SELLING YOUR BUSINESS: SUCCESSFULLY NEGOTIATING PRICE

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The Most Difficult Issue In Negotiating The Purchase Or Sale Of A Business Is Negotiating Price

Generally speaking, if you reach an agreement on the sale price for a business you can reach an agreement on everything else. In my experience, less than 10% of deals involving owner-managed businesses fall apart after a deal is reached on price.

It is important to remember two things:

- *There is more to a good deal than price*.
- *The best deal for both parties generally means no one "wins" the price argument*.

A Common Goal and Common Understandings

Ultimately the Buyer and the Seller should have the same goal: *to make the best possible deal for both parties based upon a fair assessment of the business opportunity in question.*

Both the Seller and the Buyer must accept that the best deal for both parties rarely means either party gets their best deal on price.

In order to achieve this goal, it helps if of the following principles are accepted by both sides:

You do not buy or sell a business; you buy or sell a business opportunity. Only the past can be assessed with certainty. The future is always uncertain. However, the future is all the Seller has to sell and the Buyer has to buy. Therefore, each party must seek to understand and influence the other party's view of the business opportunity on the table. After all, a deal on price and structure will only occur if the parties develop at a mutually acceptable consensus on the future of the business. Each party should have independent, empirical information to support their assessment.

The Seller's reasons for selling and the Buyer's reasons for buying will probably have nothing to do with each other. In order to successfully negotiate a good deal, both sides need to honestly disclose why they to buy or sell. A lot of energy can be wasted if each side negotiates from their own needs and perceptions instead of from the other party's point of view. If you know why the other want wants what they want, you can work together quickly to find a common ground for doing a deal. The best deals are "win/win" deals. If you think you are in a "win/lose" negotiation, you should walk away.

Be prepared to relate your pricing positions to your reasons for buying and selling. In most negotiations, the other party is smart enough to know that giving you want you want is the best way of getting a deal done. They also know that this kind of thinking is more likely to get you focussed on you giving them what they want. However, some parties give one reason for buying or selling, but then tie their pricing negotiations into a rigid formula or something else unrelated to what they have told the other party they want out of the deal. For example, if you are selling your business because you believe the best years of the company are still ahead but a different kind of owner is needed to realize on that opportunity, it is inconsistent to insist on an all cash deal and refuse to consider arguments where an earnout of some kind could yield a higher price and give the business a better chance of succeeding. Another example is a Buyer who wants to buy a business for its people, production capacity and location, and does not list buying a profitability customer base among its priorities, yet only wants to talk about price based on recent profitability. If they are buying your business for its operational base, why is the price they are willing to pay you tied to what your recent profits have been versus what they it would cost them to build the same base from scratch and what it will do to their business to get your plant as a going concern? This kind of inconsistency can kill a price discussion before it even gets going.

Value and Price is not the same thing. At lot of energy can be wasted arguing "value" versus price. The Seller often wants to argue for "fair market value", while the Buyer wants to argue for price. This table will demonstrate the difference between value and price, using the standard definition of fair market value:

Fair Market Value	***Negotiated Purchase Price***
The highest price that could be obtained for the business in question ...	What Buyer wants to pay the highest price?
... in an open and unrestricted market ...	The market for private companies is usually narrow and restricted.
... between prudent parties with equal knowledge and negotiating strength dealing with each other at arm's length...	The Seller always has more knowledge of their own business, the parties rarely have equal negotiating abilities, and the parties are not always prudent or at arm's length.
... who are not compelled to act ...	The Buyer is often compelled to sell for some reason, and the Buyer can sometimes be compelled to buy.
... and where the purchase price is paid in cash on closing.	Businesses sometime sell on an all cash basis, but there are usually multi-faceted aspects to the consideration and payment structure, and most Buyers are not in a position to finance an all cash deal (especially at the Seller's asking price).

It does not matter how you get to the same price, as long as you get there. Lots of emotion can be introduced into a negotiation when each party tries to convince the other of the rightness and wrongness of their respective assessments, assumptions, formulas, calculations and price. This is a frequent deal-wrecker. While each side should be willing to disclose and justify all those things, it does not matter if you use the same formula or assess and weight the same variables the same way. What matters at the end of the day is that you justify your assessment on some rational basis linked to the wants of both parties, seek to understand the assessments and needs of the other party, and ultimately reach an agreement on price. Formulas and rationale can get you to a gap close enough to bridge, but rarely are enough to close the gap alone.

There is no "right price"; there is only a range of reasonable prices. A Buyer will probably try to reduce its risk and increase its returns by arguing for a low price. A Seller is most likely to try to improve its return by downplaying risk, up-selling the future, and arguing for a high price. What matters is that you agree on the range, and then see if you can find a price within that range which is mutually acceptable. Set a reasonable gap. Then, if it is worth the effort and you are not too far apart, try and bridge it.

