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TECHNOLOGY ACQUISITION UPDATE

Negotiating when Value is not Tangible

Negotiations in the technology and software industries can be challenging because the company's value is often uncertain. Companies merge before they have established a record of earnings and value typically depends on earnings. Multiples of earnings or revenues are simply not relevant. Game theory gives us some insights on how to negotiate when the value is intangible.

How How do you negotiate when you are unsure of your company's value? Negotiating the value of a company whose significant assets are intangible is different from most other negotiating situations. Negotiating intangibles requires greater market understanding, an in-depth knowledge of the other party and skillful bargaining. At the end of the day, all prices are negotiated.

Asking the value of a software company is like asking the value of Elvis' guitar. The answer is whatever someone will pay you for it.

Value in the software and technology industries is becoming more extrinsic, and less intrinsic. Many companies are worth less as standalone entities than they are as integral parts of other firms. The value of a standalone business is a function of its profits. Without an earnings history, a firm's value depends simply on how much a buyer is willing to pay.

Rules of Thumb

Looking for a simple answer? Sorry, there really aren't any rules of thumb that are of any merit. Ratios calculated after the fact are rarely applicable to other transactions. Only in industries where companies have similar cost structures and operating characteristics (such as garbage collection) do revenue multiples make sense. Everyone likes rules of thumb because they make life easier. But by making life easy, they make life inaccurate.

Multiple Myths

Let's presume that Microsoft went ahead with its acquisition of Intuit for six times revenues. Does this imply that other companies competing with Quicken are also worth six times revenues? Actually, if the merger were completed, competitors would probably have a value of about zero. Who could compete with Quicken, especially if it were owned by Microsoft? This valuation reflected the importance of market position and installed base. The price was negotiated. Comparing this revenue multiple to other situations is simply not meaningful.

Common Negotiating Mistakes

Inexperienced negotiators make a number of common mistakes. Deal structures are made that are inefficient -- other structures could have been made that would have been preferred by all participants. Unseasoned negotiators often have unrealistic expectations. They see only their side of the situation, cling to their assumptions and are not good listeners; they don't fully understand the other party's point of view. Another mistake is letting a large problem engulf and mire the discussions.

Traditional Approaches to Value

The traditional methods for determining value include the Market Approach, the Income Approach and the Replacement Cost Approach.

The Market Approach uses multiples of earnings or revenues of similar companies in the same industry to calculate value. This is typically the best way to measure value; however, in the fast-moving software industry very few companies are similar enough for comparisons to be valid.

The Income Approach projects future cash flows and discounts them by a rate that reflects the degree of certainty of achieving those cash flows. The drawback to this approach is that its assumptions are highly subjective. This method is better suited for generating ballpark estimates than for determining an accurate valuation.

The Replacement Cost Approach involves estimating the magnitude of the development effort and the work required to replace it. The company's market position is not considered, however, which limits the method's usefulness.

The most common measure of value in the stock market is the Price Earnings (P/E) ratio. The average P/E ratio is currently 20 times earnings. For a company earning 5% after tax, this imputes a revenue multiple of 1.0 times. (20 x .05 = 1.0). The median Fortune 500 company has profits of 4.8% of revenue and its stock trades at 0.9 times revenue.

Measuring value in the software industry is problematic because companies either aren't profitable or they are too dissimilar for valid comparison. Software is still a nascent industry in which many companies have yet to achieve a record of earnings. In the long run, a company's value will be measured by its earnings. One day even Netscape will be valued on its profits.

A Few Strategy Tips

What strategy is best for negotiating when value is intangible? Generally, the most useful negotiating strategy is one with high realistic expectations and with small decreasing concessions. The savvy negotiator should have a realistic sense of what can be accomplished. He chooses from a range of strategies and tactics to fit the situation and the stage of the negotiation.

Negotiations are dynamic situations—the tone and balance can change dramatically throughout the discussions. The perception of value can change as well. It is difficult to prescribe a set strategy before negotiations begin; however, a few fundamental points are worth mentioning.

The first step is to examine your company and understand your strong points. Learn as much as you can about the other party's strengths, weaknesses, market and customers. Understand why your technology and intangible assets are important to them.

Anticipate concessions and plan a few in advance. A no-concessions strategy is dangerous, since concessions are usually expected. Don't compromise too early, but have a few in your bag. For example, you might request a promissory note early on and eventually concede to a royalty payment. A smart negotiator compromises by giving up something in order to get something in return.

Determine your indifference curves ahead of time. Think about what combinations of price and terms you are indifferent to. Would you prefer $8 million cash and $3 million in stock, or $4 million cash and $15 million stock? This is not about the total amount of the payment, but about your relative preference for different types of payment. A few other strategy tips:

- Keep the focus on areas of mutual interests. Emphasize the common ground. Asking for too much could sour the atmosphere.

