3.4

GETTING YOUR MONEY'S WORTH:
NEGOTIATING THE RIGHT PRICE

THIS CHAPTER WILL DISCUSS:

- How much is the potential acquisition worth to you?
- Common methods of valuing a business
- What can effect the price
- Risk analysis
- Structuring an acquisition

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Acquisitions are different from the normal routine of business and almost always involve the exciting prospect of an immediate and substantial improvement in your own business. Yet, precisely because they are outside the norm, and often a new experience for CEOs and their management teams, making an acquisition is fraught with a different type of business risk. Most experts identify over-paying as the biggest single cause of acquisition failure, as all too often buyers go into discussions and negotiations with a target without a detailed plan concerning valuation.

Determining how much to pay for a business you want to buy is a mixture of detailed business review and analysis, an assessment of your required rate of return, deal tactics and market awareness. So this is often a hugely involved process, even for a relatively small transaction, and usually very time-consuming. There is as much art as science involved.

How much is the potential acquisition worth to you?

Establishing how much the business is worth to you involves the calculation of how much more the combined business might be worth once you have achieved the benefits of the acquisition, compared with how much it's worth now. Although not all the difference might be attributable to the business you are buying, this will give you an absolute maximum figure that you might be willing to pay for the business you are considering buying.

Use a healthy dose of realism and even cynicism when making your assumptions

This calculation rather pre supposes that you know what your business is worth now and what it might look like after the proposed acquisition. For now, ignore what your business might be worth were you to sell it, and focus on its profits. So the next step is to work out how much more profit you might make after the acquisition. Of course, there might be non-financial reasons why the business is attractive to you, and you should consider those also, as a separate issue.

Calculating the synergistic benefits

Draw up a comprehensive list of all the effects of the deal, noting when the benefit might take effect and what it might cost, if anything, to achieve that benefit. Typical costs would be redundancy payments for any staff no longer needed, the cost to get out of any property or other arrangements which you would no longer need. Some cost savings might be almost immediate, whereas others might take years to come through. Once you have made this list, you should draw up a detailed analysis of how the combined business will look, highlighting the benefits from the acquisition. The easiest way to do this is on a simple spreadsheet (see example below), with your profit and loss information in one column, and the potential acquisition target in the next, and a sub-total column adding the two together, representing what would happen if you owned both businesses and ran them separately, precisely as they are today.

In the next column you can then start to make adjustments for synergies – whether increased revenue, reduced cost of goods, or reduced overhead costs. And the final column will then be the expected final result, showing what you expect the combined business to make in profit once the synergies have fed through. You should probably do this analysis for at least three years after the acquisition, allowing time for the synergies to come through.

Use a healthy dose of realism and even cynicism when making your assumptions. Merger and acquisition (M&A) history is littered

MISCELLANEOUS BUT IMPORTANT ITEMS

When reviewing your target's earnings, it's important to adjust for exceptional and non-recurring items – both positive and negative – as well as considering how sustainable they are. Perhaps the current owner takes a larger salary than the manager you will employ to run the acquired business after a deal (a positive adjustment) or perhaps the target has recently benefited from a one-off contract which temporarily inflated its profits (a negative one).

with projected cost savings that never materialised. And be aware of the risk of 'negative' synergies – for example, a customer of both your current business and your target might decide it still requires two different sources of supply after the deal is done, in which case your enlarged business may actually lose some turnover.

Other non-financial tangible/ intangible benefits

Next make a list of the potential non-profit benefits you think acquiring this business might yield. It may be that your target offers a threat from having launched a newly patented product that competes with your current business, or has just the right product to fill a gap in your product line, or even has a highly regarded production director who would be a perfect replacement for one of your key people who is about to retire. These attributes also have a value – admittedly more from a defensive perspective than in terms of growth – and need analysis in the same way as synergistic benefits.

Generating a positive perception in the marketplace through effecting an acquisition is another potential driver of value. 'It will be well received by our customers' or 'We'll go up to n^{th} in the league table' are both well-worn phrases, heard many times over the years. Inevitably, such thoughts are largely intangible in nature and, therefore, somewhat difficult to place a monetary value on. From a hard-nosed financial perspective, therefore, you should probably consider them as the 'icing on the cake', rather than the principal reason for pursuing a deal in the first place. Nevertheless, there are cases where these benefits have identifiable value – for example, the acquisition may allow you to be of a size to win a valued place on tender lists not currently available to you. Unless there are very clear tangible results expected from this, it's usually best not to place any monetary value on these benefits, but rather to bring them into your decision as to whether or not to proceed with the deal in due course.

