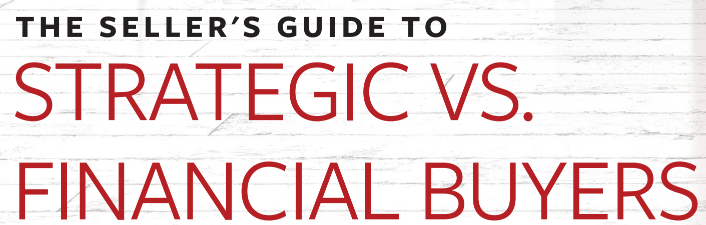
AXIAL FOR CEOS

AXIAL



AXIAL FORUM
THE SELLER SERIES

Table of Contents

5 Key Differences Between Financial & Strategic Acquirers 4

Should You Include Financial Sponsors on Your Buyer List? 10

How to Connect with the Right Strategic Buyer 12

Deciding How Many Buyers to Approach 15

Buyers fall into two primary categories.

When you decide to sell your company, one of the first things you will want to do is work with your M&A advisor or investment banker to begin researching and building a buyer list — a list of corporations, investment firms, and individuals to approach during the M&A sale process.

Potential buyers fall into two primary categories:

→ **Strategic Buyers**: These are operating companies that provide products or services and are often competitors, suppliers, or customers of your firm. They can also be unrelated to your company, but looking to grow in your market to diversify their revenue sources. Their goal is to identify companies whose products or services can synergistically integrate with their existing business

→ **Financial Buyers:** These include private equity firms (also known as "financial sponsors"), venture capital firms, hedge funds, family investment offices, and high net worth individuals. They are in the business of making investments in companies and realizing a return on their investments.

In this ebook, we'll cover topics like:

→ 5 major differences between strategic and financial buyers

→ How to decide which type to include on your buyer list

→ How to connect with the right strategic acquirer

5 Key Differences Between Financial & Strategic Acquirers

According to Pepperdine University's 2016 Private Capital Markets Report, 57 percent of closed business sales transactions in 2015 involved strategic buyers.

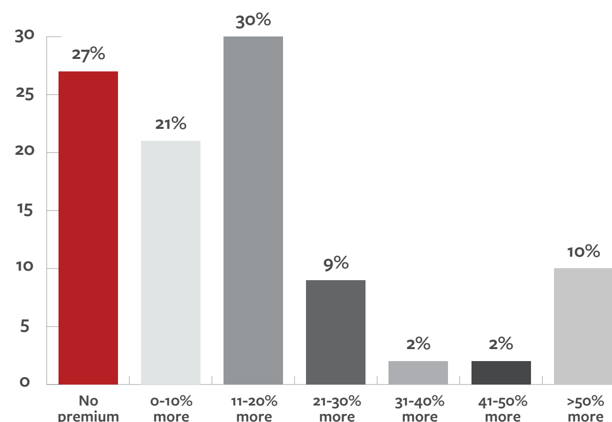
Percent of 2015 Transactions by Type of Buyer

Data from Pepperdine University

This might be because strategic buyers tend to pay more for businesses than financial buyers. In Pepperdine's research, 50% of respondents found strategic buyers to pay a premium between 1% and 20%.

Premium Paid by Strategic Buyers

(Relative to Financial Buyers)



Data from Pepperdine University

Because these buyers have fundamentally different goals, the way they will approach your business in a M&A sale process can differ in many material ways.

Here are 5 key differences.

1 Evaluation of Your Business

Strategic buyers evaluate acquisitions largely in the context of how the business will tie in with their existing company and business units. For example, as part of their analysis, strategic acquirers will ask questions like:

- Are the products sold to their customers?
- Does your company serve a new customer segment for them?
- Are there manufacturing economies of scale we can realize?
- Is there intellectual property or trade secrets that you've developed that they want to own or prevent a competitor from owning?

Conversely, financial buyers won't be integrating your business into a larger company, so they generally evaluate an opportunity as a stand-alone entity. In addition, they often buy businesses partially with debt which causes them to scrutinize the business' capacity to generate cash flow to service a debt load. Financial buyers are also focused on understanding how to quickly increase the long-term value of the company to ensure an acceptable return on their investment.

One note of caution is that all buyers cannot be neatly categorized.

While both buyer groups will carefully evaluate your business, strategic buyers focus heavily on synergies and integration capabilities whereas financial buyers look at standalone cash-generating capability and the capacity for earnings growth.

