AXIAL FOR CEOS

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THE SELLER'S GUIDE TO

M&A NEGOTIATION

FORUM

THE SELLER SERIES

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Most CEOs know how to negotiate.

Whether it's a sales contract or a supplier agreement, when it comes negotiating the elements of day-to-day operations, business owners are no novices. Should a CEO find himself seated at the opposite end of the transaction table, however, negotiation takes on a whole new meaning. Regardless of whether you are buyer or seller, there is one critical goal all parties share: getting the deal done. Since buyers seek to buy companies at the lowest possible price and most favorable terms, and sellers are looking to realize the fruits of their labor by maximizing price and favorable seller terms, skillful negotiation is an essential component of any deal process.

Since most CEOs will only go through the sale of their business once in their lives, as opposed to investors and buyers who negotiate these types of transactions all the time, studying up on best practices prior to a sale can go a long way in feeling confident about the process. To give CEOs a bit of a head start, we've compiled a few key negotiating tactics and techniques specific to M&A processes that can help set companies up for success as they go to market.

What to Negotiate

The first question in any negotiation is "what's on the table?" In the sale or purchase of a business or its assets, there are three main categories a seller and buyer will discuss during negotiations.

Price

Perhaps the most obvious and daunting component of an M&A negotiation is the price a seller is asking versus the price a buyer is willing to pay.

Structure

There are many different ways an M&A deal can be structured, and each has its own legal, tax and business implications. As any one structure may be preferable or favor one party over another, including discussions around deal structure in the negotiation process is the best way to come to a mutually beneficial decision.

There are three common options when structuring an M&A transaction:

→ **Stock sale** - During a stock sale, the buyer purchases the stock of the company directly from the selling shareholders. By doing so, the acquirer comes to own all the assets, liabilities and rights of the entity being purchased. While this type of transaction is inherently different from an asset sale, it frequently results in the transfer of the same assets and liabilities. If a buyer does not want to have specific assets or liabilities after one of these sales, it can distribute or pay them off before the transaction.

→ **Asset sale** - In an asset sale, the seller retains ownership of the original legal entity and the buyer purchases the individual assets of the seller one by one. This can include equipment, inventory, lease agreements, licenses and trade secrets. After the closing, the buyer and seller retain separate corporate existence and structure, while the owner of the operating assets changes.

→ **Merger** - A merger occurs when two companies combine to form one, on roughly equal terms. In most cases one company's stockholders receive securities in the other company in exchange for their stock. The resources of both companies are joined for the new entity's benefit. Mergers might be referred to as vertical mergers or horizontal mergers. Read our primer on **the differences between these two strategies**.

Terms

The terms of any M&A transaction matter immensely and can, in some cases, satisfy a seller if their optimal price isn’t reached. If it’s not a full sale, what stake is being transferred? How much control? Does the buyer get the first refusal for future transactions? Does the sale agreement provide the buyer with any recourse against the seller if costly problems arise immediately after the transaction? Is there any seller financing? By creating many terms beyond just price, buyers and sellers can find out what the top priorities are for the other side.

When to Negotiate

Before you delve into the details of a potential deal, make sure you’ve covered all of your bases and that no information discussed during the negotiation process will negatively affect you or your business. There are 5 things you should make sure you have done before you begin any negotiations:

1. **Explore your motivations for the sale:**

Before every sale, some soul searching is necessary. What are you planning to do after you exit your business? What will you use the proceeds for? Do you hope to stick around as an advisor or to help with the transaction post-sale? Are you concerned with leaving a legacy? Make sure you have answered for yourself the questions about what the price, structure and terms of the sale will mean to you and your post-sale plans.

2. **Understand your company’s valuation:**

Before setting expectations around your sale price, it would be wise to undertake some valuation exercises for your company. There are many ways to value a private company and every buyer may use a different method. One of the most popular, however, is **Discounted Cash Flow analysis**. The Discounted Cash Flow (DCF) business valuation model is grounded in a simple concept: the value of any given business is equal to the sum of all future cash flows of that business, discounted to reflect their value today.

3 Signed an NDA:

For many CEOs the biggest concern during any deal process is confidentiality. Whether you're raising capital or selling part of the business, you don't want your proprietary information leaking to the market, competitors or employees. A non-disclosure agreement to prevent this should be signed with any third party involved in the sale (lawyers, brokers, advisors, prospective buyers).

4 Signed a letter of intent:

After meeting with several prospective buyers, the ones who wish to continue along in the process should issue to receive a Letter of Intent (LOI) to the seller outlining the proposed deal structure and terms. Receipt of an LOI from a potential buyer is a clear signal that they are serious in their intentions; however it is not a "given" that they are fully committed yet.

