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CHAPTER 1

Winning through Mergers and Acquisitions

Buyers and sellers can create substantial value through merger and acquisition (M&A). Both can win from a transaction. That is the beauty of deal making. And that is much of the allure that has driven the tremendous volume of M&A activity worldwide over the past three decades.[1] Despite this volume, most businesses are not salable. M&A advisors disqualify roughly 65% to 75% of prospective sellers and, according to a U.S. Chamber of Commerce study, only 20% of the businesses that are for sale will successfully transfer hands to another owner. This would imply that only 5% to 7% of companies actually get sold![2]

This book focuses on private company business value, with particular focus on private (or closely held) companies in the lower end of the middle market (i.e. those generating between $3 million and $250 million in value).[3] What creates value? How do we measure it? How does a management team build it? How do they preserve it? How do they maximize it through a transaction? It is this focus that will improve the chances of selling a business. These concepts are equally important to buyers and sellers because both

[1] Chapter 5 presents a very necessary second view of the potential results of M&A.

[2] Looked at another way, the Tax Foundation reported in 2013, based on corporate tax return filings with the IRS, that there were approximately 9.1 million corporations in the United States (1.7 million C Corporations and 7.4 million S Corporations, plus another 23 million sole proprietorships). As noted at the beginning of Chapter 4, Mergerstat reported a total of 97,093 transaction announcements over the course of 10 years between 2007 and 2016, which represents approximately 1.1% of total S and C corporations.

[3] For purposes of this book, we define the middle market as companies with a total enterprise value of $250 million to $1 billion, lower middle market at $10 million to $250 million, lower-lower middle market at $3 million to $10 million, and small-cap or micro companies under $3 million.

can and should benefit from a deal. But different results frequently occur. Sellers may sell under adverse conditions or accept too low a price due to lack of preparation or knowledge. And every buyer runs the risk of purchasing the wrong business or paying too much. As seen during the Great Recession of 2007–2009, transactions during adverse economic times create their own sets of challenges. That is why understanding value – and what drives it – is critical in mergers and acquisitions.

Wise shareholders and managers do not, however, confine their focus on value to only M&A. They should be building value in their business while still running it. If you do not grow, you will ultimately decline. As Will Rogers famously said, "Even if you're on the right track, you'll get run over if you just sit there."

Value creation drives the strategic planning of shareholders and managers and, in the process, creates focus and direction for their company. Their M&A strategy supports and complements their broader goal of building shareholder value, and they buy and sell only when a given deal creates value for them.

This brings us back to the purpose of this book. It explains how to create, build, measure, manage, preserve, and maximize value in mergers and acquisitions in the context of the broader business goal of building value. Senior managers in most public companies focus on value every day because it is reflected in the movement of their stock price – the daily scorecard of their performance relative to other investment choices. Private companies, however, lack this market feedback and direction. Their shareholders and executives seldom understand what their company is worth or clearly see what drives its value. For this reason, many private companies – and business segments of public companies as well – lack direction and underperform.

Managing the value of a private company, or a division of a public corporation, is particularly difficult because that value is harder to compute and justify. Yet most business activity – and value creation or destruction – occurs at this operational level.

Being able to accurately measure and manage the value of smaller businesses or business segments is critical in the value-creation process. And this skill will pay off in M&A as well because most transactions involve smaller entities. Although we read and hear about the big deals that involve large corporations with known stock prices, the median M&A transaction size in the United States between 2012 and 2016 was approximately $43 million. Smaller deals involving closely held companies or segments of public companies are the scene for most M&A activity.

Therefore, every value-minded shareholder and executive must strive to maximize value at this smaller-entity level where daily stock prices do not exist. The concepts and techniques that follow explain how to measure and manage value on a daily basis and particularly in M&A. The discussion begins with an understanding of what value is.

