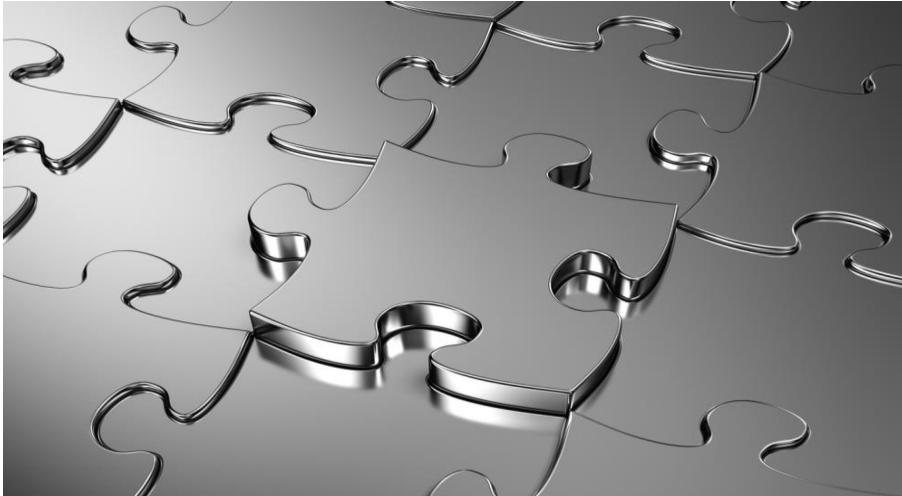
A First Step in Understanding What Buyers Want

By Chris Manfre

Understanding what your customers want is the key to any successful product or service. Selling a business is no different.



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M&A Focal Strategies

It is well understood that 'knowing your customer' is critical for the success of any product or service. Selling a business is no different. In fact, the first step in maximizing your company's value is understanding both the buyer's wants and needs and how your company could fit into the value chain of a buyer's operation. But how do you get inside the buyer's head? It's helpful to remember that most of the time, long before a buyer approaches a potential target, there is already an end goal in mind with a strategy for how to best achieve that goal. While it may be next to impossible to get a buyer to fully disclose its ultimate objectives, an understanding of the focal strategies used in M&A can provide precious guidance.

Historically, three focal strategies, often applied in their pure form, have contributed to the formation of major corporations and reshaped entire sectors of the U.S. economy. Today, these fundamental strategies are more likely implemented in various combinations, but a solid understanding of their underpinnings can still prove instrumental in interpreting the economic incentive and value drivers sought by the buyer. The three main focal strategies of M&A are Horizontal Integration, Vertical Integration, and Conglomerate (or Diagonal) Integration. In the pages that follow, Bardi Co. presents an analysis of each of focal strategies of M&A buyers in a way that will help business owners better understand the objectives of potential buyers. By understanding what buyers seek, a company can better prepare itself for a potential sale and position itself more attractively in the M&A market.

Three Focal Strategies of M&A

1. Horizontal Integration
2. Vertical Integration
3. Conglomerate (Diagonal) Integration

Horizontal Integration

A horizontal integration strategy seeks to combine businesses that operate in the same sector, in the same type of business, or in the same stage of production. Some of the big name companies that successfully used horizontal integration in the past are Kodak, Standard Oil, and DuPont.

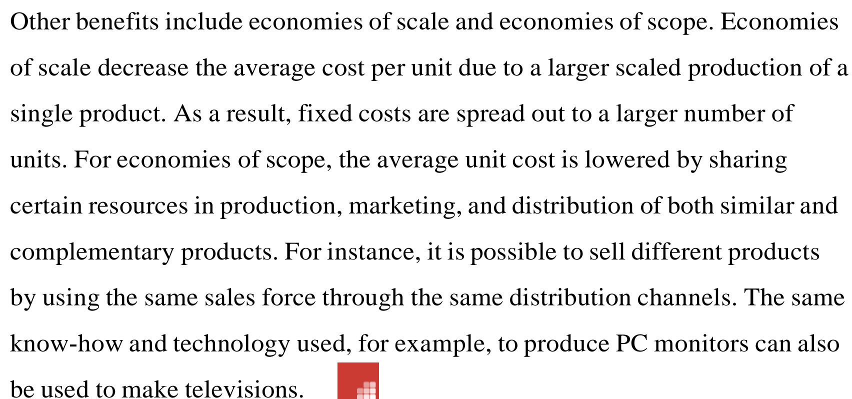
Horizontal Integration helps organizations gain a larger share of the market and also eliminates competitors.

