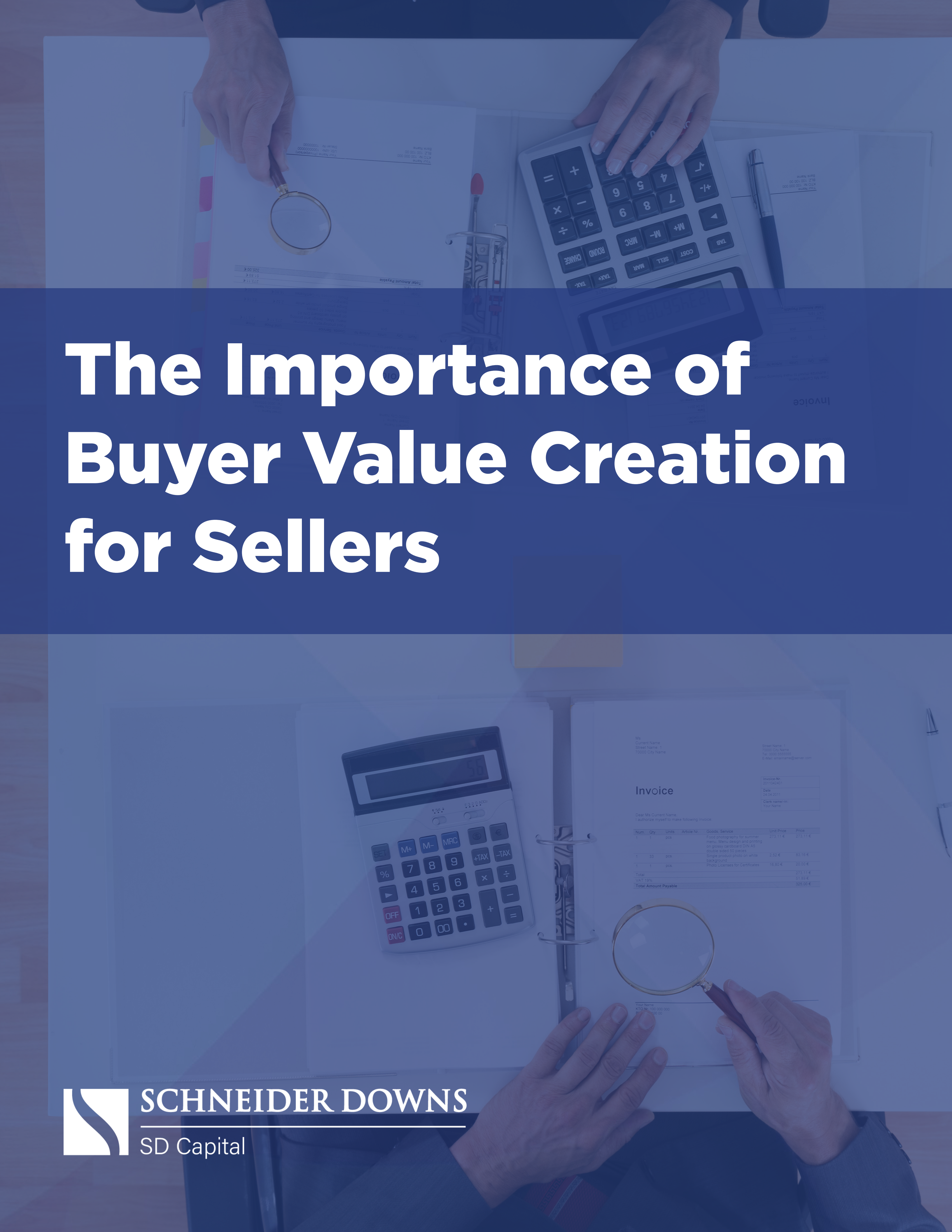

The Importance of Buyer Value Creation for Sellers

SCHNEIDER DOWNS
SD Capital

SCHNEIDER DOWNS
SD Capital

The Importance of Buyer Value Creation for Sellers

As value and transaction advisors, we collaborate with business owners to enhance their company's overall value before a transaction occurs. Our approach involves a multi-month process that includes implementing significant changes, professionalizing the management team, and clearly defining the company's strategy. We enhance the front office function to establish adequate sales management processes, improve marketing strategies, and clarify the value proposition. Additionally, we improve back-office operations to ensure accurate and timely financial reporting while providing insights into operational performance. Ultimately, our value advisory efforts aim to help achieve the highest possible purchase price during the sale process.

In addition to the aforementioned pre-transaction activities, it's important to note that value creation is not solely the seller's responsibility; buyers also evaluate target companies based on the future value they can generate and realize downstream.

When buyers consider purchasing a company, they develop a deal thesis—a clear rationale outlining why the acquisition is strategically and financially justified. A primary objective for the buyer is to achieve a return that justifies their capital investment. For the investors involved, this means realizing a financial return through the eventual sale of the acquired business, downstream monetization of the acquiring company, or the upside generated from a longer-term hold of the acquired business. In any case, a buyer must envision the potential benefits of the transaction. A well-positioned seller can assist the buyer in shaping this vision or deal thesis, which improves the likelihood of success pre- and post-transaction.

What is Value Creation, and How is it Measured?

Value creation refers to the process of developing both tangible and intangible assets within a business. It can be quantified in real dollars, which helps to determine the company's worth. The most commonly used metric for assessing value is Enterprise Value (EV), which represents the total value of a company.

