

Bidding Wars: How To Position Your Fund or Your Company to Win the Deal

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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, sellers of businesses currently are enjoying a very healthy and long-running "sellers' market" with frequent auctions, multiple offers and high valuations. What can a buyer do to distinguish its bid in an auction to become the winning bidder? This second installment of our two-part article provides insights on the middle market private company M&A process (for sales of target companies with under \$1.0 billion of enterprise value) and recommendations of how a buyer can improve results in an auction, including tips for a financial buyer (private equity fund) and a strategic buyer (operating company).

The first installment – "Maximizing Results in an Auction: A Map to Sell-Side Success" -- focused on the recommended steps a seller should take to obtain the best deal terms, including the highest possible price. That article can be found here [\[link or name/tie back to earlier article.\]](#)

For Buyers, Price Can Be (But Isn't Always) The Most Important Term

While price may be all that matters for some sellers, there are other important deal terms that a savvy buyer can offer to position itself to be the winning bidder. Buyers should follow these eight (8) recommended steps from the outset of any auction process and through deal consummation in order to distinguish itself from the pack.

1. Put Yourself in a Position to Move Quickly.

A buyer's full M&A team should be on board from the outset, including internal deal professionals at the fund or company and any required external experts in areas such as accounting, legal, environmental, insurance, consumer product/customer research, real estate, human resources, etc. The deal team should have access to any marketing materials regarding the transaction, the due diligence dataroom and any other available target or industry reports. Early access by the full buy-side team puts any bidder in a position to move quickly should it need to do so. Spending out-of-pocket money on external advisors also demonstrates to the seller that a bidder is serious. Front loading the due diligence process further signals to the seller that a bidder can do the deal on the proposed deal terms because that bidder is fully informed with all intelligence to provide its best offer, thereby giving the seller the confidence to select that bidder as a buyer with less risk that it will later demand a purchase price reduction when further information is learned. In the current sellers' market, the failure of a buyer to incur costs early (both time and out-of-pocket) and in a material way can be fatal.

2. Seek the Right Information in Courteous Manner.

Not all sellers take the steps outlined in our first installment to fully inform all bidders of all diligence information related to the target. As a result, many bidders provide follow-on (and often multiple follow-on) due diligence requests in writing and through management due diligence meetings and conference calls. In a multi-bidder process, these follow-on requests can be extremely taxing on any seller, particularly those with lean teams or who have never been through a sell-side process, and, for some sellers, can appear to be nit-picking and overreaching. Some or all of the management team that is providing the due diligence responses to each bidder may be the same (or substantially the same) management team that will end up working for the buyer after the deal. Whether conscious or not, a bidder who is not "easy to work with" may not get the full information it is seeking, may get it in a piece-meal

fashion or may get it late in the process. In a competitive process where buyer timing and responsiveness can be critical, “making nice” with the seller and management can go a long way.

3. Meet Deadlines Early and Often.

Meeting and exceeding seller-imposed timelines can be critical. Throughout an auction process, a bidder needs to position itself as serious and credible, and can do so in a meaningful way if it meets or surpasses seller’s timing requirements. At a minimum, lagging behind can mean that a potential buyer doesn’t get the full information it needs to prepare a well-informed bid and, at worse, can cause a seller to drop it from a multi-bidder process. Exceeding deadlines, such as turning in an early bid with full pricing and deal terms, can provide a bidder with the opportunity to provide a “pre-emptive” offer (essentially a “take-it-or-leave it” offer that expires before the bid deadline). “Pre-emptive” offers have been the trademark of certain private equity funds to position the fund to be the winning bidder before other bidders even submit their bids. Strategic buyers have also begun to pursue this same strategy with some success.

