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Abstract

This paper compares the position of strategic buyers and private equity buyers in a typical investment process, from fundraising/sourcing of equity capital, through deal sourcing, due diligence, valuation and deal financing, deal negotiation and transaction execution, to value creation post-closing and exit/long-term plans. The paper evaluates advantages and disadvantages of the two different types of buyers within each of the phases of an investment process, and suggests that the financial discipline, flexibility, focus, and incentives structure of private equity firms often provide them with an edge over strategic buyers. Rather than being a rigorous academic study, the paper is intended to help M&A practitioners, whether on the strategic buyer or private equity side, with understanding their "opponent".

Keywords: Private Equity; Strategic Investors; M&A; Due Diligence; Deal Sourcing; Deal Valuation; Investment Process; Value Creation.

Traditionally, strategic buyers were considered to have a significant advantage over financial investors, such as private equity (PE) firms. The argument was that strategic buyers could pay more due to their ability to share with the sellers a portion of the value generated by the post-acquisition synergies[1]. However, over the last decade or so, the tide has turned significantly and PE investors became potent competitors to strategic buyers in the race for quality corporate targets[2]. As an anecdotal evidence, one of the authors of this paper is involved in M&A transactions of a multinational pharmaceutical company and often faces PE players in the company's deals, both as competitors when on the buying side and as interested buyers when on the selling side; it is not unusual for a PE firm to be the winning bidder in a highly competitive process.

The above development notwithstanding, the rationale of the "synergy" argument still seems valid though. How is it possible that PE firms are able to overcome this challenge and what are the advantages that PE firms bring to an investment process that allow them to frequently win competitive auctions over strategic buyers? In this paper, we follow step by step a customary investment process, in each phase evaluating the main differences between a strategic buyer and a PE buyer[3]. Rather than being a rigorous academic study, the paper is intended to help M&A practitioners, whether on the strategic buyer or private equity side, with understanding their "opponent".

We will cover the following key phases of an investment process (see Figure 1): (i) fundraising/sourcing of equity capital; (ii) deal sourcing; (iii) due diligence; (iv) valuation and deal financing; (v) deal negotiation and transaction execution; (vi) value creation post-closing; and (vii) exit/long-term plans.

Fig. 1 – Typical Investment Process Roadmap:

[1] As per Thompson, O'Brien (2005): *"Strategic buyers have traditionally had the advantage over private equity funds, particularly in auctions, because strategic buyers could pay more because of synergies generated from the acquisition that would not be enjoyed by the fund"*. Also, as per AllBusiness (2012): *"The classic take on whether you should sell your business to a Private Equity Group (or PEG) says that you will be able to negotiate a better deal with a "strategic" buyer than with a "financial" buyer. The reason is quite simple: A strategic buyer will pay more. ... The common opinion about PEGs is they are merely "financial" buyers; this means they cannot take advantage of buyer-seller synergies. Therefore, the theory goes, PEGs will always pay less"*.

[2] Thompson, O'Brien (2005): *"In recent years private equity funds have become increasingly more competitive with strategic buyers in the M&A market"*. Also, AllBusiness (2012), referring to the argument presented in footnote 1: *"This kind of thinking may have been valid five or ten years ago, but it is somewhat outdated in today's [M&A] environment"*.

[3] In this paper, we only consider PE transactions in the form of an LBO, because that is the closest equivalent of a full acquisition carried out by most strategic buyers. PE firms are involved in a variety of other deal structures as well.

1. Fundraising/Sourcing of Equity Capital

(a) Strategic Investor

Sourcing of equity capital for investments will mostly not be an issue for a strong strategic investor. Capital is usually provided by ongoing operations, and with some exceptions, the strategic player is not faced with the task of regularly approaching shareholders for the purpose of obtaining equity capital in order to fund its M&A activity[4]. Moreover, a strategic investor has an acquisition currency that is not available to a private equity investor: the strategic investor can always offer its own shares as consideration to the target's shareholders.

(b) PE Investor

Quite the opposite, fundraising from limited partners is the core concern and challenge of any PE firm. It is the life-blood of the firm and without the ability to raise funds on a repeated basis, the firm will not succeed. Fundraising is also a major incentive for the PE firm to focus on what matters most for the limited partners, i.e., achieving the required IRR. Many of the differences between strategic and PE bidders can be traced to this core incentive, and as such, it has a powerful impact on how PE firms work.

(c) Evaluation

Even though the issue of fundraising may initially seem an aspect which presents a disadvantage for a PE investor, we would argue that it is in fact one of its biggest advantages: it imposes on the PE firm financial discipline, which some strategic investors may miss. Of course, it does not ensure that PE firms can regularly bid higher than strategic investors (more on this later), but it helps PE firms to proceed smartly and win deals in which they are more likely to generate value for the limited partners.

2. Deal Sourcing

Before a deal can be negotiated, executed and closed, the deal must first be identified.

