RMIT ACTIVATOR ENTERPRISE INSIGHTS

Are startups the M&A strategy of the future?

September 2017

RMIT activator

Foreword

For more than 10 years, SmartCompany has been documenting Australia's small business and startup activity, following every success and failure, every arrival and departure. It's a compelling story of daring-do, creativity, and bloody-minded determination.

While the nature of these businesses varies wildly, with many of them traversing genuinely unexplored territory and none of them impervious to the disruption of constantly changing business models, what remains a common value throughout all of them is growth. They are growth-businesses, unwilling to stagnate or sit in arrested development, and they are always striving to reach new heights and challenge old thinking.

But something may be holding some of these businesses back from realising some of these growth opportunities. As this report reveals, there may be a perception out there that acquisition is not seen as a market growth opportunity. Of those companies actively interested in the acquisition market, 58% of them are either small or micro-sized businesses. So we know small businesses are less risk averse and up for reinventing their businesses. We also know that three in five businesses would prefer a small partner. It's just that acquisition in general is not being included for consideration in their overall business growth strategies.

SmartCompany's purpose for existing has always been to see Australian small business boom. With this report we take part in a new conversation, one where the SME and startup community can look at the issue of M&A afresh and what it means for the growth of our small and independent business sector, not just from the perspective of what it means for the big players.

Zoe Dattner
Publisher, SmartCompany

ABOUT RMIT ACTIVATOR ENTERPRISE INSIGHTS

Welcome to the second RMIT Activator Enterprise Insights survey. It is one of a series in which we examine key topics related to enterprise and entrepreneurship as seen by the broader RMIT Activator community as well as local businesses.

In our second Insights survey, we asked both startups and other businesses about their attitudes to acquisitions. We compared their growth strategies, their readiness to enter into an acquisition, what they look for in an acquisition partner, and what they would hope to achieve through an acquisition.

It is important for entrepreneurs to understand the acquisition market and what businesses are looking for, to enable them to position themselves as best they can. It is also becoming increasingly necessary for businesses to consider a growth strategy through acquisition as startups drive innovation and disrupt their industries. While commercial success remains vital to both parties, the merger and acquisition (M&A) of the future is one of aligned vision and collaboration rather than a quick fix.

As well as the insights from surveyed businesses, we also call upon entrepreneurs and businesses in the acquisition market to comment on the impact and application of the findings based on their experiences. These Insights surveys aim to support and inform our startup community as its members work towards launching their businesses.

We certainly hope you enjoy the second in the series of RMIT Activator Entreprise Insights for 2017.

- Renzo Scacco, Director RMIT Activator

Contents

Executive Summary

This RMIT Activator Enterprise Insights survey compares the attitudes and approaches to acquisitions by both startups and businesses with the aim of breaking down barriers and defining the M&A of the future.

The key findings of startups and acquirers in Australia are:

- **Businesses are still hesistant when it comes to entering into the acquisition market** whether as a buyer or seller. Only 5% of businesses consider growth through acquisition to be their preferred growth strategy and 47% of survey respondents were not open to acquisition.
- **Small businesses are just as interested as large businesses in making an acquisition.** Small business respondents make up the largest group of businesses in the acquisition market (27%). Overall, about three out of five businesses looking to make an acquisition are sole traders, micro businesses and small businesses (58%).
- **Businesses are not only looking for startups making a profit.** A significant 75% of businesses are interested in startups that can show rapid growth and an ability sell anywhere.
- **Businesses of all sizes are risk averse when it comes to acquisitions**, represented by the size of acquisition partner they seek. Three in five businesses are looking to work with businesses smaller than themselves. Just over one-third of acquiring companies and 21% of startups are looking for businesses with a similar revenue.
- **Strategic fit is the most important feature that both parties look for in an acquisition partner.** However, there are more differences than similarities in what they look for. Startups place more importance on cultural fit, while acquirers favour operational fit, governance arrangements and the ability to work with the new management team.
- **Startups and acquiring businesses mostly want the same outcomes from an acquisition,** which comes down to commercial success. An accurate and fair valuation of the company, ongoing profitability and potential growth are in the top-five desired outomes for both parties.
- There are slight differences in preferred payment methods. **Startups prefer all cash up front**, while acquirers prefer a mixture of equity and cash.

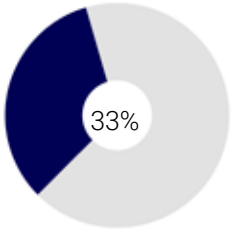
Overall, we see similar preferences and hesitations for both startups and acquiring businesses. Finding a business that is a strategic fit and that can be profitable into the future are the priorities of both parties. Businesses of all sizes are considering acquisition as a growth strategy as more startups enter the market and learn to position themselves effectively.

RMIT Activator sees the findings as an eye-opener to both startups and businesses. It is an opportunity for both parties to put more emphasis on acquisition as a growth strategy given the similarities in what they want to achieve and how they want to get there. It gives entrepreneurs an insight into what they should be focusing on to attract an acquisition partner.

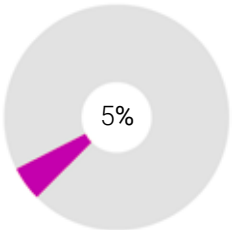
RMIT Activator is the cornerstone of our enterprise and entrepreneurial ecosystem at RMIT. It is a dynamic and integrated platform for the RMIT community that harnesses entrepreneurial curiosity and empowers people to create ideas, launch startups and innovate businesses.

Are startups the M&A strategy of the future?