Deciding your limits

You shouldn't pay as much as it will be worth to you, though, to allow room for something to go less well than you expect

By this stage you should have a clear sense of what the combined business looks like, and you can consider how much you would be willing to pay to move your current business from where it is now to where it could get to with this deal. As a principle, you should seek to pay a price that reflects only the stand-alone value of the business you want to buy. But sometimes people pay more than the estimated stand-alone value, and if your target is worth considerably more to you than its standalone value, you should consider paying more. You should try not to pay as much as it will be worth to you, though, to allow room for something to go less well than you expect.

The above analysis will give you what the absolute maximum that your business should pay for the business it might buy. That is not the same as what you should pay – it may very well be that you might pay considerably less than that, as we shall now see.

Common methods of valuing a business

The underlying value of any business is a multiple of the earnings it can sensibly expect to generate in future

There are several established ways to value a business: net asset value, discounted cashflow, multiple of turnover and multiple of profit.

Net asset value

The simplest valuation method is net asset value – what the value of the business's assets are after taking off all its liabilities. This makes sense in that the underlying net assets are at the core of what you are buying in financial terms. You need to make a qualitative assessment of the assets – audited accounts are supposed to value assets at the lower of cost and 'net realisable value' (NRV) but what does that mean:

WHEN TO CALCULATE THE NET ASSET VALUE

Net asset value will underpin any valuation – it's rare to pay less than the underlying value – and may well be a key driver to valuing an unprofitable acquisition target, but, if the deal concerns a profitable business, then other methods are usually more appropriate.

- What is the real value of fixed assets?
- Could you sell them for the balance sheet value?
- Will a bank lend against them at these figures?

In practice, it's not quite what you might hope – NRV purports to represent a 'going concern value', rather than a 'forced sale' value, with the consequence that fixed assets (other than freehold property) are usually stated at a higher value in the target's accounts than you could readily sell them for (or borrow to buy them).

Then there are the other assets to contend with – what is the age profile of debtors and will you really be able to collect them all? Are all stock items in the current catalogue and how long has the stuff been 'Available for sale'? A cautionary example of this is a £3m deal where it transpired that while the ongoing production was sold within about three months of manufacture there was an underlying £1.5m of stock that had hardly moved over the previous five to six years. Even so, the owner claimed it was 'still good and will sell eventually'. This was his honest opinion – but it won't surprise you that the acquirers took a rather more jaundiced view.

Discounted cashflow analysis

Theoretically the most accurate way to value any project, including acquisitions, is a discounted cashflow (DCF) analysis. A DCF analysis calculates the 'present value' of a series of future cashflows, with the present value (PV) being the maximum price an acquirer should

COVERING ALL BASES

It is best to do the DCF analysis twice, with and without the benefits of synergy, therefore establishing a range of values reflecting both the stand-alone value (i.e. excluding synergy) of the target and its value to you.

Table 3.4.1 provides an illustration, assuming the target business generates cash in Year 1 of £1m, increasing by 5% each year for the first 3 years and then remaining flat, with synergy benefits in Year 1 of £400,000. Discount rates of 15%–20% are considered appropriate.

Table 3.4.1 Example of a discounted cash flow

	Year 1	**Year 2**	**Year 3**	**Year 4+**	**Total**
	All values in £ × 1000				
No synergy					
Cashflow	1,000	1,050	1,103	1,103	
Discounted (15%)	870	794	725	7,350	9,738
Discounted (20%)	833	729	638	5,513	7,713
Synergy					
Cashflow	1,400	1,470	1,544	1,544	
Discounted (15%)	1,217	1,112	1,015	10,290	13,634
Discounted (20%)	1,167	1,021	893	7,718	10,798

What this table indicates is that a range of £9.7–£13.6m is appropriate to pay for this particular target using a discount rate of 15%, dropping to £7.7–£10.8m if the required rate of return increases to 20% – the significant variation confirms the sensitivity of the calculation to the chosen discount rate. The discounted Year 4 figures reflect the (stable) cashflows for Year 4 onwards into perpetuity. The ranges are quite broad given the importance to the overall cashflow of the projected synergies.

