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INSIGHT
PERSPECTIVES ON THE CAPITAL MARKETS

REPRINT
FALL 2020

Entrepreneurial Decision Making and Perceptions of Risk

BATNA—what does "best" mean?

by Mark Working

Professional negotiators use a framework called BATNA, or Best Alternative To No Action, to weigh the different aspects of a deal, with the knowledge that the result will be the "best" of all available alternatives. Evaluating competing alternatives requires a common set of criteria by which to compare. In economic terms, the metric is present value—a meaningful comparison can be made when cash flows of different alternatives are projected under the same set of standards and appropriately discounted. Some entrepreneurs are frustrating in negotiations because, in the eyes of the other party, they can appear to act irrationally. Sometimes this is true, but more often entrepreneurs are using a different equation to evaluate alternatives.

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Most entrepreneurs have a "glass is brimming" perspective and underweight, misunderstand, or ignore downside risk in their businesses; therefore, they often do not share a common view of future expectations or the embedded risk. Nearly twenty years ago, we published an article ("Seller Math; the Missing Variables", Fall 2002) that explained what we saw as a flawed economic argument used by some private company owners. The argument goes something like this – when owners sell their business, pay taxes, and invest the proceeds, the investment returns need to provide the owners an amount sufficient to sustain, if not improve, their situation. Of course, it is virtually impossible (except in some minority of business transactions with large synergies) to sell an investment in a small, risky, illiquid business, pay taxes, and invest the residual amount in a low risk, liquid investment, and obtain comparable or improved cash flow. Financial markets reward investors for taking risks. The risk inherent in a privately held business (key man, customer and/or supplier concentration, relative value chain power, market size, liquidity and lack of marketability) relative to an investment-grade, publicly-traded, liquid, diversified bond portfolio is immense. Our observation has been that many entrepreneurs perceive the difference in absolute return but ignore the difference in risk.

But, in addition to valuing risks differently, many privately held business owners view their business as an extension of themselves and their families; business ownership represents a lifestyle. Entrepreneurs generally like their situation and only want to exchange it for a future vision that is more attractive. Attractiveness is measured in income, importance, peer group, and freedom. Giving up those attributes means something more appealing must be obtained regardless of whether others might fail to see any direct linkage between the current state of the business and the implied bar for a deal. While a buyer or investor will evaluate the business in financial terms, the owner-entrepreneur will employ a wider set of criteria. Even if the investment is "over-valued" by a buyer, if the substitute lifestyle requires a compromise or doesn't provide the basis for improving that lifestyle, it is perceived as a worse alternative.

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The problem is that financial reality cannot be avoided. The risks in small privately held businesses are real. Even if everything internally is managed to a standard of excellence, external factors can change dramatically the trajectory of a business, not always for the better. Issues like personal guarantees for borrowings or real property leases, reliance on a key customer or supplier, reliance on key people, or expectations on stable end user buying patterns generally don't figure into the equation - until they do. When businesses are challenged, the lifestyles of the owners can be negatively impacted. Our friends in legal solvency practices have long lists of situations where owners' lifestyles were destroyed due to the surfacing of risks that were always present but never appreciated.

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Entrepreneurs are decision makers, and they tend to surround themselves with advisors (e.g., lawyers, tax accountants) who execute their decisions. Recognizing a bias to underestimating risk and a mix of professional, personal and financial goals and values, it is the trusted advisor's role to break those pieces apart and make sure the client understands the impact of the decision being made and the implied value of the personal part of the equation. This is not an easy job and might require questioning the basis of the client's decision. Then, again, it might be helpful to the clients to articulate to themselves what they really value. We can remember two examples that highlight why this discussion was valuable. The first involved an entrepreneur that had built a very valuable business from the ground up. He had been approached by another business as a purchaser. When we pointed out that the offer was for more than twice what the business was currently worth to him (strictly from a present value of cash flows perspective), he was surprised but came back with an unexpected answer. He told us that building and leading

(continued p.2)

this business was the most important thing in his life. It had provided enough to him such that his lifestyle would not change whether he sold the business, but if he sold, he would lose what he loved most. He stated that if the result of his decision was that the business eventually became worth 10% of the current offer, he could live with it. In another similar situation, an owner's business was in a unique situation in a fast-changing industry. He was convinced his business was worth a certain amount based on knowledge of some other transactions in the industry, each of which were valued at high strategic values as others were consolidating market positions. That high value implied enough wealth to allow him to live very well for the rest of his life. We were able to demonstrate that waiting was a dangerous alternative because the business could become less cost competitive relative to the consolidated competitors. Instead of waiting, a sale was pursued and completed with a competitor that could realize significant operational cost savings. The attractive price preserved our client's future lifestyle that would have been lost, but for the ability to see the impending changes.

By employing financial return, career desires, and lifestyle objectives into an equation, the entrepreneur is creating an economist's BATNA in that all the elements of value are being considered. An adviser can be very valuable to the entrepreneur by making sure the investment component is fairly evaluated and the amount of value ascribed to other factors is acknowledged in the greater context of the opportunities at hand. **ZS**

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ABOUT ZACHARY SCOTT

Since 1991, Zachary Scott has assisted owners of privately-held businesses in the greater Pacific Northwest to plan and execute major business or ownership transitions by offering sell-side M&A and acquisition and investment advice. For more information on Zachary Scott, go to **ZacharyScott.com.**

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