Merger & Acquisition Focus

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Ask the Advisor

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PURCHASE PRICE AGREEMENTS

You don't have to walk on eggshells

The initial offer a business buyer makes to a seller is rarely set in stone. In most cases, the two parties must negotiate purchase-price adjustments (PPAs) — differences between the originally stated and the final price at closing.

Why would a deal's price alter between announcement and completion? Reasons include change to the seller's net working capital, unexpected deal negotiation delays and due diligence findings. Because PPAs can cause major conflict, sellers should know what adjustments are considered routine and what might be excessive and worth fighting for.

Protecting a deal's value

In most cases, a business buyer makes an initial offer without having all the information needed to objectively assess the target's value, particularly when the seller is a privately owned company. So the buyer bases the bid on the selling company's recent financial statements and other available information, such as market position and growth potential.

Although upward adjustments are possible, most PPAs are downward adjustments that benefit buyers.

Once a buyer gets a chance to conduct thorough due diligence, its perception of the target's value may change. PPAs are meant, in part, to address such revised assessments. But they're also intended to account for fundamental changes — such as the availability of capital — in the weeks or months between the transaction's signing and closing.

Types of adjustments

PPAs related to working capital adjustments are common in M&A deals, even in "sign and close" transactions where a purchase agreement isn't signed until closing. Such adjustments shift the original purchase price up or down, depending on changes to the seller's net working capital (measured as current assets minus current liabilities). Unfortunately, working capital can't be confirmed in real time, so PPAs usually set a final purchase-price determination date for some time after closing.

Many other financial issues can affect the final purchase price. A seller might suffer a substantial net income loss — or, see an unexpected boost in income. Or its outstanding adjustable-rate debt obligations may grow because of rising interest rates. Then there are the occasional unwelcome due diligence discoveries. A buyer might request a PPA if it discovers that the seller has greater-than-anticipated legal liabilities or other potentially costly issues such as pension obligations.

Promised events that don't actually occur can also change the price. For example, a seller might expect that a new product will obtain regulatory approval. If during deal negotiations regulators actually deny approval to the product, a PPA may be in order. And what if the deal doesn't close when it's supposed to? A PPA can be used to account for costs related to time delays.

When much is too much

PPAs have their drawbacks. Although upward adjustments are possible, most PPAs are downward adjustments that benefit buyers. For this reason, sellers often try to cap them at a certain amount or percentage. However, buyers generally resist such caps, arguing that they weaken protections against unforeseen losses or liabilities. Deal negotiations can easily get bogged down — and a merger may even collapse — if a seller believes the buyer is requesting too many PPAs that reduce the company's final purchase price.

When PPA disagreements begin to threaten a deal, it may be best for both parties to limit adjustments and simply negotiate a more amenable price and deal terms. If this isn't possible, one potential compromise is to agree that any PPAs above an agreed-upon number or percentage will be paid as an earnout. (See "Bridging the gap" at right.)

Negotiations guide

PPAs help ensure that changes in the selling company's value are accurately reflected in its final price. But they can be tough to negotiate, which is why you need an experienced M&A advisor to guide you during deal negotiations. ■

Bridging the gap

It happens: A buyer insists on purchase-price adjustments (PPAs) and a seller flatly refuses to accept them. Can this marriage be saved? Possibly, if the parties agree to an earnout, which typically helps bridge the gap between what a buyer and seller each believe a company is worth. These payments are made some time after the deal closes and usually are based on the company's postmerger performance. Often, selling owners stay on as employees or advisors after the merger to help promote strong financial performance and the meeting of earnout targets.

Unfortunately, the solution itself isn't always simple. Earnout negotiations can be contentious in their own right. Among the issues buyers and sellers need to agree on are:

Form of payment. Will the seller receive a cash payment or stock options? Tax issues can complicate this decision.

Date of payment. Will the seller automatically receive earnout payments on specific dates (for example, beginning one year after closing) or is payment contingent upon the company achieving certain performance goals?

Seller's rights. If the new owner manages the business poorly and its performance suffers enough to cancel earnout obligations, what rights does a seller have?

Why cybersecurity is critical to your deal's success

Conducting due diligence during the M&A process doesn't just mean reviewing a target's financial statements and operations. Not anymore, anyway. These days, in addition to performing financial, legal and operational due diligence, buyers need to scrutinize a potential acquisition's data and IT networks.

Why? Look no further than the ongoing Yahoo/Verizon deal, where negotiations came to a screeching halt after Yahoo admitted that hundreds of millions of its user accounts had been hacked. Unfortunately, lax cybersecurity can affect a merger's terms, valuation, postmerger integration — and, of course, simply kill the deal.