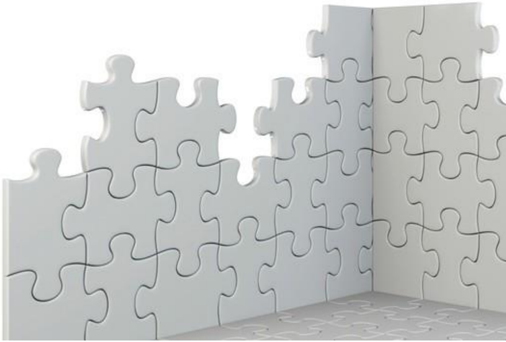
Gain Market Share

This type of integration helps organizations gain a larger share of the market and also eliminates competitors. However, the real advantage often lies in the ability to control prices and gain access to new geographic markets. By gaining more market share, companies often realize greater control over prices, since there are fewer competitors and a more narrow set of options for the consumer or buyer. Consolidating operations within a specific sector, business type, or production stage, but across different geographic regions, helps a company expand its operations on a much larger scale than a horizontal integration within just one market.

Economies of Scale and Scope

Other benefits include economies of scale and economies of scope. Economies of scale decrease the average cost per unit due to a larger scaled production of a single product. As a result, fixed costs are spread out to a larger number of units. For economies of scope, the average unit cost is lowered by sharing certain resources in production, marketing, and distribution of both similar and complementary products. For instance, it is possible to sell different products by using the same sales force through the same distribution channels. The same know-how and technology used, for example, to produce PC monitors can also be used to make televisions.



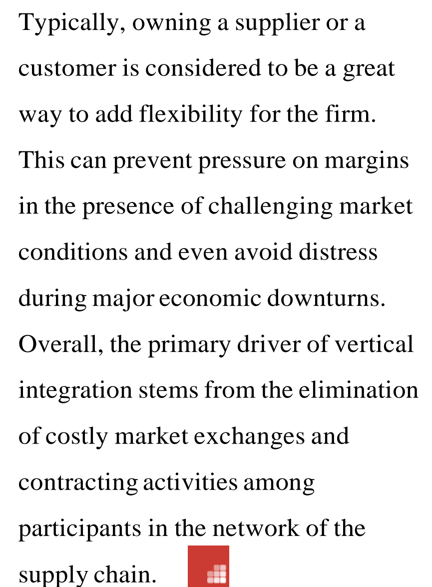


The process of vertical integration is essentially the same as supply chain consolidation.

Vertical Integration

Vertical integration entails the combination of companies that operate in different stages of production. A typical example is offered by the vertically integrated oil and gas industry where, in theory, exploration, production, refining, and retail could be performed by separate organizations rather than under a single, controlling ownership structure. Interestingly, most of the large public utility companies in the U.S. were created during the vertical integration wave between 1925 and 1929. The benefit to the buyers in this case may vary, but usually it centers on the advantage of having control over the target company. Some of the value-creation opportunities include:

- Tighter quality control
- Elimination of transportation costs, since different stages of production can be combined in the same location
- More efficient information flow and coordination of product planning, research and development, or inventory management
- Lower monitoring and transaction costs throughout the production process (these may include lower contracting, "haggling", collection, and negotiation costs)
- Lower business-to-business advertising costs, since the intermediary stages can be eliminated



Typically, owning a supplier or a customer is considered to be a great way to add flexibility for the firm. This can prevent pressure on margins in the presence of challenging market conditions and even avoid distress during major economic downturns. Overall, the primary driver of vertical integration stems from the elimination of costly market exchanges and contracting activities among participants in the network of the supply chain.

Conglomerate Integration

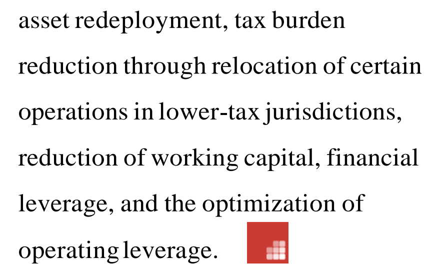
Conglomerate acquisitions bring together various companies engaged in different and unrelated business activities. Typically, a conglomerate controls operations in different sectors, which require completely different skills in very specific functions (i.e. engineering, production, marketing, etc.). At first glance, no immediate synergistic advantages or other benefits to the acquirer would surface from such strategy, but a closer look reveals the opposite. Conglomerate integrations fall into two primary sub-categories and each can be extremely successful.