Price is dependant on structure. Shares vs. assets, use of retiring allowances and consulting fees, Seller take-back financing and earnouts, non-competition covenants, and other structural issues can significantly affect each party's view of a reasonable price. In particular, the "price" can fluctuate significantly depending on how the "price" is allocated between taxable capital gains or taxable income (to the Seller), or depreciable assets or future operating expenses (to the Buyer), and whether the Seller holds any earnout risk or financing risk.

There is more to a deal than price. Finally, many factors other than price must be assessed in determining if a good deal has been reached. These include issues related to financing, tax planning, synergies and post-closing commitments. A Buyer should be willing to go higher on the price range for the right intangibles. A Seller should be willing to come down the price range for the same reasons.

A Note On Assets Versus Shares

The general rule is that the Seller prefers to sell shares for tax and liability reasons, and the Buyer prefers to buy assets also for tax and liability issues. But that is not always the case.

No two deals are the same. The issue of whether the deal involves the sale of assets or shares should be worked out with professional advisors. The issues are equally complex, and one way is not necessarily cheaper, simpler or easier to execute than the other.

However, here are some basic pros and cons of the choice between shares or assets in the sale of privately owned businesses:

Issue	***Buyer Generally Prefers An Asset Deal***	***Seller Generally Prefers A Share Deal***
Assets	More choice for the Buyer - Buyer can pick and choose which assets to buy, and avoid redundant or non-operating assets which it does not want to have to pay for or will have to figure out how to get rid of later,	The Seller is not left with assets to dispose of, which can be time-consuming, uncertain, a drain on resources, and a delay to retirement plans or moving on.
Liabilities	Less risk for the Buyer in an asset deal – Buyer assumes no liabilities or strictly specified liabilities, and	Seller not left with headaches of winding down the business and paying off the creditors – first use of cash from

Issue	*Buyer Generally Prefers An Asset Deal*	*Seller Generally Prefers A Share Deal*
	avoids risk of incorrectly quantified, hidden or contingent liabilities. Can also eliminate the need for lots of representations and warranties, some major due diligence issues, and holdbacks and similar risk management techniques.	the deal will be to pay third parties. However the Seller is less likely to get an all cash deal, and must provide representations and warranties and Buyer due diligence.
Taxes	The purchase price can be allocated to specified assets, some of which will be depreciable, essentially allowing Buyer to use some "after tax" money to pay for the purchase price. In a share deal, the Buyer uses 100% "after tax" money to pay the purchase price.	Seller will generally want to take advantage of the capital gains treatment arising from a sale of shares, which is more favourable under an arm's length share sale. A share sale also avoids tax issues related to the recapture of previously recorded depreciation on the assets being sold, which can be significant depending on the business in question.
Financing	It is often easier to finance specific assets through capital loans or lease-back arrangements than trying to raise a capital or operating loan or combination on an operating business.	Of little impact to the Seller one way or the other. However the Seller is less likely to be asked to provide post-closing financing to the Buyer in an asset deal than a share deal.
Purchase Price	Gross purchase price in a share deal is often lower than in an asset deal because of the differential tax treatment and the assumption of liabilities, with more opportunity to structure the deal with Seller provided financing.	Same comment – gross purchase price might be better in an asset deal, and more likely to be cash on closing, but after tax can be less than in a share deal.
Complexity	Asset dealers are simpler for Buyers because they do not have to consider due diligence on liabilities being assumed, or risk management on post-closing debts or obligations coming out of the closet.	Asset deals can be more complicated to Sellers, because they have to consider the funds they need to payoff all liabilities and obligations, which has to be planned for and managed on closing. A share sale is usually simpler from the Seller's perspective.

Issue	*Buyer Generally Prefers An Asset Deal*	*Seller Generally Prefers A Share Deal*
Cost	Share sales can be more expensive for the parties to put together because of the extra Buyer due diligence, increased importance of representations and warranties, and issues around Buyer risk management.	However, because an asset sale requires the Seller to deal with all creditors and arrange for them to be paid off and satisfied, the cost to the Seller can be more expensive in an asset deal than in a share deal in some cases.

In the end, there are pros and cons to both deal structures. The main things to remember are:

- No two deals are exactly the same.
- Price is dependant on structure.
- There is more to a good deal than price.

These three points are a great introduction to what this chapter is really about – getting the right price for your business.

Numbers, Numbers, Numbers - The Three Big Steps In Price Negotiation

There are many methods used in valuing businesses. Examples include:

- Multiples of sales.
- Multiples of earnings.
- Multiples of EBITDA (earnings before interest, taxes, deprecation and amortization).
- Discounted cash flows.
- Capitalization of discretionary cash flow.
- Shareholders' equity plus unrecorded goodwill.

You rarely gain anything in a price negotiation by arguing which methodology is most appropriate to the deal at hand.

The devil is often in the details. Avoid the details.

The big picture is that almost all methodologies require you to follow three big steps:

Adjust the company balance sheet to reflect the true value of the assets that must be purchased and the liabilities that must be assumed to have a going concern business, and identify and plan how to deal with redundant assets.

