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M&A Advisor

FOR EXECUTIVES SEEKING TO BUY, SELL, OR RECAPITALIZE BUSINESSES

What Professional Valuations Don't Tell You

The Myth Of Fair Business Valuation

"In business, you don't get what you deserve, you get what you negotiate". – Chester L. Karrass

So, how can Bear Stearns be worth about $20 billion dollars in January 2007 and be worth only $238M in 16th March 2008 – just 14 months later? And how can it be worth about $1B on within days after JP Morgan announced the $238M deal? What is the fair valuation?

The answer is simple and holds a message that every business owner should be keenly aware of: There is **NO** fair value for illiquid assets.

While the 100:1 valuation swing that Bear Stearns saw within a span of about an year is uncommon for public sector companies, it is not at all uncommon for mid-market businesses. We routinely see business owners who have suffered enormously from dramatic valuation compression due to poor planning and/or picking wrong advisory teams. Let's look at what "fair valuation" of illiquid assets means in the context of mid-market business owners and shareholders who are getting ready to sell or recapitalize their businesses.

Some business intermediaries and financial advisors insist that the seller get a professional valuation before placing the business in the market. Some intermediaries even insist that the business must be marketed at its "fair value" or "appraised value". Professional valuation specialists charge thousands or tens of thousands of dollars to come up with a fancy report that narrows the value of the business to a precise number or a narrow range of values. This type of report is typically tens of pages long and addresses valuation factors such as financials, industry sector, strength of management team, value of the assets, the purpose of the sale, etc. A typical report also uses various valuation methodologies to arrive at a weighted average number that is given out as value of the business.

So, what does it mean to have a "professional valuation report" or a "fair value report"? Does this mean that the seller will know the exact selling price of the business? Not really!

Professional valuations and fair value opinions aim to provide a "fair business valuation" but they are all contingent on multiple assumptions. The valuations are as good as the assumptions upon which they are based. Two of the key factors in valuations – future growth rate and operational synergies – are highly subjective and no two views on these topics are likely to be identical. Unfortunately for business owners, the exact conditions laid out by valuation professionals never occur in real life!

On top of variability in key valuation factors, sale terms such as the type of sale, the payment schedule, consulting clauses, earn-outs, and the reps and warranties can easily cause a 20-40%

swing in what the seller gets to take home. Setting aside sale terms, which are typically not covered by a valuation report, the seller will be lucky if the real sales price comes within 10% to 20% of the professional valuation. In several of our most recent deals, the initial valuation report was off at least 30% from the final sales price.

The reality of business sales process is that the value of a business is determined by the acquirer much more than any other factor. The same business could be viewed completely differently by two different acquirers depending on their strategic needs and their perceptions of future cash flows.

The business sale process also plays a big role. Acquirers tend to pay much more for a deal that they believe is competitive. While negotiating in a recent deal, one buyer, after realizing the seller needed to sell for medical reasons and thinking that there was no competition on the deal, said: “I know I got a price reduction but if I wait long enough wouldn’t the seller have to pretty much give the business away?” Fortunately for the seller, we ran a soft auction and there was another acquirer at the table who ended up consummating the deal per seller’s terms.

From our experience, the type of buyer and the type of sale skew the valuation to such an extent that it is unwise for a business owner to be not familiar with these variables and their impact before the beginning of the sales process. Business owners should be aware that these two factors play a disproportionately large role (see chart) and consequently any “professional valuation” has only limited applicability in the business sale process.

From a deal making perspective, running a competitive bid process and finding the right acquirer for the deal involves broad based search, discipline, substantial amount of negotiating, creative deal making, and people management skills. The competitive bid process tends to be longer and will require more cooperation from the seller but the upside is substantial.

The Bear Stearns deal on March 16th, 2008 was clearly based on "Fire Sale Value". To avoid a fire sale, and to stay in the green zone of valuations, mid-market business owners should plan early, hire a competent M&A advisor who can help plan and orchestrate the sales process, and take every precaution possible to plan their exits. The key messages for business owners looking to sell or recapitalize their businesses are:

- There is no fair value for illiquid assets. It all boils down to what a willing buyer can pay and what the business owner is willing to accept.

- To maximize valuation, working with the right acquirer is extremely important. Picking an M&A advisory team that can sell the value of the business to the right buyer can go a long way in feathering the next egg.

- Be prepared for a drawn out sale process. Competitive bid process, an important tool used by M&A specialists to maximize exit valuation, can take time.

- Plan early and never sell in desperation.

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