The above is a simplistic illustration but it shows that the DCF technique, although very powerful, can be extremely complex give the number of variables it incorporates. As such, it is most often used in sizeable transactions where large sums are involved and accuracy is required. It tends not to be used as often in smaller business deals, but its principles are well worth remembering.

be prepared to pay. The notion of present value revolves around the notion that for most people have that having £1 in your hands today is worth a little bit more than the promise of £1 in a year's time – the value of the promise being less due to inflation than the risk that something might happen to prevent you getting all the £1 in a year's time. DCF is a bit like applying an interest rate in reverse – taking it off money you expect to receive in the future, rather than adding it to money you put in a bank today.

When carrrying out a DCF, the 'interest rate' is called a discount rate (DR). This should reflect your cost of capital. There are plenty of books defining cost of capital, but in simple terms it needs to reflect what the money you use for the acquisition actually costs you (whether in loan interest or in dilution if you raise share capital to fund the deal) and the opportunity cost – what else you could do with that money. The rate should also take into account the risk of the business you want to buy – some businesses are riskier than others, and to take that into account the discount rate should be higher for such businesses.

To work out the present value of an acquisition you need to estimate how much money you expect the business will pay out in future. You should take into account not just profitability but also changes in the working capital needs, necessary capital expenditure, tax payments, loan repayments, etc.

Multiple of profits

Valuing companies based on a 'multiple of profits' is a quick and simple route to an approximation of DCF – profits are (sometimes) an approximation to cashflow and using a multiplier is an alternative to a complex calculation to derive a discount rate. Although it's more user-friendly, this method is not uncomplicated in itself and needs care in its application.

Probably the most recognisable multiple is the P/E (price/earnings) ratio, which appears daily in the media against the names of Stock Exchange listed companies. This figure is the result of dividing their

market capitalisation (a known figure for listed companies – their number of shares multiplied by the price per share) by their most recent post-tax profits. 'P/Es' are often quoted in negotiating meetings for private companies and they are a useful aide to valuation. Even so, they vary so much – according to the size and quality of the company concerned, its sector, whether it has recently reported results (so the market appreciation is up to date) and, of course, its prospects – so it also has to be 'handled with care'.

As an indicator, private company P/Es are often considered to be 25%–40% lower than their quoted peers – simply to reflect the lack of marketability of a private company's shares (rather than any qualitative aspects). Have a look at the *Financial Times* or use one of the online services and you will see the variety of P/Es for different sectors and company sizes.

EBITDA

Many people use slight variations when valuing private businesses, including multiples of 'sustainable' EBITDA (earnings before interest, tax, depreciation and amortisation), EBITA and EBT. As a general rule, EBITDA is favoured for three reasons:

- Excluding interest allows the financing structure of the target business to be addressed separately. So, the net cash or debt (excluding the normal working capital requirement) within the target is dealt with as a separate part of the valuation process. For example, assuming a multiple of 5, a target with EBITDA of £500,000 will be valued at £2.5m plus its net cash, so if it has £250,000 in cash its value would be £2.75m whereas if it has an overdraft of £300,000 it would only be worth £2.2m.
- Depreciation and amortisation are non-cash items that relate to past capital expenditure (Capex) and acquirers can easily adjust the valuation for any capital spending they plan in the future.
- There are a myriad of different tax rates, particularly across geographical jurisdictions, so excluding tax is deemed to remove potential anomalies.

Sustainable earnings

We have again mentioned the term 'sustainable' when referring to the target's earnings. This is crucial; the underlying value of any business is a multiple of the earnings it can sensibly expect to generate in future. Yet in any one year many one-off or unsustainable factors can affect earnings. For example, has a business had a particularly good or bad year? Is there something happening in the industry that will improve or hinder the company's prospects? What earnings can you realistically expect from the target in the future? In addition to gaining a good understanding of these issues, as well as recognising excessive reliance on particular customers or suppliers, a way of lessening the impact on valuation of recent figures is to use a weighted average of earnings over the past few years. An example is shown in Table 3.4.2.

