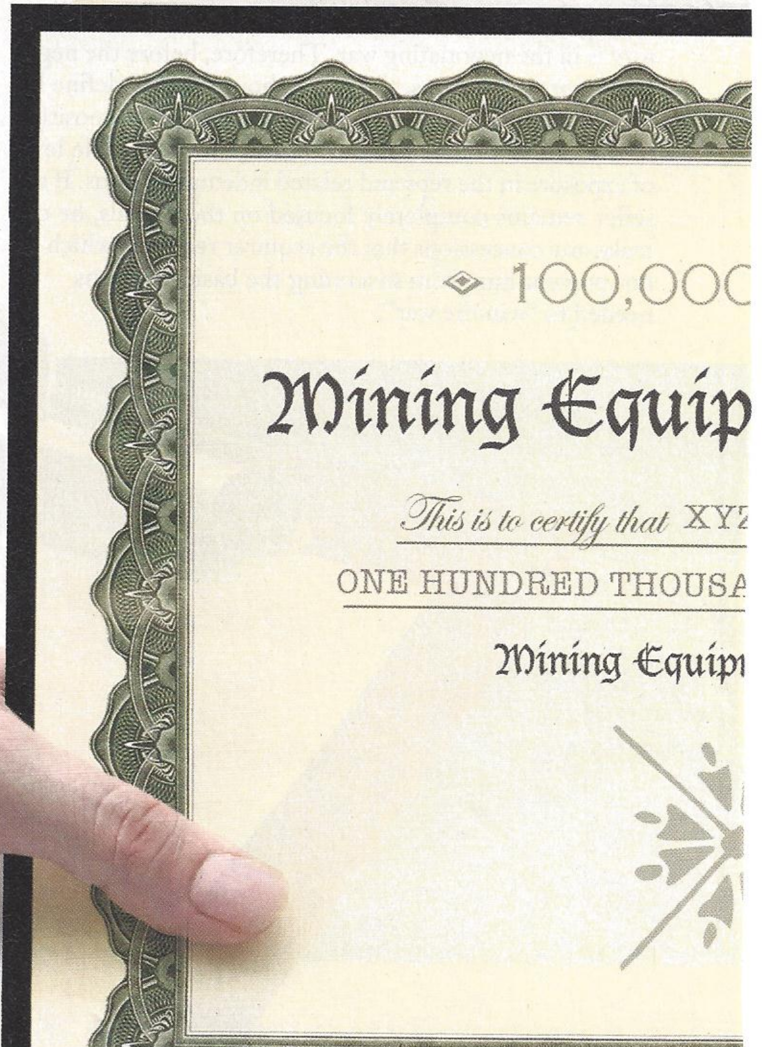
Selling Your Company for Public Company Stock

By Chuck Eaton

The construction materials industry continues to consolidate, with large international and domestic companies purchasing smaller companies to gain market share and enter new markets. Most often, the purchaser is a very large company with plenty of cash on hand, and the selling company is much smaller than the purchaser; so the purchaser simply pays cash to purchase the assets or stock of the seller.

However, in some transactions, especially where the seller is larger and the buyer is a public company, the buyer proposes paying the seller with the buyer's stock rather than cash. There may be good reasons for the buyer to want to pay with stock, and there may be good reasons for the seller to accept such a deal, but these transactions require additional scrutiny because there are more risks for the seller when accepting stock instead of cash.

The primary reason for sellers to accept buyer's stock instead of cash is to defer taxes on the sale, usually in a "tax-free" merger. (It's not really tax-free, just tax-deferred, because the tax on the sale is not due until the buyer's stock is sold, but that's a subject for another article.) For this discussion, let's assume that the seller is thinking about accepting buyer's stock instead of cash and needs to decide whether the risks inherent in accepting stock are appropriate. In these situations, the seller accepts both company-specific risk and market risk.



Company-Specific Risk

The seller is trading stock in its own company for stock in the buyer's company, so the seller is, in effect, making an investment in the buyer's stock. Therefore, like any other investment decision, the seller should consider the fundamental characteristics of the buyer's business and its stock. For example, the seller should analyze how the buyer's stock price has performed historically, and how stock analysts expect it to perform in the future.

The seller should also look at the buyer's stock's dividend history and expectations, along with the expected impact of the acquisition on the buyer's business plan. If the acquisition fits into the buyer's strategic plan and is expected to improve the buyer's profits and cash flow, owning the buyer's stock may be an acceptable investment.

Analysis of these company-specific risks will help determine whether accepting the buyer's stock is a good idea; unfortunately, the results will not be known until the stock is sold, usually years later. In the meantime, the original deal may look good at times and bad at others. If the stock does not hold its value, the seller may wish it had taken cash instead, even if the amount of cash was lower.