Buyers beware

When a buyer acquires a company, it also acquires the target's present and future data security issues. Given the potential costs and legal obligations this inheritance represents, you need to be careful about courting a seller with a history of cyberbreaches.

If your business has suffered data breaches, record and describe them in detail and demonstrate how they were successfully resolved.

Many buyers already are. A 2016 NYSE survey of public company directors and officers found that more than half believe that data vulnerabilities would significantly lower the value of a potential target. About 85% agreed that major vulnerabilities in a seller's software assets would "likely" or "very likely" affect their final purchase decision.

In addition, 22% said they'd likely abandon a deal if the company suffered a high-profile data breach.

Into the breach

The Yahoo deal is a perfect example of how a data breach can wreak havoc in an M&A deal negotiation. In June 2016, Verizon agreed to acquire Yahoo's core Internet business for $4.8 billion. In the following months, Yahoo disclosed that it had been hacked in 2013 and 2014, affecting possibly 1.5 billion email accounts.

In response, Verizon extended the deal negotiation process (the transaction hasn't closed as of this writing) and reduced its offer by $350 million. It also negotiated for Yahoo to share in current and postmerger legal responsibilities and costs associated with the breaches.

Seller strategies

Under these circumstances, selling businesses shouldn't be surprised when potential buyers express interest in the security of their data. Before even entering the M&A market, sellers should devise and implement a strong cybersecurity policy. Doing so includes performing regular audits and pinpointing system weaknesses. Sellers — particularly those that have been relatively lax about cybersecurity — may need to increase their IT security budgets.

Prospective buyers are likely to look for several things during the due diligence stage, including compliance with all applicable federal, state and international standards. For example, companies generally must report data breaches to customers within a certain timeframe.

If your business has suffered data breaches:

- Record and describe them in detail,
- Tally any past or outstanding legal obligations and related costs,
- Demonstrate how the breaches were successfully resolved, and
- Explain what steps you've taken since to prevent future hacking.

To reassure buyers that the same thing won't happen again, consider engaging a third party to conduct a fresh IT audit. Your M&A advisor can help you find an appropriate expert.

Taking it seriously

There's no going back. In 2017, every company must take responsibility for protecting its data and networks from hacking. This pressure is even stronger if you hope to sell your business because, even if you don't take IT security seriously, your buyer certainly will. ■

Internal control

HOW TO KEEP SHAREHOLDERS FROM DISRUPTING YOUR DEAL

Investors and shareholders understandably care about the future of your business and any decision that might affect it. Their support is reassuring when these stakeholders agree with your management decisions. But when they oppose a proposal — such as a sale or acquisition plan — you could have trouble on your hands.

In most cases, shareholders don't have contractual rights to block a company's merger unless they've negotiated those decisions as a condition of their investment. However, investors who aren't fully on board can make the process unnecessarily difficult.

In the way

Both sellers and buyers need to consider their major stakeholders. A public company seller, for example, could alienate private equity investors by

accepting an offer the investors consider too low. Buyers' stakeholders might object to an acquisition on the grounds that it's a poor strategic fit.

Either group can easily get in the way of deal proceedings. Even if a major investor is only lukewarm about your proposed deal, he or she can influence other stakeholders until discontent is widespread. And a strongly opposed investor in a public company could lobby other shareholders to push for a proxy vote to reject the transaction. Worse, investors could file a lawsuit claiming the deal damages the value of their holdings.

Specific interests

To avoid conflicts with major investors over a planned M&A deal, start by taking their specific interests into consideration. For example, are you dealing with a strategic investor who concentrates on companies in a single market sector? Such an investor might object to a merger with a widely diversified, multi-industry company.

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Costs commonly get investors riled up, too. M&A deals can be expensive for buyers, and their investors are likely to keep a wary eye on the bottom line. If you're buying a company, be prepared to provide specific examples of how the deal will reduce costs or increase revenues — and ultimately boost profits — and how long it will take to repay any new debt you'll be assuming.

Risk-averse investors may also be skeptical of promised synergies. To make the case that cost synergies are real, provide investors with a list of your deal's:

- Objectives, including projected growth rates,
- Increased cash flows from existing assets, and
- Expanded market shares.

The more detailed your case, the more likely stakeholders are to support you.

Another potential concern, particularly among private equity investors, is valuation. Investors don't want to sell their holdings too cheaply. Or, if they own a stake in the acquiring company, they don't want their shares devalued when the buyer issues stock for a potentially overvalued acquisition. Work with your M&A advisor to estimate a current, supportable market value.

