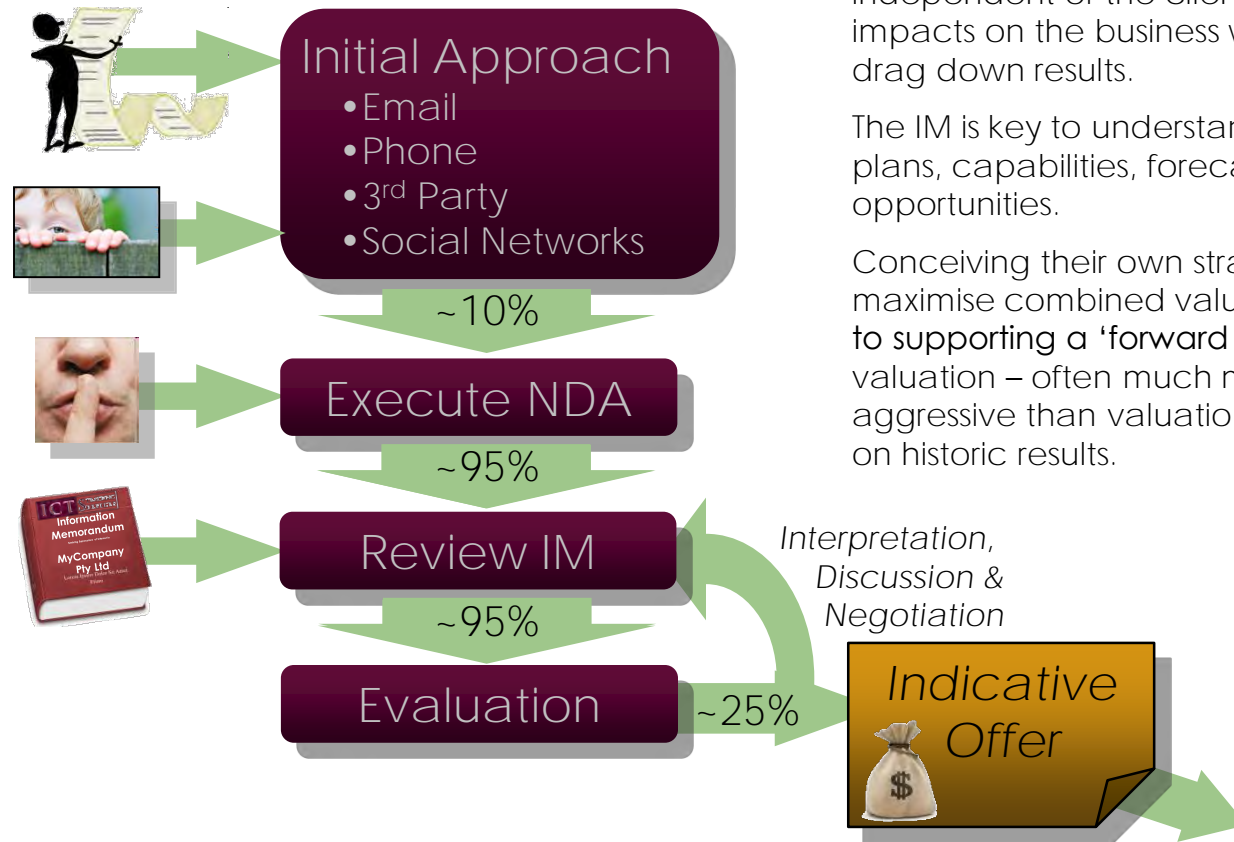
Prospects are contacted directly to review the teaser, and those interested are asked to execute a Non-Disclosure Agreement.

Those executing an NDA are given the name of the client, and initial fit and capability are assessed informally.

Viable interested parties are given a copy of the IM, either in hardcopy or a password-protected softcopy file.

ICTSC assist as possible with their assessment, and guide the creation of an Indicative Offer where possible.

The IM generally contains a format for IOs and a timeline for submission.



ICTSC conduct this phase largely independent of the client, to reduce impacts on the business which could drag down results.