Critical Values Shareholders Overlook

When buyers see a potential target, their analysis frequently begins by identifying and quantifying the synergies they could achieve through the acquisition. They prepare a model that forecasts the target's potential revenues if they owned it, the adjusted expense levels under their management, and the resulting income or cash flow that they anticipate. They then discount these future returns by their company's cost of capital to determine the target's value to them. Armed with this estimate of value, they begin negotiations aimed at a deal that is intended to create value.

If the target is not a public company with a known stock price, frequently no one even asks what the target is worth to its present owners. However, the value the business creates for the present owners is all that they really have to sell. Most, and sometimes all, of the potential synergies in the deal are created by the buyer, rather than the seller, so the buyer should not have to pay the seller for most of the value the buyer creates. But in the scenario just described, the buyer is more likely to do so because his or her company does not know what the target is worth as a stand-alone business. Consequently, the buyer also does not know what the synergies created by his or her company through the acquisition are worth, or what the company's initial offer should be.

Sellers are frequently as uninformed or misinformed as buyers. Many times the owners of the target do not know if they should sell, how to find potential buyers, which buyers can afford to pay the most to acquire them, what they could do to maximize their sale value, or how to go about the sale process. After all, many sellers are involved in only one such transaction in their career. They seldom know what their company is currently worth as a stand-alone business, what value drivers or risk drivers most influence its value, or how much more, if any, it would be worth to a strategic buyer. Typically none of their team of traditional advisors – their controller, outside accountant, banker, or attorney – is an expert in business valuation. They certainly have not seen as many businesses as an experienced business appraiser. Few of these professionals understand what drives business value or the subtle distinction between the value of a company as a stand-alone business versus what it could be worth in the hands of a strategic buyer.

The seller could seek advice from an intermediary, most commonly an investment banker or business broker. But these advisors typically are paid a commission – if and only if they achieve a sale. Perhaps current owners could achieve a higher return by improving the business to position it to achieve a greater value before selling. This advice is seldom popular with many intermediaries because it postpones or eliminates their commission.

With sound advice so difficult to find, sellers frequently postpone sale considerations. Delay is often the easier emotional choice for many entrepreneurs who identify personally with their company. But with delay, opportunities are frequently lost. External factors – including economic, industry, and competitive conditions that may dramatically affect value – can change quickly. Consolidation trends, technological innovations, or regulatory and tax reforms also can expand or contract M&A opportunities and value.

Procrastination also can hamper estate planning and tax strategies because delays reduce options. And the bad consequences are particularly acute when value is rapidly increasing.

Thus, buyers and sellers have very strong incentives to understand value, manage what drives it, measure it, and track it to their mutual benefit.

Stand-Alone Fair Market Value

With a proper focus on maximizing shareholder value, buyers and sellers begin by computing the target company's stand-alone fair market value, the worth of what the sellers currently own. This value reflects the company's size, access to capital, depth and breadth of products and services, quality of management, market share and customer base, levels of liquidity and financial leverage, and overall profitability and cash flow as a stand-alone business.

With these characteristics in mind, "fair market value" is defined by Revenue Ruling 59-60 of the Internal Revenue Service as "the *price* at which the property would change hands between a willing buyer and a willing seller when the former is not under compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of the relevant facts."

Fair market value includes these assumptions:

- Buyers and sellers are hypothetical, typical of the market, and acting in their own self-interest.
- The hypothetical buyer is prudent but without synergistic benefit.
- The business will continue as a going concern and not be liquidated.
- The hypothetical sale will be for cash.
- The parties are able as well as willing.
- The hypothetical seller is not forced to sell (i.e. accept an offer that represents a "distress sale") and a buyer is not compelled to buy (i.e. necessary to earn a living).
- The reference is to "price" rather than "proceeds."
- The parties operate at arm's length, or independent of each other.
- Both parties have reasonable knowledge of the relevant facts.
- The seller must be willing to accept the price available under prevailing economic, industry, and market conditions as of the effective date.