Table 3.4.2 Example of weighted earnings multiple

	Earnings	Weight	Weighted
2007	500	3	1,500
2006	425	2	850
2005	400	1	400
		6	2,750
Weighted average earnings			458

What this table demonstrates is that the 'base' level of earnings for valuation purposes is reduced by nearly 9% (500 down to 458) when adjusting for the latest year having seen significant growth. It may be, of course, that this recent level is, in practice, sustainable – as the potential buyer you will need to make assumptions about this and many other factors, and these can have a significant effect on the price you are willing to pay.

The 'multiple'-choice question

Once you are comfortable that you have a good handle on your target's sustainable earnings, inevitably the $64,000 question is 'what multiple to use'? Perhaps equally inevitably, there is no simple answer. Multiples often reflect the size of the target (the bigger the

WHICH METHOD?

- A possible method of deciding on a multiple which offers a direct comparison to other yield-generating investments, say, share dividends or bank deposits, is to consider return on investment (ROI). A 5 times multiple, for example, implies the need for a 20% return (pre-tax).
- Computing the payback period of the acquisition is another way of looking at multiples. Before considering the effect of tax, a three-year payback period would require a 3 times multiple – tax will lengthen the period, of course. If you choose to focus on payback, do remember to consider the cashflow, and not just earnings, implications.
- One scenario where you might pay a higher multiple than usual is where there is a genuine 'strategic need' to acquire the target business. It may be that, for example, your target has technology that you need or perhaps there would be serious consequences to your business if another party acquired the target.

deal, the higher the multiple), expected growth prospects and quality of earnings (how risky or reliable they are). A business expected to shrink or not grow is worth less than one that is expected to grow fast, and the multiple should reflect that. And the riskier the business, the lower the multiple which is usually used.

The multiple you use should also take into account your own required rate of return taking into account the perceived risk. A pretty reliable rule of thumb is that private company multiples tend to be in the range 3–8. This is a pretty wide range, and working out where any one company belongs within the range depends on its sector and circumstances – which is why there are professional mergers and acquisition advisers to guide you through the maze!

Just remember, the higher the multiple, the lower the return and longer you have to wait for payback.

Goodwill

Two businesses with precisely the same earnings and risk profile but with different levels of net assets should, intuitively, justify different

valuations. The explanation is that one of them must have 'excess' assets (namely assets surplus to those required within the business) – perhaps fixed assets or stocks – and as a possible acquirer you need to evaluate what the difference is made up of and adjust the valuation accordingly. If it is simply retained earnings in the form of cash, then it's hard to argue against the vendor keeping that in addition to the underlying target valuation. The difference between the valuation you pay and the net assets you acquire is known as goodwill, which is particularly relevant to the purchase of a business, rather than a company's shares – see more on this below.

What can effect the price?

Competition

It is often said that there are three values for any business:

- What the Seller wants for it
- What the Buyer values it at
- What the Buyer has to pay for it.

Stay focused on what the business is worth to you – and if they can sell to someone for more than that, let it go

What the seller wants to get is generally irrelevant to potential buyers. You should be prepared to pay up to what the target is worth to you. Often, the asking price will be on the optimistic side. It's only on the rare occasion you might value the target at more than the vendor wants – perhaps due to the opportunity for synergy.

At the end of the day, all the technical valuation work in the world is irrelevant if someone else is prepared to offer a more attractive deal to the vendor than you. The underlying circumstances of the sale will potentially have a significant effect on the eventual deal and certainly have an impact on how much you should offer to pay. It's worthwhile considering what the circumstances might be.

- *'Auction' sale* – this is where a vendor conducts a structured process – usually involving professional advisers – to invite potential bidders to put forward offers based on a reasonably detailed

package of information. There may be several rounds of bidding and, usually after the first round, the opportunity to meet with the seller and management team, typically in the forum of them making a presentation and a subsequent question and answer session. This process is designed to force potential buyers to offer the highest possible price to stay in the process as they are unaware of who the competitors are and what other bids they may have made. The process is typically used for larger transactions – it is expensive – but, if you are involved in an auction, then be prepared to offer/pay at the upper end of your valuation.

