Bridging Valuation Gaps with Creative Deal Structures

Iliya Zogovich, President & CEO, ONEtoONE Corporate Finance

Toll-free USA 800.380.7652 | Worldwide 408.717.4955

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During M&A transactions, valuation gaps between buyers and sellers are not uncommon; it's why negotiations exist.

Every seller has a number in his head and it's very rare that buyers agree with it. The seller is focused on the potential of the business and all the opportunities that lie ahead, while the buyer needs to think about the downside and mitigate risk. Thus, a gap arises between what the seller expects and what the buyer is willing to pay. But this gap doesn't have to be the end of the relationship. **There are many creative structures that can be employed to bridge valuation gaps, bring parties together and get deals done.**

> **Selling a business is a strategic process that can be thought of in four stages.**

Selling a business is not an event; it's a strategic process that can be thought of in four stages. When done correctly, this process creates value. **Conversely, when the process is not followed, or is pursued hastily, value erodes.** It's important to note that a business should never be run, or started, with the expectation of selling it. There's a difference between preparing for an exit, perhaps as early as the day the company is founded, and starting or running a business with the sole goal of an exit. **Businesses should always be run as if they are going to be run forever.** As a result, the core focus will be on the long-term strategy of the business. This focus will pay off in an eventual exit with maximum valuation. If an exit never materializes, then the owners have a great business to run.

Phase I: Preparation (4-8 weeks)

The value of a business is enhanced when it can generate a very robust and realistic business and financial model that is based on facts. This means having a thorough understanding of the business and its key drivers and constructing a solid equity case. Again, this is something that should be done whether seeking to sell the business or not; it's just good business.

With that solid foundation established, set up a data room that contains everything—financials, corporate governance, product information, customers and competition, marketing, management and personnel, legal etc.—that a buyer would want to see. Create a Confidential Information Memorandum (CIM) which conveys the story of the business including its past, present and future. A CIM is important because buyers aren't always experts in the seller's industry.

The CIM presents a story of the business that someone outside of the industry can understand.

Next, identify the buyer base. Who are the potential buyers of the business and which ones are best suited to provide the best value?

Lastly, create management presentations, if possible, tailored to the specific markets from which you expect to see interest. Keep your vision broad and remain open to different buyer classes and different markets.

Phase II — Marketing (4-8 weeks)

When preparations are complete, it's time to go out into the market. During this phase, it's important to **gain the interest of as many potential buyers as possible. Throughout this process sellers should constantly analyze and evaluate what's working, what's not working, the questions**

being asked, who is most interested and why. This gives the seller two advantages. First, the seller can refine the buyer base and identify more buyers in the markets where they're seeing the most traction and interest. Second, the seller can tailor their communication and management presentations in order to incite more interest.

During this process NDAs may be executed, limited access to the data room granted, CIMS distributed, questions addressed, and indications of interest received.

Phase III — Competitive Process (2-4 weeks)

After as many potential buyers as possible have been brought to the table, it's time to start the competitive process. During this process it's vital to maintain competitive tension but never reveal to a buyer who their competition is or their position. During this phase the management and the executive team have an enormous opportunity to **create additional value by demonstrating how they plan to execute the strategy presented in the CIM and due diligence materials.**

During the competitive process, broader access is granted to the data room, management presentations are given, site visits are hosted and Letters of Intent (LOIs) are received and analyzed.

Phase IV — Final Negotiations & Closing (8-12 weeks)

After LOIs have been received and evaluated, it's time to select one and **begin negotiations of the final terms with the selected buyer**. This can be a long, arduous and sometimes contentious process because, although the LOI put forth an offer, there are still a myriad of details that must be negotiated in order to come to an agreement on the structure of the deal and along the way price adjustments will inevitably occur. **During this process there might be due diligence discoveries, working capital adjustments, reps and warranties negotiations and negotiations regarding employee compensation packages and contracts.**

Finally, when both parties are satisfied with what they are getting and how the deal is structured, the deal closes.

