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Mid-market perspectives
Evaluating strategic options — a growing imperative for the middle market

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Fluctuating financial market conditions, increased interest in cross-border expansion, and constraints on organic growth are among the factors causing the owners and managers of $50 million-to-$1 billion businesses to take a step back to consider where they are in their company's lifecycle. Historically, evaluating strategic options has typically been associated with considering a sale of the business. But is it the only strategic option worth pursuing?

After deeply cutting costs over the past few years, many mid-market companies are increasingly focused on the top line. The difficulty companies have faced in growing organically and the tenacity with which companies are defending their customer bases, make holistically evaluating the operating and financial landscape, both domestic and international, a prudent approach for management teams to take. This article discusses a strategic market analysis framework that mid-market business owners and executives can use on a regular basis to help them consider the various strategic options available and make informed decisions, whether they intend to grow, diversify, or cash out.

Understanding the need

Based on our experience, Fortune 500 companies and entrepreneur-owned businesses have differed in the frequency with which they undertake a review of their competitive landscape and strategic positioning. Most Fortune 500 companies perform detailed, business-level reviews at least annually to inform capital allocation decisions, test consistency with the competitive landscape, facilitate alignment with longer-term strategy and competitive positioning, and assess the management team.

By contrast, we have seen some mid-market company owners and operators trust their intuitive senses — or "gut instincts" — to help navigate issues as they arise. Also, some are hesitant to divert scarce internal resources from important day-to-day activities.

As mid-market companies examine their strategic alternatives in this environment, we are observing that an increasing number appear to be considering M&A. "Mid-market perspectives: 2012 report on America's economic engine," which surveyed mid-market executives' business priorities and economic outlook, found 18 percent very likely to participate in an M&A transaction as an acquirer, up 11 percent from the previous year. Not surprising, given the recent M&A trends and changing market conditions. Companies, however, should consider those trends and conditions carefully before choosing a path.

In the aftermath of the recent recession, leading mid-market players are revisiting this approach for several reasons, and they are beginning to look at their strategic options not only more methodically but also more frequently due to the following factors:

- In many cases, access to operating capital has fallen dramatically, as historical lending relationships have been strained if not damaged.
- In addition, many companies have struggled to capitalize on opportunities that arose during the downturn, and are unsure how best to navigate a macroeconomic environment that may only generate flat to moderate growth.

In fact, despite steady, albeit slower than desired, improvement in the global economy, several factors remain that make a sustained recovery more tenuous. These include:

- A lack of clarity on major U.S. policies due to political gridlock
- Continuing uncertainty in the Eurozone
- Growing tension in the Middle East
- Fluctuating fuel prices.

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Assessing the overall environment

Various factors have caused volatility in the operating market for middle market companies over the past 20 years, which has caused various strategic options to look more or less favorable at different points in time. A strong stock market, windows of readily available credit, and favorable valuations propelled M&A in the 1990s and the middle part of the last decade. Conversely, the end of the technology bubble in the late 1990s, the events of 9/11, the military campaigns in the Middle East and Afghanistan, and the recent global recession contributed to a more conservative operating environment.

Conditions today suggest that the environment is reestablishing a more solid, stable footing allowing business leaders to make appropriate decisions about the future strategic direction they wish to pursue. Specifically, as the stock market stabilizes, S&P 500 companies have an increasingly valuable currency to combine with the $1.2 trillion of cash they have amassed on their books.[1] Other factors setting the stage for significant deal activity include the availability of credit market financing, the higher leverage multiples being offered on transactions, historically low interest rates, and the need for companies to show growth coming out of the recession.

Based on conversations with many of our clients, there appears to be a pent-up supply of middle market deals, defined generally as transactions of less than $500 million, as family- and entrepreneur-owned businesses that may wish to pursue a transaction are being very cautious given their experiences over the last few years. Notwithstanding, the return of higher multiples, particularly for quality companies and management teams, portend a return to higher deal activity. In addition, some larger corporations are pursuing "tuck-in transactions" in the mid-market as opposed to the transformational deals of several years ago.

The improvement in middle market capital access is evident in the recent growth in leveraged buyouts, dividend recapitalizations, and acquisitions, and a corresponding de-emphasis on refinancings, exit financings, and Chapter 11 filings. Despite substantial middle market debt maturity walls in 2012 and 2013,[2] current market liquidity and attractive multiples and maturities could fuel continued robust activity absent macroeconomic disruptions.