4. Minimize Closing Conditions.

In a competitive process, a seller will pursue all avenues to guarantee that the buyer it selects as the winning bidder will close the deal quickly and on the offered terms. A bidder who positions itself to provide deal certainty and speed will have a leg-up in any process. For example, a bidder who is willing to make a required Hart-Scott-Rodino filing “early” (essentially off of a letter of intent rather than a later signed deal) and pay for the entirety of the filing fee can gain an advantage. In addition, a buyer who is willing to forgo all required third party consents or be the party solely responsible for obtaining such consents (e.g., under supplier or customer contracts or from landlords), can also differentiate its bid. Further, a bidder who assumes meaningful deal risk between signing and closing, for example, by providing weakened or no “Material Adverse Change” closing conditions can also distinguish itself (e.g., the buyer assumes the risk of material changes in all or certain aspects of the target’s business, including changes in industry or changes in laws, or allows seller to update disclosure schedules between signing and with little to no consequence). Even strategic buyers in the same industry have been more willing to agree to “come hell or

high water” clauses in antitrust area (where they would be forced to divest any asset that creates an antitrust issue). Many of these seller-favorable deal terms that historically were offered by private equity fund buyers seeking to distinguish their bids and demonstrate with certainty the ability to close quickly are now being offered with more frequency by strategic buyers, and are being offered by buyers only after the completion of a fulsome due diligence process that allows the buyer to minimize the closing conditions with greater confidence.

Not surprisingly, in the current sellers’ market, financing contingencies are virtually unseen. Historically, many strategic buyers who could access cash on their balance sheets or draw on available lines of credit had an advantage over private equity buyers who relied on third party debt financing to pay a portion, and sometimes a meaningful portion, of the purchase price and who accordingly included debt financing contingencies in the definitive deal documents. More recently due to market conditions, many private equity funds have positioned themselves to provide the full cash purchase price for a target business without needing to access new third party debt – essentially, the full purchase price can be sourced directly from its fund limited partners, from pre-existing lines of credit maintained by the fund or through reliable equity co-investors. The private equity fund may then choose to refinance that purchase price with debt at a later date following the deal closing. Those private equity funds whose fund partnership documents limit their ability to draw the full purchase price from their limited partners (for example, because the full equity investment in the target at closing exceeds the maximum amount that can be funded for a single portfolio company investment) will customarily structure a transaction with a concurrent signing of the definitive deal documents and closing of the transaction to minimize the risk that a failed debt financing will derail the deal – or alternatively, will simply take on the financing risk entirely given the current favorable debt financing markets.

5. Consider European-Style “Locked Box” Approach with No Purchase Price Adjustment.

Sellers like certainty of proceeds. In Europe, especially the United Kingdom, deals are often done with a fixed cash purchase price with no post-closing purchase price adjustments. Typically, in US deals, the buyer buys the

target on a “cash-free, debt-free” basis with an agreed-upon level of working capital and with sellers’ transaction expenses having been paid fully by seller. As such, the agreed-to purchase price in a US purchase agreement is generally subject to upward and downward adjustments post-closing based on the actual levels of working capital, cash, debt and unpaid sellers’ transaction expenses at closing. In the UK and more recently in a minority of US transactions, there is an increasing prevalence by sellers (particularly private equity or private equity-backed sellers) to use what is known as a “locked box” purchase price approach. Under this approach, an equity price will be calculated using a recent set of accounts and balance sheet date in respect of which the buyer will have no ability to adjust after closing. The buyer will then rely on contractual protection to ensure that “leakage” from the “locked box” (basically no material cash or assets “out” and no material liabilities “in”) between the referenced balance sheet date and closing date. Absent the purchase agreement prescribing a different remedy, if such leakage takes place, then the buyer would have a right of claim against the sellers for breach of contract. Just as certainty of closing can be an important deal term to offer a seller, a buyer who is willing to offer a fixed cash price deal with no post-closing purchase price adjustments may be viewed more favorably by a seller in a competitive process.

6. Reduce Indemnification Obligations and Escrows; Obtain Representation and Warranty Insurance.

With or without the knowledge of seller, a buyer can choose to strategically use representation and warranty insurance (RWI) in order to distinguish its bid in a competitive auction. RWI protects the buyer, as the insured, from unanticipated and unknown losses that arise subsequent to the closing of an M&A transaction from breaches of a seller’s representations and warranties in the definitive purchase agreement. With the comfort that RWI insurance can be secured to mitigate the risk of seller’s breaches of representations and warranties for agreed-upon time periods, coverage amounts, retention amounts (deductibles) and other negotiated terms, the buyer is then well positioned to seek indemnification from a seller only on extremely limited terms (e.g., modest survival periods, liability caps and escrow amounts). The buyer also has the added benefit of obtaining deal protection from a more financially viable entity (a AAA rated insurance carrier).