The buyer under fair market value is considered to be a "financial" rather than a "strategic" buyer. The buyer contributes only capital and management of equivalent competence to that of the current management. This excludes the buyer who, because of other business activities, brings some value-added benefits to the company that will enhance the company being valued and/or the buyer's other business activities (e.g. being acquired by other companies in the same or a similar industry). Also excluded is the buyer who is already a shareholder, creditor, or related or controlled entity who might be willing to acquire the interest at an artificially high or low price due to considerations not typical of the motivation of the arm's-length financial buyer.

The seller in the fair market value process is also hypothetical and possesses knowledge of the relevant facts, including the influences on value exerted by the market, the company's risk and value drivers, and the degree of control and lack of marketability of that specific interest in the business.

While fair market value is impersonal in nature, investment value reflects the value to a particular buyer based on that buyer's circumstances and investment requirements. This standard of value includes the synergies or other advantages the strategic buyer anticipates will be created through the acquisition.

Fair market value should represent the minimum price that a financially motivated seller would accept because the seller, as the owner of the business, currently enjoys the benefits this value provides. The controlling shareholder in a privately held company frequently possesses substantial liquidity because he or she can harvest the cash flow the company generates or sell the company. The noncontrolling or minority shareholder generally possesses far less liquidity. As a result, the value of a noncontrolling interest is usually materially less than that interest's proportionate ownership in the value of the business on a control basis.

Prospective buyers who have computed stand-alone fair market value should also recognize that this is the base value from which their negotiating position should begin. The maximum value the buyer expects to create from the deal is the excess of investment value over fair market value.[4] So any premium the buyer pays above fair market value reduces the buyer's potential gain because the seller receives this portion of the value created.

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[4] In practice, the term *intrinsic value* is sometimes used. *Graham and Dodd's Security Analysis* (Cottle, Murray, and Block, 5th edition, New York: McGraw-Hill, 1988, p. 41) defines intrinsic value as "the value which is justified by assets, earnings, dividends, definite prospects, and the factor of management." Intrinsic value is more broadly defined than fair market value, but is similar in that it reflects characteristics relating to the asset being valued, but not those related to a particular buyer that is part of investment value.

As discussed further in Chapter 14, sellers frequently are motivated by nonfinancial considerations, such as their desire to pass ownership of the company on to their children or long-term qualified employees, or, if they work in the company, to retire or do something else. When these nonfinancial considerations exist, it is particularly important for shareholders to understand the financial effect of decisions made for personal reasons. Opportunistic buyers can take advantage of sellers, particularly those who are in adverse personal circumstances. Once again, this fact stresses the need for a continual focus on value and implementation of a strategic-planning process that routinely considers sale of the company as a viable option to maximize shareholder value. This process accommodates shareholders' nonfinancial goals and provides the time and structure to achieve them and manage value as well.

Investment Value to Strategic Buyers

The investment value of a target is its value to a specific strategic buyer, recognizing that buyer's attributes and the synergies and other integrative benefits that can be achieved through the acquisition. Also known as strategic or synergistic value, the target's investment value is probably different to each potential buyer because of the different synergies that each can create through the acquisition. For example, one buyer may have a distribution system, product line, or sales territory in which the target would fit better than with any other potential buyer. Generally this is the company to which the target is worth the most. Well-informed buyers and sellers determine these strategic advantages in advance and negotiate with this knowledge.

The difference between fair market value and investment value is portrayed in Exhibit 1.1, which shows an investment value for two potential buyers. The increase in investment value over the company's fair market value is most commonly referred to as a control premium, but this term is somewhat misleading. Although the typical buyer does acquire control of the target through the acquisition, the premium paid is generally to achieve the synergies that the combination will create. Thus, this premium is more accurately referred to as an acquisition premium because the primary force driving it is synergies, rather than control, which is only the authority necessary to activate the synergy.[5]

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[5] To address the diversity in practice among business appraisers in adjusting value to reflect benefits of control, the Appraisal Foundation developed a working group, which published *The Measurement and Application of Market Participant Acquisition Premiums* in 2017, intended mostly for valuations completed for financial reporting purposes, but containing perhaps the most comprehensive explanation of such premiums to date.