- *Informal sale* – this is most common for private companies. Many of the stages and processes are similar to those in an auction, but the process is less rigid and there should be more opportunity for contact with the vendor. Information specific to each interested party (for computing synergies) should be made available and a sale will typically not be concluded without each interested party having a further opportunity to increase their bid. So you could take a more aggressive view on a lower offer, leaving something in reserve from your valuation.
- *Unsolicited approach to the business owner* or a vendor responding to an advertisement by you seeking acquisition opportunities, for example, are obvious ways in which you can narrow the field of competition and, therefore, enhance the opportunity to pay less for your target. If there is genuine interest in a sale, it is difficult for the vendor to put discussions with you 'on hold' while seeking to generate competitive interest, so these situations will tend to reduce how much you have to pay.
- *Forced sale* – it may be that the vendor has to sell, such as where the target business is having financial difficulties or even is already in administration. In such cases, *timing* often becomes an important factor and your ability to move quickly might offer a significant reduction in what you need to pay. For example, if a business is losing £10,000 a week, then an offer of, say, £5,000 below its (realisable) NAV would seem attractive if the deal can be completed in a week. Indeed, if no one else could complete a deal for, say, two

weeks, then £15,000 below NAV will still be attractive to the vendor. You need to be aware of any advantage you have in such situations – it can be extremely valuable.

- *Prices paid for comparative deals* – these are also relevant, though they don't affect how much the business will be intrinsically worth to you. There are several databases with details of lots of private company sales, and the terms of a transaction involving a similar business to your target will provide a good indicator of what you might have to pay. One problem is that these databases are expensive and usually available through a professional M&A adviser. Perhaps more importantly, deal terms are often not entirely clear and it can be difficult to find a precise match. Nevertheless, these types of data are valuable when considering who the potential competitive buyers are likely to be and what a 'market-tested' valuation of your target is likely to be in practice
- *Established sector-specific valuation metrics* – in several sectors, turnover-related multiples are used and these have tended to become the 'standard' valuation methodology, regardless of return- or asset-based techniques. A couple of examples are the manned guarding sector, where a typical valuation of goodwill was based on 40p–50p in the £ of contracted turnover and the photocopier sales and service marketplace, where typical valuations are based on one to two times contracted service revenue. They are both sectors where a buyer is expected to absorb the target business into its own and, therefore, reflect synergistic benefits. From your point of view, it's crucial to stay focused on what the business is worth to you – and if they can sell to someone for more than that, let it go. Don't be tempted into paying more!

The vendor's agenda

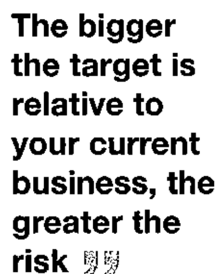
The vendor is the single most important party in (virtually) every sale process because, whether an individual or another company, it will make the key decision to accept a buyer's offer and complete

a transaction... or not. Any buyer who can develop an 'edge' over other would-be purchasers will have found another way of potentially reducing the need to pay the top price.

The headline price isn't always the determining factor in a vendor choosing whom to sell to. The key is to identify a vendor's true priorities and address them in your offer. Factors which often play a significant part in the decision include: whether or not the vendor wants an ongoing role; how key staff will be treated; and whether you represent 'a good home' for the business in the vendor's eyes.

What, if any, role does the vendor want in the business post-deal? If retirement is being contemplated, then there is less likely to be any 'personal' side to the decision but if, for example, an CEO is seeking to remain with the target in some capacity, then his or her assessment of, and empathy with, you will likely play a significant part in their decision. There have been plenty of deals where a vendor simply doesn't get on with a potential purchaser and, as a result, another bidder wins almost by default. In practice, this may lead to a vendor telling a buyer that he or she is 'preferred' and giving them the opportunity to match any higher offer which comes in.

The vendor's relationship with their employees and how they identify with the business are other factors to consider. The business may be family owned and long established and well regarded in its sector. Perhaps the team has been together for a long time. In such cases, it's possible that the vendor simply won't have any interest in a buyer who plans to shut down the business and change its name, absorb it into their own operations and make the long-standing workforce redundant. Indeed, this is probably one of the most common influences on whom a vendor selects to sell to.



