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M&A Insights

Capitalizing on Success

Navigating M&A Purchase Price Considerations

A Seller's Guide

AJ Ebels

Vice President

In the world of Mergers and Acquisitions (M&A), where a business owner seeks to sell a majority or all of their ownership to an acquirer, the structure of the purchase price plays a pivotal role. Understanding the various alternatives for purchase price consideration and their implications is crucial for achieving optimal results in a business sale. The advisory team members at Charter Capital Partners, having collectively completed hundreds of transactions for our clients, have encountered the full range of purchase price consideration alternatives. This experience enables us to guide business owners considering the sale of their company. This introduction outlines the advantages and disadvantages of the primary purchase price consideration alternatives a business seller might encounter, including cash at close, rollover equity, earnouts, and seller notes.

1: Cash at Close

Cash at close refers to the immediate payment in cash that a seller receives upon completing a transaction. It is the most straightforward and generally the most preferred form of consideration.

Advantages:

1. Immediate Liquidity: Sellers receive funds upfront, offering immediate liquidity and financial freedom. This aspect is generally the primary attraction for sellers as cash at close represents a bird in hand which is worth two in the bush, as they say.
2. **Diversification:** Aligns with a seller's typical goal of achieving financial diversification or "taking chips off the table".
3. **Risk Mitigation:** Sellers avoid future business, industry, and economic risks since payment is received at the time of sale.

Disadvantages:

1. Tax Implications: The entire sale amount is taxed in the year of the transaction, potentially leading to a significant tax liability.
2. Reinvestment Risk: The immediate influx of cash necessitates reinvestment, and sellers may face challenges in finding investments with returns comparable to the historical return on investing in their own business.
3. Limited Future Participation: Although the cash at close portion sheds go-forward risks, it also precludes participate in any future potential upside from the growth of the business.

2: Rollover Equity

Rollover equity refers to a portion of the seller's proceeds reinvested into the post-sale company. If the target company is being acquired as a standalone business, the rollover equity amount is reinvested in the post-transaction company which is often a newly formed legal entity. If the company is being acquired as an add-on or "bolt-on" to an existing platform, the rollover equity amount is reinvested either into the consolidated post-transaction platform or only into the subsidiary being acquired. Generally, a rollover into the broader platform is preferred.
Although less common for lower middle market businesses, if the acquiring company is public, rollover equity represents deal compensation furnished to the sellers in the form of public stock shares in the acquiring company. All forms of rollover equity allow the seller to maintain a stake in the business and participate in its future risks and upside.

Sellers considering rollover equity should thoroughly evaluate the buyer's growth expectations in addition to normal course diligence of the buyer's fitness as an acquirer. This includes questions about their investment horizon, return targets, and track record. An experienced M&A advisor can be invaluable in this process.

Advantages:

1. **Future Upside:** Sellers maintain a stake in the business, allowing them to benefit from future growth and profitability.
2. **Tax Deferral**: Part of the transaction value is not immediately taxed as it's reinvested into the business, potentially providing tax deferral benefits.
3. **Alignment of Interest:** Ensures continued alignment of interest between the seller and the company, as both share a mutual interest in the company's future success. For this reason, rollover equity is typically encouraged by buyers, especially if the seller is a key part of the management team.
4. **Pari Passu Terms:** Ideally, rollover equity terms are pari passu (meaning *'on equal footing'*) with the acquirer's equity, further aligning incentives and interests.
5. **Benefits from New Financial Leverage:** Rollover equity is subject to the new capital structure imposed on the business by the acquirer which often includes higher amounts of bank debt. While it is important to avoid overburdening the business with interest-bearing debt, a healthy level of debt can enhance returns for all equity holders and enable the acquirer to increase the total purchase price.

Disadvantages:

1. **Continued Risk:** Sellers remain financially tied to the company's performance, which can be a downside if the company does not perform well post-transaction.
2. **Liquidity Constraints:** Rollover equity is not as liquid as cash, limiting the seller's immediate financial flexibility.
3. **Complicated Exit:** Exiting the rollover equity position in the future may be more complex and uncertain compared to receiving cash at close.

3: Earnouts

Earnouts are a financing arrangement where the seller must earn part of the purchase price based on the future performance of the business. This involves potential additional proceeds to be paid to the seller after closing, typically based on performance targets like revenue, gross profit, or EBITDA. Earnouts are often used to "bridge the gap" when the buyer and seller have differing views on the future prospects of the business.

Advantages:

1. **Potential for Higher Total Valuation:** Earnouts allow for a higher potential total valuation, with the earnout portion based on the future value of the business as opposed to its present value.
2. **Alignment of Interests:** By tying part of the purchase price to the future success of the business, earnouts align the interests of both the buyer and seller, ensuring both parties work towards the business's growth and profitability.
3. **Facilitates Deal Closure:** Can help close a deal when there is a valuation gap between the buyer and seller.

