Leveling the Playing Field: Private Equity Versus Strategic Buyers

By Robert P. Crisp and Michael G. Lux

Broader portfolios and higher valuations from private equity groups have narrowed the gap between strategic and private equity buyers, making it more important than ever to understand the differences between them. Authors Rob Crisp and Mike Lux explain how increased liquidity is changing the dynamics for targets deciding between offers from strategic or private equity buyers.

Strategic and private equity groups offer distinct advantages and disadvantages, which sellers of businesses need to evaluate before selecting the deal that's right for their company. Increased liquidity and the capital available to support acquisitions are both expanding and leveling the playing field among strategic and private equity buyers.

The global mergers and acquisitions (M&A) market reached an all-time high of $3.8 trillion in 2006, with activity jumping 38 percent, while U.S. M&A volume increased by 36 percent to $1.6 trillion in 2006, nearly topping the record of $1.7 trillion set in 2000.[1]

The ability of the M&A market to sustain such extraordinary levels is largely dependent on several key factors, including liquidity, sustained economic growth, and the ability of companies to service debt.

Of the ever escalating number of U.S. deals, private equity firms closed 11 percent of them between 2002 and 2006.[2] But private equity buyers are gaining on their strategic rivals. In 2006, private equity buyers closed half of the top 10 transactions in the United States.[3]

In today's marketplace, private equity funds have unparalleled access to cash from institutional investors, including pension funds, insurance companies, and university endowments. Their sources for funds are soaring as these institutional investors divert more assets into alternative investments with the potential for higher returns.

Another significant factor spurring acquisitions by private equity groups is the abundant availability of debt capital. As debt markets have continued to loosen and equity groups have lowered their targeted return, valuations for leveraged buyout transactions have continued their upward climb.

For example, a company valued at $25.7 million in today's market would have been valued at $19.2 million in 2001, using prevailing valuation metrics. The 34-percent increase in value is predicated on more leverage available to the acquirer coupled with a reduction in the private equity firm's anticipated return. See chart on this page.

This increased level of capital enables private equity groups to compete more effectively with strategic buyers in auctions. During 2006, private equity buyouts surged to $440 billion in the United States and Europe.[4]

Historically, private equity firms could not leverage synergies available to strategic acquirers, which reduced their ability to offer a competitive valuation. As many of the large private equity firms have acquired broader portfolios, these funds behave increasingly like strategic buyers and have improved their competitiveness in auctions.

Both private equity buyers' access to ready funding and competition with strategic buyers are driving up the prices paid for targets. As is typical in an auction, the more bidders, the higher the price paid for the purchase.

What's the surest indicator of this trend? The median enterprise value divided by earnings before interest, taxes, depreciation, and amortization (EBITDA) is rising. It was 7.8x in 2006 compared to 5.3x in 2001 for targets valued between $10 and $250 million.[5]

But that does not mean targets can drift through the bidding process. The complexity of the M&A marketplace has increased as rapidly as the war chests supporting acquisitions. Sellers of businesses need to consider more than the size of the bid when evaluating competing bids for their business.

Overall, the goals of the two types of buyers remain the most important difference between them, with significant implications to deals. The critical question sellers and advisers should ask is, "Which buyer offers the best opportunity to achieve the shareholders' goals?"

Sample Capital Structure

($ in thousands)	2001	2006
Adjusted EBITDA	$4,000	$4,000
Valuation Multiple	4.8x	6.4x
Enterprise Value	$19,200	$25,700
PE Internal Rate of Return*	35%	25%
Sources:		
Senior Debt	$8,817	$12,024
Subordinated Debt	$4,008	$6,012
Equity	$6,375	$7,664
Leverage Multiples		
Senior Debt/EBITDA	2.2x	3.0x
Subordinated Debt/EBITDA	1.0x	1.5x
Total Debt/EBITDA	3.2x	4.5x

* Assumes a five-year exit.

The Right Partner

Take the contrast in styles in 2006 between a strategic buyer like Microsoft with 16 acquisitions and a private equity firm like Riverside Co. with 17 acquisitions.

While Microsoft is universally known to cultivate imaginative ideas within, it also looks for expansion from targets to add new skills and innovative products to its arsenal. But the right fit and culture for the target are essential. Primarily a middle-market buyer, Riverside added a diversified mix of companies to its portfolio with deals in industries ranging from healthcare to technology to transportation.[6]

Strategic and private equity buyers diverge in their tactics as they size up targets, structure transactions, and influence management after the deals are done.