Acquisition remains a secondary growth strategy for many businesses:



AND



of businesses prefer a strategy of growing the size of the market

... of businesses pursue growth through acquisition

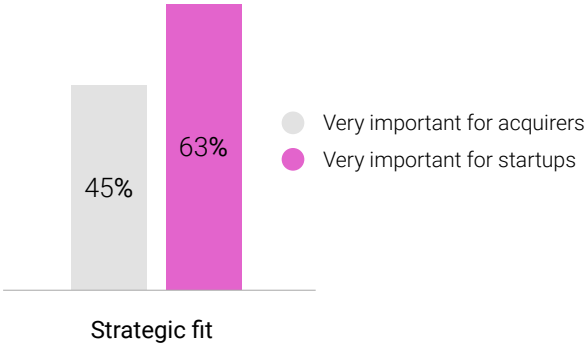
The most attractive feature of a startup is not necessarily profit, but rather:

AND

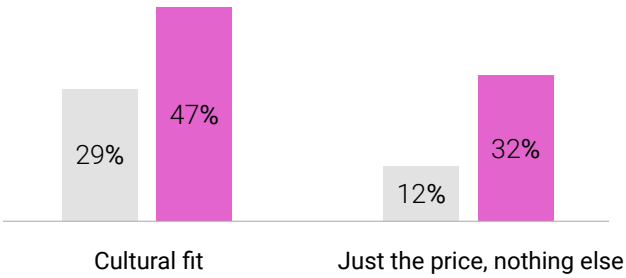
Very rapid growth

Ability to sell anywhere

Strategic fit is the most important factor sought in an acquisition partner.



There are more differences than similarities in what startups and acquirers looking for.



Top 3 expectations of an acquisition for both acquirers and startups:

An accurate valuation for the company

A fair valuation for the company

Being profitable

Introduction

Sector after sector is experiencing disruption from innovation and new entrants. Growth through acquisition is becoming an increasingly attractive way for businesses of all sizes to innovate and expand.

Methodology

RMIT Enterprise Insights is a representative survey of 501 business respondents across all Australian States and Territories. The sample group was then narrowed to 19 startups and 202 acquirers. This survey was conducted online in June 2017. A breakdown of businesses that completed the survey by size and income along with a full list of questions can be found at the end of this report.

Our second RMIT Activator Enterprise survey examines the role of startups as a choice for businesses that are looking to make an acquisition.

For the purposes of this survey, a startup is defined as a business that:

- has been in existence for under three years;
- has the ability to achieve very rapid growth;
- offers products and services not constrained by geography; and
- is not necessarily making a profit.

Businesses in existence for under three years, but which do not meet the other criteria were exited in the first part of the survey (page 6).

The sample group was also narrowed based on whether businesses were pursuing growth and open to acquisition. Respondents that answered negative to these questions were exited in the first part of the survey (page 6).

They survey looked at the attitudes to acquisition from the persepectives of the startup and the acquirer (19 startups and 202 acquirers). The same questions were posed to both groups to enable the answers to be compared.

A sample of 501 businesses from a range of sectors were surveyed across Australia and asked seven key questions:

1. How would you describe your company's appetite for being acquired by/acquiring another company?
2. If you were to be acquired/make an acquisition, what are the most important outcomes?
3. Assuming the price is right, which features of a potential acquirer/acquisition are the most important?
4. In terms of revenue, what size is most desirable for a potential acquirer/acquisition?
5. What would be your preferred way to be acquired/make an acquisition?
6. What approach best describes your company's preferred growth strategy?

Only acquirers:

7. How active is your company in looking for startups to acquire?

The second survey topic was chosen to gain insights into the mindset of the business community around acquisitions and shed light on the motivations of both startups and acquirers. RMIT Activator sees the survey as an opportunity to start a conversation about the M&A of the future.

Few businesses see acquisition as a main growth strategy

In the first instance, we seek to narrow the sample group to those businesses pursuing growth and open to either making an acquisition or being acquired.

Firstly, respondents chose one of five strategies that best reflected their business' preferred approach for achieving growth. Secondly, they were divided into groups of those open or not open to acquisition.

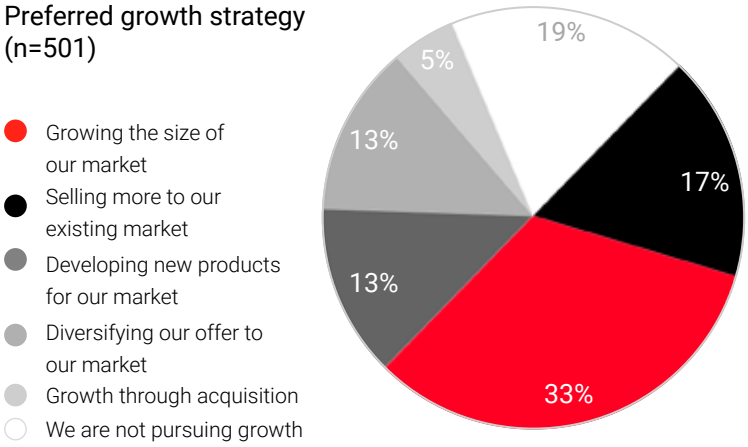
The most preferred growth strategy, selected by one-third of businesses, was expanding the size of the market. This was followed by a strategy to increase sales to the existing market (17%).

While only 5% nominated growth through acquisition as their preferred strategy, all businesses pursuing growth remained in the survey.

