ZacharyScott

INSIGHT
PERSPECTIVES ON THE CAPITAL MARKETS

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Investor, Know Thyself

Successful acquisitions & investments are borne from a thorough self-assessment.

by David Working

Challenges often bring opportunities. We've observed over the course of 2020, a roller-coaster of a year if there ever was one, that nobody's annual plan went as expected. But borne from those disruptions have been openings for well-performing businesses to make bold strategic moves. In many situations, those strategic moves have taken shape as an increased appetite for inorganic growth, or growth by acquisition and investment. Many executive teams have identified sectors or targets this year where they believe they can invest capital for long-term strategic and financial gain.

We've seen these conversations play out on the front lines—alongside our core sell-side

Unfortunately for the buyers across the table, that means that finding opportunities to earn an appropriate return on their invested capital is an increasingly daunting undertaking.

M&A and strategic advisory work, Zachary Scott also helps companies on the "buy-side," to make acquisitions and investments. While many investment banks offer buy-side transaction execution as a service line, we try to take it a step further; while it's one thing to close an acquisition, it's quite another to close an acquisition that is likely to create shareholder value. As a result of the dry powder competing to be put to work in private markets, combined with the collective efforts of transaction professionals supporting the sell-side transaction process and working hard to help private business owners capture the value they've created, the private middle market is as efficient as it's ever been. Unfortunately for the buyers across the table, that means that finding opportunities to earn an appropriate return on their invested capital is an increasingly daunting undertaking.

Our steadfast position is that value in acquisitions is realized when the acquiror (an operating business) has something – knowledge, capabilities, relationships, equipment, or locations, for example – that both (1) allow the acquiror to change the economics of the combined businesses so that the joint value

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is greater than the sum of its parts, and (2) are in some way unique to the acquiror when compared to its fellow competitors also looking to buy the same target. In the absence of those elements, the acquiror has no value advantage over the market, and will have difficulty realizing enough value from the future cash flows to defend the purchase price necessary to win the auction.

For our friends seeking purely financial investments, such as a private equity firm evaluating a new platform investment or a family

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office working through its direct investing arm, this math gets even more difficult. No longer can the source of value creation be a combination of two businesses that can share mutual strengths or match strengths with opposing weaknesses—the value must be created in the sourcing, evaluating, or management of the investment by the people making it. Many volumes of text have been written on where an investor can gain an "edge," but suffice to say for this article that it is not easy. We know of many smart, experienced investors combing the middle market for investment opportunities, and competition is fierce.

So, what's a buyer to do? We have seen the most success come from acquisition efforts when first, acquirors perform detailed (and honest) self-assessments of their unique sources of synergy value. Many businesses perform self-assessments of some kind with some regularity, but they often do so in a vacuum, or relative to the team's prior experiences, instead of against their fellow acquisitive peers. For example, we

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almost always hear from businesses that one of their competitive advantages is the strength and quality of their people—but just like how not everyone can be an above-average driver, human capital can't possibly be a differentiator for everyone seeking acquisitions. In the same vein, an equity investor is going to increase its likelihood of success when it applies its investment team's sector expertise to a small set of narrow industry sub-sectors where that expertise is particularly valuable, to guide very intentional outreach.

Perhaps unsurprisingly, we think an outside advisor can be particularly useful in helping an acquiror build a perspective of its unique set of strengths and weaknesses that can be used to guide its acquisition efforts. But other professionals can be accretive to the process as well. Sometimes the minutiae of competitive trends in an industry segment can be so critical to the context of the efforts that a specialist on that industry can be useful, and a strategy consul-

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tant is a competitor-independent information source that can help investigate the handful of attributes that will move the needle for a specific acquiror. Additionally, transaction specialists can help evaluate an organization's readiness for an acquisition, both in determining sources of strength and likelihood of integration success post-close.

Regardless of the facilitator or methodology, the most successful investors have a healthy dose of self-awareness relative to their markets that enables them to spend time on opportunities from which they can realize the most value. Often unsaid but equally important, this focus also allows acquirors to avoid sinking time and resources into potential opportunities for which they are very unlikely to be (or even shouldn't want to be) the winner. The current margin for success is razor-thin, and our observation is that self-knowledge is a critical component of staying on the winning side of that razor's edge. **ZS**

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ABOUT ZACHARY SCOTT

Since 1991, Zachary Scott has assisted owners of privately-held businesses in the greater Pacific Northwest to plan and execute major business or ownership transitions by offering sell-side M&A and acquisition and investment advice. For more information on Zachary Scott, go to **ZacharyScott.com.**

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