Strategic Acquisition Program Series Part I: Never Lose Another Auction

By: Paris Aden, Valitas Capital Partners

Synopsis: A growing universe of financial buyers has been effectively competing with strategic buyers on valuation, along with a proliferation of intermediaries that are continually extending their reach into an ever-broader buyer universe. As a result, more businesses are being sold in highly competitive auctions and proprietary deal flow is becoming increasingly challenging. A structured, proactive acquisition program delivers superior results in this environment.

Read on for our views...

The Benefits

In response to the proliferation of investment bankers and business brokers to execute auctions for *active sellers* to maximize valuations, proactive acquisition strategies are required. A Strategic Acquisition Program ("SAP") that surfaces *passive sellers* at reasonable valuations works in concert with conventional sourcing strategies and can produce significant strategic and financial benefits. The benefits of developing a pipeline of proprietary acquisitions are manifested through superior valuations, strategic choice, and increased activity levels.

A. Proprietary Deals are Superior to Auctions

i. Reasonable Valuations Enhance Value Creation

- For many vendors, price is not the sole consideration.
- The $30 million acquisition of a typical industrial company[1] would create $7.5 million in Economic Value-Added ("EVA") if bought at 1.5x below the acquirer's EBITDA multiple, *assuming no synergies*.
- This multiple "arbitrage" on that same company in an auction would be much lower.
- If the acquirer can increase target margins through cost synergies and sales through distribution synergies, the EVA increases significantly:

Figure 1: EVA Under Synergy Assumptions [(1)]

Cost Synergies / Distribution Synergies

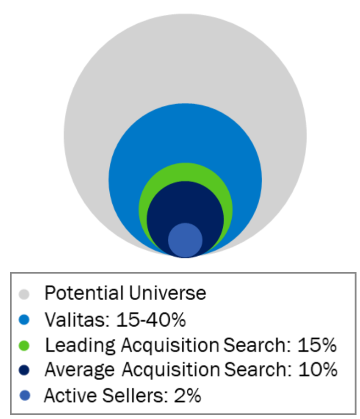
				Revenue Growth
7.5	10.0	12.5	15.0	**0.0**
8.8	11.3	13.8	16.3	**2.5**
10.0	12.5	15.0	17.5	**5.0**
11.3	13.8	16.3	18.8	**7.5**
15.0	15.0	17.5	20.0	**10.0**
0.0	**1.0**	**2.0**	**3.0**	**%**

Margin Improvement

ii. Draw "On the Fence" Targets into Dialogue

- For various reasons, most companies have no knowledge of, interest in, or desire to auction their company *today*. However, many of these are passive sellers that would entertain an approach from a serious party.
- Typically, at a given point in time, active sellers represent a fraction of the available acquisition opportunities.
- We have tracked target response rates and our experience suggests that 10-80% of a given target universe (depending on the industry and target size) are *passive sellers* who welcome an approach from a professional, motivated, and well-funded suitor.

Figure 2: Actionable Target Universe



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[1] Illustrative EVA analysis ($ millions) assumptions are:
- $5 million target EBITDA
- Acquirer trading multiple of 7.5x EBITDA and proprietary target valuation of 6.0x EBITDA
- 15% EBITDA Margin and 20% Contribution Margin (on incremental revenues from distribution synergies)

iii. A Proactive Versus a Reactive Approach

- Focus on what makes strategic sense, not just what is available.
- Targets are selected based on strategic priority and higher expected synergies.
- Reduced likelihood of the target being auctioned once an approach has been made.

iv. Control the Process and the Pace

- The vendor and their agent drive the process for auctioned targets, including schedule and access.
- A proactive approach:
  a) Controls the pace of approaches;
  b) Controls the pace within each transaction process;
  c) Can sequence targets according to your priorities; and
  d) Enables sufficient time to conduct proper due diligence and develop a relationship with the vendor(s) and management.

v. Flexibility to Apply Risk Mitigating Structures

- In auctions, there is little flexibility in terms of form and structure of consideration.
- A proactive approach may facilitate risk mitigation through structured consideration (VTB, earn-outs, other contingent structures), which can be an effective means to close any valuation gap with the vendor.

vi. If You "Win" the Auction, Your Competitors Know Everything About the Target Business

- If you were in the auction, most likely your competitors were as well.
- They will know the details of the business and may have an idea of how much you paid.

vii. Auctioned Companies May Not Be the Best Targets

- Why are the vendors selling? Is business deteriorating and the vendor is trying to salvage value?
- Has there been a lack of focus on the business over the last few years if the vendor has already decided to leave the business? Will there be leadership transition issues?

