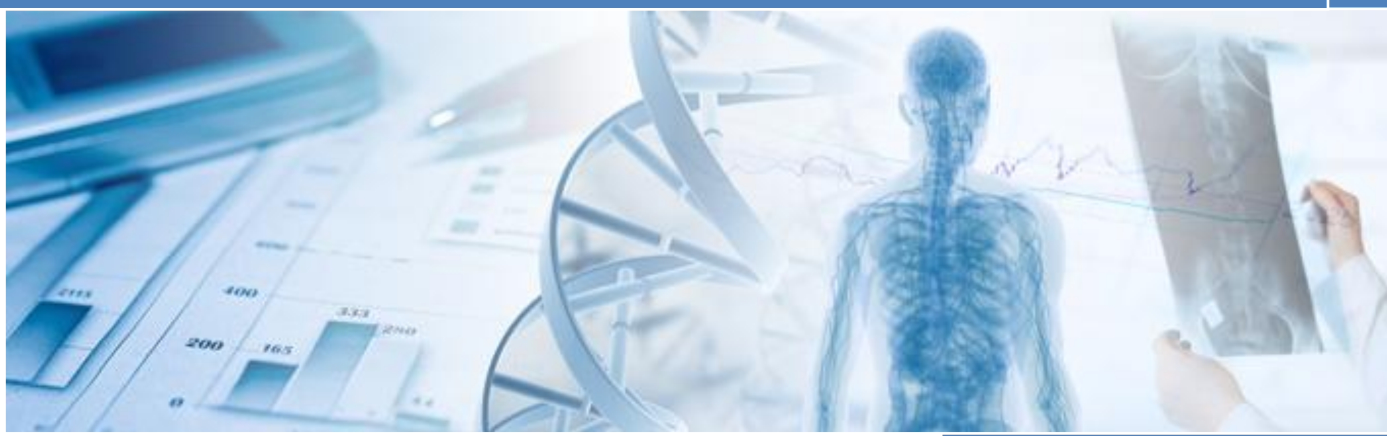
Communicating Value Expectations to a Buyer – A Primer



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SUMMARY

Providing valuation guidance can make or break negotiations. Before proceeding, a seller is well advised to:

- Understand why the buyer is requesting guidance
- Evaluate how any guidance provided may affect future negotiations
- Use guidance as a tool to create an anchor value
- Develop a credible and reasonable valuation

In M&A transactions, there comes a point where buyers request guidance as to the valuation expectations of a seller.

This is a pivotal juncture in any deal process. Given how regularly this request occurs, and the potential positive or negative implications from a seller's response, a seller's board and management team should have a unified understanding of if, when and what to communicate regarding their value expectations.

When negotiating a transaction, a seller is often well advised to not "negotiate against oneself" with a buyer. A seller should seek to have the buyer independently determine value and submit its most compelling offer.

However, certain M&A transactions occur under circumstances where an early discussion of value could positively advance the transaction process for both the seller and the buyer.

In theory, a buyer should be able to make a thoroughly informed assessment of value. However, in the early phases of an M&A transaction, this may not be the case. As such, there are several practical and tactical reasons that a buyer will request valuation guidance from a seller:

Practical reasons –

- Difficult to forecast long term cash flows
- Challenging to assess value of intangible assets or R&D projects
- Difficult to assess risks from regulatory or clinical milestones
- Substantive risk of contingent liabilities
- New market for buyer, limited experience in the field

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Tactical reasons –

- Assess if "a bargain" exists that justifies devoting resources to a deal
- Test the competitiveness of a sale process
- Cross-check internal valuation analysis and financial assumptions
- Avoid internal embarrassment if valuation is substantively off the mark
- Prevent harming relationships with a seller if valuation differs materially

In the event a buyer requests valuation guidance, a seller's transaction team should evaluate a number of factors as they formulate their response and strategy:

- Why does the buyer require guidance from the seller?
- Has the potential buyer provided a sufficient reason?
- Has the buyer been disciplined in its diligence and transaction process?
- Does the buyer have sufficient information and experience to develop a supportable valuation at the onset of the process? If not, what additional information or assistance could the seller provide to the buyer? At the early stages of a transaction, a buyer may have limited information about the seller's historical or projected financial performance, product pipeline, IP, regulatory pathway, etc…Thus, it may be difficult for a buyer to develop a credible valuation without additional information.
- What are the consequences of not providing guidance? Will the buyer continue in the process? Does the seller require the buyer's participation?
- How have other companies handled valuation discussions with this buyer? Any lessons learned?
- What form of guidance would be appropriate and sufficient?
- Does the transaction team have a sufficient basis from which to provide such guidance?

