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Negotiating the Optimal Purchase Price

Successfully closing deals hinges on understanding negotiating styles and tactics.

by William S. Hanneman

Once the buyer has arrived at the value of a target, the question turns to the amount to be offered. As indicated in the accompanying article, the worth of a target business to the buyer is not synonymous with what the buyer should pay. Ultimately, the buyer's objective is to pay the minimum amount possible, retaining as much of the future value creation opportunities for itself.

Having managed over $4 billion of M&A transactions on both the buy and sell sides, we have encountered most negotiating styles and tactics and understand what does and does not work. Based on this body of experience, we have developed a keen sense of how to improve the probability of successfully closing deals without giving away the store.

Assess the situation

Success in any negotiation favors the prepared. That is particularly true in business acquisitions, which comprise a labyrinth of issues and an inordinate amount of time. Just as each acquisition target (and its owners) is unique, each negotiation is highly situational, requiring strategies and tactics to be tailored to the specific circumstances. What are the seller's motivations? Are intermediaries involved, or is there direct access to the selling owner? Is the target being pursued in a competitive bidding process, or is it an exclusive negotiation? If competitive, how would other prospective buyers value the target? Might an acquisition of the target by a competitor place the buyer at a competitive disadvantage? How certain is the value creation potential, and what further diligence is required to improve confidence? Only after answering these questions (and more) can an astute negotiator craft a responsive acquisition proposal and begin to consider trade-offs that, through the acquisition chess game, will result in the best deal for the buyer yet still garner the seller's consent.

Price isn't everything

Resist the urge to fixate on price, since doing so reduces the negotiation to a zero-sum game. Business acquisitions are multidimensional, involving much more than price. Expanding the range of discussion can provide insight into the seller's objectives,

How To Successfully Close Deals

1. **Assess the Situation**
   Be prepared for all issues.
2. **Price Isn't Everything**
   Do not fixate on price.
3. **Develop Target and "Walk-Away" Prices**
   Do not negotiate against yourself.
4. **Don't Be Afraid To Be Aggressive**
   Make a good first offer.
5. **Get an Audience With the Seller**
   No substitute for face-to-face meetings.
6. **Make Strategic Concessions**
   Don't let compromise go unappreciated.
7. **Propose Creative Solutions**
   "Splitting the difference" is the wrong approach.
8. **Increase the Size of the Pie**
   Understand objectives, not just positions.

and ultimately can allow both sides to find the common ground necessary to make a deal. Although seemingly counterintuitive, price is rarely a seller's sole motivation. While monetary issues are undoubtedly very important,

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non-monetary issues often loom paramount. How employees will be treated after a sale, whether the name stays on the door, and how long the lease will continue on the seller's facility are among the important considerations that can influence a seller's perspective. Accommodating these points often costs the buyer little but adds significant value for the seller. If knowledge of the seller is limited, it can make sense to present alternative proposals, each designed to gather information that will be useful further along in the process.

Develop target and "walk-away" prices

Buyers often negotiate against themselves, or agree to terms that would be rejected outside of the frenzy of a heated negotiation, thereby committing the most egregious of negotiation errors. The M&A process must be approached with a clear understanding of the underlying economics of both the acquirer and the target. Remember, the goal is not to acquire the target at any price. Rather, it is to pay the lowest price required to win the deal, but still leave value for the buyer. Therefore, before crafting an initial offer, the buyer should also establish a "target" price, the value that would fulfill all of its negotiation hopes and desires, as well as a "walk-away" number, the highest amount that can be economically justified. Both amounts should be developed in a thoughtful, quantitative process as described in the preceding article. With those two numbers in mind, the buyer will be prepared to accept an agreement below the walk-away price and reject any value that exceeds it. Although new information gathered in the process might result in adjustments to those thresholds, discipline is required to avoid falling in love with the process or the prey.

Don't be afraid to be aggressive

The standard protocol when acquiring a business is for the buyer to make the first offer. Many negotiators fear that an aggressive first offer will scare or annoy the other side and, perhaps, even shut the door on the opportunity. However, research has shown that this fear is typically exaggerated. The best first offers are those that fall outside of the bargaining zone, below the seller's walk-away price, but not so far as to be discounted or ignored. One of the best predictors of satisfaction with an outcome is the number and size of the concessions extracted from an opponent. Therefore, making an aggressive first offer gives the seller the opportunity to "extract" concessions,

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thereby yielding a better outcome while also increasing the seller's satisfaction.

Build rapport—get an audience with the seller

Despite the ease of modern communications, when it comes to negotiating a complex M&A transaction, there is no substitute for face-to-face meetings. The psychology of trust is a powerful contributor to a negotiation and building trust is difficult via telephone or e-mail traffic. The non-verbal emotional cues that exist in face-to-face negotiations produce much higher levels of rapport and thereby contribute greatly to a successful outcome (see, ***"The Case for Face-to-Face"***, IN$IGHT, Fall 2007).

Make Strategic Concessions

All negotiations require concessions but the compromise often goes unappreciated and unreciprocated. Therefore, it is imperative to get credit for the allowance by making the seller aware of the value that has been conceded. How the favor can be returned must be defined, possibly making the concession contingent upon the return favor. Installment concessions work well; people are always happier to find two $10 bills on consecutive days than a single $20 bill.

Use objective criteria to propose creative solutions

Horse-trading ("you like that number, I like this one, let's split the difference") is spectacularly unsuccessful in M&A negotiations. In our experience, the most effective method of solving otherwise intractable issues is to determine what result an objective third party would judge to be reasonable. This approach first requires negotiating about the negotiation. That is, to obtain the other party's agreement to be bound by the conclusion to be delivered by the third party.

Make efforts to increase the size of the pie

Taking the time to thoroughly understand objectives, rather than just positions, allows a skilled negotiator to craft creative solutions that can increase the size of the pie. This is most successful when there is a disproportionate assessment of risk between buyer and seller. In general, sellers minimize risks because they are more familiar with them and buyers tend to see dark clouds on every horizon. Thus, working hard to segregate and quantify the perception of risks can allow them to be allocated to the party (or to a third party, through insurance) that places the lowest value on each.

Since the negotiation of an M&A transaction can become protracted, it is important to build momentum that gives both parties the confidence to keep working toward a deal. This means making progress early, even if it is nothing more than reaching an agreement on the process, the time frame, and the key issues that need to be addressed. Ideally, every negotiating session should move the ball closer to the goal line. Letting too much time pass is generally very detrimental to success. The probability of a successful outcome improves by continuously seeking common ground and opportunities to build trust. ❖

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Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

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