Understanding Arbitrage Valuation

Before any purchase and sale transaction can be completed, it is essential to arrive at a mutually agreed enterprise valuation. Both the buyer and the seller need to understand the factors that determine the value and reach a consensus on the sale price, payment method, timeline, and other related matters. However, different valuation methods may result in varying values, and not all parties may agree on the valuation determined.

There are various valid methods for valuing a transaction, including the EBITDA valuation method, enterprise value, and discounted cash flow. Each of these methods is commonly used by brokers and advisors to private business owners. These methods may lead to different valuation figures, which can be challenging to reconcile due to sellers' emotional attachments to their businesses built over many years.

Arbitrage is a useful tool for bridging the differences between the buyer and the seller over enterprise value. It provides a mechanism to support a higher selling price than the buyer might otherwise be willing to justify. The Arbitrage Value Proposition is a simple concept that involves increasing the value of a company between buying it and selling it before improvements. The core requirement for arbitrage is the capability of realizing a profit from a valuation differential.

According to Investopedia, arbitrage is the simultaneous purchase and sale of an asset to profit from an imbalance in the price.[1] It is a trade that exploits the price differences of identical or similar financial instruments on different markets or in different forms. Arbitrage is a necessary force in the financial marketplace to ensure prices do not deviate substantially from fair value for long periods.

Although a seller may take umbrage at their business being considered a commodity, the selling and buying of private businesses is an imperfect market, meeting the core requirement for arbitrage. Some participants may have different capabilities and information, leading to inefficient markets in which the most astute participants can pull greater profits than in more efficient markets.

Private markets, which lack formal exchanges, are inherently imperfect and therefore offer opportunities for arbitrage. While such opportunities are not as straightforward or tangible as in the case of commodities, value arbitrage is a tool used by private equity firms and strategic buyers to generate automatic positive returns even before realizing any benefits. Understanding this method can help both buy-side and sell-side advisors achieve fair prices for their clients.

[1] https://www.investopedia.com/terms/a/arbitrage.asp

Value arbitrage involves the fact that an asset will be sold in the future, rather than being held and made more operationally profitable to increase ROI, although the latter is also an objective. This is primarily a tool used by private equity firms, but strategic buyers also employ it. There are three instances of a value arbitrage strategy:

> *Acquisition to increase the company's size The size and scope of a company is a significant factor in valuation. Larger companies, even if otherwise identical to smaller ones, generally command a higher multiple. If companies with $5 million in EBITDA sell at 5x earnings, while those with more than $20 million in EBITDA sell at 7x earnings, then a $20 million EBITDA company can hypothetically acquire a $5 million EBITDA company for $25 million and sell the combined entity for $35 million, benefiting from multiple-of-EBITDA arbitrage. Some strategic buyers and private equity portfolio companies build strategies around consolidating industries solely to increase aggregate EBITDA and subsequently sell the entire company for a higher value than the sum of its parts.*

> *Repositioning the target in a more favorable industry Assumed growth in profitability is another driver of company and industry valuation multiples. If a consensus of buyers believes that the smartphone market will grow faster than the windowpane market, they are likely to pay more per share of a smartphone manufacturer's earnings than those of a window manufacturer, perhaps 7x and 4x, respectively. A window manufacturer might have the capabilities to turn glass into something useful for smartphones, such as their screens. A financial buyer could purchase the window manufacturer at 4x EBITDA, adjust the strategy and business plan, and sell it back to the market as a smartphone play at 7x EBITDA. Likewise, a smartphone company could purchase the window company at 4x and incorporate it into the business model, realizing the spread when it sells at 7x.*

> *Rolling a private company into a public company If a public company trading at 20x earnings acquires a small private company for 10x earnings, the earnings of the latter will automatically trade at 20x as part of the whole entity, provided the transaction is small enough not to be scrutinized. When the public company reports earnings for the first time after making the acquisition, the tranche of earnings from the acquisition naturally trades at the same multiple as the whole entity, 20x instead of 10x, completing the arbitrage.*

Understanding value arbitrage and keeping it in mind when conducting a deal can benefit your client, whether they are a buyer or a seller. As a buy-side advisor, you may be able to identify value arbitrage candidates to present to your client. If a buyer is confident in the spread and believes it is priced correctly, they will almost certainly take advantage of an arbitrage as it is essentially free money. This means that an arbitrage opportunity can justify a higher purchase price up to a certain point where the risk-reward profile of realizing the spread remains favorable. Knowledge of this can benefit a sell-side advisor negotiating a selling price. Understanding that a potential buyer may view your sale as an

arbitrage opportunity gives you greater bargaining power. Familiarity with multiple arbitrages makes you a more informed and valuable advisor.

