



The Business Value Manager

Advice for business owners, investors and service providers on how to build value and wealth through investment in closely-held companies.

Should Owners and Executives Directly Negotiate Transactions?

Business owners or executives occasionally must purchase, sell or otherwise combine a company or business segment. This edition of the Business Value Manager offers insight on issues that are addressed in the negotiations. It further explains the risks of direct owner or executive involvement in the process, and explains how a transaction advisor can provide critical assistance to help owners to achieve their goals.

RECOGNIZE THE DISTINCTION BETWEEN STRATEGIC DISCUSSIONS VERSUS NEGOTIATIONS

In the initial conversations, both sides talk about the various benefits that can be achieved if the companies were combined in some manner. In these *discussions*, both sides have a *common goal* as they look at the benefits the deal could create. If the parties are serious, the *discussions* eventually turn to *negotiations* where the sides clearly have *different goals*. Buyers want to pay the lowest possible price with the best terms, while sellers want the highest price with very different terms. While owners or executives must be involved in *discussions*, they can weaken their bargaining position when they *participate directly in negotiations*.

UNDERSTAND VALUE AND PRICE FOR THE COMPANY

In any combination, whether it is a merger, joint venture or outright sale/

purchase, you must clearly understand the value of what you are giving up or receiving. This includes a clear understanding of the company's *current fair market value* as a stand-alone business (what it is worth to the current owners) and the *strategic value* (what it could be worth in the new entity when the various synergistic benefits are considered). Strategic value clearly would be higher. The third number, which typically falls between the fair market value and the strategic value is the *price* that each of the parties is considering. Note that when a seller is entertaining offers from several potential buyers, the buyers cannot change the value of the company that the seller owns. They can merely change the price they are willing to pay to get it. This emphasizes the potential benefits to the seller of an auction process to drive up the price of a company. So all parties to a negotiation *should understand fair market value, strategic value and the price* (including terms) they consider to be acceptable.

UNDERSTAND MULTIPLES AND RECENT TRANSACTION PRICES FOR SIMILAR COMPANIES

Stock prices vary over time, as we see in the public stock markets. Buyers and sellers should clearly understand the *market multiples and prices for*

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companies in their industry that exist at the time of their transaction to make sure that the deal they agree to is appropriate for that time period and market conditions. They should recognize that some multiples are inappropriate and distort value. Understanding the market and pricing is particularly important to sellers if they are only talking to *one buyer* to ensure that buyer's offer is consistent with market prices.

IDENTIFY NECESSARY PRICE ADJUSTMENTS

Buyers or sellers can frequently leave significant value on the table without realizing it. For example, if owners agree to sell at a multiple of .75 times revenue or at 5 times EBITDA, they could be giving up significant value that is sitting on their balance sheet. The company should own a certain amount of assets to support the volume of its operations. Frequently, however, well capitalized companies have *excess assets or non-operating assets* on their balance sheet

QUARTERBACK VERSUS BLOCKER

In football parlance, the business owner or executive who possesses the authority to accept or reject a deal is comparable to the quarterback. He calls the plays and decides who gets the ball. The opponent tries to understand, anticipate and intimidate the quarterback to gain an advantage and win the game (the deal).

This football analogy extends to the transaction advisor who plays the role of a blocker. He cannot throw a pass—make a decision—and his job is to protect the quarterback. As a blocker, he negotiates directly by receiving questions, proposals or complaints, offers feedback and suggestions and identifies the other side's strategies, goals, strengths and weaknesses. In the process, he provides cover and time for his quarterback, who always remains in control, to make thoughtful, well informed responses to the issues being negotiated. Your quarterback should never be left unprotected, while your blocker is expendable. He is sometimes there to take a fall to keep his quarterback clean.

that are not measured in a valuation based on a multiple or on cash flow. When the balance sheet is considered, the purchase price often must be adjusted due to any *asset surplus or deficit*.

