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Lectures @ MSU

Private M&A: Deal Structure Basics

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- **Fundamental Considerations.** What drives structure? Valuation modelling, market sentiment, country/sector/target risk factors and requirements, tax and accounting, and the nature of buyer (financial v strategic) and seller and those who stand behind them
- **Deal Components.** From an economic perspective = valuation (unless it is distress or special situation driven by other factors eg sanctions)
- **Relationship between Structure & Valuation.** Structure as a time release of value and mechanism to test that value
- **Seller EBITDA x EBITDA Multiple = Base Value of Deal.** “Cash Free Debt Free Valuation”
- **Completion Accounts v Locked Box.** Pros and cons and the “comfort” required by buyer v bargaining position of seller
- **Earnout Mechanic.** The importance of alignment
- **Seller Motivation v Buyer Motivation.** The role of lawyers in bridging the gap(s) and uncertainties because valuation is not science and valuation is only a part (albeit a big part) of the deal
- **Deal Types & Basic M&A Structure Diagrams.** Normalised v distress/special situation

Fundamental Considerations

- **Valuation.** EBITDA Multiple save in (a) special situations and (b) distress where different considerations apply
- **Market Sentiment.** In a seller's market (bull market) nearly anything can be sold at extreme valuation multiples with near naked protection for the buyer. By contrast in a buyer's market (bear market) even a deeply discounted deal with a guaranteed put option (allowing reversal out of the deal) at a guaranteed internal rate of return (IRR) cannot be sold. Where a market is on the curve impacts (a) valuation and (b) deal terms and protections (from warranty and indemnities to claim limitations, form of consideration through to depth of due diligence and recourse)
- **Country/Sector/Target Risk Factors & Requirements.** Has driven offshorisation and "2-tier" structures. Dictates eg limitations on % of ownership and control in certain targets and requires special treatment of eg tax and environmental risks. Has driven the stakebuilding deferred acquisition strategy. Context in which valuation sits and is part of valuation
- **Tax (& Accounting).** Drives whether asset or equity deal (typically equity), whether there is to be an onshore or offshore disposal and presale movement of onshore assets into an offshore SPV. It has also – globally - driven private equity (LBO) whose dream is to borrow, push down the debt to the target (so the target pays for its acquisition leverage), asset strip to generate dividends and then exit at a premium in a rising market by IPO. How things are accounted for (consolidation) dictates control (and control premium considerations)
- **Nature of Buyer & Seller.** Motivations of private equity are different to strategic investors (and their cost of capital and objectives and timelines are different). A buyer with own funds v debt finance raises different considerations. Recourse against a deep-pocket multi-asset seller is different from a takeout of individual managers

Deal Components – Economics = Valuation

- **Guaranteed Purchase Price** . Not performance dependent. Typically amount paid at closing (subject to an escrow) with no clawback
- **Base Purchase Price**. Amount seller would conservatively anticipate to receive after earnout period
- **Potential Purchase Price**. Amount seller could potentially realize based on future performance
- **Earnout**. If a deal has an earnout, the consideration paid at closing can vary significantly, often 50% - 90% of Base Purchase Price. Dependent on the riskiness of the deal which itself relates to market conditions, the amount of due diligence conducted and the recourse to seller that buyer will have. Length of earnout varies, but 1 to 3 years is typical; this correlates to the warranty and indemnity claim period and together they are part of the price adjustment process
- **Big Picture**. The more at risk for seller, the higher the multiple needed, the more guaranteed the lower the multiple needed. Most buyers are willing to increase multiples if the earnout is over a longer payout horizon but buyer does not want too much seller focus on earnout (cf. goals of the acquirer). Seller should focus on the base valuation and amount guaranteed - use of an earnout with high or unachievable target can create the perception of a high potential deal valuation and a high EBITDA multiple
- **Consideration**. Cash or non-cash, “buyer-financing” versus “seller financing”

Relationship Between Structure & Valuation

- How much is the deal worth?
- When is the consideration paid?
- What is guaranteed v what is variable?
- What metrics will be used to measure performance?
- Completion Accounts v Locked Box?
- How much visibility does buyer have?
- What must be achieved in order for a seller to receive the variable component (earnout)? Does that make sense? Is it just a recipe for litigation? Does seller have what it needs to achieve the targets? What post-merger integration and support (PMI) is needed? What comfort does the seller have that the buyer is committed
- What recourse and leverage will buyer have over seller into the future through earnouts, call options over seller-retained equity stake or put options over with guaranteed exit price at an acceptable IRR?
- So where do the lawyers fit into this? Are buyer or seller completely off-track or acting out of market. Bridging gaps on valuation and structure and fitting the financial deal into the legal and regulatory environment

