Maximizing Results in an Auction: A Map to Sell-Side Success

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Today's M&A market is fueled by readily available acquisition financing on favorable terms, the largest "overhang" of private equity dry powder in US history, and excess cash on the balance sheets of US strategics. With these conditions, how can a seller of a business maximize the target's value and enhance certainty to a quick closing in an auction process? What can a buyer do to distinguish its bid in that process to become the winning bidder? This two-part article will provide insights on the middle market private company M&A process (for sales of target companies with under $1.0 billion of enterprise value) and provide recommendations of how to improve results in an auction. This first installment focuses on the seller. The second installment will address the recommended steps for a buyer, including tips for a financial buyer (private equity fund) and a strategic buyer (operating company).

For Sellers, Preparation and Credibility Are Key

While sellers of businesses are currently enjoying a very healthy and long-running "sellers' market" with frequent auctions, multiple offers and high valuations, a seller must do the work necessary to obtain the best deal terms, including the highest possible price. Detailed and thorough preparation with consistent, credible information is key. Sellers should follow these seven (7) recommended steps before any potential buyer is brought into the process (and should continue to support those steps by providing reliable and supportable information throughout the process).

1. Select the Right Investment Bank.

Despite (or perhaps because of) the break-up of a number of the larger investment banks or investment banking arms at the larger commercial banks, the number of "middle market" investment banks and single shingle brokers is as numerous as ever before. With a multitude of sell-side bankers from which to choose, many of whom have similar websites and pitch materials, how does a seller select the right investment bank to guide it through a sales process?

A sales process is a team effort, and the seller should interview the full investment banking team to understand each person's role and what he or she delivers. Through those interviews, the seller should develop a clear understanding of each team member's experience, his or her knowledge of the client's business and industry, the key metrics that will determine the target's valuation, the likely challenges in the sales process that the investment banking team foresees based on the client's business or industry, a range of the valuation of the business and the underlying assumptions that support that valuation, and a commitment from all team members that they will be devoting substantial time on the sales process from start to finish. The seller should ask whom the bankers would recommend as potential buyers and why. The seller should also speak directly with the investment banking team's past sell-side clients to understand the prior clients' experience with the investment banking team, including "soft" items like fit, style, how the process was run, civility, ethics, whether time schedules and other commitments were met, whether the clients' valuation aspirations were equaled or exceeded in a consummated deal and the general "feel" of the overall process. Matching up the seller's expectations and the investment bank's commitment to the sales process from the start is paramount.

2. Conduct Sell Side Due Diligence.

Any buyer will likely highly scrutinize the target company's business through a full-scale due diligence process. The seller should expect that all "warts" of the business will appear as a buyer completes its diligence. The seller can better anticipate, prepare for and position the target business if it has conducted its own due diligence on the target company in advance. Whether or not the target company has audited financial statements, an independent advisor with technical financial and accounting background (that is not the target's current audit or accounting firm) should conduct a thorough financial and accounting review of the target company for at least a full year (preferably two years) together with the most recent interim period, including an analysis of revenue recognition, inventory costing, customer concentration, unrecorded accruals, and non-GAAP measures such as EBITDA (earnings before interest, taxes, depreciation and amortization) and the preparation of a quality of earnings analysis.

Armed with its own due diligence information, a seller should be well aware of any potential issues with the target's business before any buyer blind sides the seller with unexpected problems uncovered by the buyer. A seller who highlights the target's issues in advance (whether financial or otherwise) with a ready response for the resolution or mitigation of those difficulties will better position itself to maintain seller-favorable deal terms, including price. Buyers whose expectations are dashed through the diligence process, particularly with respect to financial aspects of the target's business, will almost always seek a purchase price reduction or, even worse, will walk away from the deal entirely.

3. Provide Sell-Side Due Diligence Results.

Providing sell-side due diligence results from independent third parties to potential buyers early in the sales process, including items such as EBITDA and quality of earnings analysis, best positions the seller to receive the most competitive bids in an auction. Fully informed with this information, buyers will be more confident in submitting their "best and highest" offers in an orchestrated sales process, resulting in an increased likelihood that the seller will in fact obtain the best price for the target's business.

Additional due diligence reports that a seller should consider providing cover areas such as legal due diligence and litigation assessment, environmental due diligence (including so-called "phase I" or "phase II" reports), information technology reports, customer satisfaction or consumer product reports, insurance claims reports (and related outcomes and coverage), labor reports (including expected transaction bonus and severance costs), and real estate lease reports (with monthly run rates, termination dates and key provisions under existing leases). Providing these reports in advance also has the added advantage of speeding up the overall sales process since each buyer will essentially be conducting "confirmatory" due diligence, rather than beginning "from scratch."

Finally, some buyers (particularly financial buyers) are less likely to engage in a full auction process because they believe competitive auctions with multiple bidders can be costly to the private equity fund buyer who must engage its own due diligence experts at its own cost and are less likely to result in a winning bid for the fund given a potentially high number of bidders. However, if the financial buyer is able to reduce its deal costs in the process considerably (which sell-side due diligence allows it to do), then the fund may be more willing to participate in the process, increasing the seller's likelihood for maximizing a higher price.

