MARKET INSIGHTS:
A Tale of Two Offers: Price vs. Structure
Q2 - 2018

FIREPOWER CAPITAL

Imagine this situation (not hypothetical—it is an adaptation of one of our firm's live deals):

After taking years to build a successful company, your investment banker generated several offers from buyers. Two have piqued your interest, one for $55m and the other for $65m. The business is healthy, and, for the most part, runs without your day-to-day involvement. Last year, EBITDA was $7m, with annual growth of 10%, and $7m of outstanding debt.

Based on price alone, the $65m offer seems like the better choice, but then you dig a bit deeper and the picture isn't as clear. Which offer would you select?

Digging into the Details

At a workshop in Toronto, we asked this question to a group of about 30 entrepreneurs, most of whom were nearing retirement and owned businesses with $20m or less in revenues. Their choices are at the end of this article.

To the right are the two letters of intent that we presented to the group. Non-financial items were left out for the workshop in the interests of time, but of course, those considerations are important as well. Let's take a closer look:

Item	Offer 1	Offer 2
Purchase Price	$55m	$65m
Purchase Price/EBITDA	7.9x	9.3x
Cash on close	$50m	$35m
Equity Rolled Over	None	$7.5m (11% equity)
Earnout	None	Up to $12m, $4m eligible each year, paid 15, 27, 40 months after closing; paid only if EBITDA thresholds are met: Year 1: $7.7m / Year 2: $9.3m / Year 3: $10.2m
Vendor Take Back	$2.5m at 8% interest, principal repaid 36 months after closing	$8m at 5% interest, principal repaid 60 months after closing
Transition Period	Consult for 6 months for $120k	Employee for 36 months, with $250k all-in annual comp
Buyer	Strategic	Private Equity (PE)

Offer 2 values the business at 9.3x EBITDA, 18.2% higher than Offer 1. But as a seller, monetizing that higher valuation comes with some risk.

Cash on Close: This amount is guaranteed. The deal cannot close without you receiving this amount. There is considerably more of this in Offer 1.

Equity Rolled Over: This is the stake you will retain after the sale, a common way for PE buyers to incent you to remain at the helm for some time. There is potential upside here, in Offer 2. PE firms typically plan to exit within 3 to 7 years. You will sell your 11% stake upon that exit, at which time, it will hopefully be worth more than it is now.

What's the downside? If a clean exit for retirement is your goal, rolled-over equity detracts from your plan. And the business could go sideways and/or not crystallize an exit, making the deal worth much less.

Earnout: Earnouts may be used to bridge a valuation gap, where the seller expects significant future growth for the business and wants to be paid for that upside, and the buyer wants to mitigate the risk of paying for growth *today* that does not materialize. An earnout is typically based on revenue, gross profit, EBITDA (as in Offer 2), or in rare cases, major non-financial milestones. If you have a high degree of confidence in your business's growth prospects, an earnout is a means of realizing some of that upside, without shouldering the full ownership burden.

What's the downside? Remember, once your deal closes, you are sharing power with a new owner and board. If you don't have a clear operational scope for yourself, and a crisp definition of how the earnout is calculated so that the incentives are aligned and no "games" can be played, then earnouts can spell trouble. For example, an earnout metric like EBITDA can be driven down heavily in the short term by new ownership making big investments for long-term growth. Earnouts are risky: consider whether you'd take the deal if the earnout yields nothing.

Vendor Take Back (VTB): A VTB is a form of interest-bearing term debt provided by the seller to the buyer to finance the sale. These are generally used where there is a shortfall in the buyer's financing, or when the seller is happy to leave some money in and generate some yield.

What's the downside? A VTB is subordinated to senior bank debt. The implications: the bank gets paid out before you do and runs the show if things go badly, so you want to get paid enough interest to compensate for the risk you're taking. In our experience, however, this is rarely the case; we see most VTBs paying 5-8%, which is not sufficient relative to the risk. In addition, it's common not to get much principal repaid for a while. In Offer 2, the principal is repaid 5 years after closing. With $8 million at stake, you will, at least, want to monitor the business closely until the principal is paid out. While less risky than an earnout, like an earnout, a VTB means no clean break for you.

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Which LOI did the group of entrepreneurs at the workshop choose?

Our group of entrepreneurs, many of whom were approaching retirement age, overwhelmingly selected Offer 1 – they went for the higher cash on close, and the cleaner exit. Why this strong preference? Offer 1 offered $49.7m guaranteed within 3 years, whereas Offer 2 could only deliver $42.3m guaranteed within 5 years. While the potential upside of Offer 2 was substantial – additional tens of millions of dollars under reasonable assumptions – this group, prioritizing a clean, lower risk exit, preferred Offer 1.

The exercise illustrates that a great match between a buyer and a seller can be difficult to reach. Our workshop participants deeply disliked Offer 2, but what if they only received offers similar to Offer 2? Is the decision to walk away and go back to the drawing board with their investment bankers, or to counter with an Offer 1-like structure that will most likely be turned down, or to swallow an unattractive deal? A difficult choice indeed.

The LOI exercise piqued our curiosity, and we'll be running it again with different demographics and a much worse Offer 1. We'll share the results on our LinkedIn, so watch for them!

Prioritizing a clean exit and lower risk, the group of entrepreneurs choose Offer 1, despite the significant upside potential of Offer 2.

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