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Avoiding Common Pitfalls in M&A Transactions

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The Team!

- Investment Banker
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Pre-Transaction – Setting Expectations

TIMING

Transactions can take anywhere from 2 months (with an expedited transaction) to 7 months after a buyer has been identified. Sellers can add another 2-4 months to this timeline to account for pre-transaction diligence, engaging investment bankers, allowing time for company marketing materials to be prepared, and "going to market."

Pre-Transaction – Setting Expectations

COST

- Deal costs can run anywhere from .5% to 4% of the transaction value, depending on the size of the transaction.
- Communicate early and often to understand objectives. Uncertainty increases costs, deal timeline, and could derail the transaction altogether.
- Failure to invest in the transaction at the early stages will create a competitive disadvantage, often resulting in more significant costs post-closing resulting from indemnification claims or litigation.

Pre-Transaction – Setting Expectations

PSYCHOLOGICAL FACTORS

- Buyers generally want to know EVERYTHING that is material about a target. This level of intrusion is not something many individuals within the target company are prepared for.
- Failure to understand the level of diligence required in a typical transaction creates unrealistic expectations, frustrations, and ill will towards the buyer team.
- Planning ahead and spreading diligence work over a longer period of time ensures a smoother, less stressful environment for key players, allowing them to place more focus on their actual job during the deal.

Pre-Transaction Diligence – Don't be Surprised!

SELLERS SHOULD <u>NEVER BE SURPRISED</u> BY NEGATIVE, MATERIAL INFORMATION RECEIVED FROM A BUYER ABOUT THE TARGET.

Pre-Transaction Diligence – Don’t be Surprised!

SOME AREAS OF REVIEW

- Corporate records
- Capitalization table
- Management structure
- Shareholder agreements
- Company debt
- Asset review (good title)
- Insurance coverage and claims history
- Regulatory compliance
- Finance and Tax
- IT
- HR
- Operations
- Supply Chain
- Technology/IP
- Litigation

Pre-Transaction Diligence – Don't be Surprised!

Companies aren't purchased because they have clean records. However, sometimes companies are not purchased because of bad record keeping practices, which result in decreased confidence.

- Pre-transaction diligence should be conducted well in advance of going to market to provide enough time to fix problems or create action plans to address issues.

- Material issues may arise during diligence that could impact profitability and therefore valuation. Visibility before going to market is critical to creating realistic expectations.

Pre-Transaction Diligence – Don't be Surprised!

Sell-Side Quality of Earnings:

The quality of earnings team will perform a deep dive on the Target's financials to help support EBITDA and net working capital targets. A sell-side quality of earnings report can be costly when viewed in a vacuum but often pays for itself and more during negotiations. Buyers invariably will obtain a buy-side quality of earnings report. A sell-side report is needed to negotiate with buyer in an informed way. The visibility created by a quality of earnings report will undoubtedly help set expectations and create a more efficient transaction overall, thereby decreasing costs and the inherent distraction a transaction creates to a target organization.

Pre-Transaction Diligence – Don’t be Surprised!

OWNERSHIP ALIGNMENT

Are all owners and interested stakeholders aligned?

Minority owners or option holders may have approval rights. At a minimum, there is likely notice and disclosure requirements required prior to consummating a transaction.

Balance the need for confidentiality with the need for certain consents and approvals. Don’t wait until the end.

Pre-Transaction Diligence – Valuation & Structure

Engage investment bankers early to discuss valuation methodologies, going to market, and vetting buyers.

Good investment bankers are often worth their high fees. Failure to obtain sound advice may result in Target owners selling themselves short.

Negotiating the Deal

PHASES

- NDA
- Term Sheet/LOI
- Definitive Agreement
- Closing

NDA

- Typically, this is the first document signed when engaging in negotiations.
- The NDA controls how sensitive information is used and by who and helps set expectations.
- Sometimes sensitive information isn't disclosed until closing, including the identify of key relationships.

Primary Structures

Deal structures often fall into three categories:

- Asset
- Stock
- Merger transactions

No one structure is inherently better than another. Evaluating the pros and cons of each structure is highly factual and involve significant tax and operational-driven analysis.

Term Sheet/LOI

HOW DETAILED SHOULD IT BE?

More detail can help avoid inefficient negotiation of key terms when drafting the definitive agreement. With proper planning and pre-transaction diligence, the target owners have the requisite visibility on material issues to enable more informed decision making at this stage. The buyer can then be tasked to perform more “confirmatory” diligence as opposed to “exploratory” diligence. Buyer and sellers both find this approach attractive since it can decrease deal cost.

