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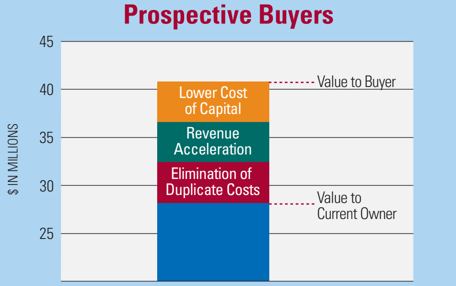
# The Controlled Auction

*Creating competition among multiple bidders results in a higher value and better terms for the seller.*

*by William S. Hanneman*

A "controlled auction" is a structured process in which prospective buyers compete to buy a business in a bidding war where the highest price wins. "Auction," because there are multiple parties bidding for a business, simultaneously. "Controlled," because the process unfolds in a carefully planned sequence designed to build and maintain a strong negotiating position. In a controlled auction, the opportunity is presented to a select group of qualified buyers in a manner that simulates a market. Competing offers are sought through several stages to ratchet up the price, until a winner is declared. Successfully conducted, the process creates value for the seller in both price and terms. A prerequisite set of conditions must be in place in order for an auction to work. Rarely do they all exist in practice, at least not without much advance work on the part of the seller and its advisory team.

**Incremental Value to Prospective Buyers**




As articulated in the Fall 2006 issue of *INSIGHT*, beauty is in the eye of the beholder, especially as it applies to business value. That is, individual buyers will reach differing value conclusions for any particular business, for legitimate reasons. Different owners may have a unique ability to accelerate sales, eliminate duplicate costs or assets, or achieve a lower cost of capital. And, some buyers may just be more optimistic about what can be accomplished in the future than others.

Of course, buyers are reluctant to share with sellers the incremental value they expect to derive from the business. Indeed, the overriding objective of a prospective buyer is to pay as little as possible for a given opportunity. The only sure way to extract a portion of those value-creating opportunities for a seller is to create competition among several buyers. The goal of this effort is to put some portion of the value that a buyer may be able to create, into the seller's pocket.

**KEY ELEMENTS TO A CONTROLLED AUCTION**

1. There must be more than one logical, financially qualified buyer interested in owning the business.
2. Buyers must have all the information they require to commit to a transaction.
3. Buyers must have the financial capacity to quickly complete the transaction once an agreement has been reached.

**PRECONDITIONS**

The key elements of a successful controlled auction include the following:

- There must be more than one logical, financially qualified buyer interested in owning the business. This could result as a function of the important position the company holds in its market niche, a particular product or capability that would be valuable in another company's hands, or simply strong performance in a growing market segment.
- Buyers must have all the information they require to commit to a transaction. This means that information must be assembled and provided in a relatively short time period to prospective buyers, so that they are sufficiently well informed to reach firm conclusions regarding value and deal structure.
- Buyers must have the financial capacity to quickly complete the transaction once an agreement has been reached.

Conducting a controlled auction, with a dynamic operating business can be challenging. Perhaps the single most important reason to hire an investment banker is to develop a marketing plan and sale process that is designed to capture the largest proportion of the value for his or her client.

**PROCESS**

The first step is to identify all of the prospective buyers that, in some measure, can improve the economics of the business, either in a combination with another business or following the institution of improved business practices. The most logical buyers have some experience or an existing position in the seller's industry, whether as an operating business or financial investor.

Targeted buyers must conclude that in order to be successful they must **1)** put their best bid forward, **2)** believe that once the process is over, the opportunity will be gone (lost forever to a competitor), and **3)** the process will have integrity, in that following the rules will be an advantage, not a disadvantage.

The investment banker, working with management, prepares a memorandum that showcases the best attributes of the business. The information must be comprehensive and complete, not hiding any facts that could, if discovered later, slow or derail the process.

Information is provided to prospective buyers and valuation bids are solicited from all buyers, simultaneously. Upon receipt, a short-list of buyers that express the highest values, demonstrate financial capability, and require the fewest closing contingencies are invited to visit the business and meet with management. At that time, select buyers are offered the opportunity to conduct more thorough due diligence to confirm the accuracy of the information that was provided. The hope is that this process will further stimulate the buyers' interest, allowing them to increase their conclusions of value (and/or improve the probability of closing quickly). During this time, buyers are asked to provide objective evidence of financial capability.

