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Auction or Negotiate?

When selling your company, process matters.

by William S. Hanneman

Is the highest value in a sale of your business achieved by negotiating with a single buyer, or by auctioning the company to a broad group of buyers? It depends.

In a pure auction, competition among buyers does the job of ratcheting up the price. In negotiations, price improvements are achieved by exploiting value-creating opportunities unique to a particular buyer.

Preparing for and conducting these two sale processes is entirely different. In auctions, competitive pressure comes from the same-side-of-the-table, whereas in negotiations the pressure comes from across the table, as is illustrated on the next page.

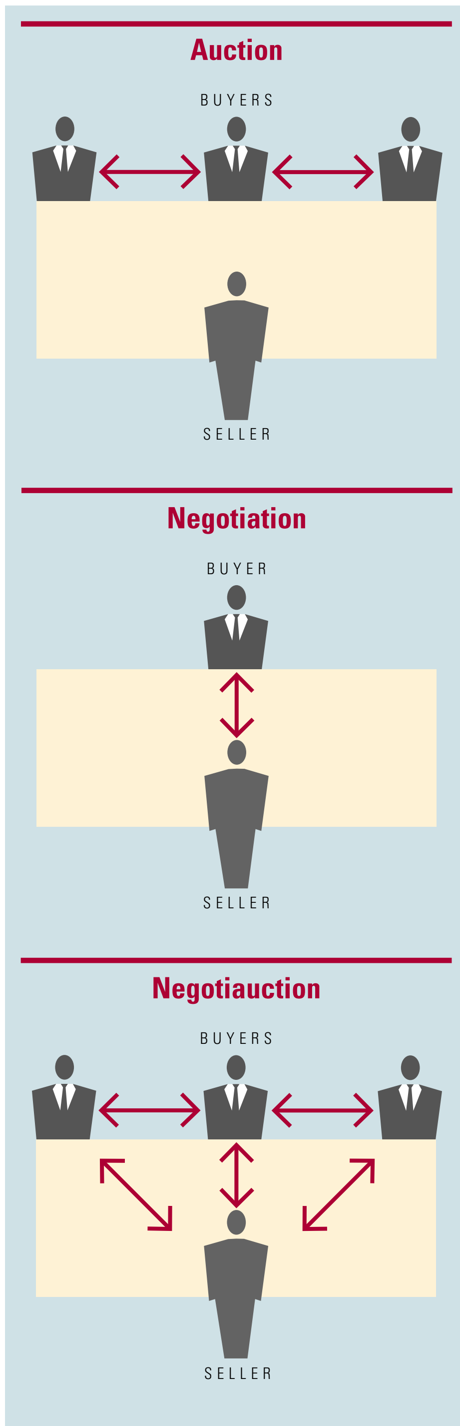
The objective in a sale is to identify value-creating opportunities and to convince the buyer to pay a portion of that value to the seller. Value creating opportunities, often times called "synergies", may include expanding a product line, offering access to a new distribution channel, or eliminating the redundant costs of a combined operation. This can be a delicate trade-off. While auctions do a great job of boiling everything down to price, the competitive process might not be particularly conducive to exploring the possibility of win-win moves.

Negotiations, on the other hand, provide an opportunity for each party to learn the other's preferences, to make trade-offs across different issues, and to craft deals that can create a larger overall pie. At the same time, competition among buyers, or at least the perception thereof, is almost always required for a buyer to be influenced to carve off a portion of the synergies and pay that value to the seller.

PROCESS DETERMINANTS

Accordingly, the process that will most likely achieve the highest value is a key decision when embarking on a sale of a business. When deciding whether to conduct an auction or to negotiate privately with an individual buyer, we consider four primary factors:

1) Characteristics of the business and its industry,
2) Number of probable bidders,
3) Profile of those bidders, and
4) Context of the negotiation.



