A White Paper from Chiron! the business doctor.™

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SHARE PRICE NEGOTIATIONS WITH INVESTORS

When you need to raise equity capital, you have to negotiate a price for your company's shares with investors who may wish to contribute funds to your venture. Those negotiations will necessarily be face-to-face and often, one-to-one. The imperative for you in this situation is that you must have some knowledge of the many factors that can influence, both favourably and adversely, share price negotiations

In negotiations, you must know your negotiating adversaries: they are trying to get the best deal they can for themselves. ***You have to get the best deal you can for yourself!*** **Preparing yourself to negotiate successfully is one of the must do realities of publishing an equity offer to raise investment funds to expand your business. So don't kid yourself: it's a tough world out there. Investors are canny, astute, frugal and sometimes parsimonious. They are certainly not generous, benevolent or charitable where their business interests are concerned. If that is a benchmark, then there is no reason for you to be generous, benevolent or charitable where your business is concerned.**

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NEGOTIATING WITH INVESTORS

You are a Client of Chiron! the business doctor.™ Together, you and Chiron! the business doctor.™ have prepared a business plan and published an equity offer to raise investment funds to exponentially expand your business. Investors are showing interest and want to discuss your plans directly with you. What happens next therefore may make or break your business dreams. The reality that you face at this point is that you must effectively prepare yourself for the ensuing negotiations with your potential investors. The central point of those negotiations will be about the sale and purchase price of the shares in your company.

Preparing means that you must not only be completely equipped to answer all investors' questions about your business plans and projections, but you and your team must project a 4C image of competence, capacity, capability and confidence. Additionally, you must know the strategies and techniques that the investors will use in the negotiations with you for a stake in your company. This is crucial if you are to reach a successful conclusion and gain the best deal possible.

Chiron! the business doctor presents this primer to point you in the right direction.

Like an invisible elephant in the room, there are some unseen but strongly felt influences that have an effect on equity offer price negotiations. You have to be aware of these influences for two reasons. The first is to ensure that you are as prepared as you can be to commence negotiating by having some appreciation of the factors that may affect your negotiating adversary's negotiating position as the negotiations commence. This is important because the initial position taken in the negotiations by your negotiating adversary can give you some clues as to the negotiating direction they are likely to take.

The second reason is that knowing these unseen but strongly felt influences can permit you to better prepare your negotiating position so that you will not be taken by surprise when your negotiating adversary follows one particular course of action rather than another.

As negotiations commence, you can bet your bottom dollar that your negotiating adversary will be seeking concessions from you to obtain the best deal possible in their own eyes. There is a fundamental rule in equity offer price negotiations that the price you have placed on your securities on offer provides investors with a guide only and the price actually paid for securities will always be a matter for negotiation between the parties.

This unfortunately creates an expectation on the part of investors that they can beat you down by getting your agreement to lower the price of the securities, or provide a larger allocation of securities than offered or by obtaining some other concession from you that has a financial benefit. For example, the investor may want to purchase a stake in your company to gain access to your customer or client base to enhance or expand its own customer base, or the investor may seek access to your technology or expertise, to name but two possibilities.

Your problem is that you would have based your business plan on receipt of a certain sum of money. This means that were you to receive less than this amount, then your business plan may be placed in jeopardy. If you and your advisers consider that your equity offer represents a good deal, you can put

a premium on the value (the offer price) for your securities. Consequently, you can introduce some bargaining flexibility into your negotiations with investors by initially seeking the premium price but with a fall back position where you cannot agree to a deal for less than the minimum amount required.

You have an important role therefore to stress to those negotiating adversaries that think that they can negotiate a bargain, that they may be cutting their own throat by denying you the resources to implement your business plan. Importantly, you could point out, it was the benefit or success that could be seen in the business plan that got the investor to the negotiating table in the first place. Why would the investor want to prejudice that benefit or success?

The investor may want to purchase a stake in your company to gain access to your customer or client base to enhance or expand its own customer base, or the investor may seek access to your technology or expertise.

While negotiations for your securities will commence from a base where you have set the price you want, and that price reflects your view of your company's fair market value, and your negotiating adversary makes a first offer based on what he or she thinks is a fair market value, it will only be in very rare circumstances that those figures would coincide. Even if your negotiating adversary concedes that equity position, he or she will not concede the point, but will try for a discount as referred earlier. As this is the position that you will expect to be in, it is important that before you commence negotiations you consider the following points and their effect on your negotiating adversary. In essence, you must pre-prepare yourself to deal with subsequent events as the negotiations unfold.

