

## Value, Price and Perspective

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*“If multiple buyers are not competing then the seller has little leverage in negotiating price and terms.”*

### What's the Difference?

#### Hedge Fund

A lightly regulated organization that uses aggressive strategies to invest primarily in public companies. They often use exotic derivatives (contracts), short selling and leverage (debt) guided by proprietary “financial engineering” models. Despite the word “hedge” they focus on maximizing return rather than minimizing risk.

#### Private Equity Group (PEG)

A lightly regulated entity that invests primarily in existing private companies. They tend to invest for the medium term to develop the businesses organically and via acquisitions before selling.

A business can be valued in many different ways but its price depends on the buyer's perspective. Here are some perspectives:

- **Transfer Value.** This is the value that the business has when an individual steps into the shoes of the owner of a standalone business. It's based on earnings that will support their lifestyle and service their debt. They're called a **lifestyle buyer**.
- **Decreased Value:** This is the value to the buyer if the business will soon require new investment to become viable. This is a **rescue or distress buyer**.
- **Added Value:** This is the value to a buyer who can immediately enjoy synergies, economies of scale and reduced

overheads. The business will be more profitable in the buyer's hands. This is a **strategic/synergistic buyer**.

Synergistic buyers *will* pay more but who are they?

**1. Peers and Competitors:** These buyers are in the same business sector and may compete directly, provide compatible products, operate in a different geography or focus on different verticals.

**2. Vertical Buyers:** These buyers are positioned above or below you in the vertical channel that you serve. They may or may not be your actual suppliers or customers.

**3. Horizontal Buyers:** These buyers serve the same customer type (maybe even the same customers) but with

different products.

**4. Strategic Financial Buyers:** These are typically PEGs that either have existing businesses (“platforms”) in one of the previous categories or wish to establish a platform in your business sector.

**5. Wild Cards:** These are opportunistic buyers that don't obviously fit into the categories above.

**Competition** also affects price. If multiple buyers are not competing then the seller has little leverage in negotiating price and terms.

**Conclusion:** (a) focus on synergistic buyers, (b) confidentially market to a wide population, and (c) have buyers compete in a professionally-managed process.

## Price is Not Everything

Buyers seeking “proprietary deal flow” like to present an investment banker's auction as being solely about price but price is seldom the deciding factor. (“Proprietary deal flow” means negotiating without competition which leaves the seller without market reference points.)

Multiple bidders with reasonable offers are in contention but that's just the beginning. The most compelling offer will be the one that takes account of factors beyond price. Here

are just a few examples:

- **The relationship** between the buyer and seller is important when they'll be working together after the deal closes. It may be for a short transition period or for a long earnout period.
- **Payment structure** is another factor. The price can be paid in cash or shares or via some more exotic method. The payment may be front-loaded or in installments. Interest could be LIBOR+2, Prime+1, etc.

• **Post-sale participation** by the seller (or a family member) may be important or the seller may simply want to exit as quickly as possible.

• **Tax structure** and timing may allow a lower price to produce a better net.

Comparing offers is never an apples-to-apples comparison but it's important to have bids to compare. You should also consider the expected Representations and Warranties (see page 4).

*“Every dollar you can legitimately add back to the EBITDA is multiplied in the price you receive.”*

## Cocktail Party Multiples

“*Sold Co.* got 8 times trailing EBITDA” is the kind of statement intended to impress but it’s not very meaningful. It’s a so-called “cocktail party multiple” and it seldom survives scrutiny.

EBITDA refers to **E**arnings **B**efore **I**nterest **T**axation **D**epreciation and **A**mortization. These ITDA costs are added back in determining operational profitability because they’re not related to operations and mask true profitability.

For most private businesses even this isn’t the true operational EBITDA. Other adjustments need to be made to see the real EBITDA of *Sold Co.*

**Lifestyle expenses** need to be added back and these can be fairly significant.

These are the usual perks of owning a business and can include the company paid airplane fraction, the spouse’s car, the “consulting fee” paid to a retired relative, the board meetings in Corsica, the Florida condo that’s the winter office, etc. Add all this back to earnings and the P/E multiple is now 7.

**Discretionary expenses** such as pre-payments, excess travel, generous director’s fees, over-sized officer salaries, memberships and any other expenses not essential to profitable operations during the relevant financial period are adjusted and we’re down to a 6.5 multiple.

**One time expenses**, including the Section 179 deduction (up to \$250k in

’08), bad debt, build-outs, etc. are added back to bring the multiple to 6.

**Real estate** held in the owner’s separate corporate entity and leased to *Sold Co.* (triple net) at above fair market must be adjusted. At a FM rent the multiple is now 5.5.

It’s common to operate a private business to support a lifestyle and minimize tax. However, when going to market you’ll most likely be paid a multiple of the EBITDA so every dollar you can legitimately add back to the EBITDA is multiplied in the price you receive.