One note of caution is that all buyers cannot be neatly categorized. Sometimes "strategics" are just looking to boost their earnings and end up acting like financials. Other times, "financials" already own a company in your space and are looking to make strategic add-ons, so they'll evaluate your business more like a strategic. By understanding the motivations of the buyer, you can understand how they're determining your business value.

2 Determining the Investment Merits of the Industry

While this might seem obvious, strategic buyers usually are more "up to speed" on your industry, its competitive landscape and current trends. As such, they will spend less time deciding on the attractiveness of the overall industry and more time on how your business fits in with their corporate strategy. Conversely, financial buyers are typically going to spend a lot of time building a comprehensive macro view of the industry and a micro view of your company within the industry. It is

not uncommon for financial buyers to hire outside consulting firms to assist in this analysis. With this analysis, financial buyers might ultimately determine they do not want invest in any company in a given industry. Presumably, this risk is not present with a strategic buyer if they are already operating in the industry.

As the seller, the risk of having a sale process fail due to "industry attractiveness" factors is reduced by ensuring that you are soliciting strategic buyers.

3 Strength of Back-Office Infrastructure

Strategic buyers are going to focus less on the strength of the target company's existing "back-office" infrastructure (IT, HR, Payables, Legal, etc) as these functions will often be eliminated during the post-transaction integration phase. Since financial buyers will need this back-end infrastructure to endure, they will scrutinize it during the due diligence process and often seek to strengthen the infrastructure post-acquisition.

As such, you'll likely want to de-emphasize the importance and/or value of your back-office infrastructure in discussions with a strategic, whereas it's important to be prepared for thorough evaluation of these functions when having discussions with a financial buyer.

4 The Impact of the Investment Horizon

Strategic buyers intend to own an acquired business indefinitely, often fully integrating the company into their existing business. Financial buyers typically have an investment time horizon of four to seven years. When they acquire and subsequently exit the business, especially in the context of the overall business cycle, will have an important impact on the return on their invested capital.

Strategic buyers tend to own an acquired business indefinitely.

For example, if your business is purchased at the peak of a business cycle for 8X EBITDA and the buyer can only sell it for 6X EBITDA 5 years later, it's tough to make an attractive return. As such, financial buyers are going to be more sensitive to business cycle risk than strategic buyers, and they will be thinking about various exit strategies for your company before making the final decision to invest in / buy your company.

5 Transaction Efficiency

Financial buyers are in the business of making acquisitions. It it one of their core competencies to execute deals in a timely fashion. Some strategic buyers may not have a dedicated M&A team, may be encumbered by slow-moving boards of directors, bureaucratic committees, territorial division managers, necessity to check acquisition against internal projects, etc.

4 Reasons Strategic Buyers Will Pay More

Are strategic buyers simply irrational?

In the M&A world, it's often said that strategic buyers pay higher valuations than financial buyers. Are they simply irrational buyers? Not necessarily. In many cases, strategic buyers are motivated by different facets of the acquisition and may have different avenues by which they can generate an acceptable ROI from the target.

In client interviews with bankers and strategic buyers who are part of the Axial network, we isolated four concrete and logical reasons behind strategic buyers' ability to pay more.

1 Revenues

Strategic buyers often have existing customer relationships they want to leverage after acquiring a company. They also want to acquire customers to rapidly grow market share. Acquiring customers one by one or taking them away from installed and entrenched service providers can be hard, sometimes near impossible.

To that end, one of the biggest synergies that companies often seek to generate relates to a one-stop shop strategy. ORACLE might be one of the best known strategic buyers in the technology industry and they have employed this strategy up and down the technology stack, from ERP and CRM, all the way through the programming layer down to the database layer.

Recently on Axial, a strategic buyer operating in the giftware industry was seeking to leverage a massive catalog distribution channel they had developed. They discovered a clothing manufacturer whose product plugged right into their catalog business, creating significant strategic revenue synergies for both the target and the acquirer.

2 Costs

When a financial buyer acquires a standalone company as part of a “new platform” acquisition strategy, there isn't an existing business into which they intend to merge that business. As such, all core administrative expenses and resources must remain in place after the change of ownership. Not so with strategic buyers; if a strategic buyer already has a great HR or Admin, Finance, and IT platform, and can merge the products, intellectual property, and other capabilities without duplicating the standalone back-end costs, then they are fundamentally able to pay more.

