FROM THE FOUNDER'S HUB

Should a Founder Sell to a Strategic or a Financial Buyer (or a Hybrid of the Two)?

As a founder, you probably know that the more critical business decisions you get right, the more likely your company will be to succeed. And eventually, that success will lead you to the ultimate decision: when to sell your business—and to whom.

Once you reach this stage, it's important to have all the information you need to determine which buyer is best for you personally and for your stakeholders (investors, employees, clients, etc). In the end, this is the most important decision you'll make for your business and the people who have built it, so it's crucial that you know your options.

Buyers come in many stripes and sizes, but generally, they fall into two categories: financial buyers and strategic buyers. First, you'll need to understand the key differences between the two.

What is a financial buyer?

A financial buyer (usually a private equity group or "PEG") is a financial organization whose primary goal is to acquire standalone businesses with opportunities for growth that they can later resell for a premium.

Typically, they focus on achieving “doubles” or maybe “triples” over a three- to seven-year time period. Private equity buyouts often use debt or “leverage” and involve purchasing shares from existing shareholders to secure 51-100% ownership in the business. The PEG works closely with management to make operational improvements and increase revenue and EBITDA. Sometimes they also pursue an aggressive inorganic growth strategy through M&A, often acting as the company’s corporate development partner.

Advantages of a financial buyer

The advantage of selling to a financial buyer is that you can maintain operational control of the business you started and some ongoing financial interest. Usually, you’ll be asked to stay on to manage the business, continuing to have some decision-making power about future direction, staffing, and investments. Private equity investors typically look for strong management teams because they are betting on your proven expertise, combined with their capital, for rapid business growth.

The founder may retain a minority stake in the business (referred to as an “equity roll”). By maintaining a minority position, the founder can experience a “second bite of the apple.” In fact, it’s not uncommon for the future sale of the remaining minority stock to exceed the cash received at the initial sale.

There are also immediate advantages of selling to a financial institution. Acquisitions by PEGs are often completed quickly, and valuations—typically based on multiples of profits—tend to be predictable.

Disadvantages of financial buyers

Choosing a financial buyer may not be right for the risk-averse. Private equity firms tend to offer a lower initial price compared with a strategic buyer with the expectation of rapid growth. In addition, they are often in favor of higher debt, which may bring some risk of over-leveraging a business.

If the expected growth does not materialize after partnering with a private equity owner, there can be some ongoing conflict. As a founder and now minority owner, you may struggle with balancing what’s best for the future of the company with the private equity investor’s goal of generating a return and exiting after the holding period.

And if retirement is within reach, a PEG buyout might not be a good fit since most financial buyers expect founders and management to stay on.

What is a strategic buyer?

A strategic buyer is typically a direct or close competitor looking to expand market share or obtain proprietary advantages. Often the founder's business has a product or service that works synergistically with the buyer's own offerings, a geographical entry point where the founder's company is well-established, or a foothold in a market that the buyer wishes to pursue.

Strategic buyers usually expect to buy 100% of the company which means the founder has limited opportunity for future equity appreciation from their company. Typically, the founder is only required to remain with the combined company for a short transitionary period, enabling them to pursue other interests.

Advantages of a strategic buyer

Because strategic buyers often have an immediate need for the entrepreneur's business and have done their due diligence, they are frequently willing to pay a higher price compared to a financial buyer. Selling to a strategic buyer results in a complete exit with immediate financial gain for the seller and no ongoing risk.

Disadvantages of a strategic buyer

The cons of working with a strategic buyer usually revolve around ongoing employment and legacy issues. Since the strategic buyer's goal is to buy the company for the benefits it brings to the larger organization, some employees may lose their jobs in areas of overlap. In addition, a founder is likely to lose the legacy of the business because strategic buyers typically absorb the original start-up into their own enterprise, including branding the products and services as their own.

What about the strategic financial buyer?

A third category of buyer to consider is a strategic buyer backed by a financial buyer (often referred to as a "private equity platform company"). This flavor of buyer can be attractive as it combines the benefits of a strategic buyer at the transaction speed of a financial buyer. And similar to a deal with a financial buyer, typically the founder can roll equity into the deal and get that second bite at the apple—even if they don't remain active in the business.

How founders decide on buyers

The final decision for each founder will be different depending on individual and business goals, objectives, and overall vision.

If you are looking for a complete exit and 100 percent sale of your company, finding the right strategic buyer will probably be your best bet. You may be able to negotiate employment issues for your staff into the agreement to at least provide some transition time for your employees.

On the other hand, if you'd like to retain some hand in your business as a minority owner, at least for the short term, you can work with a private equity investor who can provide the capital and advice needed to help you scale your business to the next level. This may provide you with a significant financial return immediately as well as a more lucrative exit in subsequent sales down the road.

Ready to take the next step for your company? ScaleView guides tech founders to raise growth capital or achieve an exceptional exit. Talk to a partner at ScaleView Partners for help deciding between a sale to a strategic or financial buyer.

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