Initially used as a strategic buy-side tool by private equity funds, more strategic buyers are currently utilizing RWI to provide the best deal terms to a seller. When used, 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. Using this same example, the buyer may be willing to reduce the escrow to 3.75% of purchase price, and some buyers are willing to go even lower than this escrow amount (typically, so long as RWI will cover exposure in excess of the low escrow amount).

7. Advance Attractive Management Rollover Investment Terms and Incentive Plans.

Private equity funds have long provided the opportunity for founders and other existing owners of a target business to maintain a portion of their investment in the target after the private equity fund’s initial purchase of the business. This “rollover investment” allows some or all of the sellers to enjoy a “second bite at the apple” (hopefully at an even higher valuation) when the private equity fund exits its investment in the target in the future. Many private equity funds are increasingly allowing this “rollover” investment to be on the exact same economics as the fund (so that incentives of all post-deal owners are aligned completely, including dollars paid per share on an exit). Moreover, in order to entice management (who may not also be a seller of the business) to “back” a particular private equity fund (including providing easy access to information during the sales process, readily available responses to diligence requests, and sit-downs to go over future strategy and business plans), many financial sponsors will offer attractive management equity incentive terms (agreed in advance prior to closing) that allow management to share in the upside of the business

at the time of the private equity fund's future exit from that business. As these "goodies" are offered to founders, sellers and management with more frequency and earlier in the process, some strategic buyers have become more flexible in putting together management incentive packages (cash or equity) for key sell-side deal team members who will continue on with the business in order for the strategic buyer to remain competitive in the auction process (or at least maintain the active attention of the sell-side management team in that process).

8. Offer Meaningful Intangibles.

Target businesses are run by people and sold by people, so the "soft stuff" that a buyer provides throughout the sales process can matter. Management should be "wooed" and treated with respect. Senior management from the buyer should meet in person with the sellers and its management; cell phones, computers and hand-held devices should be turned off during meetings; the buyers should learn the key players at the seller and target and match-up personalities with the buy-side team. The buyer should demonstrate that it "gets it" – so, the most senior team members at the buyer who understand the target's business, industry and associated risks should be actively involved in the process and provide significant "face time" to the sellers and target management. The buyer should offer in-house operational expertise that lines up with the target's business and industry and should identify a convincing go forward business strategy that stands out -- this may, for example, include attractive planned acquisition or expansion strategy. A private equity fund or strategic buyer may have opportunities unique to it that it can offer – for example, synergistic opportunities to partner with a portfolio company or limited partner at a private equity fund or customers, suppliers, licensors or research and development professionals at a strategic buyer. Finally, many sellers are also concerned with their long-term reputation and legacy – a buyer that can demonstrate a track record of success with acquired businesses may have a further leg-up in the process.

Conclusion

In today's M&A market, fierce competition among potential buyers to successfully land a good target company is the new normal. Whether as a private equity fund or a strategic acquirer, bidders must search for ways to stand out from the crowd. And, while price may be all that matters to a seller, often other terms or bidders' actions can affect the outcome of a competitive process. Bidders who get their team up to speed early and are prompt and targeted in tracking down the information needed to prepare their bid with confidence, will position themselves to meet, or even accelerate, the seller-imposed timelines that drive the process. Only if a bidder has demonstrated to the seller that it has done the necessary up front diligence work to be well advanced towards a definitive transaction will that bidder be able to submit a convincing pre-emptive offer.

In their efforts to offer attractive terms, bidders increasingly are acting early in the process to line-up RWI to better position their bid through improved indemnification and holdback terms. Sellers value certainty, and often judge a bid on the minimum proceeds that the bid delivers. A bid that the seller knows will yield not less than 97-98% of the total price looks attractive when compared to a slightly higher bid that leaves 5% - 10% of the proceeds at risk for later claims. RWI bidders get the benefit of minimum proceeds certainty. This same holds true for the bidder willing to minimize or eliminate post-closing purchase price adjustments.

Bidders who are looking for a leg up on competitors also never forget that each seller arrives at a deal with its own imperatives. In some cases, that may be a desire to stay meaningfully invested or involved, or to "take care of" a valued management team. In others, it may be an ability to manage key customer relationships, or to continue a legacy. In each case, senior team members need to communicate to the seller that the seller's concerns are understood and are properly addressed.

Whether any of these suggestions will trump a higher price is almost always unknowable. But, without them, price is your only hope—and how much greener is your money than the next guy's?

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