The Metrics of Mergers & Acquisitions

PART II

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In Part I of The Metrics of Mergers & Acquisitions series (see *CGI* March 2007) I defined some commonly used mergers and acquisitions (M&A) terminology; highlighted some of the factors that are driving today's active M&A market; and discussed some of the factors that drive the M&A metrics involving public company transactions. In Part II, I focus on some of the factors that we see driving private company transaction metrics, and illustrate why the determination of what constitutes a good multiple is ultimately in the eyes of the "beholder" (i.e. buyer or seller). In the final installment of this series, I will drill down further into some of the specific factors we see affecting the current market for mergers and acquisitions within the gases and welding distributor base.

PRIVATE COMPANY TRANSACTIONS

As highlighted in Part I, even with the readily available "transparent" information regarding public company transactions, it is often difficult to understand or draw any meaningful conclusions from the metrics of these transactions. When you factor in the limited availability of, and non-transparent nature of private company financial statements and transaction information, it becomes that much more difficult to make sense out of the metrics involving private company transactions. While most of the fundamental drivers of public company transactions apply to private company transactions, there are several other factors that play a more important role in private company transactions. A few of the key factors are discussed below:

TAXES, TAXES, TAXES

At the end of the day, what should matter most to an owner selling a business is the after-tax proceeds that are generated by the transaction and this does not always equate to the highest price. The structure and terms of the transaction can have a major impact on the total amount of taxes that must be paid. Unlike most public company transactions, which typically involve the purchase of the company's stock, private company transactions are often structured as a purchase of assets. Depending upon the legal structure of the business being acquired (C-Corporation, S-Corporation, Limited Liability Company, etc.), the nature of the assets being acquired (working capital assets, fixed assets, goodwill), and the value of the assets in relation to their tax basis, the tax consequences to both seller and buyer can vary dramatically based on the specific terms of the transaction.

For example, Figure 1 compares the estimated after-tax proceeds of two private company sale transactions involving similar C-Corporations. The two companies have the same financials statements (shown in the left hand column) and are sold at the same purchase price, but with one being completed as a purchase of assets and the other as a purchase of stock.

As you can see, the after-tax proceeds to the shareholders in the two scenarios are dramatically different. In scenario B, since the assets are being acquired from a C-Corporation, the Corporation must pay taxes on the amount of taxable gain that is generated by the sale of these assets. The amount of the taxable gain is based on the difference between the purchase price paid for the assets and the tax basis of those assets. Since the full amount of the gain is taxed as ordinary income to the Corporation, the combined state and federal income tax rate can be as much as 40 percent or higher (depending upon the state in which the tax is to be paid). Furthermore, to get the remaining cash out of the corporation and into the hands of the shareholders, a dividend must be paid, which triggers an additional tax at the shareholder level (as much as 20 percent or more).

COMPARISON OF STOCK SALE WITH ASSET SALE
For a Company with Revenues for $6 million and Assets of 2.5 million

Financial Statements

Income Statement		Balance Sheet	
Revenue	6,000,000	*Assets*	
		AR	1,000,000
COGS	3,000,000	Inventory	500,000
Gross Profit	3,000,000	Fixed Assets	4,000,000
		Accum. Depr.	(3,000,000)
Expenses	2,500,000	Net Fixed Assets	1,000,000
Operating Income	500,000	Total Assets	2,500,000
		Liabilities & Equity	
Adjusted EBITDA	850,000	Current Liabilities	500,000
		Long-Term Debt	1,000,000
Purchase Multiple	5.88	Stockholder Equity	1,000,000
Purchase Price	5,000,000	Total Liab. & Equity	2,500,000

Proceeds Analysis	Scenario A Stock Sale	Scenario B Asset Sale
Purchase Price	5,000,000	5,000,000
Corporate Tax		
Basis in Assets	NA	2,500,000
Corporate Gain	NA	2,500,000
Corporate Tax*	NA	(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		(1,000,000)
Net Pre-Tax to Shareholders	3,500,000	2,500,000
Shareholder Taxes		
Net Pre-Tax to Shareholders	3,500,000	2,500,000
minus Basis in Stock	(1,000,000)	NA
Taxable Gain/Dividend	2,500,000	2,500,000
Shareholder Taxes**	(500,000)	(500,000)
After-Tax to Shareholders		
Net Pre-Tax to Shareholders	3,500,000	2,500,000
Shareholder Taxes**	(500,000)	(500,000)
After-Tax to Shareholders	3,000,000	2,000,000

* Assumes combined Federal & State Income Tax rate of 40%
** Assumes combined Federal & State Capital Gain/Dividend rate of 20%

Figure 1

Source: Leaders LLC

SCENARIO A — SALE OF STOCK FOR $5 MILLION
Compares with Sale of Assets for $7.1 Million
For Same After Tax Proceeds of $3 Million

