Accession Capital Corp

BUSINESS DIVESTITURES: FINDING WAYS TO REDUCE THE PURCHASER'S PERCEIVED INCIDENCE OF RISK WILL INCREASE DEAL PRICE

By Richard Conn CMA, MBA, CPA

'Caveat emptor - it's not my responsibility to voluntarily disclose every wart the business has to the potential purchaser.' This is often the attitude that owner/manager Vendors have with respect to discussing those areas of their business that may be seen as weaknesses by potential Purchasers. In the Vendor's mind, it is better to say nothing rather than reveal a flaw in the business that the Purchaser may not have been already aware of and will almost certainly use as ammunition for a price reduction if disclosed. The problem with this covert attitude is that it often works against the Vendor's best interests. This is particularly true in those cases where the Purchaser will perceive an undisclosed business uncertainty with a much higher risk profile than does the Vendor. The purpose of this article is to document one such example and to discuss negotiating stratagem that will *improve* the Vendor's position by taking a more candid approach to addressing the Purchaser's perception of the business' weakness.

Certainly the purchase of every 'for-profit' business involves risk. It is not like buying a risk-free government bond - and, if it were, the highest return that one could reasonably expect from such a purchase would be the risk-free rate. Moreover, it is not the Vendor's responsibility to perform the Purchaser's due diligence. It is up to the Purchaser to make sure that sufficient analysis, investigation and substantive evidence has been undertaken/collected to warrant the price that is being paid. However, it will almost always be to the Vendor's advantage to discover which areas of the business the potential Purchaser is most wary of and address those concerns by open disclosure and possibly even by assuming some of that perceived risk himself. The following real-life example will demonstrate these points.

The Vendor was a small-scale high-tech manufacturing facility and the Purchaser was a well-informed savvy business owner with production facilities in a complimentary industry. The negotiation process had almost completely run its course with virtual agreement upon all terms and conditions except for the price. The Purchaser had not entirely accepted the Vendor's projection of future net cash growth, a substantial portion of which was based upon the recent addition of a new product line that had been specifically created for a key Customer. The new product offered a superior margin and very favourable growth potential. The relationship between the key Customer and the Vendor, personally, had been very strong for over a decade. In fact, the new product line had been developed specifically to meet the key Customer's requirements. It was a collaborative effort between the Vendor/Customer's design personnel and the Vendor had dedicated much of his own personal time and attention to consulting with the Customer and getting the prototype into production.

In preparing the business for sale, the Vendor had placed a good deal of emphasis upon the future potential of this new product line. He had aggressively marketed the strong ties his manufacturing firm had with the key Customer, and the comparative advantage his business enjoyed in having developed this superior product.

Unbeknownst to the Vendor, the Purchaser also knew the Customer and had surreptitiously discovered that the new product line had yet to meet all of the Customer's quality criteria. Only in its first year of production, the new product had yet to attain the degree of reliability that would ensure its continued survival. The Purchaser was also aware of the close personal ties between the Vendor and Customer and was concerned that, once the Vendor was no longer involved in catering to this customer's needs and finding a solution to the quality control issues, the new product orders would be cancelled and any future revenue potential would immediately evaporate.

In contrast, the Vendor was a long-time veteran of such product development cycles and was entirely convinced that a solution to the quality control production issues would be found. In the Vendor's mind, the future potential of the new product was tremendous and had been very conservatively stated in the marketing data. He saw no reason, therefore, to cloud the negotiation process with the small production hiccups that currently were being experienced in the first year of sales. Indeed, the Vendor was offended by the Purchaser's reluctance to accept the future business projections as presented.

While the Purchaser and Vendor were not then currently aware of it, their relative difference in opinion could be quantified as:

(in thousands $)	Purchaser's Perspective		Vendor's Perspective	
Future Years	Purchaser's Net Free Cash Projections	Purchaser's Cash Inflows discounted @ 14.5%	Vendor's Net Free Cash Projections	Vendor's Cash Inflows discounted @ 14.5%
1	1,475	1,288	1,560	1,362
2	1,730	1,320	2,100	1,602
3	1,520	1,013	1,730	1,152
4	1,980	1,152	2,350	1,367
5	1,990	1,011	2,450	1,245
Terminal Year, Normalized Perpetuity	2,025	7,096	2,950	10,338
Business NPV		12,880		17,066

The Purchaser perceived the business to be worth $12.9 million whereas the Vendor thought $17.1. The Purchaser was not giving **any** weight to the additional potential net free cash flows that might be generated by the new product line - assuming these to be too speculative and unproven. This was an area of perceived high-risk to the Purchaser made even more so by the fact that the Vendor's personal departure from the business would almost certainly terminate the Customer's patience towards the product quality issues.

The Vendor was convinced the new product cash flows *would* be realized and considered the 'as-stated' projections to be conservative. He was not willing to considered a $4.2 million price concession and believed that the Purchaser was just using a feigned skepticism over the new product's cash generating potential as a means of obtaining the business at an unrealistic bargain price.

