



## Fusion: A Quarterly Exchange to Power Your M&A Deals

# Private Equity's Role in the Changing M&A and Corporate Finance Landscape

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## Edouard C. LeFevre



Edouard C. LeFevre is a partner with Foley & Lardner LLP. He is a member of the firm's Private Equity & Venture Capital and Transactional & Securities Practices, as well as the Emerging Technologies Industry Team. He has worked extensively with businesses in the software, life sciences, health care, and services industries.

Mr. LeFevre represents clients in mergers, acquisitions and financing transactions of varying types and sizes. His deal experience includes:

- Representation of numerous public and private companies in sales to public and private acquirers, ranging from \$5M to over \$150M
- Representation of private companies in preferred stock financings, ranging from \$2M to over \$20M
- Representation of private equity firms in fund formation and subsequent investments in public and private portfolio companies

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## Steven W. Vazquez



Steven Vazquez is a partner with Foley & Lardner and is a member of the firm's Transactional & Securities and Private Equity & Venture Capital Practices. His practice focuses on securities offerings and other securities matters, corporate governance, mergers and acquisitions, and venture capital transactions.

Mr. Vazquez represents companies and investment banking firms in a wide variety of securities and corporate finance transactions. He has represented issuers and underwriters in 14 initial public offerings and follow-on offerings. He also has represented over 10 public companies in connection with their ongoing corporate and securities needs.

Mr. Vazquez has represented public and private companies in merger and acquisition transactions aggregating over \$5 billion in total consideration, including advising boards of directors and special committees of independent directors on corporate governance matters, change in control issues, and anti-takeover strategies. Mr. Vazquez's venture capital experience includes representing emerging growth companies in more than 25 venture capital transactions since 2000.



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## Elliot Williams



Elliot Williams has worked as an M&A and financial advisor to middle market businesses since 1992. He is a Partner and President of Mirus Capital Advisors ([www.merger.com](http://www.merger.com)), a leading middle market investment banking boutique in the Boston area. Elliot has represented over 100 middle market companies managing the successful sale, capital raise or refinancing of Mirus clients. He currently runs Mirus' Business Services practice with a strong focus on technology-enabled services.

Recent notable transactions at Mirus Capital include Eliassen Group's transaction with Lineage Capital, the sale of Lextranet to Merrill Corporation and the purchase of Emergent Network Solutions by Stratus Computer.

Elliot is a board member of the Association for Corporate Growth in Boston and served as President of ACGBoston from 2005 to 2007.



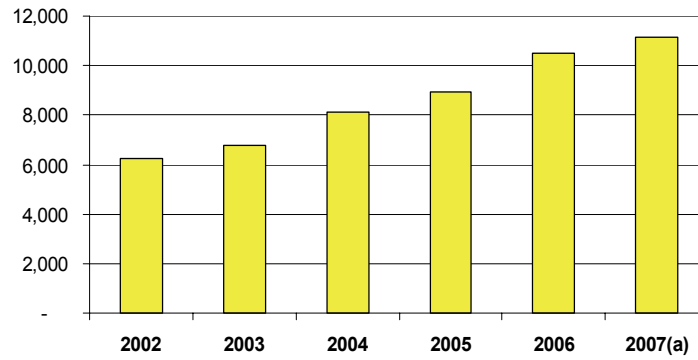
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## M&A and Buy-Out Market

M&A transaction volumes still on the rise

**M&A Deals**  
(Number of Transactions)



(a) Annualized as of 9/6/2007

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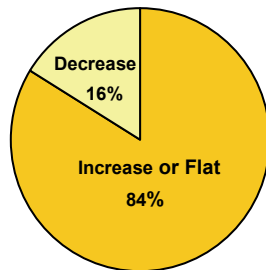
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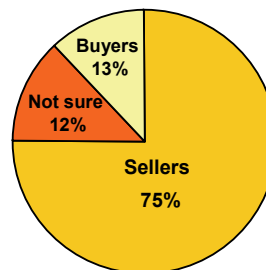
## M&A and Buy-Out Market