Let's use an example to illustrate this: Company A is for sale and generates $60M of revenues and $7M of pre-tax income. If there is a financial change of control for that business that doesn't entail an integration with a strategic buyer, then all the administrative infrastructure necessary to run the company is still required. Perhaps new ownership can renegotiate contracts and operate more efficiently, but that often leads to marginal changes in profitability.

Conversely, Company A is sold to a strategic buyer and, leaving aside any revenue-based improvements, the strategic buyer is capable of eliminating the entire administrative infrastructure. Whereas the financial buyer must model the earnings capability of the business off of $7M of pre-tax income, the strategic buyer can potentially strip out the administrative and IT costs and assume $8M of pre-tax income. Consolidating expenses (including rent, labor, insurance, and other back office functions) can significantly improve profitability, thus allowing the strategic buyer to bid more while still ensuring a successful ROI on the acquisition.

3 Eliminating Threats & Vulnerabilities

As companies grow large and become more complex to manage, they often become less agile and less able to compete with nimble competitors who have simplified cost structures and newer technologies or processes. Often, it's preferable for large companies to simply buy small companies versus try to compete with all of them.

Other times, companies have large and highly profitable business models that are entirely threatened by new entrants or paradigm shifts in their market. This happens a lot in technology and technology-enabled markets. Sometimes, strategic buyers will buy companies to simply defend the existing cash-generating business that they currently enjoy.

When a company has a profitable and powerful cash-generating business, and those economics are jeopardized by an emerging competitor, sometimes the strategic buyer will pay an enormous premium in order to eliminate the threat. Business owners who want their companies to live and thrive after a sale should be very wary of these potential situations and look for signals that this is the ultimate intent of the strategic buyer. In fact, this is one of the most compelling reasons to sell your company to a financial buyer; they are much less likely to have such multi-faceted, ulterior motives.

4 Increase Business Predictability

Many businesses are inherently cyclical while others are more stable and, when combined with a cyclical business, can provide a counter-cyclical offset. Cyclical businesses can be huge, like Intel (NYSE: INTC), whose revenues and profits often ebb and flow with their chip production and OEM purchasing cycles. Stable businesses tend to be businesses that offer non-discretionary services, such as health care. Companies with highly cyclical financial performance are punished by Wall Street with lower valuations and lower multiples. One method by which these large corporations counteract their business cyclicality is by acquiring stable businesses that have less overall variability in revenues and profitability.

Stable businesses tend to be those that offer non-discretionary services.

While it's often the case that strategic buyers may bid at and ultimately pay a premium for companies, understanding these motivations can help you determine how to optimize your business to leverage these motivations, develop the company to be a more attractive acquisition target for strategic buyers, and prepare for post-acquisition obligations.

Should You Include Financial Sponsors on Your Buyer List?

Given that financial sponsors are usually unable to pay as much for a business as strategic buyers can, should you limit your buyer list to strategic acquirers or is there a sizable benefit to including financial sponsors?

Why Financial Sponsors Pay Less

There are two core reasons why financial sponsors tend to be unable to pay as much as strategic acquirers.

First, sponsors are under pressure to hit a target return percentage on they money they invest — which puts a restraint on their entry price into every investment. They're not obligated to meet these return targets, but their ability to do so makes a dramatic difference for (a) the amount of carry received upon exit, (b) future management fees and (c) whether future funds can even be raised. The three main drivers of returns are entry price, exit price, and leverage. Consequently, buyers are rightfully focused on pricing for a certain internal rate of return (IRR) during the acquisition process.

Secondly, sponsors usually can't benefit from the operational synergies that frequently result from strategic deals. Synergies occur when two companies perform stronger financially than they do individually. This generally results from cost reduction, joint talent and technology, or cross-market revenue growth. For this reason, synergies almost always accompany strategic acquisitions and are often a driving force behind how much a buyer is willing to pay. For financial sponsors however, unless the deal is an add-on to an existing portfolio company (in which case the combined company is much more likely to realize either cost synergies or revenue synergies) they structurally can't benefit from operational synergies. The absence of these sizable benefits puts a ceiling on how much the business is worth to them, and correspondingly, their upfront offer.

Despite these limitations however, experience shows that it is actually almost always a good idea to include financial sponsors in your buyer list. Here are the primary benefits.