(a) Strategic Investor

A benefit of a strategic player is that it intimately knows its industry and, if the strategic player is in an acquisitive mood, the industry will likely be aware of this as well. The strategic bidder will follow its strategy, and will likely have a very good overview of potential acquisition targets.[5] Embarking on a transaction will then only be a matter of willingness to sell on the seller's side, or

[4] For instance, one of the goals of an initial public offering of a previously private company may be to obtain capital for future acquisitions and external growth.

[5] Investment bankers will regularly provide the strategic buyer with diverse ideas about which businesses could be combined. Potential targets which may be more difficult to identify for a strategic player are smaller businesses, however, such targets would usually court the strategic player on their own.

waiting for an opportunistic moment, such as a depressed share price of the target. On the other hand, unless a strategic player wishes to embark on a risky diversification journey, target selection is limited to the strategic player's industry and selection of targets could be limited (also given geographical focus of the strategic investor). In addition, antitrust concerns may occasionally limit a strategic investor's acquisition opportunities in highly consolidated markets.

(b) PE Investor

PE firms may sometime not have a similarly deep exposure to the industry and its players as a strategic investor, however they compensate to a large extent through their rigorous financial analysis of the potential targets which fall within the desired size, and also through their network of industry advisors, investment bankers, lawyers, and other service providers. Through such networks, PE firms are often able to identify potential targets as swiftly as industrial players – they just do not focus on strategic fit, as strategic investors do, but rather on the numbers and general industry trends. Often, the market will know that a PE firm is seeking investment opportunities in a particular industry and the PE firm (especially a major one) will be approached by investment bankers with their pitches, or by the targets themselves. Depending on the terms of the relevant fund, a PE firm may not be limited to one particular industry and a broader range of acquisition opportunities may be available to the firm in its quest for the required IRR. The incentive structure of a PE firm will motivate its personnel to actively seek attractive investment opportunities.

(c) Evaluation

Overall, as regards deal sourcing, neither strategic players nor PE firms seem to be at any major advantage or disadvantage against each other. Especially when it comes to competitive processes, it is quite likely for both strategic and PE investors to be invited to bid. One-on-one talks could be more opaque, but equal amount on serendipity seems to be involved for both types of investors. What is also common for both types of investors is that finding the right target is never easy and both investors may have to screen dozens or hundreds of opportunities before the promising one is identified.

3. Due Diligence

For both strategic and PE investors, due diligence of the target is key in the investment process, and may determine whether the acquisition will be a success or failure. The two types of investors differ in the focus of their due diligence efforts and to some extent in the methods through which they conduct due diligence.

(a) Strategic Investor

A strategic buyer will often benefit from its intimate knowledge of the industry. Yet occasionally many strategic buyers acquire targets for diversification reasons thereby entering new industries, new sub-segments of their industry, or new geographies. In these cases existing industry knowledge of the strategic player may be of little use or may even be harmful because the acquirer may mistakenly assume knowledge where in fact there is none. Nevertheless, sensible due diligence by a strategic investor will seek to confirm and expand the investor's understanding of the target's market and business model, and this will often be facilitated by the investor's existing personnel and know-how. In cases of smaller bolt-on acquisitions, due diligence of the target's operations conducted by the strategic investor may sometimes be limited to selected key topics or to high level discussions with the target's management.

Due diligence by a strategic investor will of course not be limited to the operations of the target only. The investor will also conduct specialist due diligence reviews, such as regulatory due diligence, environmental due diligence, HR due diligence, financial due diligence, legal and tax due diligence, etc. Many times, such expert due diligence reviews will be conducted through internal specialist teams, however, financial, legal, and tax due diligence will almost always be carried out with the help of external advisors. Size of the investor will be relevant: larger acquirers will often be able to rely more on their internal resources, but the increased size will also present many due diligence coordination issues. Ensuring that even seemingly small relevant details are escalated to the attention of the ultimate decision-makers may present a challenge in some larger organizations.

Generally, it is very important for the strategic buyer to know where the high-value assets (from the strategic investor's point of view) of the target are – due diligence will largely focus on these high-value areas, and less on others. Main focus of the due diligence review by a strategic buyer will be on identifying and validating potential synergies between the buyer and the target in the high-value areas (both as to existence and as to quantum). Less focus will be on management due diligence, unless the post-closing integration plan is to keep the current management of the target in place. Sometimes, such as in certain acquisitions of high-tech companies, people due diligence may however be crucial as their expertise may be the key asset of the target. During the due diligence a post-closing integration plan will also be prepared. Such plan will outline how the target's structure and business model will be folded into the organizational structure and business model of the acquirer: solutions may range from full integration to large autonomy of the acquired business, always with the aim to protect and utilize the high-value assets of the target and realize the planned synergies.