Optimism from Dealmakers continues

**How will deal volume change in the next 6 months?**



**Is it a buyer's or seller's market?**



Source: Association for Corporate Growth/Thomson Mid-Year Survey of Dealmakers

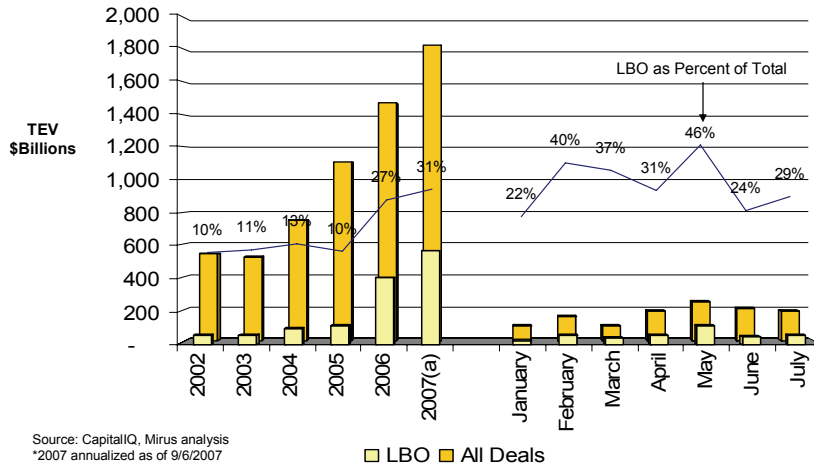
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# M&A and Buy-Out Market

Financial Sponsors account for a growing fraction of total deals



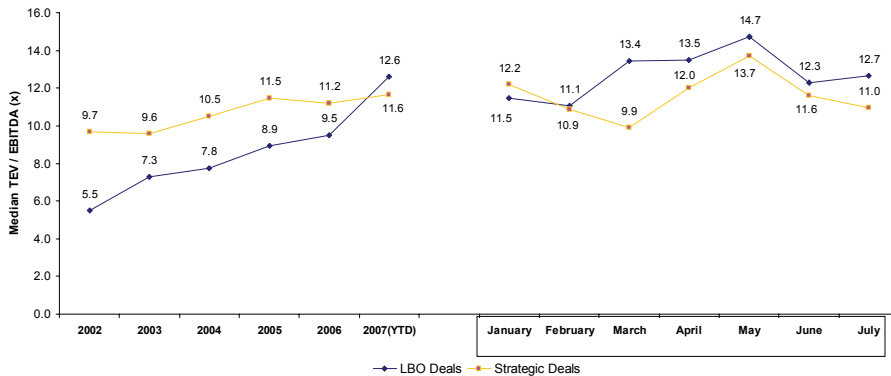
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# M&A and Buy-Out Market

Valuations are at record highs but...



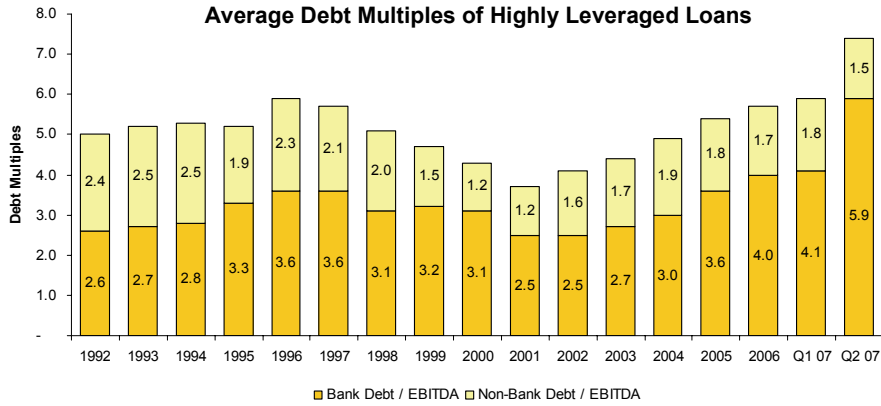
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# Financing Environment

