M&A For Staffing Services:
How Buyer's Can Successfully Navigate the M&A Landscape

By Steve Sorrentino, Principal, MergeQuest

Buying a business can be a tedious, time-consuming and expensive endeavor, filled with risks, liability and frustration – and this is never more the case than in today's uncertain economic environment. But take heart, for buying a business can be a richly rewarding and satisfying experience if done with care and foresight – one that can quickly add new geographic markets, new clients and expanded service offerings – not to mention the rapid rise in your combined business revenues and profits. And let's not overlook the addition of new, talented employees.

As many in the Staffing Industry are aware, staffing firms have been severely affected by the lingering recession over the past few years. By most accounts, staffing revenues are off by upwards of 20% to over 50% in some instances, especially for those staffing firms in the traditional commercial staffing sector, including Light Industrial and Office Support staffing. The good, news, fortunately, is that many leading economic sources point to a rising trend in temporary staffing hiring – which if continues with consistency during 2011, will lead to an increase in acquisition activity within the Industry (not to mention the current market activity from industry buyers that are currently searching for 'value' transactions in light of challenged seller financial performance during the recession).

With the potential for increased M&A activity in mind, I have been contacted by several potential buyers who have asked me about how to structure transactions in today's market – in light of the recent economic downturn. They have also asked me about what potential sellers are thinking about as they consider the sale of their business.

Sellers are wary and skeptical

During the past year, and in particular during the past few months, I have had the opportunity to not only represent several staffing firms for sale but have also conducted my own personal assessment of potential staffing sellers beyond those that I represent – to see what was on their minds as they thought about exploring the M&A market as a seller.

Not surprisingly, of the thirty or so staffing owners that I interviewed, the majority of them expressed concerns about several key aspects of selling as it related to their expectations for value, including concerns about:

- Depressed market value for their business due to falling or stagnant revenues and net profits over the past year;
- Rising cost of capital from alternative financing sources (such as funding companies) due to loss of traditional banking relationships;
- Higher debt levels with upside-down, debt-to-equity relationships;
- Rising incidence of bad debts due to client bankruptcies;
- Human Capital constraints – from staff layoffs and few new hires.

With these business challenges in mind, though, several staffing owners indicated their willingness to "test" the M&A market – to see what kind of a deal might be possible.

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In several instances, staffing owners expressed their interest in finding a larger and financially stronger company to partner with – one that would provide help with marketing, infrastructure support and financing among other things.

Motivations and Expectations

And so where there is possible motivation on the part of sellers to explore the M&A market, there are also concerns and expectations that sellers expressed in earnest, expectations that would greatly facilitate the potential sale of their business, especially in light of what many perceive as a "buyer's market" in the Industry today. Three of the consistent key concerns and expectations that I heard include:

- Seller's fear that since their revenues and profits are depressed, that there is no way to realize greater market value beyond the traditional methods of Industry market valuation and transaction structures;
- Seller's are concerned that Buyer's are only interested in acquiring distressed companies in this market – with little or no cash down and at bargain basement pricing;
- Seller's have expectations that Buyer's should take a more collaborative, "win-win" approach to structuring deals – especially if a seller's business is either holding its own or is showing slight signs of financial performance improvement.

Win-win transaction structures

As a basic, prudent tenet to any acquisition, Buyer's will want to balance "risk" – which means that they will want to share the financial risk with a Seller on a go-forward basis. That said, and with the concerns of (potential) Seller's in mind that I spoke with, I thought that some of the ways that Buyer's might address Seller concerns and expectations (in the spirit of attempting to get a deal done between the parties), is to consider some of the following transaction structure suggestions, such as:

