White Paper

Part 2

PROCESS MATTERS:

Generating Proprietary Acquisitions

How is an Effective Acquisition Program Implemented ?

This white paper is the **second in a three-part series** that addresses the critical components of a structured, purpose-built and effective acquisition program ("AP"). Using a six-phase model, the following serves as a tangible guide for the implementation of a successful AP. By mapping a course through the challenges an acquirers typically face, this guide gives a detailed look into how an AP works on a very practical level.

Part II is the culmination of key takeaways learned over many years from hundreds of acquisitions. It provides field-tested best practices in the successful planning and executing of a complex strategic acquisition program. While Part I outlined the myriad benefits of proprietary acquisitions, Part II shows you how those benefits are realized.

Osprey Capital Partners Inc.

Professional Investment Banking for Mid-Market Companies

Osprey Capital Partners

The Challenge

How is an Effective Acquisition Program Implemented?

Your organization has resolved to develop the capability to capture the myriad benefits of proprietary acquisitions. Where do you start?

Not all companies have the ability to be successful consolidators. Studies have supported the common-sense conclusion that successful acquirers have developed strong core competencies in (i) sourcing, (ii) executing, and (iii) integrating acquisitions. Significant shareholder value can be created by companies that develop competencies in these three areas.

Building the capability to proactively source acquisition targets is a significant undertaking. It requires a significant investment in the right people, a team structure that leverages specialists, customized systems and specialized skills in managing private business owners. Perhaps most importantly success requires strategic sponsorship within the organization, including the commitment of senior management, and the Board, to the strategy. A disciplined and well-defined acquisition sourcing program can address the challenge.

How would such a program be designed? To understand the resources required, process architecture should first be determined and the resources would be marshaled to execute this process.

Process Matters

In our experience, a successful proactive acquisition program ("AP") requires significant resources and systems to simultaneously support the required (i) target research, (ii) vendor contact, tracking and follow-up, (iii) management of, and negotiation with, vendors, including document and information flow, (iv) due diligence, and (v) definitive documentation. Most teams can effectively manage just one transaction at a given time. Special capabilities are required to simultaneously manage multiple target discussions at various stages in the process and keep them all moving forward.

There are many ways to execute an AP and there are no right or wrong answers. The ideal process is one that fits well with (i) the acquisition team's strengths, style and governance structure, (ii) the size and scope of the target universe, (iii) available resources, and (iv) receptiveness of targets. Typically, adjustments are made based on what is learned through the process. The process outlined below focuses primarily on the unique sourcing and qualifying aspects. This document reflects an evolution of refinements we have observed with leading consolidations and in executing many AP assignments for clients in many industries and approaching several hundred acquisition targets in North America and Europe.

There are Six Distinct Project Phases

A. Confirming that Acquisitions Fit the Strategy

B. Pre-Launch Preparations

C. Target Contact and Qualification

D. Acquisition Proposal

E. Due Diligence and Documentation

F. Closing

A. Confirming that Acquisitions Fit the Strategy

1. Clarification of strategic objectives:

- Are acquisitions part of the strategy going forward? If so, in what areas? What is the aim of this strategy?
- What are the acquisition criteria (geography, size, products/services, end markets, distribution channels, etc.)?
- What is the value creation thesis (cut G&A, rationalize capacity, best practices, fill gaps in product/service offering, leverage distribution channels, purchase multiple arbitrage, etc.)?
- How satisfied are you with your current efforts and results?
- Confirmation of strategy and criteria may be iterative, depending on target universe complexity and commitment to the strategy. It can be helpful to walk through a sample target list with the project team and the project sponsors to ensure you are on track and to confirm the thresholds of the criteria.

2. Confirm scope of consolidation opportunity:

- Conditions for a successful AP must be present:
  a) Economies of scale;
  b) Fragmentation with ample targets;
  c) Cost and/or distribution synergy potential; and
  d) An industry catalyst, such as customers rationalizing suppliers, regulatory change or technological change can be helpful.
- Based on the investment criteria, generate a target universe using standard database filters to determine the size of the target universe that would need to be reviewed to confirm the fragmentation thesis.