1. **The Influence of the appeal that your company has as a profitable acquisition.**
2. **The Influence of price as it affects both parties to the negotiations.**
3. **The Influence that market and economic conditions have on negotiations.**
4. **The Influence on the negotiations of the parties' relative negotiation skills and bargaining leverage.**
5. **The Influence of the investors' experience with prior acquisitions negotiations.**
6. **The Influence of inherent risk factors and investors' tolerance for them.**
7. **What do you know about the company or person wanting to buy your shares?**

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1. The Influence of the appeal that your company has as a profitable acquisition

If your offer price is actually below the fair market value price, your equity offer will be seen as very attractive by investors. If your offer price is about equal to the fair market value price, your equity offer will still be seen as an attractive proposition by investors. Apart from the comparison of your equity price to the fair market value price, there are other factors that contribute to your company's position as a drawcard, for example:

- Your company has a market leadership position or there is a strong expectation that your sales projections can be achieved,
- Your company's actual growth rate is high when compared to industry benchmarks; or your projected high growth rate is seen as achievable,
- Your company's earnings (profit & loss statement) are high when compared to industry benchmarks; or your projected earnings are seen as achievable,
- Your company has a strong balance sheet,

- Your company has the capacity to acquire debt,
- Your company's Board and senior management team is acknowledged as skilled, disciplined and competent.

From your point of view, if shares in your company can be seen to be an attractive acquisition, then you can put a premium on your price. You can put a premium on your price because your company's future earnings can be seen to support such a premium. Moreover, if your company can be seen to be an attractive acquisition, then it will no doubt attract a larger number of prospective investors. The larger the number of prospective investors, the higher the premium that you can ask for a sale of securities.

2. The Influence of price as it affects both parties to the negotiations

This is a serious conflict area where you must expect differences in negotiating approaches. On the one hand, you want to raise all the money needed to implement your business plan. Consequently, you have set your selling price to achieve your cash requirement (perhaps even a little bit more), and of course, you may have set a fall back position in the negotiations in case you are forced into a compromise. You will definitely set the point at which you will withdraw from the negotiations if there is no opportunity for an acceptable settlement. So your position is quite straightforward.

If shares in your company can be seen to be an attractive acquisition, then you can put a premium on your price.

On the other hand, the investors positions are not so clear-cut. Investors have to take into account a range of factors that determine what they can afford to pay for your shares. Those factors include, but are not limited to:

- the cash reserves they have available for the purchase of acquisitions,
- if the investment funds are provided by a third party, the terms under which the cash is accepted,
- the amount they are willing to invest in a single investment as a percentage of their cash reserves,
- the cost of the capital to be invested,
- the stumbling block; viz., the percentage required over and above the cost of the investment capital.

3. The Influence that market and economic conditions have on negotiations

There is no doubt that you have to pick the time that you put your equity offer to the market.

If the outlook is bullish, then you will obviously be in a better position to achieve success. If the outlook is bearish, your chance of success is reduced. Economic and market conditions therefore have a strong influence on investors' purchase decisions. Some of the factors that investors will keep in the forefront of their minds as they assess your company as an acquisition include:

- Will present favourable economic conditions and a growing market disguise problems within your company that will not surface until such conditions deteriorate?
- Will the favourable economic conditions be likely to lead to higher earnings from your company and therefore give you the opportunity to ask for a higher price?

- To follow on from that thought, will the favourable economic conditions be likely to give you higher expectations for a more favourable negotiated output than the investors were prepared for?
- Investors' attitudes to or assessments of future economic developments will determine the extent, if any, to which a premium should be offered to attract you into a deal.
- But the key point that you must keep in the forefront of your mind is this, whatever view of the future the investors hold as they determine a negotiating position, they are probably wrong!

While favourable economic condition encourage the offer of higher premiums, the inescapable fact is that economic conditions are cyclical, and therefore under constant change. Given that you know that investors want to invest for stability over a minimum period of at least three to five years duration, you should not unduly rely on the economic conditions for a negotiating advantage. Such an advantage is ephemeral and transitory.

The reality therefore is that if you use economic circumstances for a negotiating advantage, and the negotiations are extended over a longer period of time, there is a significant risk that you may be left high and dry if the economic circumstance worsen suddenly, as has been shown to happen over recent times; the GFC is a perfect example.

