M&A Auctions: Strategies for Buyers & Sellers

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Houston Chapter Event

**Sponsored by:** King & Spalding LLP

**Speakers:**
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- King & Spalding LLP

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A sale process designed to elicit competitive bidding among interested parties to facilitate the sale of a business or asset at the highest price and on the best possible terms.
When to Use an Auction

- When there are multiple potential buyers, and
- When the characteristics of an auction favor the seller
General Sequence of Events -- Timeline

- Retention of Investment Banker
- Preparation of Management Presentation Materials
- Preparation of Confidential Memorandum
- Development of Contact/Prospect List
General Sequence of Events -- Timeline

- Assembly of Data Room
- Circulation of Confidentiality Agreements
- Circulation of Confidential Memorandum
- Management Presentations
- Access to Data Room
General Sequence of Events -- Timeline

- Circulation of Bidding Rules/Procedures and Model Sale Agreement
- Solicitation of Bids
- Select Winning Bidder
- Negotiate and Finalize Definitive Sales Agreement and Related Documents
Considerations

- Generally considered an efficient and effective process for selling a business, but there are exceptions to this general rule
  - Time Consuming Process
    - Risk of Premature Disclosure
    - Litigation Risk
  - Certain Parties will not Participate in Controlled Auctions
  - Other Considerations
Extranets and VDR’s

- **Virtual Data Room** – Secure electronic environment based on standard Internet/Web technologies to facilitate document management and review

- Bankers control access to VDR.

- Bankers not required to be present in physical data room

- VDR is accessible 24 hours a day, 7 days a week

- No restrictions as to maximum number of visitors to data room at any given time

- Bankers can continuously track activity in data room to determine potential acquirers’ level of interest
**Preliminary Considerations for Buyers**

- Be discriminating in the auctions in which you participate
  - Do you have prior industry experience?
  - Who are your likely competitors?
    - Strategic buyers may make it difficult to effectively compete

- Review of bidding procedures
  - Try to determine if there are any unusual requests by Seller

- Reach out to Investment Banker
  - Have a candid discussion regarding Seller’s expectations and concerns

- Confidentiality Agreement
  - Consider having attorney review prior to signing
  - Ability to talk to other private equity funds
TIP: Seller’s perception of Buyer often materially enhances or harms Buyer’s chances of winning the auction
Seller’s Perception of Buyer

- **Trust**
  - Does Buyer have a history of renegotiating won auctions?
  - Has Buyer done sufficient diligence to support their bid price?

- **Financing**
  - How certain is Buyer’s financing?

- **Difficulty**
  - Will Buyer be difficult in negotiations once they’ve won the auction?

- **Intrusiveness**
  - Will Buyer be more thorough in its due diligence than other bidders?
    - Buyer should try to ask direct questions in a non-aggressive manner

- **Lifecycle of fund**
  - In earlier stages may be more aggressive or more likely to pursue rollup
Seller’s Perception of Buyer

- Sometimes the best indicator of future results is past performance
  - Does Buyer have a history of busted deals?
  - Is Buyer typically successful in obtaining financing based on the financing letters delivered with its bid?
  - Does Buyer have a history of renegotiating won auctions?
  - Is Buyer aggressive after closing deals?
    - Purchase price adjustments and indemnification claims
  - How has Buyer treated the management teams of their other portfolio companies?
  - Have Buyer’s prior investments been successful?
Controlling Buyer’s Costs

- Due Diligence
  - Work with counsel to develop a diligence plan at the outset
  - Focus on business diligence initially
  - Limited use of experts until needed
    - Review those matters that impact pricing and big ticket items
  - Avoid starting and stopping due diligence during the process
Controlling Buyer’s Costs

- Provide comments on the bid contract in the form of an issues list instead of a contract markup
- Develop forms that can be easily modified to the particular deal
  - Bid letter
  - Issues List (especially indemnity and escrow provisions)
Bid Letter

- **Purpose**
  - Sets forth the parties’ understanding of the material business and legal terms

- **Typical Terms (not included in preliminary indication of interest)**
  - **Deal Structure and Key Terms**
    - Asset vs. Stock acquisition
    - Purchase Price; Form of Consideration; Use of escrow
  - **Conditions**
    - Financing; Due Diligence; Execution of Definitive Agreements; Required Consents; Employment Agreements
  - **Exclusivity**
  - **Indemnification**
    - Survival period; Caps; baskets
  - **Ancillary Agreements**
  - **Reimbursement of Buyer’s expenses**
  - **Termination**
**Bid Letter**

- **Binding vs. Non-Binding**
  - Typically, only certain provisions contained in the bid letter are binding
  - The bid letter should provide that other than specific provisions, the terms are non-binding and are subject to further negotiation and the execution of definitive agreements

- **Duty to negotiate in good faith**
  - Court may impose this duty on the parties even where the bid letter clearly states there is no intent to be bound

- **Typically Binding**
  - Exclusivity
  - Confidentiality
  - Due Diligence Access
  - Expense Reimbursement / Breakup Fees
  - Non-solicitation of employees
Issues List vs. Contract Markup

- **Seller’s Concerns**
  - Seller wants to know material issues (both legal and economic) before selecting the winner
    - Seller will likely focus on the proposed indemnity and escrow terms
  - Buyer should limit the number of issues raised to the extent possible

- **Buyer’s Concerns**
  - Issues list
    - Saves time and controls legal expenses
    - Maintains flexibility to deal with due diligence issues

- **Seller will typically request a markup**
  - Not always required
  - Buyer should try to stick to an issues list approach until told Seller won’t consider its bid without a markup
Deal Points

- **Purchase Price**
  - Typically, bid price is on a debt-free basis
  - Earnouts
    - Length of period
    - Control over operating the business being acquired
  - Working Capital Adjustment
    - Focus on definition of Working Capital – may need to modify