(b) PE Investor

A PE firm may sometimes lack (and will recognize that it lacks) deep knowledge of the target's industry and business model, and will focus lots of due diligence efforts into this area. The PE firm will draw on its network of industry advisors, and the firm may use help of relevant experts employed by other companies in the PE firm's portfolio. It will likely take longer for the PE firm to understand the target's operations and industry (including its cycle), and the target will have to devote more time to educating the PE bidder. The target, especially if advised by investment bankers in an organized sale process, will likely know very early if it wants to attract PE bidders into the process and will try to minimize the above hurdle for them, also in anticipation of the usually frenetic pace of an auction process. For instance, the information memorandum and other due diligence documents will often be tailored in a way to facilitate PE players' understanding of the business.[6]

Because the PE firm will usually want the target to be operated as a standalone business, all aspects of the target will need to be diligenced. PE firms will tend to utilize external advisors on a much broader scale than strategic players (especially large ones), and will have a suite of such advisors readily available on a short notice. Given that conducting due diligence is one of PE firms' core capabilities, one can expect an efficient due diligence and good coordination of the diligence efforts of different advisors, this being an advantage of a seasoned PE firm vis-à-vis many strategic players. Also, decision-making within a PE firm will tend to be more focused and disciplined, because the outcome of the decision will be visible, plus it will directly impact the firm's performance and, given the PE firm's incentive structures, motivation of its personnel.

While the main value of the target for a strategic buyer may be in a portion of the target's business, for a PE firm the target must present value in its totality because it will be operated on a standalone basis (except in "roll-up" strategies). The PE firm will especially want to validate historical financial and operational performance of the target and its projections, and will focus its due diligence efforts on cash flows generated by the business. This is important given the future need to service heavy debt incurred in the financing of a leveraged transaction. The firm will seek to identify opportunities for operational improvements of the target, such as in the management of working capital requirement, sourcing, sales channels, marketing strategy, etc. The PE firm will also want to identify the target's potential for external growth, as this may be key to realizing the benefits of multiple expansion. Due diligence of the management (and identifying possible gaps to be filled) will be crucial for a PE firm as the management will have to deliver the expected results. The PE firm will also devote much thinking to potential exit routes for the company in the future. All these considerations and multiple others[7] will feed the PE firm's valuation model, and will also provide a basis for creating a detailed "100-day plan", to be implemented upon successful closing of the deal.

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[6] Often, one can say from the documents prepared by the seller whether the seller seriously considers PE firms as viable bidders, in which case the information memorandum might go deeper into basics of the target's industry, assuming the reader has little familiarity with the industry. Also, many times financial vendor due diligence report and legal vendor due diligence report will be prepared if PE bidders are expected to participate in the process. In case of a carve-out, the carve-out financials will be audited and there will be a noticeable effort to ensure that the carved-out entity can be conducted as a standalone business post-closing; for instance, various transitory services may be offered by the seller to the bidders even if such services would be of little use to an established strategic player (e.g., regulatory, HR, etc.).

[7] It is not possible to summarize here all possible specialist due diligence areas that need to be addressed in a typical process, because this depends on a case by case basis. It is however worth mentioning that specialist due diligence areas are subject to fashion trends. For instance, two or so decades ago, environmental due diligence

(c) Evaluation

It is probably fair to summarize that the due diligence required by a PE firm is more demanding than that of a strategic bidder creating a disadvantage at the outset of a process. On the other hand, PE firms' desire to learn, their ability to conduct efficient due diligence, and to act swiftly and flexibly present a major advantage compared to some strategic bidders, which may be inexperienced in M&A, slow and not very reactive to changed circumstances.

4. Valuation and Deal Financing

(a) Strategic Investor

Sophisticated strategic buyers will focus their valuation exercise on preparing discounted-cash-flow (DCF) models. This will include the target's standalone DCF analysis (standalone value), and DCF analysis of the target assuming various synergies (synergized value). In fact, the DCF analysis, unlike other valuation methods, will enable the strategic buyer to see which synergies present the biggest value impact and this will help with identifying areas for increased due diligence. In the DCF modeling, strategic bidders will often determine the terminal value on the basis of perpetual growth rate, rather than on the basis of a terminal year exit multiple. Validation of projections for the DCF model will be of course a very important exercise (at least for the more sophisticated strategic buyers), and often different scenarios will be prepared. A strategic buyer's knowledge of the industry and of its trends will be helpful in this respect, though in case of some larger/bureaucratic strategic buyers there may be a perverse incentive of the internal project team to present the projections (whether knowingly or unknowingly) too optimistically in an effort to increase the project's chances of succeeding in the internal competition for the top management's attention and for funding.

As regards financing of the deal, it is unlikely for strategic buyers to incur leverage to the extent that PE firms do (see below). Acquisitions of smaller targets (relative to the size of the strategic buyer) will likely be fully financed through internal cash sources. Larger targets may require that the strategic buyer obtains acquisition debt financing, but such financing will almost exclusively be through senior bank loans and will often be secured by various assets of the acquirer (even beyond the perimeter of the target's business). As already mentioned, a strategic buyer can also use its own shares (either treasury shares or newly issued shares) to pay for an acquisition.

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got to the top of the list; over the last five or so years, the big concern became anti-corruption compliance due diligence; our expectation is that within the next five to ten years the "new kid on the block" might become data protection due diligence, as governments move towards more forceful enforcement of their legislation in this area (e.g., the EU is already planning revised rules on the topic with potentially draconian sanctions).