4. The Influence on the negotiations of the parties' relative negotiation skills and bargaining leverage

You are the seller in the negotiations. You have a walk away position set by the amount of equity capital you need to implement your business plan. The investors' position is not so open and transparent. The investors want to pay the minimum amount necessary to do a deal. Investors therefore are forced to rely on their negotiating skills, bargaining leverage and the effective use of the time constraints to achieve what is possible in the circumstances.

Will the favourable economic conditions be likely to lead to higher earnings from your company and therefore give you the opportunity to ask for a higher price?

In negotiations of this nature, the power wielded by each party is derived from their perceived ability to fulfil the requirements of the other. You, as the seller, offer investors (as purchasers) the perceived economic advantages of owning a substantial proportion of the company. From the investors' perspective as the purchasers, the investors offer you, the seller, a combination of personal freedom, cash liquidity and the opportunity to further develop your company. The greatest power possessed by both you, the seller and the investors as purchasers, is to walk away from the negotiations. This is simply the power to say 'no'.

Both you and the investors will commence negotiations with a set of expectations and assumptions. Your expectations will be influenced by the attractiveness of your company and the percentage allocation of shares you have put on the table, along with any advice you may be given by advisers and confidantes.

If there are a number of potential investors willing to negotiate for part or all of the equity offer, the investors can be expected to compete with each other.

This should result in the investors driving a harder bargain while you have the opportunity to play each investor off against the rest. In this situation, you must work out a strategy with your advisers

and confidantes that creates a process and negotiating environment that encourages the highest and best offer from the investor group.

In this scenario, it is not always plain sailing. You have to keep your guard up. For example, you don't want the negotiations sunk by an overly aggressive attitude or demeanour. In particular, each investor will be trying to snow you with details of how synergistic his or her company will be with yours and how, by working together, there will be a positive vision for the future that will result in great profits. Each investor will ask you questions, many questions. The questions will be focused on trying to elicit information from you that may be useful to the investors in the negotiations. You must be careful not to reveal too much.

In negotiations of this nature, the power wielded by each party is derived from their perceived ability to fulfil the requirements of the other.

Time is a pivotal deal maker or deal breaker, depending upon which side of the fence you are sitting at the time. If an investor has a deadline to meet in concluding a deal, there may be a possibility that you, as seller, may receive an advantage in the form of reduced opposition to issues related to pricing. On the other hand, if you, as the seller, are under a deadline (which can be self-imposed or the result of some external event), then that will usually mean that you will become amenable to some flexibility on price and terms.

As a rough rule of thumb, parties involved in negotiations will always attempt to keep their time constraints confidential as knowledge of them gives a definitive edge to the other party.

5. The Influence of the investors' experience with prior acquisitions negotiations

The premium that an investor is willing to pay is often influenced by prior experience. If the investor paid a high premium in the past and the acquisition failed to deliver returns as expected, the investor is going to be very wary before offering a generous premium again; and of course, the reverse may be just as true. An investor's prior experience in difficult negotiations reduces the pressure on the premium offer. The investor's prior experience therefore provides the investor with:

- an understanding of the relative value of companies and the drivers that influence value,
- a comprehension of the strengths and weaknesses of companies in general and how to usefully compare particular companies to similar companies,
- the ability to apply procedures and systems to ensure a well-organised and efficient integration and transition phase that will permit the exploitation of existing opportunities,
- knowledge of an industry, which makes it easier to identify financial difficulties within companies in that industry and separate substance over form, and
- the ability to recognise and ameliorate risks facing similar companies and the industry.

From the reverse perspective, an investor's lack of experience in the disciplines of corporate acquisition negotiations and post-acquisition integration and transition should give impetus to the adoption of a lower offer premium, not because of the company, but because of the investor's worry that the result might be a higher probability that a bad outcome will occur.

6. The Influence of inherent risk factors and investors' tolerance for them:

Risk is defined simply as the possibility of a bad outcome. An alternative definition is that risk is the uncertainty of a desired outcome. Tolerance of risk is defined as a person's willingness to accept and manage the risks. Risk management is the action that you take to reduce the possibilities of a bad outcome and increase the odds of a desired outcome.

When it comes to negotiating the settlement of your equity offer with an investor, the biggest risk you face is that you will agree to a purchase price package that does not make economic sense: you will not receive enough funds through the agreement to implement your business plan.

