TECHNOLOGY ACQUISITION UPDATE

The Beauty of Small Acquisitions

Windows into New Growth Areas

A small acquisition is an excellent way to gain a foothold in a niche market. You can gain new capabilities, new customers and new talent. You then concentrate your efforts to build the business to be a major player in that market niche.

The market opportunity for small acquisitions is substantial. Many small companies need to be part of larger companies in order to grow and to gain economies of scale in marketing and sales. Small acquisitions are less expensive, simpler to transact and easier to integrate. Plus, the search for small acquisitions can be a resourceful window into new growth areas.

What is a small acquisition? A "small acquisition" is an acquisition of $5 million, maybe $10 or $15 million, but less than $20 million in transaction size.

The search for small acquisitions can create shareholder value in several ways—identifying new areas for growth, acquiring new capabilities and technologies, as well helping transform a company's business model.

Identify New Growth Areas

Your opportunities for growth often lie outside the confines of your current industry description. Where should you look for small acquisitions? The most fertile ground is in adjacent markets—at the periphery of your market space. These gray edges of your market are where the new niches are sprouting.

Acquire New Technology, New Capabilities

Think of a small acquisition as a type of outsourced R&D. Most new technologies are discovered in small companies. Big companies generally don't develop the breakthrough technologies. More importantly, however, is the application of the new technology—using it to solve a customer's problem. This is where small companies excel.

Transform Your Business Model

Most successful companies are continuously refining their business models. Small acquisitions are an excellent way to redefine or adjust your business model. For example, you can gradually shift the composition of revenue to include more recurring revenues.

Build it Your Way

The smart play is to make a small acquisition, get a foothold in a niche market and then build upon it. Small companies are much more malleable, easier to grow the way you want to. They are not cast in concrete. For example, you can change pricing structures before the industry gets used to one certain way. You can establish the service and support standards. You are not inheriting a situation that you can't easily change.

All large markets were small markets at one time. This buy and build strategy may involve more work but it requires less capital and you have more flexibility regarding how you choose to grow the business.

Easier to Transact

Small acquisitions are easier to transact. The deal structure is a lot less complicated. These deals are often structured as a purchase of selected assets, not as a purchase of stock. Since the stock is not being acquired, there is less concern about off balance sheet liabilities, thus reducing the due diligence burden.

There are fewer integration issues. Why? Because there are simply fewer things to worry about. The company may be small enough that it doesn't have a "culture" of its own to be dealt with.

The Market Opportunity

The opportunity is that many small companies need to be acquired in order to grow and thrive. Why do they need to be acquired? Because they have limited cash and limited capabilities in sales and marketing. Many are one-product companies that have no economies of scale. They need to team up with a larger company that has greater resources and established distribution channels.

Plus, there are many more small companies (in the $5 million to $15 million range) than there are larger companies that need to be acquired.

Small companies are under the radar because they are not "For Sale." They are plugging along, growing steadily. They are not out looking to be acquired. The good news is that the market for small acquisitions has not been picked over. The bad news is that these companies will not come knocking on your door. To identify these opportunities, buyers must actively seek them out.

Few Buyers are Searching

A second reason that underscores the opportunity is that not many buyers are actively seeking small acquisitions. The large industry buyers and the financial buyers (buyout funds) want acquisitions of a minimum size, usually revenues greater than $50 million and EBIT greater than $5 million or $10 million.

Large investment banks do not seek small acquisitions for their clients because they typically do not work on deals under $10 million. Their business model will not support it.

The best buyers for small acquisitions are companies with revenues of $25 million to $125 million. However, these firms are usually too busy running their businesses to spend time looking for acquisitions. They are also resource constrained and don't have any extra manpower to devote to an acquisition search.

Why Would a Small Company Sell?

First of all, not every small company wants to be acquired. Entrepreneurs like being their own bosses. However, some are frustrated by their lack of market penetration, weak distribution channels, or limited sales and marketing capabilities. Competition will only get tougher as the market matures. They realize that they could build the company faster, make a bigger impact, if they were part of a larger firm. They can take advantage of the acquirer's distribution channels and leverage its sales and marketing capabilities to make inroads in the market that they could never do on their own.

For many entrepreneurs, selling substantially reduces their personal financial risk. Their personal portfolio of assets becomes more diversified.

Window into New Growth Areas

A small acquisition search can provide an innovative window into new growth areas, to new markets. It is a type of market research. Even if you do not make an acquisition, the search process can give good insight to new niche markets.

Small technology companies are solving some kind problem for their customers. What problem is being solved? What need is being met? Should your firm be addressing it?

Companies usually prefer purchasing products and services from larger suppliers who are more stable with better service and support. The fact that small firms are in business means that the bigger companies are not addressing the problem or their solution is too expensive. In either case, an opportunity exists that the small company is addressing.

You may choose not to make the acquisition for one reason or another. However, you might decide to enter that market sector on your own. At a minimum, the acquisition search effort has opened your eyes to a new market opportunity.

What about Large Acquisitions?

Acquisitions have been pilloried in the press in the last few years for not creating shareholder value. However, these are almost always large acquisitions—$50 million, $100 million, or even a billion dollars. Small acquisitions are a different ball game. Small acquisitions have a much better record of creating shareholder value.

Large acquisitions can add significant value and achieve scale rapidly. The problem is that there are not as many opportunities to choose from. Financial buyers and industry buyers compete aggressively for large acquisitions. The market may be picked over. Big deals are much more expensive—not just in absolute terms but higher priced per dollar of earnings or revenue. Plus, large acquisitions can have substantial integration problems.

Two types of searches can be employed to identify small acquisitions—strategic and opportunistic.

Strategic Search

In a strategic search you know exactly what capabilities you seek. The goal of the strategic search is to drill down in these markets to identify candidates that fit your criteria. The search is a systematic and well organized effort to identify, research, screen and contact all the companies in a particular technology sector or market. For example, you may have identified a specific service capability that you would like to offer. You search the tangential markets to determine if any companies have that capability and are willing to be acquired.

Opportunistic Search

An opportunistic search works the other way—you identify a company that may be open to being acquired and then ask yourself if that is an area that you would like to address. The purpose of the opportunistic search is to "push the envelope" and look at deals that are not directly in your market, to expand your horizons and seek out companies that you would not normally consider.

These opportunities are not on your radar screen. They may be in tangential markets or even one step removed. Criteria play a very minor role. In fact, specific criteria can actually constrain the search process. These acquisition ideas may be creative or unusual. In addition to actually making an acquisition, reviewing opportunistic ideas can stimulate your thinking process and aid in revitalizing your strategic plan.

One Problem

Small acquisitions do have one problem—there are many companies to consider. The endeavor simply involves a lot of work. The process of researching, screening, and communicating with many small companies takes a significant amount of time. The best way to handle that problem is to outsource the search to an experienced M&A firm that will give committed attention on small acquisitions.

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