The bigger the target is relative to your current business, the greater the risk

Risk analysis

Once you have done the number-crunching and are serious about putting in an offer to pursue a potentially life-changing acquisition, it's time to pause – what can go wrong and how might the risks be

mitigated? It's difficult to quantify the degree of risk in making an acquisition, but it's generally higher than buyers perceive. There are some obvious reasons for this:

- However many analyses of the target you have done, you won't know everything
- However nice the selling management team members have seemed, you can't know them properly until you have worked with them for a while
- However well you think you understand the marketplace, something may be around the corner you couldn't possibly have foreseen
- However dispassionately you feel you have analysed the business, what is the risk that you have missed something because of your desire for the deal?

Try to assess the principle areas of risk:

- Is the business dependent on a particular customer or supplier?
- People issues are often underrated – what is the dependence of the target on an individual, or more likely a small group?
- How will they feel about the deal and how will they want to behave afterwards, especially if they receive significant sums from the sale or are close to retirement?
- How significant is the deal to your current business? The bigger the target is relative to your current business, the greater the risk.

Structuring an acquisition

Having identified the risks involved, they must be factored into your valuation. One way of doing this is to increase the rate of return you require from the deal, which you can do by reducing the multiple of sales or profit that you offer; this can clearly have a material effect on the valuation. Otherwise you can *sensitise* the projected earnings – effectively assume that 'something goes wrong' – and see how it affects the valuation. The downside of these adjustments, of course, is that the vendor will be unimpressed with your negativity, you are

reducing the price you are prepared to pay and therefore reducing the likelihood of winning the deal, on the basis of 'what ifs' – when nothing has actually gone wrong.

Earn-out structuring

A recognised way of overcoming (at least some of) these risks is to make some proportion of the amount you pay dependent on future performance of the business. If the business does indeed do as well as the seller wants you to believe it will, then you can pay the higher sum; if it doesn't, then you pay less and the deal still makes sense. Examples range from the highly complex – such as a deal where the eventual consideration was linked to profits over the 10 years' post-completion with annual payments and various earnings thresholds – to a simple 'you'll receive an additional £x after 3 years if customer Y has continued to spend at least £250,000 a year with us in the meantime'.

The use of earn-out structures like this is a complex topic all on its own. The performance-related proportion of the overall consideration can be a highly emotive subject and you need to find a structure which provides 'reasonable' risk mitigation without making your offer totally unattractive to the vendor. It is much harder to achieve deals like this when you plan to absorb the target business into your own, and it is most appropriate when the seller is remaining in charge of the target business after the deal and/or is comfortable that you will not be able to (negatively) influence the performance benchmarks being met. Offering bank guarantees for any guaranteed element of future payments can make it much easier to persuade a seller to accept this sort of structure.

Offering shares/sharing equity

Offering shares in your current business as part of the payment for the acquisition, or leaving the vendor with a proportion of the equity in the target, are two other ways of reducing risk. These both reduce the cash you need to do the deal initially and certainly tests the seller's

belief in the post-deal environment, although it is less commonly used in the private company marketplace where CEOs are less keen to dilute their own equity position. This approach is also more limited in application when vendors are seeking an immediate exit, for example in a retirement situation.

Tax on acquisitions can be complex, and can affect sellers and buyers very differently. Tax advice is essential in any acquisition.

Clearly, accurately assessing the 'negotiating margin' is one of the key skills in trying to make a successful acquisition, and the next chapter looks at this point in more detail.

! TOP TIPS

- ! Conduct and document a detailed review of any business you are considering buying. Make sure you understand the drivers of its earnings, market position, customer/supplier/employee relationships and how it would fit with your operations. Consider the synergies which the acquisition might have for your business.
- ! Review the target's assets and liabilities, in order to determine what they're really worth – rather than simply accept balance sheet value.
- ! Consider negative synergies – contingent liabilities that might crop up when a deal is done or the acquired business is integrated.
- ! Decide what rate of return you're seeking from the deal and how you want to measure it. This must take into account the quality of target's earnings and the cost of capital.
- ! Adjust your valuation according to the nature of the sale process, the number and nature of competitive bidders and how strong your relationship is with the vendor.
- ! Adjust your valuation for risk – sensitise the projections or increase the required return and also consider the opportunity for using deferred consideration or a purchase of assets rather than shares.
- ! Take advice from professionals with experience of acquisitions of this size, and also, ideally, who understand the business sector. Financially, a lot can be riding on the outcome, so there should be significant value added from involving a specialist merger and acquisitions adviser in the valuation – and other – stages of the process.