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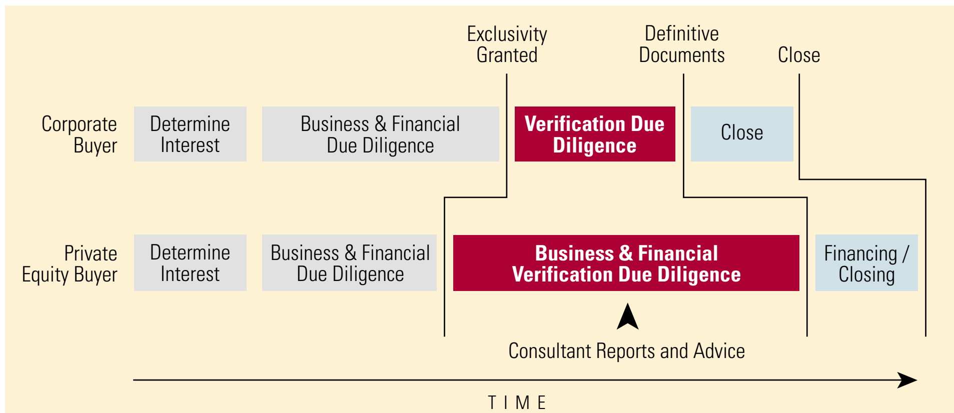
Private Equity: The Uncertainty Discount

When considering acquisition bids from private equity firms, factors other than price may weigh heavily.

by Mark D. Working

In today's active market for private company acquisitions, it is the norm for investment bankers to solicit and receive bids (or indications of interest) from a diverse group of buyers that includes both corporate entities and private equity firms. Under those circumstances, criteria other than price often may weigh heavily on the choice of alternatives. In spite of intrinsic benefits related to business and organization continuity, private equity proposals may not show as well when measured against the "three S's" in the lexicon of investment bankers—speed, simplicity, and certainty. Although the indications of value may be comparable, the road to closing a deal with a private equity firm can be longer, more complex, more expensive, and thus, less certain.

Transaction Timeline: The private equity due diligence process is time consuming and expensive.



CORPORATE / STRATEGIC BUYERS

Corporate or strategic buyers usually exhibit several common characteristics. The decision makers are already familiar with the dynamics of the industry and have well-formed opinions as to the appropriate strategy for the business. Corporate buyers are often seeking specific capabilities or characteristics that are needed to further an existing strategy. Aspects of the target firm that don't fit with that strategy, such as people, facilities, and costs associated with duplicative or ancillary functions, are discarded. Corporate acquirers are often larger companies with the capacity to integrate an acquired business into their organizations, and thereby reduce managerial and operational risks. Larger firms often do not need to arrange outside capital to complete an acquisition and their due diligence efforts tend to focus on verifying the quality of the assets rather than the target's entire business model. They often already know and are comfortable with the target's customers and product/service demand characteristics. Much of the strategic buyer's activity leading up to closing is associated with integration planning, rather than re-evaluating the business proposition.

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PRIVATE EQUITY BUYERS

In contrast, the private equity buyer typically is staffed with intelligent, financially astute business people with expertise in investment analysis, transaction management, and financing. Private equity firms manage investment funds for others (individuals, pension funds, endowments and corporations), with a mission to search out opportunities to invest in "good companies." These smart people are quick learners and insightful in analyzing opportunities; but, in most cases, have limited knowledge of the industry and the specific company under consideration.

At the point in the sale process that potential buyers submit acquisition proposals, corporate buyers are more likely to have already concluded that the target company fits with their objectives. At the same time, a rival private equity firm may only be able to submit a conceptual proposal that is subject to confirmation of its investment thesis. Before being willing to close a transaction, private equity managers will need to be as comfortable as any strategic buyer with the target company's business strategy, its position in the industry, and its value proposition. However, that effort represents a commitment of time and resources not required by many corporate buyers.

In an attempt to accelerate that learning process, private equity firms often rely on outside consultants. This help is typically provided by industry experts (former industry executives), market researchers, management consulting firms, and financial specialists (accounting firms). Each will interview employees, conduct independent research, and evaluate reams of data with the objective of generating written reports that will illuminate the target firm's strengths and weaknesses, competitive position, and industry environment. These reports serve multiple purposes. First, they may unearth valuable insights that can be used to confirm the investment thesis, or provide a basis for a decision to either walk away or revise the terms of the acquisition proposal. Second, these reports are commonly used to support the investor's efforts to arrange debt financing for the acquisition. And, lastly, the reports paper a file that documents that the

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firm has behaved prudently in making the acquisition.

These reports are not simply formalities. The professionals conducting the investigations bring their own perspectives to the deal, each of which may differ from the views of the private equity firm. And, although the private equity firm pays them, if they never come up with any intelligent insights to protect their clients or reduce the purchase price, they cannot claim to be adding any real value. The upshot of all of this is that a private equity acquisition proposal may amount to an option to complete a transaction that is subject to the opinions of outside consultants and arranging the funding necessary to close.

The private equity investigation process takes time and is expensive. So, it is no surprise that these firms are hesitant to incur much of that cost until being selected as the buyer and having a legally binding agreement that restricts the seller from continuing to pursue negotiations with other parties.

CONSIDER THE ISSUES

The takeaway for owners contemplating the sale of their privately held business is that, prior to selecting a private equity firm over a corporate buyer, it is prudent to consider the following issues:

- What is the firm's reputation with regard to timing, integrity, and perseverance in prior deals?
- Which experts will be involved; what are their specific missions; what will be needed from the company to complete that work; and how long will it take?
- Can the transaction that has been proposed be financed? Are proposals already in hand that fit the financing requirement? And, what must be done to turn those proposals into commitments?

An assessment of these concerns leads to estimates of the additional time, cost, and probability of closing. The difference between the hurdles to closing with a private equity firm and other corporate or strategic buyers is a reflection of the private equity uncertainty discount. ❖

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ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

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