Fundamental M&A Strategies:

Buyers' Goals & Strategies in Middle-Market M&A

By Chris Manfre.

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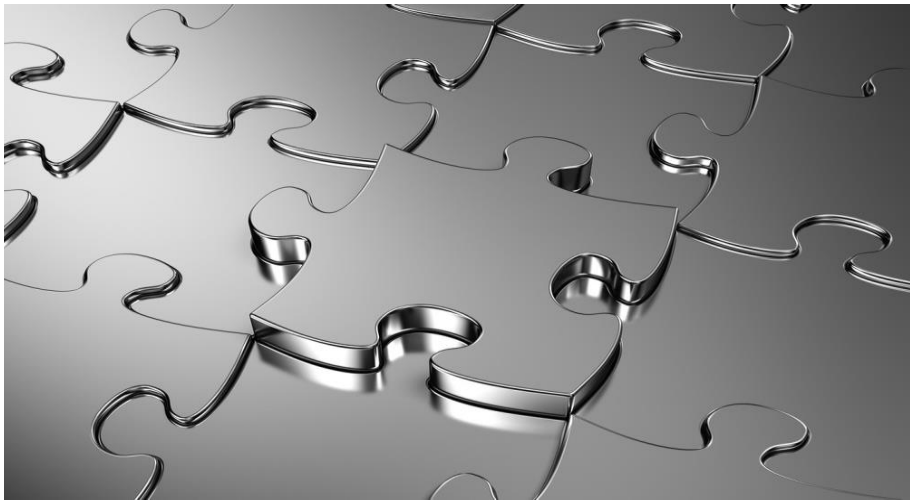

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M&A Focal Strategies

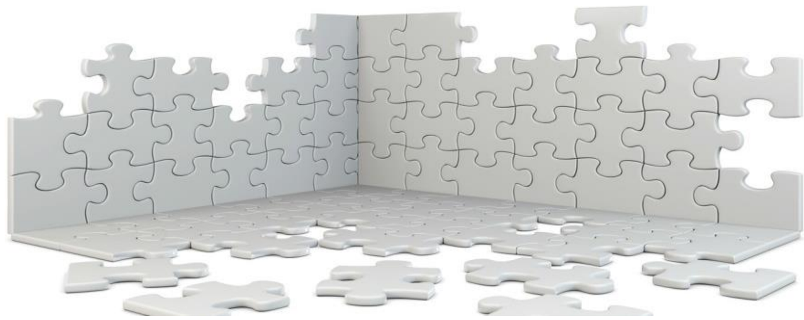
The landscape of potential buyers in M&A is multifaceted and diverse, but most buyers tend to fall into four separate categories. Identifying these general groups is helpful to the seller and its agents because it provides guidance to the overall intention and motivation of the buyer, their timing, and their way to negotiate and transact.

Although overlaps and uncertain boundaries exist, invariably most organizations that are interested in acquisitions fall into one of the following categories:

Categories of Buyers

- Strategic Buyers
- Financial Buyers
- Value Investors
- Lookie-Lous

In the pages that follow, Bardi Co. presents an overview as well as in-depth analysis of each type of buyer. This insight into the types of buyers that typically play an important role in the mergers & acquisitions market will be useful for companies looking to participate in the market, either as a buyer or as a seller. By developing a better understanding of the types of buyers that are looking to transact, executives will be more educated about the appropriate type of buyer to seek for their specific business.



Strategic Buyers

Strategic buyers come in different flavors, but normally they are corporations, private or public, in search of vertical or horizontal acquisitions. When faced with the option of returning profits to shareholders in the form of dividends or share buy backs, strategic buyers can be interested in diversifying from their core business. These acquisitions are said to be part of their "corporate strategy." Johnson & Johnson pursued this strategy quite successfully during the 90's in its early acquisitions of medical-device businesses such as Cordis and DePuy. Another example is the success story of a small company with 60 employees and approximately $3 million in revenue that was acquired by Best Buy in 2002: Geek Squad. Since then, Geek Squad has become the largest tech-support operation in the world with annual revenues in excess of $1 billion.