(b) PE Investor

A PE firm will make its valuation on the basis of an LBO model. Although the LBO model may contain DCF analysis, a PE firm will stress to a greater extent the use of multiples – for instance, terminal value will be derived from an exit EBITDA multiple rather than from perpetual growth rate. Key features of the LBO model will be forecasts of the cash flows and of the target's future capacity for repayment of debt (with the idea to repay debt as quickly as possible without strangling the company). The LBO model will also have an analysis of various scenarios and of their impact on the IRR and Cash-on-Cash returns. Unlike in case of a strategic buyer, a PE firm will unlikely be able to make use of synergies.[8] The PE firm will however include in its model expected improvements of the target's operations. Validation of the cash flow projections during the due diligence (including cash flow impact of the expected operational improvements) will be extremely important as there may be little headroom for negative surprises, and the numbers may have to be carefully discussed with the target's management, who will have to deliver the cash flows in the future (unlike in most cases of a strategic buyer acquisition).

A PE firm will also have to arrange for leveraged financing of the transaction. Setting up the financing is an exercise that may disadvantage the PE firm in a competitive bidding process, because it means that any bid provided by the PE firm will necessarily be subject to obtaining financing. Commitment letters from the banks may provide some comfort, but any commitment letter will still remain subject to final contracts with the banks. On the other hand, presence of leverage in financing of the transaction greatly enhances the IRR for the PE firm because it reduces the equity portion of the investment and decreases the WACC for the valuation. Leverage has traditionally been an important driver of value creation for the PE fund's limited partners.[9]

(c) Evaluation

When it comes to valuation, the trump card for a strategic investor is "synergies", and the trump card for a PE firm is "leverage". While a PE firm cannot usually use synergies to improve its valuation of the target, could a strategic buyer use leverage to the same extent as a PE firm? It seems that technically this should be possible, however there appear to be at least two constraints on the PE-type use of leverage by a strategic buyer: (i) lack of experience with operations under a heavy debt burden, and (ii) benchmarking against competitors. With post-closing leverage in the levels equivalent to a PE firm's LBO, the strategic investor would have to manage the target as a PE firm, i.e., with tremendous focus on financial results and cash flow management, potentially at the expense of sacrificing some long-term strategic synergies and plans. This may not be impossible, but certainly

[8] This may not be entirely true if the PE firm is engaging in a "string-of-pearls" or "roll-up" strategy of acquiring multiple businesses in the same industry with a view to consolidate them and later sell them or IPO them as one business.

[9] The other main drivers are multiple expansion and operational improvements.

very difficult without prior experience as it involves flirting with the risk of financial distress. Also, high leverage would significantly impact the strategic buyer's debt/equity ratio and could make it stand out of the crowd of comparable companies within the industry, thus potentially adversely affecting its market valuation and/or debt rating.

It is naturally difficult to measure significance of these effects, however if this reasoning is correct, one could hypothesize that in industries with a low debt/equity ratio benchmark, strategic investors would tend to use leverage less and, as a result, the leverage available to PE firms would present a bigger advantage for the PE firms, thus suggesting an increased level of investment by PE firms in such industries. Conversely, if the benchmark industry debt/equity ratio is high, it might suggest a higher use of leverage by strategic players in acquisitions and less investment by PE firms because of lower impact of their "leverage" trump card. In an attempt to test these hypotheses, we ran simple regression of average industry debt/equity ratios (dependent variable)[10] on levels of investment by PE firms into the relevant industries (independent variable)[11]. All data, upon elimination of certain outliers[12], is reproduced in Annex A. The analysis shows that the correlation coefficient between the two variables is -0.2763 (investment as per number of deals) and -0.2548 (investment as per deal value), meaning that a higher average industry debt/equity ratio is indeed negatively correlated with the level of investment by PE firms. More detailed regression analysis indicates that the relationship is statistically significant at 5% level (regression coefficients of -0.0686 and -0.0604, respectively, and P-values of 0.0087 and 0.0160, respectively).

This analysis does seem to support the above hypotheses, however, it is only a back-of-the-envelope regression and a few strong caveats need to be mentioned. First, it is only a very partial regression model and it does not explain PE investment in full (adjusted R-squared is very low). Second, the regression considers industry average debt/equity ratios (on the basis of an argument that this is relevant for benchmarking) and the results could be different if company-specific leverage was used. Third, correlation does not imply causation and we do not claim that the level of PE investment in a particular industry is directly caused by the "leverage capacity" of the industry. Rather, we would

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[10] We used average industry debt/equity ratios sourced from Aswath Damodaran's website at *http://pages.stern.nyu.edu/~adamodar/*, specifically January 2013 global data on "Levered and Unlevered Betas by Industry."

[11] As a simple proxy for the level of investment in different industries, we used 2012 data published by Preqin at *www.preqin.com*, specifically (i) percentage of 2012 investments in a given industry by the number of deals, and (ii) percentage of 2012 investments in a given industry by the deal value, all as per Preqin's publication "2012 Buyout Deals: A Year in Review." Naturally, the 2012 data may be skewed by that particular year; however, levels of investment in other years seem to be roughly equivalent so we assumed that 2012 data will be a workable proxy for this simple analysis. To ensure workability of the data, we also had to assemble the more specific industries as per Damodaran's data into industry groups corresponding to the Preqin data; such coding is provided in Annex A.