Proceeds Analysis	Scenario A Stock Sale		Equivalent Asset Purchase to get Same Proceeds
Purchase Price	5,000,000		7,083,334
Corporate Tax			
Basis in Assets	NA		2,500,000
Corporate Gain	NA		4,583,334
Corporate Tax*	NA		(1,833,334)
Flow Through to Shareholders			
Purchase Price	5,000,000		7,083,334
less corporate liabilities	(1,500,000)		(1,500,000)
less Corporate Tax			(1,833,334)
Net Pre-Tax to Shareholders	3,500,000		3,750,000
Shareholder Taxes			
Net Pre-Tax to Shareholders	3,500,000		3,750,000
minus Basis in Stock	(1,000,000)		NA
Taxable Gain/Dividend	2,500,000		3,750,000
Shareholder Taxes**	(500,000)		(750,000)
After-Tax to Shareholders			
Net Pre-Tax to Shareholders	3,500,000		3,750,000
Shareholder Taxes**	(500,000)		(750,000)
After-Tax to Shareholders	3,000,000	=	3,000,000
EBITDA Multiple	5.88		8.33
Revenue Multiple	0.83		1.18

* Assumes combined Federal & State Income Tax rate of 40%
** Assumes combined Federal & State Capital Gain/Dividend rate of 20%

Figure 2 Source: Leaders LLC

SCENARIO B — SALE OF ASSETS FOR $5 MILLION
Compares with Sale of Stock for $4.25 Million
For Same After Tax Proceeds of $2 Million

Proceeds Analysis	Scenario B Asset Sale		Equivalent Stock Purchase to get Same Proceeds
Purchase Price	5,000,000		4,250,000
Corporate Tax			
Basis in Assets	2,500,000		NA
Corporate Gain	2,500,000		NA
Corporate Tax*	(1,000,000)		NA
Flow Through to Shareholders			
Purchase Price	5,000,000		4,250,000
less corporate liabilities	(1,500,000)		(1,500,000)
less Corporate Tax	(1,000,000)		
Net Pre-Tax to Shareholders	2,500,000		2,750,000
Shareholder Taxes			
Net Pre-Tax to Shareholders	2,500,000		2,750,000
minus Basis in Stock	NA		(1,000,000)
Taxable Gain/Dividend	2,500,000		3,750,000
Shareholder Taxes**	(500,000)		(750,000)
After-Tax to Shareholders			
Net Pre-Tax to Shareholders	2,500,000		2,750,000
Shareholder Taxes**	(500,000)		(750,000)
After-Tax to Shareholders	2,000,000	=	2,000,000
EBITDA Multiple	5.88		5.00
Revenue Multiple	0.83		0.71

* Assumes combined Federal & State Income Tax rate of 40%
** Assumes combined Federal & State Capital Gain/Dividend rate of 20%

Figure 3 Source: Leaders LLC

Contrast this with Scenario A, where the stock of the Corporation is purchased directly from the shareholders. In this case, there is only one layer of tax, and the full amount of the taxable gain is typically taxed at capital gain rates. As you can see, the difference in after-tax proceeds can be quite significant.

While this may seem like an extreme example, consider the fact that surveys of GAWDA distributor members routinely show that close to 50 percent are C-Corporations, and we all know that market value of cylinder assets in relation to their depreciated book value is significantly higher. Considering these two factors, it's not such an extreme example after all.

Taking this example a step further, we calculated the equivalent price that a buyer would have to pay for the assets, to generate the same after-tax proceeds as would be generated by the $5,000,000 stock purchase in Scenario A. This Analysis is shown in Figure 2.

Alternatively, Figure 3 illustrates the equivalent price that a buyer would have to pay for the stock of the Corporation to generate the same after-tax proceeds as would be generated in the $5,000,000 asset purchase in Scenario B. As you can see, the metrics (in this case, EBITDA and Revenue purchase multiples) of each of these transactions look quite different, yet they can be traced back to companies with identical financial statements.

Your proposed solution to this might simply be, "I'll just sell my stock then!" Unfortunately, it's not quite that simple. From a buyer's perspective, there are typically two primary objections to acquiring the stock of a privately held company - one financial and one legal.

The financial impact of buying stock versus assets is that the buyer does not get to increase (Step Up) the tax basis in the assets from the current tax basis to the current fair market value. This means that the amount of future depreciation they can take against these depreciable assets is limited to the current tax basis and thus the buyer's taxable income in future years will be higher. Using our example, let's assume that the fair market value of the fixed assets was $3,000,000 (compared to a current basis of $1,000,000). By foregoing this $2,000,000 of future depreciation, the financial impact to the buyer could be as much as $800,000 ($2,000,000 @40 percent combined tax rate). While there are other factors that mitigate this (the $2,000,000 would ultimately be allocated to goodwill and would be amortized over 15 years, as opposed to being depreciated over 5 to 7 years) it illustrates the financial conflict between buyer and seller when deciding on a purchase of stock versus a purchase of assets.

The legal objection that buyers often have to buying stock relates to the fact that they are, in essence, "stepping into the shoes" of all the prior owner(s) of that stock, and the potential liabilities thereof. While this can also be mitigated somewhat through representations, warranties and indemnities, it nonetheless creates an additional potential conflict between buyer and seller.

