DRIVING YOUR STAFFING FIRM
GROWTH BY ACQUISITION

11-STEP GUIDE TO AN EFFECTIVE ACQUISITIVE GROWTH STRATEGY
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Staffing companies considering an acquisitive growth strategy cannot go forward blindly with guesswork and conjecture. That’s a recipe for disaster and will waste considerable time, money, and other resources.

This eBook provides an 11-step guide to help staffing business owners efficiently accomplish a successful acquisition. Learn how to avoid destructive efforts and implement sound best practices to make astute decisions through the acquisition process.
Introduction

Merger and acquisition (M&A) activity remains a hot topic in the staffing industry. With the exception of the spike in 2015, transaction volume during the past six years has been fairly stable, according to Staffing Industry Analysts’ Staffing Mergers & Acquisitions Annual Report: 2016. Furthermore, news from Duff & Phelps, the premier global valuation and corporate finance advisor, reveals interesting statistics:

- M&A activity in the staffing sector has averaged approximately 30 transactions per quarter for the past two years, up approximately 20% from the 2012-2014 time period.
- IT staffing continues to be the most active staffing M&A sector, with 29 transactions reported in 2016.
- Professional staffing companies (including IT, Healthcare, Finance & Accounting, and Creative/Digital Staffing) continue to see the most widespread demand from buyers.
- In 2016, 85% of the transactions were completed by privately owned buyers, with only 15% acquired by publicly traded entities.

What are most buyers looking for? SIA says, “Companies with scale, excellent growth rates, and management teams seeking to continue the growth of their businesses while taking some money off the table are proving to be very attractive investment platforms for many private equity buyers interested in the business services sector.” Before you dive into the deep end of exploring your acquisitive growth strategy, understand the following 11 Steps.

This eBook will guide you through the process of a staffing firm acquisition, including how to identify your motivating factors, get deals flowing, understand valuation drivers, perform due diligence, drive to a merger agreement, and plan integration.
**Step One** Determine Why

Why do an acquisition in the first place? Obviously, it’s to make your company stronger, but define ‘why’ in clear specifics about your business.

Are you considering adding new service offerings? For example, you might be strong in per diem healthcare and want to expand into travel nursing.

Are you looking into geographic expansion? Do you have a really strong footprint in your region and want to establish new offices? Look for opportunity in other states or regions in close proximity.

Through analyzing your business you may have discovered some client concentration issues. Capturing new clients or diversifying existing revenue may allow you to grow at a quicker pace in the market.

In every case, you really want to hone in on reasons that are going to work for you.

**Step Two** Generate Deal Flow

Seeking target companies is perhaps the hardest part of the whole process. Start with your own professional network. After that, you may need to engage an investment banker or business broker.

Always keep in mind ‘why’ you’re pursuing an acquisition and share that perspective with your business broker or investment banker. Understanding your reasons and motivations will help him/her guide deal flow and advise accordingly.

“Why are you pursuing an acquisition in the first place?”

*It is essential to understand the answer to this question as it specifically relates to your company.*
Step Three Get to a Non-Binding Letter of Intent (LOI) Quickly

After deal flow is in motion, you want to get to a Non-Binding Letter of Intent (LOI) as quickly as possible. This is one of the most important aspects in M&A (especially in smaller deals). Move with efficiency, sign a Non-Disclosure Agreement, and ask the seller for a minimum amount of information that will inform your decision-making to establish your LOI.

The minimum amount of information required is two years of historical financials and projections for the current year. It’s best if the financials have been either reviewed or compiled and audited by a third party.

Review this information carefully to get a sense of the company’s earnings and the value of the business. This isn’t the due diligence stage yet, just some quick assessments to determine if you would even want to consider making an offer.

Don't waste time! Get to the Non-Binding LOI quickly. If the seller wants $10M and you're willing to pay $5M, that's a big bridge to cross. You don’t want to waste a lot of time and money working toward an acquisition when it’s clear very early that you’ll likely never see eye to eye on the company’s value.

Step Four Conduct Preliminary Due Diligence

At this stage, you're investigating things to understand your target company's quality of earnings. Questions to ask include:

- Are the earnings relatively consistent year-to-year?
- Do you see anomalies in the P&L that give you concern?
- Regarding their balance sheet, is there sufficient working capital in the business?
- How do the pro-forma financials look?
- Is there a client concentration issue?
Ultimately, the goal is to get to the next step – a ballpark valuation – as quickly and as inexpensively as possible. This acquisition process is time-consuming and distracts you from running your business. If you find an appealing entity and the due diligence reveals encouraging numbers, then the faster you can get to a ballpark valuation the better.

Bear in mind that this Step Four is “preliminary” due diligence; there will be much deeper research later in the process (Step Seven).

**Step Five** Determine Ballpark Valuation

A business’ value is a combination of three components: Balance Sheet, Multiple, and EBITDA, which is Earnings Before Interest, Taxes, Depreciation, and Amortization. Deals done in the staffing industry are normally done on a Multiple of EBITDA.