[12] Outliers were eliminated using "3 sigma" approach; they mostly related to financial industries with excessively high debt/equity ratios.

speculate that various third factors (common-causal variables) drive, at least partially, the average level of debt/equity ratio in a particular industry and those factors also drive, at least partially, the level of PE investment into the industry. Such factors may for instance include industry growth (industry in an early life cycle grows fast and debt levels are low, yet the expected growth may make it an attractive PE investment), the level of consolidation in an industry (in an unconsolidated industry, the firms are smaller and taking debt is riskier so there is lower level of debt; yet, the consolidation potential could be attractive for PE investment), and others. It is unlikely that there would be a clear causation mechanism involved, and rather various levers, often acting in an opposite direction and indirectly, will be creating the resulting correlation effect.

It appears that it is not possible to conclude that one or the other type of a buyer has an inherent advantage over the other when it comes to valuation of a target[13], except perhaps in macroeconomic conditions which substantially restrict the availability of debt financing and adversely

[13] One would expect that this interesting aspect of strategic vs. PE bidder competition would be analyzed in a more rigorous manner by academic papers. Without going into details of the various studies, there are a few interesting papers, though overall the research seems scarce. For instance, Martos-Villa et al. (draft March 22, 2013) present a theory of debt misevaluation which explains the shifting dominance of PE firms relative to strategic acquirers over time. The authors argue that although the effects of cheap debt might seem limited since both acquirer types and target firms can access the debt markets, fundamental differences in governance (better monitoring capabilities of PE firms) and co-insurance effects (a strategic bidder will be less likely to default on debt because the default would not only impact the target, but the strategic bidder's other assets too) between the two types of acquirer become relevant to explain higher use of leverage by PE players in times of cheap debt. Their arguments seem to be in line with our hypotheses above.

Another interesting paper on the topic is Fidrmuc et al. (draft May 15, 2012). The authors show by regression analysis that private equity buyers pursue targets that have more tangible assets, lower market-to-book ratios, and lower research and development expenses relative to targets bought by strategic buyers. The also find that: *"The selling mechanism choice […] affects the buyer type. In particular, firms sold in auctions are less likely, while those sold in controlled sales are more likely, to be sold to private equity buyers relative to private negotiations"* (page 28). As regards premium paid, they however find that: *"... private equity buyers do not pay less for their target firms. In fact, the premium differences only reflect differing situations of firms sold to the two types of buyers. Neither do auctions and controlled sales versus negotiations result in differing premiums"* (page 29).

On the topic of takeover premiums, Fidrmuc et al. (draft May 15, 2012) provide a summary of the current available research: "*Recent studies have shown that private equity bidders offer on average significantly lower takeover premium than corporate buyers even though, private equity firms often manage to outbid public corporate acquirers in competitive auctions*" (page 1). They in particular refer to Bargeron at al. (2008) and describe that *"Balgeron et al. (2008) attribute the lower takeover premium to private equity bidders being more selective in the price they are willing to pay for targets than public strategic bidders. They argue that managers of public bidders have an empire-building mentality and are willing to overpay for a target firm because they do not bear the full costs of their decisions"* (page 6). Also, Gorbenko et. al (draft September 2010) find that *"[v]aluations of financial bidders are to a large extent explained by observable factors, captured by the information about the targets available from the market and financial statements. In contrast, valuations of strategic bidders are less tied to publicly observable characteristics: their unobserved component of valuations is almost twice more important than that of financial bidders*" (page 4), and even if the authors attribute this to potential heterogeneity of strategic bidders and their ability to base valuation on bidder-specific synergies, at least a partial explanation behind this finding could be the presence of agency costs suggested by Balgeron et al. (2008).

impact PE firms' ability to use leverage, while the impact on strategic buyers may be limited.[14] Otherwise, specific characteristics of the target will be relevant for the use of leverage by a PE bidder and for generation of synergies by a strategic bidder. Potential lack of financial discipline on the side of some strategic bidders may lead to such bidders being more aggressive in bidding contests; however, this is hardly an advantage even if it perhaps allows such strategic bidders to win an auction – it may just be a Pyrrhic victory.

5. Deal Negotiation and Transaction Execution

The main differences between a strategic and a PE buyer which are relevant for negotiation and transaction execution have already been largely covered above. The PE firm's advantage is clearly its experience with structuring and with negotiation (it is one of the core activities of the PE firm), while the need to assemble external financing is a complicating factor for the PE firm. A strategic bidder can use its equity as a structuring option. Further, potentially less demanding due diligence by a strategic bidder may smooth its discussions with the seller. On the other hand, successful (i.e., value-creating, not value-destroying) negotiation always requires discipline and a PE firm with its internal economics and incentives structure (i.e., direct impact of bad decisions on the firm's performance and on the rewards for its personnel) may be better positioned to exercise such discipline. Similarly, an ability to move swiftly and be flexible, another key capability needed for successful transaction negotiation, execution, and closing, is also more likely to be present on the side of a PE firm, also considering that a strategic buyer may have to deal with the necessity to obtain antitrust and/or other governmental approvals. Overall, PE firms appear to have some considerable advantages over strategic bidders in the area of deal structuring and negotiation.