Like the merger of General Electric and IDX Systems, strategic buyers look for targets with interrelated business lines to expand operations, gain access to new customers, and streamline operating facilities. They also seek to nurture long-term value and effectively merge a target into their existing operations.

The ability to successfully merge the two companies is often paramount as strategic buyers are often able to pay a premium for a business with the expectation that the premium will be offset by the realization of synergies.

On the other hand, private equity firms look for targets that generate steady streams of revenue without substantial investment required in products, services, or research and development.

The typical target has stable revenues that can be used to pay down the debt used to fund the deal. Additionally, they hunt for businesses that have ample opportunities for growth and can be sold within three to five years for returns on investment of 25 percent to 30 percent.

Steady cash cows, like healthcare billing services companies, are ideal acquisition candidates for private equity firms.

On the structuring side of the transaction, private equity buyers often retain management teams instead of reducing personnel after the transition ends, as strategic buyers routinely do. For targets desiring to retain their legacies and corporate cultures, selecting a private equity buyer may be a better choice.

Understanding the differences between how strategic and private equity buyers differ is the key for a target to find the right buyer and execute a successful transaction. For more details, see the sidebar on page 6.

The Upside of Higher Valuations

Higher valuations have resulted in more companies for sale. Business owners want to capitalize on the market's strong valuation multiples, the large number of eager buyers, and historically low capital gains tax rates.

Despite the liberal use of leverage, the Federal Reserve reports business debt default rates are hovering at lower than

Comparison of Buyer Types

Pros for Strategic Buyer	Pros for Private Equity Buyer
Provides complete liquidity.	Provides significant liquidity.
Enables diversification for owners, thereby protecting owners from changes in the industry environment.	Allows remaining management to participate in upside potential.
Encourages synergies that could result in premium valuation.	Preserves legacy.

Cons for Strategic Buyer	Cons for Private Equity Buyer
May lose the company's identity and legacy.	May not realize premium valuation due to absence of synergies.
May limit or nullify future opportunities for the management team.	May lose managerial control.

1.5 percent compared to an average of 4 percent between 1985 and 2006.[7] What does this mean for the M&A marketplace? The low default rate and easy access to cash are a one-two punch causing historically high valuations for targets.

Then there's the *Sarbanes-Oxley Act of 2002* (SOX), which some economists claim is the reason behind more public companies going private. This factor is more of a consideration for small to mid-sized companies due to the higher proportional cost of implementing SOX compliance with a smaller cushion to absorb expenses.

For example, the cost to implement SOX at a $500 million target comes at a higher percentage of annual sales than at a global entity like General Electric.[8]

Leveraged Transactions

The negative consequences of increased liquidity and higher valuations can mean riskier investments as increased leverage boosts the need for acquired businesses to maintain stable cash flow streams. As private equity and strategic buyers battle each other for transactions, their peril will increase if the target business or the economy as a whole falters.

Those most at risk are buyers who bought targets at high premiums by leveraging businesses. While liquidity is currently king, downward cycles would place unsustainable burdens on heavily leveraged companies, which will eventually drive down valuations and result in both strategic and private equity groups being more cautious. Remember the paucity of bank financing in 2001?

What factors could bust the booming M&A marketplace? One would be gasoline price increases for a sustained period — longer than the spring and summer of 2006 and 2007 — combined with a slow housing market and lower corporate profits.

Strategic and private equity buyers diverge in their tactics as they size up targets, structure transactions, and influence management after the deals are done.

Another is a sizeable or sustained increase in interest rates. But hiking interest rates by itself won't cause a market downturn. If it were coupled with a decrease in output, the economy could shift quickly downward.

Of course, there's one ingredient that could spark a powder keg of economic woes: another large-scale terrorist attack inside the United States.

Like every industry, M&A is cyclical. But strategic and private equity buyers with long-term perspectives can temper the effect through establishing contingency plans for all their acquisitions. If not, they could end up on the short end of the deal.

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[7] "Charge-Off and Delinquency Rates on Loans and Leases at Commercial Banks," Federal Reserve Statistical Release, June 25, 2007.

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