Adjust the company income statement to determine the prospective discretionary cash flow to the new owner based on historical performance and the opportunity at hand – usually EBITDA (earnings before interest, taxes, depreciation and amortization, adjusted for the true impact of arm's length management).

Apply a rate of return factor which takes into account the Buyer's risk in purchasing the business being sold – usually a multiple of EBITDA.

The first step sets the adjusted book value of the tangible operating assets and working capital of the business being purchased, and sets aside assets which the Seller might get to keep over and above the purchase price he or she will get from the Buyer.

The next two steps effectively value the goodwill and other intangible assets of the business being purchased.

The combined figures effectively represent the value of the business, and the basic starting point for each party in the purchase price negotiation.

However, as set out above, "value" and "price" is not the same thing.

Recasting The Company Balance Sheet – Adjusted Book Value And Redundant Assets

The first step in assessing the value of the business opportunity is to assess the company balance sheet. This frequently requires a recasting of the company balance sheet to reflect the fair value of the company's assets and liabilities, and to identify and exclude assets that are not a necessary part of the business operation (called redundant assets). The goals of this exercise are to agree on an Adjusted Book Value and identify the Redundant Assets and how they will be dealt with.

Adjusted Book Value = Total Adjusted Assets being purchased minus total Adjusted Liabilities.

Redundant Assets can either be purchased by the Buyer or assigned to the Seller to keep for his or her own account over and above the purchase price.

Examples of redundant assets include surplus cash or working capital, personal use motor vehicles, certain real estate assets, airplanes, excess machinery and excess inventory.

This analysis often results in adjustments to a company assets and liabilities for a number of issues, including:

- Discounting overdue or questionable receivables – note: can be assigned to the Seller to collect on his or her own.
- Discounting obsolete or questionable inventory – note: can be assigned to the Seller to dispose of on his or her own.
- Adjusting for over or under depreciation of capital assets, especially equipment.
- Adjusting real estate values to current values.
- Removing intercompany receivables or other assets that the Seller does not wish to sell or the Buyer does not wish to buy with the company.
- Removing or discounting other redundant assets or assets that are not important to company operations (e.g. owner's private airplane which is held as a business asset for tax purposes) – note: can be purchased by Buyer as part of deal or removed from the business for the Seller to deal with as he or she pleases.
- Removing goodwill figures, which will be negotiated separately (see below).
- Adjusting any liabilities that have been under- or over-stated.

- Adjusting for any surplus working capital – note: can be purchased by the Buyer as part of the deal or distributed to the Seller prior to closing as dividend, management fee, repayment of shareholder loans, etc.
- Adjusting for shareholder loans – note: can be purchased as part of the price in share sale, paid out using redundant cash, or dealt with as part of shareholders' equity in an asset deal.
- Adjusting for unusual items related to the Seller's tax planning.

These recast numbers are then used in negotiating price and assessing the business opportunity in a number of ways, including:

- Identifying the assets to be purchased and liabilities to be assumed.
- Identifying redundant assets that Seller might get to pocket over and above the purchase price, which will affect how the deal looks to the Seller (e.g. distributing surplus working capital via dividend pre-closing).
- Allocating risks between the Buyer and the Seller (e.g. risk of old or obsolete inventory).
- Identifying immediate capital requirements that the Buyer must be ready to provide post-closing.
- Setting a minimum purchase price for the business.
- Setting a base line in valuing company goodwill.
- Calculating revised corporate performance standards (e.g. profitability, liquidity and capitalization ratios).

While there are always some issues of controversy in recasting the balance sheet, they are not usually deal-breakers.

At the end of the process the assets and liabilities being taken on by the Buyer have been sorted out, and the left-over redundant assets or other asset opportunities for the Seller have been identified as well, opening the door to a useful discussion of the intangible value of the business – its goodwill. This is where deal-breakers tend to arise.

Recasting The Income Statement – The Goodwill Issue

Private companies do not normally carry a goodwill figure on their balance sheet. If they do, it is removed as part of calculating the Adjusted Book Value and identifying the Redundant Assets.

The most contentious part of any price negotiation is agreeing on a value for the company's goodwill. This issue is so contentious because it is dependant on highly subjective and intangible issues, including:

- Just how well the business has really performed in the past.
- Future general economic conditions.
- Future industry and market trends that will impact the company.
- The company's ability to react, survive or exploit both anticipated and unanticipated changes in market conditions.
- What rate of Buyer return on its investment fairly reflects the risk to the Buyer in the business opportunity?

- What rate of return the Buyer will actually get from the synergy with any existing Buyer business opportunities.
- Valuing the respective contributions by the Seller ("Heh, this opportunity only exists because I made it happen!") and the Buyer ("Heh, this opportunity will only get exploited because I make it happen!") to the opportunity.