6. Value Creation Post-Closing

A target acquired by a PE firm will in most cases continue as a standalone business post-closing. It will usually be under heavy debt, which it will have to service, and cash flow management will become the core concern. Investment into R&D and capital expenditures may be cut to free cash for debt repayment, yet in the process often efficiency improvements are generated[15]. As IRR required by limited partners puts financial discipline on the PE firm, so does heavy debt burden put financial discipline on the target's operations and forces it to operate in a lean and efficient manner. A PE firm may be willing to keep the target's existing culture and management, but only to the extent they work towards this goal. If not, the PE firm will not hesitate to instigate major changes aimed at

[14] Gorbenko et al. (draft September 2010) find that "*valuations of strategic and financial bidders react differently to changes in economic environment. While valuations of strategic bidders seem to be unaffected by those, financial bidders appear to be willing to pay higher premiums (relative to the market values) for targets after a period of low market returns and when the costs of borrowing are lower*" (page 4).

[15] See Aggarwal, V. A., Hsu, David H, "Entrepreneurial Exits and Innovation", July 2013, available at *http://insead.edu/facultyresearch/research/doc.cfm?did=52807*.

improving the financial situation and operations of the target. To support its goal, the PE firm will also heavily incentivize the management through stock ownership, allowing key personnel to generate large amounts of wealth in case of a successful investment. The PE firm will also provide extensive support to the management through its wide network of experts. Business of the target will be subject to periodic financial and operational performance review both at the board level and throughout out-of-the-board discussions with the management. The discipline imposed by the PE firm, coupled with the heavy-loaded incentives[16], is in our view another key element that significantly contributes to the success of the PE industry.

A target acquired by a strategic buyer will in many cases be fully integrated into the business of the buyer (with possible exceptions where the target will keep some form of autonomy). A key issue will be integrating the distinct cultures of the target and the acquirer, and many possible pitfalls can hinder the integration efforts on this front. Operational changes will focus on realizing the synergies planned in the transaction phase, though widely known statistics indicate that 50% to 70% of all M&A transactions fail to achieve their objective[17]. The main reason behind this is often cited to be the cultural issue. We would also speculate that, aside from outright bad acquisition decisions, the lack of the above PE-type discipline and inadequacy of monitoring and incentives in the post-closing world play a significant role in the oftentimes unfavorable result of strategic M&A activity. Simply, in the post-closing period PE firms seem to have a clear edge over strategic buyers.

8. Exit/Long-Term Plans

For a strategic buyer, there are no exit plans – its long-term planning is usually to integrate the target's business, realize synergies, and operate it indefinitely ("buy and hold" strategy). On the other hand, the PE firm is from the start guided by the necessity to exit the investment within a three to six-year period ("buy, improve, and sell" strategy). Planning for an exit will be part of considerations about buying the business, and part of the new strategic plan of the target. Ultimately, the big payoff for the PE firm will come only at the time of exit, and so the very clear goal of selling or IPO-ing the business in the future is another element that reinforces the internal discipline within the PE firm and guides what needs to be done with the target's business. This is a positive aspect of an expected exit. There is also a negative aspect in the form of possible investor myopia – there may be moves that could strategically benefit the target's business in the long-term, however, the investment horizon may be too short for the PE firm to reap such benefits (either directly or in the form of a higher exit multiple).

[16] The importance of incentives to the success of the PE model is discussed in Barber, Goold (2007).

[17] For a comprehensive overview of the topic see for instance Straub, T., "Reasons for Frequent Failure in Mergers and Acquisitions: A Comprehensive Analysis", *DUV,* 2007.

9. Conclusion

It is obvious that even if strategic buyers benefit from synergies in their acquisitions, there are multiple advantages that PE firms enjoy and that ensure leveling off of the M&A playing field. Characteristics of each strategic buyer are of course different and many of them will not suffer from the disadvantages outlined in this paper. Similarly, not all PE firms will have the resources and internal processes as some of their larger brethren and such firms may not be able to compete with sophisticated strategic buyers.

However, we believe it is fair to say that often the discipline, flexibility, and focus of a PE firm will top those of a strategic buyer. Could a strategic buyer achieve the same capabilities? Theoretically yes, but practically it would seem rather difficult. The strategic buyer would have to somehow mimic the economics of incentives in a PE firm (i.e., a major payoff similar to the carried interest) and attract similarly experienced, skilled, and motivated staff; in a way, it would have to create a "PE firm" within itself, which might be an insurmountable challenge given its existing culture and organizational processes. Some strategic players do manage from time to time to master the acquisition game and create major value (e.g., Cisco or Mittal Steel in the past), however, long term and consistent success among strategic buyers seems to be an exception. Fortunately for strategic buyers, they can from time to time forget about acquisitions and focus on internal growth through consolidation, innovation, operational excellence, and/or otherwise. It is a luxury that PE firms cannot afford – they are subject to the survival of the fittest and staying at the top of the game in the M&A is a necessity for all PE firms, thus driving their multiple capabilities and advantages discussed in this paper (for an overview see Figure 2).