Be the Buyer

The best way for sellers to prepare their business for sale and maximize valuation is to **scrutinize it through the eyes of a buyer**. Ask the difficult questions and remediate issues long before being approached by a buyer.

Commercial Strategy and Growth

- Can you demonstrate a clear strategic direction for your business and support the growth strategy?
- Can you provide evidence of your strengths and weaknesses versus those of your competitors?
- Are your business plans and forecasts sufficiently robust and supported by historical achievements or independent market evaluations? Are they up-to-date and will they withstand detailed scrutiny?
- Are there any expansion plans and are they supported by appropriate resources?

Financial

- Can you demonstrate successful past restructuring and implementations?
- Can you demonstrate

visibility into areas with potential profit improvement and how is that being managed?
- How robust are your assumptions for operational improvement?
- Can you identify and assess potential upsides not reflected in the forecast financial profile?

Structural

- Have you identified key structural process issues—tax structuring, legal structures, risk of tax liabilities or other potential liabilities?
- Do you understand potential separation issues such as stand-alone costs, the cost of shared services and the impact on buying power if separating from a parent group?
- Can you present a robust and fully costed separation plan and timetable?

Operational

- Have you prepared information in a way a buyer would want to see it, such as segmental splits, customer analysis, components of gross margin, seasonality of working capital and availability of KPIs?
- How useful is management information as it is currently generated?
- How consistent is the financial information received from each business unit?