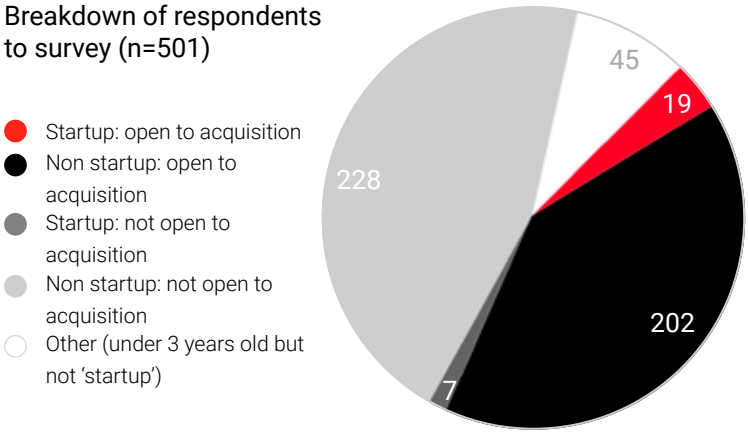
Nineteen of the 26 qualifying startups surveyed, were open to acquisition. On the acquiring side, 202 businesses were open to making an acquisition while 228 were not.

The startups and non-startup businesses not pursuing growth or not open to acquisition were exited from the survey as the subsequent questions on attitudes to acquisitions were not relevant for these respondents.

Preferred growth strategy (n=501)



Breakdown of respondents to survey (n=501)



Companies of all sizes are looking to acquire

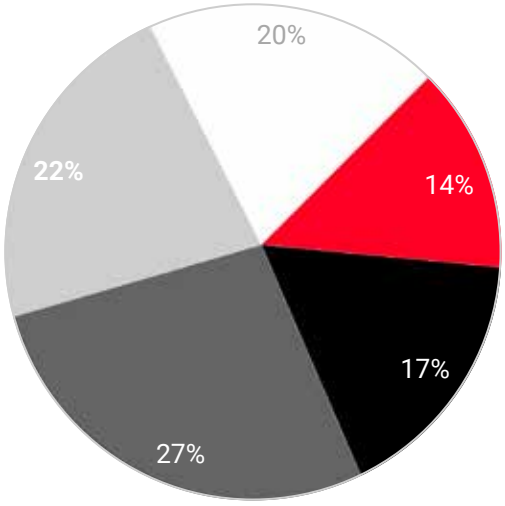
The next section takes a closer look at which businesses are in the market to make an acquisition and whether size plays a role.

Businesses of all sizes were surveyed to compare their respective readiness to make an acquisition.

The results show that you don't need to be a large business to be on the acquisition trail. As can be seen in the graph, businesses of all sizes are open to making an acquisition.

Small businesses are the largest group represented (27%). Sole traders, micro and small businesses make up nearly three out of five (58%) businesses in the acquisition market.

Companies in the acquisition market (n=202)



- Sole trader
- Micro business
- Small business
- Medium business
- Large business

Startups exhibiting rapid growth are attractive

In the main part of the survey, we compare the attitudes of startups and acquiring businesses towards acquisitions, as well as the differences and similarities in what they look for.

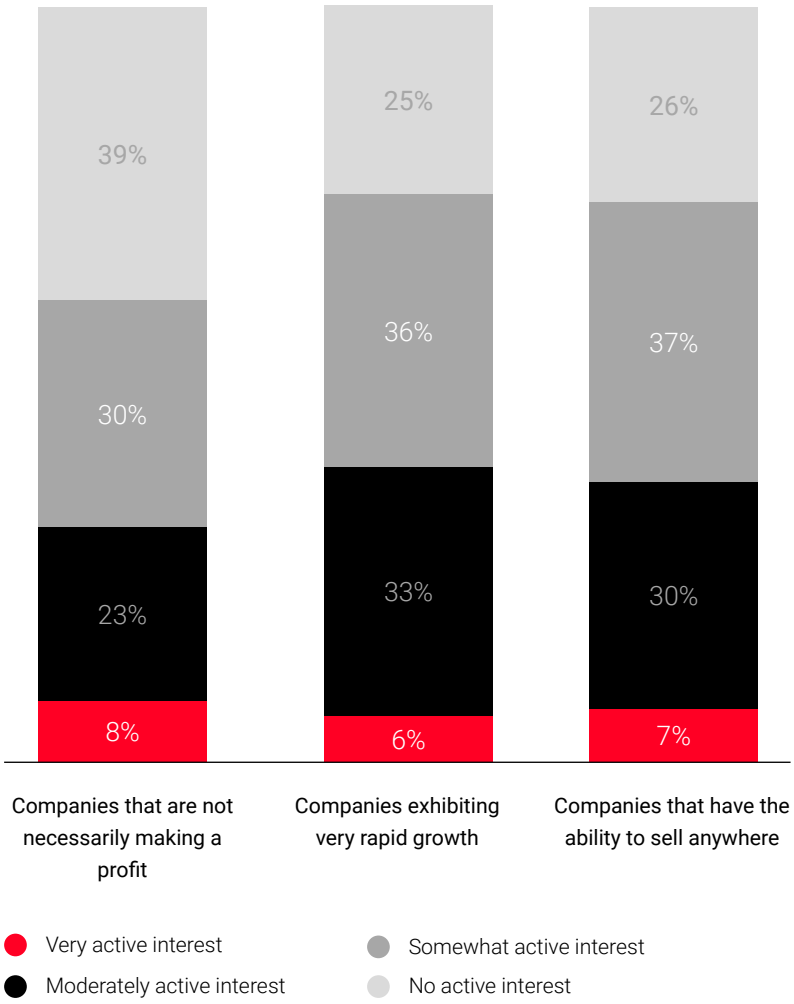
This question further defined the specific features of startups that businesses were seeking.

