

The Deal

Auction realpolitik

by Vyvyan Tenorio
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Earlier this year, New York private equity firm Riverside Co. surpassed its peers in an auction to buy a small manufacturer of protective window films called Commonwealth Laminating & Coating Inc. The company, based in Martinsville, Va., designs and makes products that reduce heat and exposure to ultraviolet rays; it sells to automotive, residential and commercial customers.

Riverside, an archetypical midmarket firm that buys about a dozen companies a year, was prepared to pay market price for the profitable property. But to establish credibility with the sellers, Riverside conducted a fairly extensive market study, contacting scores of customers in the process. And it performed legal and accounting due diligence in the electronic data room set up by Commonwealth's adviser.

Normally, that type of expensive, big-ticket due diligence is executed only after a bidder wins exclusive negotiation rights to acquire a company. But Riverside, like several other strong contenders for Commonwealth, did what it had to do — it undertook the work before it knew it even had a chance to close the deal. Not only that, but Riverside offered no financing contingency, saying financing was not an issue. Why? To try and differentiate itself in a torrid seller's market.

This is bravura dealmaking at its peak. The rules of the game may have changed, and the quest for exclusivity — the holy grail for buyers — has become more competitive and costlier than ever. Yet that has not deterred buyers from wagering their chips, as long as there's a chance of winning.

These days it's not just a matter of paying the highest price. There is no escaping the supply and demand equation in which there's too much capital chasing deals. But buyers are willing to undertake much more work at greater expense ahead of attaining exclusivity. And in highly competitive bidding, industry sources say, buyers try to compete by prenegotiating contract terms that are inherently seller-friendly. The net result: Buyers have less and less wiggle room to recoup their money if things go awry after a deal closes. And sellers have more ways to control the auction to their own benefit.

"The way to approach deals when a property is hot and you want to win is to swarm it with due diligence up front, have your financing commitment and management in hand, be ready to close, then say, 'I'm OK with your terms,' " says John LeClaire, head of the private equity practice at Goodwin Procter LLP in Boston. "That process has changed, especially in the middle market, in that sellers and their [investment] bankers run it much more than they did a decade ago."

There was a time when small and midsize companies had pricing advantages for would-be buyers. By virtue of their scale, they offered lower valuations with smaller revenues and less-developed management and operations, which provided an upside for a skilled buyer. But those attractions of the middle market have faded a bit as the competition for assets has increased.

Pools of committed private equity capital are overflowing. Midmarket funds have grown bigger. On the lower end, new funds have materialized. Even large funds with a midmarket slant often compete for the same targets. Combine that with dedicated debt funds, and the total capital sloshing around might be somewhere between \$350 billion and \$500 billion — all with a ticking time bomb for deployment. Throw in cash from acquisitive corporations, and what you get is froth.

"It feels now like it did in 1998, when things were at a peak," says Seth Lehr, a founding partner at Philadelphia private equity firm LLR Partners Inc. "Not every company is worth 8 to 10 times Ebitda, but that's what they're going for."

Over time, the business of buying and selling companies has become a much more efficient and tightly controlled process, almost regardless of transaction size. Most sales involve investment banking intermediaries who, industry practitioners say, have skillfully transferred facets of dealmaking in large public companies into the private midmarket arena.

Increasingly, the private seller's representations and warranties — certifying that information provided by the seller is true — do not survive the closing, as is the case when the target is a public company. The seller typically wants to limit the length of time it's on the hook in case of breaches of representations and warranties in the agreement. Moreover, the seller wants to limit the buyer's rights of recourse post-closing.

"When big guys buy public companies, there are no representations and warranties that survive because shareholders are out once a deal closes. So you factor into your price the fact that there are no representations and escrows that survive," says David Lobel, managing partner at New York buyout boutique Sentinel Capital Partners.

"Sellers and their advisers are pushing to see how little they can leave behind," he says. "That's where all this is going. The more robust the market, the more they can get away with it."

Depending on the degree of interest in an auction, the gravitational pull varies in strength. In a broadly shopped auction like Commonwealth's, for instance, where some 50 bidders expressed interest, Riverside's tactics are not uncommon.

One of the casualties in a hot process is exclusivity, an essential step to winning a deal. In the past, the highest bidder would enter into a two- to four-week period of exclusivity. During this time, the bidder conducts comprehensive due diligence and negotiates the terms and conditions of a definitive purchase agreement exclusively with the seller.