Seller EBITDA x EBITDA Multiple = Base Value of Deal

•**What is value?** A function of cash flow and risk. How long will it take to recoup my investment? At what risk? What is buyer clawback and recourse (warranties and indemnities, escrow and earnouts, and put back rights)

•**EBITDA.** Parties agree target enterprise value before SPA is exchanged. Typically a multiple of EBITDA (on the assumption that this measure is representative of the sustainable level of cash profit generated by target), excluding target's cash and debt.

•**Enterprise Value.** Reflects the economic value of target, irrespective of how it is financed, typically based on an analysis of or multiplied by an appropriate multiple. Includes the target's debt in its calculation, and therefore reflects the total amount that a buyer will have to pay to acquire target. Once enterprise value is established, it can be allocated to the claims on that value by the company's shareholders and debt providers to arrive at an equity value for the company. Enterprise value can be expressed as target's equity value plus its total net debt, being target's long and short-term debt and debt like instruments less its cash and cash equivalents.

•**Completion Accounts.** Following completion, accounts drawn up to determine the actual level of debt and cash in the target at completion. An equity price for the target's shares will then be determined by adding to the enterprise value the amount of any cash (or excess cash) and deducting any debt as shown in the completion accounts. It is also common practice to include a working capital adjustment alongside a cash and debt adjustment, as the buyer will usually calculate its enterprise value on the assumption that a certain level of working capital will be delivered at completion

Valuation Example

Revenue of Seller \$ 1,000,000 EBITDA \$ 300,000

EBITDA Margin 30%

Multiple of EBITDA for Deal 6.0x Base

Deal Value \$ 1,800,000

% of Deal Paid at Close 70%

Payment at Close \$ 1,260,000

Multiple of Guaranteed Payment 4.2x

Amount of Base Earnout \$ 540,000

Potential Deal Value \$ 2,340,000

Potential Deal Value Multiple 7.8x (Assuming maximum earnout with a 30% upside cap)

Completion Accounts v Locked Box

- **Completion Accounts.** Buyer pays for the actual level of assets and liabilities of the target as at completion in accordance with a post-completion pricing adjustment. Final price is not known for some time after completion
- **Locked Box.** Parties agree a fixed equity price calculated using a recent historical balance sheet of the target prepared before the date of signing of the sale and purchase agreement. Cash, debt and working capital as at the date of the locked box reference accounts are therefore known at signing and there is no post-completion adjustment. Economic risk and benefits of the business pass to the buyer from the date of the locked box reference accounts
- **Leakage.** In a locked box SPA provides for "leakage", being transfers of value from target to seller or its connected parties between the locked box date and completion (eg dividends and management bonuses). The parties negotiate what constitutes leakage and other categories of payment which are permitted (including, for example, inter-group payments in the ordinary course, agreed dividend payments, payroll)
- **Compensation.** In a locked box mechanism a target business is priced as at the date of the relevant reference accounts and this is the date on which economic risk and reward passes to the buyer, sellers may ask for a specified rate of interest on the equity price, particularly when disposing of a profitable business (given the level of profits generated would remain in the business unless otherwise agreed)
- **Relationship With Other Price Protection Mechanisms.** Completion adjustments correlate and overlap with warranty claims and earnout entitlements and the documentation must not allow for double counting. This is where the lawyers come in

Earnout Mechanics

- **Timing of Payments.** Periodic payments made over the course of the deal - calculation driven off “average” basis v calculated on “last period” – eg based on 3 year average EBITDA with a “true-up” with the final payment v one payment at the end of the earnout period
- **Hurdles.** Minimum hurdles before seller is qualified to receive earnout
- **Catch up.** Ability for Seller to recoup missed payments with extraordinary results in future periods
- **Post-Completion Changes.** How are fold-in acquisitions handled post-closing? Aligning goals of seller and buyer, make sure the seller understands what will need to be done to make earnout . Clearly defined metrics. Making sure that the seller is able to control the metric that the earnout is based on (EBITDA, revenue)
- **Caps and Floors.** Deal is capped on upside as a % of the base deal valuation. Often mirrors the floor, which is typically the consideration paid at closing. Eg if consideration at close is 80% of the base deal value, then an acquirer may put in a cap limiting the potential deal value to 120% of base value. Cap protects the buyer, similar to the floor providing protection for the seller
- **Role of Lawyers.** Alongside proper documentation of earnouts and correlation with other provisions, lawyers have to make sure that buyer and seller are aware of and protected from consequences of an unworkable and unaligned earnout mechanism that will result in disputes and premature exits