Acquiring businesses are not necessarily looking for startups that make a profit. This is a criteria for only three in five businesses.

Overall, 75% of businesses are looking for startups exhibiting rapid growth and those with the ability to sell anywhere.

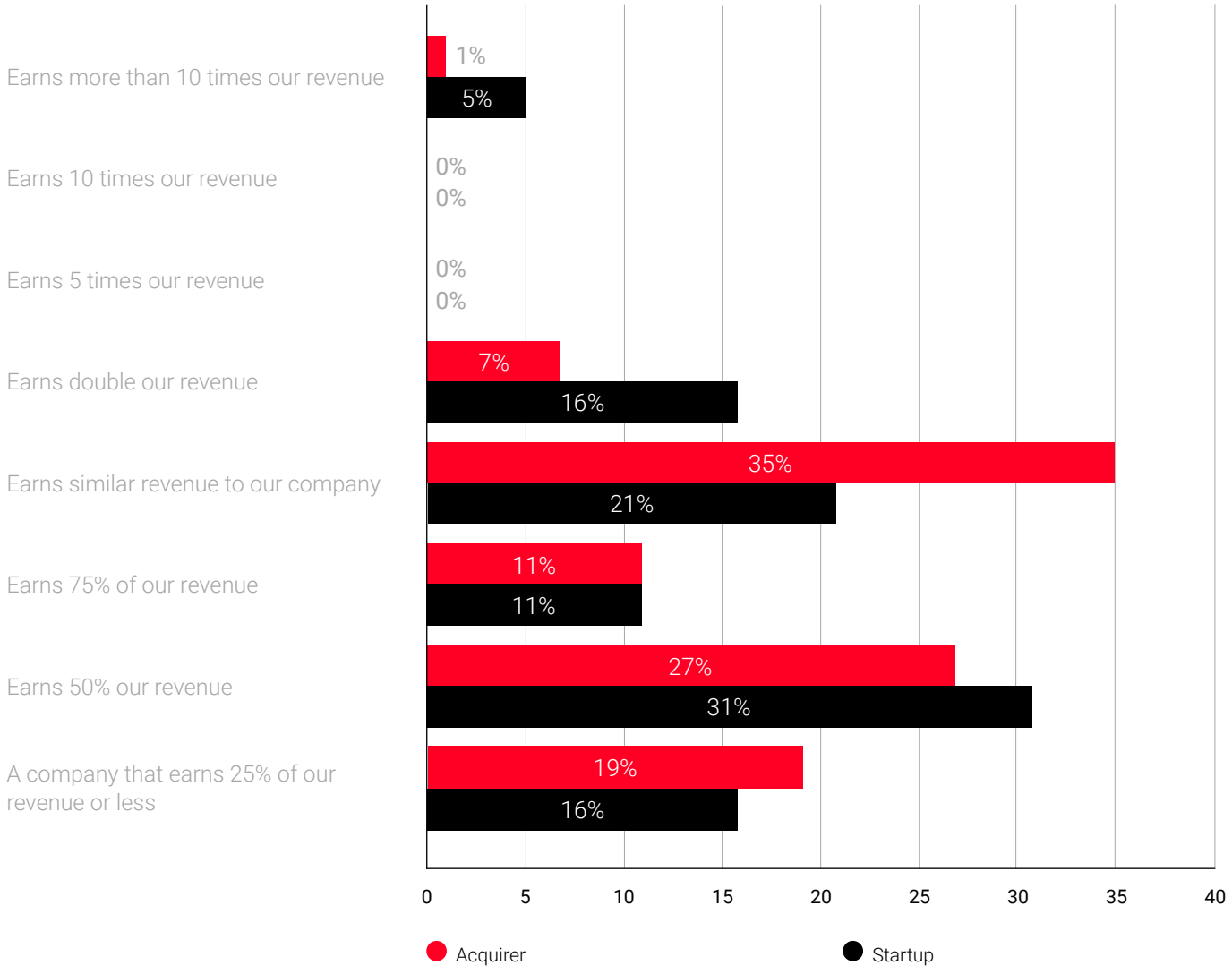
The results show that, on average, one-third of businesses are actively seeking out startups, whether they have low or high levels of interest.

Level of acquirer interest in startup features (n=202)



Three in five businesses prefer a smaller partner

Acquisition target size: view of startups vs acquirers



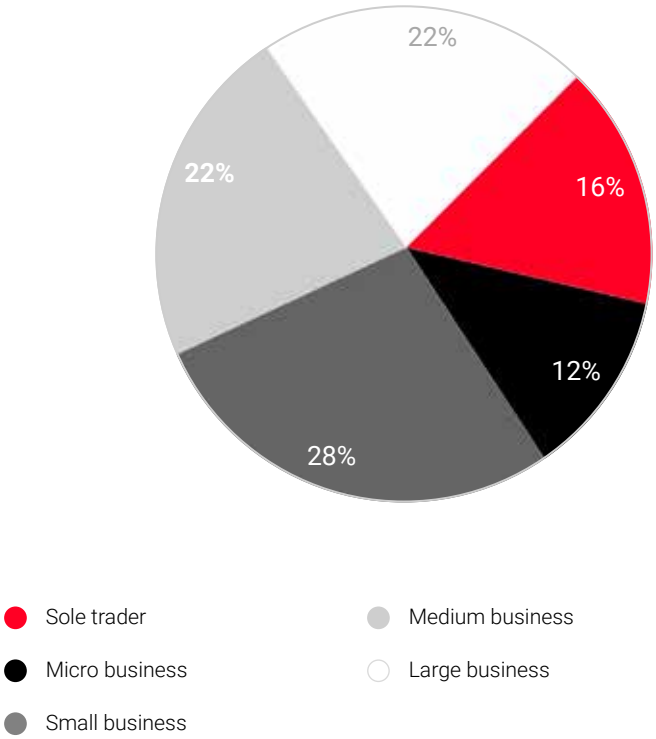
Three in five businesses prefer a smaller partner

When it comes to revenue, both sides of the acquisition - startups and acquirers - are looking to get involved with businesses smaller than their own. This equates to about three in five businesses on both sides.

