When takeover targets become takeover artists

Equity values are falling. Instead of panicking, why not buy out a competitor?

By François de Visscher

When it comes to mergers and acquisitions, family businesses usually think of themselves as potential targets, not acquirers. But now may be the perfect time to start thinking more like a potential buyer.

Several economic factors are converging to create a buyer's market in the acquisitions arena:

• **Valuations of private companies have dropped** along with public valuations. When family companies see their own valuations diminishing, they often assume a defeatist attitude. It's harder to create liquidity for shareholders. But the value of your competitors has likely fallen as well. That's good if you're a potential buyer. Instead of retrenching into a defensive posture, consider going on the offensive, by expanding or developing new lines and getting into new markets. Think of an acquisition as a different way to create value for future generations of shareholders.

• Acquisition opportunities have increased. In an effort to become more focused, conglomerates and global companies in many industries are shedding non-core operations. What an opportunity to pick up some jewels! This is your chance to be more proactive and aggressive in the acquisitions game.

In addition, fierce global competition in some industries has resulted in bankruptcy filings. Two of America's three funeral home conglomerates have filed for bankruptcy. Meierhoffer Family Funeral Services, a smart independent funeral home in St. Joseph, Mo. (see *FB*, Summer 2001), has begun picking up competitors for bargain prices. Less competition among buyers means fewer players with deeper pockets to bid against.

• Private equity capital is plentiful. It may be tough to get debt financing today—banks are reluctant to lend money. But the private equity market has raised more capital than it has been able to invest. In fact, over the last three years, private-equity funds have raised close to $90 billion a year. More than two-thirds of that money has yet to find a home for investment.

That means there is plenty of private equity to financially support business expansion plans. In fact, given today's shortage of debt capital, private-equity investors are looking for strategic partners to co-invest with them and take a strategic interest—a more active role than traditional financial investors have taken—in deals. With all that private equity capital searching for a home, family companies have a unique opportunity to tap that pool of uninvested capital at attractive terms.

Interest from institutional and individual investors remains high because private-equity returns have historically been phenomenal—in excess of 25%. With the debt market less available today, returns are closer to 20%. Today, deals require much more equity than in the past. A few years ago, a $10 million transaction might typically be financed with $3 million equity and $7 million debt. With lending ratios more stringent today, the same transactions would require $5 million equity and $5 million debt. That drives returns on private equity down, because you need to pay more for same company.

However, deals financed with more equity and less debt enjoy a tremendous advantage: They're less risky. So family companies have an opportunity to create significant future value—if instead of looking for high leverage they look for deals that offer strategic synergies.

• **Family companies often under-utilize their capital.** A heavy concentration of equity or cash on your balance sheets provides expansion resources for under-leveraged companies. Family businesses are in a unique position because they have financial flexibility—cash on their balance sheet—to invest with a private equity party. As well, traditional consolidators are streamlining instead of continuing to invest.

A third-generation equipment manufacturer in the Northeast has been struggling for the past few years against a European competitor owned by a large multinational corporation. The competitor's parent company, as part of its restructuring, decided to re-focus its business and put this division up for sale.

The U.S. company decided to take advantage of the chance to expand. The family firm was already selling in Europe, but by buying its European competitor it could sell from its own overseas manufacturing plants. This landmark deal enabled the family business to become the world's biggest manufacturer in its industry.

The family business selected a private equity partner that would not only finance this deal but also function as its long-term financial partner as the family business continued to acquire other competitors. The family business gave up 40% ownership of the combined company to the equity partner. However, the family owners understood (after some prodding) that it would now own 60% of a larger company that had much greater profitability and potential than its former stand-alone family business.

One result: After fighting for 90 years, the two companies combined can now focus the energy they used to devote to wringing each other's necks to wringing out inefficiencies. They expect to close three plants around the world without losing significant sales.

The greatest acquisition opportunities today can be found in the manufacturing and service sectors. With many manufacturing conglomerates shedding operations, smaller firms can become top global players in a niche of their industry. Similarly, in the service sector, cost efficiencies, information systems and client services require larger, well-focused companies.

Examples of other industries in which we can observe streamlining today include:

* Advanced materials manufacturing
* Oil and gas equipment (because of high energy prices)
* The power industry
* Health care products and services
* funeral homes
* Building maintenance, cleaning, landscaping (because real estate companies that used to own maintenance firms are divesting to focus on core real estate)

But before you go on a buying spree, do a little homework:

• **Define your core competencies.** To be successful long-term in a global environment, you need position yourself as No. 1 or 2 in your market. So you must define the market niche you're in and consider how to attain the top position. Where do you have a leadership position? Which of your products or services are difficult for others to duplicate? Perhaps you have a large distributor presence, a specific technology or a strong customer base. What makes your business unique and successful? The equipment manufacturer's core competency, for instance, was not its production facilities but its relationship with its customers. Its engineers work closely with a loyal customer base, which new competitors couldn't penetrate. The competitors' strategic challenge is finding what else they can supply to those customers.

• **Identify expansion opportunities to take advantage of those core competencies.** If you have a strong and loyal customer base, what other products can you provide those customers? Which companies in those markets could you acquire? If you own a proprietary technology, where else can you apply that technology? What are complementary companies?

• **Consider partnering with private equity investors.** There are many funds; the question is finding the right one. You want more than capital: You want a partner that shares your same strategic vision and can provide you with follow-up capital and strategic input on additional acquisitions. Your private equity partner should also understand the dynamics inherent in a family business.

The time has never been better to rethink your strategy. Instead of weighing whether to keep or sell your business—a question often on the minds of family business owners—why not think of yourself as a buyer, or even a consolidator?

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