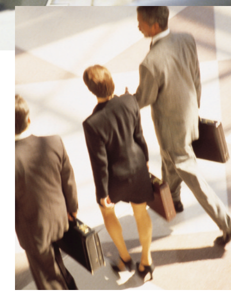
BUILDING VALUE
SUCCESS THROUGH COLLABORATION

Volume 5, Issue 2



A Quarterly Business Valuation Newsletter for Business Owners and the Professionals Who Advise Them

Tom Keith & Associates, Inc.
Tom J. Keith, ASA, CBA
121 S. Cool Spring St. • Fayetteville, North Carolina 28301
Contact: Thomas Bell • (910) 323-3222
twb@keithvaluation.com • www.keithvaluation.com

WHICH IS MORE IMPORTANT — PRICE OR TERMS?

You have recently been approached by ABC, Inc., a public company within your industry that wants to acquire your business. After a review of the business, ABC's representatives indicate that they would be willing to pay $40 million for your company – in the form of ABC common stock. While considering this offer, you are approached by XYZ Company, a private company in your industry. Following limited due diligence, XYZ offers $30 million for your company – in the form of cash. Which offer is more attractive? The example is a simple demonstration of the proposition: "Price vs. Terms."

This article addresses some of the issues that a seller of a company must consider when evaluating and negotiating the sale of a business. It is by no means an exhaustive analysis of the subject.

In terms of the example, several questions come to mind when evaluating the two offers. When examining the offer from ABC (public company), questions would include: "What is the track record of the company and how has its stock performed?" "What are the future prospects?" "Is there adequate liquidity in the company's common stock?" "Are there any restrictions on the sale of the stock (e.g. lock up provisions, affiliate issues, registration, etc.)?" "Is the proposal for a fixed price or a fixed exchange ratio?" "What are the tax implications (e.g. triggering of Alternative Minimum Tax, holding period for capital gains treatment, etc.)?"

> *This article addresses some of the issues that a seller of a company must consider when evaluating and negotiating the sale of a business.*

When examining the offer from XYZ (private company), fewer questions arise. If you are receiving all cash at closing, most questions center around the tax treatment of the consideration.

The decision to accept the stock of an acquirer is not insignificant. You share the same risk in the ability of management to effectively integrate the acquisition as the shareholders of the acquiring company. More times than not, the selling shareholder(s) will have a reduced role in the operations of the combined company. The seller should consider whether they are willing to be a shareholder in a company that they have little or no control over. If the acquiring company has a successful track record of integrating acquisitions and is significantly large relative to the seller, this risk is somewhat

continued on page 2

CASE SUMMARY — ESTATE OF KELLEY V. COMMISSIONER

The Tax Court allowed a 32 percent combined discount for lack of control and marketability for a decedent's 94.83 percent limited partnership interest in a family limited partnership owning only cash and certificates of deposit. The Court allowed the same discount for decedent's one third interest in the LLC that owned the 1 percent general partnership interest. Download the full text of this case at *www.gofcg.org/kelley.*

– John Gilbert, CPA/ABV, ASA
T.C. Memo, 2005-235, October 11, 2005

"Which is More Important?" continued from page 1

mitigated. If, however, the acquirer was formed for the purpose of consolidating a group of companies in a fragmented market, the execution risk can be significantly high. Most industry "roll ups" have failed to produce the expense leverage and revenue enhancement promised to the market. These shortfalls have resulted in stock prices that have tumbled from their highs to well below their IPO price. Many sellers saw the fruits of their labors evaporate as the share prices fell. Any company considering weighing an offer that includes stock in the consideration should do a great deal of due diligence on the acquirer. Remember that when accepting stock, you are buying as well as selling.

A tool often used to mitigate the price risk between the definitive agreement and the close is to place a floor and ceiling on the total consideration.

When accepting stock, the seller needs to understand any limitations on the ability to monetize this investment. Some restrictions may be market-based and others shareholder-specific. An indicator of liquidity is the average weekly volume in the acquirer's stock. If selling the company for $50 million in stock and the average volume in the stock is a few hundred shares, liquidity is likely limited. This limitation applies to anyone investing in the acquirer's common stock. Other restrictions may relate specifically to the shares received by the seller's shareholders. Sometimes an acquirer will

require that key shareholders of the seller's company enter into a lock-up arrangement that prohibits the sale of the stock received for a period of time. During this intervening period, there is no guarantee that the price of the acquirer's shares will not decline, thereby reducing the value of the deal. If, by virtue of this transaction, the selling shareholder becomes a beneficial owner of 10 percent, or more, of the acquiring company, Securities and Exchange Commission (SEC) rules limit the amount of stock that can be sold for a period of one year from the closing date of the transaction. Again, value can be greatly diminished during this forced holding period.

Another issue of equal importance to the seller is whether the proposed offer is for a fixed price or a fixed exchange ratio. If the offer is for a fixed price, then regardless of the price of the acquirer's stock, the seller will receive a number of shares equal to the price divided by the market value of the acquirer's stock as of a pre-determined date. If the deal is for a fixed exchange ratio, then the seller will receive a fixed number of shares for each of its outstanding shares. In this case, if the price of the acquirer's stock goes down from the date that a definitive agreement is entered into to the closing date, then the value of the consideration to the seller declines. Conversely, if the price of the acquirer's stock goes up, then the value to the seller also increases.

A tool often used to mitigate the price risk between the definitive agreement and the close is to place a floor and ceiling on the total consideration. The floor protects the seller from a free falling stock and the ceiling protects the buyer from paying excessively based on its fast rising stock.

These are only a few of the issues that sellers must deal with when considering an offer for their business. So, which offer is better – $40 million in stock or $30 million in cash? It depends.

— *Mercer Capital Staff*

FCG
Financial Consulting Group, L.C.

Building Value is distributed quarterly with our compliments. It contains articles to help attorneys and business owners understand the valuation process. Articles in *Building Value* are written by members of the Financial Consulting Group. Learn more about FCG at *www.gofcg.org*.

We encourage you to forward *Building Value* with attribution to other interested parties. Please contact us to discuss any of your valuation needs.

(910) 323-3222
twb@keithvaluation.com