

M&A Transaction Values

VALUE DRIVERS FOR GAWDA DISTRIBUTORS

By **Brian T. Deveaux**, Leaders LLC

Based on the positive feedback from my presentation at the GAWDA Convention in San Francisco, we thought it might be helpful to provide a recap of the presentation for the readers of *CryoGas International* who were not able to attend. The title of my presentation was, “M&A Transaction Values — Value Drivers for GAWDA Distributors” and while it focused primarily on the traditional GAWDA distributor, many of the topics addressed are pertinent to any reader of *CGI*.

To begin, I provided an overview of Part III of my recent three article series titled, “The Metrics of Mergers & Acquisitions”, which focused on the Supply Side, Demand Side and Market factors driving the brisk M&A activity in the current market (see *CGI July 2007*). The bulk of the presentation, however, focused on the factors driving M&A transaction values.

Similar to the factors that drive M&A activity, the factors that drive M&A transaction values can also be categorized into Supply Side, Demand Side and Market factors; however, when it comes to the drivers of transaction values, a fourth category must be included — Process factors. In making this transition from drivers of M&A activity to drivers of value, I switch from a macro level view to a micro level view. In other words, I transition from focusing on factors that drive M&A activity in general, to factors that drive transaction values for specific companies.

DRIVING FACTORS OF M&A TRANSACTION VALUES

Like most investments, the price that someone is willing to pay for a business is driven by the expected level of return, weighed against the perceived risk of the investment. For GAWDA member companies, the expected return is most often measured by post-synergy cash flow (EBITDA), and the risk factor is reflected by the purchase multiple that a buyer is willing to pay. In other words:

$$\text{Purchase Price} = \text{Post-Synergy EBITDA} \times \text{Risk Weighted Purchase Multiple}$$

Therefore, when discussing the factors that influence transaction values (i.e. purchase price), they are best understood in terms of how they influence either the expected post-synergy cash flow or the perceived risk.

Supply Side Factors — Supply-Side factors that influence transaction values can be divided into the economic and non-economic attributes of the business being sold, with the economic factors influencing the cash flow, and the non-economic factors influencing the perceived risk.

Clearly the most influential economic factor is the current cash flow (EBITDA) generated by the business since it will serve as the basis for each buyer determining what their post-synergy cash flow will be. For many private businesses, the financial statements reported



for tax purposes are not necessarily an accurate representation of the true performance of the business. For example, salaries may need to be “normalized,” property rents adjusted, and various other adjustments may be required to present a more accurate picture of the true cash flow of the business.

With regard to the non-economic (risk) attributes of the business, there are a number of factors that will be considered by most buyers. Among the more important being:

- **Management** — The strength of the management team can be a critical factor in weighing the potential risk of any acquisition, particularly in cases where the selling business owner is seeking to retire. These second tier managers are often the conduit of information from the acquiring company to employees, customers and vendors. They are a key component of the post-acquisition integration plan and can have a major impact on whether the post-synergy savings that the buyer is expecting are actually realized.
- **Contracts** — The breadth and quality of the contracts in place with employees, customers and vendors can play a major role in reducing or increasing the perceived risk of an acquisition to a prospective buyer. For example, if key sales people do not have employment contracts with enforceable non-compete clauses, the reliability of the revenue stream post-acquisition may be brought into question should one of the sales people leave. On the other hand, if a significant number of the more important customers are secured by long-term contracts this risk can be mitigated.
- **Financial Reporting & Controls** — The credibility of the financial reports generated by the company are paramount. Internal financial statements should be well organized and presented in a manner that is consistent with industry practices. Anomalies from year to year should be explained in a proactive manner, and any adjustments to the internal statements should be credible and supportable. Ideally, the financial statements are audited by a Certified Public Accountant to provide an additional level of independence.

Demand Side Factors — One of the basic principles of economics is that the higher the demand is for a certain item, the higher its price should be. This is particularly true when an item is in limited or finite supply. Since each business is unique, it is certainly in finite supply. Therefore, the more demand there is for a particular business, the higher the price should be, all other things equal.

Demand for businesses typically comes from one of four types of buyers: 1.) Strategic Buyers — Operating companies in similar or related industries; 2.) Financial Buyers — Private Equity Groups, holding companies, or individual investors; 3.) Management — a manager or group of managers interested in acquiring the company, or certain assets of the company; and 4.) Individual Owner-Operators — individuals that intend to buy and run the business on a day-to-day basis.