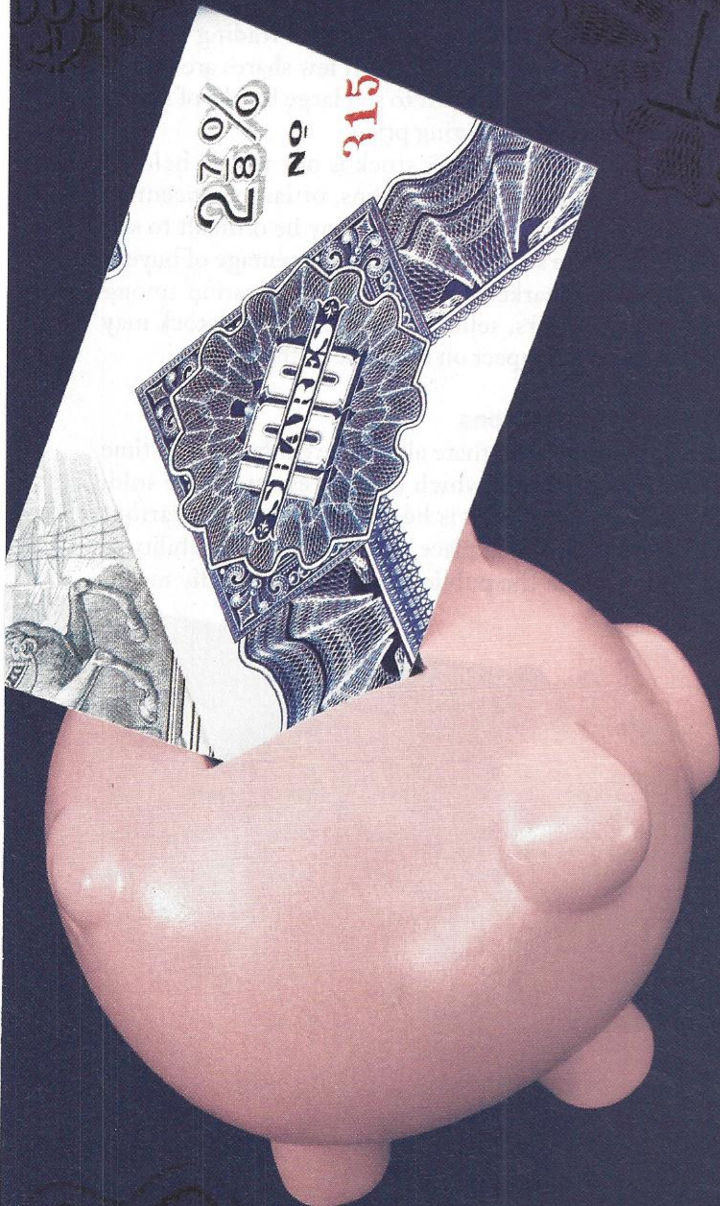
Market Risk

Another important consideration is the market for the buyer's stock. Although it is rarely possible to sell the stock immediately, at some future date the seller may want to sell all or part of the buyer's stock. Therefore, the seller should consider the liquidity of the market for the buyer's stock including the normal trading volume and the ownership of the shares. If few shares are traded regularly, it may be difficult to sell large blocks of shares without negatively affecting price.

Similarly, if the buyer's stock is not widely held by many individuals and institutions, or large concentrations of stock ownership exist, it may be difficult to sell the stock. If the seller owns a large percentage of buyer's stock and the market is thin with concentration among only a few owners, selling all or part of the stock may have a negative impact on the price of the shares.

Liquidity Restrictions

As mentioned above, there almost certainly will be a time after closing during which the shares cannot be sold. Public company stock is heavily regulated by various securities laws, which place restrictions on the ability to sell the stock in the public market. This usually means



there is a one-year holding period, during which the stock cannot be sold. Therefore, sellers who accept stock need to be prepared to hold it for at least one year. And even after that year has passed, there may be volume and other limitations on sale of the stock. However, these volume limits usually do not apply unless the seller owns a large percentage of buyer's stock.

In addition to the limits imposed by securities laws, the buyer may negotiate for an additional holding period to preclude the seller from "dumping" all its shares at one time and, thereby, depressing the market price. Also, a longer holding period may allow the buyer to discount the value of the stock it gives the seller, thus reducing the book value of its investment in the acquired company, and improving the apparent rate of return on its investment in later years.

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These liquidity restrictions, whether imposed by securities laws or by negotiation, make it even more important that sellers fully analyze the company-specific and market risks involved in owning the buyer's stock. If the value of the stock tumbles during the holding period, the seller will be unable to sell and may rue the day it accepted the buyer's stock. And even if the stock can be sold, a thin market for the stock may negatively affect the price.

Conclusion

If a buyer proposes paying the purchase price with stock instead of cash, the seller needs to consider several more issues than if the buyer proposes an all-cash deal. Accepting stock introduces additional risks, which may be acceptable in some situations and with some buyers, but not in others. The potential risks and rewards need to be fully analyzed because a stock deal may turn out to be an excellent deal for the seller, or it may turn out to be a disaster. Selling a company is an important decision, often the most important decision of the seller's business life, so the seller should be well informed about the risks and rewards of various transaction structures.

Chuck Eaton is president of Eaton Capital Corp., a Mill Valley, Calif., investment bank that specializes in the construction materials industry. Eaton provides investment banking and strategic advisory services to companies in this market, with a primary focus on merger and acquisition activity. For more information, go to www.eatoncap.com