STRATEGIC

VS.

FINANCIAL BUYER

Choosing the Best Option

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By
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Regardless of the current media concentration on the pros and cons of private equity firms and investments, those who work in the business or those considering entering a partnership with a PE firm face a decision-making process that can be complex and complicated. Financial executives face myriad complicated decisions when taking on private equity funding.

Thus, before entering into a partnership with a PE firm, financial executives should arm themselves with an in-depth knowledge of the value these business relationships can offer and whether they are a better option than a strategic buyer relationship.

From understanding various investment and exit strategies and operational expertise, to knowing how to manage these new relationships and emerging interests, such information is vital to developing a mutually beneficial partnership with whichever buyer is chosen.

The majority of private equity fund managers (70 percent) expect to close only two or three platform deals in 2012, according to the third annual *PErspective Private Equity Study*, conducted by BDO USA LLP. This is an increase from 2011, when 47 percent of fund managers reported closing no new deals.

Private equity and strategic buyers come with their own set of financial and ownership objectives, which will undoubtedly have a critical impact on the initial transaction as well as the operation of the company after the transaction closes. Financial executives seeking capital can ready themselves for the possibility that they may be charged with navigating one of those deals this year.

Choosing a Suitable Partner

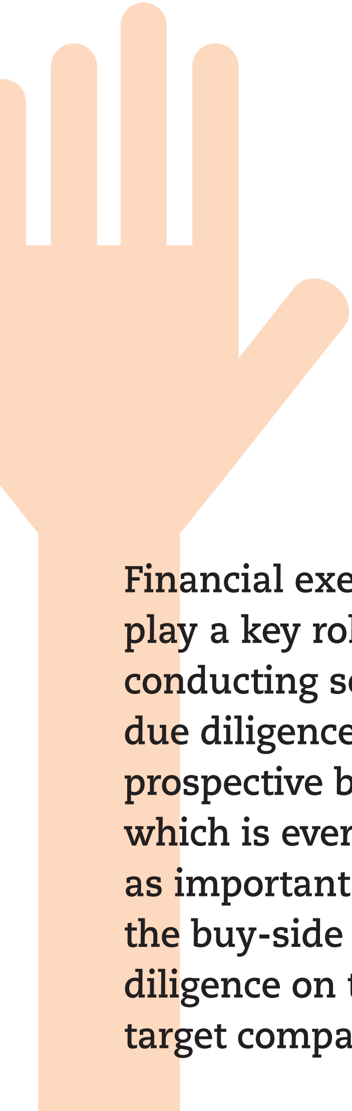
So how is a partner chosen? First, know how each potential investor operates and which one will enable the firm to meet its objectives. Let's examine the options:

- **Strategic buyers**, companies already in similar lines of business, are focused on enhancing their existing business model and the resulting financial return to their shareholders from the purchase of the target company. This type of buyer also includes portfolio companies of private equity firms that are functioning as acquisition platforms.
- **Financial buyers**, most prominently private equity firms, are companies that may have experience in a similar industry, but are not currently in the line of business of the target company. Their primary focus will be looking at the company as a standalone investment with the potential for internal growth of revenue, earnings and free cash flow. A secondary focus will be on achieving external growth by converting the company into an acquisition platform.

Before entering into a partnership, financial executives need to have in-depth knowledge of the private equity firm's investment and exit strategies and operational expertise, as well as knowing how to manage the relationship.

On behalf of target company owners, financial executives have several strategic issues to address in connection with the sale of all or a portion of the ownership of their company. Determining the objectives of the company's owners and their definitions of success in the transaction is an important first step.

In many private companies, the owners' objectives may diverge from one another. Reconciling those differences is critical to the success of a relationship with a private equity firm or any buyer. What are the financial and



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ownership objectives of prospective buyers? How do these compare to the owners' definition of success? Aligning or reconciling these objectives is imperative.

Financial executives play a key role in conducting sell-side due diligence on prospective buyers. Performing due diligence on prospective buyers is every bit as important as the buy-side due diligence on the target company.

In any transaction, there will inevitably be organizational changes and dislocations that occur post-closing. Ensure ahead of time that the financial executive will be a part of the planning team created to identify and develop solutions to these issues.

■ **Don't oversell: proper valuation will reduce downside risks.** Strategic buyers are often ready to pay top dollar for an acquisition. Several factors are at play here: The potential to realize operating synergies and their existing preparedness to receive lower returns on investment (ROI) or cost of capital.

Strategic buyers may also offer a higher price in exchange for their stock, but that comes with both upside potential and downside risk. Private equity firms typically offer a lower initial purchase price, but with the prospect of higher, long-term gain based upon the future sale of retained ownership.

■ **Deal structure: meeting the company's needs.** While strategic buyers will usually acquire 100 percent of the target company for cash or some combination of cash and stock, private equity firms and other financial buyers are able to offer all cash deal structures with the flexibility to meet the divergent needs of the ownership group. They can cash out owners who may wish to retire, while offering some liquidity for owners who want to partially cash out and leave some of their equity in the business.

One of the most important issues in deal structuring is financial leverage. Private equity tends to use higher levels of debt in the capital structure of acquisitions than strategic buyers. The effect may sometimes be to over-leverage a business, thereby reducing the reinvestment of operating cash flow into the business to fund growth.