Keep the lines open

Another way to reduce investor objections? Keep the lines of communication wide open — especially with those prone to cause trouble. If major stakeholders have a history of contentious management relationships, meet with them personally to explain your plans and how you arrived at certain decisions.

Even mild-mannered investors require care. Often, stakeholder resistance to a deal has its roots in resentment over being ignored or neglected. Investors who supported your company in its early stages are likely to be particularly sensitive. So be sure to regularly debrief and solicit feedback from all of your major investors both through formal communications and informal meetings about important decisions, such as those on price or deal structure.

Protect yourself

Despite your best efforts, it may not always be possible to get every major player on board. If you go ahead with a deal despite the objections of a major investor, be sure to take steps to protect yourself from legal action that could block the transaction.

For starters, carefully organize all records that discuss management's consideration of alternatives to the deal, such as offers from other buyers and why they ultimately were rejected. Also consider obtaining a fairness opinion about the deal's financial viability from an objective outside expert. Finally, when dealing with disgruntled investors, involve your legal counsel in every major deal-related decision. ■

Ask the Advisor

Q. What should I know about selling to a PE buyer in 2017?

A: Private equity (PE) firms have been active M&A market participants over the past decade, particularly when "bargains" were plentiful. But traditional corporate buyers, which typically make higher acquisition offers, are starting to give PE firms a run for their money. This could be good news for sellers.

If your company is interested in finding a PE buyer, you need to get a sense of the current landscape. Find out what characteristics PE buyers are looking for and identify their competition. Doing so will enable you to craft a proposal that attracts attention from serious buyers.

Jostling for position

The M&A market's strong resurgence over the past two years hasn't necessarily been good news for PE firms. That's because recent deal activity has been fueled by cash-rich strategic buyers — both domestic and foreign — and others that are taking advantage of lower interest rates to finance their transactions.

PE firms generally limit the size of their offers because they need to be able to resell the target for a profit in the near future. So it's not unusual for them to be outbid by buyers with deeper pockets and longer-term strategies. This scenario actually contributed to a slight decline in PE M&As in 2016, which were down 4% over 2015.

Targeting small

Yet PE firms remain hungry for deals and are sitting on approximately $525 billion in capital, according to investment research firm Preqin. In general, they're looking for opportunities where they won't have to go head-to-head with strategic buyers.

One target is smaller businesses. PE firms are fond of making "add-on" acquisitions (where the buyer first acquires a "platform" company and then adds smaller purchases in the same sector to that platform). If your middle-market company is having trouble attracting the attention of larger strategic buyers, an add-on acquisition with a PE firm could be a good option.

These buyers usually are flexible about structuring deals. For example, you might be able to craft a carve-out transaction, where a division or subsidiary is spun off to create a separate company for sale. And if your company is publicly traded, you might be able to negotiate a going-private deal, which is typically accomplished via a leveraged buyout. A PE firm may even be interested in making a minority investment in your business.

Seeking smart

Now could be a good time to seek a PE buyer. But before you adopt this strategy, discuss options with your M&A advisor. ■

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Passing the Business Torch ... One Successful Transaction at a Time

Our Firm:

Everingham & Kerr (E&K) is a regional merger and acquisition advisory firm focused on implementing exit and growth strategies for lower middle market companies. Our client base includes private and publicly owned companies, investor groups, family businesses and entrepreneurs. Since 1988, the firm has successfully completed hundreds of transactions spanning virtually every industry sector.

Our Maxim:

Combining Experience, Teamwork and Persistence to Produce Superior Results.

Our Services:

Sales:
E&K provides representation to sellers of lower middle market companies including sales of entrepreneur and family owned companies as well as divestitures of business units of private and publicly owned companies.

Acquisitions:
E&K assists companies, entrepreneurs and corporate executives develop and execute customized acquisition strategies designed to result in successful transactions.

Transaction Consulting:
In some instances the parties to a transaction locate each other through informal industry or personal channels. These transactions include sales to unrelated third party acquirers, as well as management, family and partner buyouts. E&K is often engaged to structure these transactions and navigate the many issues requiring attention from the initial stages to the consummation of the transaction.

Business Valuations:
E&K provides a full range of valuation services to business owners for personal and corporate affairs. Supporting our belief that all owners should know the “real” value of their business, E&K offers the “Owner’s Planning Valuation”. This is an informal valuation that can be prepared in a cost-effective manner and updated periodically to assist owners with company and personal planning issues.

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