

Strong Negotiating Principles Set the Foundation for a Deal

Buying and selling a business can be described as a combination of three games – Sudoku (a Japanese number puzzle), chess and poker. This is because the numbers have to tally, buyers and sellers have to think strategically, and each party has to be alert for “tells” from the other side, while not revealing their own hand.

Business owners and executives often focus on the quantitative elements of value when buying or selling a business. While the numbers are important, the ability to do a deal and to realize shareholder value ultimately rests in the negotiating abilities and relative negotiating positions of the parties involved. While the negotiating strategies and tactics that are used will vary depending on the specifics of the situation, both buyers and sellers should keep the following important negotiating principles in mind:

Exhibit 1 Principles of Negotiation

Understand the Other Party's Motives
Research, Research, Research
Know Your Alternatives
Maintain Credibility
The Terms of the Deal are as Important as the Price

Understand the Other Party's Motives

Many business owners and executives negotiate a deal from the perspective of trying to get what they want. However, it is just as important to understand the interests and motivations of the other party. The need and the desire of the parties to transact will dictate whether a deal can be done and on what terms. Failure to understand the other party's motives can result in ineffective or misguided negotiations. This may delay or destroy any potential deal.

For example, a seller may need to transact due to health issues or financial constraints. Conversely, a buyer that is a public company may feel pressured to consummate a transaction in order to satisfy market expectations. In other cases, the price that is paid or received may be secondary to some other overriding issues, such as where the seller needs some assurance that their employees will continue to be employed following the transaction.

Before discussing price and terms, the buyer and the seller should focus on understanding why the other party is at the table and what they hope to accomplish. The other party may not be totally forthcoming at first, for fear of compromising their negotiating position, and/or because they may have an over-protective intermediary. It often takes time to develop a rapport with the other party such that they are prepared to express their underlying interests. It is important to listen closely and to avoid the temptation to interject when you hear something that you like or don't like. A prolonged period of silence can be a powerful negotiating tactic because it can cause discomfort to inexperienced negotiators, thereby compelling them to fill the void by continuing to talk.

The seller should recognize that the sale of their business is a two-way street. They should be asking very specific questions in order to understand the buyer's needs and interests. This includes questions about how the seller's company will fit into the buyer's operations and how the acquisition of the seller's company will help the buyer to meet their long term goals.

Research, Research, Research

The better informed you are, the better your negotiating position. Information is the key. When negotiating a deal, the buyer has the advantage of knowing their key financial drivers, including their cost of capital and synergy expectations. The seller has better self-knowledge, as well as knowing the number and quality of different offers that have been received.

The buyer of a business should seek to understand as much as possible about the seller's company through its due diligence process. This goes beyond the financial results, and down to the root of understanding why historical results were (or were not) achieved. The buyer should also undertake an objective assessment of the strengths and weaknesses of the seller's business and the opportunities and threats that it faces. Where the seller operates in a different industry or different geographic area, then the buyer should also ensure that it has a sound understanding of the relevant risk factors pertaining to that industry or that geography. Where possible, the buyer should obtain data from credible third party sources (such as statistics produced by an industry body) and look for any inconsistencies between that third party information and the seller's representations about its risks and growth prospects.

The buyer should probe the seller about the divestiture process in order to gain insight into its relative

negotiating position. The buyer also should research other transactions that have taken place within the industry in the past several years, to the extent that meaningful information exists. These other transactions can provide important insights into other possible bidders and the seller's price expectations.

The seller should research as much as possible about the buyer. This is easier to do where the buyer is a public company and regulatory filings are available. However, even where the buyer is a private company, the seller might be able to gain some insight into the buyer's strategy through well-conceived questions and researching the Internet.

“The better informed you are, the better your negotiating position.”

In addition, the seller should seek to obtain as much information as possible regarding other transactions the buyer has consummated in recent years, as those other transactions often can

form a reference point in the negotiations.

Finally, the seller should ensure that they understand the buyer's decision-making process. In many cases, the buyer's negotiating representatives will not be the ones who approve the acquisition decision. Rather, those representatives will recommend the acquisition to senior management, the board of directors or an investment committee. The seller needs to know the criteria upon which the acquisition proposal will be assessed, the information that the decision makers require, and the timing of important meetings.

Know Your Alternatives

The relative negotiating position of the buyer and seller is determined by the number and quality of alternatives that they have available to them at a given point in time. An excellent book on negotiation is called *Getting to Yes*, by Roger Fisher and William Ury. *Getting to Yes* talks about a concept called BATNA,

an acronym for the “best alternative to a negotiated agreement”. Simply put, BATNA states that your negotiating strength is dictated by your next best alternative.

