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Matchmaking Can Be Beautiful

Deals between private equity firms and strategics should happen a lot more often

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Sometimes we feel like hopeless romantics, but we think intermarriage could solve all the world's problems. When two people love each other, we expect a great relationship to bloom regardless of their backgrounds. Of course, things are more difficult in the real world and that's particularly true with mixed marriages.

Similarly, when a deal makes dollars and sense for a buyer and a seller, logic dictates that it should happen. After all, the ultimate goal for both sides is the same: Put the asset in the right hands at the right time in order to maximize stakeholder value. We think deals between private equity firms and corporate strategic investors, our idea of financial intermarriage, should happen a lot more often. How can we create some love between financial investors like us and strategics—especially large public companies and other corporations?

We think about this a lot, because as sellers we know that once we've made a company bigger and better, it can be very appealing to strategic investors. Of our 57 exits to date, almost exactly half have been sales to strategic investors like TriMas Corporation, Siemens and BSN medical.

And as buyers we know that our resource-intensive but laser-like focus on a corporate orphan can enable it to fully realize its potential, and that the speed and certainty of our acquisition process will please all the key constituents within a corporate parent. Of our 239 acquisitions to date, dozens have been purchased from corporate sellers including the likes of 3M, Federal Signal, Halliburton, Henkel, RPM and JohnsonDiversey.

So in our endless quest to pair lovers from both corporations and private equity firms, we reached deep down to our inner Yenta and came up with the top five reasons these marriages should happen more often, and considered the top five things that have torpedoed deals between them in the past.

Love connections should be happening more for these reasons:

1. It's the money, stupid!– Everyone knows that strategic buyers can often pay the highest price for a private equity firm's deals. The private equity firm is happily selling at, say, 9x EBITDA while with synergies the corporate buyer is calculating a 5x purchase price. Win-win! This can also be true when the private equity firm is buying from the strategic. Private equity portfolio companies are often strategic buyers of add-ons and also able to realize synergies. In addition, private equity firms with deep industry knowledge can "pay up" when they have the right strategy and the right talent to significantly improve an orphan's future performance. Moreover, the private equity firm has the patience to live through a couple of rough years to take on a short-term headache for long-term performance. For the corporate seller, the sale frees up resources to focus on its core businesses. Both parties are better off.

2. Speed– A private equity buyer can make a quick decision and close on a transaction within 90 days and, if pressed, in less than 30 days. A fast, worry-free transaction usually benefits both the seller and buyer. Rumors of a sale send tremors through customers, suppliers and employees. These nerves can hurt earnings, weaken competitive position, drive away talent and customers, and even kill the deal that the seller sought to optimize. Quiet and fast is usually a good choice for everyone involved, especially the entity being sold. In and of itself, speedy consummation sometimes has a value greater than what can be recognized via a long, drawn-out auction process. Sales between private equity firms and corporations can be the shortest line to maximum benefits for everyone.

3. Certainty– The best private equity and corporate buyers and sellers do what they say they will do. They don't bait and switch. For private equity firms that have been around for decades and hope to be around for decades more, their reputation is particularly important. We consider Letters of Intent as commitments in spirit to be met, not the starting point for last-minute holdups.

4. Mutual understanding– Private equity firms and strategic sellers speak each other's language. Many of our investments are in small businesses that have never had a board or stringent financial standards, and there's a learning curve with an entrepreneurial seller. Corporations, however, share our financial sophistication. Everyone can speak in shorthand, and both sides are well advised by good lawyers and strong accounting teams.

5. Keeping emotions in check– Both sides are very fact-based. Winston Churchill said, "Facts are better than dreams." When it comes to dealmaking, we wholeheartedly agree. Corporations are not emotionally vested like some sellers can be, and ideally, both sides eventually get to the same information.

While we think the corporate/private equity marriage is nearly perfect, we're constantly reminded of why these don't happen more often.