Seller Motivation v Buyer Motivation

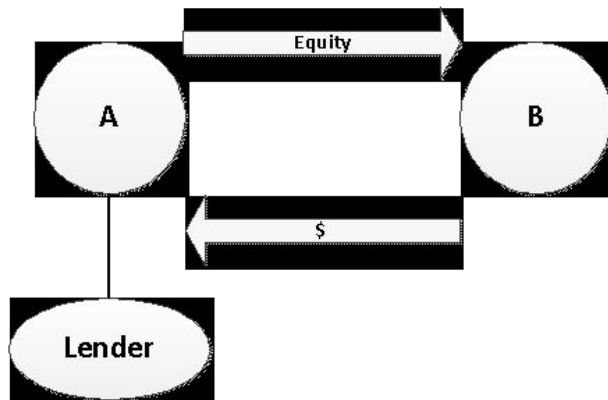
- **Seller Motivation.** 100% of the purchase price in cash paid to a SPV; no indemnities; no completion accounts; wide limitations on claims; no collateral contracts or obligations vis a vis the seller or target; anti-embarrassment provision (whereby if buyer on-sells at a higher price the seller will get a %); conduct of claims
- **Buyer Motivation.** Part deferral or escrow of the purchase price and/or a staged acquisition with a ratcheting purchase price on there being no problems and/or certain key performance indicators (KPI) and PMI targets being met, completion accounts so that the accounting and valuation assumptions underlying the purchase price are tested; ability to call on the seller to help with litigation post-closing; continued equity participation from the seller post-closing; non-compete; lock-up of key personnel
- **Bridging the Gap.** Is a matter of valuation and other deal terms. This is where the lawyers come in - alongside (a) advising on regulatory and legal requirements (b) identifying and properly calibrating the risks (due diligence) and (c) documenting the modelled deal (save where it would be contrary to client interest or out of market) knitting together the valuation terms into the other price protections and ensuring that the deal happens lawfully and that risks are not unreasonably apportioned unless there is no alternative in the particular context

Deal Types – Impact on Structure

- **Assets v Equity.** Most deals for tax and other reasons are equity deals which means that subject to pre-sale restructuring and hiveouts into SPV the seller is going to inherit all upsides and problems in the target group
- **Pre-Sale Reorganisation.** Hive outs. “2-tier” v “1-tier” structures
- **Restructuring & Refinancing.** As part of deleveraging
- **Minority v Majority.** Need for joint venture
- **MBO/MBI.** Backing a management team or parachuting in a management team with incentives and participation rights
- **Stakebuilding.** Call options over seller-retained equity. Put options at guaranteed IRR
- **Auctions & “Pre-Packs”.** In the most extreme cases this will come with available third party or seller financing
- **Distress.** Bank may be the seller driving process and, depending on the capital structure and who controls the liquidation endgame may actually “own” the company. Timetables accelerated. Fight between the different layers of debt as to who can force a sale and who is “in the money” (covered by the proceeds of sale) will determine deal structure. Limited contractual protection will be on offer so due diligence and valuation even more important

Basic M&A Structures: (1) "Normalised"

(A) Straight Sale



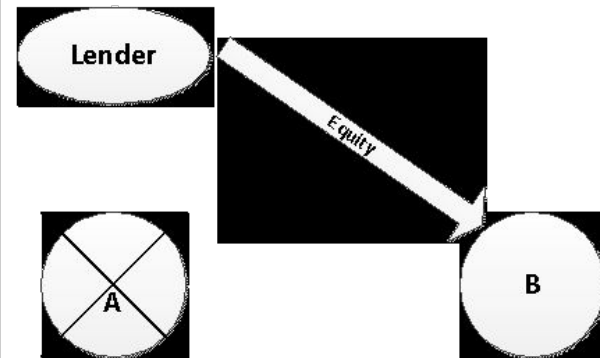
Buyer (B) buys equity (some or all) from current owner(s) (A)