In short, enterprise value is EBITDA times your multiple. Equity value may not be the same, especially if there’s long-term debt on the balance sheet. You want to see how strong or how liquid the balance sheet is – or in other terms, for every dollar of liabilities a company owes, what does it have in assets?

In staffing, when you look at the assets, you’re primarily looking at accounts receivable. Any other assets are usually soft, like prepaid expenses or something similar. Also determine if there are sufficient receivables to pay off the liabilities, as this will impact valuation.

In staffing there are specific qualities that weaken the multiple and qualities that drive it up.

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Step Six  Fish or Cut Bait with LOI

By this stage, you’ve looked at the target company’s financial statements and its working capital on the balance sheet. You also have a sense of the multiples in the industry. So now it’s time to fish or cut bait with your Non-Binding LOI and put an offer on the table.

While you may need a lawyer to accomplish this, you still don’t want to be spending a lot in professional fees at this stage because you don’t know if your offer to acquire will be accepted.

When submitting your LOI, you want to provide the offer as a range. For example, “We’re interested in acquiring ‘x’ company in a range between $4-4.5MM.” This allows you some ‘wiggle room’ – if the seller is expecting 4.5, then you’re within the ballpark. Your offer also needs to detail the structure of your deal:

- How much of that 4-4.5 is going to be cash down?
- Are you going to ask the seller to take back a note?
- Will you offer stock in the new company?
- Will the deal structure involve an earn-out and what are those arrangements? What’s your financing contingency?
- When is the expected close date?

Also clarify if you are buying assets and assuming certain liabilities, or if you are buying the equity of the company. If the former, then those details will be named in the merger agreement.

In staffing, what you’re normally buying is the accounts receivable, plus all the soft assets, like the brand name, the trade name, and the intellectual property. Standard liabilities include payroll liabilities, tax liabilities, those liabilities that are on the balance sheet, and then any others you agree to.
On the other hand, if you’re buying equity, then you’re getting everything. So, if six months after the sale an employment suit comes up for actions dating to a period prior to the change in ownership, it’s now your problem, whether you knew about it or not. Be clear: there’s a big difference between buying assets and assuming a limited set of defined liabilities, or just buying equity.

**Step Seven  Conduct Thorough Due Diligence**

This stage of the process involves:

- Reviewing operational audits
- Assessing the financial situation
- Reviewing customers, services, and strength of relationships
- Reviewing tenure of key employees and their salary and bonus history
- Assessing the depth of executive management team
- Considering risk management issues

There are a few key points to consider here:

- During the full operational audit, you should develop intimate familiarity with the company’s standard business processes – anything from hiring to financial reporting, including all technology used in the business operations.

- When reviewing the business mix and clients, compare to other businesses in that space.

- When you’re looking at their financial situation, what’s been their growth in revenues during the last two years? What direction is the company headed?

- You also want to obtain details on client contractual agreements. In situations with a Fortune 100 or 500 client, they may have non-assignable options in their agreements. As you’re gathering details about the company’s current client mix and concentration issues, also look at any notable contracts in place.

If the deal ultimately goes through, you will return to some of this due diligence research and analysis later to help you with the integration plan.
Step Eight Evaluate & Mitigate Risk

The true cost of a transaction may be higher than expected based on losses and other liabilities discovered during due diligence. Protect yourself against the risk of acquiring unknown and potentially uninsured liabilities (and maximize the transaction’s value) by addressing risk management.

Seller’s Insurance

Understand the seller’s insurance structure and program for all lines of coverage. Obtain the current year’s insurance policies as well as 2-3 prior years’ insurance policies. Examine the provider, costs, and potential gaps in coverage that may impact you post-acquisition. This information may also help you determine how well your existing program matches up in terms of coverage, deductibles, and policy structure. Evaluate new risks and establish a transition plan to support continuous insurance coverage both pre- and post-transaction. Make sure you have enough time to secure new and additional insurance coverages. Obtaining additional insurance coverage doesn’t typically happen overnight. Allow time to obtain the best pricing and get the coverage you need in place prior to the transition.

Seller’s SUTA Experience

Managing risk will require you to evaluate the seller’s workers’ compensation and state unemployment tax (SUTA) loss experience. If you have an acquisition strategy that involves geographic expansion into states you don’t currently operate in, SUTA is going to be an important consideration and impact your acquisition. The financial impact could last a few years. Laws vary dramatically from state to state and you need to have or secure experience to know what you’re getting into.
The tax rate options could include these three points: (1) the state mandates the buyer to accept the prior operator’s rate, (2) the state allows the buyer to keep their existing rate, or (3) the state uses a blended rate of combined entities. You need to understand the SUTA rates where your target company is doing business, as well as all state laws. If you have any questions on this during the due diligence process, it may be wise to speak with an attorney specializing in this subject.

