T.V. METZ & CO., LLC
Boutique Investment Banking

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TECHNOLOGY ACQUISITION UPDATE

Understanding Value in a Strategic Transaction

Strategic value is becoming increasingly important for technology, software and service companies. Many companies sell early in their life cycles, before they have had time to translate their technological edge and market insight into significant profits or a record of earnings. The sale of a company in the technology and software industries can be challenging because the company's value is uncertain.

Reviewing Financial Value

Value is based on financial performance for most companies. Value is a function of the company's profits, rate of growth and the level of risk. Financial value is determined by comparing the firm to other companies in the industry.

For publicly traded companies, a good measure of value is the price/earnings ratio (P/E), which is the company's stock price divided by the earnings per share for the last 12 months. The current P/E ratio for the S&P 500 companies is 20.9 times. In other words, the average company's market value is 20.9 times the company's profits.

For private companies, financial value is typically calculated as a multiple of operating earnings. Operating earnings is defined as earnings before interest, taxes, depreciation and amortization (EBITDA). For example, consider a company with revenues of $22 million that has operating earnings of $2.3 million. Applying a typical multiple of six times EBITDA calculates a value of $14 million. That is the company's financial value.

Large companies command higher multiples than smaller companies, primarily because small companies have greater risk. The size of the multiple varies depending on the industry and the company's size. To give you a rough idea, companies with:

- Revenues greater than $100 million, the multiple is about 7 times operating earnings.
- Revenues from $25 million to $100 million, the multiple is 6.0 to 6.5 times.
- Revenues less than $25 million, the multiple ranges from 4 to 6 times.

The problem with this rule of thumb is that it does not ascribe a very high value to a firm that has strategic value. Strategic value is almost always greater than the financial value. Most technology companies have strategic value and the owners

would not be happy selling for a price based on a multiple of operating profits.

Understanding Strategic Value

Strategic value will vary from one buyer to another depending on the degree to which a buyer can capitalize on the technology and other strategic assets of the selling company. The value of technology depends on how effectively a buyer can incorporate that technology into its products and services.

Strategic assets include technology, software, patents, intellectual property, know-how, brand-name, market position, development team, customer relationships, etc.

Strategic value is subjective. As a result, there is no objective method to calculate the real market value of a company whose assets are strategic. Market value is simply how much a buyer is willing to pay.

Siri, Are You There?

An excellent example of a strategic transaction is the acquisition of Siri by Apple in 2010. You know Siri, she is the voice of the iPhone that does what you command—your virtual personal assistant. Apple acquired Siri for about $200 million.

Apple employs many talented people—engineers, designers and other highly skilled people. These smart people certainly could have developed technology similar to Siri. Why did they acquire Siri rather than develop their own intelligent agent? The answer is time. Apple wanted to get to market as soon as possible. If they developed their own technology, it would have taken a few years—a very long time in the technology world. Apple may also have wanted to keep Siri out of the hands of a competitor.

Plus, Siri's engineering team was an important strategic asset that Apple valued.

Other strategic transactions that you may have heard of include Microsoft's acquisition of GitHub for $7 billion, Google's acquisition of YouTube for $1.6 billion and Sun Microsystems' acquisition of MySQL for $1 billion.

Negotiating a Strategic Transaction

A strategic transaction is one in which technology or other strategic assets are the critical drivers behind the transaction. Financial performance is certainly good, but it does not propel the transaction.

The buyer is not just going to pay a price based on some multiple because it is the "multiple du jour." The buyer will study the company in depth. They will examine the company's technology, market position, customers, agreements, intellectual property, etc. They will examine cross-selling opportunities. Price will depend on the degree to which the buyer can capitalize on the strategic assets of the selling company.

Understanding how a potential buyer views value is important. A buyer typically weighs the cost of an acquisition versus the cost of developing the products and technology in-house. Developing in-house will involve capital, risk and uncertainty.

Time adds an additional component to value. The buyer wants the technology now, not in two years, so it is willing to pay a premium to acquire the technology right away. How much of a premium? This depends on the opportunities and competitive threats that the buyer

faces in the market. Remember our Siri example? That was all about buying time to market.

How do you negotiate the sale of a company when the value is strategic? When there are no metrics? Negotiating a strategic transaction requires understanding the strategic capabilities of the selling company as well as the needs of potential buyers.

A critical aspect of negotiating a strategic transaction is generating competitive or multiple offers. This is the cornerstone of our negotiating strategy and it is the best way to ensure that the client receives the best price.

Successful negotiating requires skillful bargaining and the ability to read people—much like a poker game. Negotiating is a complex game. It includes tactics and strategies along with bluffs, feints and nuances. The most important quality in a negotiator is his or her experience—because at the end of the day, all prices are negotiated. Negotiating experience is the key to achieving the best price when value is strategic.

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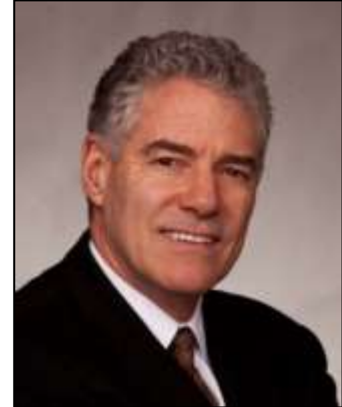

T.V. METZ & CO., LLC

Boutique Investment Banking

We specialize in selling companies with strategic value—typically in the technology, software and service industries. Transactions range from $5 million to $50 million.

Seattle, Washington
206-779-7707
www.tvmetz.com