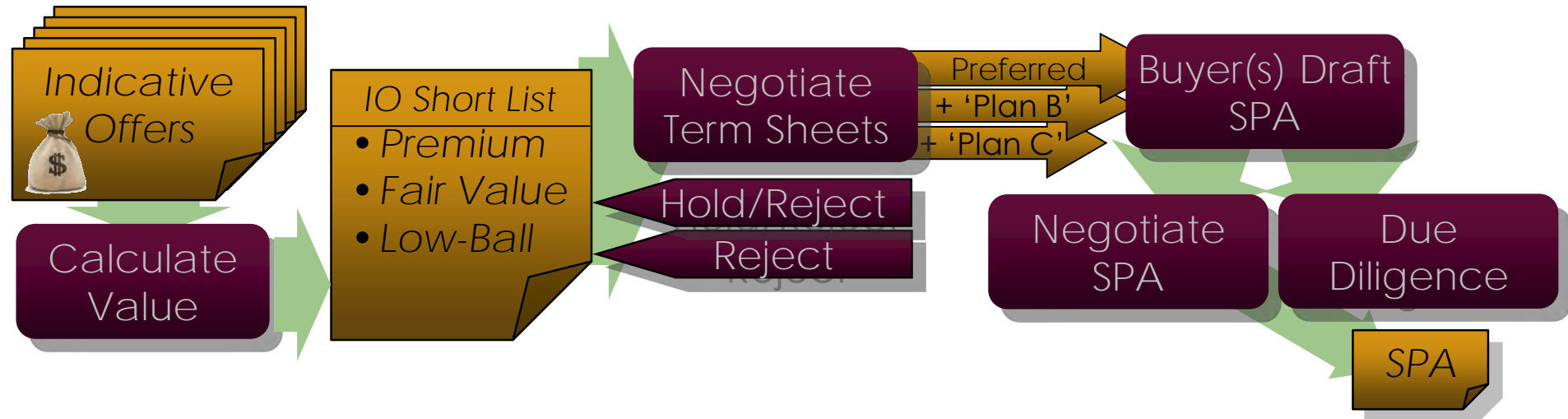
The IM is key to understanding future plans, capabilities, forecasts and opportunities.

Conceiving their own strategy to maximise combined value is critical to supporting a 'forward looking' valuation – often much more aggressive than valuation based only on historic results.

### Common 'DIY' Mistakes:

- **Putting (pessimistic) words in buyers' mouths instead of asking them;**
- **Assuming an 'objective value'** - real worth is whatever someone will pay.

# Phase III: Negotiation & Due Diligence



Considerable analysis may be necessary to value IOs which include earn-outs, share transfers, payments over time, payments contingent on achieving targets, variable rewards/penalties, incentives and other complex elements. Personal preferences must also be balanced against financial assessments.

ICTSC recommend moving forward from the short list with 3±2 counterparties to reduce the risk that none will complete successfully. Costs are balanced by moving faster with preferred parties, delaying others.

Otherwise desirable under-bidders may remain open as 'fall-back options,' if dealt with honestly and fairly.

Buyers' lawyers generally draft the Sale and Purchase Agreement (SPA), and a 'reasonable' draft gives us confidence to open up for full Due Diligence (DD).

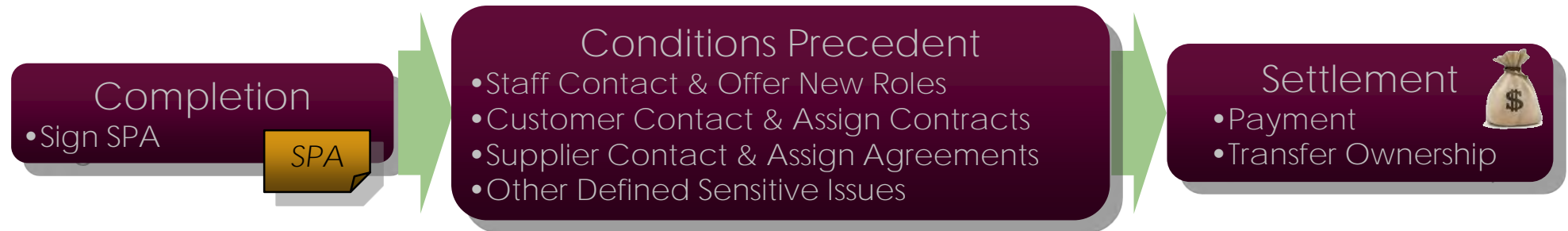
With a detailed IM, DD is just about confirming key information that buyers have relied on, rather than a broad discovery of how the business operates – this ensures a manageable and timely process.