EXHIBIT 1.1 Fair Market Value versus Investment Value

Investment Value – 2		
Investment Value – 1		
	Acquisition Premium	
Fair Market Value		

The obvious questions this discussion generates are:

- Why should a buyer pay more than fair market value?
- If the buyer must pay an acquisition premium to make the acquisition, how much above fair market value should the buyer pay (i.e. how large should the acquisition premium be, either as a dollar amount or as a percentage of fair market value)?

The median acquisition premiums for purchases of public companies in the United States have been about 33% over the last 10 years. These figures are not presented as a guideline or as a target. Premiums paid are based on competitive factors, consolidation trends, economies of scale, and buyer and seller motivations – facts that again emphasize the need to thoroughly understand value and industry trends before negotiations begin. For example, a company with a fair market value of $10 million has a much stronger bargaining position if its maximum investment value is $20 million than if it is only $12 million. To negotiate the best possible price, however, the seller should attempt to determine what its maximum investment value is, which potential buyer may have the capacity to pay the most in an acquisition, and what alternatives each buyer has, and then negotiate accordingly.

Generally speaking, buyers should begin their negotiations based on fair market value. Before they enter the negotiation process, where emotional factors and the desire to "do the deal" take over, buyers should establish their walk-away price. This is the maximum amount above fair market value that they are willing to pay to make the acquisition. Establishing the maximum price in advance encourages buyers to focus on value rather than on winning the deal. Naturally, the farther the price moves above fair market value toward that buyer's investment value, the less attractive the deal becomes. Value-oriented buyers recognize that acquisitions at a price close to their investment value require them to fully achieve almost all forecasted synergies – on time – to achieve the forecasted value. And the closer the acquisition price gets to their investment value, the less value the acquisition can create for the buyer's shareholders and the smaller the buyer's potential margin of error. When a seller demands too high a price, the buyer's better option is often to decline that deal and look for one with a better potential to create value.

This fact illustrates a fundamental but essential lesson in making any investment: Identify the distinction between a good company and a good investment. While a good company may possess many strengths, it will prove to be a bad investment if the price paid for it is too high. Conversely, a company with weaknesses may offer a good investment opportunity if the price is adequately low relative to the forecasted returns, particularly to the strategic buyer who possesses the strengths to compensate for the target's weaknesses.

Win–Win Benefits of Merger and Acquisition

In order for there to be a successful M&A transaction, three things need to be in line. First, the business itself must be ready. This means addressing many of the concepts discussed in the four chapters within Section II, Building Value. Next, the owner himself must be ready, as discussed with the mental readiness concept within Chapter 14. Finally, there needs to be a buyer ready to pay a multiple that the business owner will accept. That means that the business owner must have an understanding of what his business is worth, as covered in the eight chapters within Section III, Measuring Value.

To illustrate the win–win benefits of M&A to buyers and sellers, the next discussion summarizes the valuation of Cavendish Seafood Distributors, which is presented in detail in Chapter 21. Many of the technical steps in this illustration are explained only briefly. Each step is described in detail in the chapters that follow. Various technical issues will be introduced in italicized print with a reference to the chapter that explains how to handle these matters.

Cavendish was founded about 20 years ago by Lou Bertin, who had enjoyed a successful career as a restaurateur. Bertin, who had an MBA and always wanted to run his own business but was tired of the demands of running a restaurant, recognized a need for better distribution of seafood to restaurants in his home state. Armed with his entrepreneurial spirit, substantial expertise in running restaurants, $1.7 million of his and two 10% minority investors' equity cash, and a well-conceived business plan, he founded Cavendish.

