Executive Insights

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When PE Becomes the Competitor

Despite some capital market bumpiness during the first quarter of 2016, M&A activity reached historical highs in 2015, and the number of industrial-sector businesses being acquired by private equity (PE) companies continued to grow. Sustained deal volume has led to rising valuations within the segment, compelling newly acquired firms to drive robust profit growth in order to build shareholder value in excess of the purchase price. Having already reduced costs during the crisis, these firms are less likely to achieve further operational efficiencies and drive profit improvement through cost-management initiatives. Therefore, the likely avenue for value creation will need to come from accelerating growth.

The prospect of an M&A-fueled environment of competitors pursuing aggressive growth underscores the need for incumbent businesses to develop actionable strategies to defend their position and achieve their own growth aspirations. In this *Executive Insights*, L.E.K. Consulting looks at the possible ramifications of a private equity-backed competitor acquisition and recommends how incumbents can simultaneously defend their territories and exploit new opportunities.

The M&A Effect

During 2015, total M&A deals globally reached a new record of $4.6 trillion, or 9% more than 2007's previous high, according to William Blair's Q4 2015 Merger Tracker report. In the U.S., mid-market M&A deal volume and value are both up. In fact, 2015 and 2014 saw the highest deal values and volume since 2007.

Industrial-sector M&A, including building products, industrial equipment and packaging acquisitions, has increased by more than 30% over the past five years. Further, industrial PE activity continues to outpace the broader market, with PE-backed deal volume rising some 35% through the same period.

Meanwhile, rising deal volumes have coincided with higher multiples for PE-backed purchases. U.S. buyout firms paid an average of 10.3 times EBITDA for transactions in 2015[1] compared with an average multiple of 9.3 in 2010.[2]

With lower synergy potential from a financial sponsor — and with much of the cost cutting already completed — incoming PE ownership will need to mount an aggressive growth campaign to create value. For example, a company with an after-tax return on capital employed (ROCE) of 25% (and cost of capital of 10%) would require revenue CAGR of approximately 10% in order to justify an Enterprise Value (EV)/EBITDA multiple of 10.0.

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Figure 1
Return on Capital Employed Enterprise Value (EV)/EBITDA Multiples (10% WACC)*

Return on Capital Employed (after-tax ROCE)**

Implied 10-year sales growth forecast	5%	15%	25%	35%	45%	55%	65%	75%	85%	95%	105%	115%	125%
0%	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5
2%	5.7	6.9	7.1	7.2	7.3	7.3	7.3	7.3	7.3	7.4	7.4	7.4	7.4
4%	4.8	7.3	7.8	8.0	8.1	8.2	8.3	8.3	8.3	8.4	8.4	8.4	8.4
6%	3.8	7.8	8.6	9.0	9.1	9.3	9.4	9.4	9.5	9.5	9.5	9.6	9.6
8%	2.6	8.4	9.6	10.0	10.3	10.5	10.6	10.7	10.8	10.8	10.9	10.9	10.9
10%	1.2	9.1	10.6	11.3	11.7	11.9	12.1	12.2	12.3	12.4	12.4	12.5	12.5
12%	(0.4)	9.8	11.9	12.8	13.3	13.6	13.8	13.9	14.1	14.2	14.2	14.3	14.4
14%	(2.3)	10.7	13.3	14.5	15.1	15.5	15.7	15.9	16.1	16.2	16.3	16.4	16.5
16%	(4.4)	11.8	15.0	16.4	17.2	17.7	18.0	18.2	18.4	18.6	18.7	18.8	18.9
18%	(6.9)	13.0	16.9	18.6	19.6	20.2	20.6	20.9	21.1	21.3	21.5	21.6	21.7
20%	(9.7)	14.3	19.1	21.2	22.3	23.1	23.6	23.9	24.2	24.4	24.6	24.8	24.9
22%	(13.0)	15.9	21.7	24.1	25.5	26.4	27.0	27.4	27.8	28.0	28.2	28.4	28.6
24%	(16.7)	17.7	24.5	27.5	29.1	30.2	30.9	31.4	31.8	32.1	32.4	32.6	32.8
26%	(21.0)	19.7	27.9	31.3	33.3	34.5	35.4	36.0	36.5	36.8	37.2	37.4	37.6
28%	(25.8)	22.1	31.6	35.7	38.0	39.5	40.5	41.2	41.8	42.2	42.6	42.9	43.1

Required combination of ROCE and sales growth to justify an EV/EBITDA multiple of at least 10.0x

Notes: *EV is defined as present value of 10 years' future cash flows + perpetuity value discounted at 10% weighted average cost of capital (WACC); **ROCE is defined as NOPAT/Capital Employed; Capital Employed is defined as Net PPE + inventory + accounts receivable – accounts payable.
Sources: Capital IQ, L.E.K. analysis

Accordingly, shareholder value creation can be sustained only when the business meets or exceeds this growth rate.