The best match appears to be businesses of a similar size in terms of revenue, with just over one-third of acquiring companies and 21% of startups looking for businesses that earn the same as they do (see previous graph).

In the graph to the right, we delve deeper into the group favouring businesses smaller than their own. It shows that all business sizes are well represented among this group. This perhaps illustrates their risk appetite, with businesses of all sizes not wanting to bite off more than they can chew.

Companies selecting 25%, 50% and 75% revenue target acquisition startups (n=113)



Strategic fit is the most important feature of an acquisition

Both startups and acquirers were asked to rank the most important features they look for in the other as the acquisition deal is put together.

As can be seen in the graph on page 13, strategic fit is top of the list for both parties, albeit more highly valued by startups.

The results show clear differences in the importance placed on the speed to access new markets and cultural fit. These are more highly valued by startups than acquirers.

Acquirers place importance on: operational fit, governance arrangements and the ability to work with the new management team.

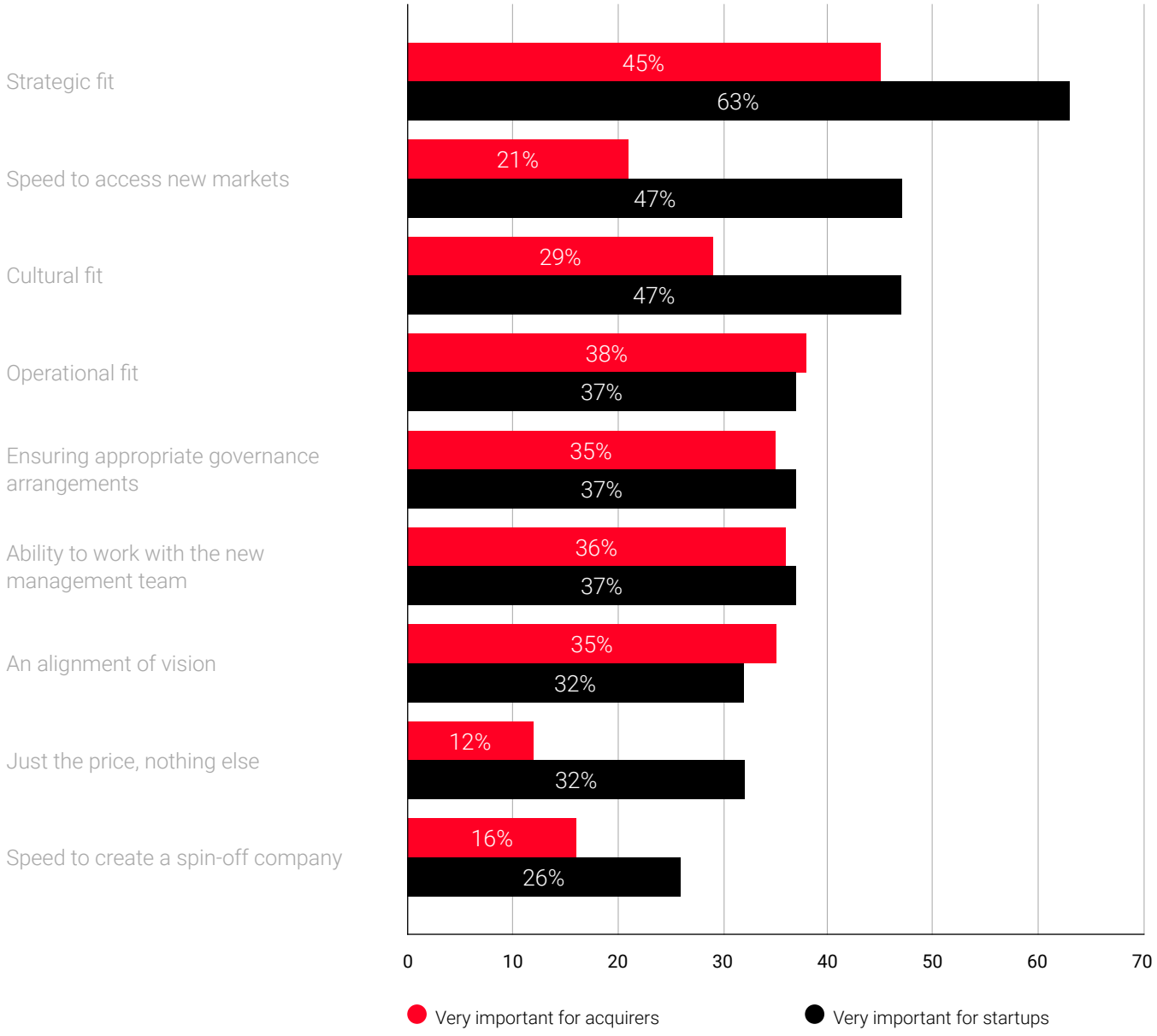
Overall, there are more differences in ratings than similarities in the list of nine factors.