Each of the buyers within these categories will evaluate the acquisition differently based on their assessment of the expected return and

the perceived risk of the investment. For businesses operating within our industry, it often comes down to which company has the most potential synergy, how much of the synergy they are willing to pay for, and how concerned they are that someone else might acquire the business. Table 1 illustrates the effect that synergy can have when comparing how two businesses might evaluate the same acquisition target with two different sets of assumptions regarding synergy.

Market Factors — When we speak with business owners about

the timing of their exit, we are often told they plan to sell the business at a certain age or on a certain date, seemingly without regard to the expected market conditions at that time. Our advice in this regard is simple — always be prepared to sell and to do it when the market is right.

In addition to the general economic outlook for the industry, two market factors that can influence M&A transaction values are interest rates and the availability of capital. Scenario 1 in Table 2 illustrates a simple return analysis from a hypothetical acquisition. Scenarios 2 and 3 illustrate how changes in the availability and “cost” of borrowed money can influence that return. Alternatively, Scenario 4 illustrates how these changes might allow a buyer to pay a higher purchase multiple yet still achieve the rate of return in Scenario 1, where borrowed money is more expensive and less readily available.

Another significant Market factor is taxes. As we heard from Dick Morris during the convention, he believes the tax structure after the 2008 election will be significantly different than it is today. The changes he expects could have a significant impact on the after-tax proceeds from the sale of a business, particularly a C-Corporation with heavily depreciated assets. The example in Table 3 illustrates how an increase in the top federal income tax bracket, along with a reverting of the dividend tax back to ordinary income tax rates, could impact the after-tax proceeds in a hypothetical, but very relevant transaction.

TABLE 1

Assumptions		Low-Synergy		High-Synergy			
	Projected Sales Loss		5.0%		0.0%		
	COGS Purchase discounts		3.0%		5.0%		
	Branches consolidated		0		2		
	Headcount Reduction		5.0%		15.0%		
Income Statement		Pre-Synergy		Low-Synergy		High-Synergy	
Total Sales		\$10,000,000		\$9,500,000		\$10,000,000	
Total COGS		\$5,000,000	50%	\$4,607,500	49%	\$4,750,000	48%
Gross Profit		\$5,000,000	50%	\$4,892,500	52%	\$5,250,000	53%
Expenses							
Total Payroll Expense		\$2,500,000	28%	\$2,375,000	25%	\$2,125,000	21%
Total Occupancy Expense		\$500,000	5%	\$500,000	5%	\$250,000	3%
Total Other Expense		\$1,000,000	15%	\$950,000	10%	\$850,000	9%
Total Operating Expenses		\$4,000,000	40%	\$3,825,000	40%	\$3,225,000	32%
Operating Profit		\$1,000,000	10%	\$1,067,500	11%	\$2,025,000	20%
EBITDA Calculation							
Operating Profit		\$1,000,000	10%	\$1,067,500	11%	\$2,025,000	20%
Depreciation & Amortization		\$300,000	3%	\$300,000	3%	\$300,000	3%
EBITDA		\$1,300,000	13%	\$1,367,500	14%	\$2,325,000	23%
	Post-Synergy Multiple		5.0		5.0		
	Purchase Price		\$6,837,500		\$11,625,000		
	Pre-Synergy EBITDA Multiple		5.3		8.9		
	Pre-Synergy Revenue Multiple		0.68		1.16		

Process Factors — As critically important as the Supply Side, Demand Side and Market Factors are in establishing the potential value of a business in a transaction, the manner in which the process is planned for and conducted will ultimately determine if that potential value is realized. In discussing the so-called Process factors, I segregated them into three phases: 1.) Pre-Sale Planning; 2.) Pre-Market Preparation; and 3.) Market to Closing.

• **Pre-Sale Planning** — involves actions that I recommend every busy owner take, whether

they are considering an exit in one month or twenty years. First and foremost, know the value of your company and what factors influence that value. Take actions that will consistently build the value of your business over time. Keep your physical and financial “house” in order by cleaning up your facilities and your balance sheet on a regular basis. By instituting these practices you will always be ready for a sale and can take decisive action whenever the time is right.