Fig. 2 – Idea at a Glance:

	Fundraising, sourcing of equity capital	Deal sourcing	Due diligence	Valuation, deal financing	Negotiation, transaction execution	Value creation post-closing	Exit, long-term plans
Strategic Buyer	• Financing from ongoing operations • Shares as acquisition currency	• Knows industry well • Strategic considerations constraints • Antitrust concerns	• Knows industry well • May falsely assume knowledge • Possible coordination issues	• DCF modeling and validation of projections • Identification and valuation of synergies • Potential agency costs	• Can use equity to pay for target • Potential inexperience and agency costs • Antitrust complexities	• Often full integration • Implementation of synergies • Possible clash of cultures • Possible lack of discipline	• “Buy and hold” strategy • Can drive long-term value
Private Equity Buyer	• Regular fundraising needed • Driver of internal discipline	• May lack deep industry knowledge • Advisory network • Broader range of targets • Incentivized to search for deals	• More industry diligence needed • Broader use of advisors • Focused and disciplined process • People diligence	• Focus on multiples • Use of leverage • Validation of cash flows • Usually absence of synergies	• Expertise in structuring, negotiation • External financing complexities • Discipline, flexibility, reactivity	• Strict cash flow management • Incentives for target management • Discipline driven by debt • Support to the target	• “Buy, improve, and sell” strategy • Preparation for exit from Day 1 • Possible investor myopia

Annex A

Regression Data

(a) Source data (Damodaran; Preqin)

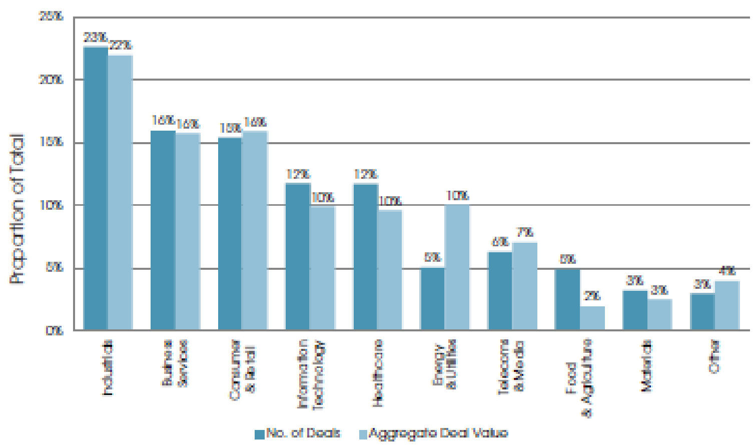
Industry Name	Industry code	Number of firms	Market D/E	Private Equity investment (# of deals)	Private Equity investment (Deal value)
Advertising	b	255	0.32	16%	16%
Business & Consumer Services	b	709	0.25	16%	16%
Information Services	b	171	0.12	16%	16%
Office Equipment & Services	b	162	0.32	16%	16%
Apparel	c	1166	0.18	15%	16%
Beverage	c	99	0.21	15%	16%
Beverage (Alcoholic)	c	209	0.24	15%	16%
Educational Services	c	145	0.20	15%	16%
Electronics (Consumer & Office)	c	208	0.58	15%	16%
Furn/Home Furnishings	c	323	0.27	15%	16%
Homebuilding	c	155	0.58	15%	16%
Household Products	c	456	0.14	15%	16%
Restaurant	c	298	0.23	15%	16%
Retail (Automotive)	c	138	0.52	15%	16%
Retail (Building Supply)	c	51	0.19	15%	16%
Retail (Distributors)	c	842	0.98	15%	16%
Retail (General)	c	226	0.32	15%	16%
Retail (Grocery and Food)	c	170	0.38	15%	16%
Retail (Internet)	c	108	0.05	15%	16%
Retail (Special Lines)	c	536	0.14	15%	16%
Shoe	c	95	0.07	15%	16%
Tobacco	c	48	0.15	15%	16%
Coal & Related Energy	e	322	0.26	5%	7%
Metals & Mining	e	1700	0.27	5%	7%
Oil/Gas (Integrated)	e	55	0.22	5%	7%
Oil/Gas (Production and Exploration)	e	1219	0.31	5%	7%
Oil/Gas Distribution	e	198	0.62	5%	7%
Oilfield Svcs/Equip.	e	570	0.37	5%	7%
Power	e	719	1.06	5%	7%
Precious Metals	e	1237	0.15	5%	7%
Utility (General)	e	61	1.07	5%	7%
Utility (Water)	e	97	0.63	5%	7%
Environmental & Waste Services	f	307	0.41	5%	2%
Farming/Agriculture	f	331	0.43	5%	2%
Food Processing	f	1223	0.28	5%	2%
Food Wholesalers	f	115	0.71	5%	2%
Paper/Forest Products	f	318	0.92	5%	2%
Biotechnology	h	666	0.13	12%	10%
Healthcare Equipment	h	448	0.17	12%	10%
Healthcare Facilities	h	170	0.81	12%	10%
Healthcare Products	h	155	0.19	12%	10%
Healthcare Services	h	328	0.32	12%	10%
Heathcare Information and Technology	h	266	0.20	12%	10%
Pharma & Drugs	h	823	0.15	12%	10%
Aerospace/Defense	i	210	0.26	23%	22%
Auto & Truck	i	130	0.94	23%	22%
Auto Parts	i	624	0.37	23%	22%
Chemical (Basic)	i	760	0.40	23%	22%
Chemical (Diversified)	i	86	0.43	23%	22%
Chemical (Specialty)	i	693	0.21	23%	22%
Electrical Equipment	i	847	0.30	23%	22%
Engineering	i	1141	0.83	23%	22%
Machinery	i	1249	0.25	23%	22%
Packaging & Container	i	399	0.63	23%	22%
Shipbuilding & Marine	i	351	0.91	23%	22%
Computer Services	it	938	0.16	12%	10%
Computer Software	it	1068	0.07	12%	10%
Computers/Peripherals	it	371	0.16	12%	10%
Electronics	it	1188	0.32	12%	10%
Internet software and services	it	715	0.05	12%	10%
Semiconductor	it	564	0.14	12%	10%
Semiconductor Equip	it	264	0.22	12%	10%
Building Materials	m	420	0.45	3%	3%
Construction	m	466	0.49	3%	3%
Heavy Construction	m	334	0.60	3%	3%
Rubber& Tires	m	91	0.52	3%	3%
Steel	m	725	0.81	3%	3%
Air Transport	o	160	1.01	3%	4%
Diversified	o	365	0.79	3%	4%
Insurance (General)	o	220	0.58	3%	4%
Insurance (Life)	o	117	0.61	3%	4%
Insurance (Prop/Cas.)	o	220	0.39	3%	4%
Investment Co.	o	448	0.96	3%	4%
Railroad	o	56	0.65	3%	4%
Real Estate	o	415	0.77	3%	4%
Real Estate (Development)	o	611	0.65	3%	4%
Real Estate (Operations & Services)	o	439	0.86	3%	4%
Recreation	o	292	0.32	3%	4%
Reinsurance	o	35	0.43	3%	4%
Tranportation	o	223	0.49	3%	4%
Trucking	o	185	0.78	3%	4%
Broadcasting	t	144	0.40	6%	7%
Cable TV	t	65	0.57	6%	7%
Entertainment	t	356	0.29	6%	7%
Hotel/Gaming	t	618	0.30	6%	7%
Publshing & Newspapers	t	401	0.40	6%	7%
Telecom (Wireless)	t	117	0.32	6%	7%
Telecom. Equipment	t	550	0.15	6%	7%
Telecom. Services	t	325	0.66	6%	7%