Today, even in auctions of small companies, buyers don't get exclusivity while conducting diligence work. In Commonwealth's case, the bidders were asked to submit an initial value based on very limited information. The owners, president Steve Phillips and a group of local investors who founded the company eight years ago, picked the 10 best. Those 10 were given a more complete package of information, presented in an electronic data room, along with opportunities to meet with management. So before exclusivity was granted, Riverside was doing critical market surveys, spending for consultants and lawyers to show that it was far along in its due diligence.

Those costs can easily add up to hundreds of thousands of dollars, depending on deal size. For a \$20 million or \$30 million company, says Riverside managing partner Andrew Strauss, his firm could be spending \$50,000 or more out of pocket without knowing where it stands. "That 50

grand may not sound like a lot to KKR [Kohlberg Kravis Roberts & Co.], but when you're buying a \$30 million company, that's a lot of money," he says.

Offering no financing contingency — "no financing out" in the industry argot — is another way bidders try to game the process. In this case, Riverside thought it would have an edge by saying in its letter of intent, or LOI, that it had no financing contingency, meaning it had no cause for renegotiating a deal if financing becomes an issue. Frequently, says Strauss, Riverside is submitting initial bids without a financing out.

"In general, we're saying to sellers, 'Here's what we're paying for the company. You don't have to worry about how we finance it.' We feel confident doing that because we're pretty sure the financing market will be fine," he says. Riverside also has a relatively large \$750 million fund raised in 2003. "If we need to, we can pay more equity," he adds.

How much time a buyer spends in the electronic room, a seemingly insignificant step in the process, also gets factored in, because it's translated into costly billable hours in lawyers' and accountants' fees. "We'll routinely have our lawyers go through the data room because they're expected to do that," says Strauss. "Intermediaries can monitor how much you're using the data room. If a buyer hasn't spent the time, the seller can discount their bid."

Riverside did prevail in the end, though it was an extremely close fight with two or three other bidders. Everything was taken into account. Phillips says, "They distinguished themselves in the process by how well they were organized, showing me that they were one of the best in their business, and they seemed to have more resources to tap to support the company."

Anecdotally, when the market is truly efficient and deals are fully shopped, pricing by bidders comes out more or less the same, say industry practitioners. If everyone's at roughly the same price, bidders look for ways to get ahead through deal terms. What can move the dial in these auctions is exactly how much risk a buyer is willing to assume before and after a deal closes.

"If a number of bidders can get roughly the same debt package, the differential on price is often how much equity a buyer is willing to put in. But there's generally a limit to the equity amount you can put in if financial buyers are involved," says Saratoga Partners' Christian Oberbeck. "If you max out on what the market will pay on price, then in effect you can start bidding on terms."

How you bid on terms has also changed. The ideal for the seller is an "as is, where is" sale, meaning the seller does not make a lot of representations and warranties about the sale and does not assume much liability if something goes wrong immediately after closing. So the job of the broker or adviser is to try to get all the difficult negotiating items on the table and prenegotiate them.

It used to be, not long ago, that the seller would solicit an LOI, which did not usually contain as much detail on terms and conditions as the definitive contract. Once the LOI was submitted, comprehensive due diligence followed with exclusivity, which could range from 30 to 60 days.

Nowadays buyers get to "mark up" a seller's draft agreement, indicating where they stand on major points that prove contentious during negotiations over the definitive purchase agreement. These would typically cover items like indemnity survival period, the "cap" or ceiling on indemnity claims, the "basket" or the amount recoverable above a threshold or deductible, and how much the seller puts in escrow.

"There are all sorts of little language games that go on in indemnity discussions; they're like little nicks, cuts and slashes, all designed to make sure the seller will not have to give money back," says LeClaire.

A buyer who bids a very high price might offset that with a "heavy" markup of the draft agreement, while someone with a lower price might go for a lighter markup. A truly aggressive buyer will pay a high price and have very little markup.

"In a larger percentage of deals these days, you're looking for fully financed, fully diligenced bids with a marked-up purchase agreement," says Bernard Zaia, a managing director at Los Angeles investment boutique Barrington Associates.

Zaia and other intermediaries say that this arrangement has pretty much supplanted the LOI in many transactions. Under the marked-up version, exclusivity is usually only granted after a bidder is picked, based on the price and the terms the buyer has agreed to. At that point, exclusivity is only for a very limited period, usually between seven and 14 days prior to the signing of a final agreement.

This approach provides "a little bit more certainty for closing," although the LOI approach might be more appropriate in some cases, says Zaia. Roughly half of Barrington's assignments so far this year and last have closed successfully at the terms incorporated in a draft purchase agreement, he adds.