- **Closing Conditions**
  - Financing
  - Due Diligence
  - Required Consents
  - Employment Agreements

- **Shareholder Approval**
  - Want to make sure most (if not all) shareholders are bound by the purchase agreement
Deal Points – Indemnity Matters

- **Applicability**
  - Buyer’s view: should only apply to acquisition agreement

- **Triggers**
  - Will need to complete diligence to determine if additional triggers are required

- **Joint and several liability of Sellers**

- **Survival period**
  - General vs. Special vs. Organic Representations

- **Limitations: Caps, baskets**
  - Should not apply to organic representations or fraud

- **Use of escrow**

- **Definition of Losses**
  - Buyer should seek a very broad definition

- **Ability to Sandbag**
  - Seller may try to limit Buyer’s right to claim indemnity if Buyer had prior knowledge of a problem
**TIP:** Due to narrow pricing spreads, it is important for Buyer to demonstrate why it is different from the other bidders.
Buyer Tips

- In today’s environment, there may not be large spreads in the pricing among the final few bidders
  - Certainty and speed of closing
  - Status of financing
  - Limited proposed changes to bid contract
- Show how you are different from other bidders
  - Prior success stories in the industry
  - History with management teams
  - Reputation of being reasonable (avoid reputation of renegotiating won auctions)
Buyer Tips

- Avoid giving ultimatums
- Hang around – never know when other bidders will drop out of the process
- Be careful of relationship with management
  - Potential for tension between management and Seller
- Know Your Seller
  - Different Sellers may have different hot buttons
    - Corporate Seller may be more concerned about certainty of closing
    - Financial sponsor Seller is usually trying to maximize value
FACT: No matter where you rank in the process, Seller will likely ask you to sharpen your pencils and increase your bid price at the end of each round.
Pricing

- No *right* approach
  - Develop pricing parameters that make sense for you and stick to it
    - Remember … it’s OK to take a pass
  - Will depend on competitiveness of the process
  - When in doubt, go with your gut instinct

- Preliminary Rounds
  - Use a range of values
  - Seek guidance from Seller’s banker: objective in the beginning of the process should be to get into the next round
Pricing

- **Final Round**
  - Bid what you’re comfortable paying – **not** to win the auction
  - Leave a little reserve for the final “final” bump

- **Be Creative**
  - Consider earnout to bridge valuation gap
  - Bonus arrangements for management

- Most investment bankers will continue to try and get you to increase your price until you say “No”
Buyer Beware: Seller Tricks

- Multiple bidding rounds
  - Seller will likely request modifications to contract comments to “put your bid on equal footing with other bidders”

- Leverage shifts to Buyer upon winning the auction
  - To counterbalance, Seller may try to create uncertainty in Buyer and have Buyer believe the runner-up is waiting on the sidelines
    - Seller may tell Buyer that its price was not the highest but was nevertheless selected because:
      - Management preferred Buyer over the other bidders
      - Better financing structure
      - Fewer issues raised on the bid contract
Ways to Avoid Auctions

- First-Mover
  - Team up with executive and/or company to leverage industry knowledge

- Preemptive bidding

- Be creative in deal structure
  - Offer Seller the ability to participate in future upside
  - Discuss continued role of management

- Look for out of favor assets
  - International portfolios, merchant power generation, telecommunication, out-of-favor technology, R.E.I.T. portfolios, etc.
Now that You’re the Seller

- Once you grant exclusivity, the negotiating power shifts to the Buyer
- Balancing tactics
  - Make sure all material economic terms are agreed in bid letter
  - Keep other bidders warm
- Protect against price re-trading
  - Full and accurate diligence disclosure to limited group of bidders
    - If withhold negative information, susceptible to price re-trade
  - Consider two-finalist approach
    - May need to reimburse loser for incremental expenses (cap)
    - Difficulty conducting simultaneous negotiations
  - Seller should carefully track Buyer’s actions during auction process
    - Important to determine if their level of diligence supports Buyer’s bid price
    - Use of electronic data room helps monitor Buyer
William "Bill" Parish

Bill Parish is a partner in the Houston office of King & Spalding. His practice consists primarily of mergers and acquisitions and dispositions (including auction and negotiated sales), private equity transactions, joint ventures, energy matters, and international infrastructure and project development transactions. Mr. Parish has broad industry expertise, representing leading U.S. based and foreign companies in a variety of sectors, including oil and gas, mining, retail, real estate, transportation, and telecommunications. Mr. Parish has extensive experience in cross-border mergers and acquisitions and joint venture transactions, particularly in Latin America and in Europe. He is fluent in Spanish.

In 2004 and 2005, Texas Monthly and Law and Politics publications named Mr. Parish a “Rising Star” of the Texas legal profession.
George “Ned” Crady

Ned Crady is a partner in the Houston office of King & Spalding LLP. Mr. Crady represents strategic and financial investors in the energy business.

Mr. Crady has extensive experience in the purchase, sale and development of power generation and distribution assets, natural gas transportation and distribution assets, oil and gas refining, LNG export projects in Latin America, LNG import projects in the Atlantic Basin, and commodity supply contracts around the world. His recent work experience includes the restructuring of a 700 MW domestic power plant; the acquisition of a natural gas storage company; the proposed acquisition of a 300 MW foreign power plant; and the development and expansion of two Atlantic Basin LNG import terminals.

Mr. Crady received his B.A. from Washington & Lee University in 1983. He received his J.D. at the South Texas College of Law in 1986. He is fluent in Spanish.

Mr. Crady is a Fellow of the Houston Bar Foundation. He is also a member of the Houston Bar Association and the State Bar of Texas.