FAMILY MATTERS

Another factor that often impacts the metrics of private company transactions is family related matters. It is not uncommon in second and third generation businesses for there to be several generations involved in the business simultaneously. In many cases, the members of the younger generation are not ready to take over management of the business and do not own any of the company. The way this sometimes manifests itself in the transaction metrics is that the senior generation owners agree to a lower purchase price for their shares, in exchange for employment or consulting agreements for the younger generation that are above "market rates" for the services that they will actually render. Since the value of these employment contracts is not considered part of the purchase price, the metrics of these transactions might not look as good as other comparable transactions, but they meet the goals of the sellers (and the seller's families).

SO WHAT DO THE M&A METRICS INVOLVING PRIVATE COMPANY TRANSACTIONS TELL US?

Without knowing all the details … not much! Even if we knew the actual metrics of all private company transactions, it would still be difficult to draw any conclusions about what a "good" multiple is for any business. The reality is that much of what we do hear regarding private company transactions is by word of mouth, and depending upon whose mouth it is coming from, the reported metrics for a single transaction can be dramatically different.

For Example #1 — Assume you are a business owner whose privately owned S-Corporation is generating $3.5M in Adjusted EBITDA on $10M in sales. You have an asset base that is arguably worth as much as $12M dollars, and your future is projected to be strong. Would you, as the owner of this business, sell it for 5 times Adjusted EBITDA? In today's market, most people would say, "No Way".

What you would not know, however, based solely on this metric, is that this purchase price was for the stock of the Company - a company whose assets were heavily depreciated, and would have triggered a significant tax liability had the assets been sold by the company. In this case, a purchase price for the stock of the company based on 5 times Adjusted EBITDA, generated higher after-tax proceeds for the owner than 7 times Adjusted EBITDA would have in an asset purchase. So, was a 5 times multiple a "good" one for the owner of this business? I'd say yes. Having said that, if the buyer and seller of this business were at the same cocktail party on opposite sides of the room, you would likely hear one of them say, "We just bought Charlie's company for 5 times EBITDA, what a deal", while on the other side of the room, Charlie would be bragging, "I got more than 7 times EBITDA for my business". Who's right? Who cares! It worked for both buyer and seller.

The reality is that much of what we do hear regarding private company transactions is by word of mouth, and depending upon whose mouth it is coming from, the reported metrics for a single transaction can be dramatically different.

For Example #2 —Would you, as an owner seeking to grow through acquisitions, buy a company for 10 times its historic Adjusted EBITDA? Again, your initial reaction would probably be, "No Way". But without knowing the synergistic savings that would be generated by the acquisition, the honest answer should be, "I might".

As a general matter, distribution related businesses lend themselves to high-synergy transactions. I would argue that the synergy potential for gases and welding distributors can be even higher. While we use the term "distributor" to describe many of the companies operating within the industry, the reality is that most of these companies, in addition to running a distribution business, also operate production facilities, retail branches, and have field service operations. As such, the opportunity to gain synergies from acquisitions comes not only through distribution efficiencies, but also from production efficiencies, service efficiencies, and through consolidation of previously competitive retail locations. In many cases, these combined synergies can drive what looks like a high pre-synergy multiple of 10 (or more), down to a post-synergy multiple that is much more reasonable and generates an appropriate return on investment for the buyer.

For Example #3 — Would you, as a seller, expect that a financial buyer (i.e. one that has no synergy) would pay 9 times EBITDA for your business? Most sellers would think not, and would likely exclude financial buyers from their prospective buyer pool. This would be a mistake. For businesses that are growing and are poised to capture an increased market share if they have the capital to grow, financial buyers will often pay aggressive multiples, especially if the existing owners have a desire to stay involved. In this case, the business was increasing its Revenue and EBITDA by about 35 percent annually, so what looked like a 9+ multiple of the *prior* year's historical EBITDA, translated into a 6 times multiple for the *following* year's projected EBITDA.

This may lead you to question why the seller of this business would accept a 6 times multiple given that the business was growing so rapidly. As we all know, the factor that most often limits the ability of companies to grow in our industry is access to capital. Whether it is working capital to fund inventory or accounts receivable, or capital to purchase the assets necessary to support growth such as cylinders and vehicles, access to capital at critical stages in a company's development can often significantly impact its future. The owners of this business recognized that they were at such a point in their company's history. By completing a transaction with a well capitalized financial buyer, they not only secured the capital needed to continue to fuel the growth of the business, but also "took a few chips off the table" by cashing out some of their equity, while retaining an economic interest in the future of the company through an ongoing ownership stake in the company.

Individually, the metrics of each of these transactions are quite varied. Collectively these (and other transactions) would generate averages or medians that some people would argue are indicative of the metrics of private M&A transactions. I'd argue that to the owner of any particular business, they don't mean a thing. Each company, each family, each circumstance, and therefore each transaction is different. What matters most to each business owner is the metrics of their transaction, not the average of all others.

In the final installment of this series, I will drill down into some of the specific factors that we see affecting the current market for mergers and acquisitions within the gases and welding distributor base, and how these factors affect the metrics of transactions in this segment of the industry.

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