Brokers and lawyers are constantly defining what the "market" for terms is and use those as leverage in negotiations. One investment adviser says his firm cites data from tracking recent deals "to really push people."

For key provisions such as the survival period — how long after deal closing the representations and warranties survive — the average might be somewhere between 18 and 24 months. But, says Lorin DeMordaunt, a managing director of investment advisory McColl Partners LLC and a former practicing lawyer, "You are seeing 12 months out there if it's a clean business."

In some ways, negotiating these provisions might be akin to Wall Street's version of extreme sport. One banker says his firm recently sold a \$150 million business to a private equity group, which allowed all representations and warranties to die at closing in order to win the deal. "But it was a very clean company, and the owner-entrepreneur really wanted it," he says. "The seller got to walk free."

One of the more telling features of the landscape are generous baskets and smaller cap arrangements. For the indemnity cap, or the percentage of the purchase price the seller agrees to pay in case of breaches of representations and warranties, buyers would often start at 20%, while the seller began at 5%. Based on anecdotal evidence, the average appears to be in the 10% range, but that number is still coming down, says DeMordaunt.

Baskets, which can range from 0.5% to 2%, "used to be a way to deal with de minimis matters, or 'don't bother me' items," says Jeffrey Horwitz, a partner at New York law firm Proskauer Rose LLP. "Now they're becoming a substitute for materiality qualifiers."

Escrows to back indemnifications in cash deals are also disappearing. Perhaps a decade ago, 5% or 10% of a cash purchase price was put into an escrow to run the course of the indemnification period, usually for up to 24 months. That's to assure the buyer that there are funds available to come back to if there's a breach in the representations and warranties. Today, one midmarket banker suggests, maybe less than half of cash deals have an escrow.

In part, the preponderance of secondary buyouts is to blame. Private equity sellers typically distribute the proceeds from a sale to their limited partners, meaning there isn't really money to go after.

These prenegotiations usually occur within a very short time frame, because there is no advantage to the seller to prolong the process of keeping the property in the market. The end result, says Goodwin Procter's LeClaire, is that buyers "are front-end-loading their work, viewing a bid with real commitment, promising quick execution and having to deliver on it, as opposed to putting in a bid just to get a seller on the hook and have a long look at the company."

It also means that there is tremendous pressure on the buyer who's been given exclusivity not to renegotiate a price if something does come up in the final due diligence work. Sellers are often advised to get an audit before the auction to ensure that there are no hiccups along the way.

But there are plenty of cases, especially involving small and midsize companies, when financial information is not completely up to date and buyers feel compelled to renegotiate the price. "I've seen a lot of pressure on clients saying, 'Do we really need to make that change?' " says Horwitz.

The danger is that once a bidder tries to renegotiate the price because of a change, the seller can turn around and say that the buyer agreed to the terms in the draft agreement. McColl's DeMordaunt says he has seen buyers, particularly in a number of consumer products companies, who go back to the seller and renegotiate, only to be told by the seller that exclusivity is being terminated.

"The tension is between trying to get a deal done as a buyer and how much of the deal are you going to change based on the fact that the facts have changed," says LLR's Lehr. "It takes great discipline to be able to say, 'Wait, this isn't what you told us.' "

If the seller is fairly confident of the market, he can then go back to the second in line. In a less frothy market, generally a busted deal is tainted. Today, it's far less of a problem, says McColl managing director David Vorhoff.

For Riverside, negotiating the right terms ultimately has far less impact on returns than buying the right company. "You have to pay market price, unfortunately, since companies are just more expensive. If you want to be in the top quartile, it's not how you negotiate the purchase agreement's cap at 5% versus 2%. That's not how you win the game," says Strauss.

The question is, how disciplined are buyers? Answer: Everything is relative. "If you're deploying capital, you can't talk about being uncomfortable," says Lehr. "What happens is, over time, you see something that appears attractive, albeit more expensive than two years ago. Everyone's in the business of deploying capital in transactions that make sense, so much of it is done on a relative basis to a point in time."

Lehr says his firm recently bid on a deal valued at roughly \$200 million where the indemnity cap was somewhere between 7% and 9% and a basket or threshold was between 1% and 1.5%. The privately held company had some regulatory issues, so there was some risk post-closing. "If you're at the low end of 7% of indemnity and you're on the high end of the basket, you effectively have 5.5% or 6% coverage. That's very nominal protection," says Lehr. "That's the worst we've seen in the past two months, but the worst is just a placeholder for more to come."

Needless to say, Lehr's firm did not win, though he adds, "You get to a point where you're not unhappy losing."