

## **Seller and Buyer Perspectives in a Trade Sale**

By  
Dr. Tom McKaskill, FCPA  
Professor of Entrepreneurship  
and  
Stephen Spring MBA (Harvard)  
Instructor and Doctoral Candidate  
Australian Graduate School of entrepreneurship

### **Merger and Acquisition Activity**

Most commercial sectors of the economy have continuous activity in the selling and buying of businesses or business capabilities. Tens of thousands of businesses are bought and sold each month as owners retire, business get into trouble or shareholders are offered an incentive to pass over ownership. Many corporations have an active process of acquisitions as they seek firms to fuel their growth and/or to enable them to acquire new innovations.

Most literature in the area of Mergers and Acquisitions (M&A) has been generated from the acquisition side with little research devoted to the sell side. This has resulted in a one sided approach to the construction of M&A strategies. Over the last two years Dr McKaskill has undertaken extensive research into the strategy that should be used by sellers as they prepare themselves for sale. This research has resulted in the development of the Trade Sale Ready Index and the development of the Proactive Trade Sale Strategy.

This document describes a class exercise where different teams undertake the roles of various parties in an industry where a range of organizations compete to acquire a small firm in the industry. The prospective buyers have the task of evaluating the potential acquisition in terms of their strategy, the impact of the acquisition on themselves and their competitors, the opportunity cost if a competitor is successful in the acquisition and the value that they are willing to pay.

For the seller, the exercise is to determine when and if they wish to sell, which potential buyers they wish to deal with and the arguments that they might put forward to advance their case. They also need to determine what value they would put on the business to make it attractive for them to sell.

Both parties need to evaluate what would happen if they decided not to enter into negotiations. In the case of the seller, this might mean continued growth and profit and a higher value later or it might mean risking the business through increased competition or a management mistake. For the potential buyers, it is possibly an opportunity forgone or perhaps allowing a competitor to acquire the business.

At the start of the exercise both the potential buyers and sellers need to evaluate the Fair Market Value (FMV) of the business for possible sale. The FMV is most often determined by looking at the current business as an investment by an independent investor looking for a

return on their money. The current profit is taken as indicative of the on-going profitability of the firm and a return on investment calculated (ROI). Where a business has clearly identified growth, this may be factored into future profit and taken into account in the FMV. A business that is incurring a loss might be valued on the basis of its net assets or the replacement cost of its assets and capabilities. This could be a make vs. buy type valuation.

Most owner/managers in growth businesses would argue that a conventional FMV would undervalue the business as few owner/managers operate the business to maximise profits. Very often they are incurring excess costs in building out a product line or a distribution channel and are yet to see the fruits of those expenses. This is where a strategic sale has a greater chance of returning to the shareholders a higher value and can recognize the potential in the business. A strategic sale occurs when the value placed on the business exceeds its fair market value.

### **The Seller**

The key to a strategic sale is to find a buyer, let's call this the 'corporation', that has a need for the assets and/or capabilities of the firm. This strategic fit can come from any number of possible areas;

- Customer base
- Distribution channel
- Brands
- Patents, trademarks, licenses
- Key employees
- Access to specialised knowledge; and so on.

Strategic buyers most often come from within the industry in which the firm is operating. They can be suppliers, customers, partners, alliance partners, joint venture partners, competitors or advisors. Sometimes inside parties will offer to buy. These could be managers, shareholders, directors or employees. Sometimes the sale will be to a corporation that is not in the sector. They may want to acquire a presence as a foothold or simply want to diversify their business.

Strategic acquisitions occur because a corporation has a need for some asset or capability that the firm has. Generally this is something that the firm already leverages to create its own competitive position.

As part of the Trade Sale Strategy, the Chief Executive Officer (CEO) of the firm for sale needs to think carefully through the operations of the business and isolate those things that it has and those things that it does that give it a competitive advantage and that it leverages to create revenue.

Competitive assets might be;

- A unique location
- Specialised plant and equipment

- Loyal customer base
- Established brands
- Good distribution system
- Intellectual property

Competitive competencies or capabilities might be;

- Specialised R&D capability
- Ability to bring new products to market quickly
- Engineering capability to control quality

Sustainable assets or capabilities generally have the highest strategic value. They need to be based on one, or several, of the following:

- Difficult or time consuming to copy
- Protected by patents, trademarks or copyright
- Only available through licensing or registration which is limited in supply
- Unknown due to confidentiality or trade secrets
- Require specialist knowledge to acquire or utilise

Once the firm has identified these competitive assets and competitive capabilities, they have identified the key to finding the strategic buyer.