Private equity firms, for their part, are another potential source of middle market deals holding more than $400 billion to invest.[3] Moreover, many of these funds may need to invest this capital in the next 12 to 24 months or risk potentially returning it to fund investors.

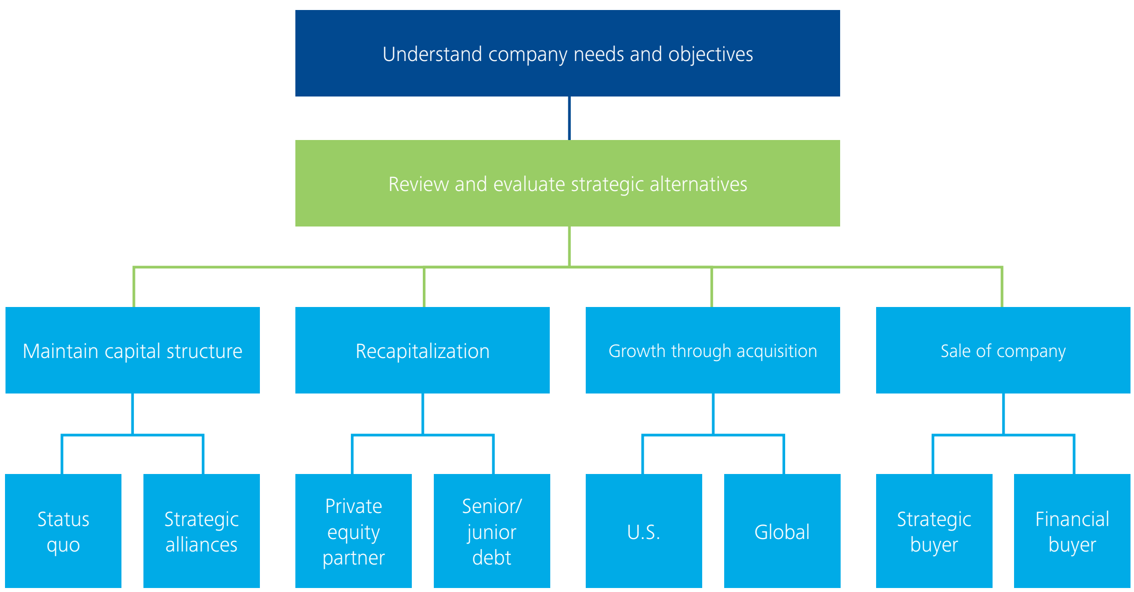
[1] Capital IQ, based on data compiled as of 12/31/2011
[2] Thompson Reuters LPC
[3] Pitchbook

The case for exploring other strategic options

Mid-market companies should consider alternatives for achieving growth based on their potential to deliver value and address the needs and objectives of the enterprise (see below). While strategic options analysis can sound like a daunting project, it is actually an exercise of objectively assessing the company, its competitors, the prospects for its sector, and the possibility for true value creation given the company's strategic plan and positioning.

The process begins by understanding the company's needs and objectives. Then, through review and evaluation of strategic alternatives, business owners and managers can determine whether to maintain the status quo, pursue strategic alliances, recapitalize the balance sheet, grow through acquisitions, or potentially sell the company.

Example strategic options analysis



Source: Deloitte Corporate Finance LLC

Understanding needs and objectives

The interests of shareholders, management, and employees play a role in determining what growth path the company should pursue. Shareholder concerns include their own financial needs and objectives, risk tolerance, and level of interest in retaining financial and operational control of the company. The management team should analyze such issues as its desire to manage rapid, or conversely declining, growth, team members' potential financial gain from a transaction, and the sustainability of financial and operational metrics. Employee considerations may include whether key workers can be recruited and retained and the impact a deal will have on company culture and morale.

Keeping the status quo

A company may decide to hold steady, implementing the existing business plan to increase profitability, finance growth with cash generated from operations and bank debt, and distribute excess cash to shareholders. Such an approach may limit the amount of change the company may need to endure, but it may also cap the amount of cash available for shareholder distribution. The company may also miss out on growth opportunities emerging from today's rapidly changing environment.

Strategic alliances

Strategic alliances can be used to move into new product lines and new markets. The advantages of such an approach can include retention of shareholder control of equity, potential operational synergies, and the ability to enhance competitive positioning and mitigate business risks. Alliances can also be formed and dissolved quickly.