Term Sheet/LOI - Consideration

CASH

Cash is King! – Cash is objective and (subject to indemnity obligations) final. However, unlike earnouts and rollover investments, cash generally doesn't have the same potential tax benefits or upside as earnout and rollover structures.

Term Sheet/LOI - Consideration

EARNOUT

Earnout payments are made based on future company performance. Earnouts can be attractive but come with risks:

- Loss of operational control (can't control your own destiny), integration inefficiencies, expenditures for growth eroding performance metrics, and lender subordination concerns.
- Earnouts are often unrealistic and are not fully achieved.

Earnout payments come with potential upside too:

- Continued investment in the business.
- Potential to leverage more significant resources and relationships.
- Potential to leverage synergies between the two enterprises.
- Pushing taxable income into future years.

ROLLOVER CONSIDERATION

Rollover investments allow an owner to invest in the business (which may now be an assemblage of complimentary businesses) post-closing. These investments can be very attractive due to the potential tax deferral advantages and the proverbial “second bite at the apple.”

A rollover investment should be viewed as such and diligence in the buyer organization needs to be undertaken. Failure to conduct buyer diligence (operational, financial, legal, etc.) results in an uninformed decision. Surprises will likely result regarding lack of liquidity and exit opportunities, capitalization table and preferred stakeholder interests, and operational concerns.

Term Sheet/LOI - NWC

Net working capital shouldn't be overlooked. Net working capital represents the assets left in the business (generically current assets less current liabilities) at closing to enable buyer to run the business without having to invest additional money to meet the short-term needs of the business. This concept results in a dollar-for-dollar increase or decrease in the total consideration flowing to target owners at closing and is therefore highly negotiated. Sell-side quality of earnings often shine during these NWC negotiations, resulting in savings that can often pay for the quality of earnings report itself. Uninformed negotiation of NWC will cost the uninformed party big.

Definitive Agreement

LEVERAGING PRE-TRANSACTION WORK

If significant pre-transaction diligence is completed, negotiating the definitive agreement will be significantly easier. Key terms included in the LOI (consideration, structure, NWC, etc.) will be reflected in the definitive agreement. Reviewing representations and warranties and preparing disclosure schedules will be much easier since the work has largely been completed.

Definitive Agreement – Reps & Warranties

REPRESENTATIONS & WARRANTIES

These can often be 30-40 pages long and include various statements of fact the target or its owners will be making regarding various aspects of the target business. If prepared, the target team should not expect many curveballs from these provisions. Nonetheless, good practice requires the appropriate knowledgeable individuals review the relevant representations and warranties with counsel to discuss their accuracy and whether disclosures are required. Expecting one or a very small group of people to know everything may not be realistic and could result in an incorrect representation or a failure to disclose, each of which could result in future indemnification payments.

Definitive Agreement – Disclosure Schedules

Disclosure schedules serve two primary functions:

- Disclose information requested in the definitive agreement; and
- Correct incorrect representations and warranties.

The interplay between the representations and warranties and the disclosure schedules are the meat and potatoes of how risk is allocated between buyers and sellers. The representations and warranties solicit information (either responsive information or corrective information). In an oversimplified way, if this information is accurate, the buyer generally can’t sue the seller for damages stemming from the representation or warranty. It’s critical to spend sufficient time and resources to ensure no material misstatements or omissions take place.

Definitive Agreement – Indemnity Provisions

Buyers want to run the purchased business – not chase sellers for indemnification payments. Everyone wants to avoid litigation. If there are indemnification claims, they may be subject to:

- Baskets;
- Caps;
- Survival periods;
- Offset rights.

Definitive Agreement - Closing

Closing a transaction requires significant coordination and planning. For example, a deal may involve 200 pages of negotiated contractual provisions, over 1,000 pages of disclosure schedules, many third-party consents, and other transitional documentation (e.g., applications to transfer necessary licenses or permits). Closing is a coordinated effort by all parties. Not having a closing checklist setting forth each party’s respective obligations with respect to a particular closing deliverable is a great way to miss something or delay closing altogether.

Prepare a closing checklist well in advance of closing and work with opposing counsel to ensure alignment.

THAT'S IT!

They haven't created an easy button for M&A transactions quite yet. In the meantime, thoughtful discussions, preparation, consulting with the right advisors, and some hard work can get you over the finish line!

Thank you! Questions?