MERGERS & ACQUISITIONS

Certainty to Close

Today's buyers and sellers choose terms designed to get the deal done

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Given the maturity of the M&A market, it's rare to find firms that are doing anything that's totally new and innovative. However, every now and then, depending on where we are in the investment cycle, something innovative does happen, or something old comes back into favor--with a twist. Today's uncertain economic climate, combined with the pent-up demand for high-quality companies, as well as ever-looming tax increases, has led to M&A deal structures that are perhaps a little different from what we have seen in the recent past. What follows are some examples of changes that have taken place in today's environment.

More Certainty To Close

Sellers want certainty to close. That's always the case, but what's different is that in today's market sellers of strong assets can demand it. As a result, more middle-market private equity firms are foregoing financing conditions to put them on equal footing with strategic buyers, which have plenty of cash in their coffers and do not need leverage or already have in-house credit facilities to complete a deal.

For example, in late July, strategic buyer Olin Corp. (NYSE: OLN) signed an agreement to acquire K.A. Steel Chemicals for a whopping 10 times Ebitda. Olin expects to finance the $328 million purchase with cash on hand and existing borrowing facilities-in other words, with no financing contingency. "Strong companies are very sought after," says Seth Hemming, co-chair of the private equity practice group at Reed Smith LLP.

With skyrocketing multiples for top-tier assets and the ability to complete a deal quickly, it makes it hard for private equity firms to be competitive with strategic buyers, if they have to secure a loan commitment. Firms are taking the risk of completing the deal and then shopping the debt after the deal has closed. "They buy the company and sell the debt later. They can bridge the loan until they can sell the debt or, most of the time, the firms will have a commitment letter for the financing before they make a bid. However, the private equity firms are still taking a risk if the financing doesn't work out," says Hemming.

Ted Koenig, president and CEO of lending firm Monroe Capital, agrees that the competition for quality deals is fierce, and private equity firms are looking for ways to differentiate themselves.

"There are more buyers than sellers today, and if a seller is going to commit to a buyer and take the deal off the street, they want certainty that the buyer will close," says Koenig. He adds that, very often, before his clients submit a letter of intent to make a purchase with no financing contingency, they will contact Monroe and let them know what they are looking at and provide relevant information about the company. At that point, Monroe will give them an early read on what their financing options will be after the deal closes.

In addition to shopping the deal unofficially, private equity firms are also engaging a greater number of lenders than normal, to make sure they will be able to finance the deal quickly after it closes.

While foregoing the financing upfront may be new to some or more popular these days, it's the way of the world for others. The Riverside Co. has been doing this for quite some time. As the firm sought out ways to give itself an advantage in purchasing situations, it recognized that completing the deal without a financing contingency is often a good differentiator. "We have done this for years, and it works well for us, but we do it thoughtfully," says Stewart Kohl, co-CEO of Riverside. "We never bid on an asset that we couldn't finance later, but we probably have a greater ability to do this because we are a large fund, buying small companies. We will finance the deal even if we have to put up all the money."

No More Escrow?

Sellers of strong assets have the upper hand, and they are being more aggressive in their negotiation of indemnification provisions.

Patrick Hanraty, a managing director with Harris Williams & Co., is involved in a deal where the parties are exploring using rep and warranty insurance, rather than placing funds in an escrow account. It's a first for all involved in the transaction. "Everyone admitted they had never done it before. On the chalkboard it makes a lot of sense to use a rep and warranty policy," says Hanraty.

Reed Smith recently had a seller present a rep and warranty insurance policy as the buyers' only source of recovery for breaches.

"There's been an uptick in activity of reps and warranty insurance. Originally, when the policy was introduced 10 years ago, it didn't have a lot of teeth, but it's evolved in the last few years to provide meaningful coverage," says Brett Carlson, senior vice president at insurance brokerage firm Willis Mergers & Acquisitions Group.

The use of rep and warranty insurance is becoming more widespread, according to Carlson, because there is an increase in underwriters making it available. What's more, the terms are better. "Through input from private equity firms and law firms, the terms are much better. It's been through an evolution, which makes the policy effective for supplementing or replacing indemnification," says Bill Monat, a senior vice president with Willis.

There are benefits to using the insurance. Rather than a buyer placing a portion of the purchase price in escrow and the seller waiting to see if that money will eventually be paid to it or returned to the buyer, a buyer would buy a policy and the seller can walk away from the closing with a greater percentage of the purchase price, and no strings attached. "The insurance policy essentially replaces escrowed funds as the buyers' source of recovery if something goes wrong. The concept of rep and warranty insurance used this way has been talked about for years, but only used sparingly and often after difficult negotiations. "Now, we have seen sellers getting rep and warranty insurance teed up on the front end of a negotiation and using it proactively to minimize their risk," says Paul Jaskot, chair of Reed Smith's U.S. Corporate and Securities Group. "For example, instead of putting, say, $10 million in an escrow account, the seller can pay a fraction of that amount for a policy and be finished with the deal."

