Transaction Costs- Economic Friction or Liquidity Tax?

Mark Working

The best way to evaluate any potential transaction is how that transaction relates to the Seller's alternative of not selling. On the surface, that would seem to be an easy comparison but often Sellers have not critically considered the alternative of not selling from an economic perspective and don't consider the effect of transaction costs in that equation. There may be great reasons for selling a business that take precedence over transaction economics but we think it is always better to know than not know.

Seller's BATNA

The alternative to selling is to retain the business. Taking into account all the external and internal factors that drive future operating cash flows, the seller should come to a conclusion as to what will be earned over a long time.

"The Seller's option is to retain the future after-tax operating cash flows of the business, and the present value of those cash flows represents the Seller's economic value BATNA"

The present value of those future cash flows adjusted for ongoing income tax obligations is the value of the business to the owner because it simulates what cash flow is available to the suppliers of capital. The Seller's option is to retain the future after-tax operating cash flows of the business, and the present value of those cash flows represents the Seller's economic value BATNA.

Economic Friction to Achieving a Seller's BATNA

The problem is that to obtain liquidity of an interest in a privately-held business, there are costs to accomplish that (e.g., transaction costs and taxes that are triggered by the transaction). If a Seller is exchanging the right to all future after-tax cash flows, the after-tax net of that exchange needs to be equal to or more than what is given up in the transaction, taking into account all of the taxes and transaction costs incurred as result of the transaction. In other words, the transaction price needs to be higher than the Seller's BATNA sufficient to result in an after-tax equivalent.

Estimating Transaction Costs

Achieving a transaction value that is economically equivalent to a Seller's BATNA may be different for different owners as the transaction costs and taxes could be different in different situations; it is not a formula. It is good to know what that hurdle is before evaluating any specific deal.

"If a Seller is exchanging the right to all future after-tax cash flows, the after-tax net of that exchange needs to be equal to or more than what is given up in the transaction, taking into account all of the taxes and transaction costs incurred as a result of the transaction."

Transaction costs include state and local taxes (e.g., capital gains, ordinary income, Obamacare Medicare Surcharge, transfer taxes), and all payments to professionals involved in the transaction (e.g., investment bank fees, legal counsel, tax advisors, QOE and accounting fees, and environmental and other consultants).

Tax obligations are specific to the company, organization legal structure, and transaction structure. As an illustration of the range of outcomes for a particular owner, a transaction that is a sale of stock of a C or S corporation would result in a federal capital gains (currently 20%), Obamacare Surcharge (3.8%), and state capital gain taxes in the state where the owners reside. Assuming owners live in Washington where there is no state income tax, the business owner would be taxed at 23.8% of the taxable gain in the transaction. That same company sold in an asset sale structure may have some portion of the gain converted to ordinary income (37% maximum rate) as a result of depreciation recapture and may be subject to state income taxes (range from 0% to 33%, average 28.7% across all states) in states where the company sells it goods or services. The overall tax bill could be double compared to a straight stock sale. The point is not to argue about deal structure but to recognize that the amount of tax to be paid is a friction to the transfer of a business at "fair" value.

"...to "breakeven" on an economic basis to the Seller's BATNA, the Buyer would need to value the business high enough to compensate the Seller for the taxes and transaction costs on an after-tax basis..."

Relative to taxes, other transaction costs are a small fraction in comparison. Again, these costs are specific to the company and transaction. They can be as low as 1-2% and we have seen them as high as 5% for a middle market size business.

As an example, we considered a company where the Seller's own standalone value is $100MM, with no debt, and sold in a stock sale structure where the tax basis (the original cost of the stock) is a nominal amount. The total transaction costs would be:

Taxes

Capital Gain	$20.0 MM
Obamacare	$ 2.3 MM
Professional Fees	$ 3.0 MM
Total	**$25.3 MM**

The implication is that to "breakeven" on an economic basis to the Seller's BATNA, the Buyer would need to value the business high enough to compensate the Seller for the taxes and transaction costs on an after-tax basis – the bottom line in this example is a value of approximately $135MM to give the Seller an after-tax value of $100MM, which is the Seller's BATNA.

Can Buyers Justify Paying More?

Different buyers will have different views on the future of the business, resulting in a range of valuations. A strategic buyer might find ways it can improve the cash flows of the business relative to what can be achieved by the Seller. These "synergies" can take the form of cross-selling, improving process efficiencies, and consolidating G&A costs.

Financial buyers can find premium value in a business for different reasons. What these buyers typically bring to the table is a deep checkbook. If there is additional value that can be created through scale, financial buyers will be interested in unlocking this value through acquiring other players in the industry and investing additional capital in the business.

Both strategic and financial buyers can find value in a transaction structure; for example, where it can assign value to accounting goodwill, which can be amortized as an expense against future taxable income. In many cases, this can be accomplished without an offset cost to the Seller.

The Transaction Decision

The purpose of this article is to help owners create a framework for evaluating potential business sale transactions, not to establish a formula or rule to establish whether or not to complete a transaction. Rather, we think it is one more piece of information that should be considered.

There are many reasons for completing a sale transaction other than the price of the transaction. The option of retaining the business in perpetuity may not be a real option. If the best available deal is not sufficient to cover the Seller's transaction and tax load over and above the Seller's standalone value, the difference is simply the cost of obtaining liquidity.

"There are many reasons for completing a sale transaction other than the price of the transaction. The option of retaining the business in perpetuity may not be a real option. If the best available deal is not sufficient to cover the Seller's transaction and tax load over and above the Seller's standalone value, the difference is simply the cost of obtaining liquidity."

To prepare for making this important decision, we recommend:

1. Conduct a planning exercise to objectively prepare a long term projection of business performance taking into account the capital needs of the business over the planning period;
2. Conduct a discounted cash flow valuation of the plan to obtain a standalone value;
3. Estimate the tax obligations and transaction expenses relating to a transaction of the standalone value;
4. Determine the transaction value that will give a breakeven economic value to not selling – this the economic BATNA.
5. Determine if retaining the business indefinitely is a real alternative and what discount could be accepted to obtain liquidity.

As the Seller enters a process to sell the business, a good framework for evaluating the best proposals will already be in place and make objective decisions possible.

ZacharyScott.

1200 Fifth Avenue, Suite 1500 Seattle, WA 98101

o: 206.224.7380

zacharyscott.com