

How Buyers Can Get an Edge in Middle-Market Deals

It is fairly common knowledge that these days in the M&A business, sellers have the advantage. A number of factors have contributed to the situation: an oversupply of capital chasing too few quality deals, buyers paying higher transaction multiples, a more sophisticated base of sellers using auctions to drive higher prices, strategic and financial buyers in heavy competition. The list goes on.

Market conditions aside, both strategic and financial buyers continue to have marching orders to find and close deals that will pay off in the future. Once a target company is identified, the next major challenge is how to position oneself to become the selected suitor and avoid overpaying.

Confronting this challenge can involve a number of factors that can affect the transaction process. Buyers can approach the mark-up and negotiation of the purchase agreement to better position themselves in a competitive acquisition process and effectively negotiate a reasonably balanced agreement.

Agreement Terms

We frequently hear stories that the terms of private company acquisitions are moving in the direction of limited seller representations and warranties and even more limited rights of recourse, post-closing. While there are undoubtedly examples of over-zealous buyers giving in to a seller's draft agreement simply to win the deal, purchase agreements still tend to contain many of the provisions that buyers typically seek: comprehensive representations and warranties, purchase price adjustments and indemnification rights—sellers are not walking away with premium prices without standing behind their businesses.

Indemnification rights provide a good illustration of this point. Indemnity survival periods may be somewhat shorter, but still tend to cover one or two audit cycles; "baskets" have been ranging between 0.5 percent and 1 percent of transaction value; and caps are in the 10 percent to 50 percent range. Representations and warranties, if anything, have become more targeted on specific aspects of the seller's business.

(A "basket" in an M&A deal is like a deductible: if there is a basket of \$1 million, then after closing, before a buyer can bring an indemnity claim against the seller, there must be damages greater than \$1 million. Sometimes, depending on the deal, once the damages exceed the basket, the buyer can either recover the amounts in excess of the basket or can recover all of the damages going back to the first dollar; this is a negotiated point. The purpose is to avoid non-material indemnity claims between the buyer and seller.)

Are buyers caving-in to the demands of the sellers? Yes and no. Buyers understand that the pendulum has swung in the sellers' direction. Buyers have had to "give in" at times, altering their usual approach to pursue attractive properties. However, what appears to be a curtailment of the traditional buyer protective provisions is, arguably, a qualitative shift in their approach to the deal process.

Buyers striving to survive an auction process are making a significant effort to be better informed about the quality of a target's assets and exposures, and are using that data to negotiate an agreement that will win them the deal and mitigate their risk.

Due Diligence

The level of due diligence that buyers are now performing has evolved significantly and has room for even more improvement. Legal due diligence provides a good example of this trend. Traditionally, legal due diligence sought to uncover and report on potential exposures or compliance issues in the target business.

The evaluation of the future of the business was usually left to the buyer. Today, buyers are (or if they are not, they should be) demanding a more qualitative analysis about a target's legal issues that may affect their future business plan for the target. Consider the following examples:

On the intellectual property front, how many deals are done where the patents and trademarks are listed on a schedule to the purchase agreement and then forgotten? Did the buyer consider whether the target's intellectual property will support the company's future business plan? Will it provide a clear path for growth, or will you run into multiple competing (or worse, broader) intellectual property rights?

Seeking a qualitative analysis of these kinds of questions can provide information that will directly impact the terms in the purchase agreement.

Consider another situation facing middle-market manufacturing companies. At one recent private equity conference, the only foreign country mentioned by the speakers and panel members was China—the conclusion being that it has become paramount for manufacturing companies to have a "China strategy."

Most companies have little understanding about the legal issues and costs involved with creating a sourcing platform in China. A buyer that understands this process will have the information necessary to analyze the target's strategy (or lack thereof), and quantify the impact on valuation. The buyer can then specifically address the issue in the purchase agreement, or not, depending on the dynamics of the deal.

There are countless opportunities for a buyer to push its due diligence analysis further. The foregoing examples demonstrate that by taking one's analysis beyond simply examining what currently exists, a buyer can develop additional insight into specific "issue areas" within the target business. Many buyers may claim that they have been pushing the due diligence envelope for years. Based on the increasing use of industry-specific consultants and the depth of analysis being performed, it is evident that this is still a developing area.

The real opportunity is how a buyer can use the information to its advantage in the process of negotiating the purchase agreement.

