In this section we're going to talk about the form of consideration in an acquisition. Is it cash, is it stock, or is it banana chips?

Clint: If I'm an entrepreneur selling my company to a private company, what's the best way to get compensated, cash or stock in this hot company?

Brad: It depends on how important the cash certain today is versus how much you want to play the upside of the company versus how much they're valuing the company at relative to what they're giving to you.

It's important to always realize that cash is well-defined. If someone is paying you $50 million for your company in cash, it's likely that you're going to get $50 million in cash. If someone says they're giving you $50 million of stock in their private company it depends a lot on whether they're valuing their company at $100 million, in which case you'd be getting half of the company or $500 million, in which case you'd be getting 10% of the company.

Them saying that they're paying you $50 million is actually directly dependent on where they are valuing the company and whether you think their valuation of the company is appropriate and whether there's upside in that or not.

Clint: Could you share a few examples of how you've seen this play out with your companies and how it's worked out?

Brad: Sure. We've had good and bad cases with this. When one private company is acquired by another private company, understanding clearly what the value drivers of that other private company are important. It turns out that there's relatively straight forward ways to understand that today.

If a private company is buying your company they should be willing to give you their financial statements so you can understand how they're performing as a business, how much cash they have, what financings they've done. You should also be able to get something called a 409a valuation from them, which is evaluation analysis of the various classes of stock, including their common stock.

The type of stock you get in the transaction, whether you get common stock like the founders or you get preferred stock like the investors, matters in all the ways we talked about the rights that are different between preferred and common stock. Those are things like liquidation preferences.

The 409a valuation doesn't necessarily tell you the right answer for what the valuation of a common is. It tells you what the fair market value at that moment in time is. Interestingly, in an acquisition scenario of a private to private company, it's likely that you'd like that number to be lower in the fair market value case from a tax perspective.

There's all these weird nuances about it, but fundamentally you need to get comfortable that the stock you're taking has both the value you think it has today, as well as the potential future growth that this company that's acquiring you is asserting that they have.

Clint: Suppose I'm being acquired by a public company and they're going to pay me in stock. Is that just as good as cash?

Brad: It's pretty close, but it again depends on the form of that stock. If the public company is giving you stock that is registered and freely tradable the minute the deal closes and there's a market to trade the stock and the market that trades the stock, ay on a daily basis is greater than the amount of shares you're getting, it's pretty equivalent to cash.

However, if you're getting stocks that are unregistered, you have one of two choices. You either have to wait for six months before you can actually sell the shares, or the company has to file a registration statement, which they can do, but until that's the case you can't actually sell the shares.

Another example would be the volatility of the stock. If the stock is a very volatile stock, constantly changing value by 10% or more either direction, understanding between the time you sign the LOI and when you close what happens to the stock price and whether you're getting a fixed number of shares or whether you're getting the upside of the stock or the downside of the stock matters too.

The example here might be—let's say a company offered you a $50 million deal in cash or $50 million of their stock at whatever the price was when the deal closed. Let's assume that the stock went up by 10% between the time you agreed to take the $50 million at the date the deal closed, you're still getting $50 million in shares but you're getting 10% less shares than you would have otherwise gotten. Effectively you gave up $5 million of consideration.

This can work the other direction. I was once involved in a company that was acquired by a public company and the public company offered us $100 million in stock, which we took. That was the agreed upon deal. A couple of weeks later, the company announced their earnings and their stock price went down some.

They came back to us and said, "Well, since our stock price went down, we think you're worth less to us, so we'll only give you $85 million to us instead of the $100 million we promised. We want to give you $85 million, which is what our stock price says now." We said, "No, no we want the $100 million that you agreed to give us."

They said, "How about $85 million in cash instead?" We thought about it for about a millisecond and decided to take the $85 million in cash. The stock we would have gotten, even at the $100 million valuation, was unregistered and we would have had to hold it for six months. Six months later, their stock had gone down from $25.00 a share to $1.00 a share. We got $85 million dollars instead of getting about $5 million worth of shares that we would have finally been able to trade.

There can be a pretty dramatic difference between the two.

Student: In the case when they give you an amount in stock, do they ever say, "We'll give you 5%." or is it always a dollar amount that you have to calculate out of the percentage?

Brad: It's both. Sometimes a company will say, "We'll give you 5% of our company." Then you get into the pre and post discussion as well. Is it 5% before the merger, or is it 5% of the company after the merger? All of it reduces back to a specific number of shares.

Understanding the specific number of shares you're getting, whether it's a dollar amount or a percentage of the company isn't important.

Student: What other things is it important to know about the acquirer to make this decision?

Brad: If it's a public company, understanding how well that company is doing. You should be able to form a point of view. It's based on whatever market information is available. Is this a public company that you're enthusiastic about being part of or not?

If you're taking cash it doesn't matter so much because you're going to get the cash, but if you're taking stock, do you believe the stock is going to appreciate in value? Do you think that the stock is going to depreciate in value precipitously?

This is independent of the qualitative feeling about, do you want to be acquired by this company in the first place? We're assuming yes. Now you're trying to make a judgment as to whether you believe that their stock is a good investment.

One way to think about it is, if they gave you cash but you had to put that cash into the company in stock and hold it for a period of time, would you do that? If the answer is, “No way.” taking stock is a pretty uncomfortable thing.