According to Monat, buyers spend between $200,000 and $350,000 for every $10 million of coverage for a rep and warranty policy.

While these policies can be favorable, there are reasons that they aren't more widespread. The first is purely about comfort. Let's face it, people are creatures of habit and like to do things that they are comfortable with, and escrow accounts have been the norm for quite some time, which makes it hard to get dealmakers to change to rep and warranty insurance policies.

Another deterrent is that it adds one more group to the sale process, which is already complicated. "It adds another person who needs to do due diligence on the deal," says Hanraty.

However, Monat says that the process of securing a policy only takes about two weeks, and many dealmakers are under a misconception of how involved the insurance firm is. "Some people struggle with the idea of a third party coming to the table, but those who have used it realize the insurance company is not re-diligencing the deal, they are performing a confirmatory review. It's a relatively high-level review and not as intrusive as people fear," says Monat.

Lastly, dealmakers fear that, like any insurance policies, you can never be totally certain what incidents will be covered under the policy. However, Monat says that is best addressed through effective negotiation of the policy terms, with involvement of the client's deal counsel. "The policy contract needs to be properly drafted with limited exclusions and manageable terms and conditions. The terms shouldn't be an obstacle," says Monat.

Perhaps these fears are fading, because dealmakers are seeing it used more. "It's being used more in the U.S., but on a limited basis. It provides a good mechanism for a sale in a situation where the seller isn't providing the indemnification the buyer wants. It's a nice third-party solution," says Kohl, who adds that the policies are also becoming more commonplace because the insurance industry is getting more used to offering them and writing these policies.

Paying Taxes Now

As with any industry, a common cry when it comes to paying taxes is defer, defer, defer. That used to be the case in the M&A world, but not any more. Sellers no longer want to partake in tax-free deals. In light of the anticipated changes to U.S. tax law, some sellers are more interested in completing taxable transactions, so they pay any gains at 2012 rates rather than risk paying higher tax rates at a later date.

And, there are a number of tax issues on the table. The first possible tax change would make private equity professionals pay more than the 15 percent they currently pay on carried interest. Carried interest tax could reach as high as 35 percent. Additionally, President Obama's plans to eliminate the Bush-era tax cuts will cause taxes to increase.

We have heard that taxes are going to increase for quite some time. Many companies sold in 2010 because they thought taxes would increase. Potential sellers feel the same now. Harris Williams has seen its deal volume rise 83 percent from January to mid-July compared to the same period the year before, attributing some of the increase to business owners wanting to sell before the increase.

The fact is dealmakers expect it now. According to a recent survey conducted by Rothstein Kass, 55 percent of private equity firms polled believe that there will be increased taxation of carried interest. "People really do feel like something needs to give. When you see all the information, it's easy to believe increases could happen," says Andrew Bentley, a tax principal at Rothstein Kass. Bentley added that a lot of his clients started thinking about the proposed increases at the end of 2011 and started making decisions as to which investments may make sense to exit.

"The proposed changes to tax treatment is definitely playing a part in dealmaking," says Bentley.

Kohl agrees that now is the time to pay the taxes. "The rule is to always defer, but we are in a unique moment where taxes will potentially be much higher and interest rates are very low. Regardless of what happens I haven't heard anyone suggest under any scenarios that capital gains will be lower for any future scenario. Taxes may stay the same for a while, but if you are a seller looking to sell your business this is the year you want the taxable gain to be in," says Kohl.

Earnouts and Rollovers Bridge the Gap

In recent times, there has been a gap between what the seller is asking for its business and what the buyer is willing to pay. To try to bridge that gap, earnouts are often used. An earnout provides deal insurance for both the optimistic seller and the cautious buyer, by agreeing that a portion of the deal payment will be contingent upon the performance of the company after the deal has closed. Earnouts are commonly used in a down economy, when disagreements about the valuation of businesses increase.

While no two earnouts are the same, a typical earnout will have the acquirer paying 60 percent to 80 percent of the purchase price up front, with the remaining 20 percent to 40 percent paid out over time, as the acquired company achieves certain levels of sales or profitability.

However, there are compromises to be made on both sides. The buyer will have to give up some control over the company, because the seller will want to be involved in the operation of the business to protect its earnout potential. The seller is forced to take less cash at closing and wait for the company to prove its worth.

"It comes up at times of uncertainty. We saw it in 1991, 2001 and 2009. I am not surprised to see it again," says Kohl.

According to GF Data Resources Inc., more than 79 percent of deals in the $10 million to $50 million range contain some form of earnout provision. Larger deals are seeing earnouts being used as well. In July, Co-operative Group agreed to acquire 632 of Lloyd branches for 750 million pounds. The bank will pay 350 million pounds now and the remainders in an earnout subject to performance.

The other mechanism investors are using to bridge the gap is a rollover agreement. Sellers are rolling over a piece of their equity. "Founders and senior management are rolling over significant amount of the proceeds into the deal, which allows the buyers to pay more over time. If the owner or management team is staying in, the check doesn't have to be significant to the overall deal, but it's meaningful to the buyers," says Hanraty.