Key Issues

The opportunity for buyers is to use better quality due diligence information to identify and prioritize their "hot" issues and address them in the purchase agreement. This approach allows buyers to take a more surgical approach to a seller's draft agreement by covering themselves on the important issues and agreeing to the seller's position on others. Consider a few examples:

Purchase Price/Valuation—Better quality due diligence can indicate whether the asking price is too high, or whether there is "hidden" value in the business. With this information, a buyer can: a) agree with the seller's valuation and submit an aggressive bid; b) walk away from the deal if it is overvalued; c) consider options such as earn-outs to keep the seller with some "skin" in the game; or d) develop purchase price adjustments targeting the buyer's specific financial concerns.

Representations and Warranties—With shrinking baskets, caps and survival periods, representations and warranties that target specific issues are another means for buyers to obtain coverage for problems associated with high-priority areas of the business. In many instances, a clean and unqualified representation on a specific issue may be easier to get than trying to make an unqualified representation covering a broad area of the business. The buyer also gains the ability to seek recourse over an issue that might otherwise be subject to materiality, knowledge or other qualifiers.

Indemnification Rights—Buyers rarely get a full set of unqualified representations and indemnification rights with small baskets, high caps and long survival periods. What sellers want most is to minimize the magnitude of their exposure and the length of time during which they can be subjected to indemnification claims. Quality due diligence information enables a buyer to craft an indemnification right in a number ways:

The indemnity survival period—a buyer can agree to the shortest period necessary to learn whether there are indemnifiable issues in the business.

The basket—the buyer can suggest a higher (or seller-favored) basket as to many breaches of representations and seek a smaller basket concerning the specific items that have been targeted. Alternatively, the buyer could seek to carve out certain representations from the basket altogether.

The cap—buyers can help themselves further in the deal process by lowering the cap on the indemnification rights to a level that will cover the known and potential unknown exposures. Better front-end due diligence will enable a buyer to be more flexible on this issue which is often a deal-breaker for sellers.

Buyer Benefits

Will a seller view a buyer's efforts to take a focused and targeted approach to negotiating a purchase agreement in a favorable light? The approach helps buyers in a number of ways:

Sellers will know that a buyer is serious about a deal if the buyer is capable of negotiating in a focused manner that demonstrates the depth and quality of its due diligence.

Sellers will believe that there is a greater certainty of closure if a buyer has taken the time to engage in quality due diligence and is selective about the issues of importance in the transaction.

Target company management will be more confident in a buyer's ability to manage and grow the business post-closing if the buyer demonstrates a thoughtful and detailed understanding of the business.

A buyer's mark-up of a seller's draft purchase agreement that thoughtfully connects specific due diligence issues to specific revisions—rather than inserting wholesale, typical "buyer provisions" —demonstrates to a seller that the buyer has prioritized its issues and is prepared to move forward with the transaction.

Obviously, there are many other considerations that can affect the course of a transaction or an auction. For a buyer, however, the purchase agreement is its calling card. After all of the meetings, dinners and glad-handing, it will set the tone for the course of the deal. The goal for a buyer is to use the benefit of a quality due diligence effort to "self-regulate" and eliminate points of contention when possible and provide protections only to the extent necessary.

Cautionary Words

Buyers should keep these points in mind:

Prioritizing your issues is critical—In any deal, you will not win all of the points you pursue. Prioritizing the most important ones will maintain your focus through the negotiation period.

Do not get caught in the due diligence trees—Quality due diligence can give you the ability to attack the purchase agreement with focus. It can also overload you with information that can distract you from the important issues. Don't let good due diligence create non-material issues that creep into the negotiations and take you off track, or worse, out of the game.

Don't become married to the deal—Too often, buyers find warts on a seller's business that should spur them to run the other way, but because of the ongoing pressure to do deals, they can become too attached to a bad deal to let go. Sophisticated buyers understand that after the warts are uncovered, the negotiated price and overall transaction still need to make sense.

Gaining an edge in any competitive M&A process will depend on a variety of factors and circumstances. A key goal for buyers should be to eliminate as many of the "negative" perceptions a seller may have about them and create "positives" that will keep them in the process. One way is to adopt a more precise and selective approach to negotiating the purchase agreement. Quality due diligence is a key driver in the process, but equally important is how the information is used.

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