At this stage, it is important to remember that the Seller will usually value his or her business higher than anyone else – after all no one understands the risks and opportunities of the business better than the Seller does. Techniques for bridging the differing perceptions between the Seller and the Buyer are discussed later in this article.

Negotiating Goodwill Value – Recast Earnings times Appropriate Multiple

There are a number of different formulas in use today in the purchase and sale of private businesses. Several are noted below:

Price = Adjusted Book Value (i.e. Adjusted Assets – Adjusted Liabilities) + Value of Goodwill (i.e. Normalized Sustainable Future Earnings X Multiple factor).

Price = Tangible Net Worth (i.e. Normalized Value of Tangible Assets - Liabilities Assumed) + Value of Goodwill (i.e. Normalized Sustainable Future Earnings X Multiple factor).

Price = (Normalized Sustainable Future Earnings X Multiple factor) – All Debt Assumed.

Price = (Normalized Sustainable Future Earnings X Multiple factor) + Surplus Working Capital - Long Term Debt Assumed.

Price = (Cash flow ÷ Rate of Return) + Redundant Assets being purchased – Interest bearing debt.

There are also many "rules of thumb" from industry to industry.

However, all these formulas and most rules of thumb are heavily weighted in favour of two important factors:

- *The company's normalized sustainable future earnings* (i.e. "recast earnings"), and
- *The Buyer's perception of risk as expressed by a multiple of normalized sustainable future earnings* (i.e. Buyer's required "return on investment").

The party most skillful at negotiating these two factors will ultimately be the most successful in negotiating all price related issues.

In assessing these factors, the party's perceptions of the nature and predictability of the business opportunity being sold will ultimately set the tone for the discussion. There will be a perception gap, and the deal will only happen if the perception gap is small enough to bridge.

Normalized Sustainable Future Earnings (aka EBITDA)

The baseline for any goodwill calculation is usually something called EBITDA: *Earnings Before Interest, Taxes, Depreciation and Amortization*.

I prefer Normalized Sustainable Future Earnings, because it focuses on the real issue: how well the company can be counted on to provide cash flow for its owners in the future.

Other professionals and other techniques have different names for essentially the same calculation.

This calculation illustrates how much pre-tax, pre-financing cost cash flow has been generated by the business, and effectively maximizes the statement of company profits.

There are several reasons why this calculation is used in the purchase and sale of private businesses:

- Most private companies have organized their financial statements to minimize taxes. Reversing tax planning for negotiation purposes allows a better understanding of how the company has really performed.
- Each business owner has their own needs and capabilities when it comes to financing, tax planning and lifestyle requirements. The revised calculation takes these personal issues off the table.
- The revised calculation is useful in financing the deal, as it indicates how much cash flow the Buyer will have to fund its financing requirements and tax liabilities.
- Pre-tax earnings are a common denominator for comparisons of companies within an industry, comparisons of companies across industries, comparisons of private companies with public companies, and comparisons of various types of investment.

With the other party's assessment of recast earning and purchase price in hand, each party can calculate and argue for the return on investment that is reasonable in the circumstances.

How to Calculate Normalized Sustainable Earnings (aka EBITDA)

The calculation starts with recasting historical financial information over a logical period of time, usually anywhere from the previous one to five years, as follows:

- After tax profits from financial statements
- *plus* taxes, interest expense, depreciation and amortization, all owner compensation (salaries, bonuses, cars, spouses, management fees, etc.), all owner perks (club memberships, toys), charitable donations, and non-recurring or unusual one-time expenses
- *less* the cost of hiring independent management to perform the owner's functions in the business
- and *other adjustments as required* (e.g. to normalize rents or other costs related to common ownership real estate or other assets) (could be plus or minus).

Different parties take different approaches to adjusting for capital expenditures. Since depreciation and amortization have been adjusted (the non-cash impact of capital expenditures), as well as interest expense (the cost of borrowing funds to finance capital expenditures) then some other method for setting aside cash flow to maintain the capital assets of the business must be used. Adjusting for actual, projected capital expenditures is quite common.

Issues With Recasting Historical Numbers

As can be expected, many of the components in assessing normalized sustainable future earnings are subjective and can be hotly debated, including:

- What constitutes a normalized cost of management?

- Which expenses are unusual or one-time expenses, and how they are treated or amortized?
- What revenues are really non-recurring, and whether they will be replaced.
- What capital expenditures are required to maintain normal earnings?
- What historical period should be used for historical analysis, and if and how those results should be weighted.

Issues with Predicting the Future of Normalized Sustainable Earnings

After the historical data is agreed upon and trended, projections into the future for some logical time frame (often one to five years) are prepared on the same "normalized" basis. Each party's perception of the future of the company (i.e. assessment of the "business opportunity") is critical at this stage.

Many quantitative and qualitative factors arise in this discussion. Key issues include:

- The size of the market for the company's products and services.
- Key market trends.
- Positioning of the company in terms of exploiting market opportunities.
- The extent to which the Buyer needs to bring money or management into the company to position the company for a strong future.
- The company's reputation and customer loyalty.
- The quality and loyalty of the company's employees and suppliers.
- The company's quality and competitiveness.
- Location and other barriers to entry.
- Money the Seller needs to invest to maximize the business opportunity.