Disadvantages of this approach can include diversion of management attention from core business activities as well as potentially creating control and cultural issues. Also, alliances may complicate business relationships with other partners that may have benefited from a strategic alliance with the company. Moreover, alliances typically do not provide capital to redeploy to other segments.

Recapitalization

There is a variety of possibilities available to companies that may seek to pursue a recapitalization and deep pools of available capital that may be accessed in order to meet the specific need and objectives of business owners and managers.

The use of debt is one of the most cost-efficient tools available to create shareholder wealth. It provides shareholders with cash as well as the opportunity to participate fully in future company growth. Debt recapitalization is also a potentially shorter process than the outright sale of the company. At the same time, it typically involves a leveraged capital structure that can put financial constrains as well as incremental burden on the business and pose risk to stakeholders. Also, few or no synergistic benefits may be realized in the transaction.

A debt recapitalization may be a particularly attractive alternative given the possibility of changes in current tax legislation. Specifically, one of the major reasons for an S corporation to consider a dividend recapitalization is the opportunity to reduce its cost basis by the dividend amount. This can allow the company to convert to a C corporation with limited basis. For both C and S corporations, potential changes in dividend tax rates suggest the need to complete a dividend recapitalization transaction in calendar year 2012 to realize the potential benefits.

Recapitalizing a company with a private equity partner can be a highly efficient way to attain the total value of liquidity. This can be done in a combination of senior debt, mezzanine, preferred stock, and common stock. Current shareholders retain a majority or minority interest depending on the strategy of the company, as well as the opportunity for future exit. The new partner can help to drive operating improvements and synergies by bringing their wealth of experience from other portfolio companies as well as their network of relationships.

On the downside, bringing in a financial investor can require a larger commitment of management time in the short-term to execute the transaction. Also, there is the potential for operational disruptions as managers navigate their new reality of additional shareholders, particularly in those transactions that have effectuated a change in control to the partner.

Growth through acquisitions

Both mid-market and large companies are increasingly turning to M&A as a means of bolstering moderate organic growth, particularly in an environment that may persist for several quarters if not years. In so doing, they are looking at possible acquisition opportunities both domestically as well as internationally, particularly in emerging countries. Unlike in prior cycles, there are now leading practices and significant precedent pertaining to perceived complexities in international deals, such as tax laws and issues related to cross-border movement of money and goods.

Global strategic acquisitions

Global expansion can provide mid-market companies differentiation and access to higher-growth economies such as Brazil and China, where manufacturers of consumer goods and retailers are pursuing customer base growth. A global acquisition strategy can leverage the capabilities of both the buyer and the target in the target's home market. A deal may produce higher top-line growth or margins from operating in lower cost environments as well as provide a differentiator that separates a mid-market company from its competition.

Conversely, global deals have different disadvantages, particularly for first-time buyers, including challenges in repatriating cash. In some cases cash cannot be taken into the United States without significant tax consequences. A business that generates significant cash abroad will need to consider whether to repatriate, put money back into the foreign operations, or make further acquisitions in the foreign country.

The company may also need to collaborate with a local business in the short term to overcome hurdles, or it may have to secure capital financing outside of traditional relationships. Differing commercial customs and economic factors can also delay realization of the anticipated benefits.

Brazil provides an example of both the positive and negative considerations in global M&A. The country's domestic consumption-led growth, demand for U.S. imports, improved financial markets, and monetary and fiscal policies are factors favorable to foreign investment. At the same time, "Custo Brasil," the term used to describe the cost of doing business there, acknowledges the complexity of the nation's legal system and labor and tax laws, as well as trade and border issues and funding considerations. Even with the considerations of Custo Brasil, companies are seeing a level playing field there vis-à-vis local competitors.

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Domestic strategic acquisitions

A domestic U.S. acquisition can allow rapid expansion of product offerings and market coverage while creating the potential for synergies in marketing, purchasing, distribution, and personnel all with the familiarity of dealing with markets in which the business owners and managers are most familiar. Depending on the manner in which it is financed and executed, an acquisition can also allow current owners to retain control and may position the company for a more valuable exit in the future. In some instances the quickest path to revenue and earnings growth is to buy a competitor, an adjacent product offering, or an enabling technology. Developing that technology or product line from scratch could take several years and provide limited benefits both to the company's bottom line and overall market positioning.