As with most small companies, however, several major risks and constraints weighed heavily on Bertin. He is looking to retire or at least reduce his hours. And although Cavendish has been a successful venture, Bertin has seen his personal wealth increasingly tied to the fate of the company at a time in his life when he knows diversification is the much wiser investment strategy. *Should Bertin's 80% equity interest in Cavendish be valued, or some other investment? Would the valuation process or computation be different if he owned a 100% interest and there were no minority shareholders, or if all of the stock were owned by minority shareholders?* (See Chapters 12 and 14.)

Sales for Cavendish's latest year top $75 million, and earnings before interest and taxes (EBIT) adjusted to reflect ongoing operations will be about $7.5 million. *Is EBIT the best measure of return for Cavendish? Would it be more accurate to use revenue or net income before or after taxes or cash flow?* (See Chapter 6.) Cavendish is heavily leveraged. To move toward long-term stability, significant additional capital spending is required. Does the financial leverage affect value, and if so, how? (See Chapter 9.) Does the anticipated capital spending affect value, and if so, how do we account for it? (See Chapter 6.)

The company's product line is narrow by industry standards, although it has developed a loyal and rapidly growing base of restaurants and grocery stores. Cavendish's profit margins are negatively impacted by forces outside its control, such as increases in fuel prices and drops in demand from restaurants during economic downturns. *How can the valuation reflect these various risk drivers and value drivers? What if the buyer can eliminate some of these weaknesses?* (See Chapters 3 and 8.) Bertin's staff is comprised primarily of family members and people like him who had burned out of working in restaurants and were looking for a career switch to an industry with normal working hours. Bertin himself has lost the enthusiasm for the strategic planning the company would need to continue its historical growth performance. *Should an adjustment be made if some of these individuals do not materially contribute to the success of the company? Should an adjustment be made if anyone is paid above- or below-market compensation?* (See Chapter 6.)

Bertin has been routinely approached by investment bankers, private equity firms, and contacts within the food distribution industry about a sale of the company, and he is especially concerned about a possible recession in coming years given how long it has been since the economy was last in recession. In addition, one of Cavendish's major competitors, a company that is five times its size, is using its leverage to push Cavendish out of some of the urban markets in Cavendish's core territory. This more intense competition, coupled with concerns about economic conditions in the near future, has led Bertin to postpone planned price increases. *Can these competitive issues be identified by reviewing Cavendish's financial statements? What additional research, if any, is required? How are these competitive factors reflected in the valuation?* (See Chapters 3 and 8.)

Computation of Cavendish's Stand-Alone, Fair Market Value

As a lower middle market size company, Cavendish carries many risks, including limited capital, high financial leverage, a narrow product line, and very limited management. When combined with the company's loyal customer base, rapid sales growth, high product quality, and average profitability, these factors generate Cavendish's weighted average cost of capital rate of 19%, which reflects its risk profile and growth prospects.

Is a weighted average cost of capital the same as a discount rate? Is this the same as a capitalization rate? (See Chapters 7 and 9.) When the company's normalized net income to invested capital of $5.84 million for this year is divided by a 15% weighted average cost of capital (WACC) capitalization rate, the fair market value on a stand-alone basis of the enterprise is determined to be $40.5 million. Is this the value of equity? (See Chapter 6). *Why is only one year of earnings used to compute value? How does this reflect future year growth?* (See Chapter 7.)

Investment Value to Strategic Buyer

A larger public company that wants to quickly acquire a presence in Cavendish's market recognizes its strengths and weaknesses. Because the larger buyer frequently can eliminate many of Cavendish's limitations, it can increase Cavendish's sales growth and profits much more rapidly. Cavendish is also much less risky as a segment of the large company that possesses a broad array of market strengths. *How are these changes in risk reflected in the valuation? Who gets this value?* (See Chapter 3 and Appendix 13A.) *Is the transaction fair from a financial point of view? Should he invest in a fairness opinion so that he and the Company's two noncontrolling shareholders are comfortable with the transaction consideration?* (See Chapter 16.)

