Sell A Company - How Is The Selling Price Determined?

By Dave Kauppi

Article Word Count: 1100 [View Summary] Comments (0)

How much are you expecting when you sell your business? I always ask this question of our clients. The answers are as different as the businesses. "We need $5 million to give us the type of retirement we want. We have invested $2 million in the product. Our investors have put in $3 million so far. It should sell for $5 million. I heard that xyz Company got $30 million for their company." Well, my response to my clients doesn't necessarily endear me to them, but it is the truth. The market doesn't care. The market doesn't care how much it cost you to develop the product or how much your investors have in or how much you need to retire or how much you think it is worth.

The market looks at what the ROI is for its investment in a company. If you are fortunate enough to have a technology that can be leveraged, the market may look at the future returns of that technology in stronger hands.

For most businesses, there are benchmarks that are often used as a starting point. The most common in a merger and acquisition situation is an EBITDA multiple. That is the gold standard for privately held companies, similar to what a PE multiple is as a business valuation metric for publicly traded stocks. One of the measures that has come into vogue on Wall Street is a PEG multiple or Price Earnings Growth. It is essentially a way to attempt to quantify the difference in PE multiples between two firms in the same industry that have a much different future growth scenario.

Buyers of businesses that are privately held attempt to ignore this factor when making their purchase offers.

One small company was in an industry characterized by slow growth of about 4%, had commodity type products and consequently very thin gross margins, and had little pricing power. This company introduced a new product that was unique, had very healthy margins, retained some pricing power, and was experiencing 50% year over year growth.

The industry benchmark valuations were at 4.5 X EBITDA. The three largest players in the industry were all interested in the acquisition and each one put out an initial bid that was, surprise, about 4.5 X EBITDA. Another factor was that our client was in rapid growth mode so a good deal of their costs were front end loaded as they launched a few big box retailers during this period. The effect of this was to depress their EBITDA performance. This made these offers even more inadequate.

The result is that we have a classic valuation gap between business buyer and business seller. This is the biggest reason that many merger and acquisition transactions do not happen. The clients are terribly disappointed and suggest that these buyers "just don't get it." The buyers have experience in making several acquisitions in their space and have their business valuation metrics pretty much in stone and think our sellers are being unreasonable in their expectations. Game over, right?

Not so fast. One of the most important roles of a business broker, merger and acquisition advisor or investment banker is devise a transaction value and structure that works for both parties. We pointed out to the buyers that their traditional way of looking at these transactions is appropriate for their prior acquisitions with standard growth metrics, lack of pricing power, and commodity type products. We suggest to business sellers that as a small company with a few big box retailers comprising 80% of company sales with essentially one main product, that they have a great deal of small company risk. For example, if the retail buyer from xyz Big Box Retailer changes and is replaced by a buyer that has a consolidation of vendors bias, then they could lose 30% of their business with one decision. A bigger company, however, with 30 SKU's would be much harder to replace with a change in buyers.

We have established a platform with both buyer and seller to consider alternatives to their hard and fast valuation positions. Here is an example of a business sale transaction structure that could be a win for both buyer and seller:

1. $1,000,000 Cash at Close which is approximately a 4 X EBITDA multiple for the year 2007.

2. An Earn out (Additional Transaction Value) based on Seller Company's Sales Revenue beginning in year 1 and ending at the end of year 5. The earnout is at risk, but is set to net the shareholders a 6 X EBITDA multiple on 2008 projected sales (sales $6 million and EBITDA margin of 16.67% or EBITDA of $1,000,000).

This is the transaction structure we are recommending to balance a low EBITDA valuation on a company that will grow revenues by 50% next year. If they don't, then the earn out will be less. Most of the transaction value is in future performance based earn out. Our projection is that with Buyer Company cost efficiencies, Buyer Company can improve operating performance by an amount that covers the entire earn out amount and maintains or even improves Seller Company's historical margins.

Most business buyers that approach a company with an unsolicited interest in acquiring them are bottom feeders and will attempt to buy way below the market. They will attempt to draw out the process and pursue several acquisitions simultaneously hoping that one or two sellers just cave and sell out at a discount. They may start out at a decent valuation, but as they go through their due diligence process will find one issue after another that makes them reduce their offer. They often throw out the term "material adverse change" in an attempt to justify their value reducing behaviors. Some business development directors get judged or paid bonuses on how much below the original offer they can ultimately close the deal.

What is the way to combat this bad buyer behavior? The best way is to have options. Those options are multiple interested buyers. We feel very uncomfortable when we end up with only one buyer. We have taken them through the entire marketing phase and end up with only one legitimate interested buyer. You bet that buyer recognizes the issues and the likelihood of limited interest and will attempt all of the maneuvers to drive down the buying price and terms. Our negotiating position on behalf of our seller client is severely weakened and we struggle to preserve value in spite of doing this every day. Think about how effective you will be in this single buyer scenario. We tell our prospective clients that contact us after an unsolicited offer, "When it comes to business valuation, if you have only one buyer, he is right."