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Trends in M&A: Target Types

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In 2005, 2007, 2009, 2011, and 2013 the American Bar Association (ABA) released its Private Target Mergers and Acquisitions Deal Points Studies (the ''ABA studies''). The ABA studies looked at the M&A agreements of publicly available transactions that occurred in the year prior to each study. In each year, the studies reviewed 128, 143, 106, 100 and 136 private company transactions, respectively. These transactions ranged in size from $17 million to $4.7 billion, across a broad range of industry sectors.

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The ABA studies are generally recognized by M&A lawyers and other professionals as the most reliable reflection of deal point ''market parameters'' and trends for U.S. private company M&A transactions.

While the ABA studies are most commonly used, and cited, for determining how specific deal points—for example, indemnity cap levels, specific reps and warranties, etc.—are addressed in M&A purchase agreements, the studies also provide information as to the ''types'' of targets[1] entering into M&A transactions.

This article looks at the mix of the three principal types of M&A targets identified by the past four ABA studies.[2]

Discussion and Trends

The ABA studies put M&A targets in three different categories, as follows:

[1] Note that within this article we use the term ''target'' to mean the target company which is being sold in an M&A transaction. In the context of a stock purchase transaction, the ''seller'' would be the selling shareholder(s), and the ''target'' would be the company being acquired. In an asset purchase transaction, the ''seller'' would be the target company itself. However, for consistency, we use the term ''target'' to cover both transaction types without distinction.

[2] The 2005 ABA study did not look at target types.

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(i) ‘‘Entrepreneurial’’ targets, defined as targets with founders who ‘‘appear to dominate management/ownership’’;

(ii) ‘‘Corporate’’ targets, comprised of targets with founders who ‘‘appear not to dominate management/ownership’’; and

(iii) ‘‘Financial’’ targets, i.e., those targets that are ‘‘backed by financial sponsors (including venture capitals) who appear to have significant influence/control.’’[3]

While the ABA studies do not provide any further criteria or information as to how a particular target is categorized, the terms used in the studies are likely reflective of similar terms used generally in the M&A industry. And while there of course are almost endless possible variations across the three categories, in everyday ‘‘M&A usage’’:

- ‘‘Entrepreneurial targets’’ would usually include privately held companies which are closely owned or otherwise without widespread or fragmented share ownership. There may be outside investment in the company (e.g., angel or early stage VC investment), but the founders typically would retain significant control over target operations and decisions. Classic tech and other ‘‘start-ups’’ would often fall into this category.

- ‘‘Corporate targets,’’ as that term is used by the ABA studies, likely would include what are often also referred to as ‘‘operating company’’ or ‘‘non-financial’’ targets. For example, this category would encompass larger, more mature targets where the ownership has become such that the original founders no longer exert significant control, either because of succession, growth, acquisition or dilution of equity ownership.

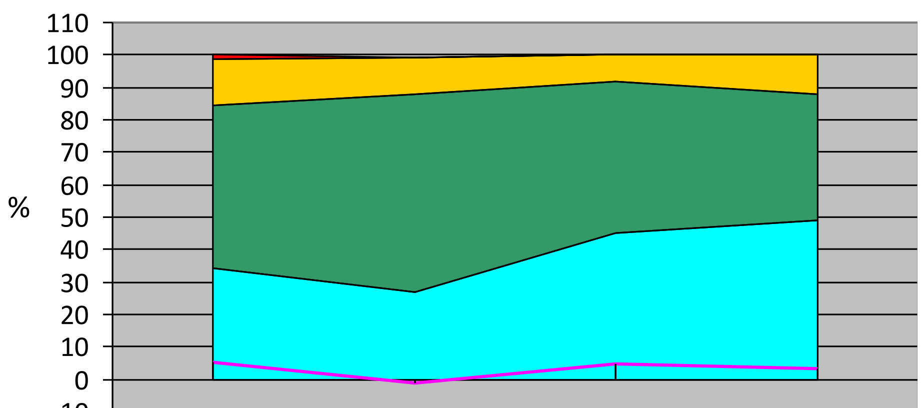
- ‘‘Financial targets’’ would include targets in which private equity, venture capital, or other financial or institutional investors or acquirers have a significant equity stake and control (as opposed to ‘‘operating company’’ investors or acquirers).

The following chart shows the percentages of ABA study reported transactions in which the respective three types of target sellers were present, along with the U.S. GDP growth change (by percentage) for each of the four years[4]:

[3] 2013 ABA study Slide 9.

[4] US GDP information is from US GPD Growth Rate Per Year, at http://www.multpl.com/us-gdp-growth-rate/table/by-year (on January 24, 2015).

ABA STUDY TYPES OF TARGET SELLERS



	2006	2008	2010	2012
Indeterminate	1.4	0	0	0
Corporate	14	11	8	12
Entrepreneur	50.3	61	47	39
Financial	34.3	27	45	49
GDP Growth	5.12	-0.92	4.56	3.47

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This chart reflects the following:[5]

- The relative representation of financial targets has roughly followed the U.S. GDP trends—when GDP growth rates were slower, financial targets represented a smaller portion of overall M&A targets;
- Conversely, the relative portion of entrepreneurial targets has tracked the inverse of the GDP trends—when GDP growth rates were slower, entrepreneurial targets represented a larger portion of overall M&A targets; and
- The proportion of corporate targets generally followed, but appeared to lag behind, GDP trends.

Of course, since the three categories of targets in the ABA studies are calculated as a percentage of the whole (i.e., the total of all three), the three points set forth above are related. For example, if the proportion of financial targets to the overall total ***increases***, it means that the proportion of entrepreneurial and/or corporate targets must ***decrease***. And since the proportion of corporate targets has been relatively low compared to entrepreneurial and financial targets, the inverse relationship between entrepreneurial and financial target presence is probably more directly linked.

Broader U.S. economic trends may also support the trends described above. From the end of 2008 to the end of 2012, the S&P 500 grew approximately 60%. Many companies saw values increase dramatically, a trend that has continued through today. Pitchbook noted in its 2H 2014 U.S. Private Equity Middle Market Report that valuations for middle-market companies have increased to 10.7x from 10.2x in 2013.[6] In addition, initial public offerings have become an increasingly available option for companies seeking an exit.

In spite of increased company valuations and the allure of IPOs, Pitchbook notes that the four quarters from Q3 2013 to Q2 2014 were four of the biggest six quarters for middle-market private equity transactions since the 2007 recession, by both deal count and capital invested.[7] Consistent with the ABA studies, financial targets saw a relatively larger increase in deal count than other target types, especially entrepreneurs. What this may suggest is either that (i) a relatively high number of entrepreneurs were seeking IPOs, (ii) a relatively high number of financial targets were seeking a private exit, or (iii) both.

Conclusion

Neither the relative mix of different types of targets over the past several years—a period including the recession of 2007 and its recovery—nor the relationship of that mix to changes in the U.S. economy, as reflected above, will come as a surprise to M&A and business development professionals. What remains to be seen is how long GDP growth will continue at current rates, how long access to capital will remain this cheap, and whether the public markets will continue to lure increasing numbers of targets away from the private exits.

[5] Note that the chart is not a perfect ''apples to apples'' comparison. The target types are calculated as of each of the last four ABA studies, which were published every other year. The GDP figures show annual growth by percentage as compared to the *prior* year.

[6] http://pitchbook.com/2H2014_U.S._PE_Middle_Market_Report.html. pp. 4, 6.

[7] *Id*. pp. 4, 12.