Corralling Strategic Buyers into a Competitive Sales Process

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The owners of a privately held business have completed preparation to sell their business: cleansed the company's financials, engaged an accounting firm to write a Quality of Earnings Report, had their lawyers review all their contracts, and re-documented the lease of property between the company and its owners to assure market pricing and terms. Their investment bank has a long list of both financial and strategic buyers. They are ready to start a competitive auction of the business.

"The seller is ready to do a deal;

Are the buyers also ready?"

There are three conditions that must exist to gain excess value from an auction sale process:

- There must be competition (or perceived competition) and the buyers must imagine that there are other buyers who are actively engaged
- Buyers must have a firm view of the future economics of the business that is being purchased
- The buyer organization must be ready to act on an opportunity and have the bandwidth to pursue and complete an acquisition

Financial Buyers

Financial buyers are perfectly structured to fit into this process. Although private equity firms are occasionally busy with other transactions that can stretch the firm's bandwidth, resources can usually be found to pursue a very interesting opportunity. Private equity firms are very familiar with auctions and do not have to be educated on the process. Their business is to make acquisitions and investments, and they are appropriately structured to do just that.

Strategic Buyers

The term strategic buyer is used in the M&A world as a category distinct from financial investors to describe operating companies that have some "strategic" connection to the business for sale. Such a buyer may have legitimate reasons to value an acquisition of a target company higher than do other buyers because, once combined, the economics of the combined businesses will be different than the two operating as stand-alone businesses. Examples of how the combined businesses may create value include:

- Combined product lines open cross-selling opportunities to customers, and/or create a more important supplier relationship with customers, thereby increasing stickiness of relationships
- Consolidation of production into fewer facilities, thereby increasing utilization and lowering per-unit costs
- Applying joint buying power to reduce input prices and lowering cost of goods
- Elimination of redundant functions, lowering overhead costs

As we have written in many previous Insight articles, value is in the eye of the beholder ("Value – In the Eye of the Beholder", Insight Fall 2006) for very good reasons.

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Value is directly related to the future risk-adjusted after-tax cash flows to be earned by the buyer, and when a company is bought by another operating company, future cash flows can vary

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dramatically from what are shown in historical financial statements. If there is a true strategic connection, such a buyer should find more value in the target company than would a financial investor, and under certain conditions, be willing to pay more.

Key Differences

It is easy to take for granted that strategic and financial buyers operate with many of the same dynamics. However, the strategic buyer is different from a private equity firm in that its managers have a full-time job running a business. A private equity firm’s core business is the business of investments and transactions, but to a strategic buyer, the investment process is an adjunct to the day-to-day responsibilities of operation. As such, the core components of investing – developing a thesis, identifying opportunities and valuing them appropriately, and corralling stakeholders to achieve approval at key decision nodes – are often not well-traveled paths at an operating company.

The implication of these differences in buyer characteristics is that some creativity may be required to develop the market. To achieve a competitive bidding process, the market has to be developed so that all (or at least the most important) parties are ready and anxious to participate on a similar timeline, and with an informed opinion of the value of the target to them. It can take some time to understand each strategic buyer’s appetite and processes (which they themselves may not have previously well-defined) in order to supply them with the materials and analysis necessary to bring them to the negotiating table when the time is right.

A Firm View of the Future

We noted earlier that a key condition that must exist to gain excess value from an auction sale process is that buyers must have a firm view of the future economics of the business being purchased. For a strategic buyer, the future economics of the combined entity are dominated by the combination plan between the constituent companies. It’s challenging for any one party to develop this kind of plan, as it requires a thorough understanding (and usually some confidential information) of both companies to construct a meaningful plan.

Providing a strategic buyer with a package of information on a target puts the entire onus of developing the combination thesis and resultant economics on the buyers – a task that they may not be well-suited for. Helping the strategic buyer understand the nature of the unique opportunity requires a knowledge of both businesses, how they operate and market, and an appreciation for the results of integration. Tossing an information package over the fence and hoping that the buyer “gets it” is a poor methodology for achieving the best result for the seller; doing the homework for the buyer and helping them critique your work gives a wealth of information that will be useful in negotiating a deal that allows the seller to receive part of the value of the synergies.

Buyer Readiness

Another key condition that must exist in the auction process is that the buyer organization must be ready to act on an opportunity and have the bandwidth to pursue and complete an acquisition. This also requires that the buyer knows what is required to complete an acquisition, and is knowledgeable about its own organizational processes and decision points.

Unlike with a private equity firm where the decision makers are known and are directly involved, the decision makers in a corporation may not be easily identified. There might be many individuals who are influential with regard to any transaction and these parties need to coalesce around a thesis supported by many. Approval processes and decision points can also be ambiguous or ad-hoc, causing stops and starts along the way. If the buyer happens to be a foreign entity, communication about the opportunity can be further complicated as a result of different languages and cultures. All of these effects add time and complexity to a process.

Managing the Sales Process

Mitigating this constraint is best served by having enough experience with buyers to understand how they approach, staff, and conduct themselves over the course of a transaction, and supporting the buyers with additional time, analysis, access, or firm process guidance. Managing the timeline can be tricky – too firm of a timeline may cause an otherwise well-suited buyer to drop out, but too flexible of a timeline may not be enough structure and pressure to get parties to the table to ever complete a deal.

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Corralling strategic buyers requires thinking like a buyer and having an understanding of the buyers at play. A strategic buyer outreach process can't be stamped out the way a broad private equity process can, and requires additional creativity in its structure (see “How to Prepare for Different Types of Buyers,” Insight Winter 2012, and “Making a Market for Private Businesses,” Insight Fall 2013). Individualized plans for each strategic buyer are not simple or easy, but might be what is needed to corral their interests and foster competition alongside other buyers.

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