Merger & Acquisition Focus

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Ask the Advisor

Win-win

Keys to negotiating a successful M&A deal

Whether you're buying or selling a business, a few guidelines can help you negotiate a deal more effectively and improve your chances for an advantageous outcome. While you're probably already familiar with basic negotiation strategies — you likely use them on a daily basis while conducting business — most parties to an M&A transaction can use a refresher course when it comes to what may be the biggest deal of their lives.

Know yourself

Good negotiators start by knowing themselves. Before you enter into sale negotiations, take time to identify your goals and your tactics for achieving them. If you're buying, what's your "reservation price" — the most you're willing to pay? Would you be able to walk away from the deal if the seller refuses to budge on price?

If you're selling, similar questions apply: What's the lowest offer you'll accept? Are you in a hurry to sell? What conditions will you require as part of the sale? For example, the retention of certain employees may be a priority. Also be prepared to speak confidently about your business's strengths and address any perceived weaknesses. Since the buyer's negotiating leverage emphasizes your weaknesses, you need to be aware of them and ready to provide a solution that mitigates an adverse effect on the buyer's offering price.

There are plenty of opportunities for differences of opinion in any business transaction, and a business sale is no different.

Know the other party

Knowing the other side is as important as understanding your own priorities. This knowledge allows you to map out the negotiation ahead of time. As a buyer, you should have a thorough understanding of the business — gained through extensive due diligence.

If you're a seller, it's essential to know that your buyer can afford to purchase the business and, if the deal will be seller-financed, how well the company will be run while the note is being paid off. It's also helpful to learn if your buyer has looked at many other businesses. Buyers who know they have other options if your deal falls through will probably drive a harder bargain.

Gathering knowledge involves more than research; you also need to be a good listener. If you're talkative by nature, make an effort to speak less and listen more when meeting with the other party. The better you understand them, the greater chance you have of anticipating their moves and preparing counter offers.

Build a relationship

There are plenty of opportunities for differences of opinion in any business transaction, and a business sale is no different. Establishing a cordial relationship can go a long way toward reducing misunderstandings or unintended offenses. Social occasions such as dinner or a golf outing can break the ice. Expressing interest in the other party's opinion and a sense of humor also can help build a good working relationship.

Going back on your word, exaggerating points or misrepresenting facts in an attempt to strengthen your position, on the other hand, can damage goodwill. Finally, don't try to box the other party into an untenable position — it's a tactic that's likely to misfire.

Remain flexible

Selling a business is a complicated process, of which price is only one component. When entering the negotiation stage, keep in mind other items that are subject to bargaining:

- Down payment amount,
- Interest rate on a seller loan,
- Collateral,
- Seller warranties,
- Earnout provisions, and
- Noncompete agreements.

Also consider the structure of the deal — whether the company's stock is being acquired, or just its assets. In general, sellers prefer a stock sale and buyers prefer an asset transaction, which provides better cash flow after the deal.

Good negotiators take advantage of the multifaceted nature of the process by remaining flexible throughout. This may mean compromising on some elements to get the ones that are most important to you, such as those related to financing terms, the closing date, employee retention or seller warranties.

With so many moving parts to consider, flexibility can get you past obstacles. If you're hung up on a tough issue — say, the price of a particular asset — try putting it aside temporarily, moving to less controversial points such as the price of other assets, and then circling back later. If you're still stuck, offer to revisit points that have previously been agreed upon and reformulate them. Within limits, nothing is settled until the deal is officially closed.

Rely on intermediaries

The role of intermediaries in a negotiation goes well beyond their technical M&A skills. Experienced professionals can suggest deal alternatives buyers and sellers might not have considered. Intermediaries also lend a degree of detachment to the process that interested parties obviously lack.

You can make the best use of your intermediaries by treating them as trusted business partners, considering their counsel seriously and empowering them to make decisions for you where appropriate. In business negotiations, two heads can truly be better than one.

Putting it all together

Getting what you want in a business transaction takes hard work. But if you adopt a flexible attitude, keep an open mind and are willing to concede some points to gain others, you increase your chances of winning the pot — even when you don't have the strongest cards.

Attention business founders

If you've built your company from nothing into a flourishing enterprise, you've likely exerted a lot of passion in the process. When it comes time to sell, however, it's essential to cultivate dispassion.

You know more about your business than anyone, but your emotional ties to your company may lead you to be less flexible during the negotiation process and hold out for too high a price. The ability to look at your company objectively — as potential buyers do — is a competitive advantage when you're negotiating a deal.

If you find it particularly difficult to divorce your feelings during the negotiation process, enlist the assistance of your M&A advisors. They can be particularly useful in helping you establish priorities.