Providing guidance can significantly advance a transaction – but one must understand the buyer's reason for needing guidance and potential consequences of providing guidance.

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So When Should a Seller Provide Guidance?

While M&A practitioners recognize that there is no definitive answer to this question, the practical answer is that a seller should provide some form of guidance to a buyer when such guidance will materially advance the M&A process with a necessary buyer. Most often, "advancing" an M&A process means moving a credible and critical buyer forward to start a negotiation.

What Guidance is Appropriate?

If the seller's transaction team determines that providing additional information to the buyer would not be appropriate or sufficient for the buyer, the seller must determine whether to provide some form of guidance. Likewise, what guidance is appropriate and how will such guidance effect the overall negotiation?

It can be easy in the heat of a negotiation to forget that valuation is only one of many important variables that determine the value to be exchanged, and risks to be assumed, by the parties.

First, by providing guidance, a seller wishes to set up a framework from which to negotiate economic terms during the process. The framework should provide flexibility for future negotiations rather than provide a concrete amount that offers minimal means to negotiate. It is important to keep in mind that in an M&A negotiation, valuation is only one factor in a number of important variables that determine the total value received, and risk assumed, by a seller's investors.

Second, the seller should use guidance as a tool to start a negotiation and create an anchor value. If properly created, the anchor will form the basis from which future concessions and changes will be measured against by each party.

Thus, it is important to consider how guidance may be used by a seller and buyer in the subsequent bartering inherent in any negotiation.

Often, guidance can be rather limited and still be effective at starting a negotiation. Valuation guidance to a buyer can include a range of options, such as qualitative comments, illustrative examples, or a specific dollar value. The actual form of guidance will depend on the specifics of the deal. However, a seller is typically best served by initially providing buyers with thoughtful, qualitative, and, perhaps, illustrative direction, rather than highly specific dollar valuation guidance.

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Examples of qualitative guidance and illustrative examples can include:

- Refer a buyer to a range of return-on-capital or internal rate of return benchmarks for the investors
- Reference a thoughtfully selected group of comparable transactions, the values or financial multiples achieved in such transactions, and why such deals are comparable
- Reference the values or financial multiples of publicly traded companies along with the control premiums associated with M&A transactions
- Support qualitative or illustrative examples with appropriate references to the seller's market size, operating margins, sales growth rates, IP or other factors that make such guidance or examples credible
- Identify where the seller has value – US sales scale and growth, OUS sales, strong operating margins, efficiency of a buyer's sales team, revenue opportunity from near term pipeline products, premium pricing, bundling, IP, value of operating infrastructure, etc.

Be creative in the guidance provided. Qualitative and illustrative direction may be more appropriate than specific dollar valuation guidance.

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Situation – *Medtech* Company had held discussions with Buyer for the past year, and the buyer has indicated an interest to explore a transaction. For several reasons, the Medtech Company and its advisor believed that few other potential partners would be interested in an acquisition at this time.

Buyer Request for Guidance – Buyer strongly requested valuation guidance as Buyer's prior experience negotiating with venture-backed sellers had resulted in vastly different views of value. Buyer noted that such guidance would be critical to progress a term sheet through its internal operating committee.

Seller's Response – *M*edtech Company's transaction team determined that some form of guidance would advance discussions with Buyer. Medtech Company also determined that the guidance can be used as a negotiating anchor and to communicate the strong conviction investors have for the company's prospects. Medtech Company and its advisor developed a set of comparable transactions and a summary of the comparability between the targets in such transactions and Medtech Company. Medtech Company met with Buyer and described how the board viewed the opportunity and the support for a "go alone" strategy. However, the management team believed

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that the investors would support a sale today at an appropriate value. Rather than provide any specific value, Medtech company and its advisor provided Buyer with a list of comparable transactions, revenue multiples, operating metrics and the rationale for the analysis.

Result – The buyer submitted an initial term sheet in the coming weeks. The term sheet became the basis for an extensive negotiation that resulted in a successful transaction in the following months. The final valuation was in line with the guidance provided to the Buyer at the initial meeting.

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Situation – Medtech Company initiated a sale process and attracted interest from several potential buyers. Despite the interest in diligence, Medtech Company was concerned that the field of buyers could deteriorate by the term sheet submission date. Furthermore, Medtech Company was concerned that low valuation multiples for comparable public companies could negatively impact the valuation assumptions of buyers.

