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Four Principles Private Equity Investors and Strategic Acquirers Can Teach Each Other in a Slowing and Ever-Changing Deal Market

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After an overheated 2020 and 2021, the U.S. economy is slowing down in the face of increasing uncertainty — and is taking the deal market with it. We expect 2022's slowing deal market to stay that way into 2023. As importantly, the time deals are taking to cross the finish line has slowed as well, which we expect to be a continuing trend next year too.

Deals are taking longer to close because today's market conditions are leading buyers, including private equity investors and strategic acquirers, to take more measured approaches to their deals, particularly with their legal, financial, accounting, tax, and IT due diligence. This is due in part to the increasing gap between buyers and sellers on purchase prices, as 2020's and 2021's valuations based on lofty EBITDA multiples are in the rear-view mirror for certain sectors, and the continued economic slowdown causes credit markets to tighten. Today more than ever, buyers (and their sources of financing) want to be sure that if they're going to make a strategic dollar investment, their due diligence has uncovered any possible red flags — and those red flags will not result in them overpaying for the deal.

As private equity investors and strategic acquirers are well aware, time kills deals. Traditionally, both types of acquirers have brought different strengths to the dealmaking table — based on how they operate and how they view the world — that help them successfully get deals done. In today's slowing deal market where the ability to get to closing quickly can be a buyer's competitive advantage, private equity investors and strategic acquirers would be wise to embrace the following four principles already embraced by the other to help them avoid the fatal delays that can doom deals.

Principle 1: Use representation and warranty insurance

Private equity investors long ago embraced representation and warranty insurance (RWI) and use it regularly to the point that it is now practically pro forma for them. But we have not seen universal adoption of this product by strategic acquirers. As a way to close deals faster (and in some cases make their bids more attractive), they should consider doing so. We've seen RWI become such an attractive selling point for sellers that it can be conspicuous by its absence in some offers, causing sellers to sometimes look elsewhere.

With a buy-side RWI policy (a far more common product than a sell-side RWI policy), buyers can protect themselves from the seller's breach of a representation or warranty, while simultaneously reducing a seller's potential liability for such a breach. For deals of a certain value — in our experience, $50 million or more — RWI can cost-effectively increase the speed at which deals can close. Despite the additional costs sometimes associated with obtaining such a policy, the allocation of which is a negotiated point among buyers and sellers, RWI policies reduce the post-closing risk of indemnity claims faced by a seller and can reduce the time spent negotiating a purchase agreement's representations and warranties and related indemnification provisions.

Private equity investors have long known that RWI can win a seller over and get them to closing faster than without it. In a tight deal market, that's an advantage a buyer will want to maintain — and strategic acquirers should seek to explore.

Principle 2: Explore minority investments

Strategic acquirers take minority positions in would-be sellers at a higher rate than most private equity investors do. In today's deal market, private equity investors may want to reconsider their favoring of majority positions.

Taking minority positions may provide an easier path to getting to "yes" both internally and with a target, and are safer propositions compared to outright purchases. But, arguably, the biggest benefit of taking a minority position is that when an acquirer does so in a company the acquirer already has a business relationship with, such as a supplier or customer, the investment can financially shore up the other party and ensure the acquirer will continue to have access to the services and/or products it is receiving and be able to rely on that party.

Of course, a minority position today does not foreclose a majority position tomorrow. If a would-be acquirer has interest in taking on a larger stake of a target company, a minority position provides the would-be acquirer a prolonged peek behind the curtain to see whether the target is worth acquiring outright down the road. It positions the would-be acquirer to acquire a larger interest by helping it to forge close relationships with the target's management and employees — which could make it easier to secure buy-in for the deal internally (and with the target). Furthermore, if a would-be acquirer was initially interested in an outright purchase but faced external or other pressures that caused it to first obtain a minority interest, it could also obtain a contractual option to buy the rest of the target at a later time for a predetermined price or a contractual right of first refusal. Even without such a contractual right, in some cases, the above-described relationships that can be forged effectively puts a would-be acquirer in a similar position of advantage.

Private equity investors favor majority positions, but they shouldn't avoid minority positions all together in today's deal market. Such positions are consummated quicker and at a lesser cost than majority positions and can provide other benefits. There's also a chance that companies that have business relationships with a private equity investor's portfolio companies would be open to a minority investment, which could provide short-term and long-term value to all parties involved.