DD and SPA negotiation must be concurrent, for two-way give-and-take. In series, both become one-sided, potentially dragging on for long periods. Lawyers and accountants must be kept commercial, and focused exclusively on material priorities.

## ***...narrowing the field, maintaining 'fall-backs'.***



## Phase IV: Execute, Complete & Settle



Buyers may not contact suppliers, staff, customers or other partners which could disrupt the vendor's ongoing business if the deal fails.

Buyers often won't commit without buy-in from these stakeholders, so Conditions Precedent (CPs) help to balance these requirements.

The SPA defines detailed, objective criteria for the buyer's acceptance or rejection of the deal, based on the outcome of these sensitive contacts, along with a process for executing the contacts and satisfying the CP criteria.

The SPA is signed ('completion' or 'exchange').

After Completion, several weeks are allowed to satisfy the CPs.

Vendor and buyer approach staff to negotiate any changes in their employment terms, and/or offer new or transferred contracts.

They may visit key suppliers and customers to seek approval for the transaction, particularly if existing contracts require assignment.

Often this can be pro-actively managed as an up-sell or cross-sell opportunity, rather than giving customers an opportunity to renegotiate 'Ts&Cs' – or prices.

Once any and all CPs are satisfied, all parties meet to 'settle' the transaction. Like settlement of the sale/purchase of real estate, the meeting is often hosted by the buyer's lawyer.

Ownership of assets, contracts and other key documents are exchanged, ownership of the business is transferred as payment of any cash is made.

Buyers and the vendor make an announcement to staff, and the buyers may issue a press release to the media.

***...the final deal hurdles – then the work starts.***

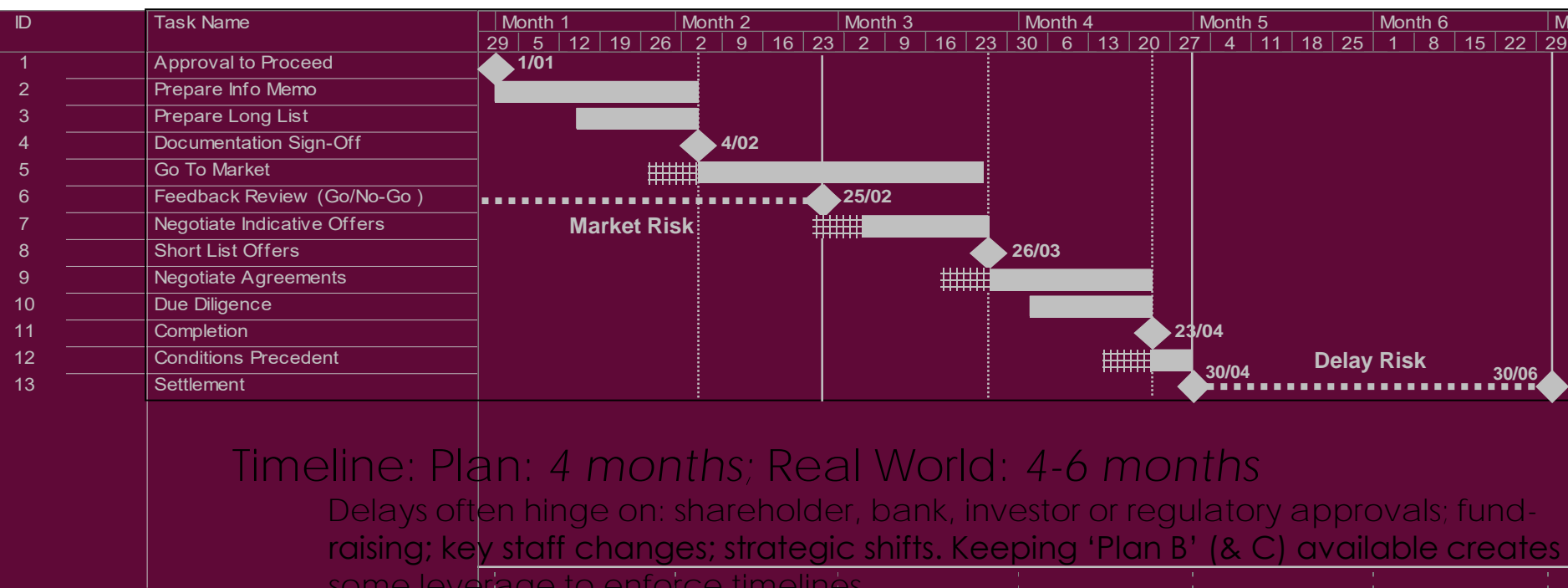
## Phase V: Integration & Growth (Earn-Out)