Disadvantages:

1. **Payment Uncertainty:** Sellers face uncertainty regarding the final total payment

they will receive for the business as earnout payments are contingent on performance.
2. Continued Involvement: May require the seller to remain involved with the business post-sale to ensure performance metrics are met.
3. Complexity: The accounting for the business's financial performance that drives the earnout can be ambiguous and needs to be clearly defined, agreed upon, and documented between the buyer and seller before closing the transaction.

4: Seller Notes

Seller notes, or seller financing, involve the seller lending a portion of the purchase price to the buyer, who agrees to repay the amount financed over a specified period, with interest. This arrangement is typically used when the buyer lacks adequate financing from other sources.

Advantages:

1. Facilitates Deal Completion: Seller notes can help close a deal when traditional financing is unavailable or insufficient.
2. Potential for Higher Sale Price: By providing financing to the buyer, sellers might obtain a higher total sale price.
3. Interest Income: The seller can earn interest on the financed amount, providing an additional income stream.
4. Tax Benefits: The tax liability is spread over the term of the loan, potentially offering tax advantages compared to other alternatives.

Disadvantages:

1. Delayed Payment: Sellers do not receive the full purchase price upfront, delaying their access to the full funds.
2. Credit Risk: Sellers assume the risk of the buyer defaulting on the loan, which could lead to financial loss.
3. Reduced Liquidity: Since the sale amount is paid over the term of the loan, it is not immediately liquid, potentially limiting the seller's financial flexibility.

Weighing Your Options

Properly evaluating and negotiating alternatives put forth by potential acquirers is crucial in maximizing the financial benefits and minimizing the risks in an M&A transaction. Sellers are likely to encounter more than one of these purchase price consideration alternatives when evaluating bids from multiple potential acquirers and when negotiating with the selected partner. Each option has unique advantages and disadvantages, and the right choice depends on the specific objectives, constraints, and risk tolerance of the seller.

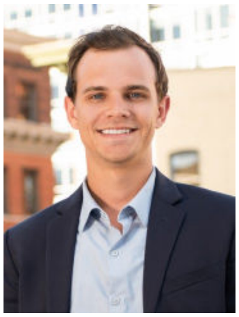
Business sellers can engage with Charter Capital Partners to understand and navigate these complex decisions. With many decades of combined experience, our advisory team has successfully executed and negotiated hundreds of transactions on behalf of sellers. Our team is available and eager to offer M&A insights and expertise, share learnings from specific case studies, and discuss current market trends with business owners contemplating a sale. Making an informed decision that aligns with your financial and personal goals is crucial, and Charter Capital Partners stands ready to assist you on this important journey.

CHARTER Capital Partners

About Charter

Founded in 1989, Charter Capital Partners is a premier investment banking firm headquartered in Grand Rapids, Michigan. We offer a comprehensive range of investment banking advisory services, including buy-side and sell-side M&A, Succession planning, business valuation and capital raise.

About the Author



AJ Ebels, Vice President

AJ has been with Charter Capital Partners since he started as an intern in 2016. In his current role as Vice President, he focuses on due diligence, deal execution, portfolio monitoring, and fund management activities for the Charter Growth Capital Fund, the Michigan Accelerator Fund, and Charter's numerous other venture capital and private equity investments. He also contributes as a deal team member for Charter's mergers and acquisitions practice, having worked on deals across the manufacturing, industrials, technology, and consumer sectors. He also leads internal technology and software initiatives for the firm.

AJ graduated from Grand Valley State University in 2017 with a BBA in Finance and Business Economics and was a graduate of the Frederik Meijer Honors College. In 2023, he earned his MBA from the University of Chicago Booth School of Business in the weekend program with concentrations in Finance, Entrepreneurship, and Accounting.

M&A Advisory Team

John Kerschen
President and Managing Partner
jkerschen@chartercapitalpartners.com

Mike Brown
Partner and Managing Director
mbrown@chartercapitalpartners.com

Mike Palm
Partner and Managing Director
mpalm@chartercapitalpartners.com

Mark Streekstra
Partner and Managing Director
mstreekstra@chartercapitalpartners.com

Jenny Dakoske
Director
jdakoske@chartercapitalpartners.com

Zach Wiersma
Director
zwiersma@chartercapitalpartners.com

Elisa Berger
Vice President
eberger@chartercapitalpartners.com

AJ Ebels
Vice President
aebels@chartercapitalpartners.com

Justin Pinto
Vice President
jpinto@chartercapitalpartners.com

Michael Pohl
Associate
mpohl@chartercapitalpartners.com

Keegan Ensing
Senior Analyst
kensing@chartercapitalpartners.com

Drew Dow
Analyst
ddow@chartercapitalpartners.com

Travis Read
Analyst
tread@chartercapitalpartners.com

Dylan Stenzinger
Analyst
dstenzinger@chartercapitalpartners.com