



DIFFERENCES BETWEEN STRATEGIC AND FINANCIAL BUYERS

by S. G. Brooke Tucker

Ask any seller and he will tell you that he wants to sell his company only to a Strategic Buyer. What he believes is that the strategic buyer will pay much more than a financial buyer. Sad to say, this is not always true, particularly for more mundane companies. Software, IT, bio-tech and nano-tech businesses may obtain seemingly obscene prices, but basic manufacturing, wholesale distribution and most service businesses are chained to counting their values in single digit multiples. The traditional strategic buyer is a corporation engaged in the same or similar line of business, while the financial buyer has traditionally been private equity groups (PEGs) and individuals. The differences between strategic and financial buyers are numerous, but the clearest differences are found in their overall approach to acquisitions. The strategic buyer wants to “Buy and Hold” and the financial buyer tends to want to “Buy Low and Exit High”. The total purchase price difference is probably not more than 10% on average – each has a required rate of return target, with the financial buyer being entirely disciplined and the strategic buyer being more prone to build in some post-acquisition synergies into their pricing models. The second part to the basic approach has to do with the exit strategy. By their very nature, investment firms must eventually sell their investment to return capital and profit to their investors. Therefore, they are in a hurry to grow the acquisition to several times its original purchase price. The strategic buyer has a slower growth model (tends to reduce pricing) because their investment horizon is usually many years longer.

STRATEGIC BUYERS

For the most part, the strategic buyer is a company in a similar line of business in a different market or is in need of new products and services to sell to their existing customers and visa versa. It is most often a much larger company or one which has a large financing capacity. Competitors are not strategic buyers. The strategic buyer finds value in the combined future of the companies and is therefore willing to consider paying some increased multiple for the future benefits. From a pricing perspective, the strategic buyer may be worth 10X earnings. By acquiring your company for 5X, your company’s earnings are now worth 10X to the buyer– simple math. One might think that the strategic buyer would pay more than 5X, but the hoped for synergies belong to the buyer and are often not shared with the seller. Think again, that the strategic buyer might simply enter your market through a de novo operation or acquire your direct competitor, rather than pay a substantial premium.

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Nevertheless, the paying capacity of the strategic buyer is greater and transactions may be for an all cash consideration. Additionally, a stock transaction vs. an asset purchase is more likely. Strategic buyers are thought to pay approximately 20% more on average than financial buyers. So 6X might be the right number. And, speaking of earnings, the strategic buyer may not require stable earnings to enter into a transaction, as its goal is more likely growth in market share.

In our example above, the strategic buyer is a corporation in the same/similar line of business. There is another type of strategic buyer these days, although their appearance is that of a Private Equity Group (PEG). A PEG may also be a strategic buyer, because it owns an operating or “platform” company. PEGs are investment funds run by investment bankers. A private equity fund is created by investment bankers to buy and sell privately held companies. It is a limited life company (usually 10 years) in which insurance companies, pension funds and private individuals invest for higher returns. PEGs today invest in a platform company in a key growing market, and then add-on other companies to accelerate growth and profitability. The roll-ups of the mid-late 1990’s were sponsored by PEGs. A typical investment profile for a PEG looking to acquire a platform or add-on company might look like this –

- A committed, entrepreneurial, and experienced management team with a proven track record.
- Proven demand for differentiated products and/or services.
- A diversified customer base.
- A well-established brand name.
- A definable and defensible market niche in a large and growing market.
- Demonstrated profitability or clear visibility to profitability and sustainable positive cash flow.

There is one substantial difference between the Strategic PEG and a strategic buyer and that is the exit strategy. The strategic buyer often does not have an exit strategy. It does not want to sell the company in the foreseeable future. The Strategic PEG has to exit the investment within the life of its investment fund. Therefore, the Strategic PEG is a half and half strategic/financial buyer.

FINANCIAL BUYERS

There are numerous distinctions between financial and strategic buyers. As discussed above the PEG is a financial buyer in some ways. Additionally, there are PEGs which specialize in leveraged buy-outs (LBOs). In an LBO the acquired company is highly leveraged to meet the purchase price. Financial buyers may only put up 20% of the purchase price in cash and borrow the rest from banks and mezzanine lenders. Because of the leverage aspect of the transaction, financial buyers require the following company characteristics in order to make a transaction work.

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- Consistent earnings.
- Reasonably high growth rates.
- Effective CEO/management team.
- Leverageable assets and cash flows.

Financial buyers may also be entrepreneurial individuals looking to get into their own business. These individuals are usually limited in their financial means, require seller financing and tend to buy smaller companies.

Financial buyers are often limited in the amount of purchase price they offer, based on the economics of the target company (seller). Based on the assets and cash flow to be leveraged, the purchase price to be offered may be 5X earnings and require some seller financing. Even if the acquisition is an add-on to another company, the ability to finance the purchase price is a limiting factor. Perhaps this financing requirement is where financial buyers got their reputation for offering lower prices.

THE STRATEGIC VALUES (VIRTUES)

Irrespective of whether a company is to be sold to a strategic or financial buyer, owners should know what differentiates their company from their competitors and how buyers measure value beyond this year's earnings. Elements of strategic value are created over time by good management and a little luck. Here are the top 10 virtues that command value in today's M&A marketplace.

1. Seasoned and Committed Management Team
2. Positioned in Growth markets
3. Attractive Market Share
4. Excellent Use of Technology
5. Recurring Revenues and Good Margins
6. Low Risk of Technological Change
7. Stable and Predictable Cash Flows
8. Loyal and Diversified Customer Base
9. Attractive Growth and Compelling Economics
10. Strong Products and Defensible Market Positions

Both financial and strategic buyers want the 10 virtues. In the last year or so, competition for good deals has heated to the point that financial buyers look like strategic buyers and visa versa. Sellers should look to both groups of buyers to obtain a transaction at a satisfactory price and on workable terms. Sellers would do well to hear both sides of the story.

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