For privately held companies, EV is typically a multiple of earnings before interest, taxes, depreciation, and amortization (EBITDA) or revenue based on the sales figures of similar companies within the same market segment. A private company's value is further established during the sale process, frequently through an auction. Engaging in value-creation activities can increase EBITDA, leading to higher market multiples.

Value creation occurs between sellers and buyers when the seller provides a clear strategy. By positioning the company as a platform or a strategic asset, the seller can develop a compelling deal thesis that outlines how the company can grow or scale with the proper capital structure. A knowledgeable seller collaborates with their advisors to create a hypothetical growth strategy that could be executed after the acquisition by a prospective buyer. Sellers should identify expansion opportunities, introduce new products and services, and explore new distribution channels or partnerships. These suggestions contribute to future value calculations, building on the company's core business strengths while leveraging its human capital, business model, infrastructure, suppliers, and customer base. The selling company's Confidential Information Memorandum (CIM) outlines these potential opportunities to help buyers identify value prospects.

Buyers can review the strategies presented to evaluate how they fit into their deal thesis. Buyers will most likely map value to one of the following:

- **Competitive Advantage and Margin Growth –** Buyers may seek to acquire a strong brand, new or advanced technology, specialized skills, or teams or to minimize competition by buying a competitor. Acquiring a competitor can also result in gaining new customers and expanding its footprint (geographic, demographics, etc.), acquiring valuable intellectual property or technology, and expanding into new markets.
- **Expansion and Diversification –** Buyers frequently aim to enter new markets or increase their market share. To achieve these objectives, they often pursue inorganic growth strategies. For example, acquiring a ready-made entry into a new market can be quicker, less costly, and less risky than expanding organically. Additionally, expansion and diversification can help reduce concentration risk, meet market demand, or enhance profit margins. Buyers experiencing slow organic growth look for inorganic options to boost revenue growth.
- **Synergies –** Cost rationalization post-sale helps create financial synergies – this may involve eliminating duplicate departments or functions such as accounting or human resources. Synergies may also result from vertical integration or the acquisition of underutilized assets. Synergies effectively buy down the cost of the target - for instance, reducing the cost of acquisition from a 5x to a 4x multiple. Cost rationalization can help drive improved financing terms and result in an accretive rather than dilutive transaction on day one.

Despite the efforts of both parties, buyers and sellers may not agree on value – a seller may have a more optimistic perception of value that does not align with the buyer's risk-adjusted perspective. This value gap is either successfully negotiated and bridged or can result in an unsuccessful transaction. To bridge value gaps, transaction advisors work with the buyer and seller to adjust the purchase price and nature of the transaction by using any one or a combination of the following:

- **Earn-out –** A portion of the purchase price is contingent upon the target's financial performance after the acquisition. Earn-outs typically last for up to two years. They are often linked to future revenue or EBITDA, which is usually based on the financial forecast provided by the seller during the sale process. Additionally, qualitative earn-outs are possible where payments are tied to specific outcomes, such as technology development or product launches.
- **Retained Interest –** The seller retains a portion of their equity, typically between 10% and 20%, allowing them to benefit from the value created through the buyer's activities aimed at increasing that value. The seller can realize this retained value either through a downstream sale or, depending on the buyer's intended holding period, by having the buyer repurchase the equity at market value based on a pre-determined trigger (such as the holding period) at a future date.
- **Minority Investment –** As an alternative to a majority purchase, a buyer could seek to position for a minority investment in the target. While this may not meet the seller's objectives, it may allow the buyer to see/realize upside value over time and position for a downstream purchase of the business. Buyers often lock in an option and value for full acquisition of the company at the time of initial investment.

Conclusion

In summary, creating value for buyers is vital to the sales process. It justifies the transaction and helps determine the amount and structure of the purchase price. In most transactions, buyers and sellers have different perceptions of value. Therefore, minimizing and bridging these value gaps is essential for a successful outcome.

As value and growth advisors on the sell side, we aim to create value for the seller while minimizing the potential value gap. A well-structured, multi-step sell-side process can help identify and address this gap before the letter of intent is issued. Closing the value gap is crucial for both parties to achieve a successful transaction.

About SD Capital

SD Capital is a premier, full-service, value advisory and investment banking practice that assists middle-market companies in creating and maximizing business value. We provide strategic evaluation and execution of various downstream sales and monetization pathways. With decades of combined executive experience running, owning and advising private companies our team is uniquely positioned to guide owners through the complex process of growing and selling their companies.

For more information, please contact our team at **contactsd@schneiderdowns.com** or visit **www.schneiderdowns.com/sdcapital**.

Schneider Downs Capital LLC is a subsidiary of Schneider Downs & Co., Inc.

SCHNEIDER DOWNS
Big Thinking. Personal Focus.
www.schneiderdowns.com

TAX
AUDIT AND ASSURANCE
CONSULTING
WEALTH MANAGEMENT

PITTSBURGH
One PPG Place
Suite 1700
Pittsburgh, PA 15222
P 412.261.3644

COLUMBUS
65 E. State Street
Suite 2000
Columbus, OH 43215
P 614.621.4060

METROPOLITAN WASHINGTON
1660 International Drive
Suite 600
McLean, VA 22102
P 571.380.9003