UNDERSTAND DEAL STRUCTURE AND DEAL TERM OPTIONS

Business combinations can be structured in many ways, including a merger, an asset sale, a stock sale, etc. The structure can have a huge affect on the *level of risk* buyers or sellers absorb in the deal, the *level of taxes* they must pay and their *return on investment*. Deal structure frequently includes non-compete agreements, employment contracts, consulting agreements, earnouts or other contingent forms of payments. Combinations can involve payments of cash at closing, transfer of stock, assumption of debt, contingent payments or deferred payments, each of which can have a *significant affect on risk, taxes, value and return on investment*. Negotiations on these issues *require careful analysis and consideration rather than an immediate response* to an offer made by the other side. The transaction advisor provides time for thoughtful negotiations and advice on how to best respond about structure and terms.

UNDERSTAND CONTROL ISSUES

The ability to control decision-making in the entity going forward can be critical to shareholders' risk, return on investment, value and overall liquidity. Joint ventures or mergers, for example, frequently create a 50/50 ownership structure, where neither side can make a decision without agreement of the other. *Any combination that could lead to loss of control requires very careful analysis and negotiation*.

PROTECT YOUR ABILITY TO CASH OUT

Private companies are notoriously difficult to sell and 50/50 interests or minority interests can be extremely illiquid. Critical in any negotiation are decisions about *stock transfer restrictions and the ability of owners to liquidate their interest should that be their choice*.

RETAIN QUALIFIED TRANSACTION COUNSEL

Very few attorneys have a practice that focuses on corporate law and mergers and acquisitions. The knowledge and skill that an experienced transaction attorney brings to a combination can be critical in helping investors to get the best risk/return agreement. These attorneys should be available to *counsel shareholders at the beginning of the negotiation on the strategy* to yield an ideal outcome.

CREATE AND MANAGE PRICE PRESSURE

Any time negotiations are with only one other party, negotiating ability, particularly for sellers, is weakened due to the lack of other alternatives. Whenever

NEGOTIATION ROLES BEST LEFT TO THE TRANSACTION ADVISOR

REJECTING AN OFFER

When the decision maker rejects an offer, the deal is usually dead— unless he counters the offer, which usually concedes ground on price or terms, and often creates a more contentious relationship.

An alternative to the decision maker's rejection is this type of response from the transaction advisor. "While we appreciate your offer, if my client asks me if he should accept it, I will have to recommend against acceptance for these reasons. (Provide details.) I can take this offer to my client, but I think he will expect you to at least consider these points." (Provide details.)

In essence, the offer has been tentatively, but not formally, rejected, but the business owner retains his bargaining position and the ball is passed back to the other side.

COACHING THE OTHER SIDE

Situation: The transaction advisor knows his client must deal with an expensive tax issue or he recognizes the purchase terms may be more attractive to his client if a portion of the proceeds go to one person in the form of a lucrative employment contract paid over time. The advisor can coach the other side on how to structure their offer to make it more attractive to his client without causing the other side to pay a higher price.

RESCUING A DEAL

Situation: Negotiations have been very detailed and difficult. An impasse seems likely and relations are strained.

When the transaction advisor and transaction legal counsel coordinate their efforts, the one who has pushed to this impasse can often be relieved by the other who reactivates the discussion, often with a second party on the other side. Advisors can fulfill this role because they are expendable and because they don't take the negotiations personally. Decision makers often get very emotional, which can kill the deal. They are usually better off letting others fight these battles for them, including restarting stalled talks.

STRATEGIC MISREPRESENTATION

Should you ever lie in negotiations? We advise against this and have seen lies do real harm.

On the other hand, there is a place in negotiations to raise doubts, suggest alternatives or take a preliminary position that may differ from your final one. For example, you might respond to an offer as follows: "We could never pay more than "X" for "Y" because we know we could buy "Z" for an even better price." This response describes neither your exact position nor your other options, but it conveys your potential to reject the offer that has been made. While this strategy can be effective, it is much more dangerous when done by the decision maker, who has the final say or approval, than when it is done by the transaction advisor, who lacks the authority to reject or accept the offer.

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possible, create a negotiating process where your side can continually remind the other that there are additional interested players in the market and alternatives to the transaction being considered. Naturally, you can overplay this hand, which requires careful balance for maximum, but tolerable, pressure on the other side.

CONCLUSION

Negotiations are by nature adversarial, as opposing sides strive to achieve their goal of the best possible deal. In most cases, participants must compromise to close the transaction, which can still result in a win for both sides. Wise owners and executives make use of advisors to provide advantages over their own direct involvement in the negotiations. They recognize that while the advisor is expendable, the decision maker is not.



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