Deal Discipline

There are 1,000 roadblocks you'll have to hurdle to close a deal.

First, having financial sponsors in your sellside process helps with deal discipline and pacing. Anyone who has ever tried to sell a business will tell you that there are about 1,000 roadblocks that you'll have to hurdle to actually close a deal. Between buyers needing more time, being unable to make decisions, wanting more information, and unexpected hiccups, even the most veteran M&A bankers have an exceptionally tough time running an expedient process.

However financial sponsors, as the name denotes, are in the business of sponsoring business growth. Because of this, they're veterans when it comes to sellside deals and will typically go through dozens of processes a year.

As a result, sponsors tend to have an excellent grasp of structure and pacing: knowing what the standard transaction looks like, exactly what the next step is, and when you should be there. They know how a normal NDA looks, when to submit it, what needs to be in the data room, and how to structure an LOI.

Moreover with multiple parallel deal processes running, investments that the sponsor has to exit in the next few months, capital that must be put to use within a tight time frame, and their own timing restraints, having these guys on your buyer list will help keep the process on track and moving forward.

Deal Certainty

Secondly, involving financial sponsors in your sell-side process typically improves deal certainly. Because sponsors are generally driven by a return targets, the amount that they're willing to pay will be predominantly based on the exit price, forecasted performance, and the IRR that they need to hit. They will then use these restrictions to solve for the entry price.

Consequently, while they generally pay less than strategics, sponsors are often happy to come to the table at some price level.

Not only does including financial buyers help with deal discipline, but it provides deal certainty, because those buyers will always be there at a price. To have someone like that in your process gives you a sometimes weak but nonetheless important safety net.

How to Connect with the Right Strategic Buyer

When trying to build a buyer list, how can you find the right strategics to include?

1 Determine where you fit in a strategy

Look at the big picture and ask yourself, "What type of company would be interested in buying me? Why? And where would I fit?" Be sure to talk to your client and understand the vision and considered capabilities of the business so as to better know the avenues to take or where it could fit as a piece of a larger company. To better visualize the positioning, it is advisable to build a matrix of the below strategies and aspects to map out the potential transaction routes.

In the case a business has a unique comparative advantage, it might be cheaper for a larger competitor to buy the business than to compete with it through time-consuming organic growth investments. This type of acquisition is referred to as a bolt-on, in which a strategic buyer folds a target into an existing business department.

2 Narrow down your possible acquirer criteria by...

INDUSTRY

You do not need to confine your buyer list to companies in your exact subsector. Include all adjacent industries who might find value in acquiring your business.

GEOGRAPHY

For most businesses (with some big exceptions like technology companies), it goes without saying that location, location, location is of high import to an acquirer, either to strengthen their market share in a certain region or to expand scope to new territories.

SIZE

Most likely a potential buyer needs to be considerably larger than your client's business, but this is not always necessarily true. More important is the available purchasing power of the acquirer, be it cash, equity, or debt.

CUSTOMERS

Do you have overlapping customers and sell complementary products, or do you have different customers and sell the same thing? Customer and distribution acquisition are seminal drivers of revenue synergies.

SUPPLIERS

Whereas customer integration can boost revenue, using the same raw materials or suppliers can possibly cut input costs by increasing buyer power of the combined business. A price break from buying in greater quantity can be a significant source of synergy.

HUMAN RESOURCES

Another traditional cost synergy is reducing headcount and redundant job functions (e.g., slashing a call center or selling a factory after acquiring a company). As an owner, it can be tough to facilitate layoffs of dedicated employees; that's a personal decision that needs to be made carefully after weighing all available options. Perhaps you could work out some kind of compensation structure for your employees who will be redundant.

TRANSACTION TYPE

Acquisitions do not always take the form of pure buyouts or even majority investments. Strategics are flexible and keen on consummating joint ventures and minority equity transactions. Both options provide your client with invaluable resources to grow. For example, pharmaceutical companies often invest in start-up companies focused on research or technology, with the option to eventually buy outright upon success.

3 Identify the correct buyers to connect with

TRADE JOURNALS AND SHOWS

Pick up literature and attend conferences pertaining to identified relevant industries to narrow down the relevant players. National and regional journals invariably run ads paid for by companies with enough scale to buy smaller firms. Conferences and events will introduce you to new people as well.

