Sunday, June 22, 2014

THREE PERSPECTIVES ON M&A VALUE: WHAT YOU PAY, WHAT YOU GET, AND WHAT YOU GIVE.

Posted by Alan Fullerton in Advice for Entrepreneurs, Mergers and Acquisitions, Selling a Business

Warren Buffett is fond of quoting Ben Graham's adage: price is what you pay; value is what you get. Mr. Buffett is a renowned investor and acquirer of companies, but what does this adage mean when it comes to selling? For the seller, **price is what you get. What do you give?**

In M&A, we often speak of **Enterprise Value**, and by that investment bankers generally mean **the value of the company as a whole, excluding non-operating assets and non-operating liabilities, but including all other liabilities and assets (tangible and intangible)**. We think of negotiating deals on an Enterprise Value basis, making adjustments to the purchase price to the extent non-operating assets or non-operating liabilities are included in the deal. One example of non-operating assets would be cash. This may be counter-intuitive, but the value of a company is generally given on a cash free / debt free basis, that is assuming there is $0 cash and $0 bank and other debt. Think of the analogy with a house. The value of the house is generally independent of the mortgage on the house and certainly independent of the cash in the office safe (particularly from the seller's perspective!). That's because houses are sold on a cash free / debt free basis – the seller pays off the mortgage and keeps the cash in the safe. Examples of operating assets include accounts receivables, inventory, and manufacturing equipment, which are necessary in the operations of the business. Operating liabilities would include ordinary payables and many other current liabilities, but not bank debt for example.

So, while the buyer is getting "value", the seller is giving what exactly?

Companies are worth the value of the cash flows to be generated over the lifetime of the company. So the price bargained for in the sale of a company is generally based on the cash flows the buyer expects to generate and the cash flows the seller is giving up, influenced by other offers for the business, other alternatives available to the buyer, and the relative bargaining power of the buyer and seller. Let's say a company that has historically generated earnings before interest, taxes, depreciation and amortization ("EBITDA", a measure of unlevered pre-tax operating cash flows) of $3 million a year is selling for $15 million. What is the seller giving in exchange for the price? In most cases, the $15 million offer represents Enterprise Value and therefore the offer represents a bid to acquire all the operating assets and liabilities of the business. It may or may not include any real estate (which is often treated as a non-operating asset). Anything involved in the operations of the company would be part of the deal, with a (typically) sufficient level of net working capital left in the business to operate smoothly. What level of working capital is sufficient is often a negotiation unto itself, but for the seller it's important to recognize that, just as there's a certain level of capital investment (plant and equipment) in a business, there is also a level of working capital that companies need to operate. So, just as equipment is an asset, net working capital is an operating asset included in the Enterprise Value purchase price of the company.

We can think of this another way: how much of that $15 million is going to pay for net working capital? How much for the plant and equipment, how much for any other assets or liabilities


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going with the deal, how much for intangibles (customer list, intellectual property, etc.), how much beyond that ("goodwill")?

If, for example, the seller kept the receivables in the business (which happens occasionally in some form in smaller transactions), the acquirer would need to fund operations while waiting for the customers to start paying for work done post-close (rather than having the benefit of collecting cash from receivables purchased in the deal). Those funds into the company are additional investments for the acquirer and therefore the company without receivables is worth less to the acquirer than the company with receivables; just as a deal that allows the seller to keep the receivables is worth more to the seller than a deal that does not. So it comes back to what was bargained for: a business that can operate smoothly without a requirement for additional capital on day one, or a business with a working capital deficiency that needs to be addressed soon after close? Using the Enterprise Value approach, the logic is almost always that the former applies – there is sufficient working capital left in the company upon sale.

So, while the buyer is getting value, the seller is giving all the operating assets and liabilities of the company, and that's the basis for an Enterprise Value negotiation. We welcome talking with business owners who are thinking through these issues of valuation and strategic alternatives for their companies.

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