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Strategics Borrow From The Private Equity Model

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On the heels of a slowly recovering economy, overall improved business performance, and lots of dry powder chasing deals, 2014 has seen a healthy resurgence in merger and acquisitions – both across public markets, and including the broad field of small and middle market businesses with growth potential and attractive value propositions.

According to Thomson Reuters, "the first half of 2014 yielded more completed middle-market transactions worth more money than the same periods in both 2012 and 2013 – a total of 1,057 deals valued at $137.9 billion."

These deals include an entire generation of baby boomers coming of age — entrepreneurs and owners of family businesses — looking to sell the businesses they founded years ago for a variety of reasons: Some wanting to cash out and retire; others suffering from burnout; or some entrepreneurs (or their progeny) keen to explore new opportunities and acquisitions. Who can blame them? In this healthy, highly competitive seller's market, valuations are way up, and with the availability of cheap debt, cash rich sponsors and strategic investors are vying neck to neck for quality acquisition targets.

These dynamics bode well for entrepreneurs and owners of middle market businesses considering a sale – often with the goal of taking significant chips off the table while participating in their company's future growth, and continuing to have an impact on the business strategy and operations.

On the back of this seller's market, interesting dynamics are unfolding. Some strategics are recognizing they can get more value from a growing entrepreneurial businesses by appropriately incentivizing company management the way private equity firms usually do. In order to accomplish this, strategics seem to be taking their clues from private equity firms, combining the best of both approaches.

How so?

For the past 30 years or so, private equity firms have promoted mechanisms that encourage management of the acquired business to invest capital alongside sponsors, and roll over part of their current ownership into equity in the new company. To maximize return on investment, a private equity firm will "leverage" the business being acquired, and use the borrowed funds as part of the purchase price for the business. Financing is provided by a third party lender, such as a bank. Post-acquisition, the company would be managed to achieve projected returns for both the private equity fund and management under a leveraged capital structure. The challenge for management is typically to grow the business while servicing principal and interest on the loan.

While management of the acquired company typically values the financial incentives under the ownership of a private equity firm, gaps such as solid operational support, cultural differences with the sponsor's approach, running the business with the objective of selling it again in a few years, or needing additional resources to grow the company can at times be a bone of contention.

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Interestingly, some strategic buyers have successfully innovated their approach to structuring transactions to include a LBO like transaction structure, thus bridging the gap with financial sponsors by thinking more like a private equity buyer. What that really means is that, by enticing management with a highly incentivized structure, strategics further strengthen perception of being a close strategic fit with the target company, including bringing a deeper understanding of the business and ultimately a longer term view.

So, what's in it for company management opting to sell to a strategic buyer versus a financial sponsor?

For one, under a "Strategic LBO" approach, rather than selling 100 percent of the company, company management would roll over equity – typically a maximum of 20 percent, (to allow for financial consolidation with the strategic buyer) but with an added put-call option on management's shares activated after a specified holding period and based on an exit valuation formula. Furthermore, and integral to this type of transaction structure, is the strategic making an intercompany loan to the company, essentially simulating some of the debt in an LBO structure. Rather than using all equity to buy the target, under this structure, management is able to roll over fewer dollars for a greater percentage of the equity. By using some intercompany leverage and adjusting the exit valuation formula for put/call on management's shares, the "Strategic LBO" meaningfully incentivizes management.

All in all these mechanisms – intercompany debt and an increased valuation at exit — present management of the acquired business with an attractive value proposition, allowing them a second bite at the apple on par with a LBO transaction. While the "Strategic LBO" has no real leverage — just intercompany borrowings — the returns in a "Strategic LBO" can be more in line with a typical LBO put in place by a private equity firm than what is found in a traditional strategic buyer purchase.

Additionally, senior management's equity is likely to be bought out by the strategic partner using the put-call options, which can incorporate valuations based on tiered EBITDA multiples — instead of having the company sold in an exit transaction. This also means less personal risk for company management while providing participation in the firm's upside.

Do private equity businesses need to be concerned in this competitive seller's market? Unlikely, but company management will also smarten up. And, as evidenced in recent months, competitive environments can lead to innovative capital structures. That said, "Strategic LBOs" are likely to work best with corporate investors who bring an open mindset to structuring transactions in innovative ways.

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