When the market is right

Understanding economic cycles can help you time a business sale

Linking the sale of your business to the right point in the business cycle can positively affect the number of prospective buyers you attract and your company's resulting sale. The stronger the economy, the better your chances for getting full market value.

Not all owners have the luxury of choosing when they sell. Some may be forced into it by factors out of their control — unexpected health problems, the loss of a key employee or pressure from a new competitor. Others, however, enjoy some flexibility when it comes to going on the market.

> ***Not surprisingly, the bottom of the economic cycle is usually the worst time to sell a business because fewer companies are able to afford acquisitions.***

That's why it's important to understand and track general trends in the economy and financial markets. Both affect the growth and profitability of your company as well as its value to prospective buyers when you decide to sell.

The business cycle

There are four key stages to a business cycle: recovery, peak, contraction and trough. The ideal time to sell a business is during a recovery or as close to the peak as possible.

How do you know when we're in the boom stage? One important sign is that asset values — the stock of publicly traded companies and prices for private firms — are high relative to past levels.

Common benchmarks for asset prices also rise during economic upturns. These include price-to-earnings ratios and price-to-EBITDA (earnings before interest, taxes, depreciation and amortization) ratios. When company profits and cash flows increase, stock prices tend to rise even faster.

In the recovery and peak stages of the economic cycle, asset values rise partly because of strong demand, which is boosted by a series of self-reinforcing trends. For example, increased employment helps raise personal income, leading to higher consumer spending. This in turn prompts greater business investment to meet consumer demand.

As personal and business spending stimulate each other, corporate profits and individual income rise. Some of the wealth created by growth is directed toward purchasing companies' stock — which boosts prices.

Role of government

To promote recovery during periods of economic contraction, the federal government takes steps, such as lowering the Federal Reserve's discount rate — the rate at which commercial banks may borrow from a Federal Reserve Bank — to stimulate demand. Other fiscal policy, such as higher government spending and tax cuts, can add to the positive effect of increased personal and business spending.

Bank regulators may promote economic recovery by allowing banks to lend on easier terms. This, when combined with lower interest rates, makes it easier and less costly for buyers to acquire companies.

All economic booms end eventually. When that happens, the government might tap the brakes, cutting off easy credit by raising the discount rate and tightening lending standards. Additionally, fiscal policy to lower government spending and increase taxes may be implemented to tighten the money supply and curtail inflation. The risk of these moves is that financial markets drop and the economy goes into a recession.

Not surprisingly, the bottom of the economic cycle is usually the worst time to sell a business because fewer companies are able to afford acquisitions. Owners forced to sell at this point will probably realize a lower price than they would in better economic circumstances.

Key indicators to watch

There are probably as many indicators to track economic and market cycles as there are economists, but several key indicators are of particular interest to business owners:

Gross domestic product (GDP). Measuring the sum of all goods and services produced over a period of time, the GDP is released every three months by the Commerce Department and readjusted as new data becomes available.

Inflation. The monthly Consumer Price Index and the Producer Price Index — both prepared by the Bureau of Labor Statistics — measure and report spending levels by consumers and producers, and are the most common inflationary measures.

Lending rates. The prime rate banks use for their most creditworthy customers and the Fed's discount rate measure the cost of borrowing and, by extension, the availability of funds.

Stock market. The S&P 500 Index is a useful proxy for the market value of a broad range of U.S. public companies. Price/earnings and price/book ratios for it and other indexes are widely available.

Other government data. Housing starts, the employment rate, the Consumer Confidence Index and the Composite Index of Leading Indicators are also useful for measuring the overall health of the economy.

Predicting the future

Of course, the availability of economic data is no guarantee you'll be able to predict the direction of the economy or your business's sale prospects. Sometimes a particular industry may flourish when the rest of the economy is flailing. And there are plenty of other factors — such as your desire to retire or the need to raise capital — that will influence the timing of your decision.

If you're hoping to time a sale, think twice about waiting for the very top of the economic cycle. It's often better to accept a good offer than hold out for a great one that may never materialize.

Is industry destiny when it comes to selling your company?

To paraphrase a popular song, every business is beautiful in its own way. It offers products or services and may own other valuable assets that differentiate it from its competitors, and it's run as uniquely as the people who manage and staff it. But every company is also classified as belonging to a larger industry, and its industry classification can dramatically affect how it's valued on the market.

Using financial ratios

While many of the same financial ratios used to value public companies by industry are also used for private companies, the price paid for companies in public transactions is typically a much higher multiple of earnings relative to prices for private transactions. Public companies' economies of scale and access to capital generally mean greater potential value.

The price paid for a public company target depends largely on the price-to-earnings ratio of the acquiring public company. Whether private or public, however, these "multiples" include ratios that express price as a function of EBITDA (earnings before interest, taxes, depreciation and amortization) and book value.