Empirical, objective assessments of all of these issues are critically important in these discussions, if they are available. The party with the most convincing information will have the best chance of influencing the outcome of this debate.

However, as with all other parts of the goodwill calculation, there is no question that any assessment at this stage can be no better than an honest, educated opinion. The thing to keep in mind is that this is really a risk-assessment issue. The more risk the Buyer perceives, the less the Buyer will want to pay for the business. The less risk the Buyer perceives, the more the Buyer will be willing to pay for the business.

Weighting The Numbers

In both the historical and projected numbers, it is not unusual for one party to request that certain years be more heavily weighted than other years for averaging purposes. The Seller wants to minimize the weight given to poor performing years. The Buyer wants to minimize the weight given to high performing years. Understanding the factors that impacted on financial performance in past years or will impact the financial performance of future years and being able to present this understanding in a persuasive manner is the key to making impact in this discussion.

Again, this is a highly subjective assessment, and one that the Buyer and Seller can expect to disagree on.

The Most You Can Do Is Agree On A Range

Keeping in mind the simple truths that from the beginning of this chapter, it is important to remember that it doesn't matter how you agree on a price as long as you got there.

The key words to keep in mind are "normalized" and "sustainable" earnings.

The Seller should be prepared to argue for an assessment of normalized sustainable future earnings in the high end of the range.

The Buyer should be prepared to argue for an assessment in the lower end of the range.

Each party should be prepared to justify their assessment of the relevant factors, but no one should expect to "win" the argument.

Ultimately the Seller and the Buyer should agree on the range of normalized sustainable future earnings. Then the debate can move on to the next and equally contentious issue – applying a Buyer's rate of return to the range of earnings agreed upon.

Assessing The Buyer's Risk: Multiples And Capitalization Rates

The next important discussion after the assessment of Normalized Sustainable Earnings is the return on investment each party thinks is appropriate for the particular Buyer and business opportunity. This discussion is based on "capitalization rates" and "multiples".

Both parties must remember that capitalization rates and multiple factors are risk management tools. They implement the principle that higher risk investments deserve a higher rate of return.

To understand the interaction of capitalization rates and multiples, consider the following:

Multiple = 100% divided by the Capitalization Rate

E.g. 100% ÷ 25% return on investment = 4 times multiple.

Capitalization Rate = 1 divided by the Multiple times 100

e.g. 1 ÷ 4 times multiple X 100 = 25% return on investment

This has a huge impact on price. For a company with $500,000.00 in normalized sustainable earnings, each "multiple" is worth $500,000.00 to the Seller. The difference between a three times multiple (33.3% return on investment) and four times multiple (25% return on investment) is the difference between a $1,500,000.00 selling price and a $2,000,000.00 selling price.

It all comes down to this:

The higher the perceived risk: the higher the capitalization rate and the lower the multiple.

The lower the perceived risk: the lower the capitalization rate and the higher the multiple.

This is illustrated in the following table:

Capitalization Rate	Multiple	Years to recover initial investment

Capitalization Rate	Multiple	Years to recover initial investment
100%	1 times Normalized Sustainable Earnings	1 year
80%	1.25 times Normalized Sustainable Earnings	1.25 years
50%	2 times Normalized Sustainable Earnings	2 years
25%	4 times Normalized Sustainable Earnings	4 years
20%	5 times Normalized Sustainable Earnings	5 years

Basically speaking, the higher the perceived risk, the lower the multiple the Buyer will want to use and the lower the purchase price. The reverse is true as well.

To appreciate the impact on price, remember that most formulas, rules of thumb or other assessments of the value of a business are heavily weighted in favour of the following:

Price is directly proportionate to: Normalized Sustainable Future Earnings X Multiple Factor.

Factors Which Affect Multiples And Capitalization Rates

Matters for discussion when arguing the appropriate multiples to use include:

- The multiples used in comparable transactions, if the research is available.
- Investment returns available from other contemporary opportunities, including mortgage rates, income-generating real estate and stock and equity markets. If good returns are currently available from lower-risk investments, than the Buyer will argue for a lower multiple for a higher risk investment.
- The degree of certainty and reliability in the parties' expectations of normalized sustainable future earnings. The more reliable the income stream, the higher the multiple that can be justified. The opposite is also true.

