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Understanding the Cost Structure of Acquisitions

By Lamont Seckman

In "*Conspiracy of Fools*," the recent book surrounding the Enron debacle, there is a description of a merger between two large companies that is announced within eleven days of the first dialogue of the concept between business principles. It is amazing that large corporations sometimes make hugely important decisions with such little time for analysis or reflection. [Perhaps one indication as to the book title?]

Conversely, it is also surprising how *long* deals can take for much smaller businesses to come together in the *privately*-held, wholesale beer arena. Such time delays can be frustrating for all involved, but at least should allow participants to conduct adequate due diligence and investigation.

Everything is Relative

When large companies get together, the revenues of even a sizable beer wholesaler are literally a rounding error. Large public companies often pay very high value multiples for businesses so small that limited public disclosure of the transaction is even required due to the "immateriality" of the transaction to the buyer. My sense is that buyers in such transactions have little time or motivation to dive deeply into the true economics of such deals and are unmoved by the dangers of high valuation multiples. *They know that nobody is going to go broke if too much is paid!*

Similarly, in the beer distributor environment, companies looking to transact brand rights associated with a product with annual volume measured in the four, or *low*-five figures, rightly spend little time trying to understand the impacts of the transaction on annual operating costs. Deals with such small volume, relative to the size of the buyer and/or seller, likely have immeasurably small impacts on the cost structures of either business. Often, such deals are driven by the understanding principles on both sides of the fence have regarding certain anecdotal transactions, generally perceived "*market multiples*," or industry "*rules-of-thumb*" that exist for the brand rights of beer products. In many cases, this approach probably works fine for all involved.

As an advisor and representative in transactions, and also as an analyst brought into to assess certain situations in litigation, I get to "peek-under-the-hood" of many deals from various angles. I recall recently reading the deposition of a business owner whose company was put into a precarious financial position as a result of a relatively sizable acquisition. He indicated that little due diligence was performed prior to his company making the purchase. Instead, much reliance was placed on his prior experience leading his company through "brand" acquisitions and through his understanding of "blue sky" value multiples. From all accounts, little real investigation or planning was performed to understand the true economics of the transaction and the resulting value-added from the purchaser's perspective. Unfortunately, this situation is not uncommon.

When a *Brand* Deal becomes a *Business* Acquisition

As in many aspects of life, there is no magic answer as to when a proposed transaction should be classified as a "brand" deal, as opposed to the acquisition of a business. Again, it is a relative assessment of the size of the transaction compared to that of the deal participants. But one thing is clear, the more a deal *looks* like a *business* acquisition - and less like the transaction of a relatively small-volume *brand* - the more important due diligence and valuation assessment becomes. Keep in mind that buyers can afford to make mistakes in the valuations of brand rights when the volume at stake has little overall financial impact. But at some level, such mistakes *can* and *do* result in significant pain.

Related to the concept of brand vs. business acquisitions is the idea of "vertical" vs. "horizontal" deals. A "*vertically*-oriented" transaction is one driven by a merger of two competing businesses covering essentially the same account base. Conversely, a "*horizontal*" transaction more resembles the consolidation of neighboring wholesalers with like brands. Obviously, the economics for these deals are different and more compelling for the vertical acquirer.

Incremental costs to support an acquisition are impacted by both internal and external factors. Buyers should have an adequate understanding of their internal cost structure as this has obvious and significant influence on deal economics. However, some aspects of the seller's cost structure are inherited and may not "wash" out of the "P&Ls" for quite some time. Additionally, suppliers with leverage in the transaction will likely take the opportunity to exact their "pound-of-flesh". *How demanding will the supplier be in your case?* I suspect a supplier is generally more demanding in a transaction when the proposed acquirer is perceived to have *under*-invested in its own operating capabilities over the years. Nevertheless, getting approval for transactions from demanding suppliers can often be more expensive than anticipated impacting projected operating costs for years.

And how many buyers are experienced in analyzing projected operating performance? I am surprised at the number of sizable beer wholesalers that are not adequately skilled in the preparation of annual financial budgets. I have talked with owners reluctant to implement pay-for-performance (PFP) systems tied to their financial budgets because they lack confidence in the ability of management to project for 12-months. These same owners then rely on internal projections for years to come as the basis for making a sizable business acquisition. How many owners prepare internal pro forma for multiple years into the future as a part of their ongoing, internal assessment of the state of their business? If such an exercise leads to increasing – or decreasing – value, how should this impact the acquirer's perspective on a potential purchase?

The assessment of important transactions needs to look further out into the future than one year. What are the normalized, historical cost trends of the business? How do fixed costs, variable costs, and step costs impact future cash flows? What capital expenditure requirements should be plugged in as investments? What increases in working capital should be expected? What are the key financial ratios analyzed by financing institutions and suppliers? What margins of safety should owners target? Should the cost of existing - but unused - warehouse space be included in the analysis? How long should it take for the investment to pay off? How does all of this translate to fair market value?

Distributor managers need to adequately address these and many other key questions for their owners prior to the consummation of important business acquisitions.

I generally find in a horizontal transaction that a buyer should be able to shave around – or greater than - 20% of the annual cash operating costs of the seller [using a "normalized" expense total as the baseline].

Vertical deals have perhaps more variability due to the nature and size differences of participants in various transactions. I have found that acquirers in vertical transactions should expect marginal, normalized cash operating expense structures anywhere from 30% to 60% of incoming gross profits [i.e. the incremental, annual cash operating expenses resulting from the purchase divided by the annual gross profits received from the purchase]. Indeed, the higher-end of this range for verticals starts to overlap the economics seen in horizontals. The wide range is due to such varied economics seen in transactions. Much of this is impacted by variances seen in gross profits on a per-case basis. Is it any surprise that relative profits are considerably higher for volume generating $4 per case in gross margin – compared to volume generating $3 or less? If incremental operating costs are $2.50 per case, does a brand contributing $2.50 per case of gross profits even have any intangible value? [A subject for a future article.]

Variances in gross margins on a per-box basis relate to product mix, but also geography. While relative operating costs tend to fluctuate somewhat in correlation with gross profits across territories [i.e. higher cost areas tend to have higher margins per box], this is not always the case.

From an investment standpoint, beer wholesale businesses generally need to invest around 1% of their annual net sales on capital expenditures. Again, this figure can vary according to recent spending patterns and the nature of asset ownership [i.e. real estate partnerships, fleet leases, etc.], such that a more relevant range to look at is perhaps 0.8% to 1.2% of net sales. This range likely captures the situations of many wholesalers.

Summary

Even with the downturn experienced in the industry of late, the economics for many proposed business combinations of beer wholesalers are compelling. But managers in transactions with meaningful financial implications on both sides fail their owners if adequate planning and due diligence is not performed. The incremental operating cost structure required to support an acquisition is a significant variable impacting the return – and hence, value – of a transaction. Yet many transactions are conducted without an adequate understanding of true marginal costs and depend too heavily on vague understandings of industry rules-of-thumb. If large corporations can conduct high-dollar transactions in limited timeframes, surely beer distributors have the time to thoroughly investigate the real economics of business combinations.