A viable option for sellers to achieve a more favorable value proposition for their company is through a qualified transaction structure known as "Partnering & Recapitalization." This structure involves the sale of less than 100% but more than 50% of the company's stock by the seller. The seller receives a cash amount or equivalent value, based on conventional multiple valuation, which exceeds the pro-rata value of stock sold. Additionally, the seller retains equity in the acquired company and realizes a premium enhancement in convertible preferred shares.

The seller then partners with the buyer, forming a holding company that operates and grows the seller's company under a new combined business model and strategic plan. The buyer provides the capital for growth, and the seller's initial proceeds are taken off the table, allowing the seller to exit from the daily grind of management and assume a higher-level role, such as strategic planning and growth or identifying possible additional acquisitions. The seller is appropriately compensated for their work, and their role is determined by their strengths, preferences, and the depth of the buyer and the company's management team.

The transaction strategy aims to grow the selling company aggressively, internally and through acquisition, resulting in a materially larger company than when originally sold. Thus, when the seller sells all or a portion of the stock retained from the original sale, the sale proceeds are typically greater than those anticipated at the initial closing, depending on the success of the intervening growth strategy.

This partnership strategy works because the buyer and seller work together as partners to grow the company, expanding its value proposition until the completion of the transaction. The seller's interests are protected by staying involved as senior management, receiving compensation for their work, and acting as the senior bank until fully paid. The buyer's interests are protected because they assume a primary management role as they deploy their cash and working capital, ultimately owning a larger, stronger, and growing company with greater value than when originally purchased. The seller receives a greater return on the sale than the original valuation could have supported, plus the seller has benefitted from a planned exit strategy.

The following is an illustrative example of a transaction between a Seller and a Buyer.

> *The Seller and Buyer establish a new holding company to transfer the Seller's company as a portfolio company. Initially, the company is valued at $40 million, and the Seller sells 60% of the company to the New Holding Company for $24 million in cash and debt, while retaining 40% of the company's value in the*

portfolio company. In addition, the Seller receives $8 million in Preferred Stock as a premium in the holding company, which increases the Seller's valuation.

The Holding Company, backed by investment and acquisition, aims to list on NASDAQ or NYSE. Any company that becomes a subsidiary of the Holding Company through acquisition will benefit from the valuation arbitrage resulting from the public process, enhancing the value of the Preferred stock shares in the Holding Company held by the Seller. The goal of this strategy is to increase the size of the Seller's company over a period of up to seven (7) years by opening new locations and making additional bolt-on acquisitions using capital deployed by the Holding Company and investors. As a result, the value proposition of the company increases to $60 million, and the Seller receives $24 million (40% of this value, representing what the Seller held).

Upon exit and sale of stock, the Seller realizes a return of $24 million, in addition to the $24 million received from the sale of the company and the $8 million in Preferred Shares. In this scenario, the Seller realizes a $16 million gain on the sale of the company through arbitrage. It is important to note that the above example is for illustrative purposes only, and each transaction is unique and driven by its own set of valuations, analyses, market conditions, management skill sets, and other relevant circumstances.

This type of deal structure is becoming a more common practice for transactions that can be structured on a staged exit for the Seller. It is a preferred structure from a wealth planning perspective because it allows the Seller to take chips off the table immediately while continuing to grow with the stock that remains in the company. This is particularly important for business owners where most of their net worth is tied up in the value of their business.

Buyers and Sellers favor this type of structure because it minimizes the risk related to an owner and their expertise leaving the business entirely, ensuring operational continuity for successful growth. It is particularly attractive to Buyers when management team risk is effectively eliminated. The structure is suitable for Sellers who are not ready to walk away entirely from the business and are willing to partner with the Buyer to grow the business, or for those who have children who can remain with the business post-transaction and work with the Holding Company to grow the business. It is also appropriate for young owners or management teams who want to take chips off the table via the transaction or those who require help or an injection of capital from a new partner to finance the continued growth or expansion of the company.

This type of deal structure, when executed according to a defined strategy, presents minimal downside risk. From a wealth management perspective, the Seller is able to extract a portion of their investment while retaining ownership in the company. In the event that the future unfolds in alignment with the plans laid out by the Seller and Buyer, there is potential for a significant increase in value.