TOP TAKEAWAYS

EVALUATING ACQUISITIONS IN THE BOARDROOM

1. The Board and management should develop and discuss, on a regular basis, the company's acquisition strategy and identify the types of acquisitions that would advance such strategy. The Board should ensure that any proposed acquisition fits into the company's overall acquisition strategy.

2. The Board's involvement throughout the acquisition process – beginning with the development of an acquisition strategy, through the selection of advisers, oversight of due diligence and the evaluation of the proposed acquisition, and ending with the approval of the acquisition – must be informed and conducted in a manner consistent with the Board's fiduciary duties of care and loyalty.

3. The Board should consider whether the proposed acquisition is the best use of the company's resources, what benefits and synergies may be recognized by the company as a result of the proposed acquisition and whether those benefits and synergies are obtainable.

4. The Board should be involved in the overall negotiation strategy for a proposed acquisition, including valuation and price. The Board should analyze, question and test the assumptions underlying any valuation and confirm that they are correct. The Board should establish the maximum price that should be paid.

5. The Board's evaluation of a proposed acquisition should include the identification and evaluation of material risks, including business risks, as well as legal risks related to the acquisition process, structure and terms. The Board should determine how these risks may be mitigated and if the acquisition is advisable in light of such risks.

6. The Board's evaluation of a proposed acquisition should also focus heavily on management's proposed strategy for integrating the acquired business. The success or failure of an acquisition often hinges on the acquiring company's ability to integrate successfully the acquired business. The Board should review and evaluate the proposed integration strategy beginning early in the acquisition process and continuing after the completion of the acquisition.

7. Depending on the structure of the Board, it may be advisable to have a subcommittee of the Board heavily involved in all of the details of a proposed acquisition and then have the subcommittee provide periodic updates to the full Board.

8. Locked Box Deals

   a. Locked Box deals are fixed price deals where the purchase price is fixed at signing and calculated based on a historical balance sheet as of a date prior to signing (the "locked box date"). There are no post-closing adjustments for working capital or debt. Mechanisms are built into the purchase agreement to protect the buyer from "leakage" of value transferred to seller after the locked box date and prior to the closing.

b. In a locked box deal the buyer essentially owns the business as of the locked box date and there is typically no closing condition that there has been no “material adverse change” between singing and closing. Therefore, a buyer’s diligence process in a locked box deal must be more comprehensive than in a deal with post-closing purchase price adjustments and a closing condition that there has been no “material adverse change”.

c. The locked box deal structure was principally driven by private equity buyers that wanted certainty around deal price. Locked box deals are popular in Europe and other international markets, but have not yet become market in the United States.

9. Representation and Warranty Insurance

a. Representation and warranty insurance is third-party insurance for claims a buyer may have for losses resulting from breaches of a seller’s representations and warranties. Although less common, representation and warranty insurance can also be issued to a seller to cover its liability for breaches of representations and warranties.

b. Representation and warranty insurance has become increasingly more common in transactions. Some of the reasons for the increased popularity are (i) lower premiums and deductibles, (ii) better policy terms (longer policy periods, narrower exclusions, higher coverage limits, etc.) and (iii) more underwriters and efficient underwriting.

c. The cost of representation and warranty insurance varies depending on the nature of the company being acquired and the size of deductible/retention, indemnification terms and scope of coverage. Typically cost of coverage is between 3.5 and 4.5 percent of the policy limit, including premiums, fees and taxes. The cost is generally split between buyers and sellers, but can vary on who benefits the most from the insurance. The trend, particularly in auctions, is moving more toward buyers bearing all costs of representations and warranties insurance.

d. For deals over $50 million, retention amounts are typically between 1 and 2 percent of enterprise value. Generally, the insurer will price the coverage assuming that the buyer and seller will each bear half of the retention. Buyers may be able to negotiate a step-down decrease over time (e.g., retention might start at 2% but drop to 1% after 12 months).

10. Current M&A Market Overview

a. The global economic crisis had a meaningful impact on global M&A activity as deal volumes plummeted beginning in H2 2008. Since 2009, there has been a gradual increase in global M&A activity as economies slowly rebounded. Recently there has been record levels of M&A transactions.

b. Strategic buyers have been able to pay a premium because of synergies and have therefore been able to squeeze out some private equity buyers.

c. Easy availability of credit has taken away some former advantages of financial engineering that private equity buyers relied on.

d. Within the United States, leverage multiples as measured by Debt-to-EBITDA remain at some of the highest levels since 2002.

For more information on Evaluating Acquisitions in the Boardroom, please feel free to contact the moderator directly:

Steve Vazquez
Foley & Lardner LLP
svazquez@foley.com