(b) Industry codes

b: Business Services
c: Consumer & Retail
e: Energy & Utilities
f: Food & Agriculture
h: Healthcare
i: Industrials
it: Information Technology
m: Materials
o: Other
t: Telecoms & Media

(c) *Preqin source data (additional detail)*

Fig. 3: Breakdown of Number and Aggregate Value of Private Equity-Backed Buyout Deals in 2012 by Industry



Source: Preqin Buyout Deals Analyst

(d) *Correlations*

	Private Equity investment (# of deals)	*Private Equity investment (Deal value)*	*Market D/E*
Private Equity investment (# of deals)	1		
Private Equity investment (Deal value)	0.975465235	1	
Market D/E	-0.276325766	-0.25481427	1

(e) *Regression for Ratio of Number of Deals*

SUMMARY OUTPUT

Regression Statistics	
Multiple R	0.276325766
R Square	0.076355929
Adjusted R Square	0.06573933
Standard Error	0.064513325
Observations	89

ANOVA

	df	*SS*	*MS*	*F*	*Significance F*
Regression	1	0.029933412	0.029933412	7.192127375	0.008760847
Residual	87	0.362091308	0.004161969		
Total	88	0.392024719			

	Coefficients	*Standard Error*	*t Stat*	*P-value*	*Lower 95%*
Intercept	0.134340405	0.012884116	10.42682373	5.46839E-17	0.10873183
Market D/E	-0.068591881	0.025576672	-2.681814195	0.008760847	-0.119428285

(f) *Regression for Ratio of Deal Value*

SUMMARY OUTPUT

Regression Statistics	
Multiple R	0.25481427
R Square	0.064930312
Adjusted R Square	0.054182385
Standard Error	0.062011023
Observations	89

ANOVA

	df	*SS*	*MS*	*F*	*Significance F*
Regression	1	0.023230607	0.023230607	6.041193755	0.015958918
Residual	87	0.334546922	0.003845367		
Total	88	0.357777528			

	Coefficients	*Standard Error*	*t Stat*	*P-value*	*Lower 95%*
Intercept	0.131528329	0.012384375	10.62050609	2.21327E-17	0.106913044
Market D/E	-0.060426144	0.02458462	-2.457883999	0.015958918	-0.109290737

Annex B

Literature Used

In preparing this paper, we generally consulted the following articles and other sources (specific citations, where relevant, are provided directly within the footnotes):

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