Company Characteristics

The structure of the industry and the position of the company to be sold in that industry are among the key considerations in determining how to achieve the highest value and go-to-market strategy. A company that represents a small market share in a fragmented industry would generally argue for a broad-based sale process. However, that conclusion may be tempered if the subject company relies on a few critical third parties (vendors or customers), or if the misplaced leak of a sale could damage the business. Businesses that operate in narrow market niches or that generate returns far in excess of the capital invested may best be sold in a negotiated sale process. Businesses that could form a platform for an industry consolidation (and therefore would likely draw the attention of financial investors), would benefit from a broader-based competitive process.

Number of Bidders

An auction is likely to wring out the maximum value when serious competition is engendered among multiple qualified buyers. When there are many capable suitors, there is more same-side-of-the-table competition, which will result in driving up the price.

Robust auctions typically ratchet up value in a succession of small increments. The natural implication is that more bidders are better; but there is no magic number other than that it is necessary to have more than one. We have conducted successful auctions with a small number of intent participants. Sometimes the perception of multiple buyers is sufficient to achieve the benefits of an auction process. However, there can be too many. When members of the buying group perceive a large number of participants, they might calculate that the odds of "winning" are too low to justify the effort necessary to treat the opportunity seriously.

Bidder Profile

Another criterion for deciding whether to hold an auction is the degree of certainty regarding the set of potential buyers. Bidders are often wary about participating in auctions, so a key consideration in determining

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the marketing strategy is the difficulty of attracting the most economically-logical parties to participate. In some situations, where prospective buyers enjoy multiple alternatives to fulfill a perceived strategic need and, when the downside of losing the auction is insignificant, a more focused process may be required to bring the desired bidders to the table.

Contextual Factors

There are also contextual factors to consider when determining whether to pursue an auction or to negotiate with a single party. Among these are the need for secrecy and speed, and the importance of the future relationship. Broad-based auction processes are difficult to keep under wraps, even when all bidders have executed confidentiality agreements. And, the more broad the auction group, the higher the probability that word will get out. Accordingly, if disclosure could be damaging to customer confidence, employee morale, and supplier relationships, consider negotiating privately with one, or a few, buyers.

Closely related to confidentiality is the need to execute a sale quickly. The passage of time rarely benefits a seller, if for no other reason than the longer the process is underway, the more likely it is that the negotiation leverage will shift in favor of the buyer. Auctions tend to happen more quickly, following a defined timetable. The duration of a negotiated sale, on the other hand, is always difficult to predict, depending entirely on the intent of the buyer (and the seller's preparation).

A negative aspect of auctions is that they can signal that the seller is indifferent among buyers other than the price received. Whether or not true, buyers can often be influenced to pay somewhat higher values if they perceive to be favored in some way.

THE NEGOTIAUCTION

In representing a seller, our role as investment banker is to design a sale process that will maximize the after-tax present value of sale proceeds. As the process setter in these situations, we constantly evaluate all the relevant factors in designing the marketing strategy. In practice, we almost never conduct a pure auction, and we generally shy away from single party negotiations. It depends entirely on the circumstances. Often, we have had the most success combining elements of both of these processes—a negotiauction[1].

A negotiauction is a hybrid process that brings to bear the appropriate source of pressure at the optimal time. It is a customized approach designed to take advantage of both the across-the-table pressure and same-side-of-the-table competition, constantly evolving the process as the deal progresses.

In practice, the trajectory of most deals is to commence with an auction process and, as the deal progresses to incorporate more negotiation-like mechanisms. This deal process captures the benefit of same-side-of-the-table competition early in the process as the most economically-logical buyers are identified, and shifts toward fleshing out value-creating opportunities and relationship building with those particular buyers that can justify the highest value.

THE ART OF DEAL MAKING

The process by which a company is sold has a meaningful impact on the ability to achieve sellers' objectives. M&A deals are maddeningly fluid; the dynamics between the parties continuously change in response to the competitive environment, the buyer's investigation, external events, and the passage of time. Understanding and managing those subtleties in order to know when and how to shift from a multiparty auction to negotiating value-creating opportunities with a single buyer is the art of deal making. ❖

[1] *Negotiauction, trademarked by professor Jeffrey Teich of New Mexico University, is a term, in conjunction with a computer algorithm and Internet software, that combines auction and negotiation processes.*

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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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