By the way, *Sold Co.*’s quoted multiple was also based on achieving ambitious growth targets over a 2 year **earnout** period.



## Valuation Based on Assets and Discounted Cash Flow

The most common method for valuing a private business is using a multiple of the adjusted EBITDA (see above). That’s not the only method nor, in some circumstances, the best.

### Tangible Assets

Some businesses are asset intensive while producing a relatively modest EBITDA. The capital cost of these assets can be a strong barrier to entry for competitors. In such cases the value of the tangible assets (plant & equipment) may provide the most realistic starting point for a valuation.

This property is valued as part of a going concern, not at liquidation value. As it takes time to select, install

and integrate equipment, staff the facility and get it running the value is greater than the sum of the replacement values of the parts. This is the adjusted asset value.

### Intangible Assets

Many businesses have valuable intangible property. This is primarily intellectual property such as patents, trademarks, brands, trade secrets (including manufacturing processes, customer lists), in-process research, URLs and the like.

For businesses requiring few substantial physical assets (such as service or software companies) the intangibles may be their sole property of significant

value. The cost of developing the IP, the “first mover” advantage, etc. are part of this value.

Of course, companies with both classes of assets will add their adjusted values together to get the total going concern value.

### Discounted Cash Flow

Valuations that are primarily based on assets can be enhanced by looking at an estimate of future cash flows that the assets can generate using the “discounted cash flow” method. This method uses asset value, depreciation, cost of capital and estimated future income to calculate a company’s current value.

*“Valuations that are primarily based on assets can be enhanced by looking at an estimate of future cash flows that the assets can generate.”*

## Avoiding Deal Killers

Sometimes good private businesses don't get sold to the right buyer, or at all, for the wrong reasons. Here are some of the wrong reasons.

**Lack of Process.** The lack of a systematic sales process can allow things to fall apart very quickly. Events need to happen in the right order and at the right pace to be successful, just like courting that's intended to lead to marriage.

**Communication** is essential to a smooth process and is best managed by an experienced advisor. That may sound self-serving but many a deal has been saved by allowing the investment banker to defuse, translate and refocus the interactions and keep things on track.

**Price and Valuation.** This is a key point of contention. Sellers must have realistic expectations and the value must be well-argued to

buyers. Buyers will lowball but most offers have a lot of "moving parts" to be discussed and negotiated, even if ultimately rejected. (see also "Cocktail Party Multiples" on page 2)

**Hiding the Bad News.** The worst time for a buyer to discover the business's blemishes is during due diligence. This reduces prices and kills deals. A blemish acknowledged and explained up front seldom becomes a deal killer.

**Delay.** Even without any change in a business's financial condition delay is a problem. It creates the opportunity for remorse, distractions or simple deal fatigue. Stick with the process and its schedule. If the other party is delaying you need to discover why.

**Musical Chairs.** The buyer's, seller's and intermediary's lead people

need to be consistently involved to insure that the process and direction are consistent and that the deal stays on the right track.

**Too Many Preconditions.** A sale is a negotiation, not an ultimatum. Almost everything must be on the table at the start and be retained through skilled negotiation.

**Limiting Competition for the Business.** Sellers often think they know who the most likely buyer is but that "buyer" is seldom the acquirer. The widest audience of potential buyers must be reached, while keeping the seller's identity confidential.

**Inadequate Financial Data.** Inconsistent or incomplete historical financial data leads buyers to see increased risk. They'll either walk away or hedge that risk with a lower bid, extensive conditions or long earnout periods.

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## Sell Side Tax Implications\*

### Limit Tax on C Corp Sale

Owners of C corporations are taxed twice: at the corporate level before dividend distribution and then again on the dividend as ordinary income. If the business is sold this tax regime also applies amounting to 35% federal tax on the price as ordinary income plus more tax at the state level.

You can limit part of your gain to the lower Capital Gains rate (currently 15% - see next section) on a C Corp sale by contracting to take part of payment as Personal Goodwill. "Personal goodwill" is the

value of the personal good relationships that the owner has developed with customers, separate from the goodwill of the company. A \$1m payment classified in this way can result in federal tax savings of \$200k.

### Planning Cap Gains Tax

The current tax rate on long term capital gains (including from the sale of a privately-owned business) is 15%. That rate is scheduled to reset to 20% after 2010. The Democratic presidential candidate (currently leading in published polls) has affirmed that he will not

renew the tax roll-back and continues to state that he would raise the tax to 25%. The latter rate is an increase of \$100k in tax per \$1m in capital gain after 2010.

While tax is not the only consideration in the sale of a business it should be kept in mind. One hedging strategy is a partial sale before 2010 under the lower tax rate and then a complete exit after 2010 when the economy and the tax rate have rebounded.

\* This is for informational purposes only and must not be construed as tax advice. Always consult a professional tax advisor when considering the tax consequences of a business purchase or sale.