> *As part of a corporate strategy, strategic acquisitions help organizations return profits to shareholders.*

When strategic buyers are just seeking to gain additional market share or expand existing services or product lines within the same industry, they pursue acquisitions as part of their business strategy. The advantage is that the buyer can use its own valuation assessment in terms of the price of the target because it is familiar with the specific sector and its industry metrics. This makes it easier to justify the acquisition to its internal audience (i.e. board of directors) and/or its external one (i.e. investors and Wall Street analysts). Other advantages include less effort in the due diligence process and smaller integration risk because the buyer and the seller speak the same lingo in terms of technology, target markets, and operations.

Ultimately, the typical strategic buyer is interested in buying out the competition to eliminate it from the market (and reduce pressure on prices), take advantage of new distribution channels / geographic markets or leverage fixed costs such as marketing and advertising expenses. Due to the synergistic potential between a strategic buyer and its target, valuations typically tend to be more generous than from other types of buyers. However, strategic buyers aren't always available. When certain industries, for whatever reason, fall out of favor (i.e. the industry is consolidated or growth opportunities are lacking), strategic buyers may be reluctant to entertain acquisitions.[1] This puts potential sellers at a disadvantage and they may have a hard time matching up with the "logical buyer." If strategic buyers are not willing to transact, the seller may become target of either financial buyers or value investors.

If large enough, strategic buyers may have the ability to finance their acquisitions internally without needing financial institutions. Regardless of the financing, it's worth noting that the strategic-buyer process can be lengthy because of internal procedures and bureaucracies, or even inexperience in the M&A arena.

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Financial Buyers

Typically, the financial buyers category is comprised of private equity firms and conglomerates that look for acquisitions that can be highly leveraged and require only small portions of equity investments. These takeovers are commonly referred to as leveraged buyouts (LBOs), where the returns to the equity investors increase as the value of the investment grows. Typically, the target return on investment (ROI) for these types of transactions ranges between 20 percent and 35 percent. Companies with steady cash flows and/or that are capital intensive are the ideal candidate because the acquisition can be easily financed with borrowed funds.[1] This strategy is favored during periods of rapid growth, which allows for painless repayment of the borrowed funds and easy availability of credit. Starting in 2004 and through the heights of late 2007, these investors were particularly active and accounted for approximately 32% of the total middle-market M&A activity in the U.S.[2] It was not unusual during this period for a financial sponsor to contribute only 10 percent of the acquisition cost, while the remaining 90 percent was financed through commercial banks at relatively cheap interest rates.

Since 2008, due to the economic downturn and widespread bankruptcies among many lenders of choice, financial buyers are less active and their equity investments normally account for a larger portion of the purchase price (e.g. 30% to 60%).[3] The reliance and eventual abuse of over-leveraging was behind the 2009 bankruptcy of CIT Group, a former major lender to mid-market private equity firms.

[1] Fixed assets can be used as collateral. The leverage potential changes based on the specifics of a business and depending on market conditions, but according to a general rule of thumb, it is possible to borrow 80% of the value of inventory and accounts receivable and 50% of the value of properties and machinery & equipment.
[2] In 2010, approximately 25% of the total middle market transactions in the U.S. were consummated by financial sponsors.
[3] Robert W. Baird & Co.: M&A Market Analysis, November 2010.

Financial Buyers (Continued)

Financial buyers and value investors may overlap. However, if a financial buyer is seeking “bolt-on” acquisitions for its existing “platform investment,” it is likely to behave like a strategic buyer and offer more enticing valuations to potential sellers. Normally, the investment horizon for financial buyers is between three to seven years; however, exceptions are increasingly more common. At the end of the investment period, which coincides with the repayment of the outstanding debt, the company is sold to new investors or goes through an IPO. Overall, debt brings discipline and requires attentive managerial action and sobriety in business decisions. The incentive of high returns, the absence of clunky bureaucracies that are typical of public corporations, and the freedom to focus on long term results rather than short term goals have transformed some of these ventures into very successful money-making opportunities. One recent example is Fleetgistics, a company created by Atlantic Street Capital though a series of acquisitions to build an expanded same-day logistics company. In 2010, Atlantic Street Capital sold Fleetgistics, and received an internal ROI on its equity investment of more than 150 percent.