ONLINE NETWORKS

Maintaining a presence on networks like LinkedIn and Axial will help you connect with potential buyers in your space.

PRIVATE EQUITY STRATEGICS

Financial buyers are increasingly also strategic buyers. Private equity firms, especially specialists, don't just rely on financial engineering and "multiple arbitrage" across the board anymore, but instead build portfolio segments the same way corporations do.

STOCK MARKET INDICES

Arguably the best way to research a publicly-traded company is to read its SEC financial statements, 10-K's, and 10-Q's, and to listen to or read transcripts of earnings calls and conference presentations. The Management Discussion and Analysis section of the 10-K Annual Report highlights the strategic direction of the company, and in doing so can signal if and where you fit.

Deciding How Many Buyers to Approach

Once you have researched strategic and financial buyers and built the buyer list, a key decision is to determine how many buyers you will approach and whether you will employ a sequenced or parallel process.

There are three general techniques:

1 Serial Approach/Negotiated Sale

You identify and contact the most logical potential buyer(s). You approach one buyer at a time and negotiate exclusively with that buyer. If unsuccessful, you approach the next party and continue to work your way down your list until you find a buyer.

2 Targeted Auction

With this M&A process, you discretely contact a limited number of potential buyers. Typically, you will approach between 5 and 20 buyers, solicit indications of interest, and then negotiate with the most appropriate and interested buyers.

3 Full Auction

You identify and contact a broad universe of potential buyers. Strategic buyers will include firms that are your competitors, suppliers and customers. It will also include "creative" strategic buyers that are not currently operating in your industry. In terms of financial buyers, you will go out to a sizable number of investment firms and executives with the financial wherewithal to buy your company.

Each approach has strengths and weaknesses. The strengths of the serial approach/negotiated sale or the targeted auction include reducing disruption to your business and limiting the chances of confidential information leaking out.

However, we have observed that those sellers who initially identify and approach a more thorough univerbuyer is making when deciding whether or not to make an offer for your business. Many of these considerations can have nothing to do with your actual business. For example, perhaps you approach the ideal financial buyer only to realize that they are raising capital for their next fund and can not get the deal done; or you approach the perfect strategic buyer but their CEO is focused elsewhere or still integrating a recent transaction.

Important things to consider in a sale process are:

→ **You never know for sure who the buyer will be.** Buyers' investment decisions are influenced by many factors, many of which you will never fully know. In all the sale processes we have been involved in, only a small fraction of the time does the initially identified "perfect" buyer end up being the actual buyer.

→ **Time and effort are required to ensure the best outcome.** You have to think strategically and critically about your business. You have to gather legal and financial information, assist in the preparation of marketing materials, build your forecasts and upload documents into a data room. You have to emotionally prepare for the roller-coaster ride of the sale process. All of this is required whether you are approaching 1 potential buyer, 10 buyers, or 100.

→ **More potential buyers usually means more options.** There are many terms and issues other than purchase price which are crucial to negotiate in a business sale. Different buyers will often propose different structures and bring different strengths and weaknesses to the table. By having more options, you increase the likelihood of finding a buyer and deal structure that fits all of your goals.

A full auction reduces the chance of deal fatigue.

→ **A full auction process reduces the chance of deal fatigue.** When employing limited approaches, sale processes tend to drag on. The management team and advisor are negotiating with one or two parties at a time and it is difficult to build momentum. When buyers see an opportunity and are excited about it, you want to build off of this initial enthusiasm. As time passes, other opportunities will come across their desk and their interest in your company can fade. By building a sufficient buyer list and keeping to a schedule of well-known milestones for preliminary and firm indications of interest, you generate momentum in your sale process and avoid deal fatigue.

→ **Multiple interested buyers leads to price discovery.** Price and value are two very different concepts. Different buyers can have differing views on the value of your company. In turn, they will be willing to pay differing prices. You may or may not like what you hear, but the more potential buyers you hear from, the better you will know what the market believes the current price of your business is.

Selling a business is a serious and complex process. While managing multiple buyers can be challenging, it is necessary to give yourself the best chance of closing a successful deal.

What is the right number of buyers to have on your buyer list? It depends on your situation. Talk to your M&A advisor, but in general, we advise to err on the side of more than less. In the end, it is not about knowing the perfect buyer when the process begins. It is about finding the right party that will structure a transaction to fit your particular needs and ensure your business is positioned to thrive in its next phase.