B. Significant Value Enhancement Through Creation of an Acquisition Pipeline

i. "Inverse Auction" Dynamics

- Negotiating leverage is critical to valuation and terms.
- This is typically the advantage enjoyed by the vendor in an auction.
- An SAP in full swing will often generate a pipeline of proprietary targets, each vying for your time and focus.
- It is much easier to move past sticking points with vendors when you (and possibly they) know that others are in the queue. Conveying, whether subtly or directly, that you are reviewing many opportunities creates some competitive tension and urgency for the vendor.

ii. Significant Value Creation on Each Additional Acquisition

- If each $30 million acquisition creates $7.5 million in EVA, *before synergies*, any increase in acquisition volume (number of acquisitions), multiplies this effect.

iii. Accelerated Consolidation Improves Return on Capital for the Platform

- If the EVA from acquisitions is realized at a faster pace, the internal rate of return ("IRR") on the company's equity is enhanced.
- Faster completion of the consolidation phase benefits both private equity funds and public company shareholders:
  a) **Private Equity:** Allows more time during the investor hold period to integrate the acquisitions and prepare the platform for sale. Shorter hold improves IRR.
  b) **Public Company:** Surface shareholder value more quickly and gain first-mover advantage over competitors.

iv. Maximum Strategic Choice and Optionality

- Where there is a pipeline or inventory of opportunities, you can decide when and where you will focus time and effort.
- Targets can be sequenced optimally.

C. Ancillary Benefits

i. Gather Proprietary Market Intelligence

- Ability to access target information that is not publicly available.
- Enhanced understanding of which industry players are consolidators and which are sellers (including *why* and *when* they are sellers).
- Assess best practices employed by targets through due diligence.

ii. Target Benchmarking

- Running parallel discussions enables comparison of one target against another (e.g., financial and operational benchmarks and fit of product/service offering with the platform).
- Facilitates prioritization of targets based on their attributes and strategic fit with your platform.

iii. Provides Valuable Market Intelligence on the Future Extent of the Consolidation Opportunity

- If you can work through the target universe in 1 year with a proactive approach instead of 5 years with a more reactive approach, it informs decisions on whether to:
  a) Continue to pursue acquisitions and secure financing and other resources to support them; or
  b) Shift the strategy if the consolidation opportunity has been fully explored and is more limited than originally thought.

Conclusion

Seeing more proprietary acquisition opportunities that make strategic sense and/or are available at better valuations, while being able to significantly mitigate risk by having more control over the process, are some of the reasons to consider making proactive acquisition sourcing part of your growth strategy. However, committing to pursue such a strategy alone does not ensure success. Implementing a state-of-the-art process that maximizes results requires significant planning, resources, and skill.

Process matters. Valitas' team has worked with many sophisticated industry consolidators and has approached well over 500 acquisition targets for these clients. We have seen first-hand the difference between processes that get results and those that disappoint.

Part II of this three-part series, ***Process Matters: Generating Proprietary Acquisitions***, provides a comprehensive walk-through of a field-tested architecture that an acquirer can use as a guide in building their internal capabilities.

Click here to receive Part II of this series.

About Valitas

Valitas Capital Partners is a relationship-focused merger & acquisition (M&A), corporate finance, and strategic advisory firm. We collaborate with ambitious owners of high-performing businesses with a potential value of at least $100 million, to discover, unleash, and realize their full business value potential.

Owners and their leadership teams rely on Valitas when they:

- Want to triple the value of their business in five years or less, but realize they lack the expertise and experience to achieve this alone.
- Want to sell their company now, assured they will look back after the transaction knowing they got the best possible outcome.
- Seek the peace of mind of taking some chips off the table now, to secure their family's financial future without giving up control or the future increased value in their business.
- Are anguished they had to say no to growth opportunities they worked so hard to create because their bank cannot keep up with the needs of their fast-growing business.
- Are frustrated at the lack of traction they are getting with their acquisition efforts, whether it is not seeing enough quality acquisition opportunities, or by wasting time and money coming up empty-handed in auctions.
- Are dispirited by the significant investments in expensive specialists, technology, systems, and financial modeling capabilities required to execute their audacious strategic goals.
- Are intrigued by the idea of selling their business to their management team over time but want to recognize the full value now, while getting their cash payments as quickly as possible.

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About the Author

Paris Aden, Partner

Paris Aden is the founding Partner of Valitas Capital Partners. Since 1994, he has been involved with more than 100 M&A transactions with an aggregate value exceeding $80 billion. He has advised clients at Morgan Stanley, Credit Suisse First Boston and RBC Capital Markets and has acted as a private equity investor at Clairvest Group where he served on portfolio company boards. Paris was also a co-founder of Alluence Capital Advisors, a mid-market M&A advisory boutique that focuses on cross-border transactions.

Paris is recognized as an expert in business strategy, M&A and corporate finance. Previous roles and speaking engagements include:

- Lecturer at the Stephen J.R. Smith School of Business at Queen's University in their Master of Finance (MFIN) program
- M&A subject matter expert for Moody's Analytics' Advanced Capital Markets Program for capital markets professionals
- Three-time expert panel moderator for the Toronto Business Transitions Forum
- TEC Canada "2018 Speaker of the Year" recipient
- Guest speaker for various industry and business leadership organizations

Paris formed Valitas to meet the unanswered needs of ambitious business owners seeking to:

- At least triple their business value in five years or less; or
- Are seeking an elite advisory boutique as their trusted advisor for their complex, mission-critical transactions.