FINANCIAL POST

Get the giants' attention with strategic mergers

Brad Cherniak, Financial Post · Monday, Feb. 14, 2011

By most accounts, the Canadian mergers and acquisitions market for small to mid-sized businesses is relatively robust, despite the global recession.

M&A activity has been buoyed by the heavy activity of so-called "strategic buyers," as well as by continuing tough conditions in the initial public offering (IPO) market (a key alternative to selling your company).

It is unfortunate there is little data for the small end of the market to be more scientific and definitive, but here are some practical observations:

"Strategic" in the eye of the beholder Today, strategic buyers are considered to be companies that buy other companies they consider complementary to their core business. This would include broadening their product offering, geographical coverage, core skill sets of staff and customer base — not simply getting bigger for bigness sake.

But the notion of what is "strategic" changes. At one time, buying unrelated businesses as part of a conglomerate strategy was considered strategic, and will probably again be one day. In the late 1990s and into the 2000s, companies of all sizes either bought or started ventures unrelated to their core business, either looking for returns on investment separate from their existing business, or simply goosing overall returns for the owners. Many of these initiatives didn't end well, particularly as capital market conditions deteriorated for small to mid-sized businesses even before 2008.

Even today, the distinction between a "strategic" deal and a "buying to get bigger" deal is fairly fine. Frankly, if it is acquired cheaply enough, it becomes strategic to the buyer and its stakeholders.

Size matters Size has a much broader and bigger impact on SMBs relative to larger corporations. In today's markets, which bucket you fall into will help determine your probability of being acquired, or getting financing to do an acquisition. (See accompanying scale). The type of buyer or investor who may be interested in your company will also change materially as you move from bucket to bucket. This will also drive what valuation methodology will be used.

So a deal that moves an SMB from one bucket to the next may be "strategic" for that reason alone, and not empty empire building.

As a general rule, you will get a better relative valuation (i. e. multiple of sales or earnings or cash flow) as you move up the scale. The same is true for the probability of selling your company or getting financing to do an acquisition.

This is by necessity a simplified picture, as each industry will have its own unique features and considerations, but the overall paradigm holds broadly. Whether any deal is truly "strategic" will be specific to each SMB.

Raising the bar Another important trend boosting the volume of M&A activity for SMBs is the increasing quality of targets.

First, many of the weakest companies have either done distress deals or disappeared.

Second, overall SMB market valuations are improving somewhat from the trough in 2008, bringing more high-quality companies into the market.

Third, with the passing of time, more and more good companies and their owners lose patience with waiting for things to get better and lower their expectations. Expectations are very sticky for SMBs on the downside — it is an effect of the unceasingly bullish sentiment that motivates and drives entrepreneurs. This is a much stronger and more influential factor for this segment than for the large cap players.

New consolidation plays Another element having a major impact on M&A activity in this segment is the acceleration of the consolidation curve in a number of market segments many SMBs are in. Software-as-a-service, cloud-computing technology, security, mobile technology, digital media and entertainment, and consumer devices come to mind. These segments are lead by cash-rich and increasingly acquisitive giants including Google, Cisco Systems, Apple, IBM, Intel, Oracle and others.

The giants are becoming increasingly broadly integrated, and are hollowing out the medium-sized segment of the corporate world as they seemingly scoop up everything to become one-stop-shops for their own customers.

All this leaves an opportunity for SMBs to follow their own growth and acquisition strategies: Namely, to move into the increasingly vacant middle ground to become big and interesting enough to be acquired by the giants, if they are not currently sufficiently attractive targets.

Consolidation plays have existed for years in both the technology and traditional business segments, but the paradigm is on steroids these days.

Opportunity in chaos While M&A deal volumes and valuations in the SMB segment are much more volatile than for the overall market, bottom line, these companies have never had such a good opportunity to define their own opportunity to benefit from these plays.

Bucket Sizes

The typical size "buckets" for evaluation of SMBs break down as follows in terms of sales revenues:

Early stage $1-million

Emerging $1-million to $5-million

Ramp-up $5-million to $10-million

Expansion $10-million to $25-million

Critical mass $25-million+

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