### Integration Guidelines:

- Speed – what's not done in the first 100 days, probably never will be;
  - Focus on sales continuity – revenue often suffers during distractions;
  - Get the team right first – cascade top down, remove duplicated positions;
  - Empower integration teams, first focused on quick wins and 'low-hanging fruit,' then aligned to the functional organisation and evolving into continuous improvement teams;
  - Acknowledge and accept that mistakes will be made and fixed later;
  - Communicate much more than seems necessary – the CEO must repeat the same message over and over again, for it get it across and stick;
  - What gets measured, gets done – your earn-out may be on the line.
- 
- At hand-over, the real work begins – integrating and growing the new entity;
  - Vendors with continuing involvement in the business may have earn-outs & hold-backs within the deal structure – their drivers will be strong, and must align with the (new) corporate goals and directions, or conflict will follow;

***...set the tone of operations & culture.***

# How long, how much, at what risk?

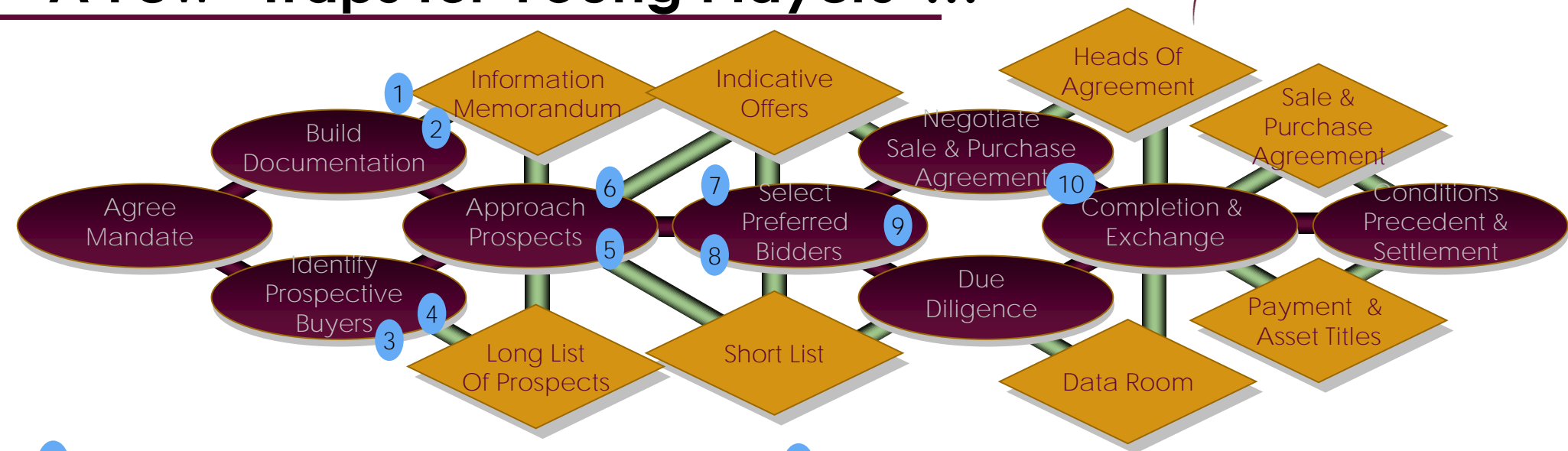


Fee Structure: *cost-based monthly retainers & success fee*  
 Retainers roughly covers costs, so ICTSC has 'skin in the game.'  
 Fees are normally dwarfed by enhanced price/value outcomes.

Risk: *retainer payment X 2 months*  
 Feedback Review reveals market response early, to halt or adjust.

*Benefits: better valuation, fit, timing – and confidence.*

# A Few “Traps for Young Players”...



1. IM: Weak IM multiplies vendor meetings, reduces field of prospects, and interferes with running the business;

2. IM: Failing to strike a note of openness & honesty increases due diligence load (and risk);

3. Long List: Limiting search scope reduces chances of finding a strong premium valuation;

4. Long List: Not reviewing prospects can interpose M&A into existing operational relationships unknowingly;

5. Approach: Prospects must get enough information to make decisions, not enough to guess client identity;

6. Approach: Targets must understand opportunities and positives, but not feel oversold;

7. Indicative Offers: Prospects require value guidance, but room must be left for a premium valuation;

8. Indicative Offers: Prospects must provide key details to obviate later delays enhancing *de facto* exclusivity;

9. Short List: Several buyers must always be worked with in parallel, lest the first choice bidder not complete;

10. Detailed Agreements: Lawyers and accountants must be managed to focus on materiality;