Acquisitions, whether domestic or international, are time and capital intensive. They can divert resources and people from daily activities, particularly in smaller companies that may not have the financial, legal, and tax capacity of larger businesses. Integration costs also need to be considered. While the company can take advantage of synergies, the costs can include one-time expenses for severance charges and rationalization of redundant IT infrastructures, as well as duplicative geographic and facility footprints. Additional capital commitments can also be needed post-transaction to capitalize on synergies.

Another consideration is the commitment of capital away from other opportunities. Companies conduct transactions in pursuit of the highest and best use of available capital. But while a transaction may have longer-term benefits, it could lock up capital that is not going to be available for other projects going forward.

Taking on a strategic partner

Disposition of the business may be an enticing alternative to consider depending on market conditions and the medium and longer-term objectives of shareholders, managers, and owners. In the current environment, business owners and managers are also weighing the additional consideration of an uncertain outlook for U.S. tax policies which may make a meaningful difference with respect to the after-tax proceeds received.

In this context, a strategic partner may provide higher value because of potential synergies and lower cost of capital. It also may offer support for pursuing organic growth that may have been previously inaccessible or deemed too risky by a mid-market company.

Strategic partners typically allow quicker entry into new markets given their existing footprint or have the experience in-house to help navigate hurdles. They can provide significant management and industry experience that may be harder to attract for a smaller enterprise. In addition, collaborating with a strategic player can provide significant tax advantages depending on how the relationship is structured.

Potential disadvantages of a sale to a strategic partner can include potential management and employee terminations and probable loss of significant management equity participation. The strategic partner may also wish to pay in stock rather than cash, which may be more or less attractive. In addition, a final issue to consider is the ongoing name and legacy of the company, which could be required to change, especially if the partner thinks it has a preeminent brand. Because middle market executives and owners often treasure the brand that they have built, branding is an issue to be considered carefully when evaluating a potential transaction with a strategic partner.

Taking on a financial partner

The private equity community's current demand for solid businesses is strong compared to recent historical standards. Private investors place high value on strong management teams and typically grant equity participation to align their interest, and the companies they collaborate with often retain their identity and employee base. The availability of a broader set of potential partners can allow deeper consideration of the best cultural fit.

Post transaction, capital may also be available for additional "tuck-in" acquisitions of companies that may be significantly smaller than the going-in transaction but fill a previously untapped product line or market.

Among the issues to consider is the manner in which financial partners compete on price. Financial partners are competitive with strategic partners in today's environment, but because they lack the opportunity for synergy benefits, they may seek other ways to attribute value.

Financial deals may provide fewer tax benefits than strategic acquirers. Also, a financial partner may require a continued carried interest on the part of the selling shareholders (especially if existing management are shareholders). Owners and operators may not obtain a hundred percent liquidity because a private equity firm may wish to ensure the full alignment of management incentives with their investment.

In addition, while the name, brand, and company for practical purposes should remain intact, private equity investors typically have a medium- to long-term goal of selling the business. Finding the right long-term home for the business may be an important consideration for the operating team in the initial transaction.

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Analyzing the opportunities

Whatever approach a mid-market company considers in order to realize the value of the enterprise, rigorous qualitative and quantitative analyses are essential. The exploration should be broad, but does not need to be complicated. Conducting a strategic option analysis can lead mid-market companies to find the right approach for today's complex conditions and continually evolving business outlook.

Perspectives

This white paper is just one example of a growing body of Deloitte research on topics of interest to mid-market and privately held companies. Presented by Deloitte Growth Enterprise Services, our Perspectives program utilizes live events, signature reports, research publications, webcasts, and other vehicles to deliver relevant insights to mid-market and privately held companies in an integrated fashion.

Please visit our Perspectives library on the Deloitte Growth Enterprise Services website http://www.deloitte.com/us/perspectives/dges to view additional material on issues facing mid-market and privately held companies.

Contacts

Bryan Barnes
Deloitte & Touche LLP
brybarnes@deloitte.com
+1 404 631 3452

Kevin McFarlane
Deloitte Corporate Finance LLC
kemcfarlane@deloitte.com
+1 213 553 1423

Paul Warley
Deloitte Corporate Finance LLC
pwarley@deloitte.com
+1 404 220 1331