AN ALERT FROM THE BDO PRIVATE EQUITY PRACTICE

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NAVIGATING THE RISKS OF POST-ACQUISITION ADD-ON INTEGRATION

As thousands of private equity firms chase a decreasing number of quality middle market targets selling for high valuations, much of the focus has turned to growing existing platform companies through add-on acquisitions.

In fact, Pitchbook recently noted that nearly 30 percent of PE-backed companies now undertake at least one add-on acquisition, compared to less than 20 percent that did so in the early 2000s.

The potential rewards driving add-on deals are plenty: these deals might come with relatively lower price tags, at least in terms of valuations, than would platform companies. Also, add-ons could help a platform company expand into new geographies, increase or diversify product lines, and boost buying power.

There are, however, plenty of risks when integrating add-ons into a platform company post-acquisition, and waiting for a deal to close to begin thinking about how an add-on will be integrated into a platform company can be a costly mistake.

As transition periods get shorter, it is imperative that acquirers be prepared ahead of time.

Here are some considerations to avoid pitfalls when integrating an add-on target:

SETTING THE STAGE

To effectively implement an integration strategy, the acquirer must gather information to develop a plan long before the deal closes.

In the information gathering phase, communication lines must be open so that input from different business units–such as human resources, accounting and finance, legal, IT, and tax–can be compiled. Not only will this avoid any problems from arising during the integration phase, it will also ensure that all units are on the same page regarding the goals and objectives of integrating the add-on target.

This will help the acquirer understand if the practices of its business units and the add-on target are in synch, if there are any redundancies that can be eliminated, and if there are any other cost-cutting or streamlining opportunities available. In other words, this will point out where the synergies are.

HOW DO I GET MORE INFORMATION?

CONTACT:

SCOTT HENDON
National Private Equity Industry Group Leader
214-665-0750
shendon@bdo.com

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A lack of proper integration planning and/or failure to conduct sufficient operational and commercial due diligence will inevitably lead to a failure to capture synergies. Any analysis for achieving synergies should be performed well before the deal closes.

LEGAL, HUMAN RESOURCES, AND TAX DUE DILIGENCE

An in-depth evaluation of the add-on target's legal, human resources, and tax situation is needed to identify issues that should be addressed. For instance, here the acquirer would learn of the assets the add-on target owns, uncover any issues surrounding employee compensation, benefits, or pension liabilities, identify if there are any permits or licenses needed to operate the business, or even learn of any litigation or tax liabilities the target has pending.

Additionally, for acquirers backed by a financial sponsor, the timing of an add-on deal could bring new tax implications.

Because of the Tax Cuts and Jobs Act, private equity fund managers could find their carried interest allocations subject to tax at the ordinary income tax rate rather than the more favorable capital gains tax rate. If a portfolio company has made an add-on acquisition less than three years before it is sold, the gains made on that add-on deal are subject to the higher tax rate. This said, properly tracking the holding period attributable to the disposed asset becomes critical, especially when a portfolio company is expanded through add-on acquisitions.

IT INTEGRATION AND CYBER RISKS

Evaluating the IT systems utilized at the add-on entity and how they can fit in with that of the acquirer's (or not), is essential to a smooth transition. For instance, if the add-on entity is using a different invoicing system than the acquirer, these will need to be harmonized to ensure invoicing systems can communicate at both the parent and newly acquired subsidiary levels. It is also critical to ensure IT systems at both levels will be compliant with any federal and state-level regulations.

And, since nowadays data breaches are a matter of 'when' and not 'if,' it is vital for the acquirer to conduct cyber due diligence to fully understand both the value of the information assets it is looking to acquire and the level of cyber threat and vulnerability facing the target add-on.

ANTITRUST ISSUES

The acquisition of an add-on could be subject to regulatory scrutiny to determine if the deal raises any antitrust concerns. This said, rushing to integrate an add-on target before obtaining the necessary approvals could torpedo the entire deal, as the acquirer and the target could face significant financial penalties for doing so.

AVOIDING POST-TRANSACTION DISPUTES

Many problems, such as post-closing purchase-price adjustments and earn-out calculations, have the potential to rear their ugly heads even after a deal is closed. Usually, these problems are the result of differing interpretations of purchase agreement terms. The best way to avoid these disputes is to work directly with the firms advising on the deal when drafting clauses related to closing balance sheet issues and ensure that all contracts are as explicit as possible and tailored to the specific deal, avoiding generic boilerplate language at all costs.

As private equity-backed companies embark on buy-and-build strategies to achieve growth, it will be important for them to develop a post-acquisition plan that can be repeated with each add-on deal. Not only will this save time and money, it will also increase the odds of a deal making it to the finish line.