TECHNOLOGY ACQUISITION UPDATE

Auction vs. Negotiated Sale

When the time comes to sell a company, which method produces the optimal results—an auction or a negotiated sale? Which method is most appropriate? The most timely? What are the pros and cons of each approach?

The auction method is most effective for transactions in which the value is based on the company's financial performance such as operating income. The negotiated sale is most effective for transactions in which the value is based on strategic assets such as a unique technology or market position. The negotiated sale also works best for smaller deals, less than $30 million.

One drawback with an auction is that the highest bidder only has to pay a small amount more than the second-highest bid. This may not result in the optimal price for the seller. The buyer might actually be willing to pay significantly more.

What about the case when there is only one buyer? Or, when one buyer is clearly a much better buyer than the others? Which method is best? It is difficult to run an effective auction with only one or two buyers; the negotiated sale is a more effective method in this situation.

The Auction Method

In the auction process the investment bank provides descriptive information to probable buyers and asks for indications of interest and preliminary valuations. Offers are due by a specific date. From these offers the investment bank selects the handful of buyers with the best value ranges and the highest likelihood of completing a transaction. Those companies proceed with due diligence in order to make final offers.

These buyers are invited to enter the second round of bidding. They visit the company, meet with management, and are then asked to make a final bid according to a letter outlining the bidding procedures. A sample purchase agreement is included with the letter and any changes to the purchase agreement are considered in the context of the bid. In other words, if a buyer wants to change the purchase terms, it will affect the attractiveness of its bid.

The seller selects the best buyer, the parties sign the purchase agreement and the closing occurs within a month or two. An auction process typically takes between four and five months to complete.

The Negotiated Sale

In a negotiated sale, the investment banker positions the company, researches the market, contacts potential buyers, and provides information to the buyers. The buyers usually request additional information and meet with management. The investment banker then proceeds to negotiate the price and terms with each buyer. He negotiates as if each buyer were the only buyer. It is important to get offers from several buyers to keep the process competitive. It is also important to receive these offers at about the same point in time. (This can take some skill on the part of the investment banker.) The negotiator goes back and forth between the buyers and endeavors to get each buyer to put forth their very best offer.

This process offers more flexibility than an auction. The seller can bend to the time constraints and resource limitations of a particular buyer. Typically there will be two or three, or at most five firms, who will respond with a high degree of interest. The reason is that most companies are truly strategic only to a handful of potential buyers. The universe of buyers is small, although it does take a significant effort to identify these companies. Some may be from outside the primary market and are using the acquisition for market entry.

The Auction—Pros and Cons

Most financially-valued transactions utilize the auction method. A financially-valued transaction is one in which the value is a function of a company's net profits or operating income (EBITDA). The auction process works well for large companies and for medium-sized firms with operating earnings greater than $3 million. In these transactions buyers are large companies that have dedicated acquisition teams and the resources to respond to the strict auction timelines.

One of the most positive aspects of the auction method is that it can get a transaction closed in a relatively quick time line, approximately four or five months. This may be an important consideration for many companies.

With auctions, price is the primary consideration. If terms are important, a negotiated sale may be more effective. For example, the management team may prefer to work for one buyer rather than with another. In a negotiated transaction, it is easier to consider a diversity of terms for each buyer.

As noted above, auction theory maintains that the second highest bid plus a slight premium will win the auction. This is okay if the top two bids are close, but if the selling company is worth significantly more to the top bidder, they are getting a bargain and the seller is not obtaining the best price. In other words, the winner only has to beat the number two bid by only a small amount.

The auction process can turn off some buyers. An auction often makes buyers jump through hoops and buyers may feel that they are in danger of overpaying. It is not a perfect process; however, it can get a transaction completed in a reasonable time frame.

For strategic transactions, the auction process is probably not the best sale approach. A buyer cannot make a realistic preliminary offer for a strategic acquisition. Unless the buyer is already quite familiar with the seller, there is no way the buyer can assess the strategic value without an in-depth evaluation of the target. Secondly, the buyers for transactions under $30 million are smaller and midsized companies that do not have M&A teams or devoted resources to respond to the time strictures of an auction.

Negotiated Sale—Pros and Cons

The key to negotiating the sale of a company with strategic value is to clearly understand how each buyer perceives the value of the strategic assets. One buyer may desire the seller's innovative technology. Another buyer may desire the seller's unique market position. A third buyer may desire the seller's customer base. It is critical to understand how each buyer views the strategic assets as well as how they value those assets.

In most strategic transaction there are only a few buyers and the range of value can be significant. For example, in the acquisition of a small software company the strategic value may be $3 million to one buyer, $4 million to another buyer and $9 million to a third buyer.

The best buyers for a small firm with strategic value are not usually the big companies. A small acquisition of $5 million or $15 million will be much more important to a smaller buyer, one with revenues between $25 million and $175 million. However, these smaller firms are rarely experienced acquirers. They may be deterred by the auction process. The negotiated sale also works well when there is a diversity of buyers, perhaps a couple of large firms as well as a few small buyers.

What about the case in which there is only one buyer? I have actually negotiated a number of transactions in which there was only one buyer. The buyer does not know that there are no other buyers. I negotiate these transactions from an assumed position of strength. Understanding how the buyer can utilize the seller’s key technology is essential to negotiating the best price in these cases.

The negotiated sale requires more work than an auction. There may be protracted negotiations with several parties. It takes effort to remember the nuances of how each buyer judges the key assets or technology. In addition, a negotiated sale may take a longer period of time, perhaps six or seven months. I have closed a few sales in record time (three to four months), but in these cases speed was more important than price. A negotiated sale will generally take two months longer than the auction process.

A Few Points on Negotiating

Negotiating the sale of a company with strategic value is essentially a high-stakes poker game. There is no concrete rationale for value. Value depends on the strategic importance to a particular buyer. Perception is more important than analysis. Perceiving value is accomplished by thoughtful and judicious questioning throughout the sale process. And remember, I do not need to negotiate value, I negotiate price.

Sometimes I may receive a lowball offer early in the process. If we receive such an offer, I may comment to other buyers that we have an offer in hand. They do not have to know that it is a low offer.

Experience is the quintessential negotiating tool. It enables one to see problems in advance. Experience enables one to figure out what the other side really wants, not just what they say they want.

Summary

In order to choose the most effective sale process, it is essential to understand whether value will be based on financial performance or on the company's strategic assets. Do not assume that the process that works well for large deals is also best for smaller deals. The auction method is excellent for large transactions and for financially valued transactions. For strategic transactions or smaller deals, the negotiated sale is the best approach to ensure that the seller achieves the highest price and the best terms.

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