Lender gets paid or rolled over

Could be escrow/deferral

A receives purchase price

(B) Sale Via Lender



Lender enforces over Target

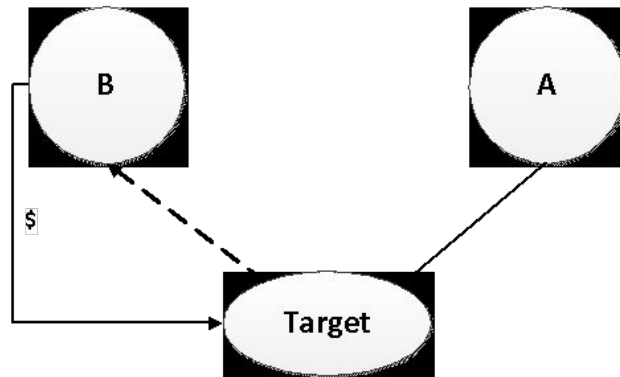
Buyer (B) buys Target from Lender

Lender may exit or rollover

A receives any excess

Basic M&A Structures: (2) “New Money” & “Pre-Pack”

(A) Dilution

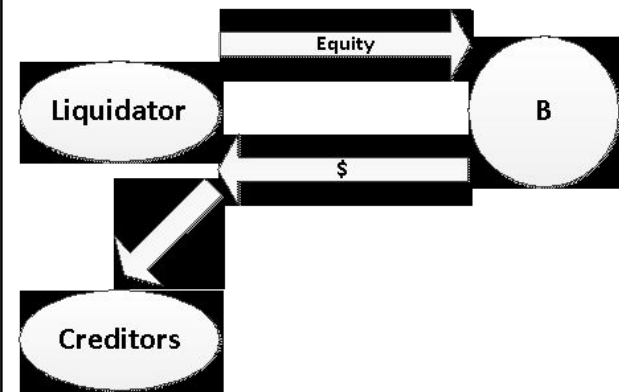


B injects capital diluting A

Lender (partially) repaid

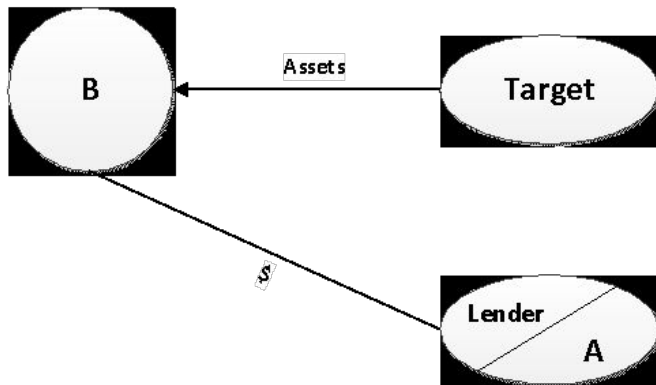
May be part of refinancing

(B) Sale out of insolvency process

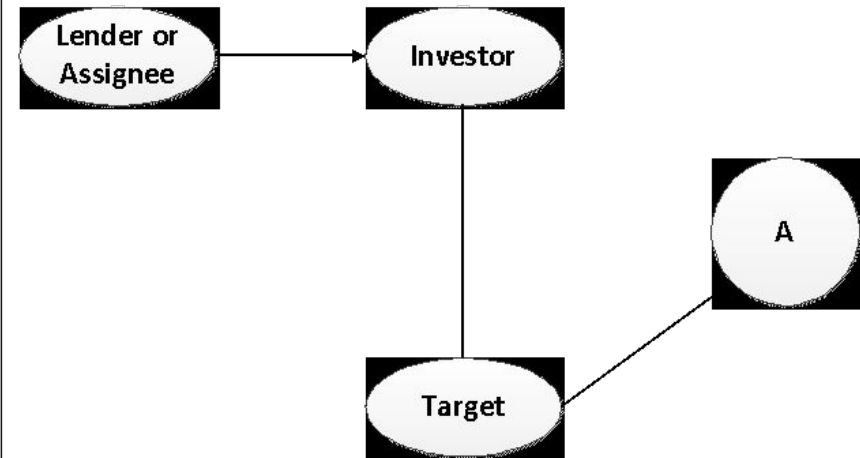


Target into liquidation

Target sold with consent

(A) Asset Sale

Driver of a cherry picking approach is concern about inherited liabilities in target

(B) Debt for Equity & Loan to Own

Lender converts some or all of its debt into equity & stays in the equity or immediately on-sells

OR

Lender sells debt at discount & new owner enforces and seeks to maximize value