Private Equity vs. The Strategic Acquirer

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When private equity firms and strategic acquirers meet on the M&A battlefield they come packing very different strategies and artillery. Who has the advantage?

With private equity (PE) sitting on an estimated US$3.6tn of assets under management, including US$1.2tn dry powder (money raised but not yet invested), M&A activity in 2015 is expected to be more frantic than ever and corporate acquirers should be prepared for the increased competition.

From fundraising to value creation post-closing, strategic and PE investors come from very different perspectives and have distinct and disparate strategies. Traditionally, strategic buyers were considered to be at a greater advantage but this has changed over the last decade. In fact, a comparison of the two acquirer classes today suggests that PE companies' financial discipline, flexibility, focus and incentives structure has given them the edge.

In the paper, **Strategic Buyers vs Private Equity Buyers in an Investment Process** I co-authored with Jan Vild, an M&A professional in a global pharmaceutical company and an INSEAD EMBA graduate, we looked at seven stages of an investment process and came up with insights which should help M&A practitioners on both sides of the fence to better understand their ‘opponent’.

1 Fundraising

As strategic buyers’ capital is usually provided by ongoing operations, these firms are often not faced with the task of approaching shareholders for equity, unlike PE companies who have the challenge of fundraising from limited partners. This may appear to act in strategic buyers’ favour but we suggest this actually imposes financial discipline on the PE firm which some strategic buyers may miss. It may not assure the PE acquirer the higher bid, but it does help the company to move ahead faster and win deals in which they are more likely to generate value.

2 Deal sourcing

When identifying deals, strategic investors have the benefit of knowing the industry and a good overview of potential acquisition targets. Again, this apparent advantage has drawbacks. Unless a strategic player wishes to embark on potentially risky diversification, the selection of targets could be limited. PE firms on the other hand, have the ability to conduct rigorous financial analysis and a network of advisors, bankers and lawyers which enable them to identify potential targets as swiftly as industry players. They also have flexibility as to the target sector and may have less antitrust constraints.

Despite the differences neither side seem to be at a major disadvantage over the other in this process.

3 Due diligence

As the strategic buyer will often benefit from its intimate knowledge of the target company’s industry, the due diligence required by a PE firm at the outset of the acquisition process is often more demanding. Having said that, when strategic buyers look to acquire targets for diversification in new areas or new geographies, their prior knowledge may be of little use or even harmful if they mistakenly assume they have knowledge where there is none.

Generally corporate buyers' due diligence will focus on the target's high value assets and on identifying and validating potential synergies. For a PE firm, the target must present value in its totality and in external growth opportunities. Due diligence of cash flows, management and potential exit routes are also crucial. On the whole, it will take longer for the PE firm to understand the target's operations and industry (although this may be minimised if the target company seeks to attract PE bidders and tailors documents to assist them).

While the process may seem a much more onerous one for private equity acquirers, conducting due diligence is one of PE firm's core capabilities. Their desire to learn, efficiency and ability to act swiftly and flexibly when uncovering vital information, place them at a decided advantage over some strategic bidders who may be inexperienced in M&A and not very reactive to changed circumstances.

4 Valuation and deal-financing

When valuing a target firm, sophisticated strategic buyers will focus on preparing discounted cash flow (DCF) models, enabling them to identify which synergies will present the biggest value impact. A strategic buyer's knowledge of the industry and its trends will help to validate projections of the DCF model.

With regards to finance, strategic buyers are unlikely to have the leverage PE firms do. While smaller acquisitions may be fully financed through internal cash sources, larger assets may be acquired through debt financing, almost exclusively through senior bank loans, or by using its own shares.

While strategy buyers have the upper hand over PE by improving valuation of the target through synergies, PE buyers have the advantage of leverage. The PE firm makes its valuation on the basis of an leveraged buy-out (LBO) model which will stress to a greater extent the use of multiples. Key features of the LBO model will be forecasts of cash flows and of the target's future capacity for repayment of debt. It will also include expected improvements of the target's operations. Validation of the cash flow will be extremely important as there may be little headroom for negative surprises.

Setting up financing may disadvantage PE firms in competitive bidding as any bid is contingent on the firm obtaining bank financing. On the other hand their ability to leverage the financing of the transaction greatly enhances their internal rate of return (IRR).

All in all it's not possible to conclude whether one type of buyer has an inherent advantage over the other when it comes to valuation of a target, except where macroeconomic conditions substantially restrict the availability of debt financing and adversely impact the PE firms' ability to use leverage.

Strategic buyers may also show a potential lack of financial discipline. Larger or bureaucratic strategic buyers may find internal project teams present projections that are over optimistic to increase the project's chances of getting internal approval and they be more aggressive in bidding contests, in which case winning the bid may be somewhat of a Pyrrhic victory.

5 Negotiation and transaction execution

PE firms 'repeated experience in structuring and negotiating deals gives them an advantage although the need to assemble external financing may complicate the process. Less demanding due diligence by the strategic bidder may also make for easier discussions with the seller. On the other hand, PE firms' structure makes them more disciplined when it comes to value-creating negotiations, while their flexibility and ability to move swiftly makes them better able to execute and close the transaction.

6 Value creation after closing the deal

In many cases, strategic buyers will be looking to fully integrate the acquired firm into their business to realise the synergies planned in the transaction. However, statistics indicate that between 50 percent and 70 percent of all M&A transactions fail to achieve their objective, often due to the difficulties in blending the two cultures.

A target acquired by a PE firm will, in most cases, continue as a standalone business. It will usually be under heavy debt so cash flow management will be a core concern. With this in mind the target's management will be under pressure to operate in a lean and efficient manner. The target's business will be subject to periodic financial and performance review. This discipline, coupled with heavy loaded incentives, give PE firms a clear edge over strategic buyers in creating value post close.

7 Long-term plans

A strategic buyer's long-term plans for the new company usually involves holding onto it indefinitely and integrating the relevant businesses into its own operations to realise synergies.

PE firms' strategy, "buy, improve and sell" will see them exit the investment within a three-to-six year period. This very clear goal of selling (or IPO-ing) the business in the near future reinforces the need for internal discipline and guides what needs to be done to improve the acquired company.

While this can be a positive for operations it can also create investor myopia as decisions that could strategically benefit the business in the longer-term may be ignored.

PE firms' competitive edge

When comparing the differing characteristics of strategic and PE acquirers it is obvious that while the former benefit from synergies in their acquisitions, PE firms enjoy many advantages which level the M&A playing field. There are, of course, great variances between companies in both categories, but on the whole it is fair to say that the discipline, flexibility and focus of an average PE firm will top that of an average strategic buyer. That's not to say PE firms will always dominate. Some strategic players, such as Cisco and Mittal Steel, were able to master the acquisition game in the past and create major value.

One great advantage strategic buyers do have, over their PE counterparts, is the ability to create value internally through consolidation, innovation and operational excellence. For PE firms, M&A is the only game they know, and staying at the top in this field is necessary for their very survival.

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