3. Confirmation of financial capacity, as required:

- It is important that process momentum be maintained by ensuring financing is available in advance
- Not an issue for many large public companies and private equity sponsored platforms.
- Consider confirming credit capacity and secure a commitment for a specific amount of capital that senior management is prepared to commit to the initiative.
- If there is a potential issue, discuss a plan to access additional funding if required. Is there appetite to do that for the right deal?

4. Confirmation of valuation expectations
   - It is important to establish that internal expectations of valuation are not significantly lower than market.
   - If there is a significant gap, consider the search costs associated with wasted time and resources.
5. Acquisition criteria and screening parameters confirmed
   - As noted above, it can be helpful to walk through a sample target list with

the project sponsors to ensure the project team is on track and to confirm the boundaries of the criteria.

B. Pre-Launch Preparations

1. *Initial target list provided to project sponsor for approval*

- Many lists may be submitted over the course of the project. This is a "batch" rather than a continuous process, where the team can reassess how the process is working, the targets they are seeing, target response, etc. It is a natural break where you have the opportunity to adjust the strategy, including deciding whether or not you wish to continue.
- Lists should be of a manageable length. A list of 10-30 targets is an ideal range.

2. *Determine which targets to pursue*

- Review target list with the project sponsors. Three potential categories for each target:
  a) Approach now – Only these go onto approved list;
  b) Not now, maybe later – agree on when team will re-introduce target for approval and follow up with project sponsors then; and
  c) No – Dropped from further consideration.
- This feedback informs your selection of future targets. Working through concrete examples allows the team to challenge the project sponsors and improve internal understanding of acquisition criteria.

3. *Initial target list finalized*

- Revisions to the proposed list are made and the revised list is submitted to project sponsors for approval.
- No target contact is made until approval is explicitly given by project sponsors.

4. *Approach letter, call scripts, NDA's, information request lists, follow-up protocol, other target correspondence and assessment protocol/tools approved*

- Developing a clear value proposition for the target will maximize the effectiveness of your approach. Articulating your value proposition should be clear in the approach letter and in the initial call with the target.
- The target may be guarded when approached by a competitor. Messaging should be subtle and nuanced. Consider how you can gain an understanding of their objectives, rather than simply saying "we might want to buy you".
- Approach strategy for a publicly-listed target is completely different than a private company approach.
- Approach letters are typically sent by FedEx to the target vendor to ensure it is not treated as junk mail. This maximizes response rates.
- Discuss what will be said on the initial call. Consider a written call script.
- Draft a short NDA to be shared with potential targets.
- Draft a proposed information request list as a means to qualify the target. Sometimes there are specific metrics or business information that are critical to see prior to committing resources to in-depth due diligence.
- Confirm how you will conduct the phone pursuit of the targets and when the team will assume there is no interest. Typically propose to initiate phone contact two business days after expected receipt of the approach letter, then two follow-up attempts per week. If no contact established after 3 phone attempts, send a final close-out letter by regular mail to say you assume

the lack of response is an indication of a lack of interest.

- Close-out letter drafted.
- Commit to track those targets that ask you to follow up with them on a more extended time frame, like "not a good time now, call me in the fall", etc.
- For those targets that submit information, agree what assessment tools will be used, key parameters and the threshold tests to be applied in qualifying targets.
- Consider drafting a letter of intent ("LOI") template in advance, to avoid loss of momentum during target dialogue.

5. *Approach strategy and contact information determined for each target*

- It can require significant time and resource to target the right people and secure their contact information. Often it requires an inquiry at the general number.
- Avoid sending a letter to an unnamed person if no contact person can be identified. Confer with your sales and operating teams who may have been in contact with the target company on whether they have any ideas and decide how to proceed from there.
- However, for targets already known to your company, ensure you have a listing of the key contacts and a history of the discussions with those contacts. Seek input from those who have been in direct contact on the best approach strategy for those targets.

6. *Internal approval to launch*

- An in-person kick-off meeting is the ideal forum to run through a readiness checklist prior to launch:
  a) Initial target list approved;
  b) Approach documentation and pursuit protocol agreed; and
  c) Other potential issues, such as financing, management team availability to follow up on targets, etc. are addressed prior to launch.

