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Financial vs. Strategic Buyers

The terms "Financial Buyer" and "Strategic Buyer" frequently arise in discussions about investment banking activities, particularly when discussing the sale of a middle market company. This article describes some of the characteristics of each type of buyer, and briefly discusses potential situations in which one buyer type might be more appropriate than the other.

Financial Buyers. Financial buyers can generally be classified as investors who bring significant financial resources to a transaction, but little or no business synergies. They are interested in the cash flow generated by a business and the future exit opportunities from the business. They are typically wealthy individuals or private equity groups (PEGS). Their goals may include growing cash flow through revenue enhancement, expense reductions, or creating economies of scale by acquiring other similar companies. Their exit plans may include an initial public offering, where the business is "taken public", or selling the company at a future date.

Financial buyers carefully scrutinize the financial statement of the company. Most look for a well-managed company with a history of consistent earnings, and preferably, earnings growth. The transactions of financial buyers are often leveraged. By using bank and/or "mezzanine" financing, the financial buyer is effectively partnering with someone who is willing to accept a level of return (a lending rate, perhaps augmented by "equity kickers" to enhance returns), that is generally lower than that required by the financial buyer.

In layman's terms, financial buyers are buying exactly what the company has to offer (i.e., a stand-alone acquisition). They are buying the expected future earnings of the company, as they are perceived to exist at the time of the acquisition. While financial buyers may see the potential for expanding cash flow beyond what the company has achieved on its own, they are generally not willing to pay for that potential. They are much more likely to keep the current personnel in place versus a strategic buyer.

Strategic Buyers. Strategic buyers are interested in a company's fit into their own long-term business plans (i.e., an add-on acquisition). Their interest in acquiring a company may include vertical expansion (toward the customer or supplier), horizontal expansion

(into new geographic markets or product lines), eliminating competition, or remedying some of it's own key weaknesses (technology, marketing, distribution, research and development, etc.).

Strategic buyers are often willing to pay more for the right company than financial buyers. There are tow main reasons for this. First, strategic buyers may be able to realize synergistic benefits almost immediately due to economies of scale that may exist through the combined purchasing power of the new entity and the elimination of duplicate functions. The better the fit (i.e., the more realizable the synergies are), the more they will gain from the business and the greater the premium they will be willing to pay. Second, strategic buyers are generally larger companies with better access to capital. They often have another acquisition currency available to them in the form of stock. Strategic buyers often offer stock, cash, or a combination the of two in payment of the purchase price.

In short, the strategic buyer is buying the company in light of how it will enhance their existing operation. They are often willing to pay for readily realizable synergies, and many times will pay for speculative synergies, particularly if the target company is being marketed to other competitors (through some type of "auction"). Strategic buyers are much less likely to retain all of the current personnel.

Which Is Right? Believe it, or not, the answer to the question "which is right?" is not always cut and dried. Whether a strategic buyer or a financial buyer is right for a specific company depends largely on the seller's goals in selling the business. Listed below are different scenarios discussing the seller's goal and the type of buyer most appropriate.

- **The Seller Wants to Cash Out, but Would Like to Remain for a Few Years.** In this situation, a financial buyer is probably most appropriate. The owner/manager is often times the most readily realizable synergy for a financial buyer. On the other hand, strategic buyers generally have the expertise necessary to operate the business, and can eliminate the money that is being paid to top level management. More and more deals are being structured where part of the consideration paid is tied to an "earnout" where the seller will receive additional money if certain, predetermined goals are achieved in the first few years following the sale.

- **The Seller Wants a High Price, but Has Other Concerns.** If the seller's goal is a high price (not to be confused with "highest" price), but the seller wants to protect employees, a strategic buyer is still probably the most appropriate. However, the seller needs to realize that there will need to be concessions made from the highest price in order for the acquisition to work for a buyer with other non-financial goals.

- **The Seller Wants the Highest Price Possible.** If the only goal in the sale is achieving the highest price possible, regardless of what happens to the employees or

- the facilities, the open auction process is the best way to drive the price upward. And obviously, with the highest price being the only goal, the strategic buyers will most likely be the best fit. That is not to say that financial buyers should not be considered in the process, particularly PEGs seeking add-ons to their existing portfolio companies.

This brief discussion is intended only to describe the two business buyer types in general terms. There are many other issues that need to be considered in the prospective sale of a middle market company, that we will address in future newsletters.

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