Significantly higher leverage has become the norm for buy-outs



Source: Standard & Poors LCD

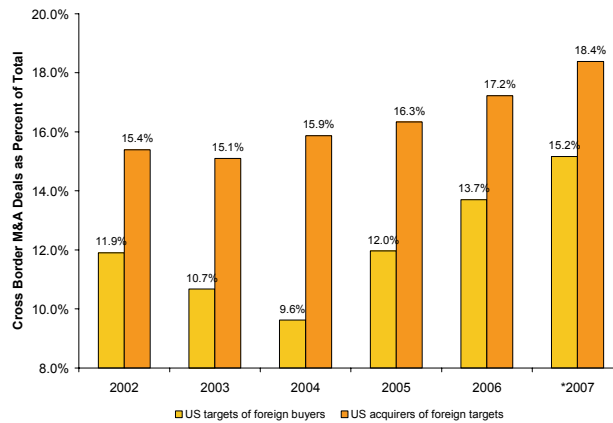


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# International Markets

Cross border deals are rising with no end in sight



\* Annualized based on first half Source: CapitalIQ, Mirus analysis



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## Will M&A Continue its Pace?

### Reasons for Pessimism

- Slow down in stock market gains in '07 as compared to previous three years
- Signs of a weakening economy
- Fear that the credit crisis in sub-prime loans will impair corporate and PEG borrowing power

### Reasons for Optimism

- General stability in markets and economy despite signs of weakness
- Record capital continue to flow to private equity groups
- Despite a tightening on terms and covenants, lending is still widely available
- Strong corporate balance sheets and cash positions
- Most industries are only partially through consolidation
- Increasing activity from foreign buyers



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## Will M&A Continue its Pace?

- Valuations are currently coming down from their lofty peak in early 2007. This will continue, but we expect valuations to remain higher than historical averages throughout next year.
- Volumes will reduce somewhat in 2008, but stay at historically high levels.
- Some additional major event will have to happen to trigger a major downturn in U.S. M&A activity and valuation. Keep your eyes on the economy.



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## Why Incentives?

- Align objectives with owners
- Maximize price
- Increase management security/comfort
  - Reduce risk of key management defections
  - Reduce risk of breach of confidentiality
- Ensure continuity
- Potential to shift cost to buyer with advance planning



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## Equity

- Stock vs. incentive units
- Tax ramifications
  - Stock: potential for capital gains
  - Incentive units = ordinary income
- Control issues
  - Stock:
    - Fiduciary obligations to new stockholders
    - Right to vote
- Incentive units = bonus



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## Change of Control Agreement

- Severance
  - How long
  - Payment schedule/tie to non-compete
- Acceleration of equity vesting
- Continuation of benefits
  - Health
  - Life
  - Other
- Definition of “change of control event”



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## Success Bonus

- Trigger
  - Closing of sale
- Amount
  - Tied to valuation
- Payout
- Timing



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## The Pros & Cons of Bid Auctions

- What is a bid auction?
- Most effectively packages company
- Maximizes value through broadest exposure & competitive situation
- Creates “level playing field” for all bidders
- Negative: puts company “on the block” with potential adverse impact on vendors, customers and employee morale
- Additional negative: allows competitors to learn selling company’s secrets



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## The Beginning of the Public Sale Process: Selecting an Investment Banker

- Understanding the requirements
- Learning about conflicts of interest
- Finding the right people: chemistry, commitment, expertise and availability
- Fee considerations: formulas and negotiating room
- The key value of a banker: access to the obvious and not so obvious potential buyers



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## Putting Together the “Book”

- Requires major effort to get it right
- Must involve key management to properly portray business and vision
- The easiest part of an investment banker’s job



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## Alternatives to the Bid Process

- The targeted approach through an intermediary
- Finding your own buyer
- The negative: valuation problems (may not be the key issue for the sale)
- Another negative: still could leak out



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## How to Find the Right Company to Buy: The Buyer's Perspective

- Bid auctions are generally the least desirable from the buyer's standpoint
- Brokers and other intermediaries prefer repeat buyers, such as funds (possible small size exception)
- The best approach: networking
  - Lawyers, accountants, consultants
  - Industry associations
- The targeted approach: find the right company and make an offer



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## Contract Terms: Current Trends

### Overview

- The emergence of mega buyout funds and inexpensive and readily committed debt that led to the surge of private equity acquisitions of large private and public companies is a relatively recent phenomena.
- Until recently a strategic buyer could pay more for a company – both because of they could benefit from the synergies and because they often had a lower cost of capital.
- And the need for a private equity firm to obtain debt financing from a third party generally made a sponsor-led deal riskier than a sale to a strategic buyer.



