MARKET INSIGHTS:
Buyers' Perspectives in a Competitive M&A Market
Q3 - 2018

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"Beauty is in the eye of the beholder".

It's an age-old saying, but if you change a couple of words – the first and the last, to be precise, you get a version relevant to M&A: value is in the eye of the buyer. To an entrepreneur, this may come as a surprise. After all, doesn't value come down to the numbers?

To resolve this, we interviewed two buy-side veterans: David McCarthy, a Partner at Stikeman Elliot, and James Johnson, Managing Director and Co-Founder of Signal Hill Equity Partners. They confirm what we know from our own deal experience; offers we generate from multiple buyers for the same business vary wildly. In a recent mandate, for example, the highest offer clocked in at 12x EBITDA while the 3 lowest averaged 5x EBITDA.

Different Buyers, Different Value

A buyer perceives the value of an acquisition target in light of its own strategy and operations. A study conducted by Intralinks, an industry research firm, and the M&A Research Centre at the Cass Business School (City, University of London) confirms this unsurprising wide range of buyer preferences and ways of valuing targets, using a sample of almost 34,000 companies collected over 23 years (which means its conclusions span three economic cycles).[1]

With that in mind, we asked our deal veterans for their take on differing buyer preferences.

A Strategic Buyer's Perspective…

David McCarthy, a Partner active in Stikeman Elliot's M&A practice, has represented strategic buyers across a range of industries over the past two decades. Many of his clients seek out acquisition targets that have the potential to realize revenue and cost synergies post-acquisition, once in their fold. That is, pre-acquisition, their targets may not look great on a standalone basis. McCarthy says strategic buyers' industry advantage over financial buyers is often most evident in more lackluster transactions, in which strategics will pay a slight premium when no PE firm is excited.

David R. McCarthy, Partner, Stikeman Elliott

"A sea change in strategic buyers' behaviours in M&A has been underway over the past few years."

In most cases, strategic buyers integrate an acquisition into existing operations, so it follows that they may place limited value on a target's management team. As McCarthy points out, however, there are exceptions to this general rule, for example, where a strategic buyer is looking to move into a new line of business, a new geography or is acquiring intellectual property still in development. In those circumstances, the strategic may seek out targets with strong management and be willing to pay up for high growth.

Over his decades advising strategic buyers, McCarthy has witnessed a sea change in their behaviours, more recently, because of the abundance of cash on their balance sheets, and because of the dramatic increase in the number of private equity (PE) firms. Strategic buyers have thus become more aggressive, more competitive and quicker to act. McCarthy is also seeing them make pre-emptive offers, using their deep knowledge of activity in their space to stop a deal from being marketed broadly.

While in our experience, for the typical Canadian mid-market seller, a competitive bidding scenario yields the most favourable price, McCarthy points out that these pre-emptive offers reflect a premium (they must, to avoid an auction), and are more likely to be made to M&A savvy sellers, such as a PE-backed company looking for an exit.

… And a Financial Buyer's Perspective

With global "dry powder" of PE firms topping a record US$1.1 trillion in Q2 of 2018[2], competition for deals has reached new heights. PE investors are adapting to this environment on several different fronts.[3] Long-term funds, which can hold assets for more than 10 years (as compared to the more traditional 3-7 year window), are now more common.

They are attractive to sellers who want to participate in growth post-acquisition to build businesses on longer-term timeframes. In addition, over recent years, to mitigate the synergy-related advantages of strategic buyers, PE firms are making platform acquisitions and specializing in industries in which the ability to grow through M&A leads to major gains, then aggressively rolling up smaller companies to 'tuck-in' to the platform company.[4]

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James Johnson, Managing Director and Co-Founder of Signal Hill Equity Partners, has more than 25 years experience investing in and building companies in the Canadian mid-market. His firm, which falls into the long-term investor category, also rigorously pursues the platform/tuck-in approach to investing. Johnson notes that he prioritizes different attributes in a target, depending on whether it is a platform company or a tuck-in. Attractive platform targets have a skilled management team, who will be incentivized to stay and grow with the company, and the potential to achieve operating leverage and scale. The seller will also be asked to 'roll in' some equity to stay invested in the platform's success.

Johnson explains that attractive tuck-ins are typically smaller companies that can easily be rolled into a platform's existing operations. Important factors for consideration include opportunities to shed costs, cross sell and reduce cost of goods sold. Finally, as these acquisitions are quickly integrated into the platform, existing management is less important. A tuck-in is typically for 100% of the company, and the buyer and seller part ways at or shortly after the close of the transaction.

Johnson acknowledges that the current competitive environment is forcing Signal Hill (along with its PE peers) to pay higher multiples for platform companies. This makes tuck-in transactions, with their associated size related multiple discount, more important, he explains, "because they help us average down the overall multiple."

James Johnson, Managing Director & Co-Founder, Signal Hill Equity Partners

"The current competitive environment is forcing us to pay higher multiples for platform companies."

What does this mean for you and your business?

It is still a seller's market, with an abundance of cash chasing targets, but buyers view the world differently from one another. Sellers can only find out how buyers value them by exposing themselves, prudently of course, to the relevant ones. While in some sectors, this is achievable by the seller, for most, it is where an experienced M&A advisor can provide significant value.

Footnotes:
1 Attractive M&A Targets: What Do Buyers Look For?, Intralinks, UCL, September 2, 2016
2 Prequin Quarterly Update: Private Equity and Venture Capital Q2 2018
3 2019 Global Private Equity Outlook
4 Pitchbook Analyst Note: Additive Deal Making

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FirePower Capital is the investment banking and private capital firm built for Canada's entrepreneurs. Our team of 30+ deal-makers help their mid-market businesses complete mission-critical transactions.

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