C. Target Contact and Qualification

1. *Approach letters sent*

- Letters are sent to target vendors by FedEx to ensure the letter is respected and read by the target person. Letters are marked "Personal and Confidential" to respect the vendor's privacy.
- Sent in manageable batches so that they can be followed up in a timely manner. The whole list wouldn't be sent in one day.
- Contact details for some targets take longer to find than others and its best not to wait for all of the contact information to start sending approach letters.

2. *Initial phone contact*

- Typically recommend two business days following expected receipt of the approach letter. However, you don't want to call before the person has read the letter.
- Don't leave details on the nature of the call with reception or assistant. Usually say, "Out of respect for Mr. Smith's privacy, I cannot discuss that. We have outlined in detail the nature of this call in the letter we sent him [last week]. Do you know if he has received the letter? It was sent by FedEx and it should have arrived there [the day before yesterday]".

3. *Interest confirmed*

- Attempt to move to verbal qualification if the target will accept a verbal commitment to non-disclosure. Otherwise, move to execute NDA.

4. ***Sign NDA with target, if requested***
   - Make a verbal commitment to confidentiality in any event.

5. ***Verbal qualification***
   - If there is interest in talking, pre-qualify with some very basic information on the phone. For example:
     a) Confirm EBITDA or cash flow for the last fiscal year;
     b) Revenue;
     c) Main products and end markets; and
     d) Ownership.
   - If this checks out, proceed with formal information request.

6. ***Information request list submitted***
   - Send target the information request list.
   - Follow list up with a phone call to walk through it and determine whether some items will be challenging for them.
   - Negotiate how to fill any information gaps.

7. ***Information received and preliminary financial modeling completed***
   - Build any models and populate any assessment templates

8. ***Call with business leadership and target***
   - First opportunity to introduce them and have a basic Q&A on the target's business.
   - Send a call agenda to the target in advance.
   - There may be several follow-up calls to enhance understanding.
   - Defer site visits until an LOI with basic deal terms is agreed.

D. Acquisition Proposal

1. ***Draft an LOI for project sponsor approval***
2. ***Send the LOI to the target***
3. ***Negotiate and execute LOI***

E. Due Diligence and Documentation

1. ***Commence drafting of definitive documents***
2. ***Confirm vendor legal counsel and recommend changes, if preferred***
3. ***Formulate due diligence plan***
4. ***Business due diligence***
5. ***Financial/Accounting due diligence***
6. ***Legal due diligence***
7. ***Environmental due diligence, if applicable***
8. ***Other due diligence***
9. ***Provide draft agreement to vendor***
10. ***Business transition***
11. ***Negotiate definitive agreement***

F. Closing

1. ***Final approval***
2. ***Execute agreements***
3. ***Activate integration plans***

Conclusion

Process matters. Developing a process to thoroughly and efficiently identify and screen potential acquisition targets is critical to establishing a plan and determining the internal resources required for success. This plan should involve approaching targets in parallel, engaging them in strategic dialogue, qualifying them and keeping the process moving forward, ideally for many targets simultaneously, with each moving at their own pace.

Implementing a state-of-the-art process that maximizes results requires significant resources and skill. Developing a well-designed process without committing the resources to execute it will disappoint those who sponsor the initiative. Furthermore, under-resourcing the initiative can result in inferior performance by the resources that have been committed because they have not been given the tools for the job. The challenge is compounded by the financial impact of adding significant fixed expense for "corporate support", which can be a tough sell to the board of directors and to shareholders. Patience and staying power are required during the first 12-18 months as the team ramps up. This includes implementing and refining the program.

Osprey has developed a process that works and has the purpose-built resources to execute it effectively. We do this in a way that is not only complimentary to our clients' internal capabilities, but that leverages these resources to make them more productive. The final installment of this three-part series, ***Addressing the Challenge: Surfacing Proprietary Acquisitions***, outlines how Osprey works with its acquisition program clients to create considerable shareholder value by bringing the considerable resources of our firm to bear in addressing these resource challenges.

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