If the investor paid a high premium in the past and the acquisition failed to deliver returns as expected, the investor is going to be very wary before offering a generous premium again.

From the investor's viewpoint, the investor's biggest risk is that he or she will agree to a purchase price package with you that does not make economic sense: he or she will concede and pay an overly generous premium! Such a situation may appear to give you an immediate financial benefit, but over the longer term, it may prove counterproductive.

It may prove counterproductive because once the investor realises that the price paid was overly generous and therefore will extend the payback period and perhaps reduce the return on investment, you may find that you suddenly have a dissatisfied shareholder/director who will have the capacity to disrupt the orderly implementation of your business plan. The shareholder/director may blame you for what the investor feels was an unconscionable act of greediness, whether that is true or not. In business as in politics, perception is often the reality. There is a downside to being greedy, whether it is intentional or not.

When it comes to the risk of acquisition pricing, you don't have a problem because you know exactly what you want. The investors may know what they want, but there is a higher relative risk in achieving it. Investors therefore are guided by two key principles:

- The lower the inherent risks of owning the shares in your company, the higher the premium the investor might have to pay.
- The higher the premium paid by the investor, the greater the risk to the investor.

During the evaluation and due-diligence process of an investment proposal (such as yours), an investor should address the following risks as a bare minimum, bearing in mind that that there will be other inherent risks that the investor must discover:

- key customer dependency,
- key employee reliability,
- marketplace uncertainty,
- competitive pressures,
- supply chain weaknesses,
- the existence of present or pending litigation, and
- the existence of present or pending governmental regulation.

If an investor wants to acquire shares in a company, there are two avenues to obtain a higher return on the investment:

- Pay less for the shares on offer.
- Implement a plan to increase the company's earnings once the transaction is concluded.

Investors are actually in some difficulty here. If they want to rely on increased earnings to justify paying you a higher premium, they have to keep in mind that the greater the number of positive assumptions they adopt, the greater the odds for an undesirable outcome.

Once an investor identifies the risks, the next step is to determine if the investor can tolerate them. If the rewards are sufficient and confidence for a positive outcome is high, the investor may conclude that the result sought will be worth the risk. Ideally, however, the investor should attempt to quantify the risk. In a potential investor worst-case scenario, an investor might pay an exceedingly generous premium and find that the anticipated synergies are just not there; circumstances dictate that they are unachievable. In that case, they may find themselves divesting their shares in the company for a price closer to the fair market value and this may result in a financial loss.

Obviously, if the investor is prepared to bet the farm on an acquisition and pay top dollar, the investor may be placing his or her investment company in financial jeopardy to a greater or lesser extent. A failure can have a potentially crushing impact on the investment company and its shareholders. Conversely, the larger the investor's overall capitalization and liquidity in proportion to the investment transaction, the more tolerable the risk. In this case, the cost of failure, while unpleasant, can be tolerated with little impact on the investment company and its' shareholders.

Once an investor identifies the risks, the next step is to determine if the investor can tolerate them. If the rewards are sufficient & confidence for a positive outcome is high, the investor may conclude that the result sought will be worth the risk

Finally, the purchase price package for your equity offer that the investor agrees to, and the manner in which the transaction is funded by the investor, is going to place demands upon the investment company's cash flow. Such demands on the investment company's cash flow will have some impact on the investment company's liquidity, working capital and ability to obtain future financing, produce a further additional risk to be taken into account.

7. What do you know about the company or person wanting to buy your shares?

I have left this factor to last because it is probably the most fundamental factor of all that can influence price negotiations with individual persons, or groups of persons representing an investment company, who are attracted to your equity offer.
Purchasers of shares in growth companies have many different motivations influencing their actions as they enter into discussions or negotiations with you about what they think your shares are worth.
Those motivations are both external and internal to the purchasers' marketplace situation. For example, is the purchaser:

- flush with money (investment funds) or tight for money at the moment?
- suffering competitive pressures from its own shareholders because of recent acquisitions that may be underperforming?
- buoyed up with support from its own shareholders because of recent acquisitions that may be performing extremely well?
- under stress in negotiations because of a risk intolerance policy that flows from internal managerial pressures?

- under stress because its' negotiating team is relatively inexperienced?
- on a fast track to quickly make acquisitions to build up an investment portfolio?
- in a situation where it makes little or no difference whether it makes an investment purchase or not?