Buyers selected to participate in this phase are provided with a draft purchase agreement,

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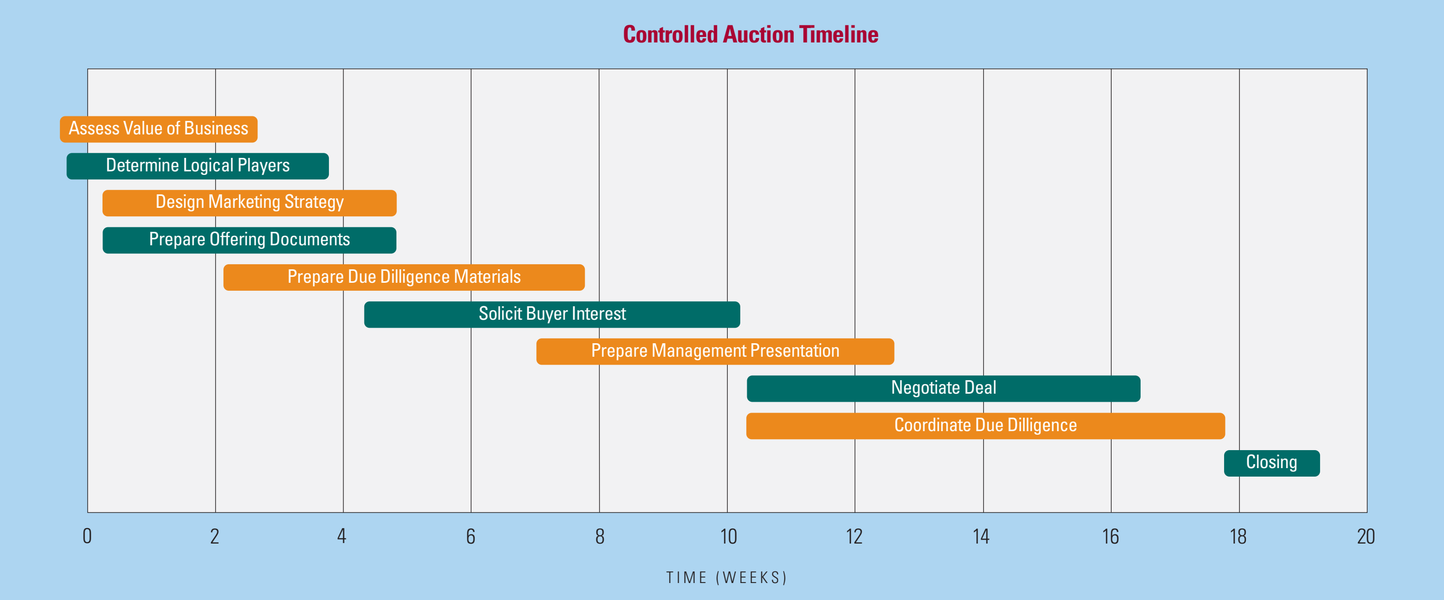


rather than the traditional letter of intent. The purchase agreement does not specify a price, but does detail the terms and conditions of a proposed transaction. Short-listed buyers are then provided with a short period of time to insert their final purchase price and mark up the draft purchase agreement for the seller's consideration. This is typically the last opportunity to improve the purchase price and/or terms, while still in the heat of competition.

Upon receipt of the marked-up purchase agreements, a single buyer is selected who will finalize the purchase and sale agreement. Once executed, the agreement will typically provide for a very short period of exclusivity during which closing conditions are met, required approvals are received, and financing is solidified (if necessary).

Accomplishing these tasks in a timely manner requires a huge dedication to advance preparation. The seller must be ready and able to close a transaction at the time that buyers are first contacted. Anything short of that will cause a delay, and all delays deteriorate the seller's negotiating position and jeopardize results.

The above chart shows a typical timeline and the activities that take place in a controlled auction process. This schedule illustrates a 20-week process, which would be typical in a transaction where nothing goes awry.

**PERILS**

Not every business can be sold in a controlled auction, and even those that begin that way can unravel. Here are a few of the many challenges to achieving the objectives of the controlled auction:

**1.** Critical to success is maintaining the integrity of the controlled auction process. Buyers must believe that there is no favoritism, that their offers will not be shopped, and that the intent is sincere.

**2.** Any differences between what is presented in the memorandum and what is learned in meetings with management or during due diligence is likely to derail the process. Accordingly, it is absolutely necessary that all information is disclosed, even the dirty laundry.

**3.** Timing and schedule are essential. If there is a belief that some buyers will be able to reach conclusions more rapidly than others, they should be contacted later in the process. Regardless of how desirable a particular buyer may be, if the party lacks either the experience or discipline to efficiently navigate the process, adjusting to an individual buyer's situation can disrupt the auction.

4. Long lead-time events, such as third party consents, financing commitments, and due diligence efforts strain the ability to maintain the competitive fervor.

In reality, few middle-market private companies are prepared to be sold in a controlled auction. But, many elements can be used in virtually every sale to increase competition for the opportunity and keep the process on track.

The pressure of competition and the threat of the opportunity being lost to a competitor are the only factors that can compel a buyer to pay what the business is worth to them. Accordingly, the highest values are invariably achieved when businesses are sold in a competitive process. A well-run controlled auction can deliver a meaningful premium to a seller over the stand-alone value of a business sold in a negotiated transaction with a single party. ❖

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## ABOUT ZACHARY SCOTT

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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