Negotiating the Price Gap Between Buyers and Sellers

Sellers generally desire all-cash transactions; however, oftentimes partial seller financing is necessary in typical middle market company transactions. Furthermore, sellers who demand all-cash deals typically receive a lower purchase price than they would have if the deal were structured differently.

Although buyers may be able to pay all-cash at closing, they often want to structure a deal where the seller has left some portion of the price on the table, either in the form of a note or an earnout. Deferring some of the owner's remuneration from the transaction will provide leverage in the event that the owner has misrepresented the business. An earnout is a mechanism to provide payment based on future performance. Acquirers like to suggest that, if the business is as it is represented, there should be no problem with this type of payout. The owner's retort is that he or she knows the business is sound under his or her management but does not know whether the buyer will be as successful in operating the business.

Moreover, the owner has taken the business risk while owning the business; why would he or she continue to be at risk with someone else at the helm? Nevertheless, there are circumstances in which an earnout can be quite useful in recognizing full value and consummating a transaction. For example, suppose that a company had spent three years and vast sums developing a new product and had just launched the product at the time of a sale. A certain value could be arrived at for the current business, and an earnout could be structured to compensate the owner for the effort and expense of developing the new product if and when the sales of the new product materialize. Under this scenario, everyone wins.

The terms of the deal are extremely important to both parties involved in the transaction. Many times the buyers and sellers, and their advisors, are in agreement with all the terms of the transaction, except for the price. Although the variance on price may seem to be a "deal killer," the price gap can often be resolved so that both parties can move forward to complete the transaction.

Listed below are some suggestions on how to bridge the price gap:

- If the real estate was originally included in the deal, the seller may choose to rent the premise to the acquirer rather than sell it outright. This will decrease the price of the transaction by the value of the real estate. The buyer might also choose to pay higher rent in order to decrease the "goodwill" portion of the sale. The seller may choose to retain the title to certain machinery and equipment and lease it back to the buyer.

- The purchaser can acquire less than 100% of the company initially and have the option to buy the remaining interest in the future. For example, a buyer could purchase 70% of the seller's stock with an option to acquire an additional 10% a year for three years based on a predetermined formula. The seller will enjoy 30% of the profits plus a multiple of the earnings at the end of the period. The buyer will be able to complete the transaction in a two-step process, making the purchase easier to accomplish. The seller may also have a "put" which will force the buyer to purchase the remaining 30% at some future date.

- A subsidiary can be created for the fastest growing portion of the business being acquired. The buyer and seller can then share 50/50 in the part of the business that was "spun-off" until the original transaction is paid off.

- A royalty can be structured based on revenue, gross margins, EBIT, or EBITDA. This is usually easier to structure than an earnout.

- Certain assets, such as automobiles or non-business-related real estate, can be carved out of the sale to reduce the actual purchase price.

Although the above suggestions will not solve all of the pricing gap problems, they may lead the participants in the necessary direction to resolve them. The ability to structure successful transactions that satisfy both buyer and seller requires an immense amount of time, skill, experience, and most of all – imagination.