- Considering an initial value structure that looks not only at the trailing twelve month financial performance of the Seller but also looks forward to the next six to twelve months;
- Allowing progressive upside value for improved financial performance – on a contingent earnout / pay-for-performance basis;
- Avoiding contingent earnout "cliffs" – which essentially stops any future earnout value and payments below certain financial performance thresholds – with no hope of possible future recovery;
- Alternatively considering a deferment of any contingent earnout downside – which simply postpones any earnout payments but allows a deferment of the earnout value (and payments) under certain circumstances;
- Purchasing the Seller's Accounts Receivables – which will improve the Seller's cash down component of the transaction – allowing the Seller to liquidate secured debt – which in turn facilitates the release of any UCC-1 claim against the Seller's assets;

As you can see, there are a number of alternative structural considerations that can be employed when approaching potential transactions in today's challenging economic environment. Like any worthwhile undertaking, some creative thinking outside the box can prove to make all the difference in constructing deals that continue to balance M&A risk – while working for both Seller and Buyer.

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Pre-Shopping Preparation

Before you begin shopping for acquisitions, you are well advised to consider why you want to make acquisitions in the first place. In short, what are your goals and objectives in your M&A endeavors? Let's take a closer look at the most common reasons:

- Grow revenues & profits
- Increase market share
- Expand and diversify service offerings
- Enter new geographic markets
- Obtain new clients
- Acquire human capital (i.e. new management and personnel talent)
- Create economies of scale through sharing of SG&A expenses

Armed with this basic framework, you are now in a position to at least begin the formation of your M&A strategy, coupled with the initial formation of an acquisition "profile" (which I will discuss in more detail in the next section).

Equally important to the development of an M&A strategy is the selection of an M&A team for your organization. Typical M&A teams are made up of a financial advisor (usually the CFO), a legal advisor (either in-house counsel or an outside attorney) and a team leader (typically the CEO or an internal Business Development executive). Many staffing owners also engage an outside M&A advisor to help focus, coordinate and advise the team.

Next on the list is to consider how your acquisitions will be financed. In today's Staffing Industry M&A environment, one can expect to pay at least 25% to 50% of an acquired company's value in cash at closing, with the balance of value tied to either promissory notes and / or future, contingent payouts – which are known as "earn-outs". Earn-outs are simply future payments for an acquired firm's value that are contingent on the future financial performance of the business. With these financial obligations in mind, you are wise to decide early in the game whether your firm will require bank financing and if so, now is the time to open discussions with your bank. In the case of public companies, the option of utilizing stock as currency is always an option, although you must weigh the recent performance of the stock and decide whether it makes sense to capitalize on its current market value.

Target Practice

Once your M&A strategy is developed and your acquisition team in place, it's time to develop a clear picture of what you want to acquire in the way of an acquisition profile.
A well developed acquisition profile will include most of the following key target profile considerations: type of services and skills offered, operating business model, size of business (annual revenues), rate of profitability, geographic preference(s), markets served, client profiles and diversity and management and personnel profiles.

With a clear picture of your acquisition target profile in hand, buyers need to develop a targeting methodology for potential acquisition candidates. Some of the more common ways to identify potential candidates involves the use of industry directories, trade association mailing lists, word of mouth with your sales staff and finally, engaging a professional M&A advisor.

Once you have identified, contacted and engaged a prospective acquisition candidate, you will want to have a preliminary discussion with the firm's ownership to determine their reasons for selling along with a discussion covering an overview of the firm's operating characteristics,

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business model and financial history and performance. You will also want to obtain a copy of the firm's financial statements for the past 3 to 4 years so that you can assess the firm's revenue trends, cost structure and rate of profitability.

You are well advised to have a face-to-face meeting with a prospective seller to "size them up" – to see if the chemistry between the parties feels right. Bear in mind that post-transaction you will have to work with one another, so it's important to be certain from the start that the chemistry between the parties will work. The other important point to bear in mind is that buyers want to be diligent in their assessment of the seller's "synergy's and fit" – that is, to carefully weigh whether the seller's business model, operating characteristics and culture fit well with the buyer's business.