It is important to note that the survey question asked respondents to rank the features on a four-point scale from 'not important', 'slightly important', 'moderately important' to 'very important'. The figures shown compares only those businesses that ranked the features as 'very important'.

Given the small numbers of startups, it is important to look at how the features are ranked as opposed to the percentage outcomes.

Strategic fit is the most important feature of an acquisition

Importance of different features startups look for in acquiring companies vs what acquirers look for



Both parties have similar expectations of an acquisition

This question assesses the desired outcomes from an acquisition by both the acquirer and the startup.

Top of mind for both parties are commercial outcomes. A fair and accurate valuation of the company is ranked first by startups and second and third for acquirers in terms of very important outcomes of an acquisition.

The most desired outcome for acquirers is being profitable after acquisition, which was ranked equal third by startups.

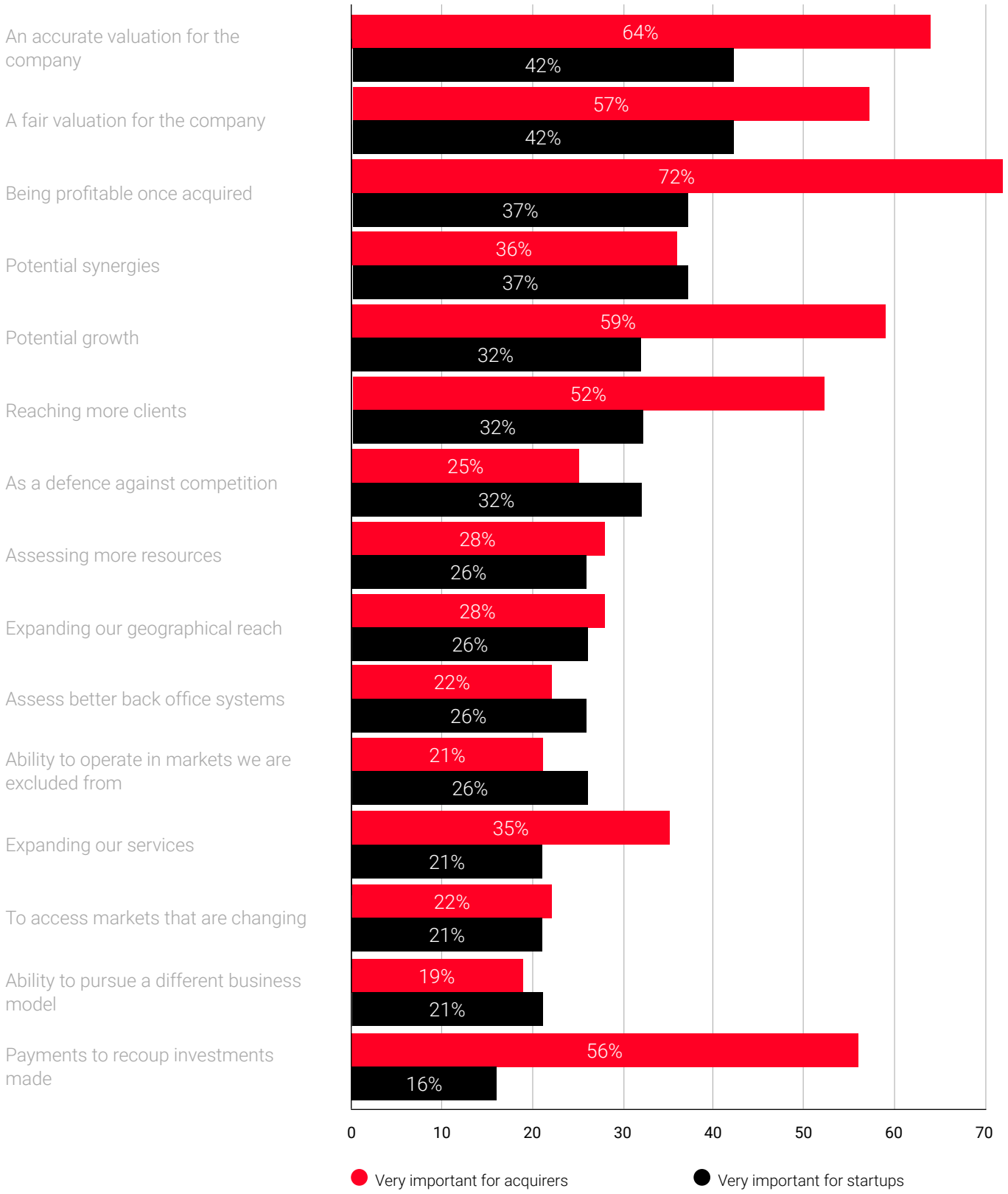
Outcomes such as the growth of clients and expanding services were of secondary importance for both parties.

Among the list of 15 outcomes, there are more similarities than differences in what startups and acquirers want and expect to see from an acquisition.

However, one standout difference is the importance of payments to recoup investments. This is much higher up the list for acquirers than startups, which ranked it last.

