Strategic Acquisitions: Their Mistake Could Be Your Next Opportunity

During this interest rate and inflation cycle, make your M&A shopping list early but be selective.

By Kal Vadasz

Jeff Bezos famously said, "your margin is my opportunity." Amazon certainly delivered in the decade since these words were spoken, despite its early naysayers. Unfortunately, recent history has also shown that a similar mentality in less able hands creates chaos and destroys value. Many neglected to read the fine print in Bezos' letters focusing on free cash flow and disciplined, efficient capital deployment.

The artificially low interest-rate environment did not help. Cheap borrowing enabled a spate of unprofitable "growth" businesses "buying" market share, harming stronger players and limiting their ability to earn sufficient economic rents to reinvest and grow. Today, both interest rates and the equities market are well into correcting this historical anomaly. And, while unpleasant, this recalibration can be an opportunity for those who have done things the right way, biding their time.

Unique Buying Opportunities

In a previous article, I discussed the proliferation of so-called "zombie" businesses under the above-described conditions and how companies should look to reallocate capital from, or divest, these underperformers while valuations remain favorable. In this piece, the focus shifts to companies that generate returns well above their real costs of capital and are poised to benefit from M&A opportunities in the months to come.

If the economic picture unfolds as expected, there will be a meaningful period of uncertainty and anxiety. But, as a new equilibrium is found, the urgency for quality growth over efficiency will reemerge. Soon, some companies will find themselves in an excellent position to turn the coming flush-out of the pretenders into a unique buying opportunity. Why?

The surge in rates and input prices will profoundly impact weak companies and businesses, especially those overleveraged. Undifferentiated products and markets may also struggle to pass on the price and wage inflation emerging within their cost structures. Some businesses may lack the scale or profitability to reinvest in new capital, research, and technology as their margins compress — if those margins exist at all. Perhaps these companies always had management teams with a limited range. Perhaps all the above is true. Many businesses in those situations may have already reached an event horizon, and may not be able to escape their fate, however long it takes to unfold. But, in time, when the failing assets get cheap enough, distressed investors or activists will begin to circle.

It remains early in this cycle — early enough that strategic buyers will not necessarily have to compete with financial sponsors. Classic vulture investors are likely just emerging from hibernation and expect distressed situations may take another year to unfold. So there remains time for owners of businesses that cannot pivot to profit to either gracefully exit the stage, or at least triage to improve their overall portfolio's prospects. As reality sets in for companies that own an asset that cannot succeed within their organization, they will either let it deplete their reserves or sap their more viable business. Or they will accept the reality that the asset is unlikely to survive under their stewardship, if at all. Sometimes this might not occur until real financial distress is unavoidable.

Bargain Hunting

As these situations unfold, the opportunities will begin to emerge for strategic buyers — real corporations in competing or complementary positions that can extract more value from the underperforming assets. Certainly, some assets should not, and will not, be viable, and should be shuttered. Others, especially competitors' businesses, will present value at the right price, to the right buyer.

Financial sponsors specialize in identifying sound opportunities and monetizing them. They understand how to price effectively, isolate risk, drop in the right experts, dispose of the unusable parts, and ultimately earn a strong total return when the asset is transferred to a strategic buyer or the public markets. However, sponsors face their own challenges. First, they must wait until prices are depressed enough to extract the requisite return. Second, they are likely to divide the company to find multiple buyers. Finally, sponsors often lack an operational advantage in retaining the asset for an extended period. Herein lies the opportunity for strong strategic buyers with vision and a high sense of urgency to grow.

Even as recession fears mount, now is the time for strong players to begin positioning themselves to go bargain hunting. As the macroeconomic environment shifts, even those who might typically be averse to acquisitions should open their minds to available opportunities. Companies that are seeking growth, whether by adding complementary product lines, brands, geographic reach, or technologies, may find hidden gems in the portfolios of troubled competitors.

To be prepared to exploit the coming opportunity, internal management systems must be in top working condition. Specifically, the strategic resource allocation process must be robust. High-return businesses must continue to identify high-return opportunities, even if below the current level of profitability. Those businesses must crave profitable growth. Lower-return businesses must be realistic in assessing improvement prospects and delivering on them. This means having the right measurement and incentive systems in place to evaluate the overall value impact of potential acquisitions and to act quickly and decisively on that information.

If reinvestment has not been historically effective, the ability of divisions to execute on inorganic growth objectives must be questioned. If, however, acquisitions can allow either of these archetypes to take advantage of opportunities to integrate the underperforming assets of other companies to achieve scale or scope, then they are likely to be viable sources of growth.

While there is a lot of uncertainty, what we do know is that interest rates are on their way up. And if inflation continues its torrid path, it may continue to climb and remain elevated for some time. As growth companies see their valuations fall, this will be the time for disciplined management to shine, putting their dry powder to use.

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