Other factors that affect the multiple include:

Lower Price **Higher Risk - Lower Multiple - Higher Capitalization Rate/Lower Price**	**Higher Price** **Lower Risk - Higher Multiple - Lower Capitalization Rate**
New business or short time frame upon which to base normalized sustainable future earnings	Established business and reliable, historical basis for normalized sustainable future earnings
Weak balance sheet	Healthy balance sheet
Questionable growth trend	Good growth trend
Weak position in weak industry	Strong position in strong industry
Few barriers to entry for competition	Significant barriers to entry for competition
Company competes heavily on price, or provides commodity product or service	Company sales not price dependant
Customer loyalty, sales, company management strongly tied to personal goodwill of departing owner	Company performance not tied to personal goodwill of departing owner
Share purchase	Asset purchase
Deal structure discourages healthy future depreciation and amortization opportunity to shelter cash flow	Deal structure favours healthy future depreciation and amortization opportunity to shelter cash flow
No Seller take-back financing	Seller take-back financing with good terms
Purchase price not tied to post-closing performance, no "earn-out"	Purchase price tied to post-closing performance, and Seller sharing in post-closing risks
Seller providing excellent management but not staying on	Seller providing excellent management and staying on for extended period of time
Lack of proprietary assets or sustainable competitive advantage	Lots of valuable intellectual property and sustainable competitive advantage
Business poorly managed or poorly positioned, Buyer providing the "sustainability"	Well managed and well positioned business, Seller providing "sustainability"

Lower Price **Higher Risk - Lower Multiple - Higher Capitalization Rate/Lower Price**	**Higher Price** **Lower Risk - Higher Multiple - Lower Capitalization Rate**
Significant personal goodwill with Seller; risk of loss of key customers, suppliers and employees	Minimal personal goodwill with Seller; lots of corporate goodwill with customers, suppliers and employees
Minimal synergy for Buyer	Lots of synergy with Buyer's other enterprises
Negative trends in margins	Good margin trends
Questionable or negative trends re: key suppliers or raw materials	Strong bargaining position on supply side, including favourable contracts for future supply
Questionable or volatile labour trends in near future, including increasing costs, labour strife, shortage of supply, lack of predictability, layoffs required	Solid trends in reasonably priced labour
Significant currency risks	Minimal currency risks
Buyer inexperienced in the industry	Buyer well-established in and familiar with the industry
Economy or industry in or headed into a downturn	Economy or industry coming out of downturn, or appears to be on track for strong future
Poor or uncertain prospects or contracts for future sales	Good prospects or contracts in place for future sales
Buyer does not "need" to do a deal	Buyer "needs" to do a deal
Seller "needs" to do a deal	Seller does not "need" to do a deal
Buyer not afraid of competitor making the acquisition	Buyer wants to eliminate or acquire a competitor, or to deny a competitor the opportunity to acquire the business
Tax situation favours Seller at Buyer's expense (e.g. none of purchase price allocated to post-closing management fees or depreciable assets)	Tax situation favours Buyer at Seller's expense (e.g. lots of purchase price allocated to management fees or other taxable income to Seller)

Lower Price **Higher Risk - Lower Multiple - Higher Capitalization Rate/Lower Price**	**Higher Price** **Lower Risk - Higher Multiple - Lower Capitalization Rate**
Acquisition or business hard to finance at low rates	Good opportunity for Buyer to finance business or acquisition at very competitive rates
Assets over valued on balance sheet	Assets undervalued on balance sheet
No opportunity for post-closing break-up of business assets	Good opportunity for post-closing break-up value
Significant capital investment required in near future	No significant capital investment needed in near future
Buyer accepted normalized sustainable earnings at the high end of the range	Seller accepted normalized sustainable earnings at the low end of the range

The best that can be hoped for is for each side to make a compelling case and to agree on a range of reasonable multiples that, combined with their range of normalized sustainable future earnings, result in an agreed range of values for the business.

And again, the party with the best empirical, independent support for their position will be in the best position to influence this discussion.

What Multiple Will Apply To Your Business?

What multiple or rate of return can you expect to apply to your business? There are some basic rules of thumb in private company valuations, especially when it comes to valuing private company goodwill:

- Goodwill rarely exceeds 5 times normalized earnings, which equals a 20% return on investment. After all, why would a Seller accept a 10 times multiple (10% return on investment) when buying a small private company when he or she can get a 10% return pre-tax when investing in large public companies?
- The more goodwill is dependent on the owner-manager, the lower the multiple. Businesses with very high personal goodwill are often valued as low as _ to 2 times normalized earnings.

A Note On Recasting Company Performance Ratios

During the course of negotiations the Buyer will often be completing their analysis of the company's profitability, liquidity and capitalization ratios. Since many of those ratios involve both balance sheet and income statement items, the calculations used for Adjusted Book Value and Normalized Sustainable Earnings will also come into play.

Key ratios include:

Annual Break Even = Fixed Expenses ÷ (Gross Profit ÷ Net Sales)

Annual Break Even in Months = Fixed Expenses ÷ (Gross Profit ÷ Net Sales) ÷ Net Sales X 12

Working Capital = Current Assets – Current Liabilities

Working Capital Ratio = Current Assets ÷ Current Liabilities

Age of Inventory = Closing Inventory ÷ (Cost of Goods Sold ÷ Number of Months)

Age of Accounts Receivable = Accounts Receivable ÷ (Net Sales ÷ Number of Months)

Age of Accounts Payable = Accounts Payable ÷ (Credit Based Purchases ÷ Number of Months)

Debt to Equity Ratio = Total Debt ÷ Total Equity

Interest Coverage = (Pre-Tax Profits + Interest Expense) ÷ Interest Expense

Return on Assets = Pre-Tax Profits ÷ Operating Assets

Return on Shareholders' Equity = Pre-Tax Profits ÷ (Adjusted Book Value + Shareholders' Loans).