4. Provide a Fulsome and Well Organized Dataroom.

In addition to providing sell-side due diligence reports, the seller should provide a fulsome and well-organized online dataroom that all bidders can easily access prior to the delivery of "final bids," thereby allowing all bidders a level playing field from which to submit their bids and providing them with increased confidence at the time of final bidding. The dataroom should include not just the sell-side due diligence reports, but all "back up" information that was collected in preparing those reports. Other customary areas provided in the online dataroom include, organizational documents, operating agreements, stockholder agreements and all documents relating to the company's ownership and capitalization; monthly, quarterly and annual financial statements and projections; the current year's budget; letters from outside auditors and law firms; complaints (and related documents) from filed or threatened litigation; customer and supplier contracts and purchase orders; real estate leases and mortgages; patents, trademarks and copyright summaries and filings; debt, financing and security agreements and filings; any material agreements related to the business; research and product development reports; and documents that present any actual or threatened issues relating to the foregoing.

5. Meet all Projections During the Sales Process.

A seller will almost always prepare its own projections as part of the sales process – typically covering at least the next full year and often for monthly or quarterly periods during that year. Since the sales process may take several months, meeting those projections throughout that process is of critical importance. Just like a seller must be prepared to provide buyers with accurate and reliable historical sell-side due diligence information, the seller can only maintain its credibility with potential buyers if it meets or exceeds its own projections during the sales process. Failure to do so can be costly – likely resulting in a downward purchase price adjustment or a failed deal. On the flip side, exceeding projections can also provide a seller with an opportunity to seek an increase in any bid – particularly if this occurs before (or at the end of) any "exclusivity" period with a buyer when a seller has the opportunity and leverage to threaten to go shop the deal to others.

6. Keep All Buyers on a Short Timeline, including Limited or No Exclusivity.

Due to the high cost of a sales process to a potential buyer (both out-of pocket expenses and lost opportunity costs), most buyers will seek some form of "exclusivity" period during which the seller is prohibited from speaking with, providing information to or responding to inquiries from any other potential bidders. During this period, the buyer negotiates the definitive transaction documents with the seller and finalizes any due diligence that is not already complete. Once exclusivity has been provided to a potential buyer, the seller loses significant leverage in its negotiations with the buyer since it can no longer effectively threaten to change the price or other material deal terms or to seek offers from other bidders to improve the seller's negotiating position. Well-prepared sellers (with detailed and available sell-side due diligence and a fully stocked data room early in the process) will be better positioned to offer exclusivity late in the process and for only a short period (from a few days to up to a week or so). If the target business is a "hot asset" with multiple bidders and high valuations, the seller may be able to avoid any exclusivity period at all with the buyer before definitive deal documents are executed. If exclusivity must be offered earlier in the process or for more than a couple of weeks, a seller should negotiate an exclusivity timetable where due diligence and document negotiation milestones must be met and deal pricing and other material terms (typically those included in a term sheet) must be re-confirmed every week or two in order for exclusivity to continue.

7. Force Representation and Warranty Insurance on the Buyer.

With more frequency, sellers are strategically forcing representation and warranty insurance (RWI) on buyers in order to obtain the best bids from each buyer in an auction. Similar to "stapled financing" offered in leveraged buyouts, a seller pre-negotiates the terms of the RWI with an insurance provider. If ultimately purchased by a buyer, the pre-negotiated RWI provides funds to the buyer to cover the seller's breaches of representations and warranties for agreed-upon time periods, coverage amounts, deductibles (or retention) and other negotiated terms. With the pre-negotiated policy, a seller signals to the buyer that the buyer must offer the best purchase price and terms to the seller given the limited scope of indemnification seller is willing to provide but knowing that RWI is available to the buyer and to all the other bidders (should any bidder choose to purchase the coverage). Through this process, the seller is able to maximize its dollars on exit and minimize any dollars it may have to return to buyer (through an escrow or indemnification) following exit.

When RWI is used as a strategic tool, the retention amount under the RWI for breaches of representations (during the survival period for those same representations under the purchase and sale contract) is often the sum of the indemnification deductible and indemnification cap provided by the seller for those representations. For example, if the operational representations survive 15 months and a seller's indemnification deductible is 0.75% of purchase price and seller's indemnification obligation for breaches of those representations is capped at 3% of the purchase price, a buyer will often only seek insurance coverage for losses in excess of 3.75% of the purchase price during that 15-month period and potentially reducing that retention amount following the 15-month period when the buyer no longer has indemnification protection from the seller.

In a competitive auction with a “hot asset,” sellers in the current market have been able to force some very favorable indemnification terms on buyers, including an indemnification deductible of 0.75% of enterprise value (not historically unusual), an indemnification cap for as low as 0.75% enterprise value (historically unusual) and an escrow matching the indemnification cap for as low as 0.75% of enterprise value (historically unusual) since buyers in the current market are typically able to obtain a buy-side RWI with 1.5% retention (i.e., the 0.75% enterprise value indemnification deductible plus the 0.75% enterprise value indemnification cap and escrow).

Conclusion

Even in the current seller-favorable M&A market, two themes pervade our Map to Sell-Side Success: Preparation and Credibility. No auction process can succeed in maximizing price if the buyers doubt the knowledge or credibility of the seller and management. Maintaining prospective buyers’ confidence requires a seller to project a candid understanding of the business and its challenges and opportunities. This requires preparation and forthright honesty. Without these, data becomes suspect; projections receive greater “haircuts”; diligence is protracted; and, a buyer’s attention wanders toward other opportunities. These key seller items outlined above will more than pay for themselves through increased purchase price, improved certainty to closing and accelerated speed to closing.

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