When owned by the strategic buyer, Cavendish's stand-alone EBIT could be increased over the next several years through more efficient operations and access to a broader market and an extensive distribution system. In the terminal period following the forecast, Cavendish's growth should be similar to that consistent with expectations for the food distribution industry. *How should the forecast and the years thereafter be used in computing value?* (See Chapter 7.)

After the deal is closed, the buyer will have to allocate the purchase price for financial reporting purposes. Part of this process will involve identifying and valuing Cavendish's intangible assets. *What financial reporting considerations will have to be made?* (See Chapter 17.) *What are the intangible assets owned by Cavendish, and how are they valued?* (See Chapters 17 and 18.)

While Cavendish has a WACC capitalization rate of 15%, Omni Distributors, the buyer, a large, well-known public company, has a WACC discount rate of about 12%. *How are capitalization rates and discount rates different, and when should each be used?* (See Chapters 7 through 9.) Because Cavendish operates in a new market for this buyer, has limited management and increasing competition, the buyer adjusted its discount rate for the added risk of Cavendish. *Should the buyer use its own discount rate to compute the investment value of Cavendish? If not, how should it be adjusted? How should this rate be affected by Cavendish's high financial leverage?* (See Chapter 9.) The discounting of Cavendish's expected future net cash flow to invested capital adjusted for synergies determined that Cavendish's invested capital is worth $69.7 million to one strategic buyer. What is net cash flow to invested capital, how is it computed, and how many years should be discretely forecasted? (See Chapter 6.) How does this discounting process reflect the potential adjustments to the return and the rate of return for the risk drivers and value drivers that have been considered? (See Chapters 7 and 8.) The $31.3 million excess of the $69.7 million investment value of invested capital over Cavendish's $38.4 million fair market value means this buyer could pay up to $31.3 million over stand-alone fair market value to acquire Cavendish. *What should be the minimum value considered by both the buyer and the seller to start the negotiations? How much above $38.4 million should this buyer be willing to pay to acquire Cavendish? Should this decision be influenced by competitors also bidding to acquire Cavendish? If the buyer ultimately pays $69.7 million to acquire Cavendish, is the buyer better off? How?* (See Chapters 1, 4, and 5.)

Cavendish's balance sheet shows assets of almost $44 million and equity of $15 million. How do these affect its value? (See Chapters 11 and 12.) Public companies in Cavendish's industry are selling at EBIT multiples ranging from 3 to 18, with a mean of 8. *Should these be considered, and how? Do the EBIT multiples generate equity value?* (See Chapter 10.) Another public food distributor recently sold for a 72% premium over its market value. *Should this transaction be considered in determining value?* (See Chapter 10.)

Since Cavendish is not a public company, should there be a discount for lack of marketability? Since Cavendish has noncontrolling shareholders, is a control premium or discount for lack of control applicable? (See Chapter 12.)

Can a buyer employ strategies to reduce risk in an acquisition? (See Chapters 4 and 18.) *How can buyers most effectively evaluate synergies?* (See Chapter 5.)

Can sellers employ a strategy to build value? Can they effectively plan in advance for a sale? (See Chapters 2 and 4.)

Buyers and sellers clearly have opportunities to gain through mergers and acquisitions. In order to create value, however, they must be able to measure and manage it. This process begins with the ability to identify and quantify those factors that create value. Most often, this must be done in a privately held company or a division of a public corporation where stock prices do not exist.

As you will see in this book, there are many factors that go into the valuation of a business. Valuation is both an art and a science. It is both a quantitative and a qualitative assessment of a business. But to boil it all down into one sentence: Business valuation is about the risk of achieving a company's expected future cash flows. Or even more simply, it is about risk and return. The chapters to come explain how to build operating value in a private company and how to create, build, measure, manage, preserve, and maximize value in mergers and acquisitions.

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