Both parties have similar expectations of an acquisition

Importance of different outcomes from an acquisition (startups n=19; acquirers n=202)



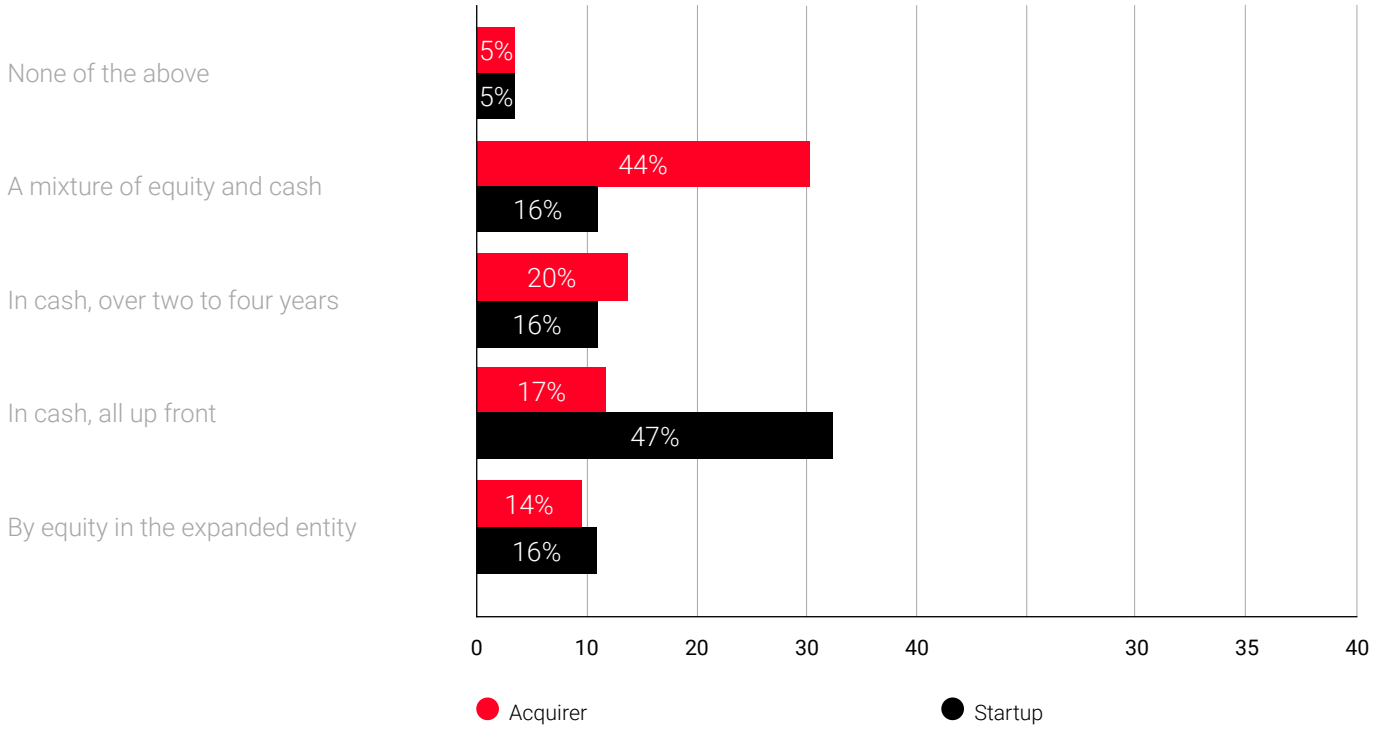
Startups prefer cash up front rather than equity

Finally, respondents were asked to rank how they would prefer the acquisition to be completed.

Not surprisingly, startups are looking for all cash up front, while acquirers prefer a mixture of equity and cash.

The least favourable options by both parties are deferred payments and equity in the expanded operation.

Preferred way to be acquired or to make acquisition



WHAT DOES IT ALL MEAN?

The second RMIT Activator Enterprise Insights survey identifies questions that startups and acquiring businesses need to be asking before entering into an agreement.

The survey results reveal more similarities than expected between what startups and acquiring businesses want to achieve through an acquisition and what they are looking for in a partner.

It highlights a few ways in which a better understanding of the other party's intentions and motivations could help overcome some of the hesitation towards being acquired or making an acquisition.

For startups, the survey results point to one main question they should be trying to answer before entering into acquisition negotiations: **Are the two businesses strategically aligned?**

This is a change in mindset for startups, which traditionally focus on selling their innovative product or service rather than themselves. Businesses are not necessarily looking for companies making a profit or are just interested in the price. Most importantly, they are looking for a business that is a good strategic fit to their own, that is going to work well with their team and that is showing strong growth.
This means the growth strategies and vision of both businesses need to be aligned. It is important to be aware that startups place more weight on cultural fit than acquiring businesses.

The findings also show that all sizes of businesses are in the acquisition market, so startups could be broadening their scope of potential acquirers.

For acquirers, the key question that emerges is: **Can my business make this acquisition profitable?**

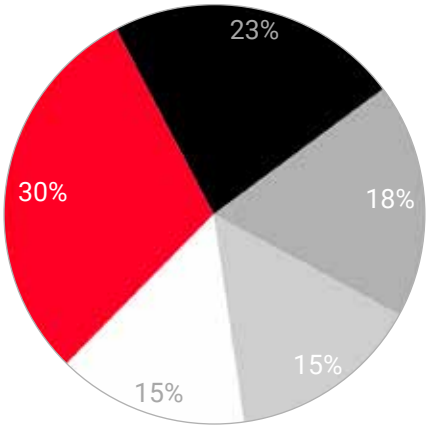
Once a business has embraced the strategy of growth through acquisition of a startup, it needs to work with a business on the growth strategy post acquisition and a process to deliver a fair and accurate valuation. Perhaps surprisingly for acquirers is that most startups share the same priorities. It is also interesting to be aware that they place less importance on recouping the investment and expanding services.

Removing the risk of buyers remorse around price and size of startup will clear the way for other management matters to be addressed.

Who completed the survey?