To demonstrate, we modeled the required sales growth and ROCE to earn a range of EV to EBITDA multiples at a 10% weighted average cost of capital (WACC) (see Figure 1).

As indicated in Figure 1, expected sales growth has an exponential effect on transactional multiples; thus, recently acquired companies would be expected to accelerate their own growth aspirations. This increased emphasis on growth and changes in competitive behavior should serve as a warning for incumbent providers: Action is required.

Incumbent Impact

As M&A momentum continues to bring fresh capital into the industrial segment, incumbent businesses will find it necessary to modify existing strategies in order to keep pace and take advantage of opportunities. While some approaches may be more effective than others based on industry type, competitive position and/or marketplace, incumbents should consider the following key adjustments to strategic growth priorities:

Pricing. Incumbents may be able to compete on price in order to gain market share, increase volumes and capture leverage over fixed costs, particularly when the competitor's new owner imposes a balance-sheet structure that does not lend itself to price flexibility. Alternatively, incumbents may find the new PE-owned competitor to be a more willing follower of price increases as it seeks to cover the added debt service costs. Understanding the nuances of the industry's supply structure — including share of capacity by competitor, excess capacity, marginal costs and balance-sheet dynamics — can help incumbent firms make the right decision on pricing.

Capacity/Manufacturing. The effect of a newly acquired company on the industry's supply curve can help incumbents determine whether investments in capacity, target-cost positions or possible consolidation through acquisitions are logical choices. Other factors include whether the acquiring owners can invest in new capacity, as well as boost productivity/cost positions at the existing facilities.

Innovation. Another thing for incumbents to consider is the impact of PE-based capital on innovation. Will an acquired firm, particularly in an industry with a lengthier innovation cycle, be less aggressive with respect to costly R&D? If so, this may create an opening outside the PE firm's holding period for incumbents to invest in innovation in order to achieve differentiation and encourage growth.

Channel. Depending on the nature of the industry, newly acquired firms may focus on widening the routes to market, particularly in segments where the channel represents a key growth element. As such, incumbents should review the potential for salesforce/distributor defections — and develop ways to ward off such risk. By the same token, incumbent firms may be able to capitalize on M&A-related disruptions by improving channel access for their sales resources and capabilities. Further, they should be prepared to exploit specific opportunities, such as troubleshooting sources of channel conflict, product bundling, creating product/channel exclusivities, and more.

M&A. Capital inflows encourage new owners to pursue additional bolt-on acquisitions, using the economies of scale and consolidation synergy to average down the cost of the platform acquisition. To maintain their market position, incumbents must determine how this competition for assets might inform their own M&A outlook as well as potential areas of divestiture.

Conclusion

When a key competitor is acquired by a PE interest, existing companies face a potentially serious challenge that requires an immediate response and an informed action plan. While the acquiring owner's strategic approach may vary depending on the industry, the level of capital inflows and other factors, incumbents should nonetheless expect PE newcomers to adopt an aggressive approach to growing their market share. Given that many firms already streamlined during the post-crisis period, attempts to "lean a company out" through further operational efficiencies may not present the most effective path to value creation. Higher M&A multiples in recent years have only amplified the need to sustain growth and create value for shareholders.

Faced with a well-financed competitor, incumbent firms may find the standard rules of engagement to be woefully inadequate and therefore should revisit approaches to fending off a competitor's potential advances. Should the acquired company's "100-day plan" include an accelerated growth model and a more aggressive approach to competitive share gain, for instance, incumbents should be prepared to develop their own 100-day plan.

This *Executive Insights* covers only a handful of strategic solutions available to incumbents, and not all options will be relevant across the board. As the M&A trend continues, L.E.K. can provide firms with additional insight and the ability to respond quickly in order to maintain a competitive advantage and respond to industry M&A developments.

[1]Danielle Fugazy, "Valuations Soared in 2015, Making It Tough for PE firms to Compete With Strategic Buyers," Mergers & Acquisitions, Jan. 22, 2016.

[2]Global M&A Valuation Outlook 2014, American Appraisal.

About the Authors

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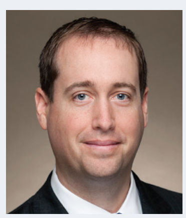

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