Let's Make a Deal

If, after carefully reviewing and assessing the seller's business and management you feel the potential opportunity between the parties to join forces makes a great deal of sense, then it's time to make an offer. My strong advice is that any offer you make should be delivered in a straightforward and sincere manner and not without careful forethought and consideration. My point is that your initial offer will be the first serious step in a series of communications with a prospective seller about the acquisition of their business, and it is this first piece of communication that will set the tone for the balance of interactions and negotiations between the parties going forward. If your initial offer is fair and reasonable, you will find that the seller's response will usually be fair and reasonable. If, on the other hand, your initial offer is a "low-ball" or insincere offer, then expect the seller to play the same game – and so on.

Presenting an initial offer to a seller can be done in one of a few ways: either informally with what is know as a Term Sheet, or more formally in a Letter of Intent ("LOI"). Each method has its pros and cons, it all depends on how formal you want to make the initial offer. My sense is that the Term Sheet should be sufficient for deals with values under say $10 million. Things to include in the Term Sheet (or LOI) will include the following transaction proposals: overall business valuation, assets or stock to be acquired, deal structure (cash down and future payment amounts and timelines), Promissory Note terms, earn-out terms and timelines, Non-Compete terms, Employment contract terms, due diligence timeline, proposed date, time and place of closing and any special terms that might be appropriate to the transaction.

A few caveats regarding deal structure and possible (unfavorable) tax ramifications: obviously, both parties to any M&A transaction want to take advantage of the most tax-minimizing transaction structures. With this in mind, buyers want to initially focus on the seller's form of business, for example: is the seller's business a sole proprietorship, a "C" corporation, a subchapter "S" corporation or an ""LLC"? Each form brings its own unique set of sale-related tax consequences that will be driven by the way in which the deal is structured.

Briefly, M&A transactions are structured as either *asset purchases* or *stock purchases*. In the case of sellers with "C" corporations, the seller usually receives favorable capital gains tax treatment on the sale of stock vs. the sale of assets. The sale of "C" corporation stock also avoids what is known as "double-taxation" for sellers vs. an asset sale (the sale of "C" assets are taxable first at the corporate level and then taxed again at the personal level when the sale proceeds are distributed to shareholders). However, most buyers are reluctant to buy "C" stock as it brings potential liability with its purchase, hence the conflict that arises with transactions that involve "C" corporations.

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Conversely, both "S" corporations and "LLC's" have no such restrictions, and so these types of organizations can easily offer a purchase of their assets (vs. stock) without ominous taxable consequences to sellers. It is wise at this juncture to consult with your CPA or tax advisor regarding the most tax-advantageous way to structure the transaction – bearing in mind that the structure must also make sense for the seller.

Finally, buyers will want to prepare a comprehensive checklist of transaction-related due diligence items for the seller (and timeline) to be reviewed by the buyer's M&A team – paying particular attention to matters of a legal, financial, tax and governmental-compliance nature.

Closing the Deal

One of the more important post-closing actions to prepare for (in conjunction with the seller) will involve the manner and timing of the acquisition announcement to employees, customers and vendors. My advice is that you give the announcement some careful forethought and consideration as to its content and timing.

Well thought-out and planned visits to key customers is a must to ensure their continued loyalty and patronage. When you make the visit to key accounts, it is the perfect opportunity to promote the positive aspects of the merger, as well an opportunity to tell them how it will benefit them as a valued customer.

Finally, and perhaps the single most important post-closing challenge, will be the integration of the seller's business with the buyer's. Success with integrating two companies and two cultures has a great deal to do with how well you manage the ***people*** side of the transaction.

Bear in mind that any merger or acquisition brings uncertainty about the future and fears about job security – and that these are normal responses from employees – so it is very important that you communicate openly, expeditiously and frequently with employees about what is going on and what they should expect – to ease their fears and to gain their needed support.

In conclusion, if there is one key thought that I would like to leave readers with it is that my years of experience with M&A that has shown me that buying a business is not simply "all about the numbers" – but rather a multi-dimensional undertaking that encompasses both quantitative and qualitative considerations. And like most of the finer things in life, once you have acquired a true taste for M&A, you will soon discover just how refined and discerning your senses will become to select the highest quality businesses to acquire.

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