This means that purchasers are not only different in the organisational and operational sense, but they differ at different times in their attitude and approach to investment negotiations. Put more simply, you have to be aware of this; it's a very important factor that can be either advantageous or disadvantageous to you in achieving a favourable outcome to your negotiations. These differences can be useful in categorising investors as purchasers. Investors as purchasers can be categorised as

- Acquisitive purchasers
- Bargain hunter purchasers
- Industry purchasers
- Synergistic purchasers

Acquisitive purchasers. Acquisitive purchasers seek high growth rates from the acquisition that will result in a high financial rate of return. Consequently, initial price is not such a limiting factor in negotiations. Generally, the purchaser will offer managerial and market assistance to help you achieve high growth rates. Acquisitive purchasers tend to prefer valuation methods based on historic and future earnings. If an acquisitive purchaser is looking at a longer-term investment objective of eventually making a takeover offer for your company (an objective that obviously will not be disclosed to you), the underlying asset values and debt capacity of your company will also be taken into account in the negotiations.

Bargain hunters. Bargain hunters are exactly what their name suggests. They are seeking to purchase your shares at the lowest price possible; and will try to beat down your offer price. Consequently, initial price is a very constricting factor in negotiations. Bargain hunters are likely to favour valuation approaches that look at tangible asset values or historic earnings using a high capitalisation rate.

Industry purchasers. Industry purchasers are companies that want, or need, to buy into your company for internal operational reasons. These reasons could include things like access to your products or services, access to your customer or client base, access to your technology or expertise, access to your production facilities or access to your managerial skill base. Consequently, these purchasers are generally well disposed to the payment of a premium over your offer price (which is your market value) to achieve their objective. The valuation method most suited to the requirements and objectives of industry purchasers is one based upon future earnings and market comparables

Synergistic purchasers. Synergistic purchasers believe that the complementary natures of their business and yours will produce synergies that will result in higher revenues, larger cost savings, process improvements, an improved profit & loss situation and an improved balance sheet. They believe that these synergies will, in effect, pay for themselves. Consequently, these purchasers are generally well disposed to the payment of a premium over your offer price (which is your market value) to achieve their objective. The valuation methods used by synergistic purchasers prefer a valuation process based upon future earnings and market comparables, but will factor in a premium for the value of the synergies.

A few words about your discussions and negotiations with investors

When talking with investors, here are some important words of warning about the influence of the law. Where an investor indicates interest in your investment proposal and direct discussions or negotiations commence, it is very important that you use a great deal of discretion in how you promote your equity offer. You must be careful not to use any words, either spoken or written, that may be considered as deceptive or misleading or cannot be supported by reasonable forecasts or projections in your business plan.

In particular, you must be careful not to give or imply guarantees or assurances that specific business objectives can or will be achieved, or that the investment is 'risk free', or is 'low risk', or has 'high returns', or has 'high yields'. Additionally, you must be careful not to give the impression that you are soliciting for money, share hawking, dealing or trading in securities, exerting sales pressure on the investor, or offering securities advice or investment advice.

When talking with investors, you must be careful not to give or imply guarantees or assurances that specific business objectives can or will be achieved, or that the investment is 'risk free', or is 'low risk', or has 'high returns', or has 'high yields'.

Most importantly (and this is critical), you must not give any impression or imply that the investment is endorsed or approved by the Australian Securities and Investments Commission or Graham Segal trading as Chiron! the business doctor.™. The regulations under which ASIC permits me to work in the private equities market specifically prevents me from making or publishing any judgements on or providing any recommendations about the commercial viability of any specific project.

That is because ASIC classifies me as a 'Business Introduction Service' bringing companies with growth potential into contact with venture capital firms, private equity firms and private investors who wish to participate in investment opportunities with growth companies. Neither I, nor any of my officers, employees, advisers, agents, affiliates or representatives are securities dealers, financial advisers, finance brokers, share brokers, remisiers or an intermediary to any established stock market and cannot buy or sell securities as a broker or buy or sell securities on behalf of a third party.

Last Word

That's it for now. Just remember though that there is a lot more to negotiations than the points I have outlined above. In this White Paper I have barely scratched the surface of the subject. Remember, if you need to discuss your situation, I am only a phone call or email away.

Sincerely,

Graham Segal

Chiron! the business doctor.™ *... relieves business pain!™*

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