Principle 3: Embrace the "right" processes

Private equity investors' business models rely heavily on transactions. As a result, those investors have established both thought processes and transaction processes that allow them to quickly come to decisions regarding whether to pursue a deal and on what terms, and then to efficiently move from a letter of intent to due diligence to closing.

Because strategic acquirers are primarily focused on operating their businesses, similar processes are not in place for all of them, and some of those existing processes may not be as well-oiled as those of the private equity investors they may be competing against for a particular asset. Without such processes, strategic acquirers can have difficulties taking advantage of short-lived opportunities that require them to quickly get to “yes” internally regarding a deal and then follow a streamlined process to get to closing. In this current deal market, strategic acquirers’ embrace of these thought and transaction processes could make them more competitive with private equity investors vying for the same deal.

As to thought processes, strategic acquirers could work on priming the layers of approval at their companies necessary to move forward on a deal. This would involve preparing for, and then communicating throughout the organization about, the transactions that would make business sense in the near term even before a particular opportunity exists and securing the board of directors’ approval early in the process.

The goal would be to set expectations about intriguing opportunities, build consensus around which opportunities the company may pursue, and help the leadership team develop a proactive mindset toward transactions — even in the face of people in the industry suggesting that now is not the right time to look for them. Once this priming has occurred, leadership, including leaders from business units, accounting, legal, human resources, compliance, IT, and data security, would have a common understanding about what the opportunities are, what the timing would be for any deals, and the type of market that would influence the strategic acquirer’s deal-making decision.

As to the transaction process, strategic acquirers could build out their corporate development departments, so there are dedicated people to identify acquisition and investment opportunities and present them for consideration to leadership. In addition, this department — which would be structured to be nimble — would be in charge of developing the internal checkpoints that must be passed during the deal process, marshalling appropriate resources, and ensuring responsiveness from those departments and/or individuals.

In a slowing deal market, the ability to efficiently find deals, determine whether they’re winners, and then close them is a competitive advantage. Strategic acquirers should emulate the efficient processes for doing so that private equity investors long ago developed and continue to refine.

Principle 4: Emphasize your operating chops

Rising interest rates and general economic uncertainty have put a strain on the money available for deals. Over the past few years, private equity investors often held a funding advantage over strategic acquirers given their access to cheap money. But now that cheap money isn’t as bountiful as it previously was, and buyers are less inclined to win transactions simply by increasing the purchase price, sellers are looking more closely at would-be buyers’ operating prowess. Can a particular buyer facilitate key business partnerships? Is that buyer able to help attract and retain the requisite talent to take the company to the next level? Can a buyer implement systems and processes that increase efficiencies? Deals can drag on while sellers scrutinize whether a would-be buyer has the operating knowledge and capabilities to make a deal a “1 + 1 = 3” opportunity.

Strategic acquirers will have well-developed operations experience and proficiency they will emphasize to sellers, so sellers know quickly what increased efficiencies might be possible after a deal. But this won’t be as easy for many private equity investors, as they are typically investors and not operators, and could put them at a disadvantage when courting sellers that strategic acquirers are also courting.

Private equity investors that have operating chops and/or deep experience in a particular industry should emphasize those traits when wooing certain sellers. While they may not be as operationally experienced as strategic acquirers, and they may not be used to tooting their own operations horns, private equity investors may need to demonstrate to these sellers that a deal could help them take their companies to the next level in part because of the private equity investors' operations know-how. Shining a light on this know-how might be the ticket to standing out from strategic acquirers and other private equity investors, and it could help speed a deal along.

A changing deal market requires a changing approach to deals

In 2020's and 2021's hot deal markets where there were opportunities seemingly everywhere and plenty of financing available, the different strengths and approaches private equity investors and strategic acquirers brought to the deal table were rarely deal makers or deal breakers. But in today's slowing deal market where fewer deals are getting done, there are typically fewer bidders for a particular asset, and those deals that do get done are taking longer to close and requiring more expensive and burdensome due diligence, these same strengths and approaches can dictate whether a deal moves forward or dies.

Private equity investors and strategic acquirers would be wise today to look at which of the above four principles they can improve and begin building their capability to do so. This new proficiency could help move their deals along in today's M&A environment and position them favorably tomorrow when the deal market heats up again, and investors benefit from being able to source and close deals at a breakneck speed.

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