Eventually, through some skillful negotiating the Vendor learned that the Purchaser was privy to some insider Customer information with respect to the quality control problems. Having the issue out in the open allowed each to better appreciate the other's position. Importantly, because of the *perceived risk differential* (i.e. with the Purchaser believing the realization of the new product cash inflows being highly unlikely, whereas the Vendor sincerely considered these to be quite likely), the obvious solution was to re-structure the deal such that both parties would be better off. By engineering a transference of new product perceived risk from the Purchaser to the Vendor, the Purchaser could mitigate his exposure to overpaying for the business, while the Vendor would capitalize upon receiving a higher price given his assurances that the quality control issues would be solved.

Ultimately, the parties agreed that:

- the initial sales price would be the $12.9 million determined by the Purchaser
- a post-purchase contingency payment of $3.1 million (see below) would he held in trust and subject to sequential partial pay outs based upon the achievement of various milestones in the new product life cycle:
    - < the Vendor was to personally continue functioning in a 2 year consulting/advisory capacity on the new product development, acting as a liaison between Customer and quality control personnel
    - < certain quality control minimums had to be attained according to schedule
    - < increasing levels of new product revenues and gross margins throughout the initial two years would trigger specific releases of the escrow cash
    - < failure to meet various criteria, such as product revenue and quality control

minimums would trigger a forfeit of certain payments and the trust would return this cash back to the Purchaser

The potential purchase price of $16 million was a concession for both parties - but one each was willing to live with. For the Purchaser, in the worst case, he would contingently pay an additional $3.1 million over his estimation of value, but only in the instance where the new product had lived up to the Vendor's assurances over the first two years of post-purchase operations. In order to be compensated for the additional risk the Purchaser was assuming after the two year minimums were achieved, a higher hurdle rate of return (18%, rather than 14.5%) was demanded for the new product net free cash flows:

(in thousands $)		
Future Years	Nominal Difference in Vendor / Purchaser's Cash Flow Expectations	Nominal Cash Differences discounted @ 18%
1	85	72
2	370	266
3	210	128
4	370	191
5	460	201
Terminal Year, Normalized Perpetuity	925	2,246
Additional NPV Purchaser agreed to place in Trust, payable to Vendor upon the post-purchase realization of various New Product minimums		3,104

For the Vendor, this was the only potential offer on the table at the time - a refusal to consider any price concession might have meant a long delay in finding another buyer. In the worst case, if he did not find another suitable buyer within the next two years, he would then be implicitly assuming all the risks of developing the new product anyway. So he was no worse off for assuming these risks now. And, the upside was that he would be collecting $3.1M of installment payments in the event that his new product instincts were correct. Further, since he was quite convinced that the new product quality and profitability minimums would be achieved, agreeing to guarantee these standards was not a significant risk in his mind. It was, therefore, a much better arrangement for the Vendor to lock-in the immediate $12.9M sale of the business and spend 2 years working on an occasional part-time basis earning-out the $3.1M contingency payment rather than hoping to find another buyer that might see the new product potential as confidently has he currently did.

CONCLUSION

Business Purchasers will tend to be skeptical of that which has not been disclosed to them. Particularly if the information appears to have been intentionally withheld, rather than just accidentally omitted. Instinctually, if risk-adverse investors are uncertain about the outcome of a certain event[1], they will tend to err on the side of caution and view this uncertainty with an even higher assessment of risk than if they were fully apprised of all the various factors. Risk and Purchase Price are inversely related - the higher the perceived risk, the less that a Purchaser will be willing to pay for a business. That is why it is often not in the Vendor's best interest to adopt a 'caveat emptor' type of attitude. Rather, it is a much better strategy to foster open lines of communication with the potential Purchaser in order to discover which areas of the business he perceives as the source of greatest uncertainty.

In the example presented, the unit cost of risk relative to the outcome of the new product line was perceived as being so high by the Purchaser that he was unwilling to offer even one more dollar to his initial value determination of $12.9M. In contrast, once the Vendor's had made the assurance that the new product line will attain the standards promised, the Purchaser becomes contingently agreeable to paying an additional $3.1M for future potential of the new product line specifically because its risk exposure in doing so has been significantly reduced. If the Vendor cannot perform as promised, only a proportionate amount of the $3.1M will be put at risk.

[1]Such as the ultimate realization of the new product net free cash flows in the example cited.

In contrast, the Vendor's unit cost of risk with respect to the new product outcome is much lower than the Purchaser's. He is willing to accept the possibility that he may never collect upon the $3.1M based upon his greater experience with the business and firm belief that the minimum product guarantees will be met.

In those cases where a *perceived risk differential* exists between Vendor and Purchaser[2], an opportunity to transfer perceived risk from high to low will increase the net benefits to both parties.

---

[2]While it hasn't been an occurrence mentioned in this article, it is also possible for the Purchaser to have a lower perception of risk than the Vendor. For example, if the Vendor was concerned that a key customer was soon to be lost, leaving the operation with reduced revenues and over-capacity this may be ***the*** key area of high perceived risk to the Vendor. Conversely, the Purchaser may be relatively unconcerned about the lost of that customer, because any resultant over-capacity would be immediately used by the Purchaser's own internal requirements for the product in question. This would be an example of vertical integration and represents a true acquisition synergy for this particular Purchaser. The presence of synergies will lead to Purchasers who are willing to pay a higher price than other investors.