For example, if a seller has received three offers for their business, each of which is worth about \$20 million, then the seller has a strong negotiating position. If one buyer walks away, there are still two others competing for the business. However, if the seller has one offer for \$20 million and the next best offer is \$15 million then the seller’s negotiating position is relatively weak.

Both buyers and sellers should fully understand the alternatives that are available to them and objectively assess the pros and cons of each alternative. This is essential in order to make an informed decision as to the best course of action. For the buyer, the alternatives available might include building vs. buying, finding another acquisition target or looking to establish a joint venture rather than an outright acquisition. For the seller, the best alternative might mean selling the company to management rather than a strategic buyer, or continuing to operate the business for a period of time until market conditions improve.

Good negotiating strategy means that it is not sufficient to understand your own alternatives. Rather, the buyer and seller should try to understand the number and quality of alternatives available to the other party through means such as market research and questions about the acquisition or divestiture process, as discussed above. It is the relative negotiating position of the parties that determines negotiating strength.

Maintain Credibility

It is common for both buyers and sellers to do a fair bit of posturing during the course of negotiations. Posturing can be an effective tactic where it is used selectively, and in contrast to the party’s normal negotiating style. However, the buyer and seller must be cautious not to lose their credibility. Once credibility is lost, it is difficult to re-establish, and that party’s relative negotiating position is weakened.

For example, when selling a business, the seller usually presents the buyer with financial projections for their company. It is tempting for the seller to show optimistic

projections, in an effort to get the buyer to pay a higher price. However, the seller must be cognizant that the divestiture process may take several months (or longer). At some point, the buyer may be in a position to compare actual results to a forecast that had been prepared near the beginning of the sale process. If the seller has not met their near term forecast, then their longer term forecast will lose all credibility. The shadow of underachievement can also impair the seller’s credibility in other aspects of the negotiating process.

Buyers sometimes lose credibility because they cannot obtain the financing they need (on satisfactory terms) in order to consummate a transaction. Particularly in today’s more rigid lending environment, buyers must be careful not to over-estimate how much their bank will lend them. If the buyer must turn to the seller in order to compensate for an unanticipated shortfall in financing (e.g. by paying a portion of the purchase price over time), the seller may be in a position to demand a higher price or other concessions from the buyer.

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The Terms of the Deal are as Important as the Price

In most transactions, the negotiations centre on the price that will be paid. However, the terms of the deal are just as important as the stated purchase price. The terms of the deal dictate when, how and even whether the price will be paid. The terms of the deal also influence the amount of tax that is paid by the seller, or tax reduction opportunities for the buyer, which can significantly influence shareholder value.

The seller should be aware that the offer with the highest price may not represent the best deal, particularly if a significant portion of the price is in the form of a promissory note, earn-out or other form of postponed or contingent consideration. The seller must remember that any funds that are not received at the closing of the transaction represent money at risk. The seller must be satisfied that the potential payoff is worth the risk.

Where the buyer is a public company, the seller should be aware that the price and terms the buyer will offer are influenced by its own valuation multiples, and how the transaction will be treated for financial accounting purposes. Public company buyers generally are wary of consummating a transaction that is not accretive to their earnings per share in the near term. The seller

can sometimes use this concept to their advantage, by structuring a deal with greater cash value in exchange for a favourable deal structure for the buyer's financial reporting purposes.

In many cases, the buyer can bridge the seller's price expectations gap with creative deal structuring. For example, rather than buying 100% of the shares, the buyer might purchase a controlling interest (say between 51% and 90%), with the right to acquire the remaining interest at a later date. This can allow the seller to realize their objective in terms of price per share, while reducing the buyer's up-front financing requirements. It also keeps the seller motivated to deliver strong financial results following the transaction in order to maximize the value of the follow-on transaction.

Conclusions

Negotiations play a major role in determining the price and terms of a deal, and whether a deal can even be done. While both buyers and sellers will select the specific negotiating strategies and tactics that are warranted by the situation, each party should always adhere to the underlying principles of negotiation in order to protect and improve their relative negotiating position.

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 7:30 am – Registration & Breakfast
 8:00 am – Presentation
 9:00 am – Interactive Questions & Answer Session
CMA Ontario – Professional Development Institute
 25 York Street, Suite 1100, Toronto, ON

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 7:45 am – Registration & Breakfast
 8:00 am – 10:00 am – Seminar
SBLR, 2345 Yonge Street, Suite 300,
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Chris Nobes, Managing Director of Veracap Corporate Finance will help business owners better understand how to maximize shareholder value in their companies.

Mitch Silverstein, Senior Partner at SBLR LLP Chartered Accountants, will help business owners uncover strategies to potentially save thousands of dollars of corporate and personal tax.

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