A strategic buyer is a corporation that is prepared to pay a premium over fair market value because the firm solves a critical problem for them or offers them a good opportunity for additional revenue and profit. Thus, in selecting a strategic buyer, the seller is seeking to identify a corporation facing a threat, or one where they can offer them an opportunity which they can execute more easily through acquiring their business.

There are five pillars to securing strategic value:

### **Removing a threat or obstacle**

Typical threats the seller might reduce or remove include:

- Access to technology needed to catch up with a competitor
- Availability of product to match a competitor's offering
- License needed to satisfy new regulations
- Specific expertise to solve a technical or marketing problem
- Access to a distribution channel to replace one lost to a competitor
- Acquiring a customer or supplier that is in financial difficulty whose failure would threaten the current business
- Acquiring a supplier or customer that might be acquired by a competitor thus denying access

## **Make vs. Buy**

It may be cheaper and/or quicker to acquire the assets or capabilities than to build them.

- Limited supply of specialist staff
- Time to develop the capability or asset
- Working capability of people and equipment is already in place limited the risk of completion
- Learning curve required to gain a optimised solution

## **Opportunity Cost of Acquisition by a Competitor**

- What market advantage would a competitor gain if they acquired the firm
- Could the corporation counter the threat

## **Denial**

- A clearly scalable opportunity that is ready to execute may be denied to the potential buyer by the seller How much revenue and profit would be forgone if the seller decided not to sell.

## **Opportunity**

The types of opportunities might be offered to a buyer include:

- Additional products to sell to buyer's existing clients
- Access to the seller's distribution channels or customers to sell buyer's existing products
- Expansion into new markets using the seller's products or capabilities
- Development of new products for the buyer's existing markets using assets and capabilities acquired in the acquisition
- Development of new products for new markets using assets and capabilities acquired through eh acquisition.

For the seller, the best strategic buyers are ones that can exploit an opportunity by scaling a unique product offering on a much larger scale than they are able to with their limited resources. The seller should look for firms that can overcome whatever constraint is holding back their business.

The seller should concentrate on potential buyers that have the experience, capability and willingness to enter into a strategic acquisition. The value in the acquisition to the buyer is enhanced when they have a well defined and highly probably strategy to exploit the acquisition. Where the seller can identify such synergies, they have a much greater chance of securing a premium on the sale.

A key to such a sale is to ensure that there is competitive tension between the potential buyers. The seller should develop a strategy that brings several potential strategic buyers into the bidding process.

## **The Buyer**

From an acquisition point of view the buyer is faced with a number of issues;

- What is controlling the timing of an acquisition bid? It is the seller's timetable or the buyer's?
- What is the revenue and profit of the seller's existing business?
- What value is locked up in the seller that the buyer can release?
- What are the likely constraints on the deal that the seller will be seeking?
- What are the integration costs of the deal? How much time, cost and hassle will be involved in bringing the new acquisition inside the corporate umbrella. Just how integrated does the new business unit need to be with the existing organisation?
- What other potential buyers will be after the same business and how will this effect the negotiations?
- What is the cost to the corporation of not securing the acquisition? How much competitive advantage will accrue to a competitor if the corporation is unsuccessful in winning the bid?
- How will the corporation secure the cooperation of the new staff and retain the key people to ensure that the business opportunities can be secured?
- If the corporation was successful in the bid, what staff are going to have the responsibility for making the acquisition work? Who has the capacity, skill, experience and time to undertake all the work to bring across the new business unit into the culture and systems of the corporation?

Many of the issues facing the acquirer are the same ones that the seller should be addressing. Due diligence is a critical activity for both parties. The risks faced by the seller are also risks faced by the buyer. While the buyer may be able to negotiate warranties and representations, reduce the price paid and impose additional costs on the sellers at the conclusion of the deal, the items are also potential deal breakers or integration risks for the buyer.

Few corporations take into account the level of skill, seniority and time that an acquisition is going to take. They often seem to act as if the acquisition is done once the deal is done. However in practice the work just begins. Systems need to be integrated, people need to move to corporate remuneration and benefits systems, all the reporting and authority systems will change, reward systems will be realigned and so on. The corporation that expects to get a ROI based on continuing financial performance is going to get a shock as people leave, customers reevaluate their relationship with the new entity, competitors attack the customer base and people's productivity wavers as the uncertainties around the acquisition are resolved.

Acquisitions are very influenced by market values. The smart seller notes the acquisition prices within the sector and the public statements of the acquirers as to where they see strategic value. The seller should be using this to solicit higher bids from competing potential acquirers. Thus the corporation needs to be aware of activity in the marketplace and to take this into account in its initial bids.