The financial buyer is generally well suited for a seller who is interested in staying with the company for the investment horizon and who wishes to retain some equity (rollover equity). Furthermore, this type of buyer tends to act quickly when it identifies a suitable target, but has the challenge of having to persuade a lender to contribute a large portion of the purchase price.

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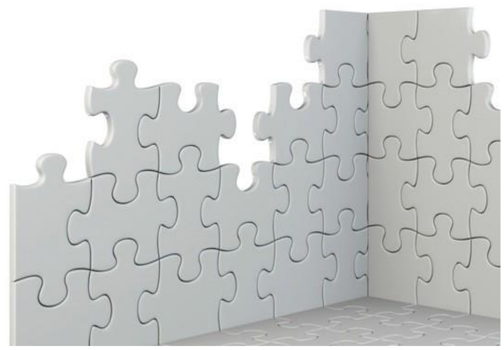

Value Investors

Value investors, also sometimes referred to as "bottom feeders" (and often dismissed as such by intermediaries), constantly scout the M&A landscape in search of cheap acquisition opportunities. Companies in distress or operating at a loss attract their interest easily. In their relentless quest to locate turn-around assets, the value investor justifies low EBIT or EBITDA multiples based on real or "alleged" problems with the business or issues related with the transition of the business to new ownership. These buyers are more likely to lower their offers during the due diligence process when the initial assumptions are not fully corroborated by their further investigations.

Value investors are willing to take on more operating risk only if they can lower their financial risk. This is accomplished through active management, with the goal of streamlining operations and cost cutting to increase the bottom line and cash flow generation. Examples of 'hands on' value-investor management tactics include employee reduction, austerity policies that lead to cost saving opportunities, and disposal of non-critical/core assets. Because of uncertainty about the turnaround outcome and the high level of management involvement required, public corporations are normally not involved since they prefer predictable, steady earnings.

The value investor might have a preference for significant debt financing to partially transfer risk to the lender; however, depending on market conditions, debt financing might not be available and this can limit the activity. Private companies and financial sponsors that have a specific taste for distressed situations and operating risk more commonly practice value investing than other types of companies.

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Looky-Lous

Lookie-lous, also known as window shoppers, can be found in each of the previous categories. Traditionally their motives and modus operandi are very specific, and they are therefore deserving of a separate category. As the name suggests, lookie-lous like to look but have no intention of buying. In M&A, these types of buyers often are eager to receive details about an acquisition opportunity but rarely engage in active discussions and are even less likely actually purchase a business.

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Lookie-lous review dozens of acquisition opportunities throughout the year. Although they do not use the information directly (they are forbidden to do so by signing a non-disclosure agreement), they study companies' financial performance and can use the data "indirectly" in their own corporate strategic planning. Having information about margins, for example, can be used for their own pricing and marketing strategies.

Although available in all sizes, lookie-lous are frequently large corporations with respected brands. They often have no difficulty convincing sellers of their genuine interest in a specific M&A opportunity. It is not unusual that one or two junior in-house corporate finance professionals spend a significant amount of time with intermediaries to obtain detailed information about targets. Every once in a while, there is a perfect opportunity that is too good to pass up; only then, these buyers might take action. From the seller's point of view, it is a good idea to have an agent that can prequalify potential buyers and screen out window shoppers early on the in the process.

Concluding Remarks

The foregoing categories demonstrate that different buyers have their own motives, value drivers, and negotiation styles. As a result, these buyers inevitably see the M&A arena through specific lenses.

Although many market participants cannot always be so easily grouped, this generalization can prove useful during the marketing process of an M&A transaction, and these general guidelines can help provide the seller and its intermediaries with clues about buyers intentions and potential outcomes. Even as market conditions rapidly evolve, it is always helpful to refer to the archetypal types of buyers as it facilitates an understanding of how market participants might adapt dynamically to different situations and external shocks.

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