Buyer Request for Guidance – In the sale process, the lead Buyer verbally raised their preference to receive valuation guidance. The request was made in order to assist the Buyer to prepare their term sheet.

Seller's Response – After discussions with the transaction team, Medtech company determined that providing valuation guidance was not necessary in order to continue to advance the process. The advisor to Medtech Company noted to Buyer that, given the demand in the process, the advisor does not believe it is appropriate to provide any single party with guidance. The board believed that the sale process would yield the best and appropriate value for the Company. Buyer verbally tested values and referred to the values of comparable public companies. In response, the advisor put forth well-rehearsed reasons why the values of such companies do not reflect the value of Medtech Company.

Result – Buyer submitted a term sheet to acquire Medtech Company. Both parties successfully negotiated the term sheet and progressed the transaction to a successful closing. The final valuation was substantially in excess of the values of comparable public companies and was in line with the values received by sellers in other comparable medtech M&A transactions.

There are often times when it is not in the seller's best interests to provide any, or further guidance. Be sure to consider your negotiating position and the dynamics of your particular transaction.

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A Comment on a Seller's Basis for Guidance

When providing guidance, sellers often start with a relatively high number, recognizing that such amount will be trimmed as part of a negotiation. While there are certainly other approaches, the "start high" tactic to create an anchor is the one most often used, with the expectation of subsequent bartering in the ensuing negotiation.

However, the "start high" anchor is effective only if it is credible and reasonable. With this in mind, sellers should ensure that they have a sufficient analytical basis from which to provide guidance. If not, the seller's starting point may be so much higher than the buyer's view of value, that the buyer determines to not proceed with a negotiation, despite the fact that the seller would have been willing to complete a negotiated deal at a substantially lower value. Before providing valuation guidance (and really, before initiating an M&A transaction), a seller should first complete the analysis required for its board to have an understanding of value. Such analysis could include:

The best guidance has sound, financial support underlying the value and information communicated to a seller.

- Discounted cash flows analysis
- Supported by a five to ten year detailed cash flow forecast on a standalone basis
- IRR and ROC scenario analysis for each class of securities, assuming one or more stand alone operating and financing scenarios
- Detailed timeline for value driving milestones (regulatory, clinical, R&D)
- Comparable transaction analysis
- Comparable public companies analysis
- Analysis of areas for potential synergies for buyer
- Supporting valuation analysis provided by bankers and advisors

With an appropriate understanding of value, a seller is well prepared to consider providing valuation guidance to a buyer and to ensure that their guidance remains in the proverbial ballpark of actual value.

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Summary

In a sale process, valuation is typically the first major economic term negotiated between the parties. A seller should prepare early in the sale process for if, when and how they will address initial questions of valuation. Sellers should recognize that their interests can be well served in many instances by providing guidance to the buyer. This guidance can not only serve to advance the progress of an M&A process but can also work to the seller's advantage by establishing an initial anchor from which to use in the ensuing negotiation.

Sellers should be sure to:

- Understand why a buyer is requesting valuation guidance – what part of the request is practical vs. tactical?
- Evaluate the consequences of not providing further guidance
- Understand how a buyer has handled valuation and negotiations in prior transactions
- Ensure that the board and management have a reasonable basis for their guidance
- Understand how any initial guidance will be used by both the buyer and the seller in a future negotiation

Lastly, when approached by a buyer for valuation guidance, be sure to take a moment, gather your thoughts, and think before you respond. Most often, the right response is to relay that you understand the question but need to think about what response is appropriate and to discuss their request internally.

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RIM Advisors provides strategic advisory services to high growth companies in the medical technology and life sciences sectors. Founded in 2008, the firm provides a range of services to its clients, including strategic sale and buy-side advisory, corporate partnering, strategic planning, in-depth assessment of product market opportunity and other strategic advisory services.

RIM Advisors offers senior level experience and a service level that is unique to today's marketplace. Based on two decades of experience in investment banking and advisory services by the principal and founder, Richard Innenberg, the firm reflects its expertise through a significant portfolio of strategic relationships and industry partnerships.

Richard brings a strong and expansive breadth of services having previously served over 100 healthcare, medical technology and growth companies through a broad range of investment banking and corporate development transactions. Specific activities include: exclusive sale transactions, buy-side transactions, division buyouts, corporate partnering, private and public financing, liquidations and corporate restructuring.

Richard is also a Managing Director with New Century Capital Partners Inc., a member of FINRA and SIPC.

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