The financial executive of the target company is in the best position to analyze debt load in comparison to projected operating cash flows to make a realistic assessment of whether the capital structure fulfills operating requirements.

■ **Time to close: sealing the deal with a minimum of friction.** The strategic buyer's industry expertise can often reduce the length and complexity of the due diligence process. Since financial buyers frequently do not have the same industry expertise as strategic buyers and may bring in outside consultants to perform part of the due diligence, the process could be drawn out, delaying closing.

Despite the time inconvenience, consultants can often help the management team of the seller to identify and develop solutions for common post-closing disputes that result from inevitable organizational restructuring.

■ **Investment criteria: learning how they operate.** Don't be afraid to ask questions that may reveal unfavorable truths; they may also reveal favorable ones. The financial executive on the selling side of the deal should carefully review the investment criteria of prospective buyers, particularly private equity firms.

Ask these questions: Is this transaction consistent with their stated industry preferences and experience? Will they be able to add value based upon previous experience? Is this transaction consistent with their stated company size and investment size? Is the proposed transaction structure similar to previous transactions in the portfolio? Is the proposed transaction type consistent with previous transactions — e.g., if the buyer specializes in acquiring businesses with solid fundamentals, what are the implications if this transaction is a turn around?

Additionally, does the private equity firm have sufficient "dry powder" to make incremental investments in the business, or will it need to raise additional capital? Previous acquisitions made by the firm will also indicate its strength in the follow-on investment stage.

■ **Previous transactions: getting at their past.** Target company owners look to their financial executives for a realistic assessment of what actually happened with the PE firm's prior transactions. Every transaction includes a lot of "happy talk." The objective, however, is to get at the whole picture, which is only achievable through careful due diligence and analysis.

If this process is successful, the happy talk at the beginning of the date will soon turn into real talk, separating the sales pitch from the reality. Uncovering issues with disruptive potential before the transaction closes is the paramount objective of this process.

■ **Strategy and vision: making the right choice.** Aligning strategies and visions may be one of the most important criteria in selecting among strategic buyers or in choosing to accept private equity funding instead. Despite the fact that strategic buyers, unlike some financial buyers, will already have their own plans, the company is tasked with clearly explaining its vision and strategy for success — nobody is a mind reader.

■ **Employees, culture and legacy: maintaining normalcy.** Minimizing employee disruption and maintaining the culture of the business will most likely be achieved through a partnership with a private equity firm, as strategic buyers will look to obtain synergies by streamlining operations through possible reductions in staff and management.

That's not to say private equity firms aren't also committed to operational efficiency, but there is more opportunity for the target company's management to remain intact, taking a strong leadership role in the new organization.

Good strategic buyers understand the importance of figuring out the essential cultural attributes that originally led to profitability and innovation in the acquired company, with the goal of preserving those essentials after the purchase.

Cultural or legacy attributes that inhibit integration and operational improvement will be quickly eliminated. Financial buyers will have a greater tendency to maintain the culture of acquired companies and preserve the legacy of the business.

■ **Control and governance: who takes the lead?** The seller is in the position to make many of the initial decisions that will determine how the relationship proceeds, despite being met with some resistance. Strong negotiating skills and willingness to compromise will be key during this stage.

If the company wishes to sell 100 percent ownership interests, the transaction with strategic buyers will be more straightforward, as they typically acquire full ownership.

Private equity firms, on the other hand, are open to other options that may entail retaining a minority position. The financial executive is in the position to help the company sort through the theory and practicality of these options so that successful growth of the company is ensured post-closing.

Regardless of the alternative chosen, corporate governance will almost always become more formalized, which entails: formal board meetings held on a recurring basis; more complete reporting packages submitted to all directors; board approval of changes to executive compensation and hiring of executives; board approval of significant capital expenditures; board approval of acquisitions; the implementation of financial dashboards to monitor the business; and the increase in consulting projects designed to improve operating processes.

■ **Management: making promises.** It's in the best interest of the buyers to tell sellers and management that they are a partner in achieving long-term financial and operating objectives. They promise to work on strategic decisions together and to let management run day-to-day operations. Normally, those are true statements, but due diligence will reveal the extent to which that will remain true post-closing.

Management should be prepared for the somewhat laborious phase following closing, when the focus is on achieving operational excellence and organic (or internal) growth. Growth through acquisition will only occur after the platform company achieves operational excellence.

■ **Exit plan: where will the future lead the company?** History has shown that the leading exit strategy for a PE firm is to sell to a strategic buyer. The second leading strategy is to sell to another private equity firm or other financial buyer focused on larger companies.

Therefore, even if the first transaction is completed with a financial buyer, the target company and the managers with retained equity interests are more likely than not going to sell their ownership in a subsequent transaction to a strategic buyer, even if the managers would prefer selling to a financial buyer.

Aligning strategies and visions may be one of the most important criteria in selecting among strategic buyers or in choosing to accept private equity funding instead.

The Bottom Line

Financial executives face several strategic issues in connection with the sale of all or a portion of the company. Before making the decision to seek private equity funding through a partnership with a private equity firm, companies must understand the complexities of these deals, which range from accounting to counseling opposing personality types.

The financial executive is in the prime position to facilitate and navigate this terrain on behalf of the target company in order to foster a strong, productive relationship among all parties.

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