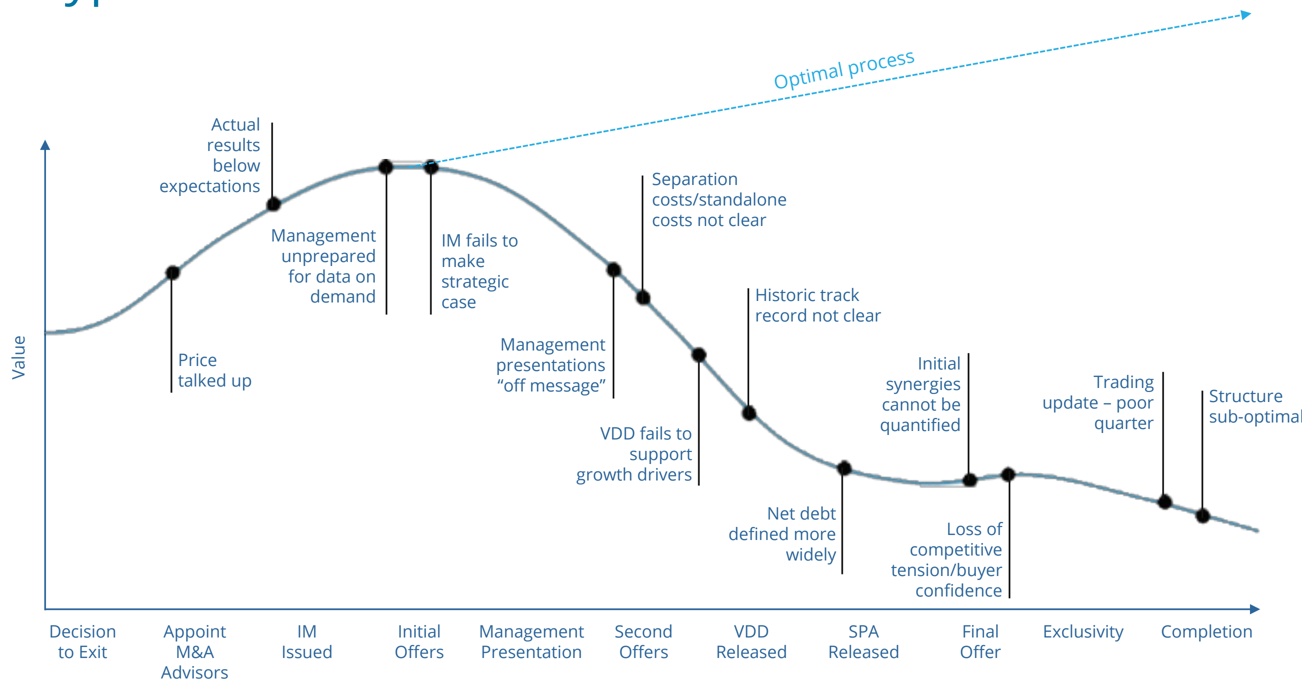
Sell Process

- How will you ensure that all geographic and functional areas are engaged in the process? Is there a plan for who will have visibility and when?
- Will management be able to devote sufficient time to the sell process? Are there sufficient management and finance team resources to achieve the desired timetable while still running the business?
- What external advisors will be utilized for the transaction? Are support documents in place, such as leases, contracts, etc.?

Key Valuation Drivers

NTM / RR Revenue	<3x	3x-5x	5x-7x	>7x
Cumulative Factors:				
Revenue / Backlog Growth	<10%	10-20%	20-30%	>30%
Revenue Composition	License / Services			Subscription / Transactional
% Recurring Revenue	<50%			>90%
EBITDA Margin / Margin Potential	<20%			>40%
Client Concentration	High Concentration			Minimal Concentration
Underlying Client Metric Growth	Weak			Strong
Total Addressable Market	< $1 Billion			$5+ Billion
Qualitative Factors:				
Market Position	< Top 10			Top 3
Market Growth	<5%			>20%
Scarcity Value	Multiple Potential Targets			Single Opportunity
Technology / Data Assets	Commoditized			Differentiated
Management Team	Less Experienced			Strong, Deep
Process Factors:				
Investor Universe	Limited / One Sector			Broad / Multiple Sectors
Market Environment	Poor			Strong
The Right Advisor	Limited Investor Coverage/ Relevant Experience			Broad Coverage / Relevant Experience

Typical Areas of Sell-Side Value Erosion



Business Elements of a Valuation

When a buyer evaluates a business they will look at a range of elements in order to set a value for that asset.

Customers

- **The Customer Base—**Who are your customers and are they financially healthy? Do they have a lot of exposure to economy swings or will they continue to buy your products no matter what the economy is doing? Do they pay on time?
- **Diversification—**Does one customer represent 80% of your total revenue or is revenue spread out among a diverse spectrum of customers?
- **Relationship to the Business—**Who owns the relationship with the customer? Is the customer relationship owned by the sales manager? By the business owner? Or is the customer's relationship with the business itself?

Product

- How is your product different from the competition?

- What stage is the product in in the total lifecycle of the product?
- Is the product scalable?
- What are the current market trends?
- What is the product's potential for expansion?
- Is intellectual property protected?

Market Dynamics

- What is the size of the market or potential size of the market?
- What are the barriers to entry for everyone else?
- What are the current spending trends?
- What are the long-term market trends?

Strategy

- Can you present evidence that your business strategy produces demonstrable results?
- What is your strategy for internal accountability?
- What is your strategy for focusing on financial drivers?
- What is your strategy for leadership?

Financial Drivers

- What is the company's revenue and recurring revenue?
- What is the company's CAGR?
- What is the company's gross margin and trends?
- What is the company's EBITDA and trends?

Structure Components

Cash

There is usually an inverse relationship between cash up front and final transaction value. First, buyers want to mitigate risk and protect their downside. The more cash that is paid upfront translates to more risk for the buyer and less risk for the seller.

The other factor is the time value of money. Receiving $1 million now and $1 million two years from now is not the same as receiving $2 million today.

Equity

When the seller is willing to retain equity in the company or roll over equity into the new company it gives buyers

more confidence that the seller believes in the business and the business plan and can translate into higher transaction values. It also gives the seller the opportunity to profit a second time and essentially have a second bite at the apple.

Seller Note

A seller note is when the seller finances the transaction for the buyer. This is not a common transaction structure because buyers generally have access to better or cheaper sources of capital than what the seller would be willing to provide. However, it could be a useful structure if the buyer has difficulty securing their own financing.