For private company transactions, when buyers compare industry segments, rather than use a single multiple, they often view a range, with a high and low valuation. For example, a company in a low-multiple industry might be worth three to six times its EBITDA, while one in a high-multiple industry is worth seven to 10 times its EBITDA. Ultimately, the multiple applied to earnings in private transactions will reflect the future earnings the buyer can expect to receive on the investment in a finite period of time — typically from three to seven years.

Why sector valuations differ

The average growth rate and profitability of an industry are the main reasons certain business sectors are considered more valuable than others. But other factors also contribute to any industry's market value, such as its average level of debt, capital intensity, barriers to entry, government regulation, international competition and vulnerability to economic downturns.

Multiples are popular because the industry data they're based on is readily available and they offer buyers and investors an easy way to compare companies.

Lower-multiple sectors tend to include highly regulated utilities and cyclical and commodity-based companies such as auto producers or paper manufacturers. Higher-multiple segments include such high-growth businesses as telecommunications equipment and biotechnology.

Making the case for categories

Business owners whose companies are classified in a lower-multiple sector may feel industry valuations are arbitrary and limiting. But keep in mind that your company's multiple is always quantified by future returns and the potential for growth and expansion. If your company is in a lower-multiple sector and produces earnings that can quantify higher-than-normal future returns, you have a better chance of securing a higher price.

Multiples are popular because the industry data they're based on is readily available and they offer buyers and investors an easy way to compare companies. In fact, a multiple is almost always supported through comparisons to transactions similar in size and industry.

They're also based on the valid assumption that a company's industry is likely to influence its financial results. For example, changes in bank regulations affect lending institutions and petroleum price hikes affect oil companies.

It's further important to note that, while industry multiples provide a useful starting point, serious buyers look carefully at companies on an individual level. To gather a more accurate picture of a company's worth, they're more likely to compare it to its peers than to companies operating in another industry.

Finally, industry multiples usually fail to express a company's value for strategic buyers hoping to achieve "synergies" through, for example, additional products or distribution channels. Such buyers typically are willing to pay more for a company than industry multiples would suggest.

Unique value

As a seller, it's useful to think of industry multiples as a framework, around which to build a marketing strategy. Because prospective buyers will likely begin their evaluation process with your sector multiples, you should know what they are. Then you can build a case for why your company deserves an above-industry valuation.

Q. Aside from my company's financial results, what do prospective buyers consider important?

A. Buyers look at a number of things beyond your balance sheet and income statements. Understanding what they are can help you make a stronger case for your company.

Smart buyers never take a seller's financial results at face value, but instead use the due diligence process to verify that the offered figures are indeed accurate. Financial records should be well organized, accessible, and adequately documented, and include at least five years of results.

"Normalized" financial records, calculated from a company's actual results to reflect what a new owner could expect to earn, are an effective way to show your company's highest value. You should, therefore, engage an experienced advisor to assist in normalizing your financials before presenting them to a potential buyer.

No matter how rosy a company's financials, buyers are likely to compare your results with those of your competitors. A superior company should command a superior price, but the amount of the premium will probably be constrained by industry multiples of comparable transactions. Therefore, be prepared to document why your company deserves a higher valuation relative to its industry peers.

Beyond the numbers, prospective owners will ask questions about your work force. For example:

- Will the most talented employees be willing to remain and will retention bonuses be needed to entice them?
- Will it be necessary — and difficult — to lay off underperforming or redundant employees?
- Will unions resist layoffs or company reorganizations?
- How is employee morale and, if low, will it be difficult to improve?

If you're selling only partial ownership of your business, buyers will want to know about the remaining shareholders. This is particularly true if a buyer is acquiring a minority stake that can be easily outvoted.

Your continuing relationship with the business may be an issue. For example, your buyer may wish you to enter into a consulting engagement to ensure the business's continuing success. Conversely, a seller may wish you to completely sever your ties with the business and ask you to sign a noncompete agreement that would prevent you from recruiting current employees and customers.

Customer loyalty is another aspect of your business that will concern prospective buyers. For example, they will want to know what customers are likely to do in the event of an economic downturn. The answer to this depends partly on the strength of your company's market. Is it growing? Are new competitors likely to enter? And if existing competitors cut their prices, how are customers likely to react?

Finally, the condition of your company's facilities and equipment will influence a buyer's decision. A business that has underinvested in new equipment or skimped on maintenance to bolster short-term profits will probably be penalized in the form of a lower offering price.

To be a successful seller, it's important to anticipate buyer questions and be prepared to provide satisfactory answers. If you can do that, chances are good you'll maximize your opportunity to get full market value for your business.