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## Contract Terms: Current Trends – continued

### Overview - continued

- More recently, auctions for the sale of the company became more overheated, resulting not only in a dramatic increase in purchase price multiples of EBITDA, but also in a rapid change in standard key terms in acquisition agreements.
- Some of these shifts include:
  - Disappearance of the Financing Condition
  - Recourse Against the Sponsor
  - Reverse Break Up Fees



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## Disappearance of the Financing Condition

- Prior to 2004, the typical purchase agreement for a sponsor-led acquisition of a private or public company contained a financing condition and was accompanied by a fully committed debt commitment letter or letters.
- Sellers/targets would attempt to further negotiate the material adverse change (MAC) conditions of the commitment letters in an effort to reduce the risk of the acquisition not closing.
- Sellers/targets occasionally succeeded in mirroring the MAC conditions in the commitment letters to those in the purchase agreement – in other words, sellers/targets occasionally had “market outs” or “market MACs” and other broad conditions eliminated from financing commitments.



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## Disappearance of the Financing Condition - continued

- Typical acquisition agreements also required the sponsor to draw down on the financing if the closing conditions were satisfied.
- The acquisition agreement would be signed only by a shell corporation with no assets other than the debt commitment from the lender and the equity commitment from the sponsor (which itself was conditioned on receiving the debt financing).
- Thus, a third party beneficiary provision in favor of the target/seller often was provided, which gave a target/seller the potential to specifically enforce an acquisition agreement.



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## Disappearance of the Financing Condition - continued

- In the last few years, a number of factors changed the pre-2004 scenario:
  - Because of the competition for deals among private equity firms, sponsors became more concerned with the reputational damage caused by walking away from a deal.
  - The use of an acquisition shell coupled with debt and equity commitment letters created uncertainty, which in turn put private equity firms at a disadvantage to strategic buyers, which rarely require a financing condition.
  - The ready availability of cheap debt, the advent of “covenant lite” loans, and the use of PIK notes (where interest is paid with more notes) enabled private equity firms to compete favorably with strategic buyers on price.



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## Disappearance of the Financing Condition - continued

- The result was:
  - The disappearance of the financing condition in many sponsor-led acquisitions.
  - Commitment letter conditions were tightened further.
  - The requirement to draw the financing and close became more specific.



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## Rise of the Reverse Termination Fee

- The removal of the financing out led to a desire of the private equity firms to protect themselves in the event that a lender breached its obligations in the commitment letter.
- This led a liquidated damages provision in favor of the target/seller known as a “reverse termination fee.”
- A reverse termination fee is a fee payable to the target/seller in the event the deal did not close because the financing was not available.



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## Rise of the Reverse Termination Fee - continued

- Reverse termination fees evolved into a broader limitation on liability if the transaction did not close for any reason (a result of the tightening of all MAC conditions).
- Sellers/targets often are now successful in negotiating for a higher termination fee if the transaction does not close for a reason other than failed financing.
- Private equity firms typically guarantee the reverse termination fee (as the shell buyer has limited assets).



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## Rise of the Reverse Termination Fee - continued

- Sometimes, private equity firms successfully make the reverse termination fee the exclusive remedy – which makes the transaction essentially an option (except for reputational issues for walking away from a deal).
- Other times, specific performance remains a remedy for the target/seller – so that the reverse termination fee operates as a cap on damages.



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## Now that the Markets May be Changing Again, Who Won?

- In the pre-2004 scenario, sellers took some risk that the financing would not be available. But, if all conditions were satisfied, it would be risky for the private equity firm or the financing source to decide not to close.
- The target retained the ability to seek specific performance, including the possibility that a court would require the shell specifically to enforce its debt and equity commitment letters against the lenders and the private equity fund or that a court would conclude that the private equity fund was in any event the real party in interest.



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## Now that the Markets May be Changing Again, Who Won? - continued

- In contrast, the new form of documentation, except perhaps where a specific performance remedy has been clearly preserved, has effectively given private equity sponsors an option to walk away for a reverse termination fee.
- In addition, the removal of the financing conditions and the presence of a reverse termination fee could create greater leverage for buyers and lenders to renegotiate price and other deal terms if there are increased borrowing costs or deterioration in the business of the target.
- The result may be a shift back to the pre-2004 form of deal documentation.



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**December 13, 2007**

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