A Note On Comparables

It is usually very difficult to obtain reliable information on other sales of private companies. However, details about acquisitions within an industry or acquisitions by public companies are often available to the parties. While no two deals are the same, reviewing and discussing comparable deals within the past few years can sometimes be helpful in narrowing the price gap and determining if one party's assessment of risk value is closer to the market. You try to find favourable comparisons to support your value and price assessment.

Even though EBITDA multiples might not be easy to find, you can often find gross sale multiples from the information issued by public companies when they acquire private companies. Public companies can afford to pay more for private companies than other private company Buyers, because of the financing options available and because of the exaggerated impact of profits on the share value of public companies. For example, a public company with shares trading at 15 times earnings gets a disproportionate impact on its share value when it buys a private company for a price that works out to 7 times earnings. But this can still help establish value at the upper end of the range.

Bridging The Gap

At this stage in your negotiation, the parties have either gone their separate ways or have identified some key hurdles which they need to get over if they are going to bridge the gap in the price and value assessments.

As mentioned before, at the end of the day it does not matter how you get to the same price as long as you get there.

Some common bridging techniques are set out below.

Bridging The Gap By Sharing The Risk: Price Adjustment Formulas

Depending on the deal structure and pricing philosophy, price adjustment formulas can be a way of bridging the gap between Buyer and Seller. For example:

If the parties disagree on the collectible of accounts receivable, a post-closing adjustment to price can be agreed upon based on a predetermined formula.

The same approach can be taken with questionable inventory...

... or questionable client or supplier relationships...

... or the price of key raw materials or labour.

Price adjustment formulas are usually supported by a price deferral mechanism, including:

- A portion of the purchase price is escrowed until the formula works through, or
- The Seller takes back a promissory note and other security (aka VTB – Vendor Take Back – Financing), or
- The Seller retains non-voting equity shares with a specific redemption formula.

In some scenarios, the adjusted asset can still be turned over to the Seller to try to obtain some financial benefit (e.g. inventory unsold after twelve months or receivables uncollected after six months come off the purchase price but are turned over to the Seller to salvage what they can).

It really comes down to risk management. If the parties cannot agree on the company's future or the Buyer's risks in certain key measurable areas, the Seller can share the risk by agreeing to reduce the purchase price if the Seller's assessment does not come true. This can also be reversed on the Buyer, by increasing the purchase price if the Seller's more optimistic viewpoint proves correct.

Bridging The Gap By Sharing The Risk: Earnouts

The same technique can be applied by structuring an "earnout", where the purchase price is adjusted after closing depending on well the company performs during the first few months or years following closing. A whole chapter in this book is devoted to structuring earnout transactions. For the purpose of this chapter, it is worth noting that earnouts can bridge the gap. However, the Buyer should offer a chance for the Seller to make more than he or she would make from a non-earnout deal. After all, in most earnouts, the Seller will no longer control the business after closing and therefore will have part of the purchase price dependent on how the Buyer runs the business. This is an increased risk to the Seller that justifies an opportunity to make more money.

Bridging The Gap By Sharing The Risk: Seller Financing (aka VTBs)

Another technique for bridging the gap is the use of Seller provided financing (aka VTB – vendor take-back financing). The Buyer may not be able to finance the price gap without the Seller's help. If the Seller believes in his or her assessment, providing the financing to cover that gap is not unreasonable. Again, this issue is dealt with in more detail in another chapter. And again, if the Seller is willing to provide financing, then the Buyer might be asked to pay interest or a higher purchase price. It is all negotiable.

Seller provided financing can be pure debt, or it can be a form of preferred or equity share. In some situations it can also be a lease-back or licensing situation, where the Seller actually retains ownership of key assets and leases or licenses them to the Buyer with options to purchase as part of a Seller-provided financing strategy.

Bridging The Gap: Redundant Assets

Sometimes revisiting how the parties have identified and dealt with "redundant assets" can bridge the gap.

The calculation and use of surplus working capital can be revisited, and it may be possible to pay out more surplus working capital to the Seller before closing than originally planned.

Also, the parties may replace certain new, or expensive pieces of equipment with older or cheaper pieces, effective reducing the purchase price to be paid by the Buyer and leaving the Seller with the opportunity to sell the new or more expensive equipment at additional financial return outside of the final purchase price.

Bridging The Gap: Personal Contracts

Sometimes the gap can be bridged by revisiting the role of the selling owner-manager following closing, and how they will be paid for any contributions they will be making.

