Bridging the Valuation Gap between Business Seller and Business Buyer

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In an earlier article we discussed a survey that we did with the Business Broker and the Merger and Acquisition profession. 68.9% of respondents felt that their top challenge was dealing with their seller client's valuation expectations. This is the number one reason that, as one national Investment Banking firm estimates only 10% of businesses that are for sale will actually close within 3 years of going to market. That is a 90% failure rate.

As we look to improve the performance of our practice, we looked for ways to judge the valuation expectations and reasonableness of our potential client. An M&A firm that fails to complete the sale of a client, even if they charged an up-front or monthly fees, suffers a financial loss along with their client. Those fees are not enough to cover the amount of work devoted to these projects. We determined that having clients with reasonable value expectations was a key success factor.

We explored a number of options including preparing a mock letter of intent to present to the client after analyzing his business. This mock LOI included not only transaction value, but also the amount of cash at closing, earn outs, seller notes and any other factors we felt would be components of a market buyer offer. If you can believe it, that mock LOI was generally not well received. For example, one client was a service business and had no recurring revenue contracts in place. In other words, their next year's revenues had to be sold and delivered next year. Their assets were their people and their people walked out the door every night.

Our mock LOI included a deal structure that proposed 70% of transaction value would be based on a percentage of the next four years of revenue performance as an earn out payment. Our client was adamant that this structure would be a non-starter. Fast forward 9 months and 30 buyers that had signed Confidentiality Agreements and reviewed the Memorandum withdrew from the buying process. It was only after that level of market feedback was he willing to consider the message of the market.

We decided to eliminate this approach because the effect was to put us sideways with our client early in the M&A process. The clients viewed our attempted dose of reality as not being on their side. No one likes to hear that you have an ugly baby. We found the reaction from our clients almost that pronounced.

We tried probing into our clients' rationale for their valuation expectations and we would hear such comments as, "This is how much we need in order to retire and maintain our lifestyle," or, "I heard that Acme Consulting sold for 1 X revenues," or, "We invested $3 million in developing this product, so we should get at least $4.5 million."

My unspoken reaction to these comments is that the market doesn't care what you need to retire. It doesn't care how much you invested in the product. The market does care about valuation multiples, but timing, company characteristics and circumstances are all unique and different. When our client brings us an example of IBM bought XYZ Software Company for 2 X revenues so we should get 2X revenues. It is simply not appropriate to draw a conclusion about your value when compared to an IBM acquired company. You have revenues of $6 million and they had $300 million in revenue, were in business for 28 years, had 2,000 installed customers, were cash flowing $85 million annually and are a recognized brand name. Larger companies carry a valuation premium compared to small companies.

When I say my unspoken reaction, please refer to my success with the mock LOI discussed earlier. So now we are on to Plan C in how to deal with this valuation gap between our seller clients and the buyers that we present. Plan C turned out to be a bust also. Our clients did not respond very favorable when in response to their statement of value expectations we asked, “Are you kidding me?” or “What are you smoking?”

This issue becomes even more difficult when the business is heavily based on intellectual property such as a software or information technology firm. There is much broader interpretation by the market than for more traditional bricks and mortar firms. With the asset based businesses we can present comparables that provide us and our clients a range of possibilities. If a business is to sell outside of the usual parameters, there must be some compelling value creator like a coveted customer list, proprietary intellectual property, unusual profitability, rapid growth, significant barriers to entry, or something that is not easily duplicated.

For an information technology, computer technology, or healthcare company, comparables are helpful and are appropriate for gift and estate valuations, key man insurance, and for a starting point for a company sale. However, because the market often values these kinds of companies very generously in a competitive bid process, we recommend just that when trying to determine value in a company sale. The value is significantly impacted by the professional M&A process. In these companies where there can be broad interpretation of its value by the market it is essential to conduct the right process to unlock all of the value.

So you might be thinking, how do we handle value expectations in these technology based company situations? Now we are on to Plan D and I must admit it is a big improvement over Plan C (are you kidding)? The good news is that Plan D has the highest success rate. The bad news is that Plan D is the most difficult. We have determined that we as M&A professionals are not the right authority on our client's value, the market is.

After years of what are some of the most emotionally charged events in a business owner's life, we have determined that we must earn our credibility to fully gain his trust. If the client feels like his broker or investment banker is just trying to get him to accept the first deal so that the representative can earn his success fee, there will be no trust and probably no deal.

If the client sees his representatives bring multiple, qualified buyers to the table, present the opportunity intelligently and strategically, fight for value creation, and provide buyer feedback, that process creates credibility and trust. The client may not be totally satisfied with the value the market is communicating, but he should be totally satisfied that we have brought him the market. If we can get to that point, the likelihood of a completed transaction increases dramatically.

The client is now faced with a very difficult decision and a test of reasonableness. Can he interpret the market feedback, balance that against the potential disappointment resulting from his preconceived value expectations and complete a transaction?

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