8 strategies for bridging the value gap between M&A buyers and sellers

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Although the value and volume of merger and acquisition (M&A) transactions varies from year to year, deal activity throughout the pandemic trended largely in one direction: up. For seven consecutive quarters between Q2 2020 and Q1 2022, global M&A activity exceeded $1 trillion.

The dizzy ascent, however, has begun to falter. Since the second half of 2022, deal-making has been sluggish due to a range of economic headwinds, such as the rising cost of debt, mounting inflation and the still looming threat of recession.

Unfortunately, not all sellers have gotten the message. Bolstered by years of rich purchase prices and public market valuations that continue to defy gravity, many private market sellers are holding out for the higher value offers no longer on the table. As the expectation gap between buyers and sellers widens, deals are stalling. This, despite the fact that private equity buyers have money to spend and many business owners remain incented to sell following the harrowing years of the pandemic and as they reach retirement age.

Fortunately, strategies exist that can help bridge the value gap between buyers and sellers interested in transacting. Some are tried-and-true solutions resurging in popularity in response to the current deal environment. Others can be combined within a single transaction to reach the desired results. All, however, rely on careful coordination between commercial and tax advisors.

1. Spin-offs or split ups

Sometimes, buyers and sellers find themselves agreeing on the value of most of the target entity’s assets or business–but not all of it. In these scenarios, it may be possible to bridge the gap between the buyer and seller by spinning off the segment of the business whose value is in dispute, assuming those assets are not integral to the buyer’s desire to acquire the target business.

In this situation, the target entity will typically spin the disputed assets or business unit into a new company that either can be retained by its shareholders (*i.e.*, the sellers) and operated independently or sold to a third party (either by the buyer, target entity or sellers) who may value it differently than the buyer. With these disputed-value assets dealt with, the target entity holding the remaining assets can be sold to the buyer at a mutually agreed upon price.

While this approach can serve to bring buyers and sellers into alignment, it typically requires significant tax planning to execute, depending on who is acquiring the disputed-value assets, whether the target entity has material accrued but unrealized gains on those assets and what that entity's other tax attributes are (*e.g.*, loss carry forwards). If those assets are being distributed to the shareholders of the target entity, tax planning is also necessary to determine the optimal form of distribution (*e.g.*, as dividends, a return of capital or something else entirely). To minimize taxes, it is essential to consider the tax attributes of both the target entity and its shareholders before locking in a structure.

2. Share exchanges

If sellers are feeling shortchanged but believe the buyer's business will continue to rise in value, they may be willing to reduce their cash purchase price in exchange for shares of the buyer. From a commercial perspective–if the buyer's shareholder is willing to be diluted–this allows the selling shareholders to participate in any upside the buyer realizes, including upside from the business they are selling. From a tax perspective, the exchange of seller's shares of the target entity for shares of the buyer can be accomplished in some cases without the gain being realized for tax purposes. For example, it is typically possible to exchange shares of one Canadian corporation for shares of another Canadian corporation without realizing accrued gains. Where the buyer is foreign, "exchangeable share" structures may be the answer. Again, understanding all the available options requires close collaboration between your trusted business and tax advisors.

3. Earnouts

Sellers who truly believe in the future value of their business may be willing to make a portion of the sale price contingent on achieving certain metrics over time. For instance, let's say the buyer is willing to pay $60 million for a business the seller believes is worth $100 million. In this case, the buyer may agree to pay $50 million on closing, plus 10 per cent of earnings or profits for the first three post-closing years, to a maximum of an additional $50 million. In this manner, the buyer's risk of over-paying is mitigated by making part of the sale price contingent on post-closing performance of the business.

This structure allows a buyer to defer part of the payment over time, while making it contingent on the achievement of carefully predefined results. At the same time, it allows sellers to attract a higher value for the business if it meets specific pre-agreed milestones within a pre-set time.

Although earnouts have been around for a long time, their structure has shifted recently. Rather than buyers paying 80 per cent to 90 per cent of the anticipated value of the deal up front, as they did in the past, today many are offering only 40 per cent to 70 per cent of the value up front–putting sellers in a position of potentially earning out more than half the value of the sale. Proving that each contingency has been met has also become highly disputed, leading to a growing incidence of litigation related to earnouts, which makes careful structuring and documentation more important than ever.

Earn-outs are especially tax-intensive, and unless structured properly, they can result in the sellers being taxed at higher rates (*i.e*., above the normal rates applicable to capital gains) on the variable portion of the sale price (or possibly the entire amount). There are certain techniques accepted by tax authorities for mitigating this potentially adverse tax result, again making early-stage tax planning very important.