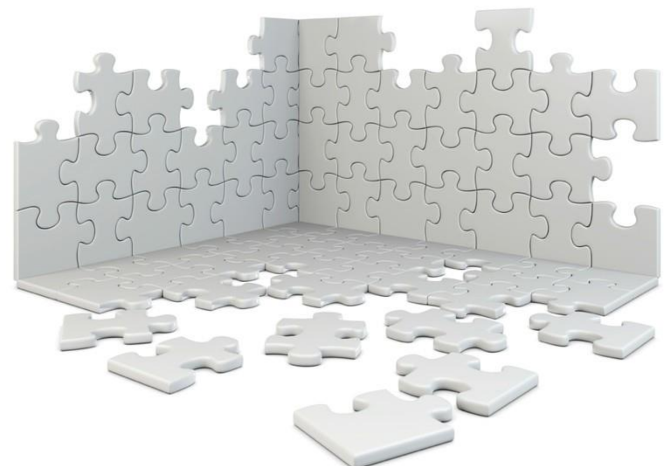
Managerial Conglomerates

For these types of companies, the idea is that the managerial functions performed at the top of the organization are general enough that they can be transferred and applied to a variety of companies in different industries. General Electric Corporation, with its diversified business units and its ability to apply value-enhancing management techniques to newly acquired companies, is perhaps the typical example of a managerial conglomerate. It is usually more challenging to identify the potential economic advantages of a specific transaction when dealing with managerial conglomerates because much of that benefit is related to the talent of the buyer's management team and the level of indivisibility of the managerial effort. In these types of transactions, the value of control, rather than the value of synergies, most likely accounts for the majority of the premium paid by the buyer.

Financial Conglomerates

This term is used rather loosely, but essentially, financial conglomerates derive their appeal from their ability to establish discipline in the financial aspects of the corporation. Management engages in financial planning and analysis with the goal of lowering the cost of capital and increasing the cash flow of the companies under its control. Normally, actions to achieve such objectives include, among others, asset redeployment, tax burden reduction through relocation of certain operations in lower-tax jurisdictions, reduction of working capital, financial leverage, and the optimization of operating leverage.



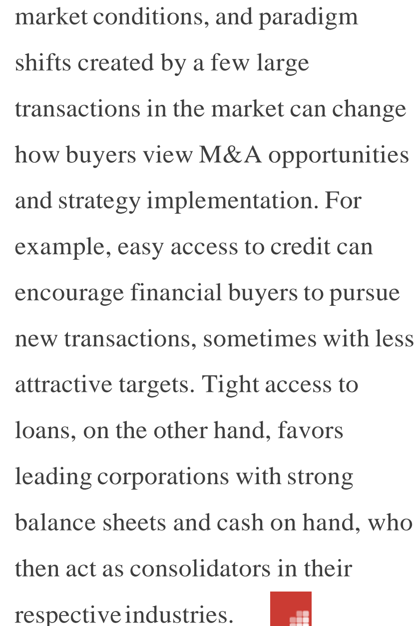


Concluding Remarks

"surprisingly, buyers often get caught up in M&A trends that influence their preference and behavior."

While the main strategies are quite straightforward and can be easy to identify, a live transaction is often characterized by various motives with the possibility of virtually infinite combinations. The primary goal of diversification, or financial synergies, might have secondary objectives such as achieving faster growth, tax savings, cost reduction, or "cash slack" opportunities, among others.

Also, and maybe quite surprisingly, buyers often get caught up in M&A trends that influence their preference and behavior. Economic climates,



market conditions, and paradigm shifts created by a few large transactions in the market can change how buyers view M&A opportunities and strategy implementation. For example, easy access to credit can encourage financial buyers to pursue new transactions, sometimes with less attractive targets. Tight access to loans, on the other hand, favors leading corporations with strong balance sheets and cash on hand, who then act as consolidators in their respective industries.

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