**Other Liabilities**

Don't neglect other liabilities and areas of potential regulatory concern, which typically take the form of material claims, litigation activities, and regulatory matters:

- Material Claims - Are these covered under the buyers’ policies?
- Litigation – Look at pending, threatened, and settled activities
- Regulatory – Review any notices, citations, and fines

Review all open claims and litigation matters to verify coverage. Review the loss runs provided by the insurance carrier to ensure that the limits are sufficient and that the insurers are solvent. A comprehensive liability review provides insight into the quality of the business you are considering buying.

Ultimately, responsibilities related to liabilities will be clearly defined and negotiated within the merger agreement and be considered as part of the escrow. However, you should understand material claims, litigation activities, and regulatory matters to be better prepared when evaluating your existing procedures and prioritizing any changes you’d need to implement post-acquisition. This will help alleviate future issues that you would be responsible for as a combined entity.

You may choose to work with your risk manager or insurance broker to develop a plan that ensures comprehensive coverage is in place prior to closure. Doing so will help eliminate any potential prolapses in coverage and confirm you have coverage in any new states where you’d be operating after the acquisition.

When involving professionals, be mindful of fees and what the process is costing you and manage what you can yourself. This said, you should seek counsel that you believe would help you avoid costly problems in the future.
Step Nine Assemble Your Professional Team

In Step Two, we identified that you may want to draw on the services of a professional investment banker to find you the deals and guide you through that aspect. You have also sought legal counsel in Step Three to assist with drafting your Letter of Intent.

To see an acquisition through effectively, your professional team should also include accountants who know tax implications for both you and the seller. Finally, you may require your lending banker be involved to help you finance the deal.

Use the resources of your professional team judiciously. If the deal goes nowhere (and this applies to many), then you’d still have to pay your professional team regardless of whether it moved to a deal or not. Rely on partners you trust to help with decisions you can make with confidence. You’re spending significant time and money in this acquisition, don’t cut corners in this area, but don’t let the meter run in areas where it’s not essential.

In Step Ten, you will involve a lawyer experienced in M&A to accomplish the merger agreement.

Step Ten Time to Close & Draft the Merger Agreement

It's time to revisit your offer. Remember – that LOI was non-binding for a reason. Now you negotiate based on all you’ve learned about the target company through the process.
For example, perhaps you can adjust your vision of the target company’s value at $1MM EBITDA because:

- You’ve identified the seller is taking excess owner’s compensation of $100K that will cease when you buy the business
- You’ll eliminate the seller’s country club fees ($20K) and family vacation ($25K) running through the business as expenses
- You’ll save $35K when you move that firm to your IT platform
- You won’t need the seller’s accountant, so save another $10K
- Your SUTA is better, so adjust for another $75K
- Your Workers’ Comp rates are better
- You’ll assume there’s one duplicative position you’ll be able to eliminate

Taking all those things into consideration and you realize EBITDA under your ownership is $1.4M. If you pay $4M for the acquisition, you’re really paying a multiple of 2.85 (while the offer appears as 3.5).

**M&A Lawyer**

When you’re ready to begin drafting the merger agreement, you now need to get your lawyer(s) involved – a lawyer experienced in doing M&A. Don’t use a lawyer specializing in real estate or divorce law. Take no shortcuts here – it’s not worth it in the long run.

Your M&A lawyer will draft representations and warranties, which are basically the underlying matters or facts as they are being presented in terms of the contract. In addition, there’s the concept of escrow buckets to address. Maybe you identify that the first $100K of claims is accounted for in the “escrow fund.” After that, any liabilities fall on you.
Step Eleven Focus on Integration

Congratulations, you just made an acquisition! It may feel like the finish line, but in many aspects it’s just the beginning and the hard work ramps up. Now that you’ve closed the deal, you have to integrate the company, and that requires a plan.

Remember back in Step Seven when we said you’d eventually return to the facts uncovered in due diligence? Now’s the time! Your integration plan must address the roles of management you acquired, the IT platform, the accounting platform, branding or rebranding of the company acquired, and an overall communications strategy.

Lastly, you may find it valuable to assign a respected staff member (from either the company you acquired or someone within your business) to oversee activities and serve as a main point of contact between organizations as they come together.

Conclusion

All acquisition initiatives must embark by answering the “why?” question. Growth is a clear motivating factor, but go deeper to find what’s driving this decision for you. Keeping that purpose in mind will guide your scope of targets, strategy, the process, etc.

Whichever approach – geographic expansion, new service offering, etc. – it’s clear that driving your staffing firm’s growth by acquisition requires that you invest a significant amount of time, resources, and energy. When you proceed to a close, it will also require your capital.

As outlined in this eBook’s 11 Steps, buyers must proceed through the acquisition process with extreme care, trusted advisors, a clear perspective on the value of your acquisition target, and defined expectations for a plan of integration.
A Partner You Can Trust

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