- Don't be afraid to introduce a few trial proposals. The other party's response can be very illuminating about their preferences and assumptions.

- With creativity and an open mind, a large problem can often be broken down into smaller issues that can be solved more easily.

- Be aware of emotion as well as logic in both your and the other party's arguments. Never underestimate the power of emotion in negotiations.

- The corollary to asking good questions is keen listening. Listen for things that give clues to the other party's assumptions.

Every transaction contains uncertainties. Each party will have a different perception of those uncertainties and have a different attitude toward risk. A skilled negotiator will recognize these differences and exploit them in order to achieve a joint solution.

Examine Your Value

An in-depth understanding of your company's strengths is imperative. What are the drivers of value in your company? Is it technology? Market share? Name recognition? Installed base? Distribution channels? Development capability? Can you quantify these strengths?

What additional revenues will you bring to the buyer? Are there cross-selling opportunities? What about recurring maintenance revenues? What people strengths do you contribute in development capability or management expertise?

Know Your Opponent

Learn as much as you can about the other party. Visit the company, tour their facility and meet as many managers and employees as you can—you'll learn more than you might think. Understand their market. Who are their customers? Why do their customers buy from them?

Asking general casual questions can be a highly effective means to gather information for negotiations. For example, "In what areas do you need to improve your technology?" Polite probing can uncover all kinds of clues that give insight to the other party's mind set and what they might be willing to pay.

Probe to learn why the buyer is interested in your company. What is your key strategic value to the buyer? Can they find this technology elsewhere? How can the buyer transform your intellectual assets into earnings? Quantify it as much as possible.

What is the buyer's framework for evaluation? How do they see your company complementing their strengths? Often their view will be different from yours.

Try to understand how they view value. Ask how they arrived at their price. It is much easier to sway someone using their reasoning and assumptions than it is to convince them that your reasoning is correct.

Companies pay large premiums to have immediate access to key technology and to avoid the time and cost to develop it. What would it cost for the buyer to develop your technology on its own? Determine what their alternatives are to doing a deal with you. Don't forget the competitive aspect—by acquiring your company, the buyer keeps you out of the hands of a competitor.

The Opening Gambit

Who should make the first offer? It is commonly believed that being the first to mention price puts you at a disadvantage. This is not as big a disadvantage as is often thought. There is an expectation that the party initiating the discussions should be the first to mention price. Go ahead and tell the other party a range of price and terms that you expect. Don't be afraid to ask for top dollar as long as it is still in the ballpark of reasonableness. Offer two price alternatives, such as $8 million cash or $12 million in stock.

The advantage of initiating the price discussion is that it gets the price issue on the table and it is now the other party's turn to respond. You can learn a lot about the other side's thinking by how they respond. The anchoring phenomenon also may come into play, in which subsequent discussions tend to center around this initial value. This subtlety can work in your favor.

Game Theory

Game theory is the study of competitive interaction and how people try to outsmart one another. By thinking in terms of game theory, you learn to think several moves ahead and to anticipate the actions and reactions of your competitor.

Game theory stresses the importance of focusing on the other party's competitive actions and needs. Problems are viewed from two perspectives—yours and the other party's. It is human nature to focus primarily on your own position. The best negotiators analyze the opponent—not just from a business perspective, but from a psychological standpoint as well. What are their hidden psychological and emotional needs?

Conversely, the other party will attempt to discover what your alternatives are, such as selling to another buyer or continuing on in business and possibly raising capital for growth. They will likely offer a price that is slightly higher than what they perceive as your best alternative. How you posture your company and its opportunities can be very important.

In the end, the price depends on the buyer's perception of your alternatives and the impact of the acquisition on their business. It is critical to understand how they perceive your alternatives and how they perceive your impact on their business.

Using a Third Party

Entertain the idea of using a third party to help you negotiate. An intermediary can minimize extreme posturing and help defuse unreasonable claims. An experienced third party can more objectively gauge reactions, devise compromises, and draft structures that meet the objectives of both parties. He can keep the negotiations moving forward without the seller appearing too anxious to sell. An intermediary can be effective in negotiating employment contracts and salary issues when the parties will be working together after the transaction closes. The benefits of using a third party often outweigh the cost.

In summary, negotiating the sale of a company with intangible value is a challenge. The savvy negotiator studies his opponent and understands the market for his technology. The final determination of price will depend on the bargaining skills of the two contenders. The value you get is the value you negotiate.

By the way, Elvis' guitar sold for $152,000.