5 Sought out legal and tax advice:

Because the way a deal is structured and the way you receive the proceeds may have serious sale advisors have provided you with legal and accounting advice regarding the sale structure, price structure and price allocation that offers you the greatest financial benefit at the lowest tax liability.

Negotiating Tips For Buying & Selling Companies

Mastering negotiation takes time, talent, homework and practice. However, there are a few key negotiating tactics and techniques that can help a CEO work towards success when trying engaging in M&A discussions.

1 Price isn't everything.

When it comes to the sale or purchase of a company, it's very easy to fixate on price. It's a key piece of negotiation, **but hardly the only one**. The terms matter too. If it's not a full sale, what stake is being transferred? How much control? Does the buyer get the first refusal for future transactions? Does the sale agreement provide the buyer with any recourse against the seller if costly problems arise immediately after the transaction? Is there any seller financing? By creating many terms beyond just price, buyers and sellers can find out what the top priorities are for the other side. This allows both sides to ultimately make concessions to the other to keep the deal moving forward.

2 Make concessions strategic.

Harvard Business School has written on the value of concessions within negotiation. Concessions, however, need not be viewed as a necessary evil. To determine what concessions you are willing to make (and what you might ask for in return) you must be strategic about the goals of the transaction.

4 strategies for making concessions strategic:

- → Make sure that your counterpart is aware you have given up something of value.
- → Define how your counterpart can return the favor. Then demand it.
- → If you don't trust your counterpart to reciprocate, make a contingent concession. Offer to yield on something only if the other side meets a certain condition.
- → Make concessions in installments. People are happier to find two $10 bills on consecutive days than one $20 bill.

3 Know your 'walk-away' number.

Buyers and sellers should enter negotiations knowing know the highest and lowest price for which you think the asset could reasonably sell. Just as important, you should know your "walk-away number." This number is your floor for consummating the deal. Knowing your walk-away number upfront takes research and preparation. Sticking to it will help you stay disciplined.

TRANSACTION TERMINOLOGY

BATNA (Best Alternative to a Negotiated Agreement) is a concept studied in used in negotiation theory that defines the course of action to be taken if the negotiations fail and an agreement cannot be reached.

4 Know your opposition.

In order to get the other party to agree to a deal, you need to *intimately* understand their interests. **Getting To Yes**, a great book on negotiating technique, recounts that 1978 Camp David negotiations started with Israel and Egypt making irreconcilable claims to the same piece of land. It was only when each side recognized the other's true interest – Egypt wanted its previous borders, Israel wanted security – that they were able to reach an agreement both sides could accept. Egypt got the land but promised to demilitarize it.

Also remember that there's a distinction between your negotiating counterpart and the organization they represent. His or her compensation structure and career goals could be playing a role in their decision-making. Understand what's driving him or her to **increase your bargaining power**.

5 Making the first offer isn't always a bad thing.

Often we're told to let the other guy show his cards and make the first offer. The advantage to making the first move, though, is that it anchors the discussions. **Studies** have shown that the first named price in a negotiation significantly influences subsequent prices. There's also an advantage to using **precision when you name your price** (see tip nine). One caveat: this strategy is useful primarily when you are confident you have an information advantage. If you don't, you may want to play coy to avoid low-balling yourself.

6 Don't fear sunk costs.

It's easy to get tunnel vision as negotiations progress. Though much time has been spent and effort exerted, sometimes walking away is the best option. As noted above, it's important to know your alternatives and walk-away number before you enter the negotiations.

7 Shake hands, then second guess.

After the deal is done, second-guessing can be helpful. Research has shown that asking yourself what more could you have done following negotiations can make you more effective. A 2009 study from professors at Haas, Kellogg, and Ohio University found that second guessers learn more and perform more effectively in the future. Not all self-reflection is equal, though. The experiments found it's better to think about what else you should have done rather than what you did but should have avoided.

8 Research, research, research.

As a number of these tips already suggested, both buyer and seller should walk into negotiations having done their homework. You need to research assets, their value, your negotiation counterparts and other textbook (and **non-textbook**) due diligence items beforehand.

9 Be Precise.

A **Columbia University study** showed that using precise values - especially in the first offer - demonstrates knowledge and confidence, and leads to less aggressive (better) counter offers. Says author Elizabeth Wiley, "If you can use precise numbers and back it up with data or analysis, you are likely to be viewed as informed, knowledgeable, and experienced. In short [precision] is a simple, yet very impactful way to convey you know what you're talking about." The group does caution negotiators not to be so specific that that you appear unreasonable.

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The Psychology of Negotiation

It's often said that negotiation is both an art and a science. Downturns in the market, skewed valuations or skeletons in the closet are unfortunately hazards of doing business and can't always be prevented. Other factors that may put a deal at risk, though, are preventable and often brought to the table unknowingly.