TABLE 2

	Scenario 1	Scenario 2	Scenario 3	Scenario 4
Post-Synergy EBITDA	\$1,500,000	\$1,500,000	\$1,500,000	\$1,500,000
Purchase Multiple	5.0	5.0	5.0	5.7
Purchase Price	\$7,500,000	\$7,500,000	\$7,500,000	\$8,490,000
Senior Debt Multiple	2	3	3	3
Amount Borrowed	\$3,000,000	\$4,500,000	\$4,500,000	\$4,500,000
Equity Required	\$4,500,000	\$3,000,000	\$3,000,000	\$3,990,000
Interest on Debt	8.5%	8.5%	7.5%	7.5%
Post-Synergy EBITDA	\$1,500,000	\$1,500,000	\$1,500,000	\$1,500,000
Interest Expense	-\$255,000	-\$382,500	-\$337,500	-\$337,500
CapEx	-\$500,000	-\$500,000	-\$500,000	-\$500,000
Pre-Tax Cash Flow	\$745,000	\$617,500	\$662,500	\$662,500
Pre-Tax Cash Return on Equity	16.6%	20.6%	22.1%	16.6%

• **Pre-Market Preparation** — is the time frame after which you have decided to sell, but before prospective buyers have been contacted. This is the time to assemble your team of advisors, plan to the process, and determine who will lead the team throughout the process. We recommend that the team leader not be the same person who is running the business. If you try to simultaneously run your business and sell a business, one of the two (or both) will suffer.

Actions taken during this time frame include: identifying prospective buyers; qualifying the buyers’ interest level and financial capability; preparing the sale materials and correspondence; anticipating questions and preparing responses; and installing systems to track critical information throughout the process.

• **Market to Closing** — To increase the likelihood of successfully completing a transaction while preserving confidentiality, the time

that the company is “on the market” should be as short as possible. This requires that the planning steps discussed previously be thoroughly completed; that a dedicated “project manager” be available to address questions from multiple buyers with rapid turnaround; and that decisions be made in a rational, unemotional way. In short, it requires that momentum be maintained throughout the process.

By following this structured approach, with the right team of advisors, you will not only increase the likelihood of maintaining confidentiality, you will increase the likelihood of successfully completing a transaction, and in most cases will increase the net financial result of the transaction.

CONCLUSION

In concluding, I left the audience with the following thoughts:

- **Consolidation in the industry will continue:** Whether you think this is good or not is up to you; however, you must acknowledge it and understand how it affects your business and its value.
- **Cash flow (EBITDA) will continue to be the top value driver:** grow profitably; improve/sustain margins through pricing discipline; and control expenses.
- **Minimize the perceived risks for potential buyers:** Build your

TABLE 3

Proceeds Analysis	C-Corp.	C-Corp.
	Asset Sale	Asset Sale
Purchase Price	5,000,000	5,000,000
Corporate Tax		
Basis in Assets	2,500,000	2,500,000
Corporate Gain	2,500,000	2,500,000
Corporate Tax Rate	35%	40%
Corporate Tax	(875,000)	(1,000,000)
Flow Through to Shareholders		
Purchase Price	5,000,000	5,000,000
less Corporate Liabilities	(1,500,000)	(1,500,000)
less Corporate Tax	(875,000)	(1,000,000)
Dividend to Shareholders	2,625,000	2,500,000
Shareholder Taxes		
Dividend to Shareholders	2,625,000	2,500,000
Dividend Tax Rate	15%	40%
Shareholder Taxes	(393,750)	(1,000,000)
Net After-Tax to Shareholders	2,231,250	1,500,000

management team; review your contracts; and keep your “house” in order (physically and financially).

- **Don’t arbitrarily plan for the sale of your business at a given date or age:** Always be ready and do it when the market is right.
- **Don’t try to do it alone:** The process of selling a business can be complex, emotional, and time consuming. If you try to simultaneously run your business and sell your business, one of the two (or both) will suffer.
- **Every business and every transaction is unique:** Don’t worry about what you heard “the other guy” got. Chances are it isn’t true, and chances are even greater that it is not an apples-to-apples comparison to your situation.

It was truly a pleasure to have had the opportunity to speak to such a distinguished audience of business owners and executives. I hope that I was able to impart a few words of wisdom to those of you who were in attendance and to those of you who have taken the time to read through this summary.

Brian Deveaux can be reached at +1-207-773-2200 or BDeveaux@Leaders-LLC.com □

WHAT EVER YOUR NEED ...WE'VE GOT IT COVERED!

Whether for pediatric oxygen, medical air or traditional oxygen, you can rely on a TOTE™ portable system from Western.

For simplicity, for cost-effectiveness, for safety: A Western TOTE system has you covered.

WESTERN ENTERPRISES

800.783.7890
www.westernenterprises.com

©2007 Western, Scott Fetzer Co., Westlake, OH 44145
OxyTOTE, PediaTOTE and AirTOTE are trademarks of Western