Contingency Payments

Contingency payments, commonly referred to as earnouts, are transaction structures where a portion of the purchase price is paid to the seller upfront and another portion is paid after specified performance milestones are met. Earnouts can be very useful tools for bridging valuation gaps, however, sellers sometimes make the mistake of being overly zealous about what they think the business can achieve and often the means for achieving those milestones is no longer under their control.

Creative Structures

When structuring M&A transactions there is really no template. **When valuation gaps exist and transactions get challenging, there is really no limit to the types of deal structures that can be employed.** These often include consulting agreements where the seller stays on as a business consultant and shares in the profits as the business grows. However, any transaction structure, as long as both parties agree, is fair game to get deals done.

Questions & Answers

Q: What are representations and warranties?

A: In the context of an M&A transaction, a representation is a statement of fact regarding the past, present and future conditions of the firm. A warranty is a promise of indemnity if that statement turns out to be false. If a representation is not true, it is “inaccurate.” If a warranty is not true, it is “breached.”

Reps and warranties are an essential part of M&A transactions because they serve as protection for the buyer. After a transaction is completed, the buyer inherits all the potential deficiencies of the firm. If there is no protection in the contract against those potential deficiencies, then there is no recourse for the buyer.

For example, a seller might provide a representation to the buyer that there are no employee liabilities. If after the deal closes an employee liability is discovered then the seller has to guarantee it and the buyer is protected.

Q: When I sell my business do I get to keep all the cash in the bank?

A: Most M&A deals are negotiated on a cash-free/debt-free basis (CFDF). In simple terms, this means the seller keeps all cash and pays off all debt at the time of the sale of the business. Although this concept seems straightforward, defining the actual CFDF terms can be a contentious point of negotiation and can significantly affect the economics and value of a deal. The CFDF terms will be defined during negotiations and will include a provision for working capital. Working capital is the amount of capital needed to continue to run the business that is left on the balance sheet at the time of sale.

Q: How do you value a company that is pre-revenue but is in an attractive vertical and has a big upside?

A: It’s always interesting when valuing early stage startups without existing revenue. Obviously, valuing a startup is very different than valuing an established company. Quantitative analysis and financial projections don't always predict the future success of the early stage startup, which is why some investors put greater value in the entrepreneur and management team.

Often what we'll do is employ the structure of convertible notes. A convertible note is a form of short-term debt that converts into equity, typically in conjunction with a future financing round. In effect, the investor is loaning money to the startup and instead of a return in the form of principal plus interest, the investor receives equity in the company.

The primary advantage of issuing convertible notes is that it does not force the issuer and investors to determine the value of the company when there really might not be much to base a valuation on—in some cases the company may just be an idea. That valuation will usually be determined during the Series A financing, when there are more data points off of which to base a valuation.

About Iliya Zogovich

**President & CEO,
ONEtoONE Corporate Finance**

Iliya P. Zogovic started his career at an early age when he bought one of the largest Sales and Marketing organizations in Mexico. He restructured the business and then grew it through Latin America using Mergers and Acquisitions until he eventually had a successful exit. He then transitioned to the Financial industry in Mexico and USA. His expertise includes business strategy, corporate restructuring, process engineering and business operations.

He combines this expertise with his knowledge of the financial industry to maximize value in every operation. Iliya has served as CEO of several companies with international operations, and he sits on Boards in different industry sectors in Latin America and USA. Iliya studied Mechanical Engineering in Mexico and is an alum of Harvard Business School.

About ShareVault

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The on-demand platform is an innovative cloud-computing solution that enables its customers to manage critical time-sensitive and document-centric processes faster and more intuitively. ShareVault offers the highest degree of security and reliability combined with unparalleled speed, ease of use and functionality. Backed by the experience of billions of dollars in successful deal transactions, along with industry-leading customer support, ShareVault can be a critical tool in accelerating deal transaction times and increasing deal success rates.

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