Cognitive biases are "mental errors caused by our simplified information processing strategies." They are human errors that can sour negotiations and are particularly dangerous because they can be hugely impactful yet we are not even aware when we act under their influence. Some believe cognitive bias **contributed to the 2008 financial crisis**.

While entirely avoiding these biases is near impossible, you can mitigate their consequences by being self-aware and taking steps to check your objectivity. Here are the biases most likely to impact your deal-making with some quick tips for how to manage. We've broken them down by stages as different types of prejudices tend to appear as deals and relationships progress.

Early in the Deal

Cognitive biases can begin impacting your deal even as you source new opportunities. When and how you interact with a specific intermediary may significantly impact your valuation of an investment opportunity. Keep an eye out for:

→ **Framing.** The context in which a situation is presented to you can significantly impact your impression of an opportunity. If a situation is framed in a positive manner, it can make you more interested and risk tolerant. Make sure you are not avoiding risks — or unnecessarily attracting risks — simply because of how the deal was presented. Look to see that your initial reaction is based on the quality of the deal, **not quality of presentation**. A helpful trick might be to present the opportunity to another member of your firm as objectively as possible.

Cognitive biases are human errors that can sour negotiations and are particularly dangerous because they can be hugely impactful yet we are not even aware when we act under their influence.

- **Anchoring.** The tendency to rely on the first piece of information offered in a conversation can be particularly impactful on negotiation around valuations. Most people tend to use this initial data as a reference point — or "anchor" — for the entire conversation. For example, if a banker initially suggests that a type of company values at 6x – 7x, the conversation will likely remain somewhat pegged to those numbers. To avoid succumbing to the effects of anchoring, run your own estimates before meeting with the intermediary and try to weigh all pieces of information equally. If you are selling a company, be careful not to anchor higher than the market will allow.

  Anchoring can also affect your impressions of an individual. First impressions of personalities are notoriously hard to shake.

Later in the Deal

As you move past LOI and into a full-fledged deal process, you expose yourself to a whole new set of cognitive biases and fallacies. Be wary of the following as you conduct later stage negotiations and due diligence:

- **Confirmation Bias.** The tendency to favor information that confirms existing beliefs or hypotheses can become particularly problematic during the due diligence process. Confirmation bias may cause you to seek out and selectively remember information that supports your initial hypothesis. If you think the opportunity is strong, you will seek out evidence to support its strength. This can result in incomplete due diligence or primed questioning. One of the best ways to avoid confirmation bias is to hire third parties to conduct effective and complete due diligence.

- **Cognitive Dissonance.** If your initial hypothesis is challenged, you may quickly experience cognitive dissonance. This is the distress you feel when you simultaneously hold two contradictory beliefs. In the deal process, the bias most often appears when a disappointing realization develops — like when you discover a risky skeleton in the closet of an otherwise perfect company. In order to relieve the dissonance you will likely either determine the skeleton is not that bad or back out of the investment. Make sure you are fully acknowledging the true impact of all information (the skeleton) if you choose to stay in the deal.

- **Groupthink.** Unfortunately, cognitive biases can emerge from within your firm as well. Groupthink, or the tendency for an individual to adopt the mindset of a larger group, most often occurs intra-firm rather than inter-firm. The pressure of conformity and the desire to fit in can often drive those with minority opinions to silence their doubt. Because of this bias, certain doubts and issues around the viability of a deal may be left unquestioned. One of the best ways to counter groupthink is to allow individuals to express their initial opinions in smaller, more personal settings. If you are a leader in the organization, allow others to voice their opinions before announcing your own.

After the Deal

Even after successfully closing a deal, cognitive biases may cloud your key takeaways. Be aware of:

- **Hindsight Bias.** People always say 'hindsight is 20/20,' but beware this old adage. Hindsight bias can skew valuable lessons in past successes or failures. The tendency to interpret events as having been more predictable than they actually were can oversimplify reality. To mitigate missing important details due to hindsight bias, keep a careful log of the deal process while it is happening. This will help you remember the variety of factors that impacted each stage of the deal.
- **Outcome Bias.** Similar to the hindsight bias, outcome bias is the tendency of an individual to remember an event solely based on its outcome. It asks "Do the ends justify the means?" Focusing solely on final results risks the development of bad deal practices and techniques. Just because something worked once does not mean it will work again.

We are all prone to these biases - in personal and professional settings. Simply acknowledging your own susceptibility to unconscious practices is a great first step in counteracting them. Remain vigilant and work to be sure you are looking at all information objectively so that you reach a deal that doesn't just feel good, but is good.