***...and many, many others – experience pays.***

## **3rd Party Assistance is usually critical...**

- Documentation, prospect approach, negotiation and managing accountants and lawyers all require specialist skills;
- Deal structuring, evaluation, negotiation and the execution process benefit from specialist knowledge and experience;
- The extensive process work can detracts from running the business, and results can suffer– reducing firm value at completion;
- Counterparties are more open with a 3<sup>rd</sup> party, and more willing to accept opinions/suggestions from an expert than a principal;
- 3<sup>rd</sup> parties don't identify you, and can maintain confidentiality;
- "Two heads are better than one."
- Specialists like ICTSC maintain detailed knowledge, specialist tools, an extensive industry database and cultivate key connections.

***...specialist skills, workload and independence.***

# Simple guidelines underlie our approach...

- Prepare Thoroughly – to address lots of options – at once – putting your best foot forward;
- Cast a Wide Net – to find buyers with unexpected drivers, willing to pay a premium;
- Open, Honest and Realistic – being up-front builds trust, speeds process, and lets us look forward; secrets inevitably come out – the later they do, the greater the damage;
- Maximise your Decision-Making Information – knowing your options strengthens your bargaining position, and adds confidence to negotiation;
- Control the Process – progressively reduce outcome uncertainty, keeping options open;
- Move Fast – act decisively at higher risk/return, develop safer option more slowly;
- **'Plan B' (& Plan C)** – always know next 2 preferred options, prepared to act on both;
- Make Decisions Only When You have Decisions to Make – don't pre-judge others' responses or assume they will act 'rationally' – ask them, and let them say no;
- **There's No 'Real Value'** – things are really only worth what people will really pay for them;

Companies are like other high-value, complex, capital goods – a strong  
**process and a 'numbers game' brings a strong outcome.**

***...most firms have numerous unexpected options.***

# ICTSC is keen to discuss the possibilities...



Further information is available at  
[www.ICTStrategicServices.com.au](http://www.ICTStrategicServices.com.au)

or

Through Dr Paul D Hauck on +61 (0)414 35 35 03  
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*We're always happy to discuss your situation, issues, and prospects, or supply further information from this briefing series. We do this (partly) because we enjoy it, and appreciate the opportunity to help companies and people.*

**...and to assist, if that's appropriate.**