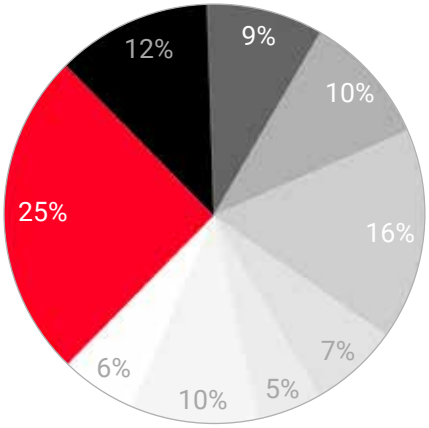
Survey respondents by business size (n=501)

- Sole trader (single employee)
- Micro business (1 to 5 employees)
- Small business (6 to 20 employees)
- Medium business (21 to 100 employees)
- Large business (100 employees and over)



Survey respondents by industry sector (n=501)

- Less than $100,000
- $100,000 to $199,999
- $200,000 to $499,999
- $500,000 to $999,999
- $1 million to $5 million
- $5 million to $10 million
- $10 million to $20 million
- $20 million or more
- Don't know



Questionnaire

RMIT Enterprise Insights: M&A of the future - is acquiring a startup the new corporate development strategy?

Startup questionnaire:

1. How would you describe your company's appetite for being acquired by another company?

- We are open to acquisition but are not actively pursuing this
- We are actively pursuing acquisition
- We are in discussions now with another company to be acquired
- We have recently been acquired
- We are not open to being acquired at all (Close out)

2. If you were to be acquired, how important would you rate the following outcomes?

Scale: not important at all, somewhat important, moderately important, very important

- A fair valuation for the company
- An accurate valuation for the company
- Payments to recoup investments made
- Potential synergies
- Potential growth
- As a defense against competition
- Expanding our geographical reach
- Reaching more clients
- Expanding our services
- Being profitable once acquired
- Ability to operate in markets we are excluded from
- Ability to pursue a different business model
- To access markets that are changing
- Accessing more resources
- Access to better back office systems

3. Assuming the price is right, how important are the following features of a potential acquirer?

Scale: not important at all, somewhat important, moderately important, very important

- Just the price, nothing else
- An alignment of vision
- Ability to work with the new management team
- Ensuring appropriate governance arrangements
- Strategic fit
- Cultural fit
- Operational fit
- Speed to access new markets
- Speed to create a spin-off company

4. In terms of revenue, what size is most desirable for a potential acquirer?

- A company which earns 25% of our revenue or less
- Earns 50% of our revenue
- Earns 75% of our revenue
- Earns similar revenue to our company
- Earns double our revenue
- Earns 5 times our revenue
- Earns 10 times our revenue
- Earns more than 10 times our revenue

Questionnaire

RMIT Enterprise Insights: M&A of the future - Is acquiring a startup the new corporate development strategy?

5. What would be your preferred way to be acquired?

– By equity in the new company

– In cash, all up front

– In cash, over two to four years

– A mixture of equity and cash

– None of the above

6. What approach best describes your company's preferred growth strategy?

– Selling more to our existing market

– Growing the size of our market

– Developing new products for our market

– Diversifying our offer to our market

– We are not pursing growth

Other business questionnaire:

1. How would you describe your company's appetite for acquiring another company?

– We are open to acquiring another company but are not actively pursuing this

– We are actively pursuing an acquisition

– We are in discussions now with another company to acquire

– We have recently made an acquisition and are not currently seeking another

– We have recently made an acquisition and are actively seeking another

– We are not open to making an acquisition (Close out)

– Don't know

2. If you were to make an acquisition, how important are the following outcomes?

Scale: not important at all, somewhat important, moderately important, very important

– A fair valuation for the company

– An accurate valuation for the company

– Earnings to recoup the investment in the company

– Potential synergies

– Potential growth

– To defend against competition

– Expanding our geographical reach

– Reaching more clients

– Expanding our services

– Being profitable

– Ability to operate in markets we are excluded from

– Ability to pursue a different business model

– To access markets that are changing Accessing more resources

– Access to better back office systems

Questionnaire

RMIT Enterprise Insights: M&A of the future - Is acquiring a startup the new corporate development strategy?

3. Assuming the price is right, how important are the following features of a potential acquisition?

Scale: not important at all, somewhat important, moderately important, very important

- Just the price, nothing else
- An alignment of vision
- Ability to work with the new management team
- Ensuring appropriate governance arrangements
- Strategic fit
- Cultural fit
- Operational fit
- Speed to access new markets
- Speed to create a spin-off company

4. In terms of revenue, what size is most desirable for a potential acquisition?

- A company which earns 25% of our revenue or less
- Earns 50% of our revenue
- Earns 75% of our revenue
- Earns similar revenue to our company
- Earns double our revenue
- Earns 5 times our revenue
- Earns 10 times our revenue
- Earns more than 10 times our revenue

5. What would be your preferred way to make an acquisition?

- By equity in the expanded entity
- In cash, all up front
- In cash, over two to four years
- A mixture of equity and cash
- None of the above

6. How active is your company in looking out for the following?

Scale: very active, moderately active, somewhat active, not active at all

- Companies that are not necessarily making a profit
- Companies exhibiting very rapid growth
- Companies which have the ability to sell anywhere (that is, are not geographically constrained)

7. What approach best describes your company's preferred growth strategy?

- Selling more to our existing market
- Growing the size of our market
- Developing new products for our market
- Diversifying our offer to our market
- We are not pursing growth

www.rmitactivator.edu.au