Table Manners: Why You Should Eat During Negotiations

According to Lakshmi Balachandra, Assistant Professor of Entrepreneurship at Babson College, eating during negotiations can significantly improve the resulting deal for both parties.

In a series of experiments, Balachandra studied the impact of food on negotiations. She concluded that "the students who ate together while negotiating — either at a restaurant or over food brought into a business conference room — created significantly increased profits compared to those who negotiated without dining."

She confirmed that it was the act of eating, not simply sharing a separate task, that drove better results in another experiment where participants completed a puzzle together during negotiation. These "did not create better negotiation outcomes than those who only negotiated a deal."

Eating "while deciding important matters offers profitable, measurable benefits through mutually productive discussions." Consider scheduling your next round of negotiations at your favorite eatery. Who wants to negotiate hungry anyway?

For more on Professor Balachandra's experiment see our **blog post** or full detail in the **Harvard Business Review**.

Using Precision in Negotiations

Negotiations are fickle. Not only do you have to anticipate your counterparty's remarks and arguments, you need to convince him that your ideas are the better route.

Victor Kiam, entrepreneur and ex-owner of the Patriots, once said "Information is a negotiator's greatest weapon." As it turns out, he was onto something.

Columbia Business School **published a study** explaining how numerical precision can be an extremely powerful negotiation tactic. The study discovered that using precise values during a negotiation — especially in the first offer — conveys knowledge and confidence, which translates into less aggressive counter offers.

While the study focused primarily on early-stage negotiations, Axial has also seen the benefits of precise numbers even before negotiations start. In an analysis of the most **successful investment teasers on the network**, we learned that opportunities with financials rounded to the thousands tended to perform better than those rounded to the millions. In order to see if our findings matched that the of the study, we spoke with the authors about their research.

Precise Numbers Demonstrate Knowledge

According to the study, "Speakers generally express information — and are assumed by listeners to do so — in a manner that is no more precise than their knowledge warrants. Thus, when prompted to provide estimates and forecasts of quantities, speakers compensate for their uncertainty by decreasing the precision with which they express them." In other words, the more uncertain you are, the more round your number will likely be.

Round numbers, despite their tendency to convey uncertainty, are used in all types of negotiations. As Alice Lee, one of the paper's authors, explained, "Round numbers are prevalent in our everyday language for many reasons. Perhaps the most obvious reason is that they are so easy to express and remember. Several studies, including our own, have repeatedly demonstrated how heavily round numbers are utilized in everyday conversation and even in sites that are centered on negotiations — like Zillow or eBay."

> *The use of precise numbers can leave a very positive impression during a negotiation — especially if you are confident about your numbers.*

By contrast, the use of precise numbers can leave a very positive impression during a negotiation — especially if you are confident about your numbers. Elizabeth Wiley, another author, explained, "If you can use precise numbers and back it up with data or analysis, you are likely to be viewed as informed, knowledgeable, and experienced. In short, a precise number is a simple, yet very impactful way to convey you know what you are talking about."

Appearing informed, serious, and insightful has clear benefits for both the current deal and future ones. Even if the given deal falls through, the positive impression you instilled in the other party can foster future opportunities and relationships.

Precise Numbers Also Get Better Offers

In addition to leaving a positive impression on the counter party, a precise offer can actually help you close the deal at a better price. The study discovered that if you made a precise offer, the counteroffer was closer to the initial offer than if you made a rounded offer. Or, in official terms, "First offer recipients make greater counteroffer adjustments to round versus precise offers."

Wiley explained, "Precise numbers are better anchors in negotiations. They create the impression that you have a sense of the real worth of the good. Round numbers, on the other hand, are more often viewed as guesses or estimates, allowing the counter offer to be more flexible."

She continued, "If you use a precise number and are able to support it with evidence, you have demonstrated you are more informed and have a good sense of the worth of the good. It is difficult for the other party to make a dramatically different counter offer."

Don't Get Too Specific

However, don't get carried away. While precise numbers are almost always beneficial during the negotiation process, they can become problematic if they are too specific or clearly overstate/understate the value of a good.

According to Lee, "While you want to use a precise number, you need to make sure your number is 'reasonable' — both in its value and its precision. If your offer is too precise or too large, you run the risk of appearing inflexible or insincere."

She continued, "Through our real-life negotiation data, we noticed that when one party suggested an exceedingly precise number, it led the counterpart to walk away because he saw no room for negotiation or conversation."

One of the best ways to determine the reasonableness of the specificity of your negotiation offer is to consider base ten numbers (e.g. 10, 1,000, 1,000,000) to be round. "When you are being precise, it is really important to do your homework to make sure that the number you are suggesting is within the realm of reality," explained Wiley.