4. Vendor financing

Like earnouts, Vendor Take Backs (VTBs) allow buyers to defer a portion of the purchase price to a later date. Rather than making the future payout contingent on achieving specific milestones, however, a portion of the purchase price is structured as a debt owing by the buyer to the seller pursuant to a vendor take back financing agreement. In essence, the buyer pays the seller-financed portion of the purchase price plus interest over a pre-agreed period (*e.g*., the next one to three years) subject to certain acceleration clauses. The VTB's applicable interest rate is typically materially lower than what the buyer could obtain from a third party.

As VTBs come back into vogue, their tax implications must be considered. In some cases, sellers may be able to defer tax recognition of the unpaid portion of the purchase price over the period between closing and when the debt is fully paid (up to a maximum of 5 years) by claiming a reserve. For instance, if the buyer agrees to pay $50 million at closing plus an additional $50 million over the next five years via balance of sale proceeds (e.g., $10 million per year for five years), the seller may be able to claim a reserve for tax purposes on the portion of the sale proceeds received after the year in which the sale closes, thereby deferring tax on some of the gain otherwise realized on the sale. Moreover, if the debt owing is structured at low or no interest, the seller may also be able to get a better total purchase price while minimizing taxes that would otherwise be owed on interest income.

5. Partial purchases

Like earnouts, partial purchases allow buyers to pay a lower price than sellers want in exchange for less than 100 per cent of the target entity. Generally, the buyer will purchase a majority stake while the seller retains a minority and both parties enter a shareholder agreement that allows the buyer to call the shares of the target entity held by the seller–or the seller to put its shares to the buyer–at a pre-set price, depending on the achievement of specific performance metrics or using a pre-set valuation formula after an agreed period of time has passed.

If target entity performs well post-acquisition, the sellers may receive the full purchase price for which they were looking. However, if performance falls short, the call may allow the buyer to purchase the seller's remaining shares at a discount (sometimes as low as $0.01 per share).

While this structure can be complicated from a commercial perspective due to the restrictions contained in the shareholder agreement, it is somewhat less tax intensive than other solutions, particularly if the buyer puts money into the target entity without requiring existing shareholders to sell their remaining shares. Instead, their ownership stake would simply be diluted. That said, if the sellers would like to take money out as part of the transaction, there are several tax issues that should be resolved in advance of the transaction.

6. Alternative consideration

Yet another way for a seller to earn a higher total return is by agreeing to work for or advise the target entity or buyer post-closing as an employee or consultant in exchange for a compensation package. This could include not only a salary and/or consulting fees, but also above-average bonuses, participation in any equity compensation or pension plan the buyer operates and even the right to earn warrants at a later date contingent on achieving certain milestones.

From a tax perspective, so long as the amounts being paid represent reasonable fair value for the services received, these expenses would normally be deductible to the target entity or buyer. While the recipient may earn amounts as fully taxable income, in some cases certain forms of compensation can be tax-advantaged to the recipient and constitute a way of putting funds directly into the hands of specific individuals providing the relevant services to the target entity or the buyer.

7. Tax relief via existing tax attributes

In some cases, a seller's over-all after-tax receipt can be significantly improved without increasing the purchase price by optimizing the use of all the available tax attributes of the target entity and the seller. For example, frequently significant taxes can be saved by using the lifetime capital gains exemption for Canadian-resident individuals, by using loss carry forwards or other available tax shelter, by having the target entity pay (or be deemed to have paid for tax purposes) dividends to a holding company owned by the seller rather than to the seller individually, by using the target entity's capital dividend account prior to closing or various other tax planning techniques. Not surprisingly, expert tax advice (preferably obtained from counsel on a confidential basis protected from disclosure to tax authorities by solicitor-client privilege) is necessary to achieve these results.

8. Dealing with liabilities

While less obvious to some sellers, liability relief may make sense where the dispute in value relates to a latent liability that could impact the long-term value of the deal. In many cases, buyers can claw back a portion of the purchase price as part of an indemnity claim if they find themselves faced with unanticipated material liabilities post-closing (*e.g.*, unpaid bills, tax obligations, pending lawsuits, environmental remediation, etc.). In exchange for having these indemnity claims waived, sellers may be willing to accept a lower purchase price. Using representation and warranty insurance, which the buyer typically pays for, the sellers could walk away from the deal with zero risk (*e.g*., selling a house without any closing conditions). Conversely, where the buyer is concerned that the target entity has a particular liability that the seller thinks is not a problem (*viz.*, the parties disagree), changing the form of the transaction (*i.e*., from a sale of the target entity's shares to a sale by the target entity of its assets) serves as a structural solution by relieving the buyer from bearing that risk and eliminating the discount to the purchase price it would otherwise insist on.

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An M&A transaction typically represents a major milestone for both buyers and sellers, but risks abound. To avoid missteps and make sure your transaction is optimally structured, it is essential to work with a team that understands not only the commercial implications of a merger, but its tax implications as well.

At BLG, we work in multidisciplinary teams to craft tailored solutions designed to meet your unique circumstances. To discuss strategies for closing the valuation gap between buyers and sellers, contact our authors directly.

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