It is not unusual for the selling owner-manager to receive a generous employment or consulting contract as part of the transaction. This can be a deductible expense to the Buyer's benefit, and effectively increase the after-tax proceeds from the transaction to the Seller.

Payments related to non-competition and non-solicitation contracts can sometimes be a deductible expense to the Buyer, giving the Buyer more room to be generous in fixing the amount to be paid.

These kinds of contracts cannot be ignored when looking at a purchase and sale transaction, and can become important tools in bridging the gap on purchase price.

As mentioned many times before, there is more to a good deal than basic purchase price. The entire structure of the transaction needs to be considered, including consulting or employment contracts or restrictive covenant payments.

Bridging The Gap: Sharing The Tax Shield

This question of a "tax shield" often comes up when the price is fine-tuned.

The Seller usually wants to sell shares so that it can get taxed on a capital gains basis. Capital gains rates are usually lower than dividend or income tax rates.

The Buyer usually wants to buy assets. Not only does this reduce the risk of assuming hidden or contingent liabilities, but the Buyer will get to depreciate the cost of buying assets, which will be an expense against future company earnings. In addition, since depreciation is a non-cash but deductible expense, it can be an important way of generating after-tax cash to the Buyer at a lower tax rate.

The benefit to the Buyer of buying assets is frequently called a "tax shield". One local accounting firm calculated the tax shield to be worth 15% of the goodwill component of the purchase price as of March 2001 at Canadian tax rates.

However, the concept of a "tax shield" also applies to the preferred capital gains treatment of the Seller when selling shares.

Each party will calculate what the other party is gaining for "tax shield" purposes, depending on the agreed deal structure, and will want the other party to adjust the price to share part of the benefit of the "tax shield".

A 50/50 split of the tax shield is common, and usually comes into play once the other major components on price and structure have been agreed upon.

Calculating the respective tax shields or burdens, and agreeing to share them through a purchase price adjustment can be another effective way of bridging the gap.

Bridging The Gap: Sharing The Burden

In some situations, transaction hurdles include "burdens" assumed by one party if it does the deal the way the other party wants to. Often, these can be quantified and traded off against each other. Techniques include:

Seller contributing to certain buyer expenses.

Buyer contributing to certain seller expenses.

Termination costs of employees being left behind, or real estate or other leases not being assumed, or early payment penalties on debts to be paid out, are examples of the burdens that can be shared in some way to bridge the gap.

Sometimes transaction costs such as lawyers, accountants, appraisers and other professionals come into play. Occasionally a contribution by one party to the expenses of the other is all it takes to reach a purchase price tipping point.

Bridging The Gap: Considering The Intangibles

Finally, when a range of values for the business have been established using a combination of Adjusted Book Value, Normalized Sustainable Future Earnings and Capitalization Rates/Multiples, as much "science" as can be brought to bear will have been brought.

In addition, each party will have had a chance to make their case and will have a greater appreciation for the business opportunity available.

In the end formulas and debates about future earnings and rates of return will probably fail to deliver a final agreement on price, and each party will have to assess the "intangibles" and "structure" of the deal to see if the gap can be bridged. Intangibles can include the following (not an exhaustive list):

- How badly each party "needs" to do the deal.
- How badly each party "wants" to do the deal.
- What synergies the Buyer thinks it can bring to the table to drive normalized sustainable future earnings to higher levels, thereby effectively reducing the Buyer's multiple.
- How the Buyer is financing the deal, and whether that financing package ultimately reduces his or her risk to an acceptable level.
- How the deal is structured, including Seller take back financing, price adjustment clauses, post-closing support, etc.
- How the deal is structured for after tax cash flow to each party.

If the negotiations are successful, the gap will be small enough to create an incentive to value the final intangibles or adjust the structure in a way that leads to the best possible deal for both parties, even though it will probably be the best possible price for either party.

If not, negotiations will fail and each party will be start looking for a better deal elsewhere.

A Closing Thought: Selling Your Business Is A Relationship-Based Transaction

Buying or selling a business involves lots of discussion and negotiation. There is a lot of room for disagreement and emotion. The whole process can become adversarial – but only if the parties allow it to go that way.

Having participated in dozens and dozens of such negotiations, I have observed that the best deals for both Buyer and Seller are made when the Buyer and the Seller connect on a personal level, like and respect each other, and want to do business with each other.

A Buyer who makes a Seller want to sell to them will probably make a good deal for themselves, as will a Seller who makes the Buyer want to help them achieve their goals in selling their business.

So this is my closing thought on successfully negotiating price: *it is as much a relationship issue as it is an accounting and risk management issue*.

In business, most things that reduce risk hurt relationships, and most things that are good for relationships increase risk.

Parties who use the due diligence and negotiating process to develop a trusting, respectful, personable and mutually rewarding relationship between Buyer and Seller not only have a better chance of doing a deal with each other, but also have a better chance of feeling good about the price they agree on at the end of the day.