BOSS MAGAZINE

How to Finalize an M&A Deal Right Now? Agree to Disagree.

By Frank Williamson

During a period when current revenue might not reflect a business's true value, buyers and sellers trying to make an M&A deal can overcome differences of opinion over the sale price by using a formula and "agreeing to disagree."

For many businesses, 2020 turned out to be a much different year than they might have been expecting a year ago at this time. The pandemic has led to a challenging and uncertain period, causing some verticals to thrive (e-commerce and grocery stores, for example) and others to struggle (restaurants and the hospitality industry).

continued next page

Despite lower-than-expected income last year, many businesses remain foundationally strong. But others have exhausted their reserves and relief funds, leaving their long-term viability in question and opening the door to a possible M&A deal.

Naturally, this environment has also affected the momentum of mergers and acquisitions. Although investors have sensed an opportunity to purchase small businesses, and some have sold for good prices, there's still enough uncertainty about the future that many organizations are opting to hold off on major sales or purchases.

If your business can afford to wait until conditions improve, in most cases it continues to be the wisest strategy. However, for some organizations, time is of the essence, either because they're struggling to survive or because they sense an opportunity to buy while there are good prospects out there — which there are.

But, during this period of uncertainty, there's often going to be one big roadblock that these organizations will face in finalizing any M&A deal. That roadblock is price.

An M&A deal that's fair for both parties

It's understandable that a seller trying to get the highest price possible might not feel that sales results from 2020 give an accurate picture of their business's strength and profitability. And if the seller feels strongly that a potential buyer's offer doesn't reflect their business's true value, there will be no deal unless the offer price changes. To ensure that both buyer and seller feel that the terms are fair, the smartest solution for those wanting to complete an M&A deal right now is to agree to disagree on the price.

Agreeing to disagree on a M&A deal essentially means agreeing on a formula for determining the final sale price at a set point in the future. It's something of a gamble, yes, but an educated one. The seller believes that their business will rebound by the agreed-upon date, bringing a higher sale price. And the buyer believes that they'll still be getting a bargain at that point in the future.

A good analogy would be a health insurance policy. Our monthly premiums guarantee us a certain level of health care, if we need it, during a set period. The specific amount paid is different for everyone and is calculated using a model that spreads risk over a large pool of individuals.

continued next page

Nobody knows exactly what's going to happen in the future — you might have a major health emergency, or you may stay perfectly healthy and never visit the hospital. But the use of this model allows people to receive expensive-but-uncommon services at an affordable price — at least in theory.

How the formula works

Before two businesses enter into a price agreement that involves a formula, buyer and seller should look at the numbers and think hard about what they consider to be a fair deal — meaning the lowest amount the seller will accept and the highest amount the buyer will pay. When using a formula for an M&A deal, both parties will typically agree on a minimum price and use a sliding scale that increases the price as the business reaches certain thresholds over a set period.

A variety of metrics can be used to measure success, and I generally recommend choosing one that is as close to the top as possible on the business's income statement. For example, revenue is normally preferable to gross profit, and gross profit is normally preferable to net income, though individual situations may vary. A formula will typically cover a time period between one and two years, and it's best to make it as short as possible.

One benefit of this method that's sometimes overlooked is how it can create positive optics for both parties. Buyer and seller both walk away believing that they got the better end of an M&A deal. Of course, one of them is going to be slightly disappointed in the end, but in the afterglow of signing the papers, both sides can discuss the deal with their boards and senior management with optimism and confidence. Maybe the buyer will say that he purchased the business for 5x earnings, while the seller will celebrate with her team that they sold the business for 10x earnings.

This type of earnout structure for an M&A deal does have the potential to convert "today's disagreement over price into tomorrow's litigation over the outcome," as Vice Chancellor Travis Laster of the Delaware Chancery Court once remarked in an opinion. Because buyers and sellers have different definitions of success, any agreement of purchase or sale needs to be drafted with care to make sure both parties have a satisfactory level of protection. Buyers and sellers can help in this process by taking stock of any conditions that might impact the business's success during the earnout period and discussing them with their professional advisor.

continued next page

An acceptable level of risk

With these common-sense safeguards in place, both parties can overcome their difference of opinion by taking on a small amount of risk and uncertainty. And for some businesses, completing an M&A deal right now might make all the difference. My firm recently worked with a software company that was having trouble raising growth equity in the current economic conditions. It was on the verge of running out of money and couldn't afford to wait much longer. With our assistance, it was acquired by another company, which helped reimburse the original owners, preserved the company's product and even kept its team intact.

Businesses in some other verticals are viewing this moment as a once-in-a-generation opportunity to make large acquisitions. Some hotel management companies, for example, see potential for growth through investing in new hotels while good prices are plentiful. If your business senses similar possibilities that might not exist for much longer, there's good reason to consider moving forward on a deal right now.

Frank Williamson is the founder of Oaklyn Consulting, a consulting firm that helps investor groups and private businesses, from startup to middle market, with mergers, acquisitions, capital-raising, investor relations, succession and other strategic corporate finance decisions. Oaklyn Consulting does not work as a broker but as an extension of clients' boards and management teams, charging time-based fees for investment banking advice.