## Capital Sources

Per the January 2008 edition of *Dow Jones Private Equity Analyst* U.S. private equity groups (PEGs) raised \$302 billion in 2007. That's an 18% increase over 2006's \$255 billion despite the stagnating economy.

The PEGs are sitting on a lot of money and charging investors 2% for the privilege while earning them back little more than those fees in interest. They need to put this money to work where it will earn bigger longer term returns for investors. This has made PEGs more interested in the lower middle market (\$5-\$100m in sales). It's also made them more interested in being an alternative to bank debt by mixing debt with equity.

**Specializing in the Middle Market – Businesses with sales of \$5 – \$150 million.**

## Representations and Warranties

Whether a business is sold in an asset sale, a stock sale or a merger the Purchase and Sale Agreement (“P&S”) typically contains a number of seller’s Representations and Warranties (“Reps & Warranties”) that are essential to the agreement.

The buyer will have done their own due diligence investigation into the accounts, assets, liabilities, etc. of the target company but will nonetheless be relying heavily on information prepared by and access controlled by the seller. It’s possible that the buyer’s investigation failed to discover relevant risk factors either through their own haste or incompetence, or through the withholding or concealment of information by the seller. To hedge against this risk the buyer will require the seller to Rep & Warrant certain things. The buyer may also be required to make Reps and Warranties.

“Representations” are statements of fact that may be affirmative (that something exists) or negative (that something does not exist) that are expected to be relied on by others. “Warranties” are assertions or guarantees that the representations are true. For example, Rep and Warrant that:

*“Seller possess clear title to all the acquired assets free of any claims, encumbrances or liens of third parties other than those disclosed in writing to the Buyer prior to the execution of this Agreement.”*

The list of Reps and Warranties can be long and contentious and they’re **the major cause of post-closing litigation**. To protect their positions either party can buy Reps & Warranties insurance. The cost is about 2-5% of the coverage with deductibles of 1-3% of transaction value. All of the Reps & Warranties can be insured or you can select to insure only specific ones.

## How Accurate Must the Targets Representations and Warranties Be?

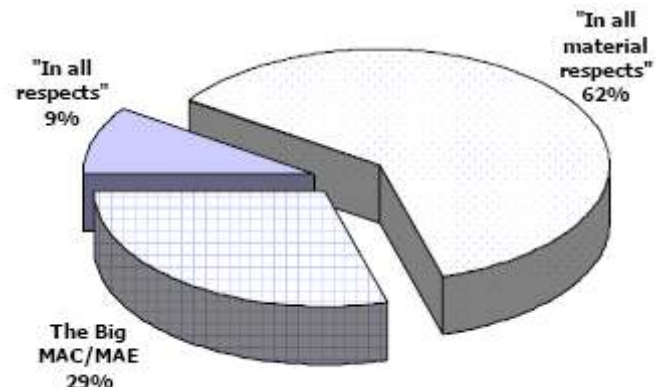
The graphs below are from the 2007 report of the American Bar Association’s Committee on Negotiated Acquisitions. It’s based on a sample of 143 negotiated acquisition agreements available in Livedgar.com. All targets were private and all acquirers were public. Transaction value ranged from \$25m to \$500m.

These three standards are compared in the graphs below as to the time at which the standard is applied. *“Reps and Warranties shall be accurate...*

1. *“...in all respects”*
2. *“...in all material respects”*
3. *“...in all respects... except [those] which individually or in the aggregate do not or could not reasonably be expected to have a Material Adverse Effect”*

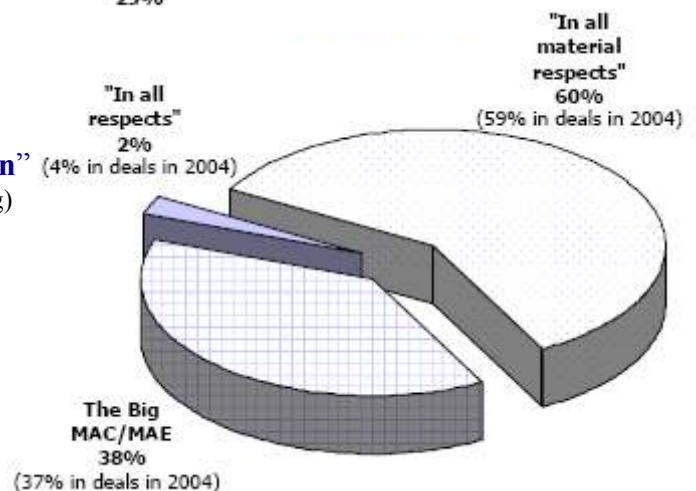
### “When made”

(i.e. at signing)



### “Bring Down”

(i.e. at closing)



**What is “Material”? How do you objectively measure an “Adverse Effect“?**