These are the top five things that spoil a fine romance:

1. It's the money again, stupid!– Everyone is in dealmaking for the same reason—to maximize gains—and when deals fall apart it's usually over valuation. Moreover, corporations often worry that they're getting ripped off any time they sell to a private equity firm while private equity firms will sometimes try to submit low-ball offers in hopes of a lucky acquisition. Corporate owners are loath to sell even the homeliest orphans at less than their public-company multiple despite the typically lower growth rates of the spinoff and the immediate strategic benefit of a sale. And as buyers, corporations can sometimes be so careful about overpaying that their bid is underwhelming.

2. Don't rush me!– Corporations sometimes aren't built for speed. Their M&A teams may need to get the operating division head's approval and then take it to the CEO and the board. By the time they get every decision maker on board, the orphan's earnings or prospects have declined, the secrecy is gone and the deal is dead or in jeopardy. Private equity buyers can also drag things out if they don't fully understand the spinoff's industry and require extensive commercial due diligence.

3. Pompous asses– Private equity guys can be arrogant jerks. Not us of course—we're perfect. But we've seen people think that wearing better shoes makes them better people. Talk about turn offs! Clearly not conducive to building effective relationships with corporate buyers or sellers.

4. That's how we always do it– Private equity firms can find corporations painfully political and bureaucratic. Nothing drives us crazier than hearing "that's our policy," rather than logical reasons for a decision. There's often a disconnect between a corporation's operating professionals and its corporate development staff. People responsible for the P&L are not always on the same page as those looking at the balance sheet.

5. Your fantasies are not my reality– Private equity sees what's actually there while the corporation sees what could be, should be or once was. Just like posting a decade-old photo of yourself on match.com, the truth—sags and wrinkles—will eventually come out. When selling, corporations focus on the past or future while when buying, private equity focuses on the present. This can make private equity firms too EBITDA-focused, while strategic sellers often think only of macro-strategic opportunities at the expense of EBITDA considerations. That's a great reason for strategic sellers to capture some of the upside of a transaction they sell via an earn-out structure. But it's also a reason that corporations often miss opportunities to swiftly prune and capture value—they wait too long and try everything they know to get a division to work before looking to unload something that's tired and old. Further complicating these deals, people managing the division may not want to go with the business or the best talent may have moved on years before, so the sold company will no longer have the human capital necessary to thrive.

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Now that we've gotten everything out on the table, can't we all just get along? Time and again, we've successfully worked with strategics as both buyers and sellers. Strategic investors usually purchase our portfolio companies for the same reasons we did—to consolidate industries, add customers, knowledge and talent, and to make their existing investment better. As buyers, we find some of our best deals come from strategic sellers.

Our purchase of Sentinel, a UK maker of treatments for hot water heating systems that was a division of General Electric, is a great example. Sentinel was thoroughly enmeshed in GE. It used GE systems from accounting to IT and purchased its raw materials from a sister company within GE. But we were still ready to close the deal in just 35 days, and after the clean carve-out at an attractive value to GE, Sentinel became a strong performer in our portfolio.

Another great example of a match made in heaven was our recent sale of Stoffel Seals to Tyden Group. Stoffel Seals, like Tyden Group, produces identification and safety seals. Tyden Group was able to realize synergies and customer gains that made the purchase of Stoffel Seals much more appealing than it would have been for a financial buyer. Another win-win.

When deals with strategics are right, they're very right. One way to bridge differences is via cross-pollination between corporate development groups and private equity firms. We have quite a few transaction professionals who came directly from the corporate development side of large companies like Siemens, Eaton and Texaco, and they bring a lot of savvy and strategy along with a corporate perspective. They are as good as any transactors in our house. On the flip side, corporations could complete more deals with more speed with a private equity mentality, which would ultimately lead to greater profits. We've noticed quite a bit of convergence recently, as corporations have become more financially nimble and private equity groups have become more operationally sophisticated.

Strategics and private equity groups can also make their own worlds better by buying and selling to each other with trust and confidence. When an intermarriage works, a little bit of mistrust is forever dispelled and the world becomes a slightly better place. As the Youngbloods famously sang, "Come on people now/smile on your brother/Everybody get together/try to love one another right now."

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