

## The Real Impact of Economic Conditions on Middle Market Acquisition Pricing

by George Spilka

Many middle-market executives mistakenly believe that external economic conditions significantly impact the timing and pricing of middle-market acquisitions—those within the price range from a couple of million to \$200 million. The reality is that economic conditions should have little, if any, impact on middle-market transaction prices, as long as a strategic buyer is located.

A selling owner should not allow a large corporate acquirer to take advantage of bad economic conditions to justify a substandard transaction offer. Instead, he should demand a similarly priced deal to that expected under optimal economic conditions.

### Value Based on Projected Earnings

Acquirers often try to “steal” a seller’s company, whether in an economic downturn, a recession or even in optimal economic times. In addition, acquirers by their very size and acquisitive nature are usually more familiar with the acquisition process than a selling owner. This combined with the vast financial clout of large multinational companies enables them to approach a prospective seller in an arrogant manner and demand unreasonably low transaction prices. Unfortunately, too many sellers fall prey to this approach.

The pricing of large corporate acquisitions, where prices exceed \$200 million, tends to be quite volatile and will mirror changes in the stock market. The same should not be true of middle-market acquisitions, which should proceed fully priced, as if economic conditions were optimal. The reason is that middle-market transaction prices should be determined by the expected future earnings (cash flow) and the risk in achieving those earnings from the business foundation given to an acquirer. The expected future earnings used in developing an acquisition price will more than likely be based on the projected earnings flow through the next business cycle. Therefore, the pricing of a deal should not be significantly affected based on the point in the business cycle that a company is sold.

### Accounting for Synergistic Benefits

A strategic acquirer will determine an affordable transaction price based on the expected incremental future earnings produced by the combination of the two companies. Synergistic benefits produced by the deal should ensure that the combined future earnings of the companies would exceed the total of both operating separately. This enables the payment of a higher premium price by a strategic acquirer, while still generating an attractive return on investment. Without synergistic benefits, the optimum acquisition price can’t be paid. Since financial buyers often fail to bring synergistic benefits to the deal, and typically add little in the way of management skills, the sole way they can produce high returns for their institutional investors is to buy at vastly discounted prices.

When a seller enters the market, its business foundation should be in solid shape, as this has a substantial impact on attaining a premium price. The selling owner should have an acquisition advisory firm review its business foundation before proceeding with a sale. The advisor should recommend necessary changes should he identify any deficiencies in the foundation that would impact the transaction price.

When evaluating the business foundation of a manufacturer, the following factors should be accounted for:

The strength of the market niche;

Their ability to control the customer base over a long period of time;

The proprietary nature of the product line;

The firm’s investments in new equipment and facilities;

How cost-effectively the production facilities operate; and

The competency of the management group.

Other characteristics, depending on the specific industry served, will also affect the business foundation and its impact on pricing.

To summarize, there are five key points to remember if a selling owner is to consummate a fully priced deal during an economic downturn or recession.

1. **Locate a Strategic Buyer for Your Firm** - A strategic acquirer will be interested in obtaining your market niche to gain the full synergistic benefits of the consolidation of the two companies. It will be interested in intermediate and long-term benefits from the acquisition. As the short-term earnings and outlook should not be of paramount importance to them, they are less likely to allow current economic conditions to justify a substandard offer.
2. **Foreign Strategic Acquirers Are Now Accessible Candidates to Acquire Your Company**. Acquisition advisors can use the Internet in order to access a vast array of foreign candidates to acquire your company. The acquisition of domestic companies by foreign acquirers is now a realistic possibility for middle-market owners. Foreign acquirers of U.S. companies usually wish to obtain strategic positions in the U.S. market. Therefore, they tend not to fixate on short-term performance as a serious deal-pricing consideration, and will not want to lose an opportunity by trying to steal a company with a substandard offer.
3. **There Has Been a Vast Consolidation in Many Industries** - With the rapid consolidation of many industries, the number of domestic acquirers has been greatly reduced. In a few industries, the major national acquirers have become brazenly aggressive in demanding substandard acquisition pricing. In these industries, a seller must remain patient and stand firm, waiting until one acquirer breaks from the pack and offers a fair price.
4. **Absence of Upside Volatility in Middle-Market Deals** - As previously discussed, the pricing of middle-market deals never increases dramatically during good economic times or buoyant stock-market conditions. During these conditions, the increase in middle-market deal pricing is extremely muted, as compared to those of larger corporate deals. Correspondingly, a middle-market seller never sees the benefit of a market top, and therefore should never accept a reduced price during poor economic conditions. Pricing for middle-market deals should not significantly vary during bad economic conditions.

**Impact of Reduced Earnings During Poor Economic Conditions** - When an economic downturn/recession subsides, sellers must not allow acquirers to use the reduced earnings generated during the down period as an excuse for a substandard offer. During prolonged good economic times, many acquirers want to discount the value of recent earnings by those that will be realized during bad economic times. Then, these same acquirers after the end of an economic downturn will try to price a middle-market company solely on the earnings realized during bad economic times. Remember: Middle-market deal pricing is dictated not by historical earnings but by expected future earnings and the risk in achieving those earnings from the business foundation given an acquirer. This concept should govern deal pricing during any economic condition.

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