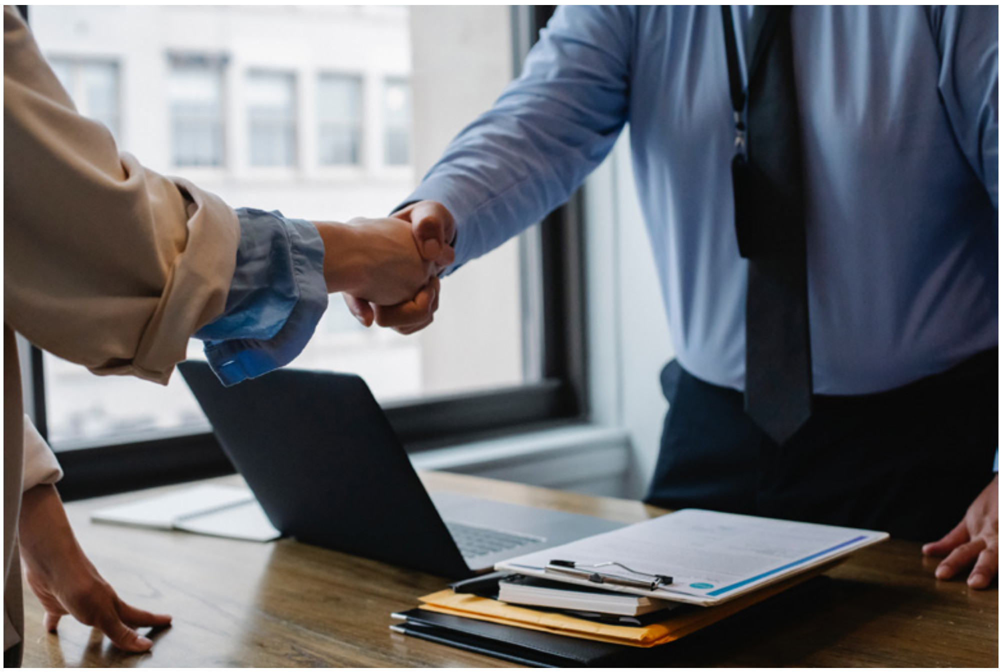
M&A Deal Price: Agreeing to Disagree

By Frank Williamson



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Business leaders who've made it through the pandemic mostly intact might be feeling hopeful about a return to some degree of normalcy. Some have already been laser-focused on growth, seizing the opportunity to buy small businesses at a premium. And as a clearer picture starts to form of what 2021 might look like for the economy, an appetite is building for larger purchases.

Other companies, however, might increasingly be between a rock and a hard place, having depleted their reserve funds after 12 months of reduced revenues. Although their businesses had been financially viable before 2020, the pandemic has impacted them to the point that they might have to either sell or close down completely.

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But one major sticking point might keep such companies from completing a merger or acquisition deal — a not-unreasonable belief that their business has a higher value than what sellers have been offering.

No one understands a business's true value better than its CFO. As the "chief measuring officer" of an organization, the CFO plays a key role in evaluating any M&A deal offer on the table and determining whether it's viable. But the unusual nature of 2020 adds a wrinkle in this evaluation: a CFO or other leader might feel that the previous year's sales results don't present a complete picture of its long-term success and profitability.

When a prospective seller and buyer are having trouble seeing eye-to-eye on price, the result can be a deadlocked process. But there's another option for constructing an M&A deal that's fair for both parties: agreeing to disagree on price.

When they agree to disagree, the seller and the buyer acknowledge that an accurate price can't be determined right now; by using a formula, though, they consent to calculate a final price on a predetermined date in the future.

Although this process carries an element of risk, both parties have access to the same information and are each making educated assumptions. The seller might feel that a revenue decline is temporary and will resolve itself by the date agreed upon, resulting in an increased sale price. The buyer might feel that the company's value will still be low enough to command a discount.

Before agreeing to a price formula for a merger or acquisition, both parties should start by crunching the numbers. Based on that data, buyer and seller will clearly lay out any potential risks of using a particular formula and suggest specific terms advantageous to their organization.

The seller should know the lowest price they'll accept, while the buyer should know the highest price that they're willing to pay. A typical formula for an M&A deal will have a minimum agreed-upon price, with the final amount calculated on a sliding scale as the business meets certain benchmarks.

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While the buyer and seller can base the formula on whatever metric they agree to, my usual recommendation is to pick one that's near the top of the business's income statement — revenue, gross profit, or net income, in that order. Usually, a formula will cover a period of fewer than two years, though it's often in everyone's interest to make it as short as possible.

Over the long term, the deal will ideally benefit one party a bit more than the other. But in the short term, agreeing to disagree can lead to positive optics on both sides. After making a deal based on the best information available, the buyer and seller can each frame the news positively to their boards and leadership teams.

The risk of entering into this type of M&A structure is that there can be hard feelings if one side doesn't end up with their hoped-for set of circumstances. As Vice-Chancellor Travis Laster of the Delaware Chancery Court once put it in an opinion, an earnout structure can potentially change "today's disagreement over price into tomorrow's litigation over the outcome."

To prevent a lawsuit, an agreement of purchase or sale should have adequate protections written into it. Both parties need to be clear-eyed about any wider economic trends or specific market conditions that could affect the business's profitability over the earnout period.

After putting these provisions in place, both buyer and seller should feel comfortable with the small level of risk and uncertainty that will allow them to get past a price disagreement.

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Completing a merger or acquisition now could be a lifesaver for some struggling businesses. And for companies in a position to buy, agreeing to disagree on price could allow them to complete a large acquisition during a period of once-in